Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF LITHUANIA	Assigned Ratings/Outlook: **A+ /stable**	Type: Monitoring, 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:	26-11-2016 12-11-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating action

Neuss, 12 November 2021

Creditreform Rating has revised its outlook on the Republic of Lithuania to stable from negative and affirmed the unsolicited long-term sovereign rating of "A+". Creditreform Rating has also affirmed Lithuania's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A+".

The outlook revision on the Republic of Lithuania reflects

(i) the rather tame economic shock in 2020 and thus the outperformance of our expectations, as well as likely contained scarring effects in the wake of Covid-19;

(ii) better prospects of robust medium-term growth aided by EU financing, structural reform effort via the national recovery and resilience plan (RRP), and improving labor market metrics; and

(iii) our expectation that the still comparatively low public debt ratio will decline over the medium term, mainly driven by strong economic growth and favorable financing conditions, and that the sovereign's debt profile will continue to improve.

Key Rating Drivers

1. Lithuania's robust economic growth trend experienced only a slight dip, thanks in part to the country's resilient export performance and economic structure; we expect strong economic activity over the medium term, led by domestic demand, the recovering labor market, and the strong impetus entailed by EU financing

2. Income convergence should continue, as we believe that underlying growth will be bolstered by NextGenerationEU (NGEU) funding and concurrent structural reforms; while imbalances should be avoided, long-standing challenges remain in place, namely skill mismatches and shortages of skilled labor, risks to competitiveness due to rapid wage growth, health and education performance, and demographics; we note that migration trends have reversed recently

3. Institutional conditions continue to be generally strong, underpinned in part by substantial benefits from EU/EMU membership; strengths somewhat balanced by geopolitical risks related to tensions with Russia and Belarus, as well as by gradually increasing cyber-risks; we observe significant headway being made with respect to the combat of corruption

4. Despite the sharply increasing public debt ratio, fiscal space remains ample; the ongoing economic recovery and Recovery and Resilience Facility (RRF) funding lay the ground for a gradually narrowing headline deficit and downward trending debt-to-GDP ratio in the medium term; spending pressure to alleviate structural issues (health, education, pensions, social needs) implies only limited fiscal risks, due to strong debt affordability, relatively low debt levels, and proven fiscal discipline
5. External risks have receded over the past decade and appear contained at this stage, as mirrored by a constantly improving and moderately negative net international investment position; the current account surplus should decrease going forward

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The sovereign's creditworthiness reflects its solid macroeconomic performance, which is characterized by sustained income convergence toward EU levels coming on the back of a firm economic growth trend, brisk labor productivity growth, prudent macro policies, and Lithuania's welcoming business environment. Despite having a track record of elevated volatility in macro-financial variables, we believe this could increasingly be less of an issue, as hinted at by the comparatively mild impact on total output in the current crisis. Having said this, medium-to-long-term structural challenges persist, in particular related to shortages of skilled labor and demographics, which go hand in hand with risks to the economy's cost competitiveness possibly being undermined by mismatches in wage and productivity growth. While EU financing on the back of NGEU, and the new Multiannual Financial Framework (MFF 21-27), will help address these challenges, we will closely follow migration dynamics, as trends have reversed recently, creating significant upside risks to macroeconomic development.

Lithuania remains among the fastest growing economies in Europe. Starting from a strong position, with real GDP expansion averaging at 3.6% in 2010-19 (euro area (EA): 1.4% p.a.), the sovereign's economic output experienced only a modest decline last year, as economic activity was relatively well-shielded from the adverse effects dealt by the disastrous Covid-19 pandemic.

Barring Ireland, Lithuania was the least-affected EU member state as measured by the real GDP outturn in 2020. Total output fell briefly and by only 5.5% in the second quarter of 2020, corresponding to one of the mildest contractions in Europe at the time (EA: -11.7%), and was followed by a strong recovery in Q3 and Q4 (2.8% and 1.8% respectively). Overall, real GDP declined by 0.1% as compared to -6.4% in the euro area as a whole and -5.9% in the EU-27.

A more severe adverse impact has been averted mainly due to Lithuania's economic structure, in which the industrial sector accounts for a significantly larger share in total gross value added (GVA) than in the euro area overall (Q2-21: 21.6% vs. 19.8%, Eurostat). At the same time, the heavily hit tourism sector is of comparatively minor importance, with direct tourism GVA standing at a mere 2.9% of GVA (2018, OECD estimate). Moreover, lockdown measures and restrictions to public life were less strict and more transitory in Lithuania than in most European

[1] This rating update takes into account information available until 05 November 2021.

countries throughout 2020, as illustrated by the Stringency Index compiled by the Blavatnik School of Government.

