LITHUANIAN ECONOMIC OUTLOOK

2012

DNB

FOREWORD

2011 was the year in which the Lithuanian economy got out of the crisis and demonstrated strong growth, while a responsible public finance policy helped the country regain the trust of financial markets. However, 2012 has brought much uncertainty from the eurozone posing new challenges for the national economy and the public. At times like these, everyone wants to now the future direction of economic development and our chances to overcome new difficulties.

Therefore I am pleased to present the latest issue of the *Lithuanian Economic Outlook* prepared by the analysts of DNB Bankas which looks into the key trends of economic development in the country, analyses the outlook for the next year and discussed the main obstacles to development.

This publication reflects our effort to create value for the clients of DNB Bankas. I believe that Lithuanian companies which managed to weather the crisis and optimise their operations are ready for new challenges and have no doubt that the long-term commitment of DNB Bankas to business in Lithuania has laid the foundations for mutual growth and sustainable development.

Bjornar Lund
President of DNB Bankas

This issue of the *Lithuanian Economic Outlook* analyses the results of the Lithuanian economy and its individual industries in 2011 and the first months of this year. The publication discusses the main macroeconomic indicators, presents their qualitative analysis, examines the main economic problems and assesses the future outlook.

The introduction to the publication outlines the latest forecast and insights of analysts about the national economy for this and next year.

The second section contains a commentary on the development and outlook of the national economy by Habil. Dr. Rimantas Rudzkis, former long-standing analyst at DNB bank and professor at Vilnius University. The author analyses the main factors impeding economic development and puts forward proposals on how to ensure sustainable growth of the Lithuanian economy.

The publication provides an in-depth coverage of individual sectors of the economy and major branches of industry. This part of the publication contains comments on the latest results of production and financial activities of economic sectors both last and this year. It also outlines the trends of development of economic sectors and branches of industry.

The authors hope that the publication will be welcomed by business and academic community and extend their gratitude to the readers for their comments and proposals in advance.

THIS ISSUE IS PREPARED BY THE ANALYSTS OF DNB BANKAS

Rokas Bancevičius
Senior analyst
E-mail: rokas.bancevicius@dnb.lt

Mindaugas Jurgelis
Analyst
E-mail: mindaugas.jurgelis@dnb.lt

Titas Budrys
Analyst
E-mail: titas.budrys@dnb.lt

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Lithuanian Economic Outlook

Contents

1. Macroeconomic overview

1. MACROECONOMIC OVERVIEW

Last year was successful for the Baltic states which managed to retain their status as the fastest growing region in the European Union. Estonia once again was the champion of growth with an impressive 7.6% economic growth rate, followed by Lithuania with 5.9% and Latvia with 5.5% (see Table 1.1). However, by the end of the year growth began to slow down in the Baltic economies on the back of slower export growth because domestic consumption had been too weak to provide any support to these economies. Lithuanian and Estonian economies continued to decelerate in the first quarter of 2012 (3.9% annual GDP growth in both countries), while a sharp leap of the Latvian economy (6.8%) can be explained by a low reference base as the growth of the Latvian GDP was twice as slow as in the two neighbouring countries at the beginning of 2011.

Although macroeconomic indicators show that Lithuania has already gone through a deep downturn, the consequences of this crisis will be felt for some time yet. The crisis of 2009 was not an ordinary development as it marked a tipping point: up to 2008 the Lithuanian economy was driven by booming construction but growth in the nearest future will mostly rely on exporting sectors. Such a shift in the national economy means that household income and labour market will need time to adjust to the new economic realities and return to the pre-crisis level.

EXPORT VOLUMES SOARED IN 2011 BUT SUSTAINABLE

GROWTH REQUIRES NEW INVESTMENTS

In 2011, the real growth of exports was 13%. If exports of mineral fuels are excluded, the best performers were traditional sectors: exports of food products rose by 19.1% last year and prepared food products accounted for 5.9% of total Lithuanian exports. Last year, exports of machinery and mechanical equipment went up by 27.3% and exports of chemical industry production soared by 45.2% (each of the sectors account for a tenth of the national exports of goods). Still, the balance of trade in the country was slightly negative at 1.5% of GDP as a result of rapidly rising prices of imported raw materials.

