LITHUANIA

Highlights

- **Household consumption has helped to uphold GDP growth.** Following a slow-down in economic activities in 2015, GDP accelerated somewhat in the first half of 2016. Investment and exports have been subdued but private consumption strengthened further.
- **The so-called new social model will positively impact Lithuania's competitiveness.** A new package of pension system reform and state social insurance has been signed by the president. Among other things, it extends the minimum work experience needed for retirement and gradually lowers social security contributions, primarily on the employers' side.
- **Electricity markets synchronisation has advanced.** Following the start of two electricity connections with Sweden and Poland in February 2016, another power interconnection with Poland is planned by 2025. Amid decreased electricity prices, which dropped markedly after the two interconnections came into operation this year, new lines will enable the full synchronisation of the electricity networks of the Baltic states with continental Europe.

Key priorities for 2017

- **Energy efficiency should be further addressed.** Lithuania belongs to the group of the least energy-efficient economies in the European Union (EU), with energy intensity at twice the EU average. Despite a recent acceleration of modernisation work in multi-apartment buildings, energy efficiency in buildings remains challenging and needs to be addressed.
- **The funding environment for innovative enterprises needs to be improved.** This finance will primarily need to be in the form of risk-oriented private equity and venture capital that would appeal to institutional investors. Such forms of finance remain underdeveloped and fragmented between relatively small local markets.
- **Competitiveness should be secured amid a tightening labour market.** Given the high increase in nominal wages over the past six years, which exceeded more than twice the labour productivity increase, price competitiveness could come under pressure if these trends continue. Given the current stagnation in export market shares, any further increases in minimum wages should be carefully assessed for their impact on competitiveness.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	3.8	3.5	3.5	1.8	2.6
Inflation (average)	3.2	1.2	0.2	-0.7	0.5
Government balance/GDP	-3.1	-2.6	-0.7	-0.2	-0.3
Current account balance/GDP	-1.2	1.5	3.6	-2.3	-2.0
Net FDI/GDP [neg. sign = inflows]	-0.7	-0.6	0.0	-1.9	-1.8
External debt/GDP	79.7	72.6	65.5	73.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	45.9	42.7	40.5	41.4	n.a.

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Macroeconomic performance

Solid domestic demand is underpinning GDP growth. In the first half of 2016, GDP grew by 2.1 per cent year-on-year, strongly supported by private consumption, whereas investment saw a sharp drop. In contrast, 2015's growth of 1.8 per cent, was primarily driven by an impressive investment expenditures growth rate of above 10 per cent, the highest since 2011. External demand has remained weak, with net exports contributing negatively to overall growth. Yet the strong import demand has softened substantially, which results from the weakened EU co-financed investment in the first six months of 2016.

Private investment continues to recover. **According to the European Commission estimates, private** investment reached 17 per cent of GDP in 2015. This is in line with the average for the other EU member states that joined in 2004, but significantly above the trough of below 12 per cent of GDP that was registered in 2010. At the same time, public investment expenditures have seen only a marginal decrease from above 5 per cent in 2010 to below 4 per cent last year. Amid the positive bank credit growth to private companies, which accelerated to above 8 per cent in annual terms in June 2016, and the new EU programming period gaining momentum, private investment growth is expected to improve further.

Export markets are still to recover but labour markets are tightening. Following a decrease of 1.7 per cent in 2015, export volumes managed to recover somewhat in the first half of this year, growing at 8.0 per cent annually. Exports to Russia saw a further decrease and their share in total exports fell from 20.9 per cent in 2014 to only 13.7 per cent in 2015. The unemployment rate dropped to only 8.6 per in June 2016, from a peak of above 18.0 per cent in mid-2010. The employment rate continues to rise. It reached 68.4 per cent (15 to 64 years old) in the first quarter of 2016, although a declining working-age population is expected to overtake job growth as the main driver behind falling unemployment. Such a tightening labour market, to a large extent impacted by increasing skill mismatches and still positive net emigration, is putting upward pressure on nominal wages. Since 2010, labour productivity increased by 11.5 per cent, whereas nominal salaries increased by more than 26.0 per cent, by the end of 2015.

