Republic of Lithuania
Rating Report

SCOPE **A** POSITIVE OUTLOOK

Credit strengths

- Record of effective macroeconomic policies, sound institutional set-up
- EU and euro area memberships
- Moderate public debt
- Solid medium-run growth prospects

Credit challenges

- Exposure to external shocks
- Adverse demographics
- Banking spill-over risks

Rating rationale:

Lithuania's A rating is underpinned by the following credit strengths: i) a track record of prudent fiscal management anchoring moderate public debt; ii) sound, transparent and accountable economic institutions, underpinned by EU and euro area memberships; and iii) strengthened resilience of the Lithuanian economy, supported by falling net external debt and robust absorption of EU structural and recovery funding, reducing the country's underlying vulnerability to shocks.

However, Lithuania's rating remains constrained by credit challenges relating to: i) adverse demographics reflected in an ageing population and skilled-labour shortages, alongside still lower per-capita income relative to the euro-area average; ii) a large export sector relative to the size of the economy increasing its susceptibility to external shocks; and iii) risks in the banking sector due to the dependence on large Nordic banks.

Lithuania's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a-		-2/3	
Public Finance Risk		25%	aa		0	
External Economic Risk		10%	bbb-		-2/3	
Financial Stability Risk		10%	aaa		-1/3	A
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bb+		-1/3	
	Governance Risk	10%	a+		0	
Overall outcome		**a+**		**+1**	**-2**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 be able to weather the economic fallout from the Russia-Ukraine war without deteriorating its credit fundamentals and that sustained strong economic and fiscal policymaking alongside robust absorption of EU structural and recovery funding will further improve macroeconomic fundamentals over the coming years.

Positive rating-change drivers

- Further improvement in structural indicators, supporting stronger income growth
- Sustained reduction in debt/GDP, supported by fiscal consolidation and/or stronger growth
- Sustained reduction in external vulnerabilities

Negative rating-change drivers

- Significantly higher debt/GDP, due to looser fiscal policy, lower growth
- Substantial deterioration in external accounts
- Widening of macroeconomic imbalances, such as persistent overheating risks
- External shock or heightened geopolitical risk undermining macroeconomic stability

Ratings and Outlook

Local and foreign currency

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

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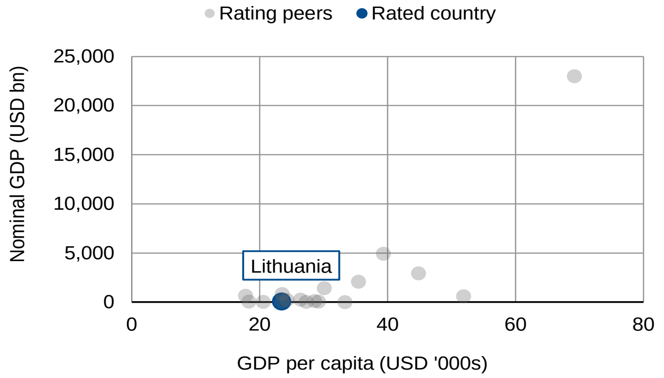
Domestic Economic Risks

- **Growth outlook**: Lithuania's ratings benefit from strengthened resilience of its economy. This is helped by the authorities' prudent and predictable macroeconomic policymaking focused upon supporting sustainable growth, underpinned by the country's EU and euro-area memberships. Following de facto no contraction during the pandemic crisis in 2020, the economy rebounded strongly in 2021, posting a 4.9% growth. At the same time, the Russia-Ukraine war is exerting considerable downward pressure on Lithuania's small, open economy via higher inflationary pressures, lower confidence and foreign trade and supply chain disruptions, all of which pose downside risks to near-term growth. We have thus revised down our growth projection for 2022 to 1.8% (previous review: 4.3%). In the medium-term, we estimate Lithuania's growth potential at around 2.5-3% annually. This is supported by the implementation of strategic public-infrastructure investment projects on the back of Lithuania's prudent absorption of EU funds.
- **Inflation and monetary policy:** Higher global commodity prices were fueling strong inflationary pressures already in H2 2021, before the escalation of the war in Ukraine. Russia-Ukraine conflict will add to inflationary pressures in the short-term, via higher prices for energy, commodities and food. Headline inflation surged to 16.6% yoy in April 2022, the fastest in 25 years. Core inflation (excluding the prices of energy and unprocessed food) was also elevated, at 11.8% yoy in April. We expect average yearly headline inflation of double-digit in 2022, at around 13%. Inflation is forecast to decline to 4.5% in 2023.
- **Labour market:** We do not see major risks to the labour market from the Russia-Ukraine war, with labour market indicators having recovered to their pre-pandemic levels. Unemployment rate reached 6.9% in March 2022, around the levels seen before the Covid-19 crisis. At the same time, skilled-labour shortages and unfavourable demographics constrain longer-term growth prospects.

