Rating Update:

Creditreform Rating affirms credit rating at "A+", while revising Lithuania's outlook to "negative" as macro and fiscal outlook have changed materially

Rating Action

Neuss, 22 May 2020

Creditreform Rating has revised its outlook on the Republic of Lithuania to negative from stable and affirmed the unsolicited long-term sovereign rating of "A+". Creditreform Rating has also affirmed Lithuania's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A+".

Reasons for the Outlook Revision

The outlook on the Republic of Lithuania has been revised from stable to negative, reflecting

(i) the sharp contraction in economic activity and deteriorating labor market metrics in the wake of Covid-19, also implying repercussions in terms of income convergence; the Lithuanian economy should stage a recovery from Q3 onwards, but medium-term growth prospects are highly uncertain in view of Lithuania's high sensitivity to the external environment and large swings in economic performance; and

(ii) weakening fiscal metrics, in particular a sizable increase in the sovereign's public debt ratio against the backdrop of the government's policy response to the outbreak of the corona pandemic and collapsing economic growth; while authorities make prudent use of the sovereign's fiscal space, recent events have materially changed the fiscal outlook for this year and next.

Covid-19 dashes hopes of a sustained income convergence in a context of sharply contracting economic activity and a highly uncertain medium-term outlook

The corona crisis will likely hit the Lithuanian economy with great force. Preliminary data on the outturn of Q1 shows that real GDP contracted by 0.2% q-o-q, the first decline since the fourth quarter of 2009. The Covid-19 pandemic necessitated an unprecedented policy response to safeguard the population's lives and slow the spread of the virus, entailing a substantial economic impact, materially changing prospects for 2020/21. On 16 March, authorities thus implemented a large package of confinement measures including a travel ban, the suspension of all activities in educational facilities, the prohibition of public events, as well as the closure of non-essential shops, recreational facilities, restaurants, and bars.

While we expect that the corona crisis will push Lithuania's economy into a deep recession, with total output declining by 8.4% in 2020, the economic fallout should be less severe than during the meltdown of the global financial system during the Great Recession in 2008/09 (2009: -14.8%). Still, this represents a downward revision of more than 10 p.p. compared to the projection of our last review. For next year, we forecast the economy to rebound with real GDP growth of 8.0%. As the development of Covid-19 and the efficacy of the seized measures are very hard

to predict, the forecast is highly uncertain. Further unknowns relate to the time it will take to find effective vaccines, and the possibility of second and third waves of the corona pandemic.

That said, income convergence should experience a setback. Prior to the corona crisis, income convergence towards EU levels had advanced significantly over recent years, with GDP per capita equaling 82.4% of the weighted EU-28 level in 2019 (2015: 74.7%, IMF data). We also note that the severe impact of the novel coronavirus strikingly exemplifies the economy's susceptibility to shocks, and the concomitant macro-financial volatility remains high. Against a historical backdrop of pronounced boom-bust-cycles, volatility in metrics such as GDP growth and HICP inflation had tended to become more remote recently. While we believe that being a euro area member as well as sound economic and fiscal policy-making will be beneficial in this regard over the longer term, volatility is likely to rise in the near term.

In our baseline scenario, we assume that the measures seized by the authorities will prevent the crisis from inflicting significant damage to Lithuanian potential growth. The government adopted the so-called Action Plan for Economic Stimulus and Mitigation of Consequences of Covid-19 Transmission, including measures to provide income support for sick workers and their families, the disabled, self-employed, and those who lost their jobs due to Covid-19. Furthermore, firms shall receive liquidity support in terms of tax deferrals and in case they have to declare downtime. To stimulate the economy, it is planned to reallocate EU funds, co-finance climate change and road investment projects, and grant guarantees to agricultural and SME loans.