Strong growth of export volumes has been encouraging lately but a disconcerting thing is that export revenues remain largely beyond the Lithuanian economy. The profitability of Lithuanian companies has almost reached its pre-crisis level (4.4% profit on income in 2011 compared to an average of 7% in 2005–2007) and was positive for the second year in a row. Nevertheless, income generated has often been frozen in bank accounts as the volume of time deposits maturing in more than two years went up sharply last year by 80% in the banking system while the volume of investments rose by merely 1.3 percentage points in the country (from 16.3% of GDP in 2010 to 17.6% of GDP last year).

Weak investment flows to Lithuania are often explained by considerable uncertainty surrounding the development of global economy which makes business people reluctant to

Table 1.1
KEY MACROECONOMIC INDICATORS OF THE BALTIC COUNTRIES

	Lithuania		Latvia		Estonia	
	2010	2011	2010	2011	2010	2011
Real GDP, annual change, %	1.4	5.9	−0.3	5.5	2.3	7.6
Current account balance, ratio to GDP, %	1.5	−1.6	3.0	−1.2	3.6	3.2
Annual inflation (HICP), % [1]	3.6	3.5	2.4	3.9	5.4	4.1
Average gross monthly earnings, annual change, % [1]	−3.3	2.7	−3.5	4.3	1.1	5.4
Unemployment rate, % [1] [2]	17.5	14.3	17.1	14.6	13.9	11.7
General government budget balance, ratio to GDP, %	−7.2	−5.5	−8.2	−3.5	0.2	1.0

[1] End of period
[2] Labour Force Survey

Source: Eurostat, national statistics offices invest in production development and by a more cautious lending policy of banks. However, it is important to note that the investment flow in Lithuania was the weakest among all Baltic states even though both uncertainty about the future and lending policy of banks were virtually the same across the region. Last year, investments stood at 17.6% of GDP in Lithuania, 22.4% of GDP in Latvia and 21.5% in Estonia, while the EU average was 18.6%. Indicators of investments in machinery were even worse in 2011 as Lithuania's percentage (5.4% of GDP) was not only below the indicators of Estonia (10.1%), Latvia (11.3%) and EU average (6.6%) but also just fractionally above Greece (5%) whose economy has been in freefall. The low level of investment slows down the potential economic growth in the long term.

IN 2012, REAL WAGES WILL FINALLY ENTER THE POSITIVE TERRITORY AND THE MAD POLKA OF PRICES SHOULD RUN OUT OF STEAM BY THE END OF THE YEAR

Employees have not felt the improving financial standing of companies so far. Last year, the nominal average wage in the country grew at a slower pace than inflation once again so the real average salary shrank by almost 1%. We expect to see the first increase in salaries in 2012, albeit a small one, in the last four years. The nominal wage should rise by 4% and inflation should be 3.2% at the end of the year.

This year, prices are expected to grow more slowly than last year (4.1% by the end of 2011) and their rise will be supported by the same culprit – high prices of oil. The high price of oil, which is quoted in US dollars, coupled with a weak euro this March drove the price of black gold in euro to the highest level since the introduction of the common currency, which means that heating bills will still make us wince next winter. Still, oil prices began to descend after the pressure eased in the Middle East and we can hope that they will continue to slide down until the end of the year. The price of wheat, which also affects inflation in Lithuania, should be by a tenth lower this year on the global market compared to last year and may even go down further after the first reports of excellent yields of this year.

KEY TO HIGHER INCOME: CREATION OF HIGHER VALUE ADDED

Incomes of the population could outpace inflation if business could learn to skim off a larger percentage of the final price of production sold, i.e. to generate higher value added. The industry needs to manufacture a quality product (which Lithuanians can do) and also to create an attractive brand. We make excellent furniture in Lithuania sold by *Ikea* and excellent clothes branded *Nike* but the largest share of the profit margin is retained by foreign companies able to attract the buyer and ensure sales income because of their brand. We also need investments in higher value added production and export of services so that higher profit margins could translate into higher salaries for employees.

Of course, building a brand attractive for foreign markets or a high value added product requires time and money, while Lithuanian businesses still find it difficult to jostle with foreign companies (although small victories have already been won: recently *Maxima* has acquired a retail chain in Spain). So for now it is important to lure strong foreign companies to Lithuania with their technologies, well-known brands and sales markets abroad.

