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:	25-11-2016 22-11-2019 "Sovereign Ratings"

Rating Action

Neuss, 22 November 2019

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

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Key Rating Drivers

1. Income convergence towards EU levels continues, fostered by strong economic growth which we expect to remain resilient going forward, mainly due to solid domestic demand supported by favorable labor market conditions, EU funds, and a welcoming business environment
2. Despite currently changing migration patterns, risks to Lithuania's cost competitiveness entailed by vivid wage growth persist, as is the case with medium- to long-term growth challenges stemming from adverse demographic developments
3. While institutional quality remains generally high, the recent reshuffling of the government coalition may hamper the government's ability to forge ahead with decisive policy-making; geopolitical risks related to Russia; benefits from EU/EMU membership
4. High fiscal strength mirrored by moderate and downward trending government debt, which benefits from recurrent primary surpluses and robust economic growth; declining interest costs result in increased debt affordability, which limits risks related to the upcoming election and to the uncertain fiscal outturn on the revenue side, while the share of fixed spending items increases
5. Still elevated vulnerability to external shocks and macro-financial volatility, but risks somewhat mitigated by further improving NIIP and strengthening services export performance

Reasons for the Rating Decision

Creditreform Rating has raised its ratings on the Republic of Lithuania to "A+" from "A". The decision is underpinned by (i) the sovereign's strong fiscal performance, reflecting a further declining public debt ratio from already moderate levels and higher debt affordability on

the back of dwindling interest outlays; and (ii) strong and resilient economic growth, which is not accompanied by resurfacing imbalances, resulting in a continued income convergence.

Lithuania's high level of creditworthiness mirrors strong and improving fiscal metrics and a generally high institutional quality, somewhat balanced by the solid macroeconomic performance profile and risks stemming from the external sector.

Macroeconomic Performance

We maintain our view that the Republic of Lithuania's credit profile is generally supported by the solid macro performance as reflected by strong and robust growth and continued income convergence towards EU levels, accompanied by a welcoming business environment, which has to be set against a high degree of macro-financial volatility. At the same time, risks to Lithuania's cost competitiveness entailed by vivid wage growth remain in place, as is the case with medium- to long-term growth challenges stemming from adverse demographic developments.

Most importantly, the economy is continuing apace with positive repercussions on Lithuania's income convergence towards EU levels. Lithuania's per capita income rose from USD 32,377 to USD 34,597 in 2017-18 (IMF data, PPP terms), further closing the gap to the median of our A-rated universe (USD 35,939). Thus, Lithuania's GDP p.c. was one the highest among the Central and Eastern European (CEE) economies. Due to the strong performance in terms of per capita income growth seen over the recent years, Lithuania has continued to make huge strides in income convergence. Lithuania's per capita GDP stood at 80% of the weighted EU-28 average in 2018, up by 2 p.p. as compared to 2017. It has to be mentioned that Lithuania stands closer to the EU average than the other Baltic states (EE: 79%, LV: 69%).

Despite the current challenging external environment, real GDP growth remained relatively resilient in 2018. After a marked increase 2017, with growth coming in at 4.2%, economic growth eased to 3.6% last year, above the annual average of 3.2% between 2013 and 2017 and outperforming our expectations. While total output expanded almost twice as fast as in the euro area as a whole, Lithuania grew significantly slower than its Baltic peers Estonia and Latvia (4.8 and 4.6%, respectively).

As expected, Brexit fears, escalating tensions in international trade, and softening external demand dented export growth considerably, curbing the growth contribution of net external trade to 0.3 p.p. (2017: 1.4 p.p.). To be sure, base effects were also at play, as export growth dropped from an exceptionally high 13.6% in 2017 to 6.3% in the following year. Import growth also pulled back, falling from 11.5 to 6.0% in 2017-18, supported by robust domestic demand, which again was the backbone of the Lithuanian economy last year.

