# Creditreform Sovereign Rating

Creditreform Rating

| Rating Object | Rating Information | |
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| REPUBLIC OF LITHUANIA | Assigned Ratings/Outlook: **A+ /stable** | Type: Monitoring, Unsolicited with participation |
| Long-term sovereign rating<br>Foreign currency senior unsecured long-term debt<br>Local currency senior unsecured long-term debt | Initial Rating Publication Date:<br>Rating Renewal:<br>Rating Methodologies: | 26-11-2016<br>20-10-2023<br>"Sovereign Ratings"<br>"Rating Criteria and Definitions" |

## Rating Action

Neuss, 20 October 2023

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.

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## Key Rating Drivers

1. Although the war in Ukraine poses some downside risks, Lithuania's economic growth trend should remain relatively robust; we expect a marked slowdown in economic growth this year, followed by accelerating GDP growth next year, enabling Lithuania to resume its income convergence towards EU levels, which has experienced a setback recently

2. EU-funded investment and significant advancement in establishing alternative energy infrastructure contribute to positive medium-term growth prospects alongside ongoing competitiveness of the transport sector and progress in export diversification, including Lithuania's growing fintech industry; continued efforts to further improve the quality of healthcare and education, as well as initiatives to counter potentially growth-constraining skill shortages remain to be monitored

3. The sovereign features a generally strong institutional framework, buttressed by substantial advantages associated with EU/EMU and NATO membership; such strengths remain somewhat balanced by the geopolitical risks related to Russia and Belarus, as well as by increasing cyber risks; authorities have made progress in bolstering measures against money laundering and the financing of terrorism

4. Risks to fiscal sustainability remain limited; we anticipate that the sovereign's general government balance will deteriorate due to measures to alleviate the rising cost of living and spending pressure resulting from higher expenditure on social protection, defense and education; while the relatively moderate public debt ratio should trend downward gradually over the medium term, sound debt management and a track record of fiscal discipline help to mitigate fiscal risks

5. External risks have receded over recent years, also reflected in a constantly improving net international investment position; we expect the current account balance's recent swing to a large deficit to be temporary, but re-adjustments amid retreating energy prices could take some time given the challenging geopolitical circumstances

## Reasons for the Rating Decision and Latest Developments[1]

### Macroeconomic Performance

*Lithuania's creditworthiness is underpinned by its favorable macroeconomic performance, including a competitive transport sector, a welcoming business environment, increasing diversification of its export markets, and progress in terms of income convergence towards EU levels. Its underlying economic resilience has been further strengthened by the growing importance of its financial sector in recent years. Headway has been made in establishing an alternative source of energy imports after the end of Russian energy imports in 2022, while vulnerabilities remain associated with the weight of energy in the consumer price basket and the elevated level of energy intensity of Lithuania's economy. In a context of persisting upward pressure on energy prices and a marked degree of macro-financial volatility, the aforementioned strengths are somewhat offset. We view medium-term perspectives as constructive, supported by significant EU funding. If sustained, the recent positive trend in net immigration could help to alleviate labor shortages, alongside reforms and measures included in the national Recovery and Resilience Plan (RRP) to address them. In light of strong wage increases, the country's cost competitiveness may need to be monitored going forward.*

With a view to the average output expansion over the five-year period 2018-2022, Lithuania remains well ahead of the euro area (EA) overall, and also outperforms the average GDP growth rate of its Baltic peers Estonia and Latvia (LT: 3.5%, EA: 1.2%, EE: 2.7%, LV: 2.2%). As a result, Lithuania also compares favorably with most of its Central and Eastern European (CEE) peers when it comes to income convergence towards the EU level, despite a slight setback in 2022. Drawing on latest IMF estimates, Lithuania's GDP per capita came in at USD 47,107 in 2022 (PPP terms, current prices), corresponding to 86% of the EU average, having gained 11 p.p. since 2015, making faster progress than other CEEs, notably Estonia (+6 p.p. to 82%) and Latvia (+7 p.p. to 72%).

