Republic of Lithuania
Rating Report

SCOPE **A** POSITIVE OUTLOOK

Credit strengths

- EU and euro area memberships
- Moderate levels of public debt
- Robust economic growth prospects

Credit challenges

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

Rating rationale:

The Outlook revision to Positive on Lithuania's ratings reflects the following key drivers: i) robust economic recovery prospects and strengthened resilience of the Lithuanian economy, underpinned by the government's credible and effective macroeconomic policy framework and the country's EU and euro-area memberships; ii) continued improvements in external finances on top of persistent current account surpluses, stability in the banking sector, alongside a track record of fiscal prudence underpinning the strength of the government's balance sheet and moderate debt levels.

Scope foresees that improvements in Lithuania's economic and financial stability will further reduce the country's underlying macroeconomic volatility.

However, Lithuania's ratings remain constrained by outstanding credit weaknesses relating to: i) adverse demographics reflected in an ageing population and skilled-labour shortages; ii) still moderate per capita income levels relative to the euro-area average, and wage-productivity growth imbalances; iii) a large export sector relative to the small size of the national economy; and iv) risks in the banking sector related to 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+	Reserve currency adjustment (notches)	-2/3	A
Public Finance Risk		25%	aa-		-1/3	
External Economic Risk		10%	a		-2/3	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Risk	5%	aaa		-1/3	
	Social Risk	5%	bb+		-1/3	
	Governance Risk	10%	a+		0	
Overall outcome		**aa-**		**+1**	**-3**	

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 GmbH.

Outlook and rating triggers

The Positive Outlook represents Scope's opinion that risks to the sovereign ratings are tilted to the upside over the next 12 to 18 months.

Positive rating-change drivers

- Higher growth potential, supported by continued implementation of reform
- Firm downward trajectory in public debt, supported by fiscal consolidation actions
- Further sustained reduction in external vulnerabilities

Negative rating-change drivers

- Weakening public-finance outlook, due, as an example, to significant loosening of fiscal policy
- Material deterioration in external finances
- External shock or heightened geopolitical risk undermining macro-economic 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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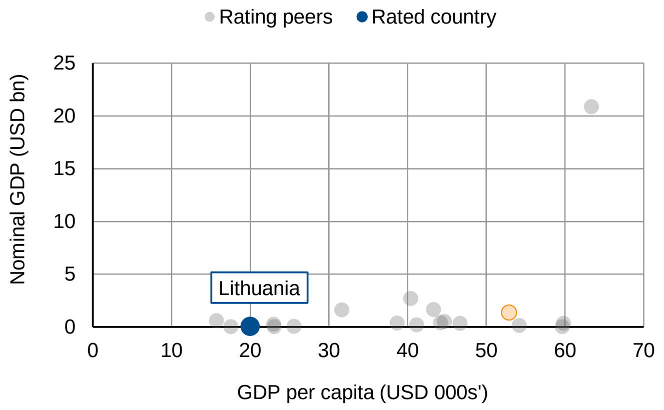
Domestic Economic Risks

- **Growth outlook**: Lithuania's ratings benefit from robust economic recovery prospects and strengthened resilience of the Lithuanian economy. This is helped by the government's prudent and predictable macroeconomic policy making focused upon supporting sustainable growth, underpinned by the country's EU and euro-area memberships. Following an essentially no contraction in 2020, of real GDP growth of 0.0% (seasonally and working day adjusted), Scope projects Lithuania's output to grow 4.7% this year, and 4.3% in 2022 supported by a solid recovery in private consumption and investment, assisted by Lithuania's prudent absorption of EU funds. Scope currently estimates Lithuania's medium-term potential growth at around 2.5% annually. This is supported by implementation of strategic public-infrastructure investment projects co-financed by the EU, including the construction of Rail Baltica connecting the Baltic region with the European rail network (planned to be completed by 2026).
- **Inflation and monetary policy:** Higher energy prices and rising production costs due to shortage of intermediary goods are expected to raise inflation to around 4.3% in 2021 and 3.0% in 2022. These factors are expected to slowly fade in the second half of 2022 and cause inflation to fall towards the 2% target in 2023. While some central banks have started tapering their asset purchase programmes or indicated interest rate rises in the near term, the ECB has signaled that it will maintain its accommodative monetary policy in the near term.
- **Labour market:** Labour market situation has been improving with a continuing economic recovery**.** Unemployment rate declined to 6.7% as of September, around the EU averages, but above the pre-crisis rate of 6.2%.

