Republic of Lithuania
Rating Report

A POSITIVE OUTLOOK

Credit strengths
- Sound institutional setup, underpinned by membership in euro area and NATO
- Improved economic resilience, solid medium-run growth prospects
- Moderate public debt

Credit challenges
- Moderate income levels
- Exposure to external shocks
- Adverse demographics
- Financial spillover risks

Rating rationale

Sound institutions: Lithuania's effective policymaking is underpinned by its status as a member of the euro area, ensuring a robust framework for fiscal policy, economic policy and banking supervision. Its membership in NATO strongly mitigates external security risks in the context of heightened geopolitical tensions.

Solid growth prospects: The country's solid economic growth and improved macroeconomic resilience have accelerated its convergence towards euro area income levels during the past years. Despite a significant hit from the current energy crisis, we expect the country to grow by 2.4% this year and 0.5% next year, with economic growth converging near an estimated potential rate of 2.5% thereafter.

Moderate public debt: Lithuania's record of prudent fiscal policy has led to a debt-to-GDP ratio of 43.7% at end-2021, one of the lowest levels in the euro area.

Rating challenges include: i) moderate income levels, despite continued convergence over the past decades; ii) exposure to external shocks, given the small size and openness of the economy; iii) adverse demographic trends, increasing labour shortages and fiscal pressures; and iv) financial sector risks related to a dependence on Nordic banks and elevated cross-border financial flows.

Lithuania's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb	EUR [+1]	0	A
Public Finance Risk		20%	aaa		0	
External Economic Risk		10%	bb-		-2/3	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Factors	5%	aaa		0	
	Social Factors	7.5%	b-		-1/3	
	Governance Factors	12.5%	aa-		0	
Indicative outcome			**a+**		**-1**	
Additional considerations					**0**	

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's Sovereign Ratings Methodology'. Source: Scope Ratings

Outlook and rating triggers

The Positive Outlook represents our view that Lithuania will weather the economic fallout from the Russia-Ukraine war without its credit fundamentals deteriorating; and that a continuation of sound policies, paired with swift absorption of EU funds, will support further economic and fiscal improvements.

Positive rating-change drivers
- Solid economic growth continuing through structural reform and investment
- Debt-to-GDP anchored to moderate levels, thanks to broadly balanced government finances in the medium run
- External and/or financial sector vulnerabilities continuing to decline

Negative rating-change drivers
- Weaker fiscal fundamentals, leading to a significant increase in debt-to-GDP
- Increasing macroeconomic imbalances, weakening growth prospects
- Substantially greater external and/or financial sector vulnerabilities
- Heightened geopolitical risks undermining macroeconomic stability

Ratings and Outlook

Foreign currency

Long-term issuer rating	A/Positive
Senior unsecured debt	A/Positive
Short-term issuer rating	S-1/Positive

Local currency

Long-term issuer rating	A/Positive
Senior unsecured debt	A/Positive
Short-term issuer rating	S-1/Positive

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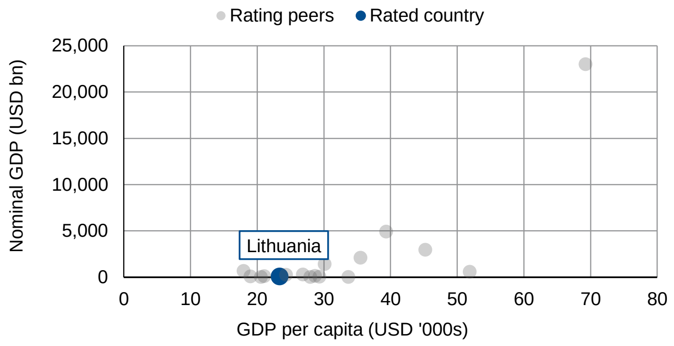
Domestic Economic Risk