After a comparatively mild downturn in the acute pandemic phase, Lithuania saw a strong economic recovery in 2021, before experiencing a considerable growth slowdown last year amid the negative repercussions from Russia's war on Ukraine. At 2.4% in 2022, Lithuania's GDP expansion was well below that of the euro area (3.3%), with notable volatility in the quarterly growth profile. Private consumption was stifled by skyrocketing consumer prices, in particular for energy, but ultimately made the largest contribution (1.2 p.p.) next to exports to last year's overall GDP growth result. Investment added less to growth (0.8 p.p.), but was bolstered by residential investment. Exports continued to expand strongly, with a marked increase in road freight boosting transport services, but the positive effect of net trade on GDP growth was significantly dampened by deteriorating terms of trade amidst soaring import prices.

Following a recessionary phase over the winter season 2022/2023, real GDP rebounded strongly by 2.4% q-o-q in Q2-23, adding to the impression of volatility in the data. Private consumption has declined in four out of five quarters since Q2-22, highlighting households' caution against the backdrop of still high, albeit retreating, inflation rates. At 4.1% in Sep-23, the inflation rate has come down significantly from a peak of 22.5% in Sep-22, but core inflation has only just left

[1] This rating update takes into account information available until 13 October 2023.

double-digit territory (9.4% as of Aug-23). That said, average gross monthly earnings saw a further strong increase by 13.3% in 2022, and continued to rise by 12.3% y-o-y in Q2-23 (whole economy, excluding individual enterprises, Statistics Lithuania). In addition, 2023 saw a substantial rise in the minimum wage of 15.1%.

In light of the downward trend in inflation rates, and the prospect of significant wage increases in the near term, given skill shortages in a number of sectors, we expect private consumption to recover over the coming quarters. According to the government's draft budget 2024, there will be tax relief for low-income earners and families with children, and the minimum wage will rise further in 2024. However, while still moving below the euro area level, Lithuania's unemployment rate has inched up closer, posting at 6.3% as of Q2-23, compared to 6.5% in the euro area (Eurostat data). Moreover, while employment increased vividly in 2022 (5.1%, EA: 2.3%), the momentum has slowed more recently (Q2-23: 0.9% y-o-y), emphasizing a more moderate pace in the labor market following the economic slowdown. Against the backdrop of ongoing net immigration and the reskilling/upskilling measures being implemented, we think that the outlook for the labor market remains broadly constructive, but will closely monitor developments in this respect. This also includes the authorities' efforts to simplify migration procedures for foreign talent.

Over recent years, Lithuania's labor participation rate has compared favorably against the euro area as a whole, with the gap widening slightly in favor of Lithuania, underscoring advancements in mobilizing the potential of its population. As of Q2-23, the participation rate stood at 78.5% (EA: 75.1%). That said, drawing on the European Commission's (EC) Social Scoreboard, Lithuania presents a somewhat mixed picture, with scope for improvement regarding equal opportunities and in the area of social protection/inclusion.

As regards the outlook for gross fixed capital formation, there are two overlapping effects. On the one hand, tighter financing conditions amid more restrictive monetary policy should weigh on investment, while significant EU funds including the Recovery and Resilience Facility (RRF) and the Multiannual Financial Framework (MFF) 2021-2027 are supportive, in particular regarding public investment. Judging by available data on ESIF (European Structural and Investment Funds) absorption, Lithuania is among the most advanced member states in terms of spending the respective funds (MFF 2014-2020), which strengthens confidence in a timely uptake of newly available funds. In total, Lithuania has been allocated about EUR 2.1bn in conditional grants from the RRF.

Reflecting Lithuania's progress in implementing the initiatives included in its RRP, RRF funds were disbursed this May. We note that EUR 542mn was disbursed, whilst the EC decided to withhold part of the requested EUR 565mn. Two of the 33 targets and milestones that were deemed insufficiently achieved (see also below) will be reassessed by the EC in the fourth quarter of this year. Meanwhile, authorities have submitted a modified RRP (Jun-23), including a chapter on RePowerEU and additional investments from the RRF loan facility, which results in an additional EUR 1.94bn compared to the overall amount of the initial RRP (Ministry of Finance, MoF).

With regard to export prospects, tighter monetary policy is likely to weigh on demand from Lithuania's main export destinations, in particular Europe. We assess the authorities' push to diversify export markets, e.g. to the Indo-Pacific region as positive, which could make up for some of the assumed slowdown in demand from the euro area. Overall, we currently expect Lithuania's GDP to almost stagnate in 2023 (0.1%), mainly due to the weak start into the current year. In

2024, we anticipate an acceleration to around 2.8%, primarily driven by strengthening private consumption and ongoing fixed investment.