From the perspective of expenditure, a prominent factor explaining the mild recession is Lithuania's resilient and well-diversified exports. While these increased by 0.4% in 2020, imports of goods and services dropped by 4.4%, resulting in a substantial positive growth contribution of net exports last year (3.8 p.p.). Lithuania's export growth stands out in particular in light of plunging exports of goods and services in the euro area as a whole (-9.0%), and mainly as a result of relatively brisk growth in exports of goods (+3.6%) led by machinery, pharmaceutical products, and foodstuffs. Favorable net external trade performance largely compensated for the decline in household spending (-2.1%) and gross fixed capital formation (GFCF, -1.8%), which shaved 1.3 p.p. and 0.4 p.p. off growth in 2020 respectively.

Having almost averted a recession last year, the relative outperformance enabled an accelerated income convergence towards EU levels. Drawing on IMF data, Lithuanian per capita income posted at USD 38,817 (PPP terms, current prices). Hence, the country was the only EU member state (excl. Ireland) with positive GDP per capita growth in 2020, at 0.3% (EU-27: -4.9%). Lithuanian GDP per capita amounted to 87.4% of the weighted EU average last year, up from 82.8% in 2019, and outperforming most of its fellow Central and Eastern European (CEE) peers. What is more, Lithuania's GDP p.c. stood well above the levels observed in Estonia (USD 37,277) and Latvia (USD 31,485).

We view Lithuania's economic prospects as favorable, and we expect a strong economic expansion over the medium term. This notwithstanding, we flag that downside risks with regard to the Covid-19 pandemic remain high, while the short-term outlook may be adversely impacted by supply-side bottlenecks.

The economic recovery which began in Q3-20 firmed up in the first half of this year – despite the fact that the second quarantine regime lasted until 30 June 2021, with many restrictions remaining in place amid a third wave of Covid-19 infections in spring. In this context, we have to highlight that the Lithuanian economy surpassed its pre-crisis level (Q4-2019), as early as Q1-21, amid real GDP growth of 2.1% q-o-q (EA: -0.3%), which was largely driven by private consumption (+1.2%). Brisk growth continued in the second quarter alongside the gradual withdrawal of confinement measures (+2.0% q-o-q).

More recently, the pace of Lithuania's economic recovery has decelerated noticeably, not least pointing to remaining vulnerabilities in a challenging international environment. According to Statistics Lithuania's first estimate, real GDP stagnated in the third quarter (0.0%) as compared to the previous quarter. While we have no visibility on the expenditure breakdown as yet, we assume the slowing momentum partly mirrors the advanced stage of recovery, but also global supply-chain disruptions, also underscored by monthly data. The volume of industrial production increased by 3.0% m-o-m in August following a drop by 1.4% a month earlier, while anemic retail sales growth of 0.5% and 0.1% y-o-y in July and August respectively partly reflects the impact of supply shortages on the volume of stocks currently held.

Mounting supply shortages of materials and intermediate products may curtail Lithuanian corporates' investment plans going forward, and soft data appears to signal that these impede their production. Indeed, surveyed businesses from the industrial sector assess their current production capacities negatively (Q4-21: -5.0, Eurostat), and increasingly cite equipment as a dominant factor limiting production. These growing near-term downside risks are accompanied by what

already appears to be a severe fourth wave of Covid-19 infections. Thus, the cumulative 14-day infection rate has been rapidly rising since August, soaring to 1,320 in week 42-2021, relentlessly approaching its previous peak dating from week 51-2020 (1,376, ECDC data).

That being said, we still expect the Lithuanian economy to display robust economic growth, mainly on the back of vivid domestic demand. This year and next, we expect real GDP to increase by 4.4% in 2021, before growing by a still solid 3.6% in 2022. In our baseline scenario, we view the risks implied by surging Covid-19 infections to be partly mitigated via the progressing rollout of vaccines and a concurrently further increasing coverage of the Lithuanian population.

At present, inoculation in Lithuania by and large proceeds in lockstep with the EU average. Latest available ECDC data show that 72.0% of the Lithuanian adult population is fully vaccinated (2-Nov-21) as compared to 75.0% in the EU overall. With this, the share of fully vaccinated adults outstrips fellow CEE peers by a wide margin. Also, authorities continue to implement incentives to accelerate the vaccination campaign, such as a bonus of EUR 100 to all pensioners over 75 yrs.

Growth dynamics should be more moderate in the second half of this year before picking up from the second quarter of 2022. At this stage, we expect the effects of the abovementioned supply bottlenecks to ease gradually in the course of 2022, while assuming that adverse effects from the pandemic should gradually fade. Under these conditions, we assume robust export growth, as exporters should be able to meet strong external demand against the backdrop of the ongoing economic recovery of Lithuania's main trading partners. Judging by Q3-21 survey data, export expectations in the industrial sector moderated as compared to Q2, but still stood at elevated levels.