Gross fixed capital formation sustained its brisk pace and expanded by 8.4% in 2018, after having grown by 8.2% in 2017, thereby adding 1.7 p.p. to real GDP growth. Investment in transport equipment was particularly dynamic, rising by 18.5% on the year, while investment activity related to other buildings and structures was also significantly shored up, growing by 11.3%. We assess positively that investments in intellectual property continued

to increase, being up from 2.3 to 2.4% of GDP in 2017-18, as we view this form of investment as more conducive to the economy's trend growth. Concurrently, we note that investment activity was largely driven by the private sector, as public gross fixed capital formation stalled.

As in the previous year, private household spending was the main growth engine, increasing by 3.7% (2017: 3.5%). Private consumption was bolstered by strong employment and wage growth, especially in the public sector. Coupled with somewhat more moderate HICP inflation (2018: 2.5%, 2017: 3.7%), higher wages resulted in an increased purchasing power of households, as mirrored by the increase in per capita disposable income growth from 3.1 to 3.8% in 2017-18 (Eurostat, PPS terms).

Labor market conditions have improved since our last review, further aiding economic development. Employment resumed, coming in at 1.4%, after having decreased by 0.7% in 2017, broadly the same pace witnessed in Latvia (1.6%) and Estonia (1.2%). The LFS adjusted unemployment rate concurrently followed its firm downward trend and dropped to 6.2% in 2018, after 7.1% a year before and corresponding to the lowest reading since 2008 (EU-28: 6.8%). Labor participation reached a new record-high, having gone up from 75.9 to 77.3% in 2017-18, standing well above the EU-28 average (73.7%) and ranking among the highest in the euro area.

We expect that the pace of economic expansion in Lithuania will moderate, with real GDP growth slowing to 3.5% in 2019 and by 2.4% in the following year, still exceeding EU and EA-19 dynamics and establishing the basis for further income convergence. While the slowdown mainly reflects the weaker external backdrop, domestic demand should remain resilient, mainly underpinned by solid household spending prospects and healthy investment activity.

Domestic demand should continue to be the main driver of the Lithuanian growth expansion. In this respect, government consumption expenditure is set to play a more prominent role, partly mirroring increases in the public sector wage bill as well as an accelerated uptake of European Structural and Investment (ESI) funds. This is underscored by available national statistical account data for the first half of 2019, according to which government consumption expanded by 1.2 and 1.6% y-o-y in Q1 and Q2 respectively as opposed to a quarterly average of 0.1% y-o-y in the preceding three years.

Meanwhile, private consumption is likely to remain at the core of economic growth. Household spending will presumably be fueled by real disposable income growth, which will come on the back of continued, though somewhat slower employment and wage growth as well as administrative tax measures and the minimum wage increase. To some extent, consumption should benefit from very gradually declining consumer price inflation, whilst favorable credit conditions and still upbeat consumer sentiment should also be supportive. From a historical perspective, Eurostat's consumer confidence indicator stands at high levels, albeit it has trended downwards since the turn of the year. Further out, we expect employment growth to peter out, as capacity constraints due to the declining working-age population and skills shortages may begin to bite. The reversing migration trend observed more recently adds an element of uncertainty in this regard (see below).

In addition, we expect brisk gross fixed capital formation to further contribute to economic expansion, aided by still low borrowing costs, the favorable business environment (see below), and a continued drawdown on ESI funds. As suggested by EU cohesion data, there are reasons to assume that ESI fund absorption will remain supportive. Financial resources allocated to selected projects increased from around EUR 4.9bn at year-end 2017 to EUR 6.9bn at the end of last year (from 49 to 69% of planned investment). The project pipeline was further filled in 2019, with allocated funds climbing to EUR 7.6bn or 77% of total planned investments by the end of the first half of 2019. High levels of capacity utilization in the industry sector point to the need of expansion investment, having steadied at historically high levels over the recent quarters, reaching 77.2% in 4Q19 (4Q18: 77.4%) – significantly above the long-term average of 72.5% (2005-19). Latest survey data on sentiment, order books and business development also bode well for fixed investment in the industry sectors. Still, growth should decrease to some degree given gradually weakening ESI fund absorption and slower construction investment growth. The number of building permits, both for residential and non-residential buildings, has levelled off, indicating that construction investment growth may ease somewhat going forward. Likewise, confidence in the construction sector has also been diminishing throughout the year, albeit standing at historically elevated levels.

