Euler Hermes Economic Research

Country Report

Lithuania

Domestic demand overcompensates slack in exports

General Information

GDP	USD48.2bn (World ranking 85, World Bank 2014)
Population	2.93mn (World ranking 137, World Bank 2014)
Form of state	Parliamentary Democracy
Head of government	Algirdas BUTKEVICIUS
Next elections	October 2016, legislative

Strengths

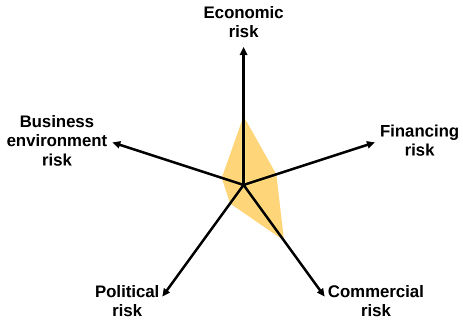
- Low systemic political risk
- Good international relations, EU and NATO membership
- Eurozone accession in January 2015 provides for low transfer and convertibility risk
- Adequate public finances and access to international capital markets
- Strong business environment

Weaknesses

- High external debt burden
- The industry is dominated by one large refinery complex, Orlen Lietuva (formerly known as Mazeikiu Nafta), which accounts for around 20% of total industrial output and 25% of total exports
- Banking sector vulnerability
- High export and import dependence on Russia, especially on crude oil imports
- Number of insolvencies more than twice as high as prior to the 2008-2009 economic crisis

Country Rating

BB2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Russia	20%	1	29%	Russia
Latvia	10%	2	9%	Germany
Poland	7%	3	9%	Poland
Germany	6%	4	7%	Latvia
Estonia	6%	5	5%	China

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	22%	1	20%	Crude Oil
Plastic Articles	5%	2	5%	Refined Petroleum Products
Furniture	5%	3	4%	Natural Gas
Other Edible Agricultural Prod	4%	4	4%	Plastic Articles
Fertilizers	3%	5	3%	Commercial Vehicles

Source: Chelem (2013)

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Gradual recovery expected in 2016-2017

Following the severe recession in 2009 amid the global financial crisis, the Lithuanian economy recovered quickly and showed resilience to the Eurozone crisis that unfolded at end-2009, posting average annual growth of +3.6% in 2010-2014. The recovery was broad-based, however, in 2014 external trade activity already decelerated markedly as a result of sanctions on and the economic slowdown in Russia, Lithuania's main trade partner. Since both export and import growth slowed down, annual real GDP still grew by +3% in 2014.

In Q1-Q3 2015, average real GDP growth decelerated to +1.5% y/y. Domestic demand actually gained momentum, with private consumption increasing by +5.2% y/y, public spending by +2.1% y/y and fixed investment surging by +10.5% y/y. Moreover, after two years of decline inventory re-stocking added +1.4pps to growth in the first three quarters. In contrast, net exports made a large negative contribution of -5.5pps to Q1-Q3 growth as real exports expanded by a mere +0.7% y/y – a result of the intensified adverse effects of the crisis in Russia – while real imports re-surged by +7.7% y/y. Euler Hermes expects full-year GDP growth of +1.5% in 2015. The negative impact from Russia should fade next year as trade with the eastern neighbour should stabilise, such that an acceleration of economic growth to +2.3% in 2016 and +2.7% in 2017 is forecast.

Deflation to wane gradually in 2016

Owing to subdued energy and food price developments, consumer price inflation fell to an average 0.1% in 2014 and has been continuously negative since December 2014. It stood at -0.7% y/y in October 2015. As the effect of low oil and energy prices will wane in 2016, deflation should give way to positive inflation in the next quarters. Euler Hermes projects inflation to reach about 0.8% at end-2016.

Despite low inflation and interest rates, private sector credit growth has remained subdued but at least it has moved into positive territory in May 2015 and stood at +2.3% y/y in September, indicating that private sector deleveraging is eventually abating. Euler Hermes expects credit growth to continue to increase only gradually in 2016-2017.