Medium-term growth prospects remain constructive in our view, despite some downside risks related to structural features of the economy. On the positive side, there has been significant progress in establishing and using alternative energy infrastructure since last year, when direct energy imports from Russia were halted, with the floating LNG terminal in Klaipeda being a key factor. In addition to the issue of stepping up its energy security, there has been progress in the process of integrating Lithuania into the continental European electricity grid system, although full compatibility is not expected until February 2025 (MoF). Having said this, oil and gas play a key role regarding Lithuania's energy mix, underscoring persisting vulnerabilities to upward price pressures. The need to diversify import sources for wood and metals could still lead to some disruptions in supply chains.

While Lithuania's convergence progress towards EU income levels continues to develop well, we will also pay attention to the development of the free economic zones, bearing in mind possible scope for improvement in their focus and related strategies, as echoed by the Fiscal Council. A strong strategic focus remains the further promotion of the fintech sector. According to the MoF's 2023-2028 fintech strategy, total investment in tech start-ups amounted to EUR 291.8mn in 2022 (approx. 0.4% of 2022 GDP), of which EUR 67.9mn was attracted by fintech companies. To support such strategic goals, the government also envisages enhanced training for locals and simplifying migration procedures for incoming foreign professionals.

In this context, we observe that net immigration has been positive since 2019, significantly boosted by people fleeing from Ukraine since 2022. From Jan-Aug-23, the net number of immigrants was 31,092, following net immigration of 72,372 in 2022 as a whole (MoF). We will continue to monitor whether a positive migration balance can be maintained, as this could benefit labor market developments and foster Lithuania's potential growth. The latter has outpaced that of the Baltic peers since 2019, and is expected to continue to do so this year and next, with estimated growth rates of 2.9% in 2023 and 2.6% in 2024 (EU: 1.5% and 1.6%, respectively).

Lithuania's performance in terms of business friendliness would broadly support favorable expectations regarding its macroeconomic performance. According to relevant international indicators such as the IMD competitiveness indicator, Lithuania ranked 32nd out of 64 economies considered (2023). Starting from spring 2024, the World Bank's 'Business Ready' project is set to replace the currently suspended World Bank's Doing Business report. With reference to the latest available 2020 Doing Business Report, Lithuania remained at the top of the ranking among euro area members, 11th out of 190 economies. Concerning the EC's Digital Economy and Society Index (DESI) overall, it was considered to be roughly in line with the EU average, while performing stronger with regard to digital public services. Based on various indicators related to e-government in the modified 2023 update of the DESI, Lithuania continues to outperform the EU level on this count, ranking 7th in the current report published this October.

As a perceived moderate innovator among the EU members, there remains some room for improvement, especially with regard to business investment in R&D. That said, private sector R&D investment has pursued a moderate upward trend over recent years, climbing to 0.55% of GDP in 2021 (EU: 1.50% of GDP, Eurostat). Having reached EU levels as regards government sector R&D in percent of GDP in 2017, Lithuania has since fallen back, but remains just ahead of its Baltic peers. Moreover, looking at Lithuania's perceived innovation potential on a global scale, it maintained its rank of 39 out of 132 economies included in the 2022 Global Innovation Index

ranking, pointing to stability in terms of non-cost competitiveness in a challenging environment. We also recall the establishment of an innovation agency in 2022 with the aim of creating and promoting an innovation ecosystem.

Turning to competitiveness from a cost perspective, Lithuania continues to give a strong impression, notwithstanding significant wage increases recently. Judging by its global export market share, its competitive position has improved steadily over the last few years, with the share of total exports rising to 0.20% in 2022 and the share of services exports at an even higher level (2022: 0.27%). Compared to 2017, the latter increased by 0.10 p.p. Adding to the positive assessment, we note that exports have increased in sophistication (IMF intelligence), thus potentially strengthening competitive advantages. In addition, transport services saw strong expansion despite the expected negative effects from implementing the EU's mobility package.

Reiterating the dichotomy between strong wage growth in terms of attracting and retaining talent on the one hand, and potentially eroding competitiveness on the other, wage increases do not seem to have had a very negative impact at this stage. We will continue to monitor wage developments in light of the currently somewhat slower labor market, but think that persisting skill shortages will maintain upward pressure on remuneration in a number of sectors. While there are still some structural shortcomings that could pose some constraints on growth, we would highlight ongoing efforts to enhance the health and care system and to bolster public administration functions in the context of rolling our further RRP measures.

