Country Report

Lithuania

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The Economist Intelligence Unit

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Lithuania

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Highlights

Editor: **Alex Nice**

Forecast Closing Date: **March 10, 2014**

Outlook for 2014-18

- Although considered a potential candidate for the presidency of the European Commission, Dalia Grybauskaite is likely to seek and win a second term as Lithuanian president in the domestic election in May.
- Although the parties in the ruling coalition won the 2012 election on a mildly anti-austerity platform, fiscal policy will remain constrained by a desire to join the euro.
- The budget deficit is estimated to have narrowed to 2.3% of GDP in 2013. In 2014 we forecast a shortfall of 1.9%, in line with the government's target.
- GDP growth exceeded expectations at 3.3% in 2013. The economy is forecast to expand by 3.5% in 2014, supported by growth in real wages and household consumption.
- We expect Lithuania to join the euro zone in 2015. The main risk to this is inflation, although a fall in prices during 2013 should ensure that Lithuania meets the Maastricht criteria when it applies in 2014.
- The current-account deficit will widen during the forecast period owing to an increase in the goods shortfall. At an average of 1.8% of GDP in 2014-18, the current-account deficit will, however, remain well below the 2006-08 level.

Review

- Despite the mixed results of the Eastern Partnership summit in Vilnius, the capital, Lithuania's presidency of the Council of the European Union in the second half of 2013 boosted the prestige of Ms Grybauskaite.
- In January, the Lithuanian government and E.ON, two shareholders of the national gas distribution company, Lietuvos Dujos, launched an arbitration case against Russia's Gazprom, the monopoly gas supplier.
- Real GDP rose by 3.3% year on year in 2013, supported by stronger household consumption and a jump in investment, which expanded by 12.8%.
- The unemployment rate fell again in 2013, to 11.8%. Significantly, given high emigration in recent years, the number of employed rose by 1.3%.
- Real wages rose 3.7% year on year in 2013, the first annual real-terms growth since 2008, helped in part by low inflation and falling unemployment.
- Average annual inflation stood at 1% in 2013. In January it rose by just 0.2% year on year as a result of falling transport and utility prices.
- Exports grew by 6.9% year on year in 2013, however non-oil exports weakened in the second half of the year, due to softening external demand.
- Imports rose by 6.6% year on year in 2013 as household consumption strengthened, resulting in a trade deficit of LTL6.6bn (US$2.7bn; 5.5% of GDP).

Outlook for 2014-18

Political stability

Following the defeat of the centre-right government in the parliamentary election in October 2012, a coalition administration, built around two moderately left-wing parties, was formed. This process was temporarily delayed by the president, Dalia Grybauskaite, who objected to the inclusion of the Labour Party because of accusations against it of electoral misconduct. The government is headed by Algirdas Butkevicius of the Social Democratic Party (LSDP). It includes the Labour Party of Viktor Uspaskich, a consistently controversial figure in Lithuanian politics; the right-wing Order and Justice, led by Rolandas Paksas, an impeached former president; and Lithuanian Poles’ Electoral Action (LLRA), which represents ethnic Poles. Following byelections in March 2013, the coalition now has 87 seats out of 141 in the Seimas (parliament).

In line with an established pattern, Lithuania will continue to be governed by an ideologically disparate coalition. Nevertheless, there remains a broad political consensus in favour of an open economy, pro-Western foreign policy and adoption of the euro.

The government has faced a number of scandals in 2013. In June Birute Vesaite was dismissed as minister of economy and replaced by Evaldas Gustas. Ms Vesaite was accused of allowing a conflict of interest when she travelled to Kazakhstan on a plane owned by a company that was in negotiations with the government. In July three members of the Labour Party were convicted of fraud. Mr Uspaskich and Vitalija Vonzutaite, another labour member of parliament (MP), received custodial sentences, while a third, Vytautas Gapsys (the party leader), was fined LTL35,700 (US$13,500) by the court. All three are appealing against the verdicts. So far, the trial has not destabilised the government or diverted attention away from policy issues.

Lithuania's presidency of the Council of the European Union delivered mixed results, with Ukraine failing to sign an association agreement with the EU at a summit in the Lithuanian capital, Vilnius, in November 2013. However, the rotating presidency raised Ms Grybauskaite's international prestige and has further strengthened her popular support at home.

Election watch

The next presidential election will take place on May 11th. Although she has been touted as a potential contender for the presidency of the European Commission, we expect Ms Grybauskaite to run for domestic re-election in May and win comfortably. A survey in November 2013 indicated that Ms Grybauskaite would get 38.5% of the vote, with none of her declared opponents polling in double digits. Her position is so strong that Mr Butkevicius, who had been rumoured to be interested in running against her, has already indicated that he will not stand. Rather, his party has nominated a member of the European Parliament (MEP), Zigmantas Balcytis, as its candidate for the post. However, even Mr Balcytis does not appear to rate his own chances very highly, and he has already declared his intention to run for re-election to the European Parliament in June 2014. In addition to the presidential poll, elections for the European Parliament will take place on May 25th.

International relations

Lithuania will continue to pursue a foreign policy based on strong Euro-Atlantic ties and a guarded approach to Russia. Russia’s relations with Lithuania have usually been better than with Estonia and Latvia. However, ties have become more fraught since 2006, when the Russian state-owned pipeline operator, Transneft, shut down the Druzhba pipeline, which transports oil to the refinery complex in Lithuania. The unbundling of the gas-transmission network from Lietuvos Dujos, the national energy company, which is part-owned by Russia’s state gas producer, Gazprom, has raised tensions. Lithuania is at the centre of an investigation launched in September 2012 by the European Commission into the activities of Gazprom, over potential abuse of its dominant position in the EU market. The government entered into negotiations in September with Gazprom, concerning a reduction in the price of imported gas but no deal has yet been reached. Like its Baltic neighbours, Lithuania has been the target of Russian economic pressure. In October 2013 Russia banned Lithuanian dairy imports, further increasing tensions between the two countries. The invasion of Ukraine by Russia in late February 2014, ostensibly to protect the rights of Russian "compatriots" will have increased concern in Lithuania regarding Russia's policy toward the former Soviet space. In contrast to the other Baltic states, however, Lithuania does not have a sizeable ethnic Russian community. Nevertheless, the crisis will only consolidate Lithuania's already strong commitment to NATO and European integration.

Another problem that the new administration has started to address is a deterioration in relations with neighbouring Poland in recent years. This is rooted in antagonism over the treatment of the ethnic Polish minority in Lithuania. However, ties have begun to improve, not least because of the inclusion in the coalition of a party representing the ethnic Polish minority. In mid-February 2013, a visit by Bronislaw Komorowski, the Polish president, to Lithuania for its independence celebrations confirmed the trend in this direction. Good ties with Poland will be vital in order for Lithuania to be effective in EU institutions and to press ahead with joint energy projects.

Policy trends

During the electoral campaign, the parties at the core of the new government stood on mildly anti-austerity platforms. This included promises for greater flexibility regarding the budget deficit target. Although the government raised the minimum wage by 18% in January 2013, economic policy will remain circumscribed by the government’s desire to join the euro. This policy objective was given further impetus in early June when the EU endorsed Lithuania’s convergence plan for deficit reduction and confirmed that its neighbour, Latvia, will join the single currency in 2014. A degree of fiscal consolidation will therefore remain a central element of economic policy. It will be vital in order to keep public debt on a downward path, and so reduce the drain of debt financing. It is also necessary to maintain the credibility of the litas’s peg to the euro and to qualify for adoption of the single currency. In late January 2013 the new government set out its broad policy priorities. Chief among these were pledges to increase employment, counter emigration, promote energy security and aim for adoption of the euro by 2015 (a year later than officially planned by the previous government). With inflation having tumbled through 2013, we believe that the government is likely to meet its target of adopting the single currency in 2015.

The policy agenda in 2014 will be dominated by energy concerns, the implications of the on-going crisis in Ukraine, and accession to the euro zone. The Lithuanian government will continue to implement measures to reduce reliance on Russian gas, which currently meets 100% of the country's energy supplies. A new liquefied natural gas (LNG) terminal in Klaipeda will become operational in the second half of 2014. Mr Butkevicius has also raised the prospect of a second referendum on the construction of a new nuclear-power plant, previously rejected by voters in a 2012 poll.

Since the outbreak of the global financial crisis of 2008-09, the government has avoided recourse to the IMF, and has been financing its larger budget deficits through the international capital markets.

Fiscal policy

In April 2013 the Ministry of Finance submitted its revised convergence programme for 2013-15. This targeted a steady reduction of the budget deficit to 2.5% of GDP in 2013. However, a strong budgetary performance in the first three quarters of 2013 indicates that the target for that year is likely to be surpassed.

During the forecast period we expect the deficit to narrow gradually, as spending is kept in check and revenue continues to rise on the back of steady economic growth. This will be particularly the case given the government's commitment to meeting the conditions for euro zone entry. All parties remain committed to adhering to the EU's fiscal compact, and we do not expect the deficit to exceed the Maastricht criterion of 3% of GDP.

In October the government issued its budget for 2014, which targets a shortfall of 1.9% of GDP. Revenue is expected to rise by 3%, owing in part to rising tax income as consumption and earnings rise. Expenditure is forecast to rise less quickly, owing in part to the expectation of falling debt-servicing costs. We believe that the government's target is broadly realistic, and forecast that the deficit will come in on target in 2014, narrowing to 1% of GDP by 2018.

Monetary policy

We expect the Bank of Lithuania (BoL, the central bank) to continue with its main policy objectives of maintaining the currency board (whereby the monetary base is fully backed by foreign-exchange reserves) and ensuring price stability. After rising slowly at the beginning of the year, the stock of outstanding credit extended by banks to residents contracted in every month in the second half of the year in annual terms, and fell by 15% over the year as a whole. With the process of post-crisis deleveraging therefore still ongoing (albeit at a slower pace than in previous years), a fundamental recovery in credit growth is unlikely in 2014. This is in part underpinned by a high level of non-performing loans (NPLs), which has caused banks to tighten lending criteria. However, the fundamentals of the sector remain sound, with the Swedish banks that own most of the Lithuanian banking sector (and are among the best capitalised in Europe) unlikely to refuse to roll over existing debt.

International assumptions

	2013	2014	2015	2016	2017	2018
Economic growth (%)						
US GDP	1.9	3.0	2.6	2.5	2.4	2.6
Euro zone GDP	-0.4	1.1	1.4	1.4	1.4	1.6
World GDP	2.9	3.6	3.8	3.9	3.9	4.0
World trade	2.9	5.2	5.0	5.3	5.4	5.4
Inflation indicators (% unless otherwise indicated)						
US CPI	1.5	2.2	2.2	2.3	2.3	2.5
EU28 CPI	1.6	1.3	1.9	2.0	2.1	2.2
Manufactures (measured in US$)	-3.1	0.0	0.9	1.8	1.9	2.0
Oil (Brent; US$/b)	108.9	105.5	107.3	103.8	97.5	93.0
Non-oil commodities (measured in US$)	-6.8	-5.6	2.9	0.7	1.8	2.8
Financial variables						
US$ 3-month commercial paper rate (av; %)	0.1	0.1	0.2	1.0	1.9	2.9
Exchange rate LTL:US$ (av)	2.60	2.70	2.74	2.74	2.72	2.71
Exchange rate US$:€ (av)	1.33	1.29	1.26	1.26	1.27	1.26

Economic growth

Overall real GDP growth stood at 3.3% in 2013. The economy expanded by 2.9% year on year in the second half of 2013, a slowdown from 3.7% in the first half. The slowdown largely reflected an improvement in private consumption and the consequent impact on imports, which led net exports to make a smaller contribution to overall growth. Private consumption rose by 5.5% year on year in the second half of 2013, up from 4.1% in the first half, helping to underpin import growth of 7.2% in July-December year on year. By contrast, exports rose by 4.6%, a significant slowdown from the first half of the year, owing to weaker demand in key export markets, notably Russia. Nevertheless, growth was faster in the second half of the year than expected, owing to rapid expansion in investment, which rose by 12.8% year on year in 2013 as a whole.

With strengthening household consumption pushing up imports, the external sector is forecast to make a net negative contribution to growth in 2014 for the first time since 2010. The weakening rouble and lower growth in Russia will add to this trend. Nevertheless, Lithuania's export base is relatively well diversified, companies have made significant competitiveness gains since the global financial crisis (which have, so far, been maintained), and the country's other main export markets—notably Germany, Sweden, Poland and the other Baltic states—are among Europe's strongest economies. As a result, Lithuania should maintain comparatively balanced growth in the coming years compared with the pre-crisis period, with external imbalances kept in check.

With the external sector unlikely to provide a net contribution to growth in 2014, private consumption will pick up the slack, rising by 4%. This will result in overall growth of 3.5% this year. Real GDP growth is forecast to remain steady thereafter, averaging 3.5% in 2015-18.

Policymakers are concerned about emigration, as the country's population dipped below 3m at the start of 2013, which could hinder growth prospects and put pressure on the public finances towards the end of the forecast period and beyond. Data indicate that net emigration since mid-2008 reached almost 200,000 by the end of October 2013, and that those leaving have been disproportionately young. The dependency ratio jumped by 4.2 percentage points between 2007 and 2012, the fastest rate in the EU (the bloc's average was a 1.5-percentage-point increase).

Economic growth

%	2013[a]	2014[b]	2015[b]	2016[b]	2017[b]	2018[b]
GDP	3.3	3.5	3.4	3.4	3.5	3.8
Private consumption	4.8	4.0	3.5	3.9	4.2	4.3
Government consumption	1.8	1.0	1.5	1.5	1.5	1.5
Gross fixed investment	12.8	4.5	6.0	6.5	6.5	6.0
Exports of goods & services	9.5	5.2	4.8	5.0	4.8	4.6
Imports of goods & services	9.8	7.3	4.8	5.3	5.3	5.3
Domestic demand	26.3	-7.5	4.9	5.3	5.7	1.7
Agriculture	1.5	2.0	1.5	2.0	2.0	2.0
Industry	2.0[c]	3.0	3.5	3.7	3.8	3.8
Services	5.0[c]	3.4	3.4	3.4	3.4	3.4

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Economist Intelligence Unit estimates.

Inflation

Consumer price inflation slowed sharply in 2013, owing to lower global food and energy prices. Year-on-year price growth was 0.4% in August, September, October, November and December, representing a 40-month low, and fell to 0.2% in January 2014. Weaker inflation means that Lithuania is likely to meet the EU’s Maastricht criteria for entry to the euro zone when it applies in early 2014. Under the Maastricht criteria, Lithuania’s trailing 12-month harmonised index of consumer prices (HICP) average must not be more than 1.5 percentage points higher than the average of that in the three EU member states with the lowest HICP growth. In the 12 months to December 2013 Lithuania’s average HICP inflation was 1.2%, 0.9 percentage points higher than the average of the three EU members with the lowest rates (excluding Greece as an outlier).

We expect price growth to remain low in the forecast period, with demand-side pressures likely to grow only gradually and global food and energy costs unlikely to be particularly inflationary. The government has complained to Gazprom, the Russian supplier of 100% of the country’s gas, that its export prices are too high. According to EU figures, Lithuania has the second-highest netback gas prices in Europe after Bulgaria. The completion of the LNG terminal at Klaipeda in 2014 may lead to a cut in energy bills for consumers and businesses and push down slightly on inflation from 2015. We forecast average annual inflation of 3.8% in 2015-18.