We would recall downside risks to services exports in connection with the EU Mobility package. While part of the package entered into force last year, the obligatory return of a vehicle every eight weeks to the member state where the haulier is headquartered, and the application of cabotage quotas on international combined transport operations, shall come into force in February next year. The Republic of Lithuania and several other EU member states have raised a complaint against these rules. Furthermore, in Feb-21 the European Commission (EC) cautioned that the foreseen measures may imply adverse environmental effects. In light of these developments, the current set-up of the package may be amended to some degree, possibly removing some of the downside risks.

In any case, we assume net external trade will make a negative growth contribution in 2021/22, since import growth, boosted by strong domestic demand, is set to outstrip export growth. In this vein, household spending should lend decisive support to Lithuania's output expansion, despite softer consumer sentiment driven by wage and employment growth, as well as an unleashing of pent-up demand, whilst the expansion in disposable income should be somewhat tempered by the presumably transitory bout of inflation.

Nominal wage growth should continue to aid private consumption, due to the recovery of the labor market, minimum wage and other social pay increases, as well as resilient Lithuanian exporters and businesses more generally, which have been significantly supported by the authorities' exceptional emergency measures. In the first half of 2021, average monthly wage growth accelerated to 11.0% y-o-y (2020: 10.4%, Statistics Lithuania), and we expect it to stay vivid over the next quarters.

Wage growth is also backed by the strong minimum wage hikes. Following increases by 5.8% as compared to 2020 and by 60.5% since 2018, the government recently approved another 13.7% rise of the monthly minimum wage from January 2022. Additionally, the purchasing power of households should benefit from envisaged increases in child benefits, pensions, and ramped-up public sector wages in the fields of education and health. Structural upward pressure stems from the mounting shortages of qualified labor and skill mismatches on the labor market. In addition, Lithuanian households have accumulated substantial savings, which will further buttress consumption going forward.

Labor market conditions have improved over recent months, after the corona crisis interrupted the favorable long-term trend observed since the global financial crisis. As a point of reference, annual unemployment dropped from 17.8% to as low as 6.3% in 2010-19 before edging up to 8.5% last year (EA: 7.9%). However, we deem this deterioration on the rather flexible Lithuanian labor market to be largely temporary, as suggested by monthly data (LFS-adj.). The monthly average surged immediately from the onset of the crisis, from 6.7% in Feb-20 to 9.9% in Sep-20, but has been declining since then, decreasing to 7.2% this August (EA: 7.5%) given the ongoing economic recovery. Likewise, employment rose by 0.5% in Q2-21 after having fallen for four consecutive quarters.

While we also view rising labor participation as a sign of strength, at 78.5% (2020) well above the respective euro area average (73.1%), structural deficiencies related to the scarcity of skilled labor remain in place. Survey data hint at pronounced and rising labor shortages across the board, i.e. in industry, construction, and services. Eurostat data points to pervasive vertical skill mismatches, as Lithuania exhibits one of the EU's highest shares of people (20-64y) with tertiary education and working in ICSO 4-9 (2020: 23.4%).

Furthermore, GDP growth will increasingly come from expanding GFCF, which we deem as a key driver of Lithuania's medium term outlook. In the near term, we expect supply bottlenecks to be a headwind. The industry sector may struggle to cope with the surge in demand, since the supply-side shortages may hamper manufacturing activity and entail a sharp increase in order backlogs. Notwithstanding, these obstacles should gradually dissipate in the course of next year, so that private investment is likely to expand vividly in line with the development of external demand. More generally, well-filled order books and high capacity utilization (Q3-21: 78.0%) bode well for private investment. Industry sentiment has retreated since July, but still posts at pre-crisis levels.

At the same time, significant plans for new public investment, against the backdrop of the commencing MFF cycle 2021-27 and NGEU, will pave the way for sustainable and brisk economic growth, further aiding the economy's catching-up process regarding wages, productivity and incomes. Lithuania is a strong beneficiary of NGEU, receiving EUR 2.22bn (4.5% of 2020 GDP) in RRF grants, as well as roughly EUR 0.7bn in funding for rural development and from ReactEU. In addition, the EU member state will obtain a whopping EUR 12.9bn or 26.1% of GDP as part of the MFF 21-27 (ESF, ERDF, CF ETC: EUR 6.5bn; EAGF: EUR 4.1bn).

We note that the sovereign is characterized by a generally favorable performance in terms of ESIF absorption. As of 30 June 2021, the Republic of Lithuania has already spent 68% of the MFF 2014-20 funds (EU-27 average: 57%). All else equal, we think that EU financing will significantly foster Lithuania's potential growth, which already ranks among the highest in the EU (2021: 4.1%, 2022: 3.5%, AMECO). According to EC estimates, the RRP alone may lift Lithuanian GDP by 1.0% to 1.6% by 2026.