### Institutional Structure

*The sovereign's credit rating remains buttressed by a generally strong institutional framework, including EU/EMU and NATO membership. The latter balances, to some extent, geopolitical risks entailed by Lithuania's geographical proximity to the Russian Federation and Belarus in the current geopolitical context. A track record of relatively strong consensus on key policy priorities, as recently demonstrated on security and energy security issues, in our view adds to institutional quality. In light of the growing importance of fintech and, e.g., an advanced stance in terms of e-government, addressing heightened exposure to cyber risks, money laundering and financing of terrorism gains even more attention. Overall, as suggested by the latest set of the World Bank's Worldwide Governance Indicators (WGIs), Lithuania's institutional quality remains broadly favorable and roughly in line with the median of the euro area economies. It is also worth highlighting that, despite the challenging geopolitical circumstances, Lithuania was among the more advanced EU countries when it comes to implementing EC country recommendations over the period 2019-2022, which in our view underscores a high degree of responsiveness.*

Drawing on the recently released WGIs for the reference year 2022, Lithuania by and large maintained stable relative ranks regarding the four WGI pillars on which we place the greatest emphasis when assessing the quality of a sovereign's governance framework. With regard to 'voice and accountability', Lithuania ranks 40th out of 208 economies considered (EA median: 33), compared with a relative rank of 41 in 2021. In terms of 'government effectiveness', it slipped slightly to rank 44 out of 213 (EA median: 43), from rank 41 in 2021. When it comes to 'rule of law', the sovereign continues to rank 37th out of the 213 economies (EA median: 36), whilst it deteriorated somewhat more notably in terms of 'control of corruption', to 51 from 44, but remained close to the EA median rank of 49 in this respect.

The enduring war in Ukraine highlights the strategic importance of Lithuania's NATO and EU/EMU membership in the current geopolitical and economic context. In addition to the potentially deterrent function of NATO membership, Lithuania's integration into EU/EMU structures facilitates the ongoing reorganization of trade routes, energy supplies, and related infrastructure, as well as the provision of funds to support these shifts. This also includes financial support for the transition to renewable energy sources.

With regard to advancements and further ambitions to become a hub for fintech and virtual asset providers, the authorities are committed to stepping up related regulation and supervision. The same applies to increasing risks of cyber attacks, as well as vulnerabilities to money laundering and financing of terrorism. In its 2022 annual review, the Bank of Lithuania (BoL) hinted at some scope for strengthening sanctioning and remedial measures in this regard. The 3rd enhanced follow-up report and technical compliance reassessment concerning recommendations in the AML/CFT space (Moneyval, Dec-22) concluded that Lithuania is now compliant or largely compliant with 35 out of 40 recommendations, reflecting a slight improvement on two recommendations since November 2021.

Turning to the domestic political environment, there remains the impression of a comparatively high level of political consensus on key issues. That said, a narrow parliamentary vote in favor of snap elections in connection with allegations of undeclared expenses by several cabinet members was ultimately not pursued further, leaving the governing center-right coalition in power. A regular election will have to be held by 6 October 2024. Current opinion polls show the oppositional Social Democrats in the lead, polling at about 23%. Our base scenario is that the general consensus described above will prevail even if the government composition changes.

While there remains some room to catch up with leaders in terms of the EC's eco innovation index (LT 2022: 17 among EU-27), Lithuania's overall share of energy from renewable sources rose to 28.2% in 2021, continuing to compare favorably with the EU level (EU 2021: 21.8%, Eurostat). To be sure, Baltic peers Estonia and Latvia remain far ahead of Lithuania in this respect. While the share of renewables used for heating and cooling is comparatively high in Lithuania (2021: 48.6%), it remains relatively low in the transport sector, which is considered to be the largest greenhouse gas emitter. However, looking at Lithuania's overall level of greenhouse gas emissions per capita, it remains slightly below the average EU level in 2021, after remaining stable compared to 2020 (LT: 7.3 tons p.c.).

Pressure to follow through on the green agenda remains high, not least in light of the ongoing Russian hostilities in Ukraine. Among other things, Lithuania plans to complete preparations for offshore wind development by 2024, for an envisaged capacity of 1.4GW. A second tender process is envisaged for this fall, following a first one this spring. A special focus will also be placed on encouraging energy 'prosumers', i.e. enabling consumers to produce their own energy in the coming years. As regards incentives for private households to switch to electric mobility, the target of at least 54,000 private charging points for electric vehicles by 2030 will be maintained.