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

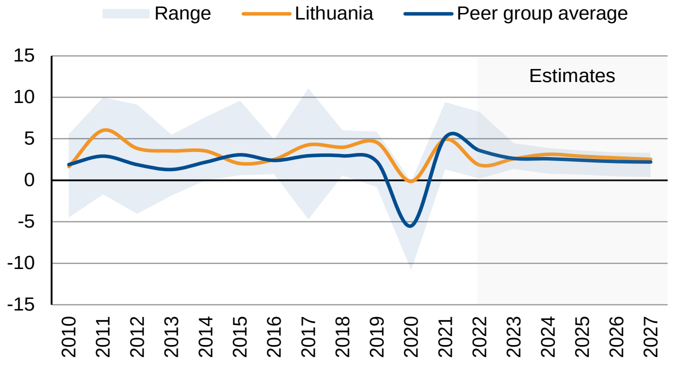
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Weak	-1/3	Medium-run growth potential faces travails from adverse demographics
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Weak	-1/3	Shortages of skilled labour

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings

Real GDP growth, %



Source: IMF, Scope Ratings

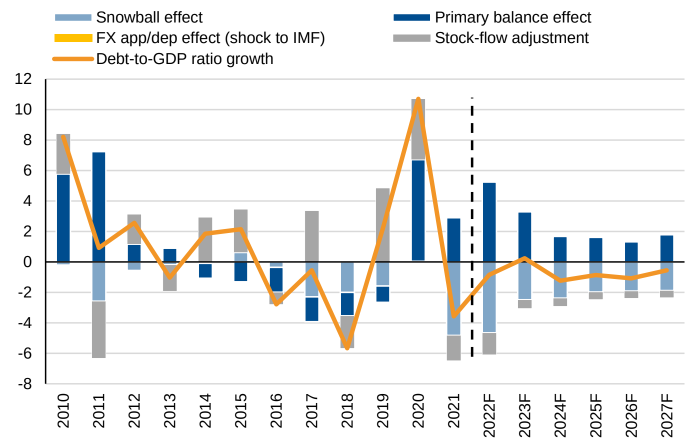
Public Finance Risks

- **Fiscal outlook**: We expect the Lithuanian government to remain committed to fiscal prudence despite increasing budgetary pressures from decelerated near-term growth as well as policy initiatives to provide fiscal support to tackle inflation. We project the general government deficit to widen to 4.5% of GDP in 2022, from 3% of GDP last year. The deficit is projected to narrow to 2.5% of GDP by 2023 and to 1.5% of GDP by 2024, supported by the economic recovery and budgetary consolidation. Medium-term budget reform incorporates strategic goals and expenditure reviews to improve the design of budgets and the effectiveness of public spending. The authorities are also reviewing the tax system to enhance tax collection and improve its efficiency, given the still-sizeable shadow economy and comparatively restricted tax base in Lithuania. The realization of these reforms could enhance Lithuania's fiscal space and could improve our fiscal forecast over the medium-term.
- **Debt trajectory**: On the basis of our medium-term growth, fiscal and inflation outlook, we anticipate that the general government debt will stabilize at 43% of GDP this year. Thus, the debt ratio will remain well below the EU's 60% Maastricht threshold.
- **Market access**: Lithuania's debt structure continues to improve. Lithuania has no foreign-currency debt since February 2022. The average maturity of the debt portfolio is high at close to nine years, which helps keep government financing needs at moderate levels of around 6% of GDP annually over 2022-25.