On the other hand, we recall that Lithuania should continue to face persistent demographic pressures over the medium to long term, likely weighing on its growth potential going forward. As suggested by the latest vintage of the EC's Aging Report (May 2021), Lithuania's working-age population (20-64) is projected to decline heavily, by -5.0 p.p. by 2030, tantamount to the sharpest decline in the EU. Over the same time frame, the old-age dependency ratio is forecast to display the largest increase among EU member states (+10.3 p.p.).

Recent demographic developments have ameliorated labor market pressure to some extent, as net migration came in positive for the second year in a row after posting negative rates since Lithuania regained its independence. Brisk economic growth and rising per capita incomes, exceptional events related to the UK's decision to leave the EU, and circumstances related to the pandemic appear to have attracted non-Lithuanian and Lithuanian citizens alike. If this trend can be perpetuated, improving demographics will likely facilitate Lithuanian underlying growth. However, challenges related to skill mismatches may not be overcome any time soon, as migration seems to have partly been of low-skilled workers from Belarus and the Ukraine so far. Also, we observe that immigration showed signs of deceleration in the first nine months of 2021, with the balance standing at +689 people (Jan-Sep 2020: +14,612). In any case, we will continue to follow migration patterns closely.

Further structural challenges remain in place, namely risks to the country's cost competitiveness. Crucially, rapid wage growth allowed the living standard to rise markedly during the last decade, whilst competitiveness has hitherto not been eroded. Real compensation per employee jumped by 19.5% between 2017 and 2020, significantly faster than in many key trading partners and the euro area overall, and outpacing real labor productivity per person (+8.2%). Although Lithuania continues to export largely low- to-medium-technology, as reflected by a laggard high-tech export share (2018: 7.9%), its global export market share has continuously increased (2020: 0.19%, 2015: 0.13%), not suggesting adverse cost competitiveness effects so far.

We note that Lithuania still features a strong position in terms of non-cost competitiveness, benefiting from one of the most favorable business environments in the euro area. While the World's Bank Doing Business report will be discontinued, we would still take into account its latest assessment (2019) according to which Lithuania stood at rank 11 out of 190 economies worldwide. And while we see weaknesses associated with low R&D expenditure which totaled a mere 1.0% of GDP in 2019 (EA: 2.2% of GDP), Lithuania is among the leading EU countries with regard to an emerging Fintech industry, and occupies a decent average rank (14 out of 28 EU members) in the EC's DESI 2020.

Institutional Structure

In our view, the Republic of Lithuania's generally strong institutional conditions continue to lend decisive support to its creditworthiness. Furthermore, the sovereign continues to benefit significantly from EMU/EU membership, involving broader and deeper capital markets, significant trade integration, as well as access to substantial financial support (e.g. via MFF, NGEU) and the adoption of common standards and rules. After the move to a Homeland Union-led center-right government coalition at the end of last year, we continue to expect broad policy continuity. Authorities are resolutely pushing ahead with reforms targeted towards combating corruption, and have made headway in this respect as ultimately reflected in improving World Bank metrics. Credit strengths remain somewhat balanced by cyber-risks, as well as by lingering, and to some extent even increasing, tensions pertaining to Russia and Belarus respectively.

Progress continues to be made with a view to the institutional framework, as reflected by the World Bank's Worldwide Governance Indicators (WGIs). In this regard, we note that Lithuania has again shown remarkable improvement since our last review. Hence, the sovereign was able to further close the gap toward the respective euro area median readings, and now ranks among the best-performing CEE states.

When it comes to the perceived quality of policy formulation and implementation, Lithuania improved from relative rank 41 out of 209 economies in 2019 to rank 37 in 2020, now standing broadly on par with the euro area median (rank 35). Having presented an extensive plan for the legislative period 2021-2024 in order to tackle economic and social challenges, we think that sound and responsive policy-making in Lithuania will continue to support the economy's convergence process and adequately address longer-standing issues. Hence, the center-right government of PM Simonytė, which was approved by Seimas last December, appears to tie in with the work undertaken by the predecessor government, thus ensuring policy continuity.

Most importantly, we have witnessed substantial improvement as to the perception of the extent to which public power is exercised for private gain. The sovereign is now ranked 43rd out of 209 economies on the WGI control of corruption (EA: rank 43), up by 12 places compared to 2019. In fact, this outcome marks the best result since the inception of the WGIs back in 1996. In our view, GRECO's recent report on the fourth evaluation round (May 2021) pays testament to the headway being made with respect to preventing corruption on behalf of MPs, judges, and prosecutors, stating significant progress in transposing GRECO's policy advice, having successfully implemented ten of the eleven recommendations.