Public finances are adequate

The impressive rebalancing of the Lithuanian economy after the deep recession in 2009 was achieved through "internal devaluation", i.e. massive real wage cuts and sharp fiscal tightening. The fiscal deficit has been reduced from -9.3% of GDP in 2009 to -0.7% in 2014. It is forecast to pick up to -1.3% or so in the wake of the economic slowdown in 2015 and to reach similar annual ratios in 2016-2017. Financing such deficits is not a problem as Lithuania has long regained access to international bond markets. Gross public debt has risen from just 15% of GDP in 2008 to 41% in 2014 and is forecast to edge up further to around 44% in the next two years.

Eurozone membership is beneficial

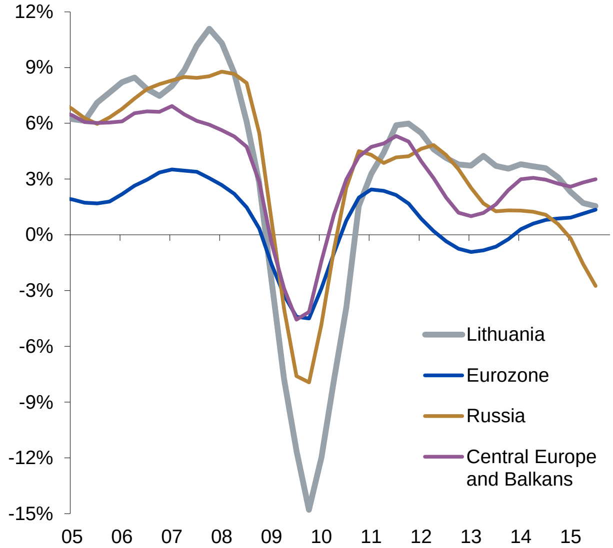
Lithuania joined the Eurozone at the start of 2015. While monetary policy is now conducted by the European Central Bank (ECB), membership of the Eurozone provides for low transfer and convertibility risk and has substantially decreased external vulnerabilities related to exchange rate risk.

Key economic forecasts

	2014	2015f	2016f	2017f
GDP growth (% change)	3.0	1.5	2.3	2.7
Inflation (%, end-year)	-0.3	-0.7	0.8	1.5
Fiscal balance (% of GDP)	-0.7	-1.3	-1.5	-1.4
Public debt (% of GDP)	40.7	43.0	43.5	44.0
Current account (% of GDP)	3.6	-3.0	-2.5	-2.0
External debt (% of GDP)	70.6	77.7	78.0	77.0

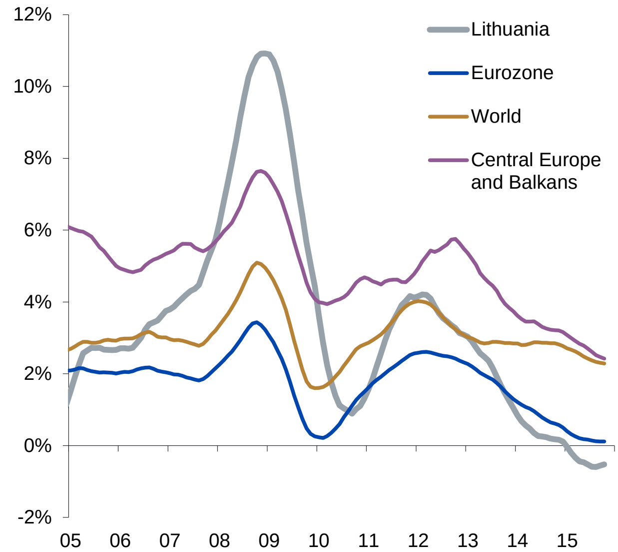
Sources: National sources, IHS, Euler Hermes

GDP growth (% y/y, 4 qtrs cumulated)



Sources: National sources, IHS, Euler Hermes

Inflation rate (% y/y, 12-month moving average)



Sources: National sources, IHS, Euler Hermes

Export growth hit by Russia crisis ...

The Baltic States are more vulnerable to disruptions to export flows to Russia than other EU countries because their share of exports to Russia in total exports is much higher: 21% for Lithuania, 15% for Latvia and 10% for Estonia in 2014, as compared to an average 4% for the 11 EU members in Central Europe or just 2% for the whole EU. In H1 2015, Lithuania's nominal exports of goods to Russia dropped by -38% y/y. This caused total nominal exports of goods to decline by -5%.