Exchange rates

Under the currency board, the monetary base is fully backed by the foreign-exchange reserves of the BoL, and the litas has been pegged to the euro at LTL3.45:€1 since February 2002. Our central forecast is that Lithuania will maintain the currency board until it adopts the euro in 2015. The Lithuanian authorities remain committed to euro adoption. Over two-thirds of total bank loans are denominated in foreign currencies (primarily the euro). In order to avoid a shift in the exchange rate, the previous government pursued a policy of “internal devaluation”—falls in wages and prices—which has helped Lithuania to make progress on competitiveness.

External sector

We estimate that Lithuania's current account recorded a surplus equivalent to US$370m (0.8% of GDP) in 2013, a significant upward revision from our previous report. It also marks the strongest outturn since 2009; in 2012 the current account recorded a deficit of US$100m. The biggest factor driving the current account’s transition into surplus in 2013 was the current transfers account, which rose by LTL1.7bn (US$650m) over the year compared with 2012. A rise in EU support funds and stronger economic performance in the UK and Ireland, where many migrant workers are based, have underpinned the rise in transfer payments.

The financial account posted a LTL3.1bn shortfall in 2013, a significant jump from the LTL2.2bn deficit in 2012. This was partly owing to the redemption of a €1bn Eurobond in March 2013. As a result, international reserves fell by LTL2bn over the year.

In 2014 we forecast a widening of the external shortfall to around 1% of GDP. Import growth should continue to strengthen as domestic demand recovers, and the removal of supportive base effects will prevent exports rising as quickly as they have during 2013. On the financial account, there are no Eurobond redemptions in 2014 (the next will be a US$1.5bn bond that matures in 2015, according to Ministry of Finance data), and therefore the financial account should look healthier. As a result, we do not see the recent pressure on foreign reserves becoming a serious problem.

The trade deficit is expected to increase during 2015-18 as external demand falters and relative competitiveness falls. These factors will push up the current-account deficit over the forecast period. We expect the current-account deficit to remain contained, but to widen to 2.7% of GDP by 2018.

Forecast summary

Forecast summary

(% unless otherwise indicated)

	2013[a]	2014[b]	2015[b]	2016[b]	2017[b]	2018[b]
Real GDP growth	3.3	3.5	3.4	3.4	3.5	3.8
Industrial production growth[c]	3.3	4.3	4.4	4.3	4.3	4.3
Gross agricultural production growth	1.5	2.0	1.5	2.0	2.0	2.0
Unemployment rate (av)	11.8	11.2	10.6	10.0	9.5	9.2
Consumer price inflation (av; national measure)	1.0	1.5	3.2	3.4	3.8	4.4
Consumer price inflation (end‑period; national measure)	0.4	3.4	3.1	2.6	5.0	4.1
Consumer price inflation (av; EU harmonised measure)	1.2	1.6	3.3	3.5	3.9	4.5
Short-term interbank rate	0.1	0.2	0.2	0.5	1.0	1.0
General government balance (% of GDP)	-2.3[d]	-1.9	-1.6	-1.4	-1.2	-1.0
Exports of goods fob (US$ bn)	31.8	33.3	35.4	37.5	39.5	42.1
Imports of goods fob (US$ bn)	33.5	35.8	38.4	41.0	43.5	46.8
Current-account balance (US$ bn)	0.4	-0.4	-0.7	-1.0	-1.3	-1.7
Current-account balance (% of GDP)	0.8	-0.8	-1.3	-2.0	-2.3	-2.7
External debt (year-end; US$ bn)	29.6[d]	31.1	33.9	37.6	40.9	46.8
Exchange rate LTL:US$ (av)	2.60	2.70	2.74	2.74	2.72	2.71
Exchange rate LTL:US$ (end-period)	2.51	2.74	2.74	2.73	2.73	2.74
Exchange rate LTL:Rb (av)	0.082	0.085	0.083	0.083	0.083	0.088
Exchange rate LTL:€ (end-period)	3.45	3.45	3.45	3.45	3.45	3.45

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Sales of industrial production. Total industry except construction. [d] Economist Intelligence Unit estimates.

Data and charts

Annual data and forecast

	2009[a]	2010[a]	2011[a]	2012[a]	2013[a]	2014[b]	2015[b]
GDP							
Nominal GDP (US$ m)	37,060	36,728	43,088	42,359	45,935	46,427	48,871
Nominal GDP (m)	92,032	95,676	106,893	113,735	119,469	125,483	133,921
Real GDP growth (%)	-14.8	1.6	6.0	3.7	3.3	3.5	3.4
Expenditure on GDP (% real change)							
Private consumption	-17.8	-3.7	4.8	3.9	4.8	4.0	3.5
Government consumption	-1.4	-3.4	0.3	0.6	1.8	1.0	1.5
Gross fixed investment	-39.5	1.9	20.7	-3.6	12.8	4.5	6.0
Exports of goods & services	-12.6	17.4	14.1	11.8	9.5	5.2	4.8
Imports of goods & services	-28.1	17.9	13.7	6.1	9.8	7.3	4.8
Origin of GDP (% real change)							
Agriculture	1.4	-6.8	8.2	11.8	1.5	2.0	1.5
Industry	-24.4	4.0	11.4	3.7[c]	2.0[c]	3.0	3.5
Services	-12.4	1.3	4.9	8.0[c]	5.0[c]	3.4	3.4
Population and income							
Population (m)	3.2	3.1	3.1	3.0	3.0	3.0	2.9
GDP per head (US$ at PPP)	17,036	17,737	19,707	21,116	22,240	23,463	24,876
Recorded unemployment (av; %)	13.8	17.8	15.4	13.4	11.8	11.2	10.6
Fiscal indicators (% of GDP)							
General government revenue	35.5	35.0	33.2	32.7	32.7[c]	32.2	30.8
General government expenditure	44.9	42.2	38.7	36.1	35.0[c]	34.2	32.3
General government balance	-9.4	-7.2	-5.5	-3.3	-2.3[c]	-1.9	-1.6
Public debt	29.5	38.3	39.1	41.0	40.0[c]	38.5	36.7
Prices and financial indicators							
Exchange rate LTL:US$ (av)	2.48	2.61	2.48	2.69	2.60	2.70	2.74
Exchange rate LTL:US$ (end-period)	2.41	2.61	2.67	2.61	2.51	2.74	2.74
Consumer prices (av; %)	4.5	1.3	4.1	3.1	1.0	1.5	3.2
Stock of money M1 (% change)	-5.5	24.3	14.3	14.6	10.9	5.5	6.7
Stock of money M2 (% change)	0.7	9.4	4.8	7.2	8.3	4.9	5.9
Lending interest rate (av; %)	8.4	6.0	5.8	5.3	5.2	5.3	5.3
Current account (US$ m)							
Trade balance	-1,639	-2,212	-2,494	-1,452	-1,700	-2,510	-2,930
Goods: exports fob	15,419	19,679	27,029	28,771	31,760	33,320	35,420
Goods: imports fob	-17,058	-21,890	-29,524	-30,222	-33,460	-35,830	-38,350
Services balance	1,017	1,512	1,979	1,852	1,830	1,910	2,010
Primary income balance	459	-1,043	-1,601	-1,755	-1,700	-1,830	-1,880
Secondary income balance	1,626	1,758	1,498	1,254	1,940	2,042	2,149
Current-account balance	1,463	15	-619	-100	370	-388	-651
External debt (US$ m)							
Debt stock	32,037	29,814	29,988	27,898	29,573[c]	31,111	33,893
Debt service paid	6,364	8,758	6,749[c]	10,294[c]	6,443[c]	6,768	6,594
Principal repayments	5,689	8,014	5,770[c]	9,805[c]	6,028[c]	6,346	6,104
International reserves (US$ m)							
Total international reserves	6,626	6,599	8,210	8,529	8,072	11,817	12,835

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Economist Intelligence Unit estimates.
Source: IMF, International Financial Statistics.

Quarterly data

	2012 1 Qtr	2 Qtr	3 Qtr	4 Qtr	2013 1 Qtr	2 Qtr	3 Qtr	4 Qtr
Central government finances (LTL m)[a]								
Revenue	7,149	8,034	7,889	9,287	7,402	8,258	8,647	8,951
Expenditure	8,426	8,916	7,927	8,784	8,500	8,559	7,950	8,449
Balance	-1,278	-882	-38	503	-1,098	-301	697	501
Output								
GDP at chained 2000 prices (LTL m)	18,940	20,451	22,843	21,645	19,594	21,235	23,357	22,420
GDP at chained 2000 prices (% change, year on year)	3.8	1.8	5.0	4.0	3.5	3.8	2.2	3.6
Industrial production (% change, year on year)	2.8	-3.8	6.6	8.7	6.4	9.5	0.2	-1.7
Employment, wages & prices								
Unemployment rate (% of the labour force)	14.5	13.3	12.5	13.2	13.1	11.7	10.9	11.4
Consumer price index (2000=100)	136.5	138.3	138.9	139.2	139.4	140.1	139.5	139.8
Consumer price index (% change, year on year)	3.6	2.7	3.2	2.9	2.1	1.3	0.4	0.4
Producer price index (2000=100)	149.1	147.8	149.6	147.1	147.5	142.7	144.4	141.1
Producer price index (% change, year on year)	8.4	4.3	5.0	2.6	-0.2	-2.6	-3.2	-3.5
Financial indicators								
Exchange rate LTL:US$ (av)	2.63	2.69	2.76	2.66	2.62	2.65	2.61	2.53
Exchange rate LTL:US$ (end-period)	2.59	2.76	2.68	2.61	2.70	2.65	2.56	2.51
Exchange rate LTL:€ (end-period)	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
Deposit rate (av; %)	1.38	1.10	1.01	0.86	0.72	n/a	n/a	n/a
Lending rate (av; %)	5.70	5.58	5.33	4.51	4.58	n/a	n/a	n/a
Money market rate (av; %)	0.18	0.15	0.16	0.08	0.11	0.10	0.14	0.14
M1 (av; LTL m)	30,844	31,847	32,562	35,894	35,673	36,345	37,178	39,808
M1 (% change, year on year)	13.5	13.3	12.8	14.6	15.7	14.1	14.2	10.9
M2 (av; LTL m)	49,671	50,707	51,833	53,623	53,754	53,284	53,911	56,280
M2 (% change, year on year)	5.2	6.0	5.7	7.2	8.2	5.1	4.0	5.0
Stockmarket index (end-period; Jan 1st 2000=100)	314.9	339.9	343.8	355.1	393.6	404.0	422.0	421.6
Stockmarket index (% change, year on year)	-25.4	-25.5	-2.1	21.7	20.0	23.9	28.5	23.3
Sectoral trends								
Agriculture livestock purchased ('000 tonnes)	55	61	63	66	62	66	63	70
Agriculture livestock purchased (% change, year on year)	4.4	11.8	0.8	2.2	14.1	8.9	0.3	6.5
Foreign trade (LTL m)								
Exports fob	17,678	18,067	21,021	22,813	20,770	20,237	21,744	22,028
Imports cif	20,306	19,399	22,745	23,464	21,893	21,808	24,163	23,658
Trade balance	-2,628	-1,332	-1,725	-652	-1,123	-1,572	-2,419	-1,629
Foreign payments (US$ m)								
Merchandise trade balance	-806	-311	-367	32	-281	-333	-653	n/a
Services balance	342	659	469	382	354	647	567	n/a
Primary income balance	-542	-249	-566	-398	-505	-547	-431	n/a
Current-account balance	-846	626	-90	211	-277	575	8	n/a
Reserves excl gold (end-period)	7,674	6,564	7,851	8,218	6,911	7,077	7,743	7,847

[a] Central government budget; Ministry of Finance data.

Sources: IMF, International Financial Statistics (IFS); Statistics Lithuania, Economic and Social Development in Lithuania; Ministry of Finance.

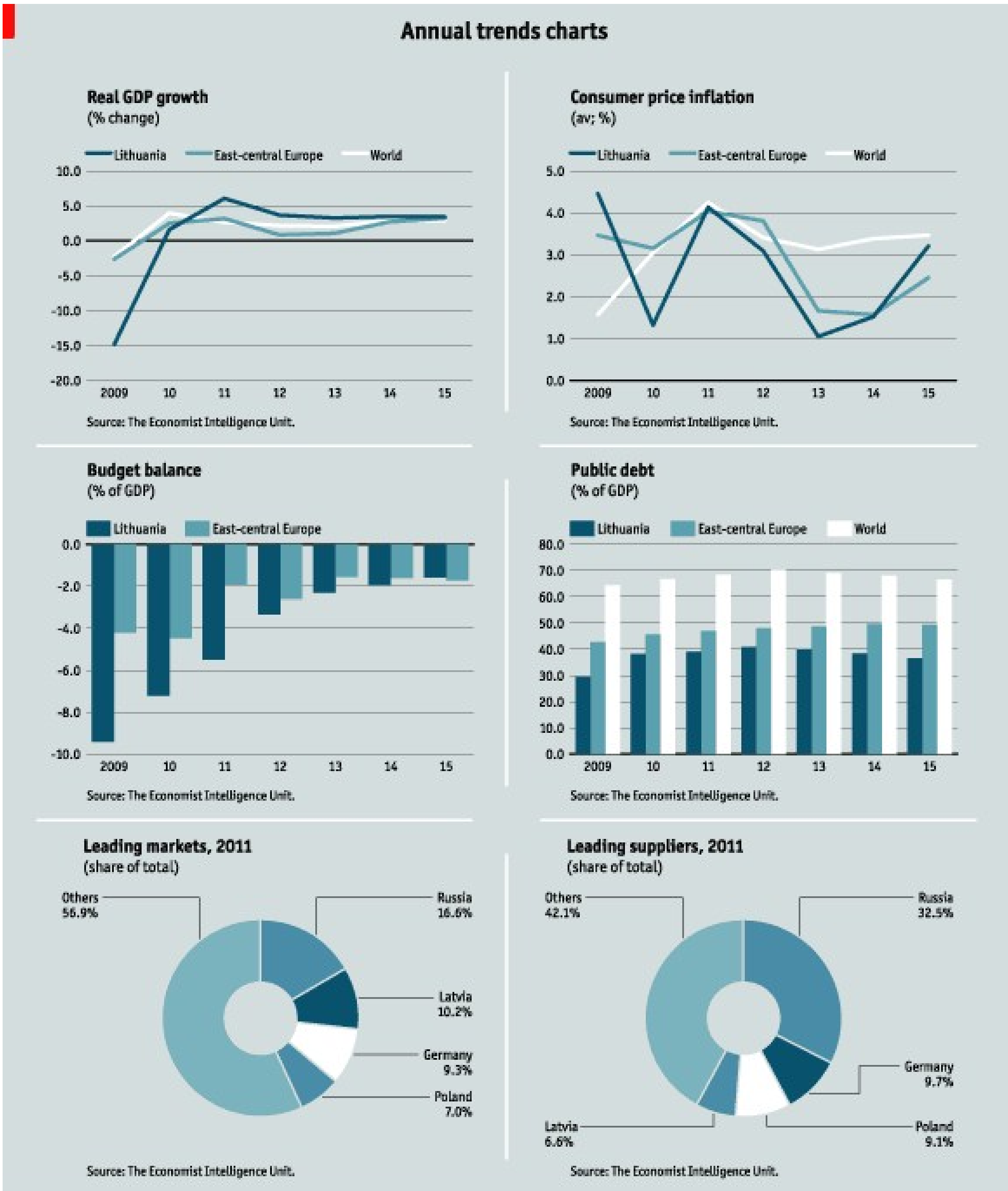
Monthly data

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate LTL:US$ (av)												
2011	2.59	2.53	2.47	2.40	2.40	2.40	2.42	2.41	2.50	2.53	2.54	2.62
2012	2.68	2.61	2.61	2.62	2.69	2.75	2.80	2.79	2.69	2.66	2.69	2.63
2013	2.61	2.58	2.66	2.66	2.66	2.62	2.64	2.59	2.59	2.53	2.55	2.52
Exchange rate LTL:US$ (end-period)												
2011	2.52	2.50	2.46	2.33	2.42	2.40	2.41	2.38	2.54	2.46	2.59	2.67
2012	2.64	2.58	2.59	2.62	2.77	2.76	2.81	2.75	2.68	2.67	2.66	2.61
2013	2.56	2.64	2.70	2.64	2.66	2.65	2.60	2.60	2.56	2.51	2.54	2.51
Real effective exchange rate (CPI-based; 1997=100)												
2011	156.57	157.91	159.46	162.38	163.27	163.17	162.94	161.94	159.81	158.27	158.82	156.01
2012	154.88	156.97	156.68	156.92	155.36	153.61	152.89	152.27	155.33	155.95	155.38	156.91
2013	157.96	158.36	155.31	155.56	155.90	156.37	155.21	156.71	157.08	159.16	158.78	158.90