ELECTIONS WILL BE A TEST FOR THE SUSTAINABILITY OF INVESTMENT PROMOTION POLICY

Despite consistent effort by *Invest Lithuania* and targeted policy of the Cabinet, last year did not bring any breakthrough in foreign direct investment (FDI). In 2011, accrued FDI increased by 4.5% and showed that FDI growth in 2010 was below 7.7%. So far, we have been at the very end of EU and Baltic countries in terms of accrued FDI but the activity of *Invest Lithuania* drawing in foreign companies to Lithuania should bear fruit and we hope to see a much better FDI indicator this year. The outgoing government treated FDI as one of its priorities and even top government officials have nearly always been accessible to foreign companies interested in investing in Lithuania. Hopefully, the new government sworn in after the parliamentary elections will retain the same focus on FDI.

UNEMPLOYMENT WILL GO DOWN BUT EMIGRATION WILL REMAIN A PRESSING ISSUE

Foreign investments would also help tackle unemployment problems which are closely related to emigration. Before the crisis of 2009, the construction industry employed almost 169,000 workers and this number contracted to just 97,000 by the end of 2011. Other sectors, including the recovering manufacturing industry, are unable to provide jobs to these workers who often have poor skills. Therefore, the unemployment rate went down at a very slow pace and stood at 13.9% by the end of the year. Due to its seasonal nature, unemployment even jumped to 14.5% in March. We expect to see lower unemployment this year even though we cannot pinpoint a single sector which would drag the unemployment rate down. That being said, all profitable sectors of the economy should gradually increase the number of workers.

High unemployment continued to motivate Lithuanians to emigrate. Last year, nearly 54,000 people left the country, which is the second highest number of emigrants in the last decade. At the same time, the number of returning people was also unusually high. In 2011, 14,000 Lithuanian nationals returned to the country, which is the highest number in the last decade. For instance, only six thousand Lithuanians returned to the country in 2007, which was a much 'better' year. Most Lithuanians returned from the United Kingdom and Ireland (over eight thousand), the two countries that are also currently in recession, so it can be expected that these returnees may pack their bags and go back at any time.

It is important to understand that in our age migration has become a constant global phenomenon where emigrants are not so far away from their homeland and their mobility is very high. Although Estonians point out that emigration from their country has been small, many Estonian construction workers have jobs in Finland and Sweden and return home almost every weekend because of a short ferry trip.

Once again, an improved FDI flow would contribute greatly to a more speedy reduction of unemployment and emigration. Companies which decided to invest in Lithuania last year plan to create 2,400 new jobs in a period of three years. Given that many unemployed are people with 'soft' educational background in management or economy, it is important to attract exporters of services or their branches because young people who have the relevant education could be easily trained to, for instance, provide accounting and financial services to the headquarters of the company located abroad. We already have branches of this type in Lithuania: *Lindorff*, *Citco*, *Western Union*, etc. However, exports of services from Lithuania are still thin and the country is the outsider among the Baltic states by export volumes. On average, Estonian invisible exports per capita (in euro) are almost double the volume of exported services per capita in Lithuania. However, our active fight for foreign investments may improve this situation.

PUBLIC FINANCE HAS BEEN REINED IN AND MARKETS SHOW RESPECT

A tight rein of public finance is probably the biggest achievement of Lithuania in recent years. Currently, Lithuania is able to offer decent yields on its ten-year eurobonds (5.5%) indicating the interest rates available to the country on the international market, which are lower than the yields of all countries in Southern Europe. In addition, Lithuania is still able to hedge against debts (CDS contracts) at one of the lowest costs in Central and Eastern Europe. Lithuania has already borrowed LTL 6.4 billion out of nearly LTL 9 billion, which the country needs to borrow this year, in various currencies at much lower interest rates than in 2009–2010.

GROWTH IN 2012 WILL BE STRONG BUT THE EURO CRISIS AND FORTHCOMING ELECTIONS ARE DISCONCERTING

We believe that Lithuanian and Estonian economies should grow by nearly the same margin of 2.5–3% this year (see Table 1.2). Because of the favourable reference base effect, the Latvian economy is expected to grow by 3–3.5% this year and this will be the strongest growth among the Baltic states (and across the EU most likely). Even though the Baltic economies will be growing more moderately, they will still be the champions of growth because the economy of the entire European Union will also slow down.