- **Growth outlook:** Lithuania's economy proved remarkably resilient to the Covid crisis with no GDP contraction in 2020 (0%) followed by a buoyant 6% rebound last year. However, the economic ramifications of the Russia-Ukraine war are significantly affecting the country's growth outlook via high inflationary pressures, supply chain disruptions and weaker trade. Confidence has taken a hit as well, even though Lithuania managed to rapidly substitute its energy imports from Russia. After resilient economic performance so far this year, we expect a significant slowdown in upcoming months. Annual GDP growth should reach 2.4% this year followed by 0.5% in 2023 and 3.1% in 2024. In the medium term, we estimate Lithuania's growth potential at 2.5%. This is supported by Lithuania's access to ample EU funds exceeding 23% of GDP over 2021-27 when considering the Recovery and Resilience Facility, Cohesion Policy and Common Agricultural Policy. In addition, the Lithuanian economy benefits from sound economic policies and an attractive business environment set to support continued convergence towards euro area income and productivity levels in upcoming years.
- **Inflation and monetary policy:** Along with the other Baltic states, Lithuania is heavily affected by the current, exceptionally high inflationary pressures. Even before the war, the economy was at risk of overheating given a tight labour market and loose monetary policy. A large share of energy and food items in its consumption basket, on top of deregulated gas and electricity markets, makes Lithuania heavily exposed to current supply-side price shocks. Inflation stood at 23.6% in October. We expect an annual inflation rate of 18.5% for 2022, followed by a lower but still elevated 7% in 2023. The ECB is rapidly normalising monetary policy, with rate hikes of 200bps so far this year, on top of stopping net asset purchases under its QE programmes. The resulting tighter financing conditions will contribute to an economic slowdown next year.
- **Labour market:** Employment reached record high levels in Q2 of this year, at over 1.4m people, supported by swift integration of Ukrainian refugees in the labour market. Participation remains elevated, at close to 80% of the labour force, while the unemployment rate is at historically low levels (5.0% in September). Given that this is below its structural level and the economic outlook is weakening, we expect the unemployment rate to rise in upcoming months, averaging 5.7% this year and 6% in 2023-24. Despite favourable aspects including flexibility and wide participation, Lithuania's labour market faces labour and skill shortages on top of unfavourable demographic trends. This represents an obstacle to growth and has been fuelling wage pressures that have led to double-digit wage growth in recent years.

Overview of Scope's qualitative assessments for Lithuania's *Domestic Economic Risk*

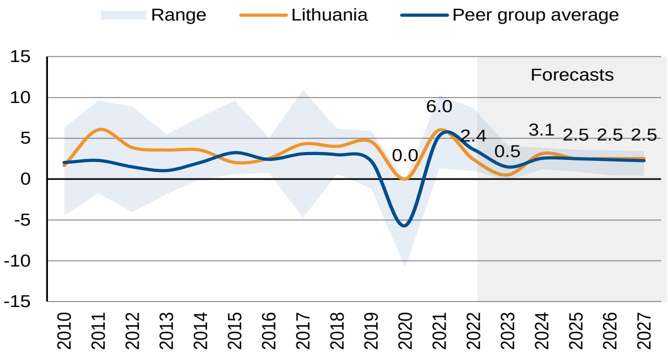
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Robust economic prospects supported by EU funds, although adverse demographic trends are a challenge
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank over the cycle
	Macroeconomic stability and sustainability	Neutral	0	Improved macroeconomic resilience and flexible labour market, but labour shortages, overheating risks and large regional disparities

