Creditreform Sovereign Rating

Creditreform Rating
www.creditreform-rating.de

Rating Object	Rating Information		
REPUBLIC OF LITHUANIA	Assigned Ratings/Outlook: **A /stable**		Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	25-11-2016 24-11-2017 “Sovereign Ratings”	

Rating Action

Neuss, 24 November 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “A” for the Republic of Lithuania. Creditreform Rating has also affirmed Lithuania’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “A”. The outlook is stable.

Contents

Rating Action 1
Key Rating Drivers 1
Reasons for the Rating Decision .. 1
Rating Outlook and Sensitivity...... 6
Economic Data 6
Appendix 7

Key Rating Drivers

1. Output expansion is gathering pace and we expect growth to remain strong in 2017-19, buttressed by robust private household spending and exports, as well as accelerating take-up of EU funds
2. Convergence with EU income levels has come to a halt due to weaker labor productivity growth and stagnating investment activity; challenges pertaining to demographic development and persistently high emigration
3. Despite recent domestic political turbulences, we believe that the government will remain committed to prudent policy-making geared towards addressing structural shortcomings
4. Sound fiscal policies accompanied by solid macro performance should result in declining government debt going forward
5. Highly susceptible to shocks stemming from external developments (trade, ESIF, geopolitics), resulting in high volatility of macro-financial variables

Reasons for the Rating Decision

Our assessment of the Republic of Lithuania’s creditworthiness continues to balance solid economic growth, strong fiscal sustainability metrics, and sound economic and fiscal policy-making against a laggard catching-up process with EU income levels, structural shortcomings and a relatively high susceptibility to external shocks.

Economic performance remains favorable, although output expansion was somewhat sluggish in 2015-16. Real GDP growth picked up from 2.0% in 2015 to 2.3%, but stayed significantly below its annual average of the years 2010 to 2014 (3.7%). While the Lithuanian economy was broadly on par with its Baltic peers (Latvia: 2.1%, Estonia: 2.1%), it

lagged behind other Central and Eastern European (CEE) countries such as Poland, Slovenia, and Slovakia. Economic growth was largely driven by brisk private household spending. Fostered by the favorable labor market development and rising real wages, private consumption increased by 4.9%, after 4.0% in 2014 and 2015 respectively. Contrarily, growth was somewhat held back by the slow absorption of European Structural and Investment Funds under the new programming period 2014-20. According to the Central Bank of Lithuania, EU funds allocated to Lithuania came in EUR 550m (1.4% of GDP) lower than in 2015, which was mainly felt in public construction investment. Thus, government investment dipped from 3.7% of GDP in 2015 to 3.0% last year. Thanks to stronger private investment activity, in particular related to residential construction, gross fixed capital formation only contracted by 0.5% in 2016. Despite the recovery in exports, which came on the back of a surge in exports of services (+11.1%) and exceeded the previous year's level by 3.5% (2015: -0.4%), net external trade did not significantly contribute to growth in 2016 (-0.1 p.p.).

At the same time, convergence with EU income levels has stalled since 2015. As compared to the EU-28 average income level, Lithuanian GDP per capita income remained flat at its level first reached in 2014, 75% of the EU-28 average. At USD 29,972 (2016, PPP terms, IMF data), its economy is not only lagging most of its A-rated peers such as Slovenia (USD 32,216), Slovakia (USD 31,331) and Malta (USD 39,878), but also AA-rated sovereigns displaying per capita income levels of more than USD 42,000.

Revitalizing the convergence process could turn out to be challenging in the face of persistent emigration flows and the demographic development in general. According to Statistics Lithuania, emigration has again accelerated. On a net base, approx. 30.200 people emigrated from Lithuania in 2016, after 22.400 and 12.300 in 2015 and 2014 respectively. Over the last decade, net migration amounted to approx. -290.000 people. Hence, the resident population of Lithuania has fallen by 1.4% in 2016 and 5.2% over the last five years. As illustrated by latest UN data, Lithuania's population experienced one of the sharpest declines in the EU-28 in 2000-15 (by some 16%) and total population is projected to fall by another 10% by 2035 – the highest reading after Latvia. Prospects for the development of the working-age population also appear rather gloomy as these are forecast to dwindle from 66.5% in 2016 to 59.8% by 2035.

Accordingly, economic growth is likely to become more dependent on productivity growth going forward; however, due to Lithuania's recent anemic productivity growth, the gap towards EU levels has somewhat widened. Real labor productivity per person was almost flat in 2016, ticking up by a mere 0.3%, significantly below its Baltic peers (Estonia 1.8%, Latvia: 2.4%), and by only 1.1% in 2014-16. Thus, Lithuania's labor productivity fell back from 74.3 to 71.8% of the EU-28 average (Eurostat and AMECO data).