Net external trade is rather unlikely to lend support to Lithuania's output expansion. Export growth should be dragged down by weakening demand from its main European export markets, and weaker global growth and international trade more generally. However, the adverse effects entailed by the weaker external environment should be cushioned by enhanced export capacities. Services exports also play a key role, having strengthened markedly over the last quarters. In the first half of 2019, services exports soared by 17.5 (Q1) and 18.8% (Q2) on the year, lifting total export growth to 9.8 and 10.4%. Nevertheless, export growth will be met by equally vivid import growth, coming on the back of robust domestic demand.

The basically favorable macroeconomic performance profile continues to be clouded by two key risks, namely misaligned wage and productivity growth, and demographic challenges to Lithuania's potential growth. The ongoing labor market tightening continues to translate into extremely high wage growth, not only driven by robust economic activity, but also due to the unfavorable demographic development (see below), the shortage of skilled workforce, and legislative changes more recently. Average monthly earnings gained further traction throughout 2018. In the last quarter of 2018, average earnings for the whole economy leapt by 9.7% y-o-y (4Q17: 7.8%). As a result of the tax and social security contribution reform, which implies legislative obligations to ramp up gross salaries on behalf of employers, the average monthly earning surged by 39.1% to EUR 1,278 in 2Q19, creating further pressure with regard to the competitive position of the Lithuanian economy. What is more, minimum wages were lifted from 400 to 555 euros (+39%).

We thus think that such dynamically rising wages may become a double-edged sword. On the one hand, and with a view to the economy's potential growth, pay increases are urgently needed to attract and retain quality workers, raise living standards, and address income inequality. That said, further diverging wage and productivity growth trends may

harm cost competitiveness and put medium-term growth at risk. According to AMECO and Eurostat data, real unit labor costs (ULC) rose by relatively high 1.7% in 2018, a more pronounced rise than in the euro area as a whole, where productivity and wage developments were broadly aligned (+0.7%), but also compared to key trading partners and Baltic peers. Real compensation per employee increased sharply by 4.1%, thereby outstripping productivity growth which came in at only 2.3%. Hence, not only have real wages been rapidly rising since 2013 (+24.9%), but they have been accompanied by laggard labor productivity growth. In fact, real labor productivity per person increased by a relatively moderate 9.9% in 2013-18, arguably somewhat too slow for a catching-up economy and behind many other CEE economies, including its fellow Baltic states (EE: 10.3%, LV: 14.7%). Also, when measured as a percentage of the EU-28 total (based on PPS), labor productivity per person increased only by 2.7 p.p. in 2013-18, well below the readings of Estonia (4.6 p.p.) or Latvia (6.9 p.p.).

We expect that real ULC will continue to increase notably, so that the competitive position of Lithuania will have to be monitored vigilantly. At this stage, however, misaligned wage and productivity developments do not appear to have an adverse impact on Lithuania's cost competitiveness as reflected by its broadly stable global export market share which stood at 0.16% in 2018, the same figure as in 2013. Meanwhile, we see that Lithuanian service export are gaining importance, with the global share jumping from 0.15 to 0.20% over the same period.

Moreover, we note that Lithuania apparently has a strong position in terms of non-cost competitiveness, as it may be regarded as the most business-friendly environment in the euro area. As signaled by the latest Doing Business report by the World Bank, Lithuania improved from rank 14 to 11 out of 190 countries, and lies ahead of its Baltic peers (EE: rank 18, LV: 19). In this context, we observe that Lithuania strengthened the protection of minority investors and has made getting electricity easier. The World Economic Forum's (WEF) Global Competitiveness Indicator does also not point to a deterioration in competitiveness, as Lithuania's relative ranking was broadly stable in 2019 (2019: 39th out of 140 economies, 2018: 40/140).