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

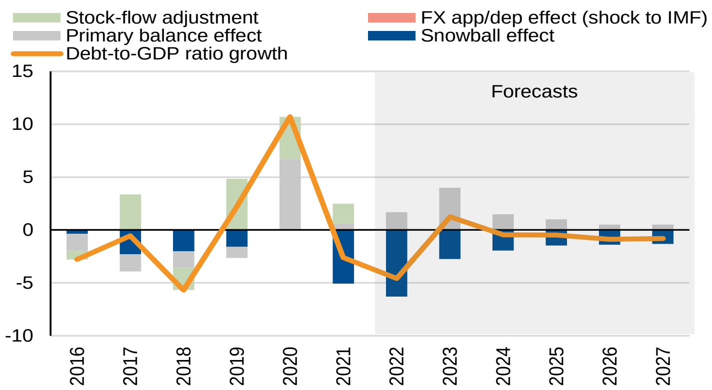
Public Finance Risk

- **Fiscal outlook:** The Lithuanian government has a track record of prudent fiscal policy, reflected in budget surpluses averaging 0.4% of GDP in the four years prior to the Covid-19 outbreak. The pandemic caused significant fiscal scarring, but targeted measures enabled a swift budget recovery last year, with the fiscal deficit declining to just 1% of GDP from 7% in 2020. The cost-of-living shock stemming from the energy crisis is requiring further fiscal support measures. While this year's budgetary result should be much more favourable than initially expected, resulting in a deficit of 2.0% of GDP, sizeable spending increases have been authorised for next year, which should widen the deficit to 4.5% of GDP. A gradual fiscal recovery is expected afterwards, with the government budget converging towards a deficit of 1% of GDP by 2027, although low social spending levels and civil servants' wage pressures could slow fiscal consolidation in the current high inflation environment. The government is reforming budgetary processes to improve the design of budgets and the effectiveness of public spending. Authorities are also reviewing the tax system to enhance tax collection and improve its efficiency in light of the country's persistent, sizeable shadow economy and restricted tax base.
- **Debt trajectory:** On the basis of our growth, fiscal and inflation outlook, we expect that general government debt will initially drop below 40% of GDP this year from 43.7% in 2021. The public debt ratio should then stabilise at 39%-40% of GDP in 2023-25 and slightly decline to 38% by 2027. The debt ratio should remain below the EU's 60% Maastricht threshold even under our adverse scenario incorporating more lasting scarring of economic growth and impediments to fiscal consolidation. Over the long run, however, Lithuania faces mounting fiscal pressures from unfavourable demographic dynamics. The IMF estimates the present value of changes in healthcare and pension spending through 2050 at over 60% of GDP.
- **Debt profile and market access:** Lithuania's prudent policy limits on debt management are reflected in a low-risk debt profile. The average maturity of the debt portfolio is high at over nine years, which should keep government borrowing needs at moderate levels of around 7% of GDP annually over 2022-27. The Treasury issues at favourable terms in domestic and international capital markets, although yields have markedly increased from last year, reflecting the normalisation of monetary policy in the euro area. Prudent liquidity management including pre-funding and an ample cash buffer further mitigate risks in the current volatile environment.

Overview of Scope's qualitative assessments for Lithuania's *Public Finance Risk*

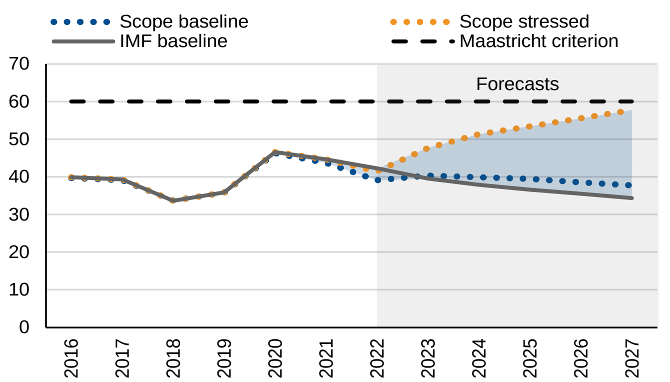
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Track record of fiscal prudence, but sizeable shadow economy and restricted tax base
	Debt sustainability	Neutral	0	Moderate debt; stabilisation and gradual fall of the debt ratio in the medium run
	Debt profile and market access	Neutral	0	Prudent debt management, low funding needs, ability to issue on favourable terms

Contributions to changes in debt levels, pp of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