Meanwhile, the labor market has continued to evolve favorably. Intensifying emigration and economic growth have led to declines in unemployment, with the annual unemployment rate dropping from 9.4 to 7.9% in 2015-16. As we expect the driving forces to remain in place, the jobless rate is likely to decline further in the near to medium term – in Q3-17 the quarterly average of the unemployment rate was down to 7.6% (Q3-16: 7.7%). Having said this, the aggregate numbers mask some duality in the labor market, as the

labor market recovery was still uneven as measured by skill levels. Although unemployment of low-skilled workers (levels 0-2) decreased from 27.3 to a high 25.9% in 2015-16, this compares unfavorably with Estonia, Latvia, and the euro area average. Concurrently, unemployment of high-skilled workers dropped markedly to 3.0% (2015: 3.7%), well below its Baltic peers and the euro area average, pointing to some skill shortages in the Lithuanian labor market.

Challenges to recruiting high-skilled workers exacerbate the tight labor market situation, as indicated by sharp wage increases over recent years. Furthermore, the increase in minimum wages continued to exert upward pressure, now standing roughly 30% above their 2014 level. Real compensation per employee leapt by 5.2% in 2016 and increased by 15.0% in 2013-16 as compared to the euro average of 0.4 and 0.8% respectively. While welcome as regards income convergence, rapidly rising wages should be monitored, as these could hurt Lithuania's cost competitiveness going forward.

We expect real GDP to grow by 3.5% in 2017 and average at 3.2% in 2018-19. Economic prospects for 2017-19 have improved, as recent data signals that the economy is gaining momentum. Output expansion has strengthened markedly since the turn of the year, with yearly growth rates coming in at 4.2 and 4.1% in the first and second quarter, respectively (Q1-16: 2.1%, Q2-16: 1.9%). According to the most recent flash estimate for the third quarter, real GDP almost stagnated on a quarter-on-quarter basis, but rose by 3.4% as compared to last year.

We expect that growth will continue to be fueled by private consumption spending, which posted at 5.8 (Q1) and 4.6% y-o-y (Q2) in the first half of the year. Private consumption should be buoyed by rising wages, while being somewhat dented by rising consumer prices going forward. We thus believe that private consumption will remain robust, thereby insulating the economy from potential volatility related to export and investment flows. Investment activity rebounded in 2017, with gross fixed capital formation rising by 3.3 and 4.0% in Q1 and Q2 respectively, and we expect investment to grow vividly in 2017-20, helping to provide the needed productivity gains. While the flow of support funds still declined by 14.0% y-o-y in the first half of 2017, we believe that EU fund absorption will significantly contribute to fixed investment growth in the medium term. As could be observed during the last programming period 2007-13, the flow of funds can be expected to gather significant pace 3 to 4 years after the start of the period. It is noteworthy that public investment in tangible assets surged in the second quarter (+15.3% y-o-y in current prices), its first increase since Q4-15. Private investment is likely to remain robust, benefiting from continued credit growth and high capacity utilization which has surpassed last year's levels throughout 2017 (avg. Q1-Q4 77.2%, 2016: 75.9%). Increasing external demand from Lithuania's key trading partners as well as investment growth are likely to spur export growth going forward, but the growth contribution of net external trade is likely to be negative due to strong investment-driven import growth.

Together with the ongoing structural reform momentum, more dynamic investment growth should support the alignment of productivity and real wage growth, thus facilitating income convergence and mitigate still very high inequality (Gini coefficient 2016: 37.0; EU-28: 30.7). According to Eurostat data, real labor productivity (per hour worked) has picked

up since the beginning of this year, displaying annual growth rates of more than 4.5% in Q1-Q3. At the same time, average gross monthly earnings have also continued to rally, rising by 9.3 and 8.7% in the first and second quarter of 2017 (annual changes).

The authorities are pushing structural reforms to address the economy's structural bottlenecks, including the labor market as well as the social security, health and educational systems. Significant progress has been achieved with regard to regulation of the labor market, the provision of social security, and the pension system. While the part of the New Social Model regulating social security came into effect in January 2017, the labor market regulations ("New Labor Code") were adopted in July. Against this background, a huge reform package geared towards eliminating deficiencies in the regulation of employment relations, reducing undeclared employment and encouraging different labor contract forms, balancing employment guarantees, and combining flexibility with employment security, is envisaged going forward. Meanwhile, the social security and pension system is foreseen to become more efficient; e.g. by modifying the indexation mechanism, broadening the scope of insured people, and enhancing the scope and adequacy of unemployment insurance.