The parliament adopted a new National Anti-corruption Agenda 2022-2033, while the government is following through on its Action Plan 2020-22 legislated in November 2020, foreseeing anti-corruption measures ranging from amendments to lobbying regulation, to increasing transparency via information systems and enhancing whistleblower protection.

Whilst the WGI voice and accountability remained unchanged from last year (rank 42/208), the sovereign climbed two places to relative rank 39/209 with regard to the WGI rule of law, i.e. the quality of property rights and courts. The favorable quality and efficiency of Lithuania's judicial system are facilitated by a high degree of digitization, and have also been confirmed by the EU Justice Scoreboard 2021. The latest edition documents a relatively short time needed to resolve civil, commercial, and administrative cases, as well as a modest backlog of pending cases – on both counts Lithuania exhibits one of the lowest readings in the EU.

Over the coming years, reform progress will center on the raft of initiatives articulated in the national RRP which was submitted in May-21 and endorsed by the EC in early July. The RRP rests on seven components, the cornerstones being the green and digital transition as well as the promotion of economic and social resilience. Reforms will be significantly supported by EU financing (see above). A major focus will be on digital objectives, e.g. moving forward with the digitization of public services, and the rollout of 5G networks.

We assess as positive that the RRP focuses on key themes to foster income convergence and economic and social resilience, namely social protection (e.g. minimum income reform, enlarged coverage of unemployment insurance), the quality of education and training, enhancing innovation and the business environment, and ameliorating the quality and efficiency of healthcare. Additionally, authorities plan to improve the effectiveness of the tax system by increasing tax compliance and broadening the tax base.

The majority of the RRF funds (37.8%) will be allocated to green transformation. The authorities intend to develop offshore and onshore wind and solar power, reduce greenhouse gas (GHG) emissions by fostering sustainable transport and ramping up the share of renewables in the transport sector, and to speed up the renovation of buildings. Indeed, Lithuania displays one of the lowest shares of energy from renewable sources in transport in the EU, amounting to only 4.0% in 2019 (EU average: 8.9%). On the other hand, the overall share of energy from renewable sources is relatively high (25.5% in 2019, EU: 19.7%), albeit below the level observed in other Baltic peers.

With regard to climate change-related policy efforts, the parliament adopted the National Climate Change Management Agenda on 30 June 2021, which sets ambitious targets for the reduction of GHG emissions (55% by 2030, 85% by 2040, 100% by 2050). GHG emissions per capita have been relatively stable over the last decade, coming in at 7.4 tons in 2019 (2010. 6.7 tons), below the EU average (8.4 tons). We note that Lithuania is identified as a country still catching up in the area of eco innovation, judging by a mediocre 19th rank among the EU-27 in the EC's Eco-innovation index.

Considering the geopolitical context, we would point out that Lithuania continues to face tense relations with the Russian Federation. The country still shows a strong energy dependence, sourcing 74.4% of its oil and petroleum product imports from Russia in 2019 (up from 64.3% in 2018, 2010: 93.0%, Eurostat). Since our last update, we have observed increasing geopolitical risks related to Belarus, mainly due to the migration crisis also involving the Lithuanian-Belarusian border. Lithuanian authorities declared a state of emergency in border communities in July.

Fiscal Sustainability

Irrespective of the Covid-19 pandemic and the resultant material impact on Lithuania's public finances, we deem medium-term fiscal sustainability risks as modest, representing a key determinant of the sovereign's credit quality. We expect that robust economic growth, together with sizable EU financing support via the RRF and MFF 2021-27, will bring Lithuania's public debt ratio onto a downward trend over the medium term, with headline deficits gradually declining. Fiscal risks stemming from considerable spending needs to tackle the economy's structural deficiencies are largely defused by strong debt affordability against the backdrop of monetary policy support on behalf of the ECB and sustained market access, a track record of fiscal discipline, an improving debt profile, and the still comparatively low debt level which implies ample fiscal headroom.

Sound fiscal policy-making allowed Lithuania's public finances to digest the material increase in spending to avert economic and social fallout from the Covid-19 pandemic. In the years before the onset of the corona crisis, the sovereign significantly deleveraged, recording general government surpluses for four consecutive years, posting an annual average of 0.3% of GDP between 2015 and 2019. The government's forceful fiscal response to the pandemic gave way to a substantial headline deficit, which came in at 7.2% of GDP in 2020 (2019: +0.5% of GDP), according to the GFS autumn notification.

We have to highlight that Lithuania's general government deficit was less pronounced than in the wake of the Global Financial Crisis, which can mainly be attributed to resilient exports and the fact that confinement measures were comparatively less stringent and rather short-lived (see above), translating into a relatively modest economic decline by international standards.