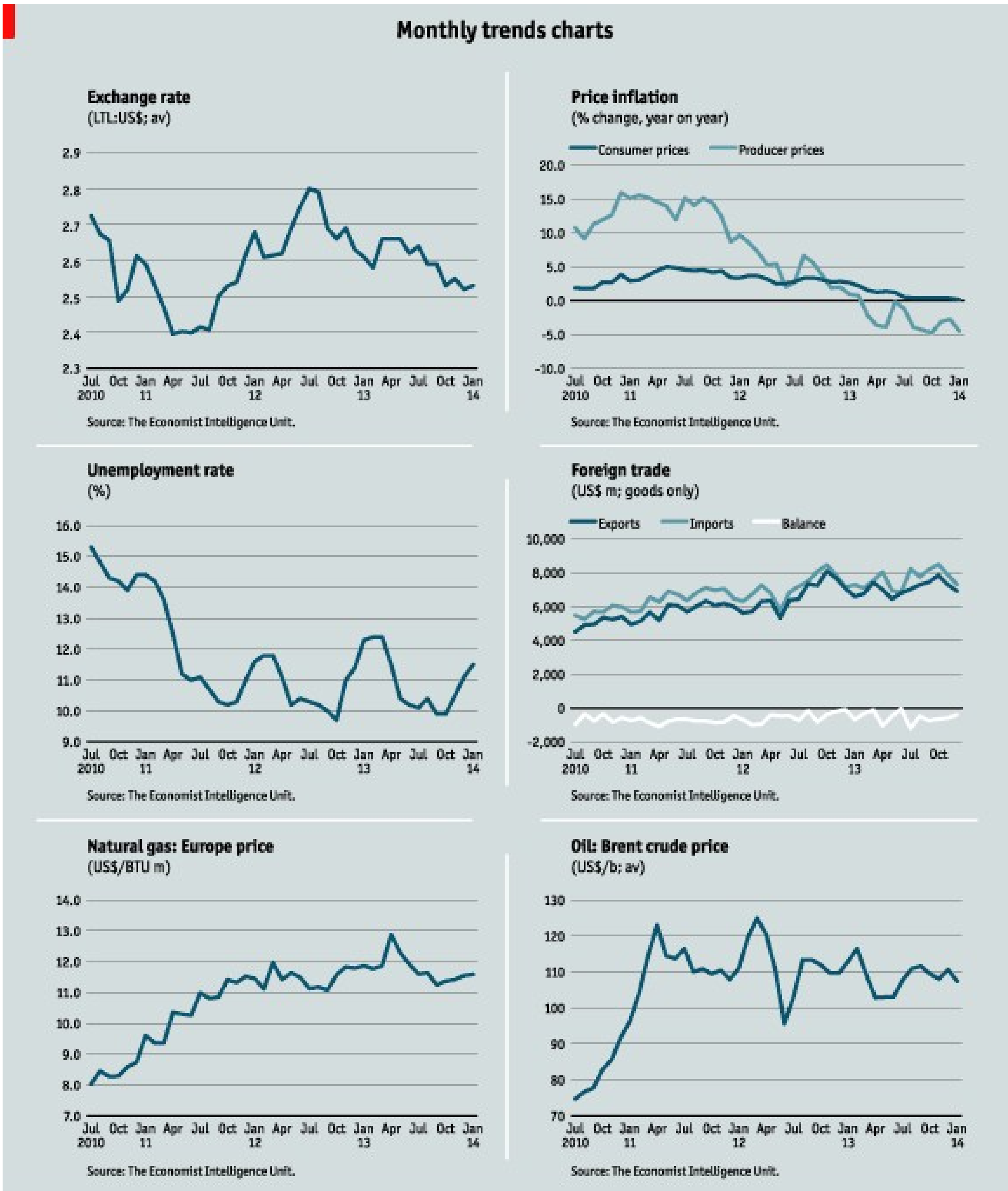
Deposit rate (av; %)												
2011	1.3	1.3	1.2	1.2	1.4	1.4	1.5	1.5	1.6	1.5	1.5	1.6
2012	1.6	1.4	1.2	1.2	1.0	1.1	1.1	1.0	0.9	1.0	0.9	0.8
2013	0.8	0.7	0.6	0.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Lending rate (av; %)												
2011	6.3	6.4	5.4	5.9	6.0	6.1	6.0	6.3	5.6	5.4	5.0	5.3
2012	5.3	6.1	5.8	5.8	5.7	5.2	5.3	5.2	5.5	4.6	4.3	4.7
2013	4.0	5.2	4.5	4.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Stock of M2 (LTL m)												
2011	46,892	47,183	47,216	47,262	47,548	47,817	48,459	48,567	49,036	49,035	49,598	50,034
2012	49,530	49,713	49,671	50,135	50,604	50,707	51,468	51,773	51,833	52,527	52,825	53,623
2013	52,390	53,349	53,754	53,704	53,356	53,284	53,590	53,938	53,911	54,502	54,749	56,280
M2 (% change, year on year)												
2011	10.0	9.1	9.0	7.6	7.3	7.3	7.7	7.5	9.2	8.1	7.4	4.8
2012	5.6	5.4	5.2	6.1	6.4	6.0	6.2	6.6	5.7	7.1	6.5	7.2
2013	5.8	7.3	8.2	7.1	5.4	5.1	4.1	4.2	4.0	3.8	3.6	5.0
Industrial production (% change, year on year)												
2011	12.8	11.7	12.4	5.6	12.5	10.9	5.1	6.4	9.2	-2.0	0.9	-4.4
2012	1.3	2.3	4.9	8.4	-17.2	-1.7	5.4	10.2	4.3	13.4	7.9	4.9
2013	8.1	1.4	9.6	6.8	22.8	1.2	2.5	-2.8	1.1	1.2	-3.4	-3.0
Retail sales (% change, year on year)												
2011	4.0	6.4	4.6	7.7	6.4	6.7	6.2	9.8	10.3	8.9	12.5	11.1
2012	11.3	7.8	6.0	1.6	5.4	4.9	5.0	15.4	4.7	25.5	3.9	5.9
2013	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Stockmarket index (end period; Jan 1st 2000=100)												
2011	407	411	400	385	398	396	398	373	333	356	299	299
2012	311	315	315	331	335	340	347	347	344	346	350	355
2013	374	369	394	396	400	404	411	413	422	417	413	422
Consumer prices (% change, year on year)												
2011	2.9	3.1	3.8	4.4	5.0	4.8	4.6	4.4	4.5	4.2	4.4	3.4
2012	3.4	3.7	3.6	3.2	2.5	2.5	2.8	3.3	3.4	3.1	2.8	2.8
2013	2.6	2.2	1.5	1.2	1.4	1.2	0.5	0.4	0.4	0.4	0.4	0.4
Producer prices (% change, year on year)												
2011	15.1	15.5	15.2	14.6	13.9	12.0	15.2	14.1	15.1	14.4	12.4	8.7
2012	9.7	8.5	7.1	5.3	5.4	2.0	2.7	6.7	5.6	3.8	1.9	2.0
2013	0.9	0.8	-2.2	-3.6	-3.9	-0.2	-1.2	-3.9	-4.3	-4.7	-3.1	-2.7
Registered unemployment rate (%)												
2011	14.4	14.2	13.6	12.5	11.2	11.0	11.1	10.7	10.3	10.2	10.3	11.0
2012	11.6	11.8	11.8	11.1	10.2	10.4	10.3	10.2	10.0	9.7	11.0	11.4
2013	12.3	12.4	12.4	11.5	10.4	10.2	10.1	10.4	9.9	9.9	10.5	11.1
Exports fob (LTL m)												
2011	4,953	5,153	5,674	5,194	6,123	6,069	5,716	6,026	6,342	6,094	6,196	6,020
2012	5,636	5,729	6,313	6,355	5,333	6,379	6,457	7,331	7,233	8,082	7,670	7,061
2013	6,595	6,758	7,418	6,990	6,454	6,793	7,016	7,280	7,448	7,840	7,281	6,908
Imports cif (LTL m)												
2011	5,696	5,732	6,556	6,281	6,891	6,717	6,382	6,800	7,097	6,955	7,035	6,478
2012	6,318	6,731	7,257	6,762	5,798	6,840	7,189	7,485	8,072	8,458	7,860	7,147
2013	7,279	7,084	7,530	8,037	6,933	6,838	8,222	7,751	8,189	8,491	7,867	7,300
Trade balance fob-cif (LTL m)												
2011	-744	-579	-881	-1,087	-768	-648	-666	-774	-755	-861	-839	-458
2012	-682	-1,002	-944	-407	-464	-461	-732	-154	-839	-376	-190	-86
2013	-684	-326	-113	-1,047	-480	-45	-1,206	-471	-741	-651	-587	-392
Foreign-exchange reserves excl gold (US$ m)												
2011	6,217	6,097	6,663	6,885	6,349	6,730	6,576	6,955	7,051	7,444	7,900	7,916
2012	7,310	8,316	7,674	8,093	6,437	6,570	7,119	7,313	7,887	8,035	8,086	8,223
2013	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Sources: IMF, International Financial Statistics; Haver Analytics.

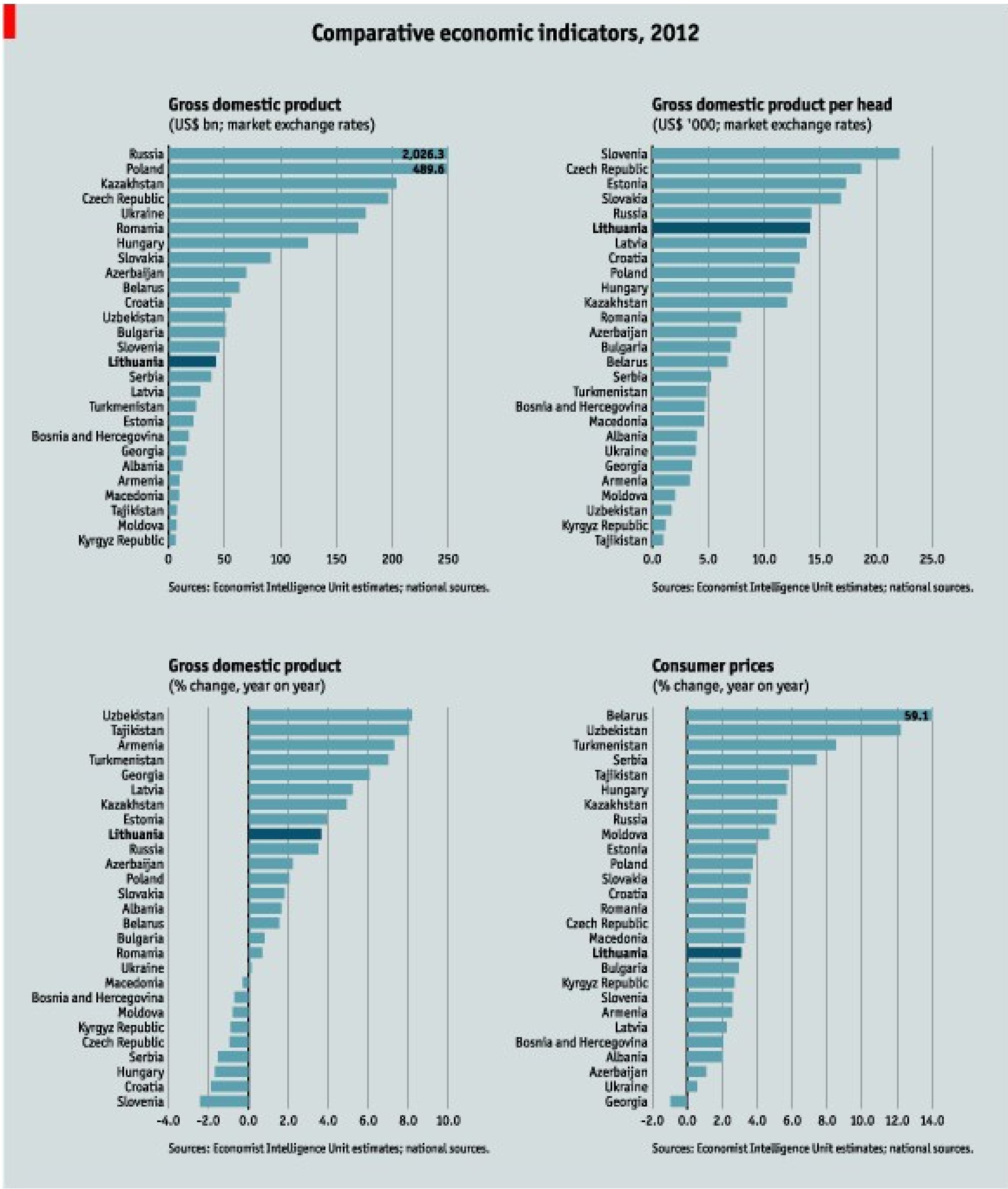
Annual trends charts



Monthly trends charts



Comparative economic indicators



Basic data

Land area

65,300 sq km

Population

3.20m (January 1st 2012)

Main towns

Population in '000 (January 1st 2011):

Vilnius (capital): 554

Kaunas: 337

Klaipeda: 178

Siauliai: 121

Climate

Moderate continental; average temperatures range from -5°C in January to 23°C in July

Languages

Lithuanian is a member of the Baltic group of languages (along with Lettish and the now extinct Old Prussian) and is the first language of over 80% of the population; there are sizeable minorities of native Russian- and Polish-speakers

Weights and measures

Metric system

Currency

The national currency, the litas (plural litai; LTL), which is divided into 100 centas, replaced the transitional talonas (coupon) in June 1993. Average exchange rates in 2012: LTL2.69: US$1; LTL3.45:€1

Time

Two hours ahead of GMT

Fiscal year

Calendar year

Public holidays

January 1st (New Year's Day), February 16th (Independence Day), March 11th (Restoration of Statehood), Easter Sunday and Easter Monday, May 1st (Labour Day), July 6th (Statehood Day), August 15th (Assumption), November 1st (All Saints' Day), December 24th–26th (Christmas)

Political structure

Official name

Republic of Lithuania

Legal system

On March 11th 1990 parliament voted to restore Lithuanian independence. A new constitution was approved on October 25th 1992

National legislature

Unicameral assembly, the Seimas, with 141 members; 71 are directly elected and 70 are elected on a proportional basis; parties need 5% of the vote to achieve representation, with the exception of parties representing national minorities. All Lithuanian citizens over the age of 18 may vote

National elections

October 2012 (legislative); May 2009 (presidential). Next legislative election is due by October 2016; next presidential election is due in 2014

Head of state

President, elected directly; currently Dalia Grybauskaite, sworn in on July 12th 2009

National government

The government formed following the election in October 2012 is a coalition comprising the Social Democratic Party, the Labour Party, Order and Justice, and Lithuanian Poles’ Electoral Action. It holds 87 of 141 seats in the legislature

Main political parties

Social Democratic Party (LSDP); Labour Party; Order and Justice (formerly the Liberal Democratic Party); Lithuanian Poles' Electoral Action (LLRA); Homeland Union-Lithuanian Christian Democrats (TS-LKD); Liberal Movement (LS); Liberal and Centre Union (LCS); Civic Democracy (PD); Russian Alliance (RA); New Union-Social Liberals (NS-SL); Peasant Nationalists (LVL); Christian Party

Key ministers

Prime minister: Algirdas Butkevicius

Agriculture: Vigilijus Jukna

Culture: Sarunas Birutis

Defence: Juozas Olekas

Economy: Evaldas Gustas

Energy: Jaroslav Neverovic

Environment: Valentinas Mazuronis

Finance: Rimantas Sadzius

Foreign affairs: Linas Antanas Linkevicius

Health: Vytenis Povilas Andriukaitis

Interior: Dailis Alfonsas Barakauskas

Justice: Juozas Bernatonis

Transport & communications: Rimantas Sinkevicius

Central bank governor

Vitas Vasiliauskas

Recent analysis

Generated on March 14th 2014

The following articles were published on our website in the period between our previous forecast and this one, and serve here as a review of the developments that shaped our outlook.

