MISSION CONCLUDING STATEMENT

Republic of Lithuania: Staff Concluding Statement of the 2022 Article IV Mission

June 7, 2022

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC: *Lithuania rebounded strongly from the pandemic due to resilient macroeconomic fundamentals, a decisive policy response, and accommodative financial conditions. Russia's invasion of Ukraine and its impact on energy and commodity prices have already had a significant impact on economic activity and inflation and remain a source of downside risks going forward. Nevertheless, strong macroeconomic fundamentals, large policy buffers, and a flexible labor market will help maintain the resilience of Lithuania's economy. In the short term, the main challenge is to prevent the surge in inflation from triggering a vicious price-wage spiral that could undermine macroeconomic stability. Over the medium term, the focus should be on unlocking the economy's potential by removing structural bottlenecks through long overdue reforms and taking proactive steps to address the challenges associated with climate change and energy security. At the same time, there is a need to consolidate the initial success in developing the Fintech sector by strengthening the integrity of the AML/CFT framework.*

Recent Developments, Outlook, and Risks

Prior to Russia's invasion of Ukraine, the Lithuanian economy was on a strong post-pandemic recovery path with signs of overheating. With resilient macroeconomic fundamentals, a decisive policy response, and high immunization rate, the economy avoided a recession in 2020 and rebounded vigorously in 2021, outperforming the rest of the eurozone. Domestic demand was the main driver of growth—supported by low unemployment, double-digit wage growth, and a recovery of investment—which contributed to accelerating inflation by year-end. The external position remained strong, reflecting competitiveness gains.

The recent spike in global energy and food prices and persistent supply bottlenecks have compounded inflationary pressures, disproportionately hurting the poor. As a result, inflation increased from the recent trough of -0.1 percent at the end of 2020 to 18.5 percent in May 2022, the second highest in the euro area. Inflation excluding energy and food components has increased alongside strong wage growth, suggesting that the surge in inflation has become broad based. Furthermore, the tight labor market and compressed profit margins could lead to further pressures from wages to price inflation. Higher consumer prices have put a relatively greater strain on low-income households as they allocate 60 percent more of their consumption on food and energy than do higher-income ones.

Strong macroeconomic fundamentals, large policy buffers and a flexible labor market are key factors explaining the resilience of Lithuania's economy :

- *The banking sector remains profitable, well-capitalized, and liquid.* Capital adequacy ratios (at 23 percent at end-2021) are well above the required minimum and profitability is above that of eurozone peers, although it remains below pre-pandemic levels.
- *The fiscal position in 2021 was strong.* Reflecting a robust recovery and prudent policies, the deficit fell to 1 percent of GDP, bringing government debt down. In 2022, while pandemic-related support is minimal, ample fiscal space has allowed the government to approve a package of about 3.5 percent of GDP to mitigate the increase in energy prices to households, support vulnerable groups and increase military spending.
- *Trade links to and energy dependency on Russia have long been declining.* Trade and financial linkages have become significantly less important over time after the integration into the EU. The share of exports to Russia, Ukraine, and Belarus declined from 30 percent of total exports in 2014 (before Russia's annexation of Crimea) to 16 percent. Furthermore, a significant share of these flows (90 percent in the case of Russia) represents reexports, significantly reducing the impact on economic activity in Lithuania. With regards to energy dependence, Lithuania has recently discontinued imports of electricity, oil, and natural gas from Russia.

Growth this year will be around 2 percent, half the pre-war forecast, but abundant risks could further hinder growth. Projections are subject to significant uncertainty and based on the assumptions of no further escalation of the war and a gradual decline in commodity prices starting later this year. Inflation will remain elevated throughout 2022 and early 2023 because of high commodity prices, tight labor market conditions, and persistent supply-side disruptions. This could lead to a wage-price spiral that could become entrenched, endangering macroeconomic stability. Risks to the outlook are clearly tilted to the downside: they include a further escalation of the war, lack of momentum in structural reforms, and tightening financial conditions. On the other hand, the economy could prove to be more resilient than projected, supported by the strong financial position of the private sector.

Macroeconomic Policies

The authorities' response to unprecedented energy prices limits economic disruption, provides targeted support to the vulnerable and allows for market price signals . With a more targeted response than that adopted in other countries, the passthrough of higher energy prices to consumers has been significant, particularly for companies. Initially, the authorities limited the increase in regulated energy prices, imposing loses in the public electricity company, Ignitis. As high energy prices proved persistent, the authorities amended the budget to subsidize the energy bill to consumers and compensated Ignitis for the losses accumulated in the first half of the year. The decision to allow a significant pass-through of energy prices and reflect this subsidy transparently in the budget is welcome. Pre-existing targeted programs to subsidize heating for vulnerable households have also been enhanced and the VAT rate on district heating for households was temporarily reduced to zero in the first four months of this year at a modest fiscal cost. Going forward, the subsidy to energy tariffs should gradually be phased out even if high energy prices proved persistent with the bulk of the support being provided in a targeted manner to the more vulnerable.

