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IMF Executive Board Concludes 2022 Article IV Consultation with the Republic of Lithuania

July 28, 2022

Washington, DC : On July 22, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation [1] (file:///Q:/COM/MR/Press%20Releases/2022/PR22276-%20Lithuania-%20IMF%20Executive%20Board%20Concludes%202021%20Article%20IV%20Consultation%20with%20the%20Republic%20of%20Lithuania.docx# with the Republic of Lithuania.

With resilient macroeconomic fundamentals, a decisive policy response, and a high immunization rate, the Lithuanian 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 past 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 20.5 percent in June 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.

Russia's invasion of Ukraine has impacted activity and inflation with growth projected around 2 percent in 2022—about half the pre-war forecast. Projections are subject to significant uncertainty and abundant downside risks could further hinder growth. Inflation will remain elevated throughout 2022 and early 2023 because of high energy and 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 skewed to the downside and include a further escalation of the war in Ukraine, 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.

Executive Board Assessment 2 (file:///Q:/COM/MR/Press%20Releases/2022/PR22276-%20Lithuania-%20IMF%20Executive%20Board%20Concludes%202021%20Article%20IV%20Consultation%20with%20the%20Republic%20of%20Lithuania.docx#

The authorities' response to the energy crisis aims to limit economic disruptions, provide targeted support to the vulnerable, and allow for market price signals. With a more targeted response than that adopted in other countries, the pass-through of higher energy prices to consumers has been significant, particularly for companies. While the support provided for the first half of 2022 was not in line with best practices, the more recent 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 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 add to pre-existing pressures. 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 a strong fiscal position with public debt on a declining path. To avoid turning short-term challenges into structural problems, efforts should focus on improving the quality of spending while broadening environmental and housing-related taxes. 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. Although fiscal policy should ideally take a counter-cyclical stance in Lithuania given the lack of monetary policy, the moderately procyclical stance in 2022 is an appropriate response to the new environment with heightened uncertainty and downside risks, especially considering that half of the fiscal stimulus is on additional military spending on mostly imported equipment with little impact on domestic demand. Public debt is still projected to decline this year. A tightening of fiscal policy next year in line with the national fiscal rule 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.

The banking system has ample capital and liquidity buffers to withstand a weakening economic environment or even greater shocks. The expected emergence of a large financial institution with a non-resident base business model will require prompt action by national and supranational authorities to ensure effective supervision under the existing European arrangements.

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

The external position was moderately stronger than implied by fundamentals. The current account surplus decreased to pre-pandemic levels. National savings remained buoyant reflecting temporary factors rather than a long-term misalignment.

Structural reforms are necessary to ensure continued income convergence. The authorities need to address structural impediments by accelerating reforms in education and healthcare, and by closing gaps in the transportation infrastructure, and reducing information asymmetries that limit access to financing for small and medium enterprises. Ample fiscal space and European funds imply that upfront reform costs can be met without jeopardizing the fiscal position.

A comprehensive carbon tax will be necessary to achieve the authorities' emission reduction objectives for 2030. Achieving the reduction in emissions and energy imports will require (i) reducing fossil fuels, (ii) investing in low-emission transportation, and (iii) raising energy efficiency. The introduction of an economy-wide carbon tax—set to gradually increase to EUR50 per metric ton of CO_2 emissions by 2030—would help achieve these goals.

The next Article IV Consultation is expected to be completed on the standard 12-month cycle.

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[1] (file:///Q:/COM/MR/Press%20Releases/2022/PR22276-%20Lithuania-%20IMF%20Executive%20Board%20Concludes%202021%20Article%20IV%20Consultation%20with%20the%20Republic%20of%20Lithuania.docx#
Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team

visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

2 (file:///Q:/COM/MR/Press%20Releases/2022/PR22276-%20Lithuania-%20IMF%20Executive%20Board%20Concludes%202021%20Article%20IV%20Consultation%20with%20the%20Republic%20of%20Lithuania.docx#
At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm (http://www.imf.org/external/np/sec/misc/qualifiers.htm) .

Lithuania: Selected Economic Indicators, 2017–27

Life expectancy at birth (2020): 80 years (women), 70.1 years (men)

Quota (current, % of total): SDR 441.6 million, 0.09 percent Per capita GDP (2021): € 19,760

Main products and exports: refined fuel, machinery and equipment; Literacy Rate (2015): 99.8%

chemicals, textiles, foodstuffs, plastics, wood products. At-risk-of-poverty (after transfers), share of population (2020): 20.9%

Key export markets: Russia, Latvia, Poland, Germany, U.S.