Politics

Forecast updates

January 16, 2014: Political stability

Still on course for euro accession in 2015

Event

Following lengthy and reportedly heated discussions, the four-party centre-left coalition government of the prime minister, Algirdas Butkevicius (Social Democratic Party), has agreed to continue to target accession to the euro zone in 2015.

Analysis

Following the discussions, Mr Butkevicius confidently stated that "Lithuania will have the euro on January 1st 2015, and this coalition will implement this". He has staked his political future on it, promising to tender his resignation if the target is not met.

Mr Butkevicius was forced to take this radical step after vocal public disagreement within his coalition threatened to derail euro accession. The ambitious speaker of the Lithuanian parliament, Loreta Grauziniene (Labour Party), had cast doubt on Lithuania's accession by arguing that the country was simply "not ready" and that the minimum wage and pensions should be increased first. At the same time, Rolandas Paksas, the leader of the coalition partner Order and Justice, participating in a political debate on Lithuanian radio, had argued that Lithuania should hold a referendum on euro accession. Following the public declarations of these two prominent politicians, Mr Butkevicius clearly felt that he needed to re-establish clarity among voters and investors over government policy.

To back up Mr Butkevicius' promise, the government has now taken the first legal steps towards euro adoption. The Ministry of Finance has submitted a draft law on euro adoption to the cabinet, envisaging accession on January 1st 2015, with an extended period of dual display of prices, a shorter dual circulation period and the stipulation that the central bank will exchange litas for euros for an unspecified period. Lithuania also has strong public support from European officials, with both the president of the European Council, Herman van Rompuy, and the president of the European Commission, Jose Manuel Barroso, recently stating that they expected Lithuania would join the euro zone in 2015.

As we have outlined in detail in previous articles, Lithuania remains on track to meet the Maastricht Criteria for euro adoption. The conservative parliamentary opposition also supports accession. However, the latest opinion polls show that 49% of the population are against accession, compared with 40% in favour. As a result, there is a risk that government coalition parties could again pander to popular opinion, in a year when Lithuania sees both presidential and European parliamentary elections. However, although this is a risk, the firm line taken by Mr Butkevicius is likely to discourage his coalition partners from again seeking to rock the boat in the coming year.

Impact on the forecast

Although political risks should not be entirely discounted, we continue to expect Lithuania to join the euro zone on January 1st 2015.

Analysis

December 2, 2013: International relations

Vilnius summit delivers mixed results

On November 28th and 29th, EU leaders gathered in Vilnius, Lithuania, which currently holds the rotating presidency of the EU, for the third Eastern Partnership summit. The Eastern Partnership is the EU's flagship foreign-policy initiative, intended to advance the economic and political integration with six post-Soviet states (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). Despite the high hopes of EU officials earlier in the year, the tangible gains from the summit were limited. Armenia and Ukraine—whose negotiations with the EU were by far the most advanced—failed to sign agreements on association and free trade. With Russia committed to resisting increased EU influence in the "common neighbourhood", the likelihood of further tension and instability is rising, particularly in Ukraine.

Armenia abandoned negotiations on an association agreement with the EU in September, when the president, Serzh Sargsyan, unexpectedly announced that his country would join the Russian-led Customs Union. The EU has long stated that membership of the Customs Union is incompatible with an EU association and free-trade agreement (FTA). The decision to abandon negotiations with the EU is likely to have been driven by fears that Russia could withdraw its security guarantees to Armenia, which is locked in a conflict with its neighbour, Azerbaijan, over the territory of Nagorny Karabakh. In a statement to the press, Mr Sargsyan argued that, as Armenia is a member of the Russian-led Collective Security Treaty Organisation (CSTO), it could not stay outside a "corresponding economic space" involving its military allies. Economic pressures may also have played a role. In May Russia's Gazprom raised gas-import prices by 50%, leading to a rapid jump in inflation. Since Mr Sargsyan agreed to join the Customs Union, negotiations have been re-started to reduce the gas price. The EU appears to have been given no warning prior of Armenia's volte-face, and the abrupt change of course is likely to have harmed relations between the EU and Armenia for some time to come.

No Ukraine deal

While Armenia's withdrawal from the association agreement came as a shock to the EU, Ukraine's EU negotiations have hung in the balance for some time. The EU had made a conclusion of the deal conditional on the release of Yuliya Timoshenko, an opposition leader and enemy of the president, Viktor Yanukovych. While Mr Yanukovych vacillated over whether to allow her to travel to Germany for medical treatment, Russian officials began to put pressure on Ukraine not to conclude an EU association deal. Sergei Glazyev, an advisor to the Russian president, warned Ukraine against taking a "suicidal step". Russian customs officials introduced restrictions on a number of Ukrainian products and warned of the possibility of a broader trade embargo on the basis that an FTA with the EU would expose Russia to a flood of tariff-free EU goods. With reserves dwindling and its currency under pressure, a sudden slump in exports to Russia could tip the country into a balance-of-payments crisis. On November 21st the prime minister of Ukraine, Mykola Azarov, announced that Ukraine was suspending preparations to sign the agreement.

Limited gains

With Ukraine joining Armenia among the refuseniks, it was left to Georgia and Moldova to provide a modest success story at the summit. Both countries initialled association agreements and Deep and Comprehensive Free Trade Agreements (DCFTA) with the EU at the Vilnius summit. The EU expects to conclude negotiations and sign the final texts of the agreements by September 2014. Georgian officials have indicated that the process may be accelerated, and a signing ceremony could take place in the first half of the year. The failure of negotiations with Ukraine may also have given a boost to Moldova's integration ambitions. On the eve of the summit, the EU announced that it would offer a visa-free regime to Moldova. On November 18th, the president of the European Council, Herman Van Rompuy, described Moldova as the "front-runner" in the Eastern Partnership.

Little progress was made in the EU's relations with the other two members of the Eastern Partnership initiative, Azerbaijan and Belarus. The only notable achievement was an agreement between Azerbaijan and the EU on visa facilitation, while the EU and Belarus agreed to begin talks on the same issue. EU-Belarus relations remain virtually frozen following the violent suppression of protesters in the Belarusian capital, Minsk, following the presidential election in 2010. This led the EU to renew travel bans against a number of high-ranking officials. Both countries view the EU's efforts to exert external governance over its eastern neighbourhood with suspicion, and reject the subordinate relationship implicit in a conditionality-based model of integration. Belarus views the EU in instrumental terms, to be used as a diplomatic counterweight during the periodic bouts of tension with Russia in order to secure further subsidies. The Azerbaijani leadership is keen to enhance co-operation with the EU on a range of technical issues. However, it has no desire to engage with the deeper reform agenda implied by the terms of the Eastern Partnership integration agenda.

A blow to the Eastern Partnership

The failure to sign association agreements with Ukraine and Armenia, after four years of negotiation, represents a significant blow to the Eastern Partnership. In the final analysis, the leaders of Ukraine and Armenia were either unable or unwilling to risk a serious and immediate breach in their relations with Russia for the sake of the promise of longer-term gains from increased trade with the EU and assistance in institutional reform. In the run-up to the summit, Mr Yanukovych hinted that the signing of the association agreement required the guarantee of further aid from the EU—and possibly an IMF bail-out—in order to protect the Ukrainian economy from the impact of Russian trade sanctions. In an address to the Ukrainian people on November 30th, Mr Yanukovych called for "joint work on a programme of measures to make the Ukrainian economy less vulnerable". Yet suspicions remain that Mr Yanukovych had never intended to sign the agreement, and wished to use it simply as a bargaining tool to extract greater concessions from either the West, or Russia, or both. Having arrived at a final text for the agreement, the EU avoided making last-minute concessions, or being drawn into a geopolitical bidding war with Russia over Ukraine's political future.

A wave of mass protests in Ukraine following the Vilnius Summit suggested that many Ukrainians hold Mr Yanukovych, and not the EU, responsible for the failure of negotiations. By appearing to give in to Russian pressure, Mr Yanukovych has transformed the FTA into an issue of national identity. The refusal to sign the agreement has become the focal point for more general anger at the dire state of the economy and the failings of the political class. While this underlines the EU's soft-power, there is also a risk—not for the first time—that the European integration process becomes burdened with unrealistic expectations of political transformation and economic modernisation.

Where next?

While the EU's standing in Ukraine may never have been higher, the Vilnius Summit has done little to advance the core goals of the Eastern Partnership: that is, to support the development of stable, prosperous and democratic states on the EU's border. Indeed, in the case of Ukraine, the outlook is for greater instability. EU officials continue to insist that its policy in Eastern Europe "does not come at the expense of relations between our European partners and their neighbours, such as Russia", as a joint statement from Mr Van Rompuy and the president of the European Commission, José Barroso, put it on November 25th. However, the campaign of diplomatic and trade pressure suggests that Russia read the EU's strategy in zero-sum terms. Mr Yanukovych's failure to sign the association agreement means that the next presidential election, due in 2015, is likely once again to be fought on the issues of Ukraine's national identity and geopolitical orientation. This sets the stage for a renewed period of tension between the EU and Russia.

December 10, 2013

Attention will shift to domestic issues in 2014

As Lithuania prepares to hand over the presidency of the Council of the European Union to Greece, its political agenda will turn from international to domestic issues. In 2014 both presidential and European Parliament elections will be held in Lithuania. The centre-left coalition government of the prime minister, Algirdas Butkevicius of the Social Democratic Party (LSDP), will wrestle with energy and trade issues with Russia, while simultaneously seeking to ensure that Lithuania meets the conditions for euro zone entry in 2015.

The presidency of the Council of the European Union in the second half of 2013 has been a major challenge for Lithuania. As a small state holding the post for the first time, Lithuania has seen its administrative and bureaucratic resources stretched to the limit. Whereas the administrative burden has been managed, the presidency failed to bring Ukraine further into the European fold through the signing of an association agreement. Moreover, Lithuania's persistent attempts to cajole and persuade Ukraine to sign up to the agreement have antagonised and complicated relations with its eastern neighbour, Russia.

The only beneficiary from this clash has been the Lithuanian president, Dalia Grybauskaite. Not only did the hosting of the Vilnius Summit raise her international profile, but her firm and adept handling of Europe's politicians enhanced her already high stature within Lithuania just six months before the country's next presidential election.
Ms Grybauskaite, a former European Commissioner and Minister of Finance, was elected to her first five-year term as president in May 2009, winning in the first round with 69.1% of the vote, by far the biggest mandate won by a candidate in a Lithuanian presidential election. However, Ms Grybauskaite has not yet declared her intention to run. There is some speculation that, as a woman from a small European state, she may be a leading candidate for the Presidency of the European Commission. Her skilful handling of the Vilnius Summit will not have harmed her chances.

Ms Grybauskaite strongly positioned for second presidential term

It is more likely that Ms Grybauskaite will run for a second term as president in the election scheduled for May 11th 2014. She remains hugely popular, partly as a result of her office standing above the day-to-day fray of Lithuania's heated party politics (Lithuanian presidents have long been more trusted than governments or political parties), but also because of a lack of serious competitors for the post. According to November polling data, Ms Grybauskaite would get 38.5% of the vote in a presidential election, with none of her declared opponents polling in double digits. Her position is so strong that Mr Butkevicius, who had been rumoured to be interested in running against her, has decided not to stand. Rather, his party has nominated a member of the European Parliament (MEP), Zigmantas Balcytis, as its candidate for the post. However, even Mr Balcytis does not appear to rate his own chances very highly, and he has already declared his intention to run for re-election to the European Parliament in June 2014. Another potential rival is the recently elected chair of the Lithuanian parliament, Loreta Sniokaite-Grauziniene (Labour Party). She appeared to be being groomed for a run at the presidency, having made efforts to appear more presidential, and sharply criticising the president on an almost daily basis. However, this rhetoric did not dent Ms Grybauskaite's popularity, and led to a big slump in Ms Sniokaite-Grauziniene's own poll numbers. Ms Grybauskaite will run as an independent candidate (although the Christian Democratic party has already announced its support for her) and stands an excellent chance of becoming the first Lithuanian president to be re-elected for a second consecutive term of office.

Energy issues will loom large

A number of important energy issues will loom large on the political agenda in 2014. First, Lithuania's new liquefied natural gas (LNG) terminal in Klaipeda will become operational in the second half of 2014, potentially increasing Lithuania's energy independence from the Russian energy giant, Gazprom, which is a national strategic aim. Mr Butkevicius has also raised the prospect of a second referendum on the construction of a new nuclear terminal at Visaginas, previously rejected by voters in a 2012 poll. This would be a joint project between Latvia and Lithuania that would move all three Baltic States away from energy dependence on Russia. Russia has responded by barring certain Lithuanian dairy imports (costing Lithuanian exporters an estimated €3m, or US$4m, per day) as well as revealing plans to construct its own LNG terminal in Kaliningrad, the Russian exclave cut off from Russia by Lithuania, by 2018.

On course for euro zone accession in 2015

Finally, Latvia's upcoming accession to the euro zone on January 1st 2014 has focused Lithuanian policy-makers' attention on its own bid to join the currency. Inflation has fallen to within the limits set by the Maastricht criteria for euro zone entry, and planned reductions in the budget deficit for 2014 (to 2.5% of GDP) and 2015 (1.9% of GDP) are likely to ensure that Lithuania meets the conditions for entry. Moreover, as the only EU member-state to have been rejected from joining the euro zone (in 2006, owing to high inflation), the Lithuanian government is likely to ignore any possible electoral and international distractions and remain fiscally disciplined and focused on euro zone accession throughout 2014.