While also being detrimental with a view to labor and skills shortages, demographics remain a major concern when it comes to Lithuanian potential growth. At present, Lithuania's potential growth certainly ranks among the highest in the EU-28. Judging by EU-28 forecasts, trend growth may be expected to increase from 3.0 to 3.9% in 2018-21, mainly buttressed by recovering investment activity and labor input, while TFP may play a minor role going forward. However, potential output could be significantly impeded by adverse demographic effects. As elaborated before, the working-age population is forecast to show the steepest decline among all EU-28 members (-8.2 p.p. in 2016-30) and the old-age dependency ratio the sharpest increase, rising by 17.4 p.p. to 46.4% by 2030 (EU Ageing Report 2018). Admittedly, the government is forging ahead with measures to mitigate the adverse demographics, and indeed, there are some early signs that these come into fruition, as net migration has turned positive for the first time since the sovereign declared its independence. Net migration amounted to +6,746 persons in the first nine months of 2019, and we expect to see a positive balance for the whole year. We believe that this may also

be explained by the economy’s increasing prosperity and vivid wage growth. In this vein, it has to be closely followed whether this migration pattern remains in place as this should have a favorable impact on the economy’s competitiveness and potential growth.

In general, we believe that the high volatility of macro-financial developments remains a rating constraint. As a small and very open economy, Lithuania is subject to a high degree of macroeconomic volatility, with metrics such as GDP, inflation, credit, and the current account fluctuating heavily. With its nominal GDP of USD 53.3bn (IMF data, 2018), Lithuania is one of the smallest economies in the EU, while trade-to-GDP equated to roughly 149% of GDP (EE: 145%, LV: 123%).

Institutional Structure

The sovereign’s ratings continue to be reinforced by its institutional quality which we deem as generally high. The country benefits from EU/euro area membership, involving access to EU funds, adoption of common rules and standards as well as significant trade integration. ESI funds over the programming period 2014-20 account for 18.5% of 2018 GDP, making Lithuania a major beneficiary of EU support among the member countries.

The generally high quality of Lithuania’s institutional setup is also reflected in the World Bank’s Worldwide Governance Indicators (WGI), our preferred measure of good governance and institutional framework. In terms of governance effectiveness, which captures the capacity to formulate and implement sound policies, Lithuania’s rank slightly improved from 42 to 41 out of 209 economies. With that, Lithuania continued to hold a position close to that of our A-rated sovereigns (median of 44) and EU countries (median rank 39). Euro area countries again compared more favorably in this respect, displaying a median of 35. While Lithuania is on par with the median of our A-rated sovereigns when it comes to rule of law (rank 43) as well as voice and accountability (rank 46), the indicator gauging Lithuania´s control of corruption (rank 66) lags somewhat behind that of our A-rated group (median of 59). The latter finding is more pronounced when assessing the remaining gap to fellow euro area countries (median rank 41). We assess positively that Lithuania performs relatively well as compared to other CEE countries. By the same token, Lithuania outperforms the majority of CEE countries on the first pillar ‘institutions’ of the Global Competitiveness Index compiled by the WEF, according to which it takes the 34th rank out of 141 economies.

As for some of the challenges relating to the current geopolitical context, we would continue to highlight Lithuania’s exposure to potential fallout from tensions with Russia, also bearing in mind Lithuania’s high dependence on energy imports from Russia, from whom it received around three quarters of its total petroleum product imports in 2016 (Eurostat). However, we acknowledge that vulnerabilities have been reduced, considering that in the late noughties this share was closer to 90%.

Looking at domestic politics, we took note of the reshuffling of the government coalition in October this year which saw the country go back to a minority government. While we view political commitment to necessary reforms pertaining to healthcare, education, and social

security generally as rather broad-based, we would flag some concern over a minority government's ability to forge ahead with decisive policy-making and implementation in the remaining time of the legislative cycle. This is illustrated by the only very slow progress in reaching an agreement on details of the healthcare and education reforms. We are aware that the next parliamentary election will be held in October 2020 and will therefore monitor political developments.

Assessing Lithuania's recent headway in terms of developing and using fintech solutions, which we generally view as conducive to increasing the country's productivity and to attracting highly-skilled employees, we are mindful that this may entail vulnerabilities to money laundering and financing terrorism activities. To this end, we are aware that the Bank of Lithuania raised concerns over cases of money laundering linked to several Nordic banks resulting in reputational risks to the financial system (also see below).