Hence, Lithuania's revenue side was to some extent shielded from the devastating effects, being one of the very few EU member states which was able to achieve positive revenue growth in 2020. Total general government revenue increased by 2.6% in absolute terms (EA: -4.3%, EU: -3.9%), mainly driven by rising net social contributions (+8.1%) and taxes on production and imports (+2.0%). Despite plunging household spending and employment, revenue from tax on income and wealth held up reasonably well, remaining virtually unchanged (+0.2%).

By contrast, total expenditures leapt by 25.0%. In particular, subsidies surged from 0.4% of GDP to 2.5% of GDP in 2019-20, whilst GFCF increased to 4.1% of GDP (2019: 3.1%) and the public wage bill expanded by 1.1 p.p. to 11.3% of GDP. Drawing on Ministry of Finance (MOF) data, the budgetary impact of Covid-19-related measures totaled EUR 2.7bn or 5.5% of GDP in 2020. The most costly measures were wage subsidies during and after the end of downtime (1.4% of GDP), flat-rate sickness benefits for self-employed workers (0.3% of GDP), job search allowances (0.3%), social assistance related to children, the elderly, and the disabled (0.4% of GDP), as well as benefits to recipients of social insurance/assistance (0.4% of GDP)

Numerous fiscal supportive measures had been extended in light of a second quarantine regime that lasted until the end of the first half of 2021. Accordingly, expenditure to support the recovery and limit the economic and social repercussions from Covid-19 will continue to weigh on this year's budget. However, spending for Covid-19-related measures will come in significantly lower than the approx. EUR 1.8bn envisaged in the budget 2021 amended this June, as not all the budgeted funds will be tapped this year. According to latest available information (DBP22), the pandemic envelope is expected to decline to roughly EUR 1.5bn or 3.5% of 2020 GDP in 2021.

We expect the headline deficit to decline noticeably, and would pencil in a deficit of 4.8% of GDP for 2021. Funds for purchasing vaccines and vaccination-related services (~0.6% of estimated 2021 GDP), as well as wage subsidies (0.7% of GDP), will continue to drive up expenditure. The same applies to benefits for the self-employed (0.2% of GDP) and unemployed (0.3% of GDP). At the same time, the revenue intake will increase this year as compared to 2020, with VAT and corporate tax revenues evolving significantly better than at the beginning of this year. Budget execution data underscores our favorable revenue expectations, as the total general government revenue raised during the first nine months of this year already accounts for around 81% of the targeted level for the whole year.

At this stage, we expect the deficit will decline further to 3.5% of GDP in 2022. While we assume a solid revenue intake given the ongoing economic recovery, Covid-19 measures should be eased gradually, providing significant relief to the budget. We view it as positive that the government plans to wind down the support measures cautiously, in a bid to avoid cliff-edge effects. The government has adopted tax policy changes which come into force from January 2022, such as the increase in the tax-free income for low- and middle-income earners. Further deficit-increasing measures include allowances for heavily-hit industries such as food and accommodation services, the indexation of social insurance pensions, spending on managing migration flows at the Belarusian border, and pay increases for employees in the public sector, e.g. teachers and pedagogical staff.

Against this background, the sovereign's public debt ratio is likely to stabilize this year and next before entering a downward trajectory over the medium term. In the wake of the corona crisis, general government debt rose sharply from 35.9% of GDP in 2019 to 46.6% in 2020 (Eurostat

data). Under our assumption of a gradually declining headline deficit, robust medium-term economic growth, significant EU financial support, and moderate debt servicing costs, we project that public debt will post at 46.3% of GDP in 2021 and 46.5% of GDP in 2022. Again, we have to emphasize the still very high degree of uncertainty around those estimates, as the pandemic may require renewed confinement measures, and we deem the economic recovery as still fragile.

We continue to view fiscal sustainability risks as limited. Even after its strong increase, Lithuania's public debt-to-GDP ratio is still relatively low from a European perspective, offering ample fiscal room for maneuver going forward. As a point of reference, the euro area average was twice as high at the end of 2020 (97.3% of GDP). As with many other countries from the EU bloc, we think that the abundant availability of EU financing represents a mitigating factor. We believe that these funds will help to remedy the Lithuanian economy's structural deficiencies, prospectively raising its growth potential and likely translating into more vibrant revenue growth.

Moreover, debt affordability remains credit positive, and in our baseline scenario the sovereign will be able to capitalize on the fact that the interest rate environment is likely to remain favorable over the medium term. Lithuania should thus continue to benefit from low long-term government bond yields. 10y-bond yields stood at 0.295% as of 22-Oct-21 (weekly quote), and the relatively moderate Bund spread has narrowed further since the start of the year (22-Oct: 39bp, 01-Jan: 62bp). As measured by general government revenue, interest payments have been persistently falling since 2012 (6.0%), dropping from 2.5% in 2019 to 1.9% last year.