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

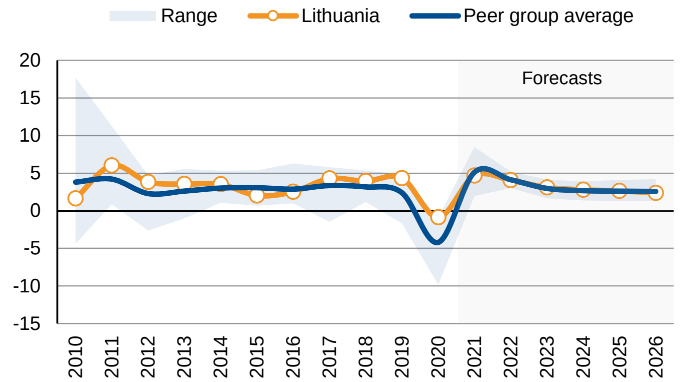
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Weak	-1/3	Medium-run growth potential faces travails from adverse demographics
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; appropriate central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

Nominal GDP, USD bn **and GDP per capita,** USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

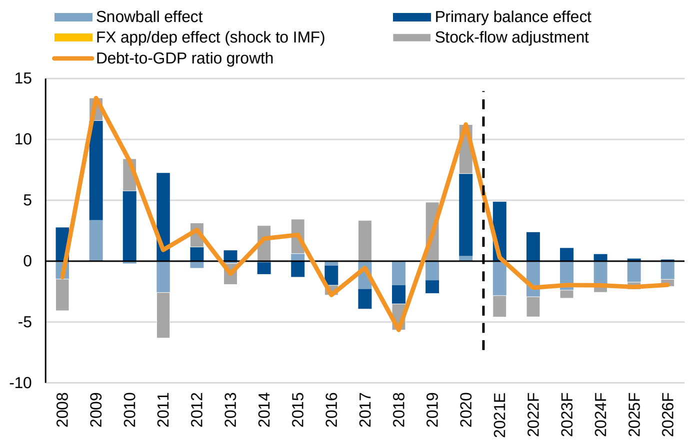
Public Finance Risks

- **Fiscal outlook**: Scope projects the general government deficit to narrow to 3% of GDP in 2022 and further to 1% of GDP in 2023, from 4.3% of GDP this year. This is being actively assisted by an improved outlook for tax revenue growth and a gradual expiry of Covid-19-related expenditure measures, the latter estimated at around 3% of GDP in 2021. Medium-term budget framework reform incorporates strategic goals and expenditure reviews in the design of budgets starting 2022, aimed at improving 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**: Lithuania's general government debt will stabilize and gradually decline to 44% of GDP by 2023, well below the EU's 60% Maastricht threshold. This is supported by solid growth in nominal GDP and narrowing fiscal deficits in the medium-term.
- **Market access**: Lithuania's public finance outlook benefits from favourable financing conditions and a supportive debt profile. Yields on the 10-year government bond was at close to 0.2% at time of writing, anchored by Lithuania's access to the European Central Bank's asset purchase facilities. The average maturity of the Lithuanian debt portfolio is high at 9.7 years, which helps keep general government gross financing needs at a moderate around 6% of GDP annually over 2022-23. Lithuania's foreign-currency denominated debt (reflecting one Eurobond denominated in USD), totaling USD 1.5bn, will be repaid by 2022 through accumulated pre-financing.