That being said, the structural reform process may become more difficult going forward, as reforms might be delayed or watered down in light of domestic political upheaval, as was witnessed this autumn. As a result of differing opinions on policy issues, the Social Democrats (SD) had announced their departure from the governing coalition with the Farmers and Greens Union (FGU), which was formed at the end of 2016. A collapse of the government could be avoided by a split of the SD's fraction in parliament. However, governing has not become easier as the FGU, holding 56 of the 141 parliamentary seats, forms an "informal majority", having to rely on the newly formed Social Democratic Labor Political Group (12 seats) and the Electoral Action of Poles in Lithuania (8).

Still, we believe that the authorities will remain committed to prudent policy-making and continue to tackle the economy's structural shortcomings. In general, we assess the sovereign's institutional setting as supportive to the credit rating. The latest World Governance Indicators (WGIs) compare Lithuania well to its CEE countries. Notably, Lithuania is on par with A-rated peers as well as the with the euro area (median rank 35) as regards the quality of policy formulation and implementation, albeit having slipped from rank 31 to 38/209 economies within the last year. While Lithuania exhibits a considerable gap towards the euro area average when it comes to the WGIs voice & accountability (LT: rank 49, EA: 29) and control of corruption (LT: rank 57, EA: 41), the sovereign climbed 5 places as compared to the last year's control of corruption ranking. Moreover, we view the reform progress being made as beneficial towards Lithuania's business environment. As indicated by the 2018 Doing Business report, the business environment has further improved. Already being among the most business-friendly economies in Europe, the World Bank ranked the country at 16 out of 190 economies, up from rank 21 last year, with resolving insolvency (rank 70) remaining its main weakness.

The sovereign's strong public finances and improving fiscal metrics are a key credit strength. Lithuania's headline budget balance has continued to improve as the government has repeatedly outperformed its fiscal targets over the recent years. Thanks to

stronger-than-expected tax revenues, which were lifted by benign labor market development and stronger sales in the corporate sector, proceeds from the Deposit Insurance Fund, and contained government outlays, the general government balance moved into surplus from -0.2 to 0.3% of GDP in 2015-16 (stability program 2016 projection -0.8% of GDP). Lithuania thus recorded a surplus for the first time since 1990, when its independence was restored.

We expect that the sovereign will be able to preserve moderate budget surpluses going forward, posting at 0.1% of GDP this year and somewhat widening thereafter – chiefly the result of strengthening GDP growth, which is likely to boost tax revenue and should more than compensate for expenditure increases arising from the authorities' reform packages.

In terms of budgetary measures, the government reckons with significant outlays related to the New Social Model, while wages of persons employed in state and municipal institutions as well as in the education sector will be raised. On the other hand, policy efforts aimed at enhancing tax administration and combating the prevalent shadow economy are ongoing. Latest data on VAT collection indicates that Lithuania is still among the economies with the highest VAT gap in Europe (2015: 26.4% vs. EU-28 total 12.8%). Also, the size of Lithuania's shadow economy is estimated to have increased from 15.0 to 16.5% of GDP in 2015-16. In 2017-18 the authorities plan to raise tax revenue by measures that have been or are planned to be introduced to improve tax collection and compliance, such as a new tax administration system (i.MAS), the automatic exchange of information, the establishment of a SME accounting management service, and electronic invoicing and consignment recording. According to the Ministry of Finance, the measures have already begun to bear fruit (i.e. 40% y-o-y increase in PIT intake on Class B income in H1-17). What is more, the government implemented changes in the tax system, with a host of increases in excise duties intended to offset the increase in non-taxable income, which will dampen tax revenues.

General government gross debt has edged down from 42.6 to 40.1% of GDP, one of the lowest general government debt levels in the euro area (EA-19 average: 88.9% of GDP), and well below its A-rated peers as well as all CEE countries but Estonia. After a transitory increase due to the government's pre-financing of a Eurobond, which is going to mature in February 2018, general government is set to decline on the back of solid economic growth, converging towards 30% of GDP in the medium term. For 2017, the Ministry of Finance expects debt-to-GDP to tick up to 41.5% as a result of the planned accumulation of EUR 1.3bn. It has to be highlighted that debt is highly affordable and we believe that the Lithuanian economy benefits from euro area membership. Last year, interest expenses accounted for only 3.9% of general government revenue, down from 4.4% a year before. In addition, Lithuania's maturity profile has continued to improve, with average maturity increasing to 6.2y at the end of 2016, having risen from around 4 to 5.5y in 2013-15.

Contingent liability risks appear to be negligible (public guarantees 2017e: 1.3% of GDP) and favorable financial soundness metrics render fiscal sustainability risks stemming from the banking sector unlikely. Having fallen to 3.3% in Q2-17 as compared to 4.5% in Q2-16 and 9.9% in Q2-14, the NPL-ratio continued to follow its downward path, while the CET 1 ratio increased slightly from 19.1 (Q2-16) to 19.5% (Q2-17), pointing to sufficient

capital buffers at Lithuanian banks. Steady loan growth, which should continue to support economic growth, seems to be sufficiently covered by deposits, with the loan-deposit ratio standing at 88.5% at the end of the third quarter 2017 (Q3-16: 95.1%, Bank of Lithuania data).