Whilst support measures will foster government final consumption expenditure, this will very likely be the only component contributing positively to real GDP growth this year. Private consumption, on the other hand, should decline by double-digits, and will thus put a significant drag on growth. Contracting household spending will be largely driven by deteriorating labor market conditions, although the support measures should cushion the worst effects from the coronavirus, while measures buttressing wage growth (e.g. a minimum wage hike) and disinflationary pressures somewhat mitigating the decline in household incomes. Private investment activity will likely grind to a halt in view of the enormous uncertainty, and public investment projects which should have benefited from EU funding support are likely to be hampered. Capacity utilization in the industrial sector was in free fall in Q2 (70.0%, Q1-20: 76.4%), suggesting an imminent decline in industrial production of capital goods, which had increased significantly over recent years.

Net exports should also impair economic growth. To be sure, the effects of the weak external environment had eventually taken hold of Lithuanian export growth towards the end of last year, showing up in Q4 data, and we would not have expected a meaningful contribution to this year's growth anyway. With the bleak outlook for its main trading partners, export growth is almost certainly set to plunge in 2020, mainly driven by supply chains that are disrupted by closed borders and constrained production. We await to see a harsh impact on transport which has been key to Lithuania's export performance over recent years. Covid-19 will also put marked pressure on import growth, which will limit net exports' negative contribution to some extent.

Going forward, we anticipate that economic activity will normalize in Lithuania's key trading partners. A further main assumption underlying our baseline scenario is a gradual rebound, with the Lithuanian economy gaining traction from the third quarter of 2020 onwards, as the corona pandemic slowly subsides and policy efforts gradually unwind. Indeed, the government has begun to ease restrictions since mid-April, now being in the fourth phase of its exit plan.

Public finances under significant pressure given extensive discretionary measures and automatic stabilizers weighing on this year's fiscal performance

Government finances have been a key support to the sovereign's credit rating in recent years. Before the outbreak of the corona pandemic, we saw the sovereign set for recording another slight surplus in 2020, with authorities making prudent use of the fiscal leeway to facilitate inclusive growth and tackle structural impediments to the economy's growth potential.

The envisaged budgetary plans for the current year had to be heavily amended in the wake of the Covid-19 pandemic, as high human costs had to be prevented and the economic fallout mitigated. According to the recently published Stability Program, the implemented set of measures announced by the government total EUR 4.7bn. In the Covid-19 package, EUR 1.3bn is related to the reallocation of EU funding and EUR 0.4bn come from state guarantees, and should be considered as budget neutral for now. Discretionary measures are specified to amount to roughly EUR 3.1bn, with the bulk pertaining to the expenditure side. Corporate compensation for parts of the downtime represents the biggest spending item (EUR 1.1bn). Other costly discretionary measures include the co-financing of road and climate change investment projects (EUR 150m and 160m respectively), the acquisition of medical devices (approx. EUR 120m). Additionally, on 7 May the government introduced an additional package geared towards aid after quarantine, such as subsidies for persons returning from downtime and job search allowances, and enhanced social benefits.

On the whole, recent events have materially changed the fiscal outlook for this year and next, as the Covid-19 shock will raise the sovereign's fiscal burden markedly. Together with receding revenues and automatic stabilizers at work, we pencil in a headline deficit of approx. 8.9% of GDP in 2020, before the budget balance should narrow significantly next year, mainly due to the assumed economic recovery. Our estimate of the Lithuanian budget does not incorporate the take-up of the guarantees mentioned above, which we would treat as a considerable downside.

Against the background of the government's budgetary policy response to the outbreak of the corona pandemic and collapsing economic growth, we see the sovereign's public debt ratio rising sharply to just short of 48% of GDP in 2020 from 36.3% of GDP in 2019 before stabilizing at that level in 2021. In this vein, the sovereign raised an unprecedented amount on international financial markets by issuing two Eurobonds with face values of EUR 0.75bn and EUR 1.25bn, at maturities of five and ten years, and yielding a low 0.345 and 0.829% respectively.