In the coming months, cracks appearing in the single currency union of Europe will be the main challenge for the Lithuanian economy. Greece leaving the eurozone would not be so dangerous if the so-called contagion effect could be avoided

Table 1.2
FORECASTS FOR LITHUANIA

	2012	2013	2014
Real GDP, annual change, %	3.0	3.0	3.0
Current account balance, ratio to GDP, %	−2.5	−3.0	−3.0
Annual inflation (HICP), % [1]	3.2	2.7	2.5
Average gross monthly earnings, annual change, %	4.0	4.0	4.0
Unemployment rate, %	12.0	10.5	9.5
General government budget balance, ratio to GDP, %	−3.5	−3.0	−3.0

[1] End of period
[2] Labour Force Survey
Source: DNB Bankas

as it may push Spain and Italy to the brink of default. However, it is encouraging to know that measures to stop this contagion are already being developed. At the moment, at least EUR 500 billion has been pooled in the European crisis fund and latest statements of German politicians that higher inflation could be tolerated may mean that the European Central Bank might step in if panic broke out on the markets. Therefore, Greece leaving the eurozone currently seems less menacing for the entire Europe than at the beginning of the year.

In the short run, the Greek exit may trigger higher borrowing interest for Lithuania during the issue of government bonds. Although the Cabinet still needs to borrow more than LTL 2.3 billion this year and the majority of these funds will be raised on the local market, the government may need to knock on the door of financial markets at the end of this year because of the approaching redemption of one billion euro bond issue in March 2013. It means that decisions of Greek politicians may affect the cost of borrowing for Lithuania as well.

A financial earthquake in Western Europe would also deliver a painful blow to Lithuania's export income and would rock the economy which has been on an even keel lately. Still, we believe that the risk of a sharp contraction of export volumes and slowing GDP growth this year remains below average. It should be noted that oil prices may fall quite sharply in case of a serious crisis, which would reduce Lithuania's trade deficit and inflation.

The autumn of 2012 is likely to bring in a new government which, preferably, will stay on the right track and will continue to manage public finance carefully, increase efficient management of the activities of state companies and state property, complete the construction of the gas terminal and work closely with foreign investors. The current European crisis is forcing the affected companies look for cost-cutting solutions and they would be eager to relocate part of their operations to Eastern Europe, which may create a springboard for Lithuania. However, all our neighbours are competing for investments and we will painfully lose this battle for new jobs if the new government turns its back on foreign investors.

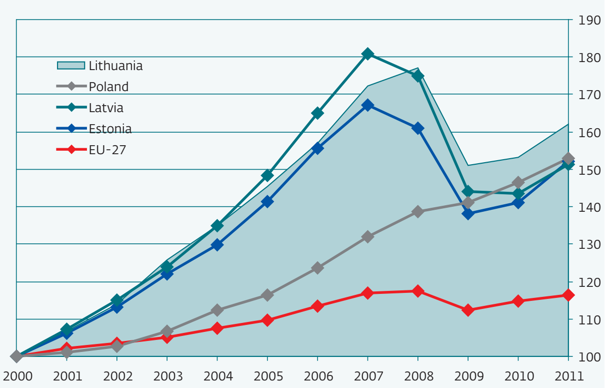
2. Comments by Prof. Rimantas Rudzkis: Where will the Lithuanian economy go?

Below is the commentary on the national economy by Habil. Dr. Rimantas Rudzkis, professor at Vilnius University and former long-standing senior analyst at DNB bank. The opinion of the author is not an official position of the bank.

Last year's macroeconomic indicators exceeded all expectations as growth of the Lithuanian economy was among the strongest in the European Union after an interval of three years. As in 2010, exports were the main driving force of the economy as their volumes rose to record highs. Meanwhile, industries focusing on the domestic market have been slow to recover making last year's GDP at constant prices much lower than in 2007 and 2008. The pre-crisis level will not be reached this year either. Data of the labour market signal a positive direction but the unemployment rate remains abnormally high while wages are barely able to catch up with soaring consumer prices. Nevertheless, the average profitability of companies improved significantly in 2011, the tension in the public finance sector eased a little and the current account of the national balance of payments was almost balanced.

The overview of the latest macroeconomic results asks for the comparison with the situation in 2001–2002. At that time, almost two years after the downturn, the national economy was also gaining momentum and was growing strongly. The best-case scenario would be a sustained or even stronger growth for several years like a decade ago but it is quite unlikely. It is not a much higher current level of the Lithuanian economy (see Diagram 2.1) whose further strong growth requires more substantial investments than at the beginning of this century

Diagram 2.1
REAL GDP, 2000 = 100%



Source: Eurostat

but several negative factors that make strong and sustained economic growth a distant possibility.