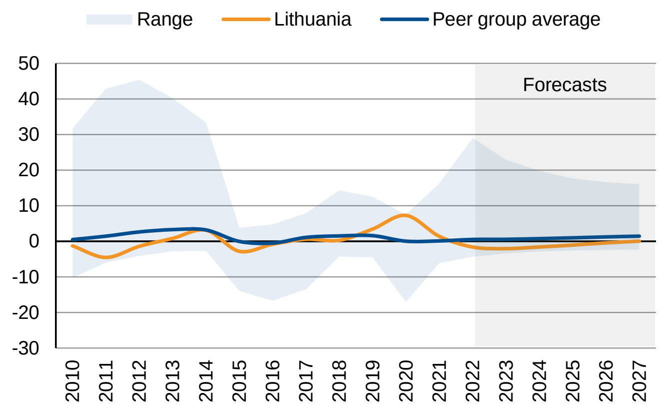
External Economic Risk

- **Current account:** Lithuania has continuously gained global export market share in recent years thanks to improvements in the value-added structure of its exports. The importance of trade with Russia has been decreasing, with most exports being re-exports before the escalation of the war in Ukraine. This decline mitigates the trade sanctions' negative impact on the Lithuanian economy. The current account remained close to balance in the five years prior to Covid-19 on average but jumped temporarily to a surplus of 7.3% of GDP in 2020 due to the shock to consumption, which lowered goods imports. The current account balance then fell to a deficit of 2.9% of GDP in the year to Q2 2022 due to continued pressures on the trade of goods balance stemming from elevated energy and commodity prices. High energy prices, weakening demand from key European trading partners and structural headwinds to transportation services exports – a key export sector for Lithuania – will only allow for a gradual recovery of the current account in upcoming years.
- **External position:** Lithuania's net international investment position improved to negative 6.2% of GDP in Q2 2022 from below negative 40% in 2017. The country's external debt stood at 68.7% of GDP, one of the lowest levels in the euro area and down 15pp from five years ago. Over 45% of external liabilities relate to inward foreign direct investment, which curbs the risk of sudden capital flows in times of global stress and enhances the long-term sustainability of the external position.
- **Resilience to shocks:** Lithuania's small, open economy remains vulnerable to external shocks due to large export and import sectors, each representing around 80% of GDP. The Russia-Ukraine war is having significant direct and indirect negative impacts on the country's economy, primarily due to shortages in raw materials and weaker growth among key trading partners. At the same time, we do not expect the conflict to cause permanent scarring of the country's growth potential. This is thanks in part to continued improvements to Lithuania's energy security, enabling a rapid and complete substitution of Russian energy imports. The connection of Baltic states to mainland Europe's electricity networks is due for completion by 2025, and synchronisation during emergencies is already possible.

Overview of Scope's qualitative assessments for Lithuania's *External Economic Risk*

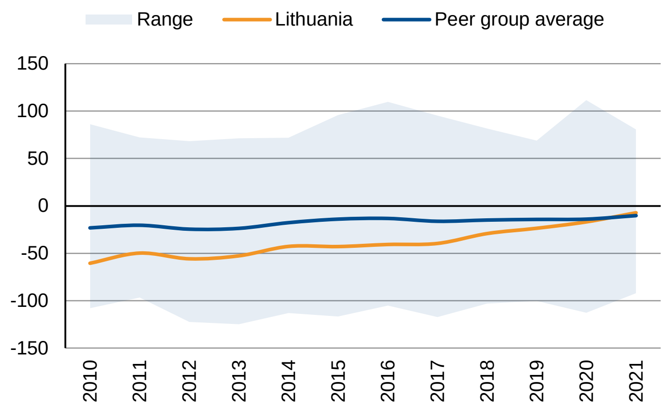
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Current account resilience	Weak	-1/3	Risks from reliance on low value-added export sectors, although competitiveness and diversification are improving
	External debt structure	Neutral	0	Falling levels of net external debt, sizeable share of foreign direct investment in external liabilities
	Resilience to short-term external shocks	Weak	-1/3	Small and open economy, highly exposed to external developments

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

Financial Stability Risk

- **Banking sector:** Lithuania's Nordic-dominated banking sector presents limited contingent liability risk to the sovereign balance sheet and is in a good position to absorb the current economic shock. The sector's resilience is underpinned by comfortable capitalisation and liquidity metrics, with CET1 and liquidity coverage ratios of 20% and 388% respectively as of Q2 2022, as reported by the EBA. Profitability is among the highest in the euro area, despite some moderation relative to pre-pandemic levels, reflected in an aggregate return on equity ratio of 10.5% as of Q2 2022. Strong asset quality, with a non-performing loans ratio of under 1%, low cost-to-income ratios relative to peers and rising interest rates will all support profitability over the medium term, despite headwinds related to the deteriorating economic outlook. Additionally, Lithuania's dynamic fintech sector, one of the largest in the EU, fosters innovation in the financial industry, supporting productivity gains and a more efficient allocation of capital.