Higher revenues from inflation allow the budget to accommodate pressures for higher social and defense spending in the short term, but difficult tradeoffs await down the road. Permanent spending commitments, such as additional defense expenditures of about 0.5 percent of GDP, add to pre-existing pressures associated with social demands and age-related spending. With discretionary spending low and lack of consensus on significant tax reform in the current environment, further increases in spending will result in a moderate deficit over the medium term instead of the authorities' goal of a balanced budget. This would still keep the public debt-to-GDP ratio on a declining path. To avoid turning these short-term challenges into structural problems, efforts should focus on improving the quality of spending while broadening the scope and strengthening the collection of environmental and housing-related taxes and eliminating distortionary tax concessions and exemptions that tend to favor higher incomes. To this end, the government's proposal for revamping real estate taxation is a step in the right direction.

Given the risk of persistently high inflation, fiscal policy will need to be decisively countercyclical going forward . The fiscal response this year is appropriate given the social impact of high energy prices, their negative impact on economic activity and the fact that new spending consists of a large share of imports with little impact on domestic demand. The lack of an independent monetary policy makes fiscal policy the main tool left to support macroeconomic stability. Thus, a tightening of fiscal policy next year in line with the national fiscal rule without activating the escape clause will help minimize the risks of persistently high inflation. Furthermore, the increase in public sector wages and the minimum wage over the next few years should be consistent with expected inflation and productivity gains to provide a strong signal to the private sector and prevent a vicious wage-price spiral.

Financial Policies

The banking system has ample capital and liquidity buffers to withstand a weakening economic environment or even greater shocks. The balance sheets of households and firms appear to be resilient but overheating in the real estate market remains a risk. The implementation of a series of macroprudential measures, including tighter down payment requirements for second and subsequent housing loans and a new sectoral systemic risk buffer for banks with the largest mortgage portfolios is welcome. However, their effectiveness might be limited in light of excess capital in the banking system and the large share of home purchase transactions undertaken in cash. The expected emergence of a large financial institution with non-resident base business model will require prompt action by the national and supranational authorities to ensure effective supervision under the existing European arrangements.

Further efforts are needed to mitigate money laundering and terrorist financing (ML/FT) risks in the financial sector, particularly from the dynamic and growing fintech sector. While the Bank of Lithuania (BoL) has made important strides in strengthening AML/CFT supervision, the fast-growing non-resident activity in the fintech sector presents regulatory and supervisory challenges, particularly in cross-border payments. In this context, the focus should be shifted from growth of this sector to its consolidation, with a focus on mitigating ML/FT risks. This should

include more effective controls for access to the BoL's payment system (CENTROlink). For virtual asset service providers, the Ministry of Interior and the Financial Intelligence Unit should develop risk-based supervision, stronger supervisory powers, and market entry controls. The AML/CFT supervisory capacity of the BoL will also need to be substantially strengthened, a process which will take time and require significant new resources and greater coordination with other jurisdictions.

Structural Challenges

Structural reforms are necessary to ensure continued income convergence. Lithuania has long benefited from the structural flexibility of its economy, absorbing shocks, and reducing the burden of fiscal policy in the context of a currency union. This is critical for sustaining productivity gains and thus maintaining a competitive export sector. To this end, the authorities need to address structural impediments by accelerating reforms in education and healthcare, by closing gaps in the transportation infrastructure, and reducing information asymmetries that limit access to financing for small and medium enterprises.

A comprehensive carbon tax will be necessary to achieve the authorities' emission reduction objectives for 2030. Recent developments have highlighted the importance of climate change mitigation and energy security. The authorities have taken important steps on both fronts, but more aggressive policy adjustments are necessary to achieve the reduction in greenhouse gas emissions and energy imports. This will require (i) reducing fossil fuels in the energy matrix, (ii) investing in low-emission transportation, and (iii) raising energy efficiency. The introduction of a economy-wide carbon tax —set to gradually increase to €50 per metric ton of CO_2 emissions by 2030—could provide the necessary incentives for a faster reduction in energy consumption and emissions while generating additional revenues. At the same time, since long term climate risks cannot be eliminated, adaptation measures to strengthen physical, financial, institutional, and social resilience will be important.

The IMF team is grateful for the generous hospitality of the Lithuanian authorities and would like to thank all its interlocutors in government, the Bank of Lithuania, the European Central Bank, the private sector, unions, and business associations for constructive and fruitful discussions.

MEDIA RELATIONS

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