## Fiscal Sustainability

*Fiscal sustainability risks remain low in our view, as the sovereign's debt-to-GDP ratio is not only relatively moderate, but will presumably decline in the medium term, despite a likely increase in the headline deficit this year due to measures to compensate for price pressures and other adverse effects caused by the war in Ukraine. Lithuania's track record of fiscal prudence over recent years, and its*

*benign government debt profile, resulting from sound debt management, support our favorable assessment of fiscal sustainability, notwithstanding increasing debt refinancing costs in the wake of a well-advanced monetary policy tightening cycle in major Western economic areas. Expected government revenues from a temporary bank levy this year and next are intended to finance defense spending. While reforms of the tax system seem to take shape, we will closely follow the eventual design, also with a view to a potential broadening of the tax revenue base. The small, albeit concentrated, banking sector appears sound at this stage, and we will continue to monitor house price and mortgage loan developments in the context of tighter monetary policy and the potential effects from net immigration. Cyber risks and related downside risks to fiscal sustainability become more prominent given the growing importance of fintech and e-government.*

At -0.7% of GDP in 2022, Lithuania's headline balance again turned out less negative than in the preceding year (2021: -1.2% of GDP) and less negative than we had estimated in our last review (Nov-22: -1.6% of GDP). Against the background of comparatively robust economic growth following the lifting of pandemic restrictions, and despite the challenges presented by the war in Ukraine, total government revenue posted an even stronger increase than in 2021. On the back of surging tax revenues and higher net social contribution receipts, the general government intake rose by 17.3% (2021: 13.5%), driven by strong employment and wage growth, as well as rising corporate profits.

Contrary to 2021, when general government expenditure had dropped slightly (-0.8%), it increased significantly last year (+15.7%), boosted by further substantial increases in public wages (12.7%) and a sharp rise in subsidies (31.5%), amid fiscal support measures to cushion the adverse effects of Russia's military invasion of Ukraine. However, spending on aid measures was ultimately lower than authorities had estimated for 2022, as was defense expenditure. Drawing on EC intelligence, the budgetary impact of energy support measures should have been at about 1.3% of GDP in 2022.

With regard to the current year, the budget law 2023 foresees support measures directly related to energy to the tune of approx. EUR 1.8bn. The security budget was enhanced by EUR 309mn. According to the latest release of monthly budgetary execution data (Sep-23), state and municipal budget revenue from Jan-June 2023 rose by 8.5% as compared to the same period a year before. At the state level, major drivers were VAT tax (+5.8%) and corporate tax revenue (14.8%). Apart from that, personal income tax revenue increased by 9.1% y-o-y, reflecting still positive labor and wage developments, pointing to an ongoing favorable trajectory of the revenue side.

In its draft state budget 2024, approved by the cabinet on 5 Oct-23, the government prioritizes the implementation of the education agreement, increasing private disposable income, strengthening Lithuania's security and high value-added investment. Among other things, EUR 387mn will be allocated to increase the salaries of teachers, and R&D will receive an additional EUR 48mn. Moreover, the minimum monthly wage will be raised by 10% and the tax-free income threshold by 20%. Child benefits and old-age pensions are to rise as well, as will defense spending and expenditure to improve cyber security.

Also taking into account our macroeconomic estimates, we expect Lithuania's headline deficit to come in at around 2.0% of GDP this year, which would be considerably lower than what was approved by parliament in the budget law for 2023. While public wages and social spending are to rise further, as set out in the draft budget for 2024, uncertainty about the outcome of public finances remains elevated amidst geopolitical tensions and the upcoming parliamentary elections, which may well increase spending incentives. On the other hand, we expect real GDP

growth to accelerate in 2024. At this stage, we forecast the general government balance 2024 to remain close to -2.0% of GDP.

The overall outlook for public finances in the coming years is positive, supported by prospectively constructive medium-term growth. Tangible signs that the tax reform measures, to which the suspended part of the recent RRF disbursement is linked (see above), are being implemented, would strengthen confidence regarding benign fiscal prospects further. We view the authorities' commitment to fiscal prudence as credible, also taking into account a favorable track record in terms of achieving fiscal targets in recent years. Furthermore, we are aware of efforts to increase the use of analytical tools to assess the impact of fiscal policy decisions in parallel with the move to multi-annual budgetary planning.