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
		Projections									
Output											
Real GDP growth (annual percentage change)	4.3	4.0	4.6	-0.1	5.0	1.8	2.3	3.0	2.8	2.6	2.3
Domestic demand (contribution to growth)	2.7	3.3	1.4	-3.9	5.7	3.8	4.3	3.8	3.5	3.2	2.9
Domestic demand growth (year-on-year, in percent)	2.6	3.4	1.6	-4.0	5.9	4.1	4.5	4.0	3.6	3.2	3.0
Private consumption growth (year-on-year, in percent)	3.6	3.6	3.1	-2.1	7.4	3.3	4.3	3.7	3.4	3.0	2.8
Domestic fixed investment growth (year-on-year, in percent)	8.9	10.0	6.6	-1.8	7.0	3.6	6.6	5.9	5.4	4.9	4.5
Inventories (contribution to growth)	-1.3	-1.1	-1.7	-2.0	-0.5	0.7	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	1.6	0.7	3.2	3.8	-0.7	-2.0	-2.0	-0.9	-0.8	-0.6	-0.6
Export growth (year-on-year, in percent)	13.5	6.8	9.9	0.4	15.9	-2.2	3.0	4.4	3.6	3.5	3.0
Import growth (year-on-year, in percent)	11.1	6.0	6.1	-4.4	18.7	0.0	5.5	5.6	4.6	4.2	3.7
Nominal GDP (in billions of euro)	42.3	45.5	48.9	49.5	55.4	64.6	72.4	77.5	82.1	86.5	90.8
Output gap (percent of potential GDP)	0.3	0.7	1.6	0.0	1.6	0.6	0.2	0.1	0.0	0.0	0.0

Employment											
Employment (annual percentage change)	-0.5	1.5	0.3	-1.5	0.8	0.5	0.1	0.3	0.0	-0.2	-0.4
Unemployment rate (year average, in percent of labor force)	7.1	6.1	6.3	8.5	7.1	7.3	7.0	6.5	6.2	6.0	6.0
Average monthly gross earnings (annual percentage change) 1/	8.2	9.9	8.8	10.1	10.5	17.2	14.5	5.8	5.6	5.6	5.5
Average monthly gross earnings, real (annual percentage change)	4.3	7.2	6.4	9.0	5.6	-0.6	6.0	2.9	3.2	3.2	3.2
Labor productivity (annual percentage change)	4.8	2.5	4.3	1.4	4.2	1.3	2.2	2.6	2.8	2.8	2.8
Prices											
HICP, period average (annual percentage change)	3.7	2.5	2.2	1.1	4.6	17.9	8.5	3.0	2.4	2.4	2.3
HICP core, period average (annual percentage change)	2.6	1.9	2.3	2.6	3.4	9.3	5.8	3.6	2.6	2.4	2.4
HICP, end of period (year-on-year percentage change)	3.8	1.8	2.7	-0.1	10.7	17.2	4.6	2.4	2.5	2.3	2.3
GDP deflator (year-on-year percentage change)	4.2	3.5	2.7	1.5	6.5	14.5	9.6	3.9	3.1	2.8	2.5
General Government Finances											
Revenue (percent of GDP)	33.6	34.5	35.2	35.7	37.7	38.3	37.2	36.7	36.4	36.2	36.2
Of which EU grants	0.6	0.7	0.9	0.6	0.7	1.5	0.8	0.7	0.7	0.6	0.6
Expenditure (percent of GDP)	33.2	34.0	34.8	42.9	38.7	40.2	38.5	37.9	37.6	37.4	37.2
Of which: Non-interest	32.1	33.1	33.9	42.3	38.3	40.0	38.3	37.7	37.3	37.0	36.9
Interest	1.1	0.9	0.9	0.7	0.4	0.3	0.2	0.2	0.3	0.4	0.4
Fiscal balance (percent of GDP)	0.4	0.5	0.5	-7.3	-1.0	-2.0	-1.3	-1.2	-1.2	-1.2	-1.0

Fiscal balance excl. one-offs (percent of GDP)	0.4	0.5	0.4	-7.3	-1.0	-2.0	-1.3	-1.2	-1.2	-1.2	-1.1
Structural fiscal balance (percent of potential GDP) 2/	0.5	0.5	0.3	-6.6	-1.2	-2.0	-1.2	-1.1	-1.0	-1.0	-0.9
General government gross debt (percent of GDP)	39.3	33.7	35.9	46.6	44.7	42.1	38.3	36.5	35.2	34.1	33.1
Of which: Foreign currency-denominated	11.1	9.5	10.1	6.5	3.1	1.5	0.7	0.3	0.2	0.1	0.0
Balance of Payments (in percent of GDP, unless otherwise specified)											
Current account balance	0.6	0.3	3.5	7.3	1.4	-1.5	-1.5	-1.0	-0.5	-0.2	0.1
Current account balance (billions of euros)	0.3	0.1	1.7	3.6	0.8	-0.9	-1.1	-0.8	-0.4	-0.2	0.1
Saving-Investment Balance (in percent of GDP)											
Gross national saving	19.8	20.6	21.0	20.8	20.0	17.6	17.4	18.5	19.5	20.2	20.8
Gross national investment	19.2	20.4	17.6	13.5	18.6	19.1	18.8	19.6	20.0	20.5	20.7
Foreign net savings	-0.6	-0.3	-3.5	-7.3	-1.4	1.5	1.5	1.0	0.5	0.2	-0.1

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.

Note: Data are presented on ESA2010, and BPM6 manuals basis.

1/ 2019 adjusted for tax reforms.

2/ Calculation takes into account standard cyclical adjustments as well as absorption gap.

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