Long-term prospects of the national economy are not good because:

- Exports are not sufficiently diversified and the main markets – the EU and Russia – are facing major difficulties. Although the latter country currently enjoys quite good macroeconomic indicators because of high global oil prices, the country has worn-out production facilities, its competitiveness is weakening and more than half of the federal budget revenue has come from the oil and gas sector this year, so the consequences of cheaper oil are quite obvious.
- Shortage of skilled labour has become more pronounced because of accelerating emigration and failure by vocational training and higher education systems to meet the contemporary needs of the national economy.
- The market of bank loans to the private sector has been unable to recover for the third consecutive year as the net flow of credits is still negative. By the way, insufficient lending to the real sector can be seen in many EU countries at the moment.
- Relative indicators of capital investments have been very poor for several years and the level of innovation has been low as well. In addition, even though several reputable foreign companies came to Lithuania, the country continues to lose the battle for foreign direct investment (FDI) to other EU member states and thus has no basis for strong growth of capital and considerable technological progress.
- Lately, expectations of businesses and households have been poor as few believe in successful development of the country.
- Efforts by the government to improve business environment and raise effectiveness of the public sector have borne little fruit yet (even though the programme of the largest governing party in the coalition (Homeland Union) was really strong).

It is obvious that these factors are interrelated so problems must be addressed in a comprehensive manner but strategic planning is the *Achilles heel* of our government as we can see from actions of the current Cabinet. Even though national exports will grow slowly or even come to a standstill (the first signs are already there) for a couple of years because of the above-mentioned unfavourable factors and the EU support will be cut dramatically in 2014–2015, the government plans to make huge investments in very ambitious major projects with low economic return in the near future. The government and EU institutions expect to see a balanced consolidated national budget in 2015 already.

The Visaginas nuclear power plant project is the glaring example of irresponsible planning as the project will most likely be unprofitable and is simply a high-stakes gamble given the current uncertainty. Lithuania, which has insufficient financial resources, plans to freeze much needed massive amounts of money in the new electricity generation plant for several years while its run-down heating network is in dire need of investments. Meanwhile, electricity generation capacities are already excessive since the country has the powerful Elektrėnai power plant as a backup (its old units are currently idle because of cheap electricity imports and high prices of gas) and its new modern 450-MW unit has been put in operation, total capacity of cogeneration plants is growing and the fleet of wind farms is expanding rapidly.

Quite often the argument for the need of the new nuclear plant relies on high natural gas prices in the future and rapid growth of electricity demand but both assumptions are quite unrealistic.

Boisterous application of new technologies in the energy sector has created a situation where gas supply grows faster than demand which inevitably leads to cheaper gas in the longer term. Quite recently, the United States was a major importer of gas but the country expects to start exporting liquefied gas in 2016 and China also has similar plans. At present, the average price of gas imported to the European Union is about five times higher than on the US market. But the situation will change soon once a normal gas market is created in Europe which will ensure a sharp fall in gas prices. The reason behind the current strange situation is the fact that gas is imported to EU countries mostly under long-term supply contracts pegging gas prices to the oil price but efforts are being made to phase out this pricing approach and they will bear fruit sooner or later. Once gas prices go down, the energy security, which is a priority for the Cabinet, will be reliably ensured by the new liquefied gas terminal making the new nuclear power plant unnecessary. To quote the deceased authoritative scholar E. Vilkas: 'Security improvements come at a cost and financial resources are limited'.

The latest data on electricity consumption are also unfavourable for the Visaginas power plant proponents. Consumption has been falling for three years in row and preliminary estimates indicate a further contraction last year from 2010 despite a 10% growth of the manufacturing industry. The structure of the national economy is changing: the percentage of services companies is on the rise, energy efficiency technologies are being put in place by companies and households and the population is shrinking rapidly. In the last year, the number of people in the country contracted by 1.4% and changes in the number of children under 18 years of age were even worse. Between 2007 and 2011, this number fell by 14.4% at an average annual rate of nearly 3%. Taking all the above circumstances into consideration, a significant increase in electricity consumption is very unlikely in Lithuania in the nearest decade.