Lithuania's debt-to-GDP ratio continued to decline in 2022, to a low 38.1% of GDP, from a pandemic peak at 46.2% of GDP in 2020. Steering well clear of the Maastricht threshold of 60% of GDP, this also continues to compare as moderate in the European context. Also reflecting our assumptions for nominal GDP growth and the headline balance, we expect the public debt ratio to continue to trend down over the next few years. We forecast general government debt to edge down to 37.3% of GDP in 2023 and decline further to 36.9% of GDP in 2024. Contingent liabilities in the form of public guarantees remain moderate at present, amounting to 1.1% of GDP as of 31 Jul-23 (31 Dec-22: 1.1%, MoF).

Sound debt management and still high debt affordability remain risk-mitigating factors on the fiscal side. Interest payments continued to decrease last year (-3.2%), corresponding to a low level of 1.0% of total revenue or 0.4% of GDP. Although the cost of debt is set to rise on the back of the ECB's monetary policy tightening, we expect debt to remain broadly affordable. The average remaining maturity of state debt was 8.8 years in Aug-23 (MoF), down from a peak of 9.4 years in 2021, but above its 2019 (pre-pandemic) level of 7.5 years (end-of-year).

Lithuanian 10-year government bond yields seem to have plateaued lately, standing at 4.29% as of 22 Sep-23 (weekly data), with the Bund spread having narrowed slightly to 155 bp. We consider it likely that the ECB has reached the peak of its interest rate-hiking cycle in Sep-23, when it raised its policy rates for the tenth time in a row. In our view, a first rate cut is unlikely to occur before the second half of 2024. Meanwhile, the APP portfolio continues to be wound down as scheduled, and maturing government bonds under the PEPP will be reinvested until at least the end of 2024.

Lithuania's predominantly foreign-owned banking sector remains healthy, as mirrored by metrics concerning asset quality and capitalization. The CET1 ratio decreased to 18.3% as of Q2-23, but remains well above the EU level (EU: 16.0%, EBA data). Similarly, the NPL ratio of 0.6% as of Q2-23 counts among the lowest in the EU and moves well below its pre-pandemic level (Q4-19: 1.5%, EBA data). The higher interest rate environment has further boosted the profitability of banks, with the spread between average interest rates on mainly floating-rate loan portfolios and deposits rising to a historic high this year, which could lead to sharply rising net interest income in 2023 (EUR 1.6bn, BoL estimate). Rising profitability prompted the government to introduce a temporary windfall levy on credit institutions, which will benefit this year's and next year's fiscal outcome.

Risks to fiscal sustainability via the banking sector appear manageable at this stage, not least as macroprudential measures have been activated in addition to existing Responsible Lending Regulations. Banks are thus required to comply with a countercyclical risk buffer of 1% from Oct-

23, in addition to other requirements. We note that REvolut Bank UAB is now considered systemically important and has been be subject to an additional capital buffer of 1% from 1 Jul-23. As a side note, it seems worth mentioning that lending to the sectors most vulnerable to climate transition risk, including transport, manufacturing and agriculture, accounted for 32% of loans to NFCs in Q4-22 (BoL data). Risks linked to possible cyber attacks have gained even more prominence against the current geopolitical backdrop, and in light of the growing significance of the fintech and virtual asset industries. Lithuania has the highest number of licensed fintech providers among EU countries, with payment services accounting for the bulk thereof (34% in 2022, MoF).

With regard to lending the private sector, we observe that annual growth of outstanding loans to NFCs has slowed markedly, but remains in positive territory (Aug-23: 2.3%, ECB data). While loans to private households for house purchases have slowed down due to tighter financing conditions, they had still increased at a relatively brisk annual rate of 8.0% as of Aug-23. Turning to price developments, annual real house price growth has been negative since Q3-22 according to OECD data (Q2-23: -2.1%), while Eurostat data points to a slowdown in annual nominal price increases (Q2-23: 9.4% y-o-y). Judging by affordability indicators such as the price-to-income ratio (OECD), there are no signs of price misalignments. Some upward pressure on house price levels is to remain in place against the backdrop of net immigration and continued income convergence, i.e., for fundamental supply-demand reasons.