February 20, 2014

Greece's EU presidency: priorities and challenges

Greece's fragile coalition government has been placed at the helm of an inefficient EU at a time of looming European and local elections, with the coalition parties trailing in the polls and facing internal turmoil. Its credibility with other EU member states may be at an all-time low. Yet, after years of being marginalised amid talk of a Greek exit from the euro zone ("Grexit"), it is trying to seize the opportunity. Greece will attempt to act as a consensus-builder while the European Parliament is still in session during the first part of its presidency. After parliament is dissolved, it will try to assume the role of agenda-setter, most notably on issues of maritime security and trade.

The semi-annual rotating presidency of the Council of the EU is a dysfunctional legacy of the bloc's origins in 1958, when it consisted of just six member states and had a limited agenda. This year, the elections for the European Parliament in May will complicate matters further, not only focusing key players on their internal constituencies, but also resulting in a month being lost to campaigning. Against this backdrop, Greece is called on to assume the presidency's dual role of consensus-builder and agenda-setter.

Greece has suffered greatly during the last six years, with the prolonged economic depression wiping out almost 30% of its GDP and its credibility as an interlocutor. Other EU member states, already weary of Greece's delays in implementing legislation, have oscillated between impatience and frustration as Greece has stalled in the implementation of the reforms agreed as part of its €240bn (US$330bn) bail-out package.

Challenges abound in Greece

The coalition government faces a double election. The European elections are coupled with Greek local authority elections. At the moment the coalition partners—the centre-right New Democracy (ND) and the centre-left Panhellenic Socialist Movement (Pasok)—are well behind the left-wing, anti-austerity Syriza Unifying Social Front (Syriza) in public opinion polls. The alternate minister of the environment, responsible among other matters for urban planning, has agreed to resign in order to run for mayor of Thessaloniki, the largest city in northern Greece, with little hope of succeeding, while other ministers have reportedly declined requests from the prime minister's office to do so, notably to run in Athens. Several party rebels have announced their candidacies without awaiting official party nomination.

Coincidentally, difficult negotiations with the country's lenders are also taking their toll. This is best illustrated by the fact that the EU will be represented at the upcoming G20 meeting of finance ministers and central bank governors in Brisbane, Australia on February 22nd-23rd by a high-ranking civil servant of the Greek Ministry of Finance rather than by the Greek finance minister himself, who is engaged with the troika of invigilators (the European Commission, IMF and the European Central Bank) representing the country's lenders.

In short, a declawed and distracted Greece has been placed at the helm of an EU that has recently seen a popular backlash in many countries amid claims of inefficiency and democratic deficit—and also at an inopportune time given the upcoming elections. What might be achieved over the next few months is thus more likely to be in spite of the Greek presidency, rather than because of it.

The presidency's wish list

The Greek presidency's programme runs to 56 pages—more than double that of the preceding presidency, Lithuania, which implies difficulty in setting priorities. The programme sets out three main policy areas:

- growth, jobs and cohesion
- EU-euro zone integration
- migration, borders and mobility

There is also the theme of maritime policy that is supposed to run horizontally through all of the presidency's priorities. However, these themes are far too broad to be anything other than an elaborate wish list.

Greece is to be succeeded by Italy as rotating EU chair, with a new European Commission to be inaugurated during the Italian presidency. The two countries share a number of common priorities in the fields of maritime policy, immigration and energy. Tackling the immigration issue in particular fits well with the internal agendas of many countries that struggle to stem the rise of far-right political forces. This policy area will be additionally propelled by public opinion.

Greece as consensus-builder

Against this backdrop, Greece plans to work towards the smooth implementation of EUROSUR (European Border Surveillance System), as well as towards rules for surveillance of the external borders. Greece successfully took over the baton from Lithuania in approving through the Council of Ministers during February the visa waiver programme for 19 countries. This has yet to be ratified by the European Parliament, but this may still happen during the current parliamentary term.

Another Lithuanian leftover will be reform of the Markets in Financial Instruments Directive (MIFID II). It was agreed between the European Parliament and the Council in mid-January and will reform financial markets, marginalising dark-pool trading in equities (usually trades that are conducted outside the central exchanges and concealed from the public), while also improving supervision and investor protection.

The prime legislative matter for Greece, however, will be the conclusion of discussions, within the European Parliament's current term, of the single resolution mechanism (SRM). This is a key element of the proposed banking union, and the prolonged Greek crisis is a case in point of its necessity. Essentially, the SRM is an important corollary of the single supervisory mechanism (SSM), which gives supervisory powers for the euro zone banking sector to the European Central Bank (ECB). The SRM would boost the SSM by allowing funds to be used to bail out troubled banks in order to prevent a financial crisis from developing and spreading. However, there is still some distance between the positions of the Council and the European Parliament on this issue.

In another consensus-building challenge, Greece is one of 11 countries currently participating in so-called "enhanced co-operation" on the introduction of a financial transaction tax, which aims to levy 0.01-0.1%, depending on the asset class, if at least one of the counterparties to the transaction is based in the EU. Under the enhanced co-operation mechanism, any group of nine or more countries can advance a legislative initiative of their own accord without it being mandatory for all member states.

The EU-US trade negotiations, known as the Transatlantic Trade and Investment Partnership, also pose challenges for consensus-building. An informal meeting of foreign ministers with an emphasis on trade has been scheduled for February 27th-28th in Athens, and it is possible that some progress may be achieved. Trade agreements are a potential thorn in the side of relations between the European Commission and the Council of Ministers as both institutions share competence on trade issues, in other words they require the consent of member states, which is occasionally pre-empted by the Commission in negotiations.

Greece as agenda-setter

A contentious issue that Greece may try to put on the agenda is the extension of the "protected destination of origin status" of member state products to markets outside the EU, in a manner similar to that applicable inside the single market. This is likely to happen in strategic discussions during the second half of the presidency, after the current parliament has been dissolved.

Similar tactics may be used in the area of maritime policy to address continental shelf disputes in the Mediterranean. Greece's aim—to identify European maritime interests and potential threats—is a stepping stone towards the country's wider goal of establishing an integrated European marine area.

Economy

Forecast updates

December 10, 2013: Inflation

Price pressures remain weak

Event

Year-on-year consumer price inflation in November remained unchanged from October, at 0.4%. In month-on-month terms prices rose by 0.1% (seasonally adjusted).

Analysis

Inflationary pressures remain weak in Lithuania, with the 0.4% rise in November far below the 2.8% rise recorded a year earlier. The strongest rise, of 2.7%, was for tobacco and alcoholic beverages, reflecting the impact of excise duty hikes rather than demand pressures. Inflation in hotels and catering services rose by 2.6%, in part reflecting the impact of this year's rise in the minimum wage on low labour cost services. The hotel industry is currently lobbying for a reduced value-added tax (VAT) rate—it currently levies the standard 21%—in order to make it more competitive regionally. This year's falling oil prices had a widespread effect, including pushing year-on-year transport prices down by 1.3%.

We expect consumer price inflation to pick up modestly in 2014 in line with stronger GDP growth, forecast at 3.2%, compared with an estimated 2.9% this year. Rising income is also expected to exert modest upward pressure on prices next year. Average nominal earnings rose by 6.2% year on year in the third quarter, the fastest rate of growth since the final quarter of 2008. Although unemployment remains high, at 10.6%, the number of registered unemployed fell by 3.2% (seasonally adjusted) quarter on quarter in July-September, to 193,700.

A large revision to the gas import price represents the most significant risk to the inflation forecast. Lithuania currently pays among the highest netback rates for its gas imports from Russia of any EU country. Lithuania is currently in negotiations regarding a cut in the price, however to date no agreement has been reached. Algirdas Butkevicius, the prime minister, recently stated that a 20-25% reduction in the gas price could be possible, although it is unclear what concessions Lithuania could offer to secure such a deal.

Lithuania remains within the inflation corridor for accession to the euro zone. According to the Maastricht criteria, Lithuania's average annual harmonised index of consumer prices (HICP) must be no more than 1.5 percentage points above the average of the three countries with the lowest 12-month HICP rates. These are currently Latvia (0.3%), Sweden (0.5%) and Ireland (0.7%); we assume Greece will be excluded as an outlier, as it was when Latvia's eligibility was assessed this year. In October Lithuania's HICP fell to 1.6%, from 1.8% in September. November is likely to show a further fall in the HICP, as annual average consumer price inflation fell to 1.3% month on month, from 1.4% in October.

Impact on the forecast

We will be revising down our estimate for average annual inflation in 2013 to 1.1%, from 1.2% currently.

December 11, 2013: External sector

Exports struggle in October

Event

Exports in October fell by 2.8% year on year in nominal terms, to LTL7.9bn (US$3.13bn), while imports rose by 0.1%, to LTL8.5bn, according to Statistics Lithuania.

Analysis

In October the unadjusted trade deficit expanded by 62.1% to LTL609m year on year. In January-October the deficit stood at LTL5.8bn, compared with LTL6.1bn in the equivalent period of 2012. Oil product sales fell by 19.1% on the back of low refining margins at Orlen Lietuva. The import value of mineral fuels fell by 13.1% in October, largely because of the refinery's reduced requirement for feedstock, but also because of falling imported car fuel prices.

Cereal exports plunged by 40.5% as output failed to match last year's exceptional harvest, while falling world prices were responsible for the 39.7% decline in fertiliser export values. Dairy exports fell by 13.2%, with sales to Russia down by 72.1% as a result of an import ban imposed in October. Some major commodities performed well in October, including electrical machinery and wood, with exports growing by 32.8% and 23.8%, respectively. There was also a small pick-up in the regional transit trade in second-hand vehicles.

Despite the ban on dairy products, Lithuania's total exports to Russia in October were up by 11.4% year on year, with big increases in sales of other consumables such as vegetables and beverages, as well as machinery and furniture. Russia retains its position as Lithuania's main market. In January-October it accounted for 19.6% of exports (and 30.1% of imports), followed by Latvia (10%), Estonia (8%) and Poland (7.4%).

Excluding oil products, exports and imports in October grew by 2.5% and 7.5%, respectively, suggesting that the trend is that of an inevitable slowdown from the double-digit growth rates recorded since 2010 rather than a sudden downturn in sales. In the third quarter of 2013 export growth slowed to 3.6%, from an average 14.7% in the first half of the year and 16.7% in the third quarter of 2012. Import growth fell to 5.6%, from 10.4% and 12.2%, respectively.

Impact on the forecast

Based on previously released balance-of-payments data for the third quarter, we will be revising down our estimate for the 2013 current-account deficit to around 0.3% of GDP, from 1.3% at present. The October merchandise trade data are in line with our new estimate. In 2014 we expect the shortfall to widen as domestic demand strengthens.

December 20, 2013: External sector

Current account remains in surplus

Event

According to the Bank of Lithuania, the current account recorded a small surplus, of LTL21.7m (US$8.6m), in the third quarter of 2013, equivalent to 0.1% of GDP, compared with a deficit of LTL247.7m (0.8% of GDP) a year earlier, and a surplus of LTL1.5bn (5% of GDP; US$594m) in the previous quarter.

Analysis

The merchandise trade deficit in the third quarter of 2013 widened by 84.7% year on year, to LTL1.5bn, because of faster growth in imports. Exports over this period grew by 3%, to LTL21.7bn, and imports by 6.1%, to LTL23.2bn. In contrast, the services surplus expanded by 17.1%, to LTL1.3bn. Despite Russia's disruption of vehicle traffic entering the exclave of Kaliningrad in September, transport services exports, which account for nearly 60% of the total, grew by 15.7%, to LTL2.8bn, and road transport by 29.1%, to LTL1.3bn.

The income deficit narrowed by 28.2% year on year, to LTL1.1bn. Investment income, which largely reflects investor outflows, such as repatriated profits and dividends, declined by 28.1%, to LTL1.4bn. Inflows from employee compensation fell by 20.2%, to LTL148m, and outflows by 6.1%, to LTL91.6m.

Current transfers, as in previous quarters, remained firmly in surplus. In the third quarter, the transfers surplus grew by 32.4% year on year, to LTL1.4bn. Net government transfers, essentially the balance between Lithuania's receipts of EU funds and its contribution to the EU budget, fell by 40.1%, to LTL462m. Workers' remittances inflows, the main source of transfers credits, grew by 41.4%, to LTL1.3bn, while outflows fell by 33.6%, to LTL428.6m. As a result, the surplus on workers' remittances almost trebled, reaching LTL919.9m. These dynamics reflect improved economic prospects in countries such as the UK and Ireland, the main destinations for Lithuanian migrant workers.

The financial-account deficit edged up by 4%, to LTL920.5m. Direct investment declined by 36.2% year on year, to LTL997.5m. Portfolio investment moved from a surplus of LTL442.6m a year ago, to a deficit of LTL708.4m, and that of other investment (such as trade credits and bank loans), from a surplus of LTL34.7m to a deficit of LTL136.6m.

The current account for the first nine months posted a surplus of LTL820.1m (0.9% of GDP), compared with a deficit of LTL794.6m (0.9% of GDP) a year earlier. According to preliminary estimates, October saw a further surplus, of LTL50.5m.

Impact on the forecast

The latest data pose a significant upside risk to our current estimate of a full-year current-account deficit equivalent to 0.3% of GDP.

January 10, 2014: Inflation

Still on course for euro accession

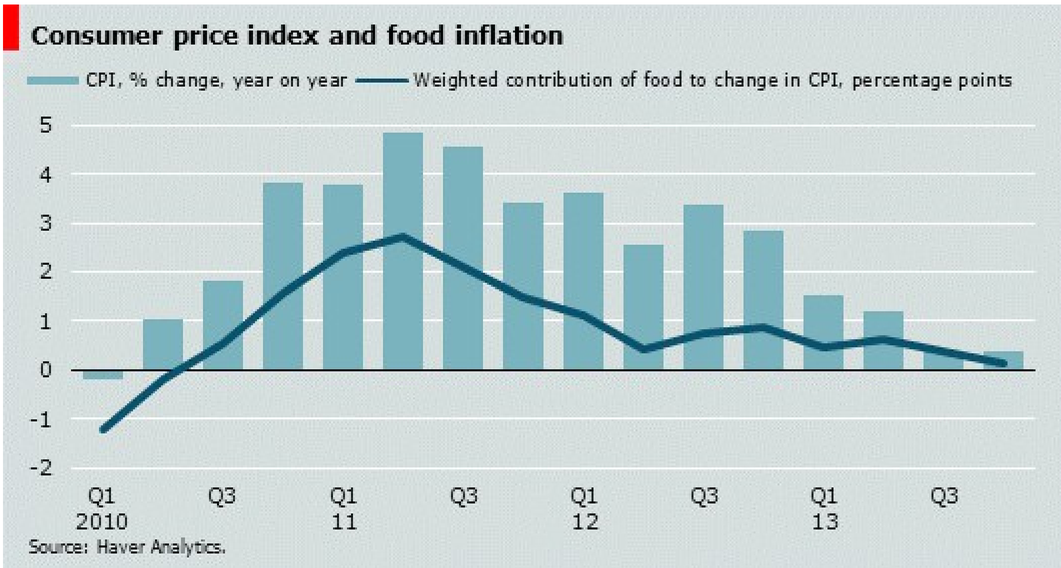
Event

Year-on-year consumer price inflation remained unchanged in December at 0.4% for the fifth consecutive month, while average annual inflation for 2013 declined to 1%, from 3.1% in 2012. The general budget deficit narrowed in the first nine months as a result of a surplus in the third quarter.