The strengthening negative trends in the Lithuanian economy can be reversed but that requires strong political will as well as consistent and proactive government policies. Unfortunately, the realities of political scene in the country have been less than encouraging lately. There is little hope that the new ruling majority after the parliamentary elections this autumn will be able to ensure the quality of public governance necessary for effective reforms. As they say, however, hope springs eternal. So let us once again discuss the potential landmarks of the new Lithuanian policies aimed at ensuring strong and sustainable economic growth (even though the topic has been debated so many times that we need specific action not never-ending discussions). The most important thing is: **Promotion of competitiveness must be the main priority in order to ensure strong and sustainable growth of the national economy.**

We should first identify the weakness of our country on the basis of the results outlined by the World Economic Forum (WEF) in its competitiveness reports. The Lithuanian economy needs a more simple tax system, higher labour market flexibility, much lighter administrative regulation burden, better accessibility to venture capital and bank loans. The country also wastes significant public resources and has a high rate of brain drain, poor FDI regulation and underdeveloped clusters. Meanwhile, Lithuania scored high in terms of the overall level of infrastructure, with the exception of air transport infrastructure which received a negative score. In addition to these findings it should be said that airports are not the only weak link in our country as the WEF report did not look into the situation of the struggling heating network which has been overlooked by the government as well.

The action plan should include measures that can be quickly put into place. We need to:

- switch to simple regulation and accounting of activities of small companies because current red tape barriers deter creative young people from going into business and exacerbate emigration;
- involve leading companies in the country into the vocational training system which has lost its attractiveness entirely;
- encourage higher education institutions to adapt their activities to the needs of the economy and collaborate with companies in employee retraining;
- support industries which displace imports (e.g. use of biofuel in the energy industry) and diversification of exports by helping companies to enter new markets and increase the diversity of exported goods and services (more flexible issue of visas would boost exports of tourism services, better management of forestry entities would support the development of the wood industry, etc.);
- use budget resources in a rational manner on the basis of cost-benefit analysis (the period of completion of investment projects is also an important parameter).

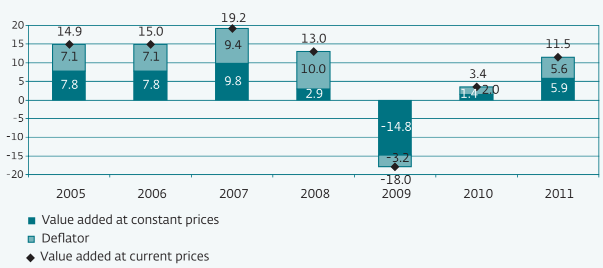
At the same time, a plan aimed at broad reforms in the public sector and significant improvement of business environment must be drawn up and implemented. The quality of services provided by public authorities must be monitored continuously on the basis of surveys of service receivers (individuals, companies, etc.) rather than opinions of bureaucrats. If the long-awaited reforms continue to be delayed, the wave of youth emigration will remain high and the Lithuanian economy will not be able to attract investments which will trigger a long-term depression.

3. Gross domestic product

According to Statistics Lithuania, GDP at constant prices grew by 5.9% in 2011 in Lithuania (see Diagram 3.1) and the country returned to the ranks of the fastest growing economies in the EU after an interval of several years. Within the EU, only Estonia whose economy expanded by 7.6% grew faster than Lithuania while Latvia was the third among the Baltic states even though it also saw quite strong growth at 5.5%.

Changes in the Lithuanian GDP correlate clearly with the development of economies in Western Europe. GDP growth was stronger at the beginning of 2011. The indicator rose by 5.9% in the first quarter, 6.5% in the second quarter and reached its peak in the third quarter growing at 6.7% year-on-year. However, once economic uncertainty returned to the markets, the annual growth of the Lithuanian economy slowed down to 4.3% in the last quarter of 2011. The same trends in the GDP growth were seen across the EU. The overall GDP rose by 1.5% in 2011 but in the last quarter of 2011 the economy of the EU shrank by 0.3%. It has to be said though that the contraction is largely attributable to countries in Southern Europe.

Diagram 3.1
GDP, ANNUAL CHANGE, %



Source: Statistics Lithuania

CONVERGENCE WITH THE EU ACCELERATED

Despite its strong growth last year, the Lithuanian economy has not yet recovered to its pre-crisis level. At the end of 2011, the national GDP was by 5.9% lower than in 2007 and 8.5% lower than in 2008. This year, GDP at current prices should finally reach the peak of 2008 but the indicator at constant prices will still be lower.