### Foreign Exposure

*While external risks have increased in the present geopolitical environment, we believe they are manageable. To be sure, macro-financial volatility at times complicates the interpretation of underlying movements. The resilience of service exports, despite challenges from the implementation of the mobility package, supports these expectations, with the growing importance of financial services contributing to this. We regard the fact that the current account balance has turned into a deficit to be likely temporary and mostly due to energy price developments, but it may well take some time for a more significant normalization to take place. Lithuania's position as a net international debtor is not excessive, and the composition of the stock of liabilities is mitigated by a pronounced share of foreign direct investment.*

Lithuania's current account balance turned into a large deficit in 2022 (-5.5% of GDP, Eurostat data), after five years of surpluses (2017-21 average: 2.5% of GDP). Last year's massive widening of the goods trade deficit, which more than doubled in terms of GDP amid soaring energy import prices, was the main factor behind this development. By contrast, the surplus in services trade was relatively robust (-0.7 p.p. to 8.9% of GDP). More recent data up to Q2-23 support the expectation of a movement towards a more balanced position, as energy prices have retreated since the initial phase of the war in Ukraine. In the second quarter of this year, the current account deficit measured as a four-quarter average decreased markedly to -2.4% of GDP, on the back of a narrowing goods deficit and a widening services surplus. We expect this overall trend to continue in the coming quarters, with a small deficit in 2024 remaining the most likely scenario in our view.

Looking at Lithuania's net international investment position (NIIP), the sovereign remains a moderate net debtor, with the position having improved further. As of Q2-23, the NIIP stood at -2.6% of GDP (Eurostat). Liabilities are dominated by foreign direct investment, thus a relatively stable component, which has increased over recent years. Adding to risk-mitigating factors, the NIIP

excluding non-defaultable components (NENDI) is positive, standing at 23.4% of GDP as of Q2-23, showing an improving trend.

## Rating Outlook and Sensitivity

Our rating outlook on the Republic of Lithuania is stable. We regard persisting risks to the macroeconomic outlook, fiscal consolidation and external vulnerabilities emanating from the unpredictable developments related to the war in Ukraine and the wider geopolitical situation as largely balanced by still positive medium-term growth perspectives, sizeable fiscal headroom and external buffers.

A positive rating action could be prompted by stronger-than-expected GDP growth performance in the current challenging environment, which could further improve medium-term prospects and accelerate the convergence process towards EU income levels. Continued net immigration would add positively to that. Swift implementation of revenue-enhancing tax reforms, potentially leading to a faster and/or more pronounced decrease in the public debt ratio could also lead us to consider lifting the rating or the outlook.

Conversely, we could consider downgrading Lithuania's creditworthiness or the outlook if there is a substantial and protracted slowdown in economic performance, halting or even reversing the convergence process and entailing longer-lasting adverse effects on public finances. A further escalation of the war in Ukraine could be a trigger for such a scenario, as could be substantial delays in the implementation of further RRP measures.

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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

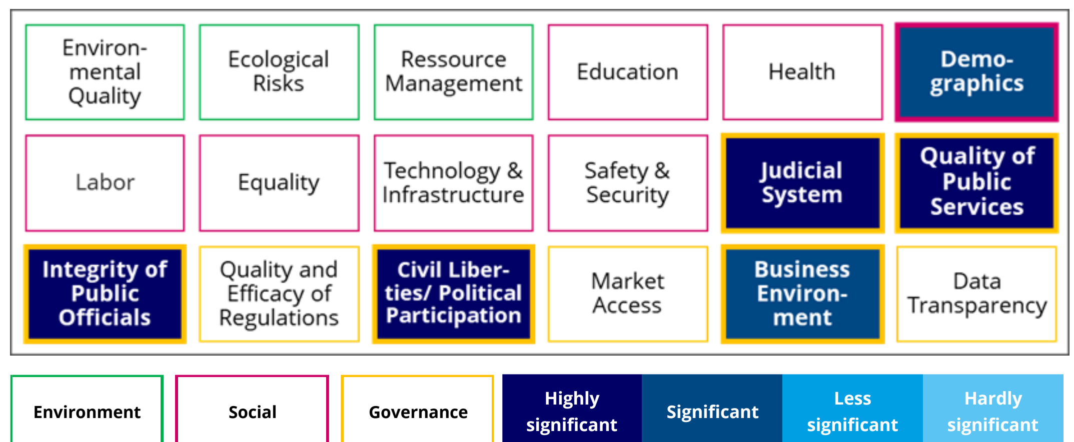
## ESG Factors

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.

### ESG Factor Box



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 assessment of an economy's competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School and the World Intellectual Property Organization (UN) 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.

While Covid-19 may exert adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing on public finances. To be sure, we will follow ESG dynamics closely in this regard.

## Economic Data

| [in %, otherwise noted] | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023e | 2024e |
|---|---|---|---|---|---|---|---|---|
| ***Macroeconomic Performance*** | | | | | | | | |
| Real GDP growth | 4.3 | 4.0 | 4.7 | 0.0 | 6.3 | 2.4 | 0.1 | 2.8 |
| GDP per capita (PPP, USD) | 33,827 | 36,369 | 38,836 | 39,323 | 43,455 | 47,107 | 49,245 | 52,200 |
| Credit to the private sector/GDP | 43.4 | 42.8 | 41.2 | 39.3 | 39.9 | 38.7 | n/a | n/a |
| Unemployment rate | 7.1 | 6.2 | 6.3 | 8.5 | 7.1 | 6.0 | n/a | n/a |
| Real unit labor costs (index 2015=100) | 104.5 | 106.2 | 109.9 | 113.2 | 113.7 | 111.0 | n/a | n/a |
| World Competitiveness Ranking (rank) | 33 | 32 | 29 | 31 | 30 | 29 | 32 | n/a |
| Life expectancy at birth (years) | 75.8 | 76.0 | 76.5 | 75.1 | 74.2 | 76.0 | n/a | n/a |
| ***Institutional Structure*** | | | | | | | | |
| WGI Rule of Law (score) | 1.0 | 0.9 | 1.0 | 1.0 | 1.1 | 1.1 | n/a | n/a |
| WGI Control of Corruption (score) | 0.5 | 0.5 | 0.7 | 0.8 | 0.8 | 0.7 | n/a | n/a |
| WGI Voice and Accountability (score) | 1.0 | 0.9 | 1.0 | 1.0 | 1.0 | 1.1 | n/a | n/a |
| WGI Government Effectiveness (score) | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | n/a | n/a |
| HICP inflation rate, y-o-y change | 3.7 | 2.5 | 2.2 | 1.1 | 4.6 | 18.9 | 9.8 | 3.2 |
| GHG emissions (tons of CO2 equivalent p.c.) | 7.3 | 7.3 | 7.4 | 7.3 | 7.3 | 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 | n/a |
| ***Fiscal Sustainability*** | | | | | | | | |
| Fiscal balance/GDP | 0.4 | 0.5 | 0.5 | -6.5 | -1.2 | -0.7 | -2.0 | -2.0 |
| General government gross debt/GDP | 39.1 | 33.7 | 35.8 | 46.2 | 43.4 | 38.1 | 37.3 | 36.9 |
| Interest/revenue | 3.3 | 2.5 | 2.5 | 1.9 | 1.2 | 1.0 | n/a | n/a |
| Debt/revenue | 116.3 | 97.5 | 101.8 | 128.2 | 120.2 | 107.2 | n/a | n/a |
| Total residual maturity of debt securities (years) | 6.1 | 6.8 | 6.9 | 8.4 | 9.4 | 9.3 | n/a | n/a |
| ***Foreign exposure*** | | | | | | | | |
| Current account balance/GDP | 0.5 | 0.3 | 3.5 | 7.3 | 1.1 | -5.5 | n/a | n/a |
| International reserves/imports | 13.8 | 15.8 | 14.2 | 14.5 | 12.5 | 9.7 | n/a | n/a |
| NIIP/GDP | -37.3 | -30.2 | -23.5 | -15.7 | -7.4 | -7.0 | n/a | n/a |
| External debt/GDP | 83.9 | 78.3 | 70.0 | 80.7 | 78.9 | 67.6 | n/a | n/a |

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Statistics Lithuania, own estimates

## 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 |
| Monitoring | 11.11.2022 | A+ /stable |
| Monitoring | 20.10.2023 | A+ /stable |

### Regulatory Requirements

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This sovereign rating is an unsolicited credit rating. Lithuania's Ministry of Finance participated in the credit rating process as it provided additional information. 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 | YES |
| 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 has 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, World Intellectual Property Organization (WIPO), IMD Business School, 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" methodology. 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 the event 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".

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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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