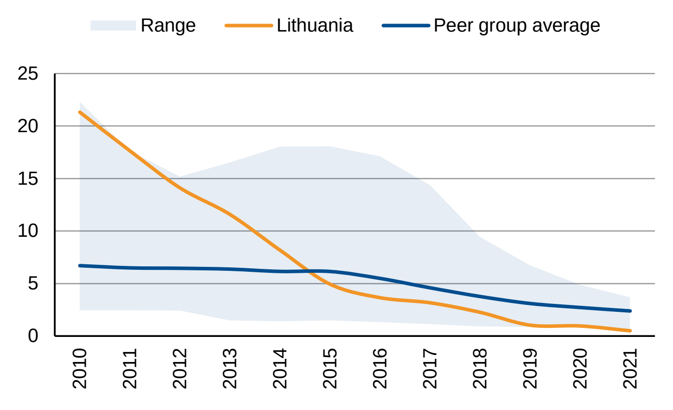
- **Private debt:** Despite a significant pickup in credit demand after the pandemic, private sector indebtedness remains low relative to peers, with household and non-financial corporate debt amounting to 23% and 42% of GDP respectively as of Q2 2022. The Lithuanian private sector is exposed to interest risks due to a very large share of variable-rate loans, with around 90% of new loans having variable-rate terms since 2015. Debt service ratios are thus expected to increase in line with ECB policy tightening, albeit from a low level. Low levels of private debt also reflect obstacles to accessing finance, particularly for SMEs.

- **Financial imbalances:** Lithuania's banking sector is exposed to concentration and spillover risks due to its integration with Nordic and Baltic banking systems. Two Swedish banking groups, Swedbank and SEB, account for two thirds of Lithuanian bank assets. Capital flight and cross-border money laundering risks are reduced by a moderate share of non-resident deposits standing at 4.4% of the total, below those of Latvia (16%) and Estonia (13%). Still, the rapidly growing fintech industry requires a continued upgrade of anti-money laundering policies. Booming activity in the residential real estate market, driven by robust demand, resulted in rapid price growth in the years leading up to the pandemic. After continuing to rise throughout the Covid crisis, we expect price dynamics to moderate as a result of tightening financing conditions and the central bank's rollout of macroprudential measures, including lower limits on loan/value ratios.

Overview of Scope's qualitative assessments for Lithuania's *Financial Stability Risk*

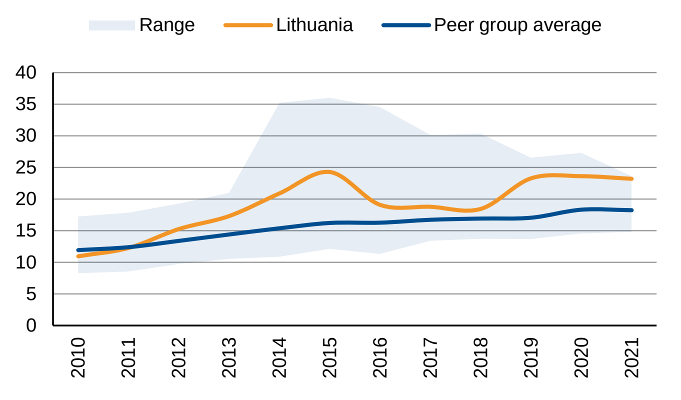
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Oversight under the Bank of Lithuania and the ECB as part of Banking Union
	Financial imbalances	Weak	-1/3	Concentration and spillover risks from dominant Nordic banking groups; elevated cross-country financing flows; high share of variable-rate loans