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

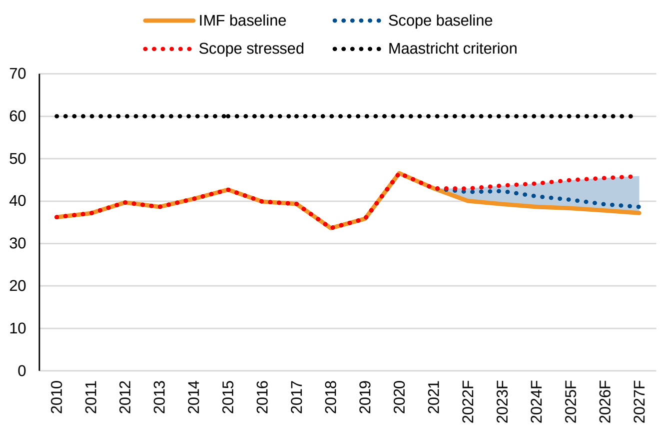
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Track record of fiscal prudence, improving fiscal framework, but still-sizeable shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Moderate debt; stabilization and gradual fall in debt medium run
	Debt profile and market access	Neutral	0	Improving debt structure, long debt maturity, ability to issue on favourable terms

Contributions to changes in debt levels, pps of GDP



Source: IMF, Scope Ratings

Debt-to-GDP forecasts, % of GDP



Source: IMF, Scope Ratings

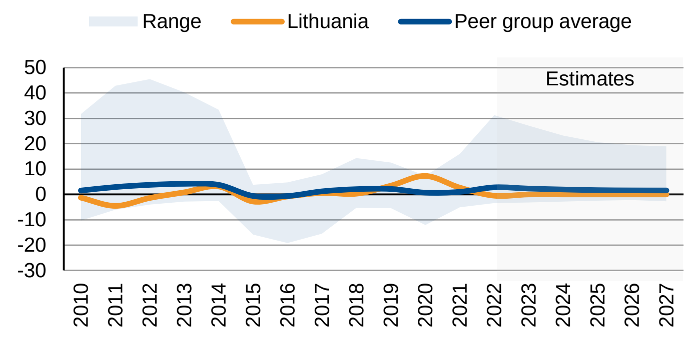
External Economic Risks

- **Current account**: Lithuania has been continuously gaining global export market shares over the past years, supported by improvements in the value-added structure of its exports. At the same time, the importance of trade with Russia has been decreasing. Lithuania's exports of goods of national origin to Russia is small, at around 1.7% of total exports in 2021, while Russia accounted for 12% of total imports of goods, most of which being fuel, oil and associated products. We do not expect major energy disruptions due to Lithuania's halting of Russian energy imports since May, given the country's enhanced energy self-sufficiency.
- **External position**: Lithuania's net international investment position (external financial assets minus liabilities) improved to -7.2% of GDP in Q4 2021, from -24% of GDP in Q4 2019, supported by sizeable current account surpluses. In addition, 45% of gross external liabilities relate to inward foreign direct investment, which curbs the risk that the external balance sheet deteriorates markedly 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 (in goods and services) of around 80% each relative to the size of the economy. As a result, the Russia-Ukraine war will have a direct (due to headline exposures, which are likely to result in shortages of raw materials) and indirect (due to declining exports given slowed growth in the main trading partners) negative impact on the Lithuanian economy. At the same time, we do not expect the war to have a more substantial or more permanent impact on the economy. This is due to the continued improvement of Lithuania's energy security and sustainability. The connection of Baltic states' and continental Europe's electricity networks is planned to be completed by 2025, with a possibility of earlier synchronisation, while the Lithuanian as well as the Baltic natural gas transmission systems have already been connected with the Polish and EU systems.