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

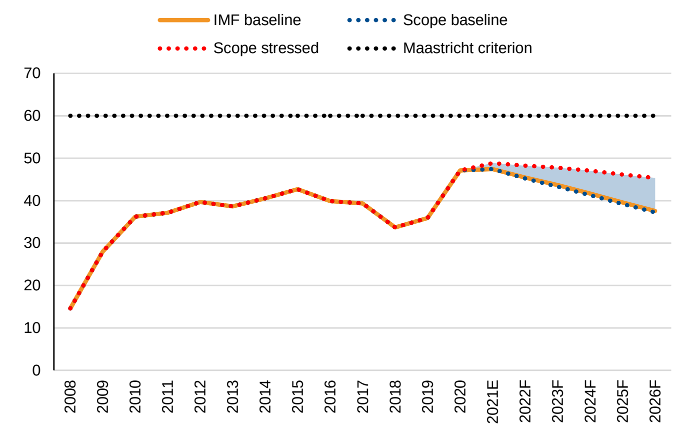
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Weak	-1/3	Track record of fiscal prudence, but still-sizeable shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Still-moderate debt levels
	Debt profile and market 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: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

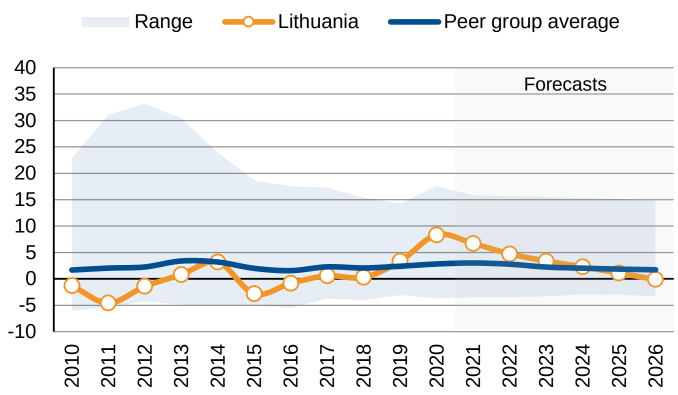
External Economic Risks

- **Current account**: Lithuania has been continuously gaining global export market share over the last five years, supported by improvements in the value-added structure of exports. As a result, Scope projects Lithuania's current-account surplus at around 3% of GDP in 2021 (7.3% of GDP in 2020), before 2% of GDP in 2022. This will further improve Lithuania's external finances.
- **External position**: Lithuania's net international investment position (external financial assets minus liabilities) improved to -11.5% of GDP in Q2 2021, from -28.8% of GDP in Q2 2019. In addition, nearly half of gross external liabilities relate to inward foreign direct investment, which curbs the risk that external balance sheets deteriorate 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 and is reliant on external demand, due to a large export sector (in goods and services) relative to the size of the economy, of around 78%. The recent reform of the EU road transport sector (as part of the EU Mobility Package) could negatively impact Lithuania's transportation services exports to the rest of the EU, the latter accounting for around 13% of Lithuania's total exports. The new reform, which is set to enter into force in early 2022, requires truck drivers to return to their home countries regularly to improve working conditions, and could increase service costs for Lithuanian operators due to extra journeys.

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

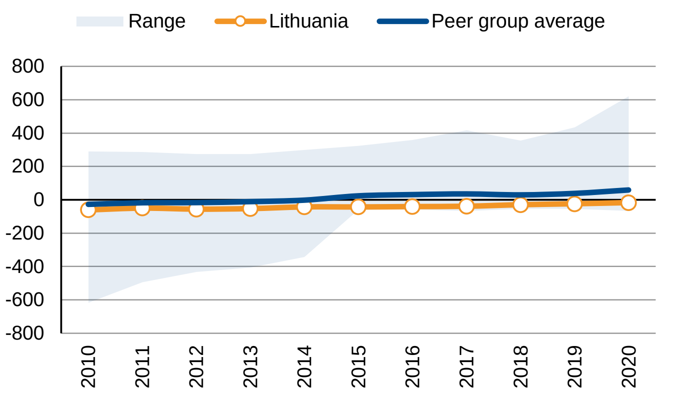
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Current account resilience	Weak	-1/3	Risks from higher reliance on transport services' exports and higher share of lower technology exports
	External debt structure	Neutral	0	Share of direct investment in external liabilities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