Last year, Lithuania's GDP at current prices stood at LTL 106 billion and crossed the threshold of one hundred billion litas for the first time since 2008. In terms of the purchasing power standards, the Lithuanian GDP per capita accounted for 57% of the EU average in 2010. The data for 2011 are not yet available but extrapolation of the real economic growth indicators shows an increase to 62%. Until now, the highest indicator at 61% was recorded in 2008. It has to be said though that it was easier to catch up with the rest of Europe because of the recession in Southern Europe which has dragged the EU average down.

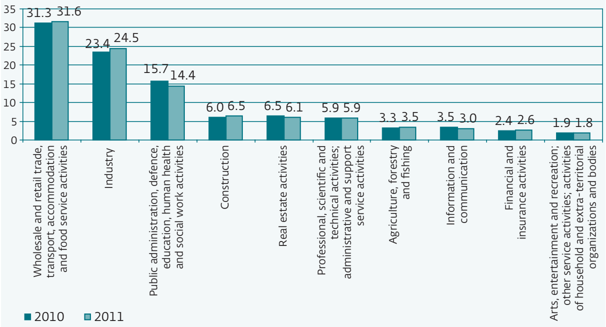
It is important to note that eager borrowing by the private sector poured some oil into the blazing national economy in 2005–2008. In that period, the private sector debt to GDP ratio went up from 23.9% in 2004 to 64.6% in 2009. Between 2009 and 2011, borrowed funds were also important for the economic development but this time it was the public sector, i.e. the state, that borrowed more. Between 2009 and 2011, the national debt went up by 23 percentage points (from 15.5% to 38.5% of GDP). At the same time, the private sector debt shrank from 64.6% to 48.6%. Although the majority of money borrowed by the government was not channelled as the direct economic stimulus, it was used for social benefits which mostly were spent in Lithuania. Assuming quite liberally that the larger part of budget deficit in 2009–2011 (LTL 21.5 billion) was paid out to recipients of social benefits we can see after the deduction of interest paid (LTL 4.8 billion) that LTL 16.7 billion was injected into the economy during that period. The question whether such stimulus model is the best one and whether social benefits reach those who need them the most remains debatable.

RECOVERING CONSTRUCTION INDUSTRY JOINED THE USUAL GDP DRIVERS SUCH AS THE MANUFACTURING INDUSTRY AND TRANSPORT

An analysis of economic sectors which generated the largest amount of value added in 2011 (see Diagram 3.2) shows the importance of the manufacturing industry (MI) for GDP growth. In 2011, value added in the sector rose by 10.6% compared to the previous year and the entire MI made up 20.4% of the national GDP (up by 1.6 percentage points from 2010). The majority of production of the manufacturing industry (68% in 2011) was exported.

Sectors which focus more on the domestic market also contributed to the economic growth. Value added rose by 7% in domestic trade, transport, hotels and restaurants in 2011 and accounted for nearly a third of the national GDP (31%).

Diagram 3.2
VALUE ADDED IN ECONOMIC ACTIVITIES, % OF GDP



Source: Eurostat

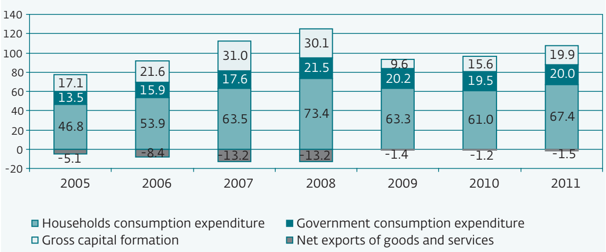
Finally, the construction sector managed to take off in 2011 from the trough reached during the crisis. Although value added generated by the sector grew by almost a fifth due to a very low reference base, the relative size of the sector is quite small and accounts for 6.5% of the total economy.

In 2011, value added generated by the government sector increased for the first time after an interval of two years. However, growth was marginal (0.9%) and the entire GDP percentage of the public sector shrank from 15.7% in 2010 to 14.6% in 2011.

SLUGGISH EXPORT GROWTH INDICATES MORE MODERATE ECONOMIC DEVELOPMENT

An analysis of the economic growth in Lithuania in 2011 using the expenditure approach (see Diagram 3.3) also shows that growth relied strongly on rapidly rising exports and recovering domestic consumption. More moderate economic growth is projected for Lithuania in 2012 because exports are expected to rise at a slower pace. The volume of Lithuanian exports jumped by 28.9% at current prices in 2011 but the indicator was supported by a 13.5% increase in the prices of exported products. The volume rose mainly because of the higher price of exported petrol driven by more expensive oil. Still, if the price effect is excluded, exports increased by 13.6%. This is a good result which was mostly secured by performance of the manufacturing industry and transport. Exports of services continue to contribute just fractionally to the total volume of

Diagram 3.3
GDP COMPONENTS BY EXPENDITURE APPROACH, LTL BILLION



Source: Statistics Lithuania

exports. This *Achilles* heel of the Lithuanian economy could be quickly reinforced by higher foreign direct investment (FDI). Invisible exports per capita in Estonia are almost triple the respective indicator of Lithuania. FDI per capita are also almost three times higher in Estonia (see *Investments*) which is no coincidence.