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

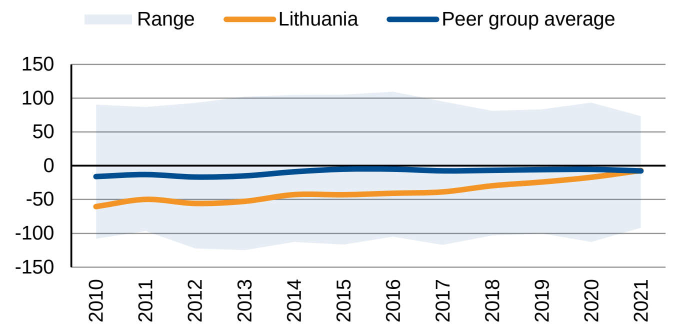
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Current account resilience	Weak	-1/3	Risks from higher reliance on transport services' exports and higher share of lower technology exports
	External debt structure	Neutral	0	Share of direct investment in external liabilities in line with CEE peers, falling levels of net external debt
	Resilience to short-term shocks	Weak	-1/3	Small-open economy

Current account balance, % of GDP



Source: IMF, Scope Ratings

NIIP, % of GDP



Source: IMF, Scope Ratings

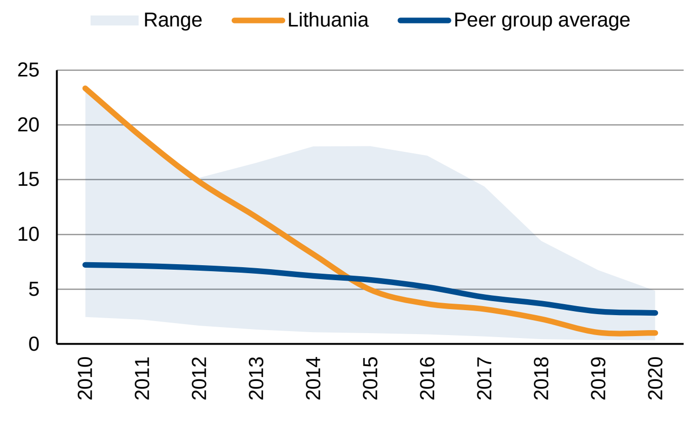
Financial Stability Risks

- **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 banking sector is highly profitable, capitalised and displays strong asset quality. As of Q4 2021, the system-wide Tier 1 capital was 22% of risk-weighted assets, return on equity was 10.7%, both among the highest in the euro area, while the non-performing loan ratio was very low 0.7%.
- **Private debt**: The Russia-Ukraine war and Covid-19 are not expected to cause material macroeconomic imbalances, with household and non-financial corporations' debt at low levels in Q4 2021, at 23.9% and 37.1% of GDP respectively, virtually unchanged compared with pre-Covid levels.
- **Financial imbalances**: Lithuania's banking sector is exposed to concentration and spill-over risks due to the integration with Nordic and Baltic banking systems. Two Swedish banking groups, Swedbank and SEB, account for two-thirds of Lithuanian bank assets. However, capital flight and cross-border money-laundering risks are curbed by the moderate share of non-resident deposits, at 6.3% of total deposits in March, under that of Latvia (15%) and Estonia (12.9%).

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

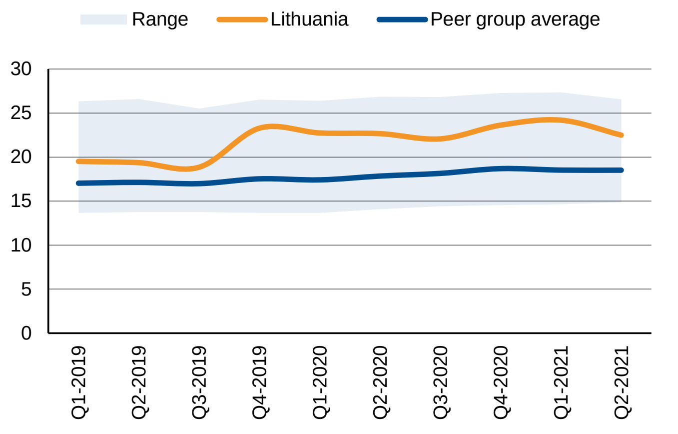
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with a low NPL ratio; profitability and asset quality impacted by the crisis
	Banking sector oversight	Neutral	0	Oversight under the Bank of Lithuania and the ECB as part of Banking Union
	Financial imbalances	Weak	-1/3	Concentration and spill-over risks in the banking system from dominant Nordic banking groups