Analysis

Lithuania's 12-month annualised harmonised index of consumer prices (HICP) fell to 1.4% in November, from 1.6% the previous month, placing it 0.5 percentage points below the ceiling stipulated for accession to the euro zone. According to the Maastricht criteria, HICP must be no more than 1.5 percentage points above the average of the member states with the lowest rates. Excluding Greece as an outlier, the lowest rates were recorded by Latvia (0.2%), Sweden (0.5%), and Ireland, Cyprus, Portugal and Denmark (all at 0.6%).

The fall in inflation in 2013 was largely driven by falling food prices, as a result of a good harvest, a strengthening euro and weaker commodity prices. The prices of food and non-alcoholic beverages, the biggest component of the inflation basket, rose by only 0.5% year on year in December, down from 2.3% in the first quarter.



We continue to expect that demand-side pressures on inflation in Lithuania will be weak in 2014 as fiscal policy is tight and the unemployment rate remains high. External supply-side factors are likely to also push up prices in other EU countries, and thus we believe that Lithuania's HICP will still be within the Maastricht inflation corridor when the European Commission makes its eligibility assessment later this year.

Meanwhile the general budget deficit, the other potential obstacle to euro zone membership, is shrinking. In the third quarter of 2013, according to Ministry of Finance figures, the general budget recorded a surplus of LTL280m (US$110m), compared with a deficit of LTL280m in the same period of 2012. On the basis of a 12-month trailing average of the budget balance and GDP, the deficit stood at 2.1% in September 2013, compared with 2.8% a year previously. Historically, fiscal performance tends to be far stronger in the third quarter than the fourth quarter, when we expect the budget to move back into deficit. Nevertheless, the annual budget balance should fall comfortably within the 3% of GDP limit set by the Maastricht criteria.

Impact on the forecast

The inflation and fiscal outcomes confirm our view that Lithuania will meet all of its criteria for euro adoption in 2015.

January 13, 2014: External sector

Trade deficit continued to expand in November

Event

According to Statistics Lithuania, exports in November fell by 5.2% year on year in nominal litas terms, and by 7.5% month on month, to LTL7.3bn (US$2.9bn). Imports grew by 0.1% year on year, but declined by 7% month on month, to LTL7.9bn. The trade deficit expanded by 215% year on year, to LTL600m.

Analysis

Lithuania's trade is dominated by its oil industry, with mineral fuels accounting for 23% of exports and 34% of imports over 2013. Weaknesses in this sector, including overcapacity, reduced demand and low refining margins, were largely responsible for November's poor trade performance. Mineral fuels exports fell by 27.9% year on year, to LTL1.3bn, and imports, including crude oil feedstock for the Orlen Lietuva refinery, by 17%, to LTL2.1bn. Ukraine was the main mineral fuels export market in November, accounting for 22% of all sales, followed by Latvia (19%), Poland (18%), the UK (13%), and the US and Estonia at 11% apiece.

Excluding oil, exports in November rose by 1.5% year on year and imports rose by 7.9%. The export sectors with the strongest growth were furniture (up 12.6%), wood and wood articles (up 17.2%), and beverages (up 30.6%). There was a marginal pick-up in the second-hand vehicles transit trade. Germany, Russia, Belarus and Poland were the main origins of these vehicles, and Russia, Belarus, Kazakhstan, Latvia and the Kyrgyz Republic were the main destinations.

Export growth slowed significantly during the second half of 2013, a trend witnessed across the Baltic states. This was driven both by less favourable base effects (export growth in the second half of 2012 was very strong) and a slower pace of growth in key export partners such as Germany and Russia. Cereal exports have slowed significantly, reflecting the baseline effect of the exceptional harvest in 2012 when sales more than trebled.

Russia's ban of Lithuanian dairy products in October 2013 was responsible for this sector's depressed sales, with exports to Russia falling by 5.4% month on month and 1.2% year on year in November. This ban did not extend to other food products such as beverages and vegetables, sales of which strengthened in November, as did exports of heavy machinery, furniture and plastics. Meanwhile, Lithuanian dairy producers have diversified into new markets such as Cuba, while boosting sales to existing big customers such as Italy, Latvia, the Netherlands and Estonia.

Impact on the forecast

With private consumption strengthening, import growth is likely to remain robust in 2014. Exports should also strengthen, although growth will be lower than in 2012-13. As a result, we continue to forecast a widening trade deficit in 2014-15.

January 23, 2014: Economic growth

Industrial production weakens

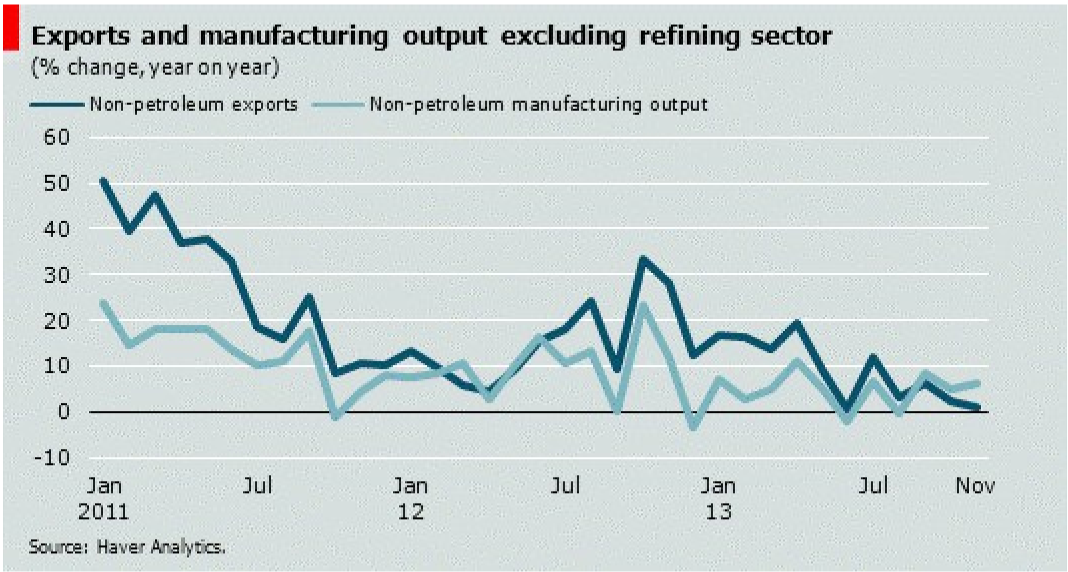
Event

Industrial production fell 3.1% year on year in December (3.8% working-day adjusted).

Analysis

Industrial output was dragged down in December by the continuing weak output of the Orlen Lietuva refinery, which accounts for around 40% of total production, and also a sharp drop in output in the utilities sector, which declined by 18.7% year on year. The poor performance of utilities may reflect the impact of the unusually mild weather in the first half of the 2013-14 winter, which has cut gas and electricity consumption. Although manufacturing output as a whole was flat in December year on year, if oil refining is stripped out, the sector recorded growth of 11.8% year on year, its best out-turn since November 2012.

The rapid growth of non-petroleum manufacturing has come despite a recent slackening in exports. Non-petroleum exports were up by 2.4% year on year in October and 1.2% in November (December data are not yet available), compared with a year-on-year rise in January-November of 9%. With exports soft, demand has been underpinned by strengthening private consumption, which climbed by 6% year on year in the third quarter of 2013. Real wages rose by 5.4% year on year over the period, the fastest rate of growth since the fourth quarter of 2008 and the third successive quarter of real-terms growth, following 16 quarters of declining earnings.



Based on the initial December data, industrial production rose by 3.3% on an annual basis in 2013, down from 3.7% in 2012 despite the impact of positive base effects arising from the shutdown of the Orlen Lietuva refinery for repairs in May 2012. This factor will be absent in 2014, and as a result we expect the rate of growth of exports to slow slightly this year. In June-November 2013, exports of petroleum products fell by almost 9% year on year.

The rate of growth of aggregate real domestic demand is forecast to accelerate in all of Lithuania's main trading partners in 2014, with particularly strong performance in Germany (up by 1.8%, compared with 0.9% in 2013) and Poland (a 2.5% year-on-year rise, compared with a contraction of 0.4% last year). With household consumption in Lithuania forecast to remain steady this year at 3.5% year on year, non-petroleum manufacturing should post slightly stronger growth in 2014.

Impact on the forecast

We may revise down slightly our forecast for industrial production in 2014, from 4.3% currently. Excluding petroleum products, we expect manufacturing to perform robustly; however, slower output growth at Orlen Lietuva is likely to weigh on overall industrial production.

February 10, 2014: External sector

Exports decline due to refining weakness

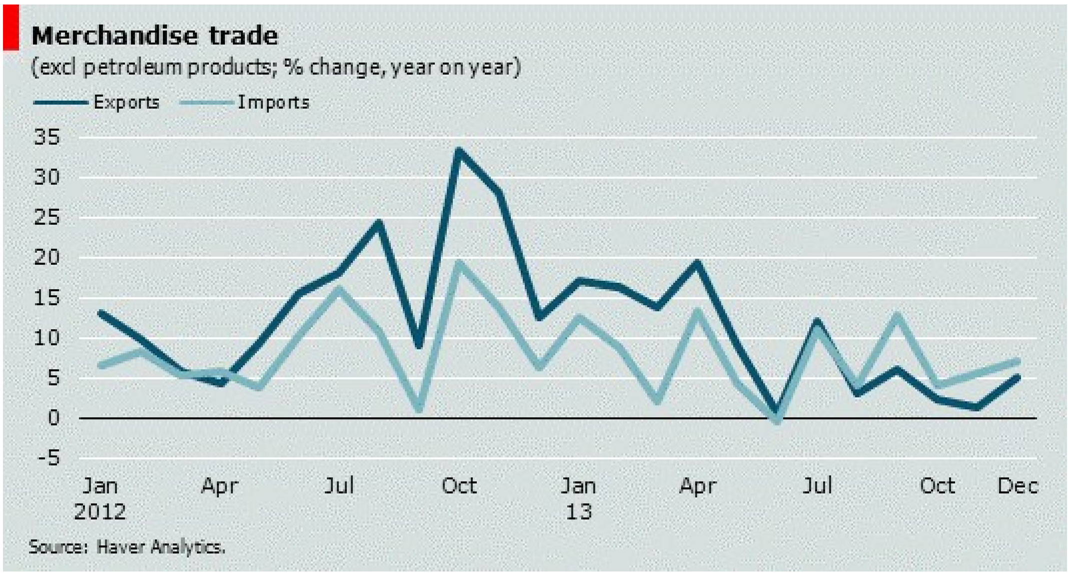
Event

According to Statistics Lithuania, exports contracted by 2.2% in nominal year-on-year terms in December 2013, to LTL6.9bn (US$2.7bn), in the third consecutive month of decline. Imports increased by 2.1%, to LTL7.3bn. As a result, the trade deficit widened to LTL391.7m, from LTL85.8m a year earlier.

Analysis

Weaknesses in the oil refining sector, the biggest source of Lithuania's exports and imports, continued into December, with exports of mineral products falling by 23% year on year. In the case of imports, mineral products fell by 16.2% owing to lower demand for crude oil to serve the Orlen Lietuva refinery. Despite the weak final quarter, a strong performance in the first half of 2013 led to annual growth in exports of 6.5%, to LTL84.8bn, while imports expanded by a similar rate, to LTL91.5bn.

While the oil refining sector struggled, non-mineral exports strengthened in December, rising by 5.5% year on year, compared with 1.4% in November. Growth in non-oil exports has slowed since the first half of 2013 owing to weakening demand among key trade partners such as Russia and Germany. Base effects also played a role, as exports rose strongly in the second half of 2012. Excluding mineral products, imports grew by 7% year on year in December, providing further evidence that domestic demand is strengthening. In 2013 as a whole, imports of consumer goods rose by 13.5%, to LTL19.8bn.



We continue to expect that import growth will rise in 2014. Investment will expand by 4.5%, compared with 1.8% this year, which will push up demand for imports from businesses. We may also revise up slightly our forecast for growth in private consumption expenditure in 2014 (currently forecast at 3.5%, the same rate as in 2013). Retail trade rose by 9.4% year on year in the final quarter of 2013, compared with 4.5% for the year as a whole.

Stronger growth in Russia (our forecast stands at 2.8% in 2014, compared with 1.4% in 2013) and the euro zone (our GDP forecast has been revised up to 1.1%, from 0.9% previously) should give a boost to non-oil exports. However, headline export figures will continue to be held back by narrowing margins at Orlen Lietuva owing to excess European refining capacity and intense competition from more modern facilities in the US, Asia and the Middle East.

Impact on the forecast

We continue to forecast a widening trade deficit in 2014‑15.

February 17, 2014: Inflation

Inflation continues to fall

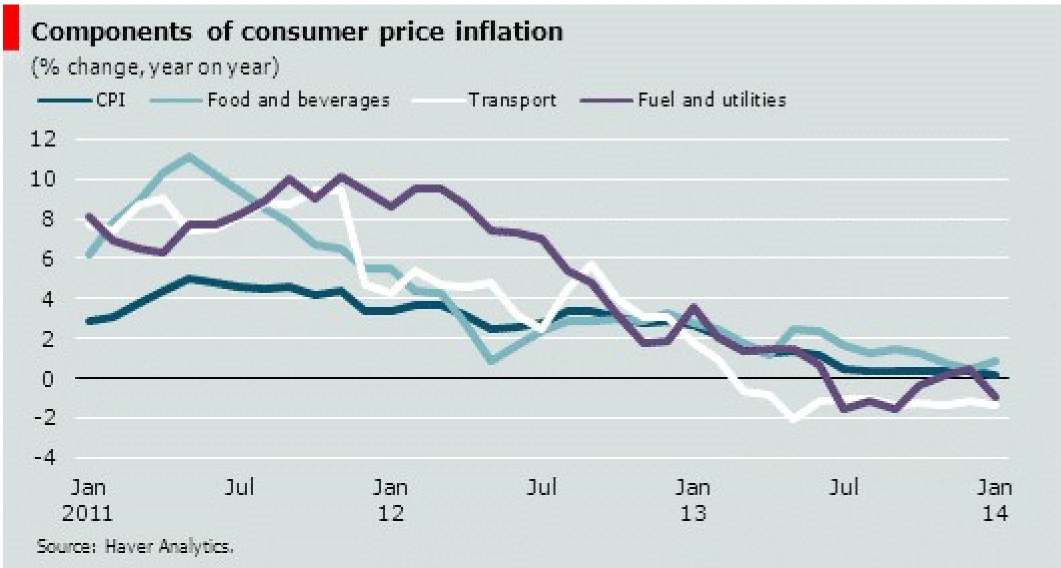
Event

According to Statistics Lithuania, consumer prices in January fell by 0.3% month on month (seasonally adjusted), while year-on-year prices rose by 0.2%, compared with 2.6% in January 2013.

Analysis

Inflation has been falling in month-on-month terms since October 2013, and the rate of year-on-year inflation has also slowed over the same period.

In year-on-year terms inflation fell across all major categories except recreation and culture. However, this only accounts for 6% of the re-weighted price basket. The index of food and non-alcoholic beverages, with a 25.2% share, rose by just 0.9%, from 2.8% a year earlier. The cost of transport (14.1% share) fell by 1.4% in January 2014, compared with a 1.8% rise in 2013, and the cost of utilities and fuel decreased by 0.99%.