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

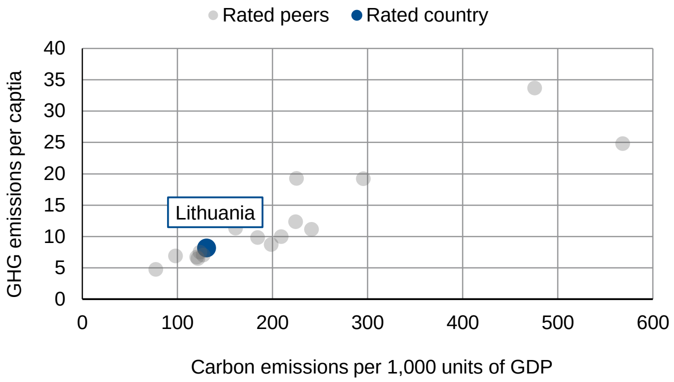
ESG Risk

- **Environment:** Lithuania has made important progress in the development of renewable energy. The share of energy from renewable sources in gross final energy consumption reached 27% in 2020, higher than the EU average of 22%. The country has an ambitious plan to increase this share to 50% by 2030. By then, renewables would cover 70% of electricity production. Reducing the carbon footprint of the economy has proved challenging in recent years, especially due to rising emissions in the transport sector. In addition, resource productivity and the circular economy rate lag behind the EU average and require further policies and investments. Lithuania has dedicated 38% of its Recovery and Resilience Plan to climate action. It plans to allocate the resources to upgrade its building stock, enhance the sustainability of its transport sector and further develop renewable energy, including via offshore wind parks.
- **Social:** Lithuania's performance across key social factors is mixed. The country's labour market is inclusive, with high labour-force participation rates and no gender employment gap. Yet there is high income inequality, and poverty risks are above the EU average, although they are declining, with 23% of the population now at risk of poverty or social exclusion. The EC's Digital Economy and Society Index 2022, which assesses EU member states' digital competitiveness, ranks Lithuania as average (14th) among the EU-27. Adverse demographics are a key challenge. Over the next 20 years, Lithuania's working-age population is projected to decline by 25%, while the old-age dependency ratio is projected to exceed 50.
- **Governance:** Policymaking in Lithuania has largely been effective and enjoyed relative continuity. Membership in the EU and euro area enhances the quality of macroeconomic policies and the macroprudential framework. The centre-right coalition government led by PM Ingrida Šimonytė came to power in 2020, and the next parliamentary election is scheduled for 2024. External security risks for Lithuania have increased since the escalation of the war in Ukraine. However, we believe that Lithuania's and other Baltic states' membership in NATO strongly limits the risk that the conflict will expand into the Baltic region. Both NATO and Lithuania have continually confirmed their commitment to Article 5, which states that if one member of the alliance is subject to an armed attack, other members will consider this as an armed attack against all members and will provide necessary support.

Overview of Scope's qualitative assessments for Lithuania's *ESG Risk*

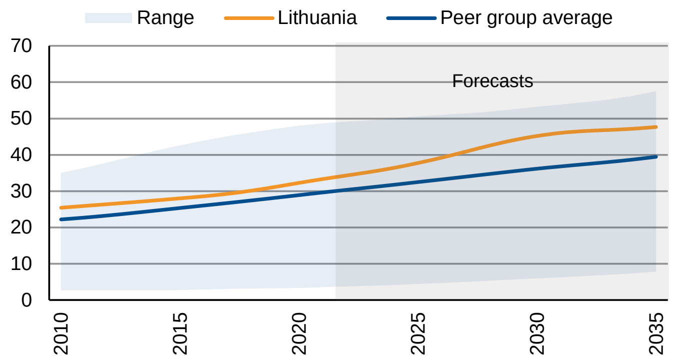
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Environmental factors	Neutral	0	Transition risks in line with peers; ambitious climate agenda
	Social factors	Weak	-1/3	Above EU-average poverty risks, high income inequality, adverse demographics
	Governance factors	Neutral	0	Stable institutional setup, supported by membership in EU and euro area; external security risks mitigated by NATO membership