NPLs, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

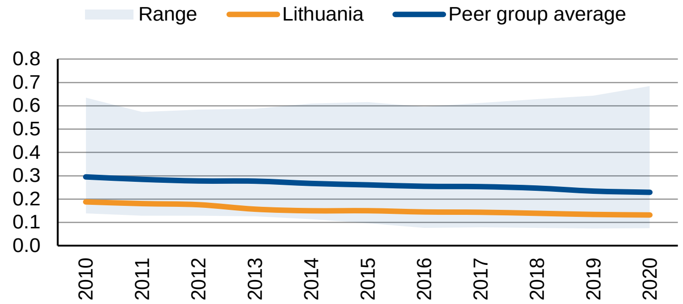
ESG Risks

- **Environment:** By 2030, Lithuania plans to meet 70% of its *electricity* needs via domestic renewable sources. The share of energy from renewable sources in gross final energy consumption reached 26.8% in 2020, higher than the EU's 22.1% and the target of 23%. Lithuania has an ambitious plan to increase this share to at least 45% by 2030. In addition, Lithuania plans to increase the level of decentralisation and to enable consumers to produce electricity by themselves (the share of 'energy prosumers' in total consumers is planned to reach 30% by 2030).
- **Social:** Lithuania's performance across key social factors is mixed. This is reflected in above-EU-average poverty ratios, although ratios are declining (24.5% of the population was at risk of poverty or social exclusion in 2020, compared with 21.5% for the EU-27), relatively high levels of income inequality, unemployment rate (6.9% as of March) around EU averages, and high labour-force participation rates. The EC's Digital Economy and Society Index 2021, which assesses EU member states' digital competitiveness, ranks Lithuania as average (14th) among the EU-27. Adverse demographics are a key credit challenge.
- **Governance:** Policymaking in Lithuania has largely been effective and enjoyed relative continuity. Lithuania's EU and euro-area memberships enhance the quality of macroeconomic policies and its macroprudential framework. In our view, external security risks for Lithuania, which has borders with Russia and Belarus, have increased since the escalation of Ukraine war. However, we believe that Lithuania's and other Baltic states' NATO memberships (since 2004) limit the risk that the conflict could expand into the Baltic region. Lithuania's security guarantees are underpinned by NATO's 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. Both NATO and Lithuania have continually confirmed their commitments to Article 5.

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

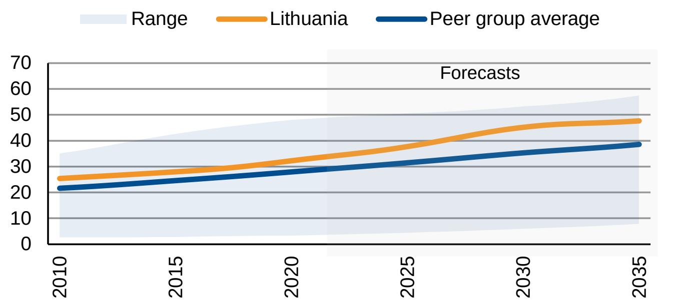
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risks	Neutral	0	Transition risks in line with peers, ambitious climate agenda
	Social risks	Weak	-1/3	Above-EU-average poverty ratio, relatively high income inequality, adverse demographics
	Institutional and political risks	Neutral	0	Comparatively stable governance framework and established institutional set-up, supported by EU and euro area memberships; risen external security risks mitigated by NATO membership