Fiscal Sustainability

Lithuania's healthy public finances continue to brighten up and remain the sovereign's key credit strength. The favorable fiscal profile is characterized by downward trending and moderate government debt, high affordability, and the government's prudent fiscal policy-making.

The sovereign has made remarkable progress in fiscal consolidation over the past decade. After the headline balance went from a very high deficit of 9.0% of GDP to a surplus of 0.2% in 2011-16, the government was able to sustain this surplus position in the following years. Last year, the budget surplus increased marginally to 0.6% of GDP, up from 0.5% of GDP in 2017, in line with the target set in the Stability Program 2018. Strong economic growth and dynamic labor market development provided for strong increases in the intake of income and wealth taxes as well as net social contributions, which rose by 12.4 and 11.2% or 0.3 and 0.5% of GDP respectively. VAT revenues grew also significantly (5.6%), but less dynamic than nominal GDP growth. Vividly rising revenues were broadly balanced by expenditure growth, which was buttressed by outlays for public employees and higher consumption expenditure, showing an increase of 0.3 and 0.2% of GDP. The implementation of several social policies (e.g. child money) also pushed up expenditures, with social benefits other than social transfers in kind surging by 1.0% of GDP. We note that public gross fixed capital formation remained unchanged at 3.2% of GDP, mainly due to the underutilization of EU funds, and receding interest outlays contributed decisively to keeping expenditure in check.

Based on the recently published draft budget 2020 which contains a raft of ongoing and also newly added discretionary measures, we expect to see the headline surplus narrowing to 0.1% of GDP this year, and remain unchanged in 2020. We assess positively that the government plans to make use of the fiscal headroom to address structural bottlenecks to the economy's medium- to long-term growth potential.

Revenues should continue to be facilitated by tax-rich, but gradually easing GDP growth and favorable labor market conditions. For the first nine months of the current year, we continue to observe a strong increase in tax revenues. According to preliminary data on

state budget execution, total revenues increased by 17.3% y-o-y, mainly due to substantially higher income and profit taxes. The budgetary effect of the personal income tax reform, which implemented a more progressive tax structure, should be broadly neutral, as revenue gains should be balanced by the adjustments to the social security contribution base and concurrently lower social security contributions. Among the bigger revenue-increasing initiatives are those which are geared towards an enhanced tax administration and the termination of transfers from the SSIF to the second pension pillar. Besides higher excise duties on tobacco and other products, new tax items shall be introduced, as financial market participants and retail companies are envisaged to be taxed, and additional taxes are applied to pollution caused by vehicles.

On the expenditure side, outlays linked to the public wage bill and social benefits will rise significantly, while the sovereign's commitment to the 2% of GDP defense spending target and ramped-up public investment associated with ESI funds will also result in higher government spending. Meanwhile, we expect decreasing interest expenditure to provide for a significant budget relief.

We have to highlight that next year's general elections imply some uncertainty to the budgetary outlook. Against the backdrop of uncertain yields associated with measures to increase tax compliance and uncertainty regarding the eventual budgetary impact of the comprehensive tax and pension reform, we carefully monitor budget execution going forward. From our point of view, this seems particularly advisable given the implementation of additional fixed spending items in 2019/20. As a case in point, authorities had to adjust their fiscal targets this year, as the SSIF surplus should come in lower in 2019, while expenditure may turn out higher than initially planned. That being said, the sovereign generally has a track record of outperforming its target in 2014-18.

Driven by strong economic growth and sustained primary surpluses, general government debt has decreased sharply over the last three years, falling to 34.1% of GDP after having peaked at 42.7% of GDP in 2015. It is worth noting that Lithuania has one of the lowest debt-to-GDP ratios in the EU-28, and the lowest among our A-rated sovereigns (median 49.2% of GDP). Looking forward, we expect that the public debt ratio will increase moderately this year and continue on an only gradual downward trend thereafter, mainly due to the pre-financing operations related to the redemption of Eurobond issuances in the years 2020 to 2022. The outstanding volume of the three Eurobonds maturing over the next three years sums up to a nominal amount of approx. USD 4.4bn. In general, we view these operations as a testament to the authorities' prudent debt management, since they contribute to the clearing of Lithuania's remaining debt denominated in foreign currency. According to the Quarterly Public Sector Debt database, FX debt accounted for 20.1% of general government debt in 1Q19, down from 21.4% a year before (1Q15: 27.3%).