GDP growth is expected to remain strong in the short term. This year, GDP growth will likely be at 2.6 per cent, whereas the expected faster eurozone recovery and a greater number of investments co-financed by the European Union will likely provide an additional boost for growth in 2017.

Major structural reform developments

Electricity network integration with the European Union has advanced. Two electricity connections were launched in February 2016 – one between Lithuania and Sweden (NordBalt) and one connecting with the Polish network. In addition, a tender for a feasibility study for a second power interconnection with Poland was announced in July 2016. This will be the next step towards the synchronisation of the electricity networks of the Baltic states and continental Europe, which is expected to be finalised by 2025. Apart from more power security, access to new electricity markets is expected to have a further positive impact on electricity prices in all three Baltic countries. During the first six months of the two power grids being operational, electricity prices in Lithuania declined by 4 per cent.

The Baltic states' gas market will also be integrated with the EU common market. Following the agreement on the financing of the Gas Interconnection Poland-Lithuania (GIPL) that was reached between the three Baltic countries, Poland and the European Commission in October 2015, the Lithuanian government approved in June 2016 a plan for the construction of the Lithuanian section of the pipeline. The pipeline is expected to be operational by 2019-20 and it will enable the Baltic states to connect to a single EU gas market.

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Lithuania is progressing towards OECD membership. The government submitted the initial memorandum for accession to the Organisation for Economic Co-operation and Development in January 2016. Before the accession materialises, however, Lithuania is expected to fulfil a number of requirements, among other things, to reform state-owned enterprises (SOEs), amend the Forest Law, and improve the healthcare system and the protection of consumer rights. Lithuania applied for fully fledged membership in 2002, but had to wait until mid-2015 to be invited to start the OECD accession process. Membership would further strengthen a number of standards in competition policy, corporate governance, and tax policies, among others.

The so-called new social model has been announced. In July 2016 the President of Lithuania signed an 18-bill package into law, which includes reforms of the pension system and the state social insurance agency, Sodra. It extends the minimum work experience needed for retirement from the current 30 to 35 years. It also gradually lowers the social security contributions, primarily on the employers' side, which will become regressive over the next five years. However, the labour code amendment has been vetoed by the president, as the trade unions complained that the new law further increases social inequality and benefits employers only while aggravating the situation of workers. The signed legislation will start entering into force from 2017, whereas the labour code amendment will be further discussed in the parliament. Overall, the amendments are expected to have a positive impact on Lithuania's competitiveness, with a particularly positive impact on the labour market.

The business environment remains conducive to starting and running an enterprise. The World Bank's *Doing Business 2017* report ranks Lithuania 21st globally (out of 190 countries). The country scores relatively well in the registering property category as well as enforcing contracts, at second and sixth place, respectively. At the same time, despite some improvements relative to the previous edition of the survey, resolving insolvency remains a key obstacle for doing business in Lithuania, the lowest such position among the central Europe and the Baltic states (CEB) countries, followed by Hungary and Croatia.

EU funds have been managed well. According to the 2016 KPMG *Progress Report 2007-2015*, which regularly assesses the progress of EU structural funds' utilisation by the new EU member states, Lithuania was the leader in administration of EU structural funds in the previous planning period. Until the end of 2015, which was the final year to use the EU funds, Lithuania managed to absorb all of the contracted money (€6.8 billion). As reported in the government EU funds' evaluation report, since Lithuania's EU accession in 2004, GDP growth has benefited on average by an additional 1.6 percentage point of annual growth from EU co-financed projects, whereas foreign direct investments have been higher by 16 per cent than they would have been without EU resources. For the period 2014-20 around €8.4 billion is allocated to Lithuania through three national programmes. Key targeted areas are innovation, competitiveness of small and medium-sized enterprises (SMEs), resource efficiency, labour markets and social inclusion.