Hence, debt remains affordable as financing conditions are very favorable. Although yields on 10y government bonds have picked up since mid-March, they still post at historically low levels. Moreover, we acknowledge that fiscal risks are so far mitigated by modest public guarantees (0.7% of GDP according to the SP20) and significant fiscal space resulting from low base levels. Lithuania's public debt is one of the lowest in the EU-27. Also, short-term liabilities make up for 12.7% as of end-2019, and the weighted average maturity of the Lithuanian debt portfolio amounted to 7.6 years.

Reasons for the Rating Decision

Apart from dim near-term prospects and extreme uncertainties associated with the nature of the Covid-19 shock and its amplification channels, we regard the sovereign's macroeconomic performance profile as robust. Lithuania exhibits a relatively high per capita income and gener-

ally strong economic growth, and is a frontrunner in terms of its business environment, as documented by an excellent 11th rank out of 190 economies in the World Bank's Doing Business report. This is contrasted by still high volatility of macro-financial variables and impediments to potential growth stemming from the demographic side, as well as risks to the economy's cost competitiveness emanating from highly dynamic wage growth.

According to latest available IMF data, brisk economic growth lifted GDP per head to USD 36,701 (PPP terms) in 2019, comparing favorably to Central and Eastern European peers and converging towards the median of our A-rated sovereigns (USD 37,582). Lithuania was among the fastest growing economies in Europe last year (EU-28 average 1.5%). Real GDP expanded at a rate of 3.9%, edging up from 3.6% in 2018, largely driven by robust foreign trade amidst a challenging external environment. Exports rose sharply to 9.3% in 2019 (2018: 6.3%), clearly exceeding import growth (6.7% after 6.0%) and resulting in a significantly positive growth contribution of net external trade (2.1 p.p.). Domestic demand came in somewhat weaker, though also displaying favorable performance. Robust employment and wage growth facilitated household spending (3.2%, 2018: 3.7%), whereas investment growth eased from 8.4% to 7.4% in 2018-19. Whilst the labor market remained supportive, first signs of loosening were discernable. At 0.5%, employment growth posted well below the annual average seen in 2014-18 (1.3%), and the LFS adjusted unemployment rate stabilized at 6.3% (2018: 6.2%), after having persistently fallen since 2011.

We continue to monitor risks to Lithuania's cost competitiveness, as its real unit labor costs continued to increase vividly in 2019, by 3.1% according to latest AMECO data (EA-19: 0.3%), mainly due to strong real compensation per employee (6.6%). To be sure, there are signs of lost cost competitiveness, as its global export market share went up from 0.16 to 0.17% in 2018-19, and has increased steadily over the years, boosted by strong services exports and transport in particular. Also, deteriorating labor market conditions are likely to result in easing wage growth going forward.

We acknowledge the government's determination in addressing structural challenges, but remain vigilant concerning adverse demographic developments which may dampen Lithuanian potential growth. It has to be mentioned that net migration has turned positive for the first time since the sovereign declared its independence (2019: +10,794 persons), although many arrivals are lower-skilled workers, adding to apparent skill mismatches on the labor market. We view continuous efforts to tackle the economy's bottlenecks as crucial.

Risks to the economy's increasingly important transport sector not only remain in place, but have increased further in light of the EU Council's decision to adopt the Mobility Package on 7 April. New rules on drivers' working conditions, posting rules for drivers in international transport, and provisions on access to the haulage market, may hamper small and medium-sized transport businesses and constrain the transport sector's flexibility in general. While the legal acts still need to be adopted by the European Parliament, political discussions are ongoing as transport ministers from eight member states had previously urged to postpone the consideration and adoption of the regulation until the COVID-19 pandemic has ended.

Lithuania's institutional set-up remains supportive to our credit assessment. This is primarily buttressed by the World Bank's Worldwide Governance Indicators (WGIs), which are broadly aligned with the median of our A-rated sovereigns, though showing room to improve as regards euro area averages. Benefits associated with EU/EMU membership, including significant EU funding support, real and financial integration, and the adoption of common standards and rules, have to be set against geopolitical risks related to cyber-attacks as the sovereign is forging

ahead in developing its fintech industry, escalating tensions with the Russian Federation, and energy security. We note that its high reliance on Russia's energy supply appears to be subsiding against the backdrop of visible efforts to press on with the interconnection of Baltic energy markets and gas interconnection with Poland.