Falling fuel and utility prices will be particularly welcome for the authorities. A jump in the prices charged by Russia's Gazprom, the supplier of all of Lithuania's gas, was one of the reasons behind a spike in inflation in 2007, which prevented the country from meeting the euro accession criteria. Lithuania is making slow but steady progress in its dispute with Gazprom over the price charged by the Russian supplier to Lietuvos Dujos, the domestic distribution company, although any positive results are unlikely to materialise before the country's compliance with the Maastricht criteria for euro adoption are assessed later this year. At the end of January 2014 the Lithuanian government and Germany's E.ON, Lietuvos Dujos's other shareholder, pushed through a decision to launch an arbitration case—the country's second—against the gas giant. On February 11th Gazprom reportedly offered new terms on gas prices, which Dalia Grybauskaite, the president, described as "worth considering".

The prognosis for Lithuania meeting the Maastricht inflation criterion for euro adoption remains encouraging. Inflation as measured by the EU's 12-month harmonised index of consumer prices (HICP) fell to 1.2% in December, from 1.4% the previous month. As a result, Lithuania is 0.6 percentage points below the inflation ceiling for accession to the euro zone (set at 1.5 percentage points above the average of the three countries with the lowest 12-month HICP rates).

Impact on the forecast

We maintain our belief that Lithuania will meet the inflation criterion for adopting the euro in 2015.

March 3, 2014: Economic growth

Economic growth was 3.3% in 2013

Event

According to Statistics Lithuania's second estimate, real GDP grew by 3.3% year on year (unadjusted) in 2013, and by 3.6% in the fourth quarter.

Analysis

Both full-year and fourth-quarter GDP growth were 0.1 percentage points higher than in the first estimate—although this still marks a slowdown, from 3.7% and 4% respectively in 2012. In expenditure terms the most significant change was the sharp year-on-year slowdown in exports of goods and services to 3.1% in the fourth quarter, from 21.1% a year earlier. Imports grew by 5.9% in the fourth quarter, compared with 12.7% in the same period of 2012.

The relative strength of import growth is partly due to rising domestic demand taking up the slack for the fall in external demand. Private consumption growth expanded to 4.9% year on year in the fourth quarter of 2013, from 2.9% in the same period of 2012, reflecting higher employment and wages—the latter boosted by an 18% rise in the minimum wage last year. Public consumption grew by 1.7% in 2013 as a whole, from a mere 0.6% in 2012, as fiscal austerity pressures eased. Gross fixed capital formation soared by an average of 12.2%, compared with a decline of 2.8% in 2012.

Capital formation growth was mirrored by a recovery in construction. This registered the biggest leap in gross value added (GVA) in 2013, of 10.6%, compared with a decline of 5.4% in 2012, while its share of total GVA expanded by 0.5 percentage points to 6.5%. In the fourth quarter of 2013 growth accelerated to 20.7% year on year. In the trade, transport, storage, motor vehicles, accommodation and catering sectors, which collectively account for the largest share (33.2%) of GVA, yearly growth slowed to 3.9%, from 6.9% in 2012. The growth in manufacturing (20.5% of GVA) also declined, from 5.1% to 4.9%. As in the case of exports, weakening demand for refined oil products from the Orlen Lietuva refinery was partly responsible for the slowdown.

Public services—the third-biggest sector, with 13.4% of GVA—registered modest growth of 1.2%, as did information and communications (2.3%), finance (2.9%) and real estate (1.7%). The only significant decline, of 1.8%, was registered by agriculture and related activities, with the 11.4% rise in 2013 exerting a strong baseline effect.

Impact on the forecast

Full-year 2013 growth came in above our 2.9% estimate. As a result, we may revise up our 2014 growth forecast, which currently stands at 3.3%.

Analysis

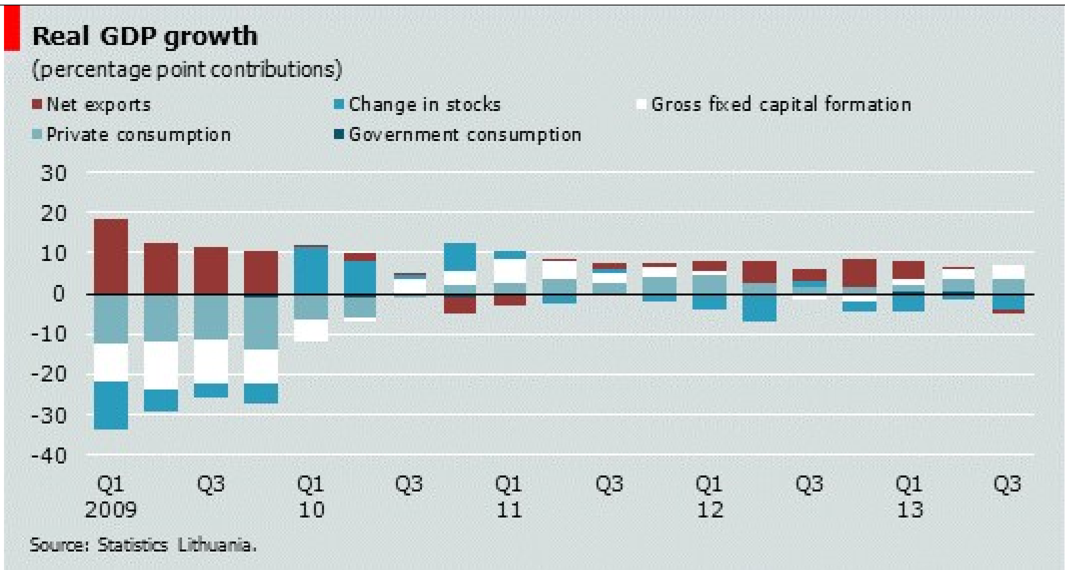
December 3, 2013: Economic growth

Growth will remain robust in 2014

While the slowdown in the pace of economic growth in the third quarter reflected weaker external demand, it was also a function of strengthening private consumption (and, consequently, imports), which led net exports to make their first negative contribution to growth since January-March 2011. In the coming quarters, we expect private consumption to continue to strengthen, underpinned by weak inflation, a gradual tightening of the labour market and rising consumer confidence. Investment will also remain strong, owing to improving business confidence, looser credit conditions and EU fund inflows. Net exports are likely to contribute less strongly to growth, due in part to increasingly robust domestic demand and a consequent rise in imports. However, with Lithuania's key trade partners all forecast to grow relatively strongly in 2014, net exports should continue to contribute positively to headline real GDP growth.

The Lithuanian economy grew by 2.3% year on year in the third quarter, according to detailed data released by Statistics Lithuania. This was a slight improvement on the original 2.2% flash estimate, but nevertheless represented a significant slowdown on the 3.7% year-on-year growth rate posted in the first half of 2013. On the back of the latest data, we hold to our estimate of 2.9% growth in 2013 (which implies a similar annual growth rate in the fourth quarter).

The third quarter represented something of a change from the trend of much of the past three years. Private consumption rose by 6% year on year, the fastest rate since early 2012, while gross fixed capital formation—which suffered much more than other areas of the economy, following the 2008-09 global financial crisis—jumped by 16.9% year on year, the fastest rate since 2011. Meanwhile, net exports, which have been a key driver of growth in recent years, had a negative impact on the headline GDP number for the first time since January-March 2011. Export growth slowed quite significantly across the Baltic states in the third quarter, reflecting both less favourable base effects and weaker external demand from some key trade partners. German economic growth was slower in the third quarter than the second, while Russian growth has disappointed on the downside through 2013. However, the negative contribution of net exports is also a reflection of the strength of domestic demand, and its consequent impact on imports. Although the pace of import growth also slowed in the third quarter (again, a reflection of much less favourable base effects), it was 2 percentage points faster than that of exports, the first time that this has been the case since the first quarter of 2011.



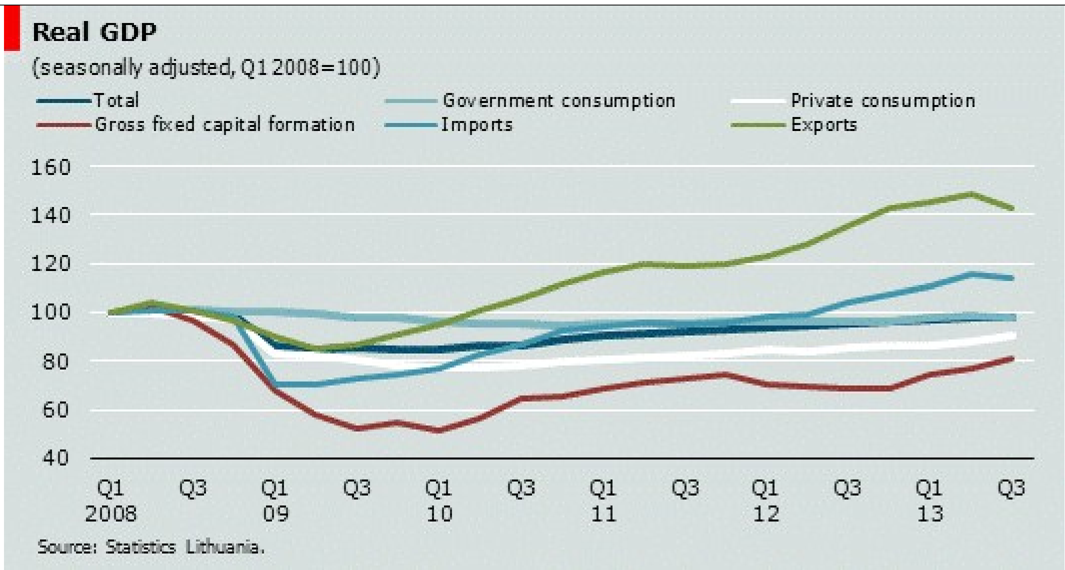
Consumption will continue to strengthen gradually in 2014

Robust private-consumption growth in the third quarter reflects moderate improvements in the labour market and rising real wages. The unemployment rate remained steady, at 9.9%, in October, the same level as in September, close to a multi-year low. However, this is in part reflective of hefty emigration since the financial crisis, with the labour force in the third quarter at 185,000, smaller than in the same period of 2009. More importantly, those in employment rose above 1.3m in July-September, for the first time in four years. This indicates a relative tightening of the labour market, which in turn has underpinned a rise in wages. Net earnings increased by 5.8% year on year in the third quarter, the fastest rate since 2008. The concomitant collapse in inflation (price growth was just 0.4% year on year in July-September), means that real net wages rose by 5.4% year on year in the third quarter, also the fastest rate since 2008. These developments should continue through 2014, underpinning private-consumption growth of 3.5% (the same level as we estimate for 2013). While inflation should pick up from current levels, we expect it to remain relatively low, at 2%. Meanwhile, we forecast average gross-wage growth of 4.7%.

We also see investment continuing to strengthen, and forecast real growth of 4.5% in 2014. This will be underpinned by rising business confidence as the robust economic recovery continues, as well as slightly easier credit conditions and EU-funding inflows.

External sector positive

Further increases in consumption will continue to weigh on the contribution of net exports to growth. Nevertheless, we forecast the contribution to remain positive in 2014, at 0.4 percentage points (albeit well down from an estimated 1.1 percentage points this year and 4.4 percentage points in 2012). This is for two key reasons. First, domestic demand in all of Lithuania's main export markets—Germany, Poland, Russia and the other Baltic states—should strengthen in 2014. Second, Lithuania has made impressive competitiveness gains since the global financial crisis—even compared to its Baltic neighbours—and this should ensure that its exports continue to perform well on global markets. In seasonally adjusted terms, exports are now 42.6% above their level in the first quarter of 2008, whereas the overall economy remains smaller, indicating the scale of the adjustment.



Weak lending likely to remain a drag on growth

Despite the relatively optimistic outlook, we do not expect a return to anything like pre-crisis levels of growth during the forecast period. We forecast real GDP growth of 3.3% in 2014, rising to an average 3.6% in 2015-18, with risks largely weighted to the upside. One factor holding back stronger growth is ongoing deleveraging in the banking sector. Having made a small recovery at the beginning of the year, bank lending fell in annual terms in June-October, and the outstanding stock of credit extended by monetary and financial institutions (MFIs) to non-MFIs is now 18% below its 2008 peak. A return to the average 40% year-on-year credit growth of 2003-08 is certainly off the cards. We see credit growth reaching 2.7% in 2014 as conditions gradually improve.

December 13, 2013

Agreement on key points of EU and euro zone banking reform

After three days of negotiations, on December 11th EU finance ministers agreed the outlines of a deal on key aspects of the process of banking reform that will commence across the bloc next year, with different levels of commitment to resource-pooling for countries inside and outside the euro zone. As is often the case when major decisions are required in the EU, the outcome was last-minute and it fudged important questions as to the balance of sovereignty between national governments and European institutions. This deal is a significant institutional step forward, but four years after the eruption of crisis in the euro zone, Europe's policymakers have yet to move beyond an ad hoc and piecemeal approach to institutional questions that ought to have been resolved earlier and with greater clarity and transparency.

The deal reached at ministerial level on December 11th does not represent the final word in these negotiations. Final approval rests with EU leaders, who meet in Brussels on December 19th-20th. In addition, that meeting will be preceded by a further round of ministerial negotiations to smoothen the rough edges of the various compromises that shape the agreement.

The two key institutional underpinnings of Europe's proposed banking union are a single supervisory mechanism (SSM) and a single resolution mechanism (SRM). The creation of the first of these is under way, with the European Central Bank (ECB) set to take on supervisory responsibilities in November 2014. The recent negotiations related to the SRM, which is politically more charged because it entails decisions on who will foot the bill in future if a bank goes bust. All euro zone countries will be required to conform to the full rigours of both the SSM and the SRM. Other EU states will be able to opt in if they wish, and will be covered by the general requirements of the SRM process that has been agreed, but not by the burden-sharing element towards which the euro zone is moving.

The rationale for banking union

The purpose of the SRM is to break the loop between the finances of banks and states, which was central to the escalation of the euro zone crisis. When the global financial crisis broke, it led to huge capital holes appearing on the balance sheets of over-extended lenders. The banks' national governments then found themselves putting their states' solvency at risk with repeated capital injections aimed at preventing the financial system from seizing up. An estimated €473bn of public money has been pumped into the European banking sector by national governments. As well as ultimately requiring a series of EU/IMF bail-outs for euro zone states that could no longer fund themselves in the bond markets, this also created new weakness on the balance sheets of many banks, through their heavy exposure to the increasingly distressed sovereign debt of their parent countries.

In theory, a properly functioning resolution mechanism would have prevented this vicious circle, by allowing for the orderly winding down of non-viable banks and ensuring that public funds would have been a last line of defence after private sources of capital had been exhausted. Bank bondholders and large depositors would be "bailed in" to the rescue process before governments would need to provide any bail-out funding. In a national context, such a system is relatively uncomplicated to establish. In a European context, it requires decisions that go to the heart of questions about the depth of European political and fiscal integration. There were two key points in particular that negotiations needed to settle, both of which turned on the extent to which national governments would be willing to pool resources of various kinds with their peers: who will have the authority to invoke resolution procedures and who will pay the costs of recapitalising ailing banks.