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

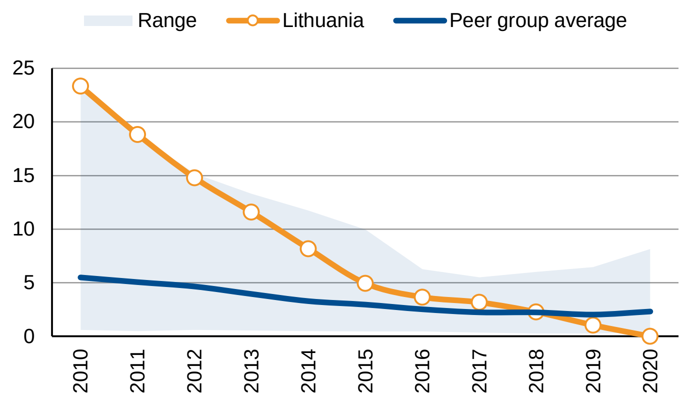
Financial Stability Risks

- **Banking sector**: Scope considers Lithuania's Nordic-dominated banking sector to be in a good position to absorb the current economic shock. The banking sector is highly profitable compared with those of euro-area peers, is highly capitalised and displays strong asset quality. As of Q2 2021, the system-wide tier 1 capital ratio was 22.5% of risk-weighted assets, return on equity was 10.9%, both among the highest in the euro area, and the non-performing loan ratio was very low 0.9%.
- **Private debt**: Covid-19 crisis has not caused exceptional macroeconomic imbalances, with household and non-financial corporations' debt ratios at low levels as of Q2 2021, at 24.2% and 39.4% 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 integration with Nordic and Baltic banking systems. Two Swedish banking groups, Swedbank and SEB, account for 66% of Lithuanian bank assets. However, capital flight and cross-border money-laundering risks are curbed by the small share of non-resident deposits, at 3.6% of total deposits as of October, significantly under that of Latvia (16.2%) and Estonia (15.1%).

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

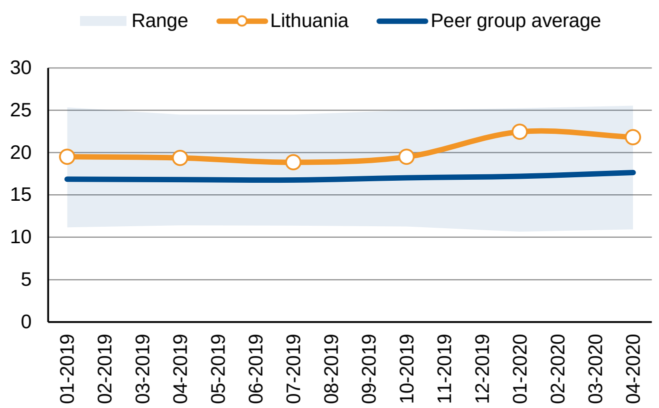
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with a low NPL ratio; profitability and asset quality impacted by pandemic crisis
	Banking sector oversight	Neutral	0	Oversight under 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 GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