Awaiting parliamentary elections this October, we continue to follow political developments closely. While we have witnessed relatively frequent government reformations amidst a fragmented political landscape over recent years, we think that the thrust in economic and fiscal policies will not change given broad consensus. As of yet, polls have been dominated by the conservative TS-LKD party, followed by the Farmers and Greens Union.

Despite tremendous headwinds posed by the Covid-19 shock, Lithuania's fiscal sustainability profile remains a credit strength, mirroring the sovereign's prudent fiscal approach, affordable debt, and the fact that general government debt is likely to remain low from a European perspective.

With a view to its budgetary performance, 2019 marked the fourth year in a row in which the headline balance finished with a surplus. The budget surplus narrowed from 0.6 to 0.3% of GDP in 2018-19 as spending grew more dynamically than revenues at 9.6% vs. 8.5%. Outlays were mainly driven by the public wage bill, which increased sharply by 12.0% (from 9.8 to 10.3% of GDP), and a strong 11.1% rise in social benefits and transfers. Revenue growth came in somewhat lower, since extraordinary growth in current taxes on income and wealth (from 5.7 to 8.8% in 2018-19) was overcompensated by net social contributions, reflecting the labor taxation reform.

Thanks to prudent policy-making and the favorable macroeconomic backdrop, Lithuania's debt-to-GDP ratio had been trending downwards after peaking at 42.6% in 2015, though rising from 33.8 to 36.3% in 2018-19 as authorities engaged in pre-financing measures to replace dollar-denominated debt. Irrespective of last year's increase, its public debt ratio remained among the lowest readings in Europe. Interest payments have dwindled over recent years and stood unchanged at 0.9% of GDP in 2019. As measured by government revenues, interest expenditure accounts for a moderate 2.5%, suggesting that debt remains affordable.

Lithuania is a small and open economy, and therefore very sensitive to the external environment and the performance of its trading partners. We note that external risks seem to be increasingly tempered by receding external debt in the deposit-taking sector, and a widening current account surplus, which has recently jumped from 0.3 to 4.3% of GDP in 2018-19, corresponding to the country's largest current account surplus on Eurostat records. The significant increase came mainly on the back of an improvement in the trade balances. The increasing external strength is underscored by rapidly widening services surpluses, which have more than doubled over the last five years (2019: 10.1% of GDP, 2015: 4.7%). Looking ahead, we expect the current account to remain in surplus, even though it should narrow in view of the detrimental effects of the corona pandemic on goods and service trade (see above).

Increasing current account surpluses have, together with transfers from EU funds used to finance investment projects, contributed to a persistently rising net international investment position (NIIP). Although still in negative territory, Lithuania's NIIP thus improved significantly last year to -23.7% of GDP (2018: -31.0% of GDP), and has more than halved since 2013 (-50.6% of GDP).

Rating Sensitivity

Our Rating outlook on the Lithuanian long-term sovereign ratings is lowered from stable to negative, as we assume that the risk situation underlying the key factors affecting sovereign credit risk is likely to deteriorate. Under the current circumstances and the very dynamic development of the corona crisis, however, the assessment of Lithuania's economic development is fraught with extreme uncertainty and is therefore significantly more difficult than usual, as is the case for other metrics.

We could lower Lithuania's ratings if the prospective setback in income convergence proves to be more protracted, involving lower income per capita over the medium term, or if the sovereign fails to bring debt-to-GDP on a downward trajectory again, causing a sustained rise in general government debt beyond the initial Covid-19 impact. Downward pressure could also be triggered by a persistently deteriorating external position on the back of increasing current account deficits.