... and current account moves into deficit

Since imports have continued to grow in 2015, the current account balance shifted from a large surplus of +EUR1,305mn (+3.6% of GDP) in 2014 into a deficit of -EUR855mn in Q1-Q3 2015 alone. Euler Hermes expects a full-year shortfall of around -3% of GDP in 2015, followed by a slightly smaller deficit of -2.5% of GDP or so in 2016.

External debt remains relatively high

The external debt burden surged to a worrisome level of 87% of GDP in 2009, built up by the earlier large current account deficits. The ratio declined to 70% in 2013, but has since edged up again to 78% of GDP in mid-2015, partly due to the recent EUR depreciation against the USD (part of the external debt is in USD). Euler Hermes expects external debt to stabilise at just below 80% of GDP, a comparatively high level.

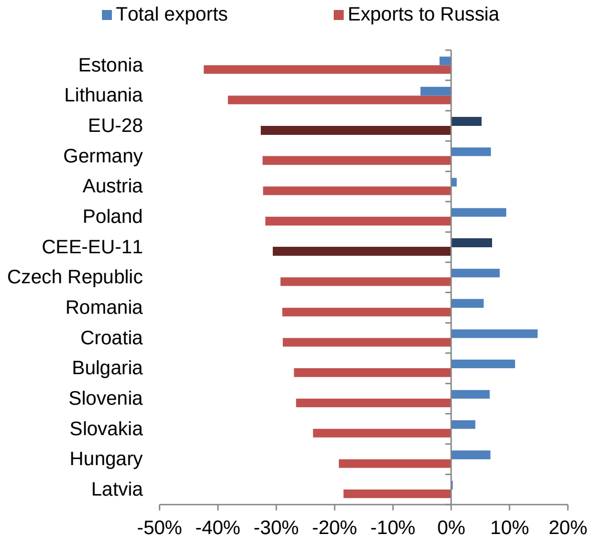
Low risk of a systemic crisis

Overall external liquidity risk has continued to decline, and access to ECB liquidity thanks to Eurozone accession is a clear positive. Still, the refinancing or repayment of maturing external debt may prove difficult for some companies amid still tight credit markets, especially in the event of an external shock, as reflected in the still elevated number of corporate insolvencies. However, the risk of a systemic financial crisis is low.

Insolvencies remain at high level

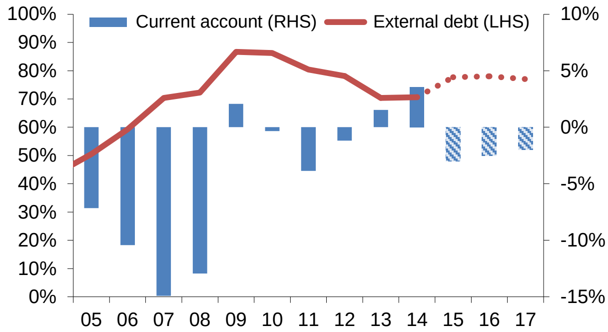
Following a +8% rise in the number of business failures to 1,684 cases in 2014, Euler Hermes forecasts further increases by +7% in 2015 and +3% in 2016 to reach about 1,850 cases next year, a similar level as recorded in the crisis year 2009 and well above the average annual 694 cases recorded in 2003-2007.

Change in exports to Russia and total exports (% y/y, H1 2015), selected economies



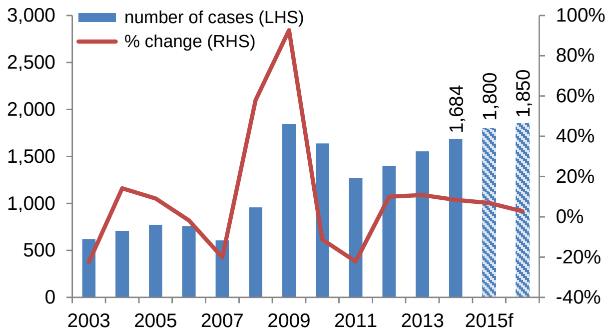
Sources: IMF, Euler Hermes

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Number of insolvencies and percentage change



Sources: National sources, Euler Hermes

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