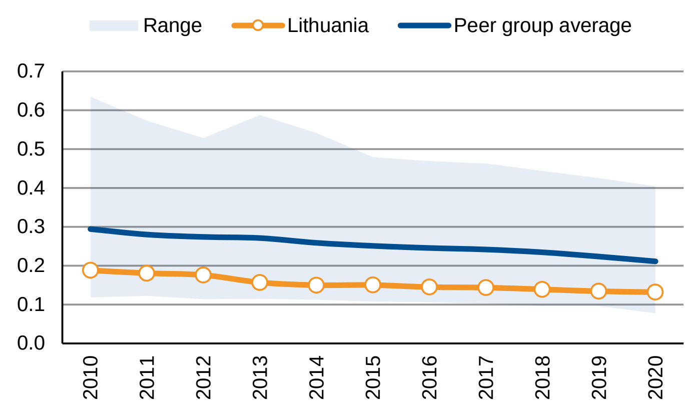
ESG Risks

- **Environment:** Environmental factors are explicitly considered in the rating process via the environment sub-category under the ESG risk pillar. In 2020 Lithuania generated nearly 60% of its electricity from renewables. The share of renewable energy in total energy consumption in Lithuania is estimated at 27.2% in 2020, which exceeds the EU's average of 21.3% and the national target for 2020 of 23%. Lithuania has an ambitious plan to increase this share to 45% by 2030, including by making use of EU development funds, such as EUR 385m in EU funding for renewable-energy installations.
- **Social:** Lithuania's performance across key social factors is mixed. This is reflected in above-EU-average poverty ratios, although ratios are declining (24.8% of the population was at risk of poverty or social exclusion in 2020, compared with 22% for the EU-27 as an entirety), relatively high levels of income inequality, unemployment rate (6.7% as of September) around EU averages, and high labour-force participation rates. The European Commission's Digital Economy and Society Index 2021, which assesses EU member states' digital competitiveness, ranks Lithuania as average (14th) among the EU-27.
- **Governance:** Under governance-related factors in the CVS, Lithuania's performance is stronger compared with that of central and eastern European sovereign peers as assessed under the World Bank's Worldwide Governance Indicators. In general, policymaking in Lithuania has largely been effective and enjoyed relative continuity. Lithuania's EU and euro-area memberships enhance the quality of macroeconomic policy making and Lithuania's macroprudential framework.

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

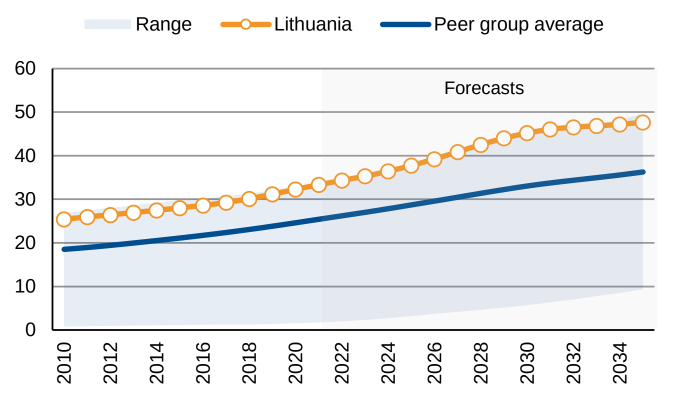
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risks	Weak	-1/3	Transition risks in line with peers, improving but still lower policy measures compared to peers
	Social risks	Weak	-1/3	Above-EU-average poverty ratio, relatively high income inequality, adverse demographics
	Institutional and political risks	Neutral	0	Comparatively stable governance framework, supported by EU and euro area memberships