Thanks to persistently sound debt management, the debt profile has continued to improve, illustrated by the high and increasing average weighted maturity (AWM), which posted at a relatively high 9.83 years in August 2021, up from 9.33 years in August 2020 and 7.11 years in December 2019 (ECB data). Adding to our positive assessment is the debt holding structure, given that the Eurosystem's cumulative Lithuanian asset purchases under PSPP and PEPP have amounted to roughly EUR 8.1bn by the end of Oct-21, approx. 41% of the sovereign's total outstanding debt securities (as of Q2-21). By the same token, risks pertaining to debt denominated in foreign currencies will be removed in Q1-22, as the last high-yielding, USD-denominated bond will mature next February (EUR 1.1bn).

Risks related to public guarantees remain low, as these stack up to a mere 1.0% of GDP in 2021, of which 0.2% of GDP are guarantees associated with Covid-19 (as of Aug-21, DBP22). The maximum amount of guarantees for 2022 is capped at 1.7% of GDP. Furthermore, we see imminent risks for the relatively small-sized (77% of GDP in Q1-21) and largely foreign-owned (foreign subsidiaries ~90% of total assets) Lithuanian banking sector as limited at present. As indicated by EBA data, the Lithuanian banking sector continues to exhibit comfortable capital buffers and high asset quality, with its CET-1 ratio among the highest in the EU (Q2-21: 22.5%, EU: 15.8%), whilst featuring one of the lowest readings regarding the NPL ratios (0.9%, EU 2.3%)

At the current juncture, we would want to flag risks to banking sector soundness, namely money laundering (ML) and cyber security, as well as housing price developments. We see pockets of vulnerability relating to the buoyant growth of the Lithuanian Fintech industry. The country now hosts around 230 Fintechs, up by roughly 21% in 2020 (Bank of Lithuania data), which may generally be conducive to ML- and cyber-risks. While authorities are aware of the related risks, having launched several counter-initiatives, the number of cyber-attacks increased markedly during the pandemic.

Dynamic house price growth remained in place throughout the pandemic, with the annual growth rate even rising from 7.0% in Q2-20 to 13.3% in Q2-21 (Eurostat), while mortgage loan growth accelerated to 11.0% y-o-y in Aug-21 (Aug-20: 8.3%). We would ultimately view risks entailed by a correction on the residential property market as remote, bearing in mind sound financial stability metrics and modest losses stemming from the pandemic so far. Affordability indicators (e.g. price-to-income ratio) do not hint at misalignments at this stage. The recent decision by the Lithuanian Central Bank to tighten requirements for borrowers who take out additional housing loans, and to apply a sectoral systemic risk buffer of 2% for housing loan portfolios, should further mitigate risks in this respect.

Foreign Exposure

Lithuania's high degree of trade openness generally poses some external risks, while elevated macro-financial volatility at times complicates interpretation of underlying currents. Still, its susceptibility to external shocks continues to recede, helping to contain respective risks at this stage. Recurrent surpluses in the Lithuanian current account have supported the sustained improvement in its net international investment position (NIIP), which is dominated by net foreign direct investment (FDI). We expect the current account surplus to narrow going forward, assuming rising import growth amid significantly strengthening domestic demand.

In the wake of the Covid-19 pandemic, transitory factors caused Lithuania's current account to surge to new record-highs. After having shifted into surplus back in 2017, mainly lifted by a strengthening services balance (in particular transport services), the country's current account surplus rose to 3.5% of GDP in 2019, before leaping to 7.3% of GDP last year, one of the highest readings in the EU.

This exceptionally large surplus came mainly on the back of the marked narrowing of the goods deficit, from 4.8% of GDP to 0.8% in 2019-20, largely driven by import compression. The services surplus proved resilient to the devastating pandemic (2020: 10.1% of GDP, 2019: 10.1%), with financial services and ICT services lending strong support, while transport services held up reasonably well.

Looking ahead, we expect the current account to remain in surplus this year and next. That said, the surplus will presumably weaken going forward. Against the background of normalizing external balances, the goods deficit should widen considerably, driven by the recovery in domestic demand and the boost from EU financing via the RRF. Also, the primary income deficit should increase, as revenues from non-resident investment will likely rise again. As a case in point, the current account surplus fell to 5.0% of GDP in Q2-21 (rolling four-quarter-sum), as the goods and the primary income deficits widened to 2.4% of GDP and 3.3% of GDP respectively (Q4-20: -0.8% and -3.0%). Meanwhile, challenges related to the EU Mobility Package remain in place (see above), and could adversely affect the services surplus.