Moreover, the bond redemptions will likely increase the sovereign's fiscal strength as these are set to result in a higher debt affordability on the back of further diminishing interest outlays. In the previous year, interest payments plummeted by 15.3%, and dropped to 2.5% of general government revenues, our preferred measure of debt affordability, down from 3.3% in 2017 (2012: 6.0%). In this regard, Lithuania should also continue to benefit from the low interest rate environment, in which long-term government bond have seen their

yields dwindling to historical lows. The 10-year bond yield stood at 0.45% at the beginning of November (08-Nov-19), well below the level seen a year before (1.2%) and recording a very low Bund spread.

We view fiscal risks entailed by the banking sector as limited at the current juncture. In our view, the essential aspects that warrant closer monitoring are the development of residential property market as well as fintech-related and reputational risks. House prices have been growing vividly over the last quarters. The three-year growth rate has posted at 20% or above for seven consecutive quarters (2Q19: 26.2%, Eurostat data). To be sure, house price developments seem to be buttressed by solid fundamentals, namely robust growth of household disposable income (see above, Macroeconomic Performance). In this vein, affordability indicators such as the price-to-income ratio stand below their respective long-term average. Additionally, household debt makes up for only 37.8% of disposable income (4Q18), one of the lowest readings in the EU. Yet, vigorous house price growth is accompanied by brisk mortgage lending, which has shown monthly growth rates of more than 8% y-o-y over the last two years.

Furthermore, we note that money laundering issues associated with several Nordic banks, which are controlling large parts of the Lithuanian financial system, pose reputational risks to the banking industry in Lithuania. Also, the booming fintech industry in Lithuania carries significant risks, mainly related to money laundering and finance of terrorism, supervision, and cybersecurity. The threat of cyberattacks appears to increase. According to the Bank of Lithuania's (BOL) Review of the Survey of Risks to Lithuania's Financial System, cyberattacks are viewed as a major risk to the financial system. We understand that four financial institutions were the target of cyberattacks, though apparently not having incurred any losses.

At the same time, we think that there are several aspects that mitigate implied risks to the Lithuanian budget. Firstly and drawing on EBA data, we deem the resilience of Lithuanian banks as high. NPLs make up for a relatively low and declining share of the total loan book, standing at 1.8% in 2Q19, compared to 2.7% in 2Q18 (EU-28 average: 3.0%). Capital buffers, as measured by the CET1 ratio, increased by 0.1 p.p. to 19.4% in the year up to the second quarter of 2019 – well above the EU average of 14.6%. Moreover, Lithuanian banks count to the most profitable in the EU, as return on assets amounted to 1.5%, up from 1.3% a year before (EU-28: 0.5%). Secondly, the Lithuanian banking sector is one of the smallest in Europe with an asset to GDP ratio of 60.1% in 2Q19, and as a corollary, a bank failure appears easier to handle from a fiscal perspective.

The last aspect worth mentioning is a blessing and a curse at the same time. The Lithuanian banking sector is dominated by subsidiaries of Nordic banks. As illustrated by ECB data, foreign-controlled subsidiaries account for 90% of the banking sector (third-highest share in EU-28, 2Q19), shielding the budget from contingent liabilities in case of a financial upheaval in the banking sector as we assume that the parent banks might step in. Having said this, an unwinding of gradually building imbalances in the Nordic real estate markets may have detrimental contagion effects on the Lithuanian economy. Risks are somewhat mitigated by the fact that the exposure of domestic banks towards their mother companies is

decreasing as Lithuanian banks are reorganizing their financing structure and the share of parent bank deposits is declining.