CO2 emissions per GDP, mtCO2e



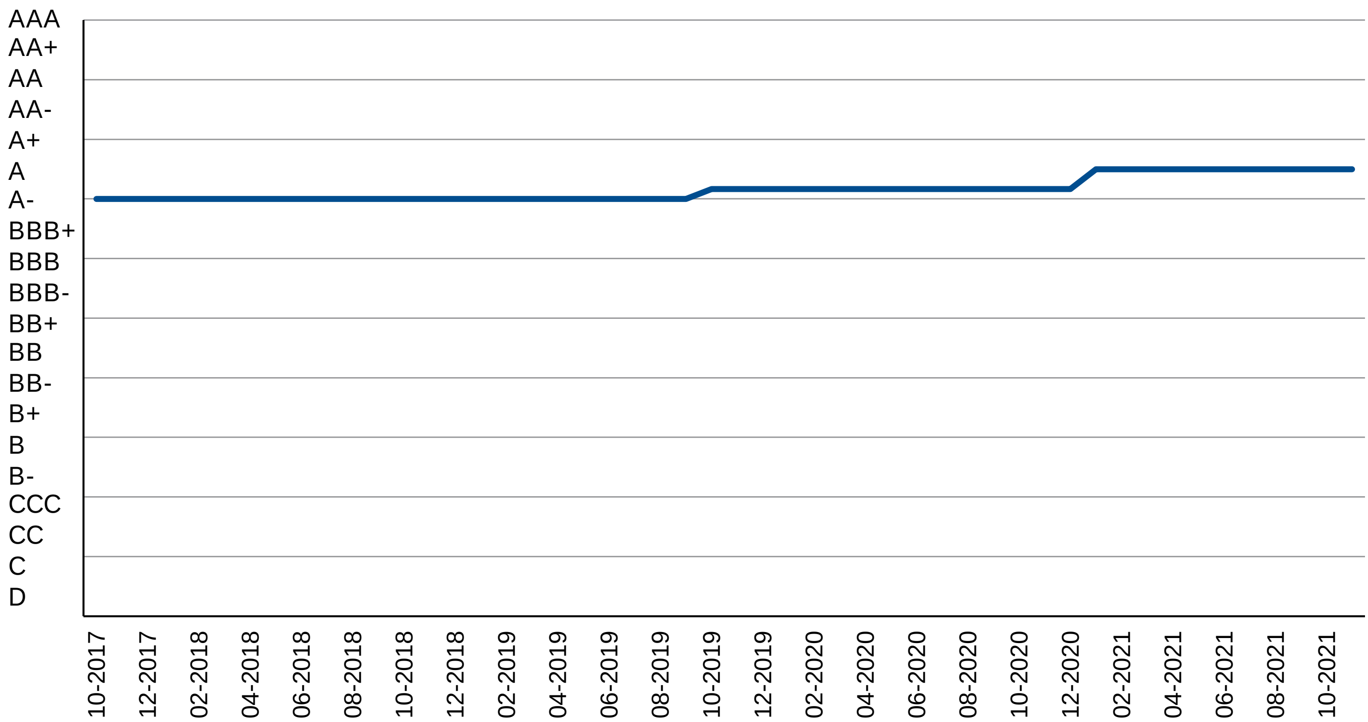
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

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
Latvia
Slovenia
Poland
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	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	15.0	16.9	19.2	19.6	20.0	22.4	24.2
Nominal GDP, USD bn	43.0	47.7	53.7	54.6	55.8	62.6	67.7
Real growth, %[1]	2.6	4.2	4.0	4.6	0.0	4.7	4.3
CPI inflation, %	0.7	3.7	2.5	2.2	1.1	4.3	3.0
Unemployment rate, %[1]	7.9	7.1	6.2	6.3	8.5	6.9	6.2
Public Finance Risk							
Public debt, % of GDP[1]	39.7	39.1	33.7	35.9	46.6	46	45
Interest payment, % of government revenue	4.0	3.6	2.8	2.3	1.7	0.9	0.9
Primary balance, % of GDP[1]	1.6	1.6	1.5	1.1	-6.8	-4.9	-2.4
External Economic Risk							
Current account balance, % of GDP	-0.8	0.6	0.3	3.3	7.3	3.0	2.0
Total reserves, months of imports	1.0	1.4	1.6	1.4	1.5	-	-
NIIP, % of GDP	-42.8	-36.5	-30.5	-24.0	-15.8	-	-
Financial Stability Risk							
NPL ratio, % of total loans	3.7	3.2	2.3	1.0	-	-	-
Tier 1 ratio, % of risk weighted assets	19.1	18.8	18.4	19.5	21.8	-	-
Credit to private sector, % of GDP	42.7	41.0	40.4	39.1	38.1	-	-
ESG Risk							
CO^2 per EUR 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	-	-	-	-
Labour force participation rate, %	75.6	76.1	77.6	78.2	-	-	-
Old age dependency ratio, %	28.6	29.3	30.1	30.4	30.6	31.0	31.5
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, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 9 December 2021	48

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