The corona crisis did not interrupt the upward trend of the NIIP observed over the last decade (2011: -53.6% of GDP). To the contrary, in tandem with the improving current account, Lithuania's NIIP shot up from -24.0% of GDP in 2019 to -15.8% of GDP at the end of 2020, and stood at -11.5% of GDP in Q2-21. With this, the country currently has one of the least negative NIIPs among the CEE economies. External risks thus seem remote, further mitigated by the key role played by net FDI, which have posted at around -30% of GDP for more than a decade.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Lithuania's long-term credit ratings is stable, as we believe that still prevalent downside risks related to the pandemic are mitigated by the favorable medium-term perspective on the macroeconomic and fiscal side, and the respective factors elaborated above. The stable outlook is ultimately supported by prudent policy-making and the generally high and improving quality of institutional conditions. Nevertheless, we have to highlight that the assessment and forecast of economic development remains much more challenging due to the high degree of Covid-19-related uncertainty, as is the case for other metrics.

We could contemplate a positive rating action if the real GDP growth in the medium-term surpasses our expectations, translating into a faster income convergence towards EU levels, or if the sovereign's debt-to-GDP ratio converges to the pre-pandemic level faster than expected at this stage. Improving relations with the Russian Federation, as well as easing tensions with Belarus, could also be credit positive. Rising underlying growth could create upward pressure on the rating, which could result from swift implementation of the envisaged structural reforms, and/or sustained positive net migration.

A negative rating action could be prompted by slower-than-expected medium-term growth, or the build-up of macroeconomic imbalances. Failure to follow through on vital structural reforms outlined in the RRP could also create downward pressure on the rating. Moreover, a substantial deterioration of the epidemiological situation may require another round of substantial fiscal measures, possibly leading to a more entrenched upward debt trend. We see derailing geopolitics (i.e. Russia, Belarus) as a tail risk which could nevertheless translate into a negative rating action.

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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 noted]	2016	2017	2018	2019	2020	2021e	2022e
Macroeconomic Performance							
Real GDP growth	2.5	4.3	4.0	4.6	-0.1	4.4	3.6
GDP per capita (PPP, USD)	30,922	33,827	36,343	38,701	38,817	42,091	45,011
Credit to the private sector/GDP	45.4	43.4	42.8	41.3	39.6	n/a	n/a
Unemployment rate	7.9	7.1	6.2	6.3	8.5	n/a	n/a
Real unit labor costs (index 2015=100)	104.5	104.5	106.2	109.6	116.5	n/a	n/a
Ease of doing business (score)	79.2	80.6	81.0	81.6	n/a	n/a	n/a
Life expectancy at birth (years)	74.9	75.8	76.0	76.5	75.1	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	1.0	1.0	1.0	1.0	1.0	n/a	n/a
WGI Control of Corruption (score)	0.7	0.6	0.5	0.7	0.8	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.0	0.9	1.0	1.0	n/a	n/a
WGI Government Effectiveness (score)	1.1	1.0	1.1	1.0	1.1	n/a	n/a
HICP inflation rate, y-o-y change	0.7	3.7	2.5	2.2	1.1	3.4	2.6
GHG emissions (tons of CO2 equivalent p.c.)	7.2	7.4	7.3	7.4	n/a	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	0.3	0.4	0.5	0.5	-7.2	-4.8	-3.5
General government gross debt/GDP	39.7	39.1	33.7	35.9	46.6	46.3	46.5
Interest/revenue	3.8	3.3	2.5	2.5	1.9	n/a	n/a
Debt/revenue	115.2	116.3	97.5	101.8	130.6	n/a	n/a
Weighted average maturity of debt (years)	5.6	6.1	6.8	6.9	8.4	n/a	n/a
Foreign exposure							
Current account balance/GDP	-1.1	0.5	0.3	3.5	7.3	n/a	n/a
International reserves/imports	0.1	0.1	0.2	0.1	0.1	n/a	n/a
NIIP/GDP	-42.8	-36.5	-30.5	-24.0	-15.8	n/a	n/a
External debt/GDP	86.2	82.6	78.3	70.1	75.7	n/a	n/a

Source: International Monetary Fund, Eurostat, Statistics Lithuania, own estimates

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth.

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	**Demographics**
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	26.11.2016	A /stable
Monitoring	24.11.2017	A /stable
Monitoring	23.11.2018	A /positive
Monitoring	22.11.2019	A+ /stable
Monitoring	22.05.2020	A+ /negative
Monitoring	20.11.2020	A+ /negative
Monitoring	12.11.2021	A+ /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

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. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). 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 and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG used the 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, World Economic Forum, European Centre for Disease Prevention and Control (ECDC), Blavatnik School of Government, 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. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. 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" method-ology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

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

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with 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 each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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