The outlines of the deal

Greater progress was made in relation to the funding question, although important uncertainties have still to be ironed out. One important development was that the new financial arrangements will take effect from the start of 2016, two years ahead of the previously agreed timeframe. This suggests that policymakers have grasped the weight of expectation that has built up in relation to banking union. The deal envisages a process in two stages. Private capital would be bailed in first, in a move which would affect shareholders, bondholders and large depositors. Deposits of less than €100,000 would be exempt and protecting the non-exempt deposits of individuals and small businesses would be prioritised as far as possible.

Once bail-in funding from these sources hits a threshold of 8% of the failing bank's total liabilities, it would become possible to dip into public resolution funding, up to a maximum of 5% of bank liabilities. Over a period of ten years, resolution funds would be established amounting to 1% of covered deposits, equivalent to around €70bn. This would almost certainly be funded through national levies imposed on banks. In the 17-member euro zone, this resolution funding takes on greater significance as it becomes a central pool that can be drawn on in the event of an emergency in any of the single currency's members. Importantly, euro zone ministers have yet to agree how access to this central resolution fund would be regulated.

The idea of a central fund is one that Germany had opposed because of the risk that it would again be called upon to pump money into weaker periphery countries. However, the compromise it insisted on—whereby use of the common resolution fund would be subject to a vote by participating states in which larger countries would enjoy a greater say—is vigorously opposed by a number of governments and is certain to be revisited in the next round of negotiations.

On the question of the authority to initiate the resolution mechanism in the euro zone, the agreement reached by the bloc's ministers involves a more clear-cut pooling of sovereignty. A central resolution board would be tasked with proposing decisions to recapitalise or wind up distressed banks in the single currency area. Its proposals would require the approval of the European Commission. If the Commission granted its approval, then the only circumstances in which a national government could block the resolution process would be if one of its national banks required public bail-out funding as well as private bail-in funding.

The increasing centrality of the ECB

Although the agreement on banking union may have been hammered out by finance ministers and may still be subject to the approval of political leaders, the European Central Bank (ECB) has been a key source of momentum and direction in relation to banking union. The bank's president, Mario Draghi, left policymakers very little room to drag their heels, repeatedly insisting in public that agreement by the end of the year was necessary if the ECB's assumption of its new supervisory powers was not to be adversely affected.

Mr Draghi has emerged as a canny and powerful operator since taking the helm at the ECB in November 2011. He was pivotal to moving the euro zone crisis out of its acute phase with his declaration that he would do "whatever it takes" to protect the single currency. He clearly understands the influence he now wields and was not shy to use it to force the hand of the region's laggardly politicians on the resolution question. By forcefully linking the ECB's effectiveness as a banking supervisor to the timely and satisfactory conclusion of a deal on a resolution mechanism, in effect he was making his "whatever it takes" commitment conditional on the leaders' actions. This represents a potentially significant shift in the balance between euro zone governments and their shared central bank. Until now, euro zone leaders have used the ECB's successful calming of the crisis as an excuse to slow the pace of reform. On banking reform, however, the ECB has reversed the process, using its increased leverage to accelerate the pace of reform.

January 23, 2014

The EU's 2030 climate package attempts tricky balancing act

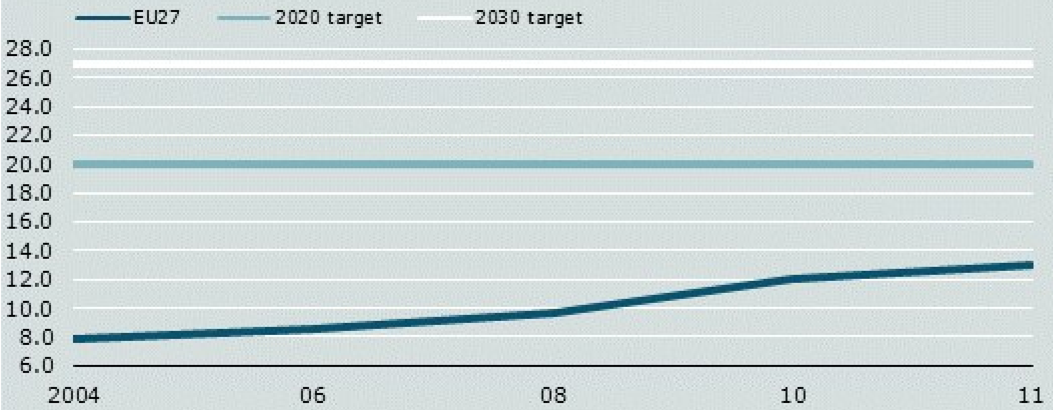
In a long-awaited publication of its suggested framework for the EU's climate and energy policy for 2030, the European Commission has placed a stronger emphasis on boosting economic growth, job creation and industrial competitiveness compared with its previous climate package (for 2020) released seven years ago. This is highlighted by less ambitious targets for renewable energy and reductions in greenhouse gas (GHG) emissions as the renewables sector is maturing and industry remains concerned about high energy prices in Europe. Nonetheless, the EU is set to remain a global leader in the fight against human-induced climate change in upcoming international climate talks.

The Commission suggests a binding target for reductions in harmful GHG emissions of 40% from their 1990 levels by 2030 (up from just above 18% currently). The 2020 target was 20% and looks set to be more than achieved, but primarily because of the recent economic downturn in the EU that has slashed energy demand. In terms of renewable energy, the Commission aims to raise the share of renewables in total energy consumption to at least 27% by 2030, up from around 13% currently and compared with a 20% target for 2020.

Greenhouse gas emissions in the EU27
(m tonnes)

Note: Does not include Croatia, which joined the EU in 2014.
Source: European Environment Agency.

Share of energy from renewable sources
(% of gross final energy consumption)



Note: Does not include Croatia, which joined the EU in 2014.
Source: Eurostat.

The end justifies the means

Unlike the 2020 goals, the 2030 renewable energy target of 27% does not include individual country targets, instead focusing on the EU aggregate. This was a major concession to countries such as the UK, which is prioritising nuclear power and shale gas—this may well help the country to contribute to the EU's GHG target but may weaken its contribution to the renewables target. Likewise, Poland, which has large shale gas exploration potential, is only likely to support the GHG target if the Commission does not propose new legislation on shale gas exploration. The 2030 policy document barely mentions shale gas; that said, the Commission has recently published a set of recommendations to member states, addressing concerns about public health and the environmental effects of shale gas exploration. The 27% renewables target in the Commission's policy framework was made binding—rather than indicative—on the insistence of countries such as Germany that are undergoing a major energy transformation, putting greater emphasis on renewables and phasing out nuclear energy.

The president of the European Commission, José Manuel Barroso, emphasised that the GHG target was the priority, with the renewables target a function of the GHG target, in addition to other means such as emissions trading and raising energy efficiency. With regard to energy efficiency, the 2030 policy framework does not include a binding target. Instead, it says that a GHG emissions reduction target of 40% would require raising energy efficiency by around 25% by 2030; the 2020 framework had included a non-binding target of 20%. The latest policy framework is short on details on how energy efficiency can be raised, instead pointing to the Energy Efficiency Directive due to be concluded later in 2014. The lack of focus on energy efficiency is unfortunate given that buildings account for 40-45% of energy consumption in Europe, according to the United Nations Environment Programme.

However, the policy framework puts a greater emphasis on reviving the EU's dysfunctional emissions trading scheme (ETS); it was launched in 2005 with high hopes of reducing GHG emissions and setting a standard for the rest of the world, but the European economic crisis and an oversupply of carbon allowance have led to a sharp fall in the carbon price since 2008, failing to discourage the use of fossil fuels in the power sector (especially coal). In order to ensure more stable carbon prices and boost low-carbon investment, the Commission proposes in its 2030 policy framework the establishment of a market stability reserve in 2021. Hence, the carbon price could become an increasingly important signal for investment opportunities, rather than subsidy schemes in EU member states, especially as binding national targets for renewables have been replaced by an EU-wide one. Nonetheless, Europe's renewable energy sector will continue to benefit from subsidies in the coming years, but less so from 2020 than previously. This may, however, be less of a concern as the sector is becoming more mature and able to compete with the non-renewable energy sectors.

Industrial competitiveness

Overall, while the EU is on course to meet its—at the time when they were adopted (2007)—ambitious renewables and emissions targets for 2020, the 2030 targets are distinctly less ambitious. One of the main rationales behind easing the requirements, especially on raising the share of renewable energy, is the fact that energy prices in Europe are comparatively high. For example, according to the Commission, household electricity prices rose by an annual average of 4% between 2008 and 2012 across the EU, and industry retail electricity prices increased by around 3.5% per year during this period. In a global competitive context, industrial retail electricity prices are now more than twice those in the US (where a shale gas boom has lowered gas prices) and Russia and 20% higher than in China. Renewables subsidies, in addition to existing support for fossil fuel producers, have pushed up energy costs in Europe over the short term. The price differentials with its key trade partners and competitors threaten Europe's industrial competitiveness, production and investment.

At the same time, setting ambitious long-term targets remains a crucial element of EU climate and energy policy. Despite the overall easing of targets, the EU is likely to remain a leader in driving global efforts to reduce harmful GHG emissions. This long-term approach is set to yield benefits, as it manifests the EU's position as a force for innovation, investment and job creation in green industries. The long-term targets also mean a greater sense of predictability for investors and are part of the EU's strategy to reduce its energy import dependency and boost its security of supply.

Global climate talks

With energy demand increasing globally, especially in Asia, Europe has an opportunity to maintain its role as a global leader in fighting human-induced climate change. In 2012 the EU was the third-largest emitter of carbon dioxide (CO2), with 11% of global emissions, behind China (29%) and the US (16%). In China, CO2 emissions have grown by around 290% since 1990 and by around 70% since 2005. Emissions per capita are now roughly at the same level as those of the EU (about 7 tonnes). US emissions of CO2 have fallen by over 12% since 2005. However, emissions per capita are much higher in the US, at 16.4 tonnes in 2012.

The timing of the Commission's initiative was probably partly driven by the fact that the terms of the current Commission and that of its president, Mr Barroso, will end in June this year, giving this team of commissioners a last chance to formulate long-term climate policy. But the proposal also puts early pressure on the European Council (representing the member states) and the European Parliament to agree on GHG emissions reduction targets by end-2014, so that the EU can pledge the 40% reduction in early 2015 as part of international negotiations on a new global climate agreement, which is due to be concluded in Paris at end-2015. Although the Commission was careful to include the often diverging interests of member states in its proposal (for example, on the binding renewable energy target), it will still be challenging to convince all 28 EU member states to sign up to the new targets. In March the European Council will get a chance to discuss the Commission's proposals.

February 26, 2014: Economic growth

Job market continues to improve

The unemployment rate continued to fall in Lithuania in 2013. Although net emigration slowed last year, it continued to play a significant role in absorbing unemployed labour. Real wage growth finally recovered in 2013 as a result of the higher minimum wage and lower inflation, but as long as earnings remain well below EU averages the country will continue to lose its most skilled workers. The continuation of the positive trends in employment and wages is essential for the health of the wider economy as private consumption takes over from exports and manufacturing as the main driver of real GDP growth.

Lithuania's labour market indicators continued to improve in the fourth quarter of 2013 in annual terms, according to Statistics Lithuania's quarterly labour force survey. The number of people unemployed fell by 13.1% year on year (25,300), to 167,200, and the unemployment rate declined by 1.8 percentage points, to 11.4%. Male unemployment fell from 15.2% to 13.1%, and female unemployment from 11.6% to 10.5%. Significantly, the number of people in employment grew by 2.3% (29,200), to 1.3m, with the employment rate rising by 1.7 percentage points, to 51.6%.

Over 2013 as a whole, the total number of people unemployed fell by 12.3% (24,300), to 172,500, and the rate fell by 1.2 basis points, to 11.8%. The number of people classed as "inactive"—those neither employed nor looking for work—also fell, by 1.6% (17,100), to 1.06m, and the number of employed grew by 1.3% (17,100), to 1.29m.

The proportion of the population aged 15 years and over shrank once again in 2013, with emigration accounting for the discrepancy between the fall in the number of unemployed and inactive people and the rise in the number of those in employment. Between 2006 and 2013 the number of people in Lithuania aged 15 and over fell by 316,600, to 2.53m. However, net migration has slowed significantly, to 16,748 in 2013, from 21,257 in 2012 and 38,178 the previous year.

The creation of new jobs remains uneven

Job creation has been confined to a relatively small number of sectors. As a result of the recovery in building, construction generated the highest number of new jobs—9,800 in 2013—with demand for both skilled and unskilled labour on the increase. Public administration generated 6,600 new jobs, mainly as a result of temporary posts generated by Lithuania's presidency of the Council of the European Union in the second half of 2013. At the other end of the spectrum, education lost 8,700 jobs, reflecting the falling population and lower school enrolment. Information and communication lost 3,600 jobs, a surprising development given the purported skills shortages here. One possible explanation is that although this sector is the country's second best remunerated after finance, skilled information technology (IT) workers can find much better paid jobs elsewhere in the EU. Agriculture, forestry and fishing lost 3,300 jobs. The 2013 harvest did not match the previous year's exceptionally strong performance and consequently the demand for seasonal labour was lower.

Other positive trends include a fall in the rate of long-term unemployed—defined as those out of work for more than a year—from 6.6% in 2012 to 5.1% in 2013, and a significant decline in youth (aged 15-24) unemployment, from 26.7% to 21.9%. The jobs trends are in line with the economic recovery. In 2007, when real GDP soared by 9.8%, the unemployment rate reached a ten-year low of 4.2%. Factors included an overheated construction market, and a shrinking labour pool following the post-EU accession opening of labour markets in countries such as the UK and Ireland for Lithuanian workers. Following the collapse of the economy in 2009, when real GDP plunged by 14.8%, the unemployment rate shot up to 13.8%, peaking at 17.8% the following year. Significantly, the rate of the fall in unemployment has slowed down since 2011 in line with slower economic growth, and is unlikely to fall to pre-crisis levels in the forecast period.

Lower inflation and a higher minimum wage boosted real earnings

Wage growth has taken longer to recover than that of employment. The policy of "internal devaluation" pushed wages down in real terms by an average of 3.3% in 2009–10, with earnings only starting to rise on a yearly basis in 2012 for the private sector, and in the following year for public-sector workers. In 2013 average gross monthly earnings grew by 3.5% year on year in nominal litas terms for public-sector workers, to LTL2,400 (US$950), and by 6.1%, to LTL2,139, for the private sector. In real terms wages increased by 2.3% and 4.7% respectively over the same period. Public-sector wage growth will accelerate further this year, following the government's decision in 2013 to restore the earnings of the civil service and judiciary to pre-crisis levels.

The main drivers for higher real wages were lower inflation—an average of 1% in 2013 compared with 3.1% a year earlier—and an increase in the minimum wage. In January 2013 the government raised the minimum monthly wage by 18%, to LTL1,000. Earlier this year Loreta Grauziniene, the Seimas (parliament) speaker and chair of the Labour Party (a member of the coalition government), argued for a further increase, to LTL1,500. The rise primarily pushed up earnings in the low-paid accommodation and catering sector, and to a lesser extent in agriculture, construction, and wholesale and retail trade. Although the policy was probably responsible for an uptick in the recent price inflation of services like hotels and accommodation, there is little likelihood, given that Lithuania is some way off full employment, of a wage-price spiral in the near future. The minimum wage is in any case low by European standards—the third lowest in the EU after Bulgaria and Romania at the start of 2014, according to Eurostat.