Emissions per GDP and per capita, $mtCO_2e$



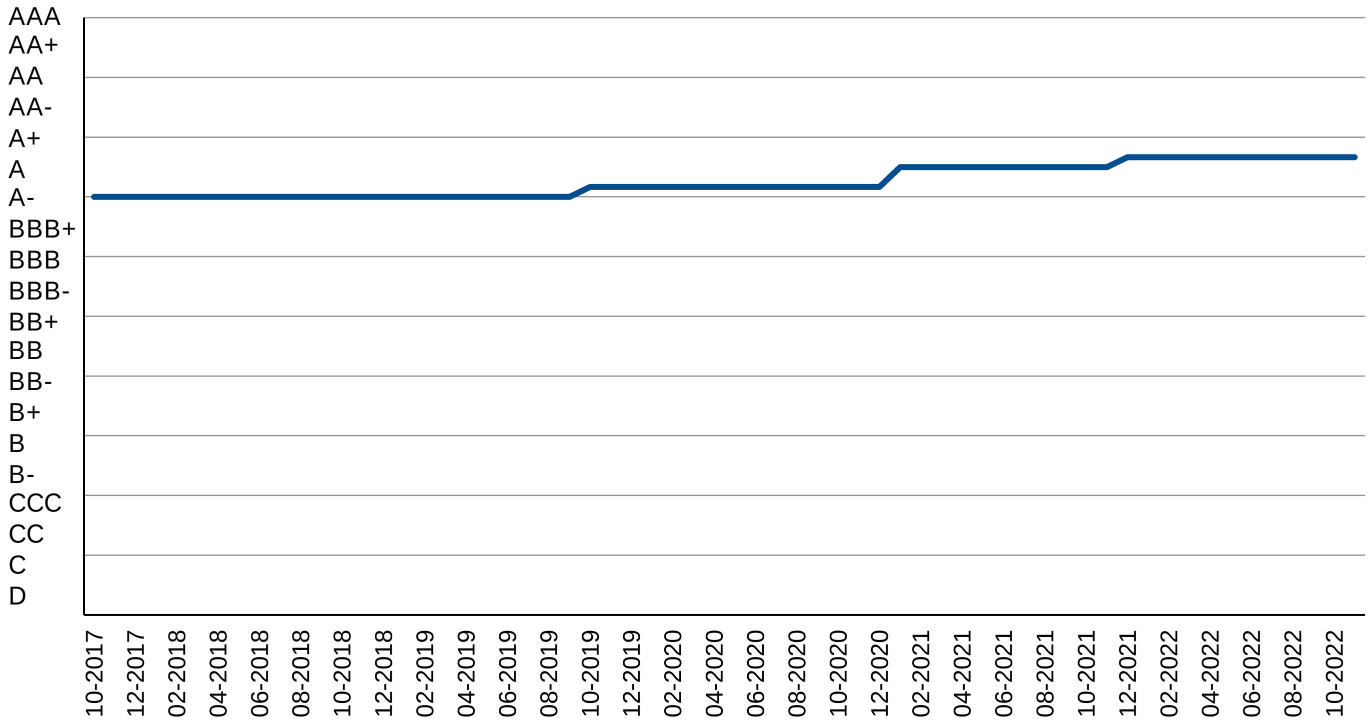
Source: European Commission, Scope Ratings

Old-age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Belgium
Czech Republic
Estonia
France
Italy
Japan
Latvia
Malta
Poland
Portugal
Slovakia
Slovenia
Spain
United States

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	16,879	19,195	19,578	20,216	23,386
	Nominal GDP, USD bn	IMF	47.7	53.8	54.7	56.5	65.5
	Real growth, %	IMF	4.3	4.0	4.6	-0.1	5.0
	CPI inflation, %	IMF	3.7	2.5	2.2	1.1	4.6
	Unemployment rate, %	WB	7.1	6.2	6.3	8.5	7.9
Public Finance	Public debt, % of GDP	IMF	39.3	33.7	35.9	46.6	44.7
	Interest payment, % of revenue	IMF	3.6	2.8	2.3	1.7	0.7
	Primary balance, % of GDP	IMF	1.6	1.5	1.1	-6.7	-0.8
External Economic	Current account balance, % of GDP	IMF	0.6	0.3	3.5	7.3	1.4
	Total reserves, months of imports	IMF	1.4	1.6	1.4	1.5	1.3
	NIIP, % of GDP	IMF	-39.7	-29.2	-23.6	-16.9	-7.2
Financial Stability	NPL ratio, % of total loans	IMF	3.2	2.3	1.0	1.0	0.5
	Tier 1 ratio, % of RWA	IMF	19.7	19.3	19.5	22.7	24.2
	Credit to private sector, % of GDP	WB	41.0	40.4	39.1	37.6	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	143.3	138.6	135.1	130.7	127.0
	Income share of bottom 50%, %	WID	17.1	17.9	18.1	18.1	18.1
	Labour-force participation rate, %	WB	76.1	77.6	78.2	-	-
	Old-age dependency ratio, %	UN	29.3	30.1	31.1	32.3	33.3
	Composite governance indicators*	WB	0.9	0.9	0.9	1.0	-

* Average of the six World Bank Worldwide Governance Indicators

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps)	120

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