KEY TO SUCCESS: PROMOTION OF MANUFACTURE REPLACING IMPORTS

Although the volume of exports made up 73% of GDP in 2011, the high level of imports (74% of GDP) made it difficult for exports to contribute more significantly to the economic growth. The experience of well-developed and developing countries such as Japan, South Korea and China shows that the government needs to support manufacture which is able to replace imports. For Lithuania, it is a more challenging task because we are unable to put in place protectionist customs policies and do not have the freedom to set a very low exchange rate of local currency. But there are some options; for instance, we could generate more energy by using local biofuel. More information about foreign trade is provided in the relevant section (see *Foreign trade*).

The expenditure of household consumption, which rose by 6.1% in 2011, was the second most important type of expenditure driving the Lithuanian economy. It will be the consumption expenditure which will largely determine the growth of GDP in 2012 after the slowdown in export development. However, consumption should not be expected to grow strongly since the rise of wages (2.5%) was not able to offset inflation (4.2%) in 2011 and it is likely that salaries will continue to go up slowly in 2012 as well. More information about inflation and earnings can be found in subsequent sections (see *Inflation* and *Labour market and income*).

In recent years, segments of the public sector such as public administration, education and health care have not seen extensive growth due to the tense public finance situation. In 2011, consumption expenditure of the general government sector made up 19% of GDP and ranked third in terms of importance of expenditure. This expenditure did not change much in 2011 and did not contribute to stronger economic growth. Although the area of public finance is nearly always viewed as potential room for improvement of effectiveness, we would not be in favour of higher public expenditure given the current structure of the public sector. At the moment, Lithuania pays about 6% in interest for a ten-year loan. Therefore, any idea to increase public expenditure should be based on the fact that the return on such expenditure must be at least 6%. Maybe such financial calculations are not always appropriate in the light of socially sensitive projects but the vast majority of public projects must be assessed on this basis. A more comprehensive analysis of public finance is outlined in a separate section (see *Government finance*).

MORE INVESTMENTS ARE NEEDED FOR SUSTAINABLE DEVELOPMENT OF THE COUNTRY

The most worrying feature of the Lithuanian economy is low expenditure on capital formation or, to put it simply, the fact that investment expenditure ranked only fourth in terms of importance in 2011. Last year, just 18% of the Lithuanian GDP was spent on investment. Although investment expenditure went up by an impressive margin of 70% last year, this growth reflects a very low reference base, especially for investments in buildings. It can be mentioned that Estonia spent 22.1% of its GDP on investment in 2011, Latvia spent 20% and the EU average was 18.5%. So Lithuania still spends too little on investment.

The vast majority of investments went into residential and other construction (11% of GDP) rather than projects designed to increase production capacities, only 4% were spent on machinery and equipment (the EU average was 6.4%) and 2% were invested in vehicles. It is this low level of investment in machinery and equipment that can hamper stronger growth of the Lithuanian GDP in the future. A more consistent analysis of investments is provided in a separate section (see *Investments*). We will repeat here what will be written later: Lithuania is in dire need of foreign investments. Often foreign investors bring their technologies which are too expensive for Lithuania, their own brands which require many years of development and access to foreign markets which would be extremely difficult to penetrate for Lithuanians on their own.

In the first quarter of 2012, the national economy continued to decelerate gradually and growth stood at 3.9%. The slower growth of export volumes is still the main reason behind this sluggish development. In 2011, the volume of exported goods and services increased by 13% and we believe that exports will grow at a lower rate of 6% this year. Since domestic consumption is slow to recover due to high unemployment, slow rise of wages and considerable inflation and is unable to offset the slowdown in export growth, the pace of economic development in Lithuania is likely to be cut by half this year to 3%.

4. Prices and inflation

ECB: BETWEEN A ROCK AND A HARD PLACE