Risks arising from Lithuania's external conditions appear contained, as the country's net international investment position (NIIP) continued to improve. Its NIIP strengthened slightly from -43.9 to -43.2% of GDP in 2015-16 (2012: -53.4% of GDP), thus comparing well to its CEE peers. Risks of a sudden reversal of international capital flows are somewhat muted by the fact that 68% of the negative NIIP is made up of FDI, given the net FDI position of -29.4% of GDP in 2016. As indicated by the World Bank's Quarterly External Debt Statistics, the NIIP improvement came mainly on the back of deposit-taking corporations. Due to the reversal of financial flows from the Lithuanian subsidiaries to their Nordic parent banks, the banking sector's external debt fell from 41 to 9% of GDP in 2009-15, before rising to 12% of GDP in 2016. At the end of 2016, the central bank (19% of GDP) and the general government (34% of GDP) sectors accounted for the bulk of external debt. Meanwhile, the current account deficit narrowed from 2.8% of GDP in 2015 to 1.1% of GDP last year. The improvement was mainly driven by the widening balance of services, which was up from 4.7 to 5.8% of GDP, and the smaller deficit of the goods balance (-4.6% of GDP). We assume that the current account deficit will increase again, with the ESI funds being chiefly responsible, as a faster absorption of funds should boost investment and related imports.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged over the next 12 months.

The rating could be downgraded in the event of substantially lower growth which may result from a shortfall in the absorption of EU funds or structurally lower growth in Lithuania's key trading partners. Given the high vulnerability to external shocks, rising geopolitical tensions with regard to Russia or Belarus could also drag on investment activity and export growth. The rating could also be lowered if we observe a significant deterioration in the sovereign's fiscal metrics.

In the medium term, considerable downward pressure on the rating could be exerted if the adverse demographic developments continue unabated or if structural reforms are significantly postponed, or if the desired effects fail to materialize, thus leading to a setback in income convergence. A persistent decoupling of wage and productivity growth could translate into a deterioration of external competitiveness, curbing potential growth.

By contrast, factors that could trigger an upgrade include a higher per capita income, a faster-than-expected fiscal consolidation brought on by higher growth, leading to a stronger boost to tax revenues, or a broadening of the tax base. We could also consider

an upgrade to the rating if we conclude that significant progress in the implementation of structural reforms is being made, thus contributing to higher productivity growth.

Primary Analyst
Johannes Kühner
Sovereign Credit Analyst
j.kuehner@creditreform-rating.de
+49 2131 109 1462

Chair Person
Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

Long-term sovereign rating	A /stable
Foreign currency senior unsecured long-term debt	A /stable
Local currency senior unsecured long-term debt	A /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	3.8	3.5	3.5	2.0	2.3	3.5	3.4
GDP per capita (PPP, USD)	24.384	25,908	27,530	28,591	29,972	31,935	34,074
Inflation rate, y-o-y change	3.2	1.2	0.2	-0.7	0.7	3.6	2.6
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	73.9	73.9	74.5	75.1	n.a.	n.a.	n.a.
Fiscal balance/GDP	-3.1	-2.6	-0.6	-0.2	0.3	0.1	0.7
Current account balance/GDP	-1.4	0.8	3.2	-2.8	-1.1	n.a.	n.a.
External debt/GDP	80.1	73.0	63.7	74.5	81.6	n.a.	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Central Bank of Lithuania, Ministry of Finance Lithuania, Official Statistics Portal Lithuania.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

Disclaimer

Any rating issued by Creditreform Rating AG is subject to the Creditreform Rating AG Code of Conduct which has been published on the web pages of Creditreform Rating AG. In this Code of Conduct, Creditreform Rating AG commits itself – systematically and with due diligence – to establish its independent and objective opinion as to the sustainability, risks and opportunities concerning the entity or the issue under review.

When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by mar-

ket participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

This report is protected by copyright. Any commercial use is prohibited without prior written permission from Creditreform Rating AG. Only the full report may be published in order to prevent distortion of the report's overall assessment. Excerpts may only be used with the express consent of Creditreform Rating AG. Publication of the report without the consent of Creditreform Rating AG is prohibited. Only ratings published on the Creditreform Rating AG web pages remain valid.

Creditreform Rating AG

Creditreform Rating AG
Hellersbergstrasse 11
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Prof. Dr. Helmut Rödl
HRB 10522, Amtsgericht Neuss