We could reinstate Lithuania's stable outlook or upgrade its credit ratings if the Covid-19 impact on medium-term growth is less pronounced than currently assumed, and strong economic growth leads to higher per capita incomes without creating macro-financial imbalances, or if we believe that the sovereign's public debt ratio has resumed a sustainable downward trend. More generally, upward pressure could result from a successful implementation of comprehensive structural reforms and receding geopolitical risks.

Analysts

Primary Analyst
Wolfgang Lauer
Sovereign Credit Analyst
w.lauer@creditreform-rating.de
+49 2131 109 3865

Chair Person
Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

Long-term sovereign rating	A+ /negative
Foreign currency senior unsecured long-term debt	A+ /negative
Local currency senior unsecured long-term debt	A+ /negative

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	3.5	2.0	2.6	4.2	3.6	3.9	-8.4
GDP per capita (PPP, USD)	27,611	28,731	30,092	32,377	34,597	36,701	n.a.
HICP inflation rate, y-o-y change	0.2	-0.7	0.7	3.7	2.5	2.2	0.8
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	74.7	74.6	74.9	75.8	76.0	n.a.	n.a.
Fiscal balance/GDP	-0.6	-0.3	0.2	0.5	0.6	0.3	-8.9
Current account balance/GDP	3.5	-2.4	-1.1	0.5	0.3	4.3	n.a.
External debt/GDP	70.7	76.8	86.2	83.9	78.5	68.0	n.a.

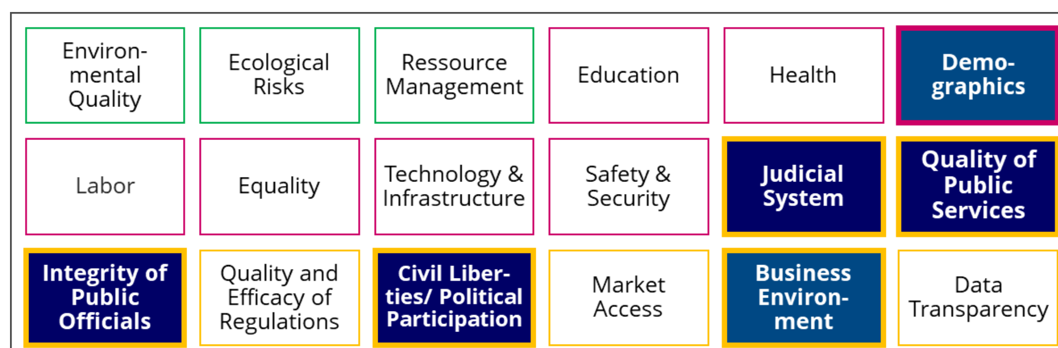
Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In what follows, we explain how and to which degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box



The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact

on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	26.11.2016	A /stable
Monitoring	24.11.2017	A /stable
Monitoring	23.11.2018	A /positive
Monitoring	22.11.2019	A+ /stable
Monitoring	22.05.2020	A+ /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, Central Bank of Lithuania, Ministry of Finance Lithuania, Official Statistics Portal Lithuania.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information

about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

Disclaimer

Any rating issued by Creditreform Rating AG is subject to the Creditreform Rating AG Code of Conduct which has been published on the web pages of Creditreform Rating AG. In this Code of Conduct, Creditreform Rating AG commits itself – systematically and with due diligence – to establish its independent and objective opinion as to the sustainability, risks and opportunities concerning the entity or the issue under review.

When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

This report is protected by copyright. Any commercial use is prohibited without prior written permission from Creditreform Rating AG. Only the full report may be published in order to prevent distortion of the report's overall assessment. Excerpts may only be used with the express consent of Creditreform Rating AG. Publication of the report without the consent of Creditreform Rating AG is prohibited. Only ratings published on the Creditreform Rating AG web pages remain valid.

Creditreform Rating AG

Creditreform Rating AG
Hellersbergstrasse 11
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Prof. Dr. Helmut Rödl
HRB 10522, Amtsgericht Neuss