CO_2 emissions per GDP, mtCO2e



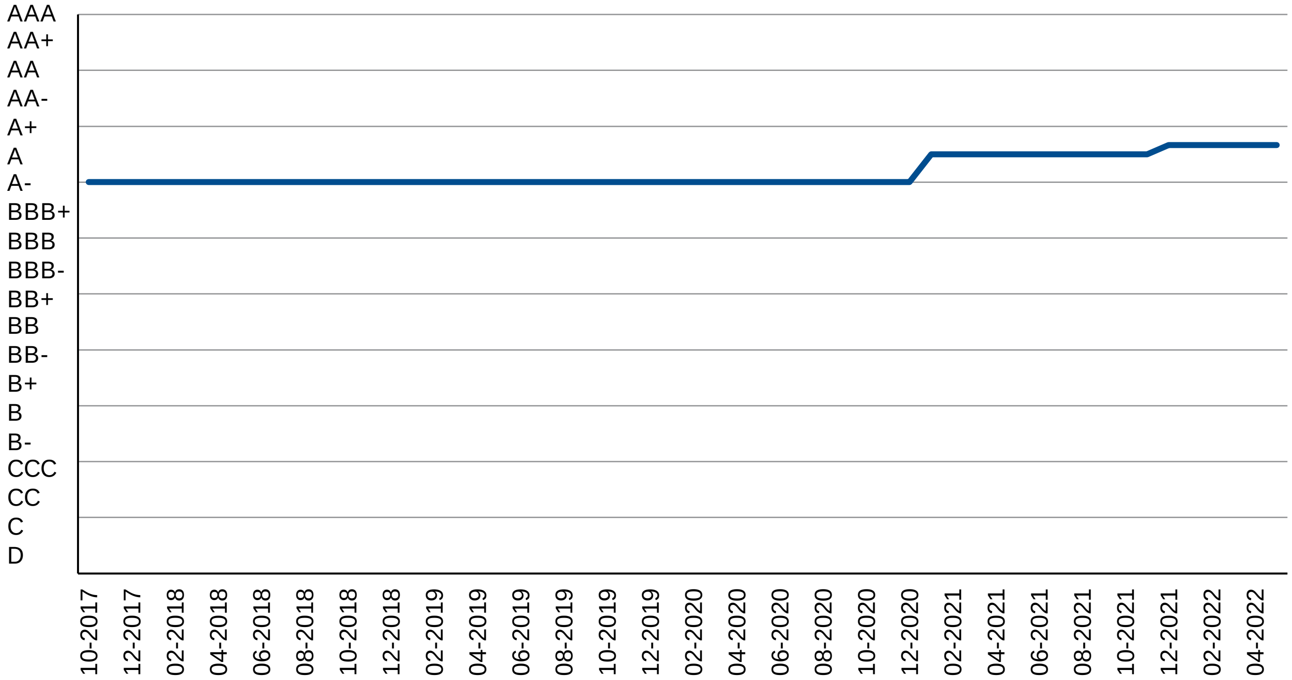
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



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.

Peer group
Belgium
Czech Republic
Estonia
France
Italy
Japan
Latvia
Malta
Poland
Portugal
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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	15.0	16.9	19.2	19.6	20.2	23.5	25.0	27.2
Nominal GDP, USD bn	43.0	47.7	53.8	54.7	56.5	65.5	69.8	76.0
Real growth, %[1]	2.6	4.2	4.0	4.6	0.0	4.9	1.8	2.8
HICP inflation, %	0.7	3.7	2.5	2.2	1.1	4.6	13.0	4.5
Unemployment rate, %[1]	7.9	7.1	6.2	6.3	8.5	7.1	7.3	7.0
Public Finance Risk								
Public debt, % of GDP[1]	39.9	39.3	33.7	35.9	46.6	43.0	43.0	41.5
Net interest payment, % of government revenue	4.0	3.6	2.8	2.3	1.7	0.2	1.0	0.8
Primary balance, % of GDP[1]	1.6	1.6	1.5	1.1	-6.7	-2.9	-4.0	-2.3
External Economic Risk								
Current account balance, % of GDP	-0.8	0.6	0.3	3.5	7.3	2.7	-1.5	-1.0
Total reserves, months of imports	1.1	1.5	1.8	1.5	1.5	1.4	-	-
NIIP, % of GDP	-42.8	-36.5	-30.5	-24.0	-15.8	-7.2	-	-
Financial Stability Risk								
NPL ratio, % of total loans	3.8	2.8	2.4	1.5	1.3	0.7	-	-
Tier 1 ratio, % of risk-weighted assets	19.7	19.4	18.5	23.4	23.4	21.7	-	-
Credit to private sector, % of GDP	42.7	41.0	40.4	39.1	37.6	-	-	-
ESG Risk								
CO_2 per USD 1,000 of GDP, mtCO_2e	145.0	143.7	139.2	134.3	132.0	-	-	-
Income quintile share ratio (S80/S20), x	7.5	7.0	6.5	6.1	-	-	-	-
Labour-force participation rate, %	75.6	76.1	77.6	78.2	-	-	-	-
Old-age dependency ratio, %	29	30	30	31	31	-	-	-
Composite governance indicator[2]	1.0	0.9	0.9	0.9	1.0	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, National statistical office and Central bank, Scope Ratings

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 03 June 2022	75

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