Foreign Exposure

We note that Lithuania made further headway in reducing the still elevated vulnerability to external risks, as its highly negative net international investment position (NIIP) continued to improve in 2018. Climbing from -37.9% of GDP in 2017 to -31.0% of GDP in 2018, the position marked the least negative reading since 1998, and a further improvement to -28.4% of GDP in 2Q19. What is more, we continue to view the large FDI-share in external liabilities (accounting for 37.6% in 2018) as a factor mitigating risks from the economy's still pronounced exposure to external shocks. Net FDI in percent of GDP came in at -28.7% in 2018, narrowing from -30.4%, but chiefly as a consequence of strong nominal GDP growth, as Lithuania also saw higher FDI inflows in that year. Since the country has become a leading hub for fintech solutions in Europe, in particular relating to payment services, recent FDI inflows may partly reflect progress made in this field. To what extent these developments will come with heightened risks regarding money laundering and financing of terrorism will have to be carefully monitored (see above, Institutional Structure). Also contributing to a less adverse NIIP, reserves were increased further, amounting to 11.1% of GDP in 2018. Moreover, we notice that net portfolio investment in percent of GDP more than doubled to 7.7% of GDP in 2018.

The current account balance, which has been somewhat volatile over the last decade, albeit generally oscillating around a balanced position, displayed a moderate surplus to the tune of 0.3% of GDP in 2018, edging down from 0.5% in 2017. While the trade deficit in goods widened from -4.9 to -6.9% of GDP amid a more challenging external environment, the surplus in the services balance rose from 7.2 to 8.1% of GDP and thus continued its positive trend.

Going forward, there seems to be scope for the current account surplus to widen beyond 1% of GDP in 2019. In the second quarter of this year, the balance rose to 1.9% of GDP, mainly driven by the service component. Transport services accounted for 58.4% of all services exports in Q2 (BOL data), underlining the significance of the transport sector. While the external environment remains demanding for trade in goods amid geopolitical tensions that may affect Lithuania's main trading partners, trade in services looks set to remain more robust, having displayed double-digit growth in the first half of 2019 (also see above). 2020 could see a moderately positive current account balance as well. However, in addition to trade politics on the global stage, potentially adverse effects on transport services associated with the EU Mobility Package require close attention if it is approved without any changes by the European Parliament. We understand that some of the proposed measures may be challenged by a number of Eastern European countries including Lithuania.

Rating Outlook and Sensitivity

Our Rating outlook on Lithuania's sovereign ratings is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to remain fundamentally unchanged over the next twelve months.

We could raise the sovereign's credit ratings if medium-term growth outperforms our expectations, thereby putting Lithuania on a steeper upward trajectory with regard to its income convergence towards EU levels, or if we observe a further improvement of its public finances, resulting in a faster decline in general government debt. While we view a comprehensive implementation of the structural reform program as imperative for a further rating upgrade, as these structural reforms are key to safeguarding the economy's competitiveness and boosting its potential growth, upward pressure on the ratings could also result from unwinding geopolitical tensions.

By contrast, we could lower the rating if substantial fiscal slippages lead to a reversal in the general government debt trend, if medium-term growth prospects fall short of our baseline scenario, if macro-financial imbalances resurface, if competitiveness was eroded by severe misalignments of productivity and wages, and/or if we observe failure in implementing the envisaged reforms or, worse, if we perceive backtracking on already adopted structural reforms.

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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

	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	3.5	2.0	2.6	4.2	3.6	3.5	2.4
GDP per capita (PPP, USD)	27,611	28,731	30,092	32,377	34,597	36,701	38,751
HICP inflation rate, y-o-y change	0.2	-0.7	0.7	3.7	2.5	2.3	2.2
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	74.7	74.6	74.9	75.8	n.a.	n.a.	n.a.
Fiscal balance/GDP	-0.6	-0.3	0.2	0.5	0.6	0.1	0.0
Current account balance/GDP	3.5	-2.4	-1.1	0.5	0.3	n.a.	n.a.
External debt/GDP	70.7	76.8	86.2	83.9	78.5	n.a.	n.a.

Source: International Monetary Fund, Eurostat, 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

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.

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.

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

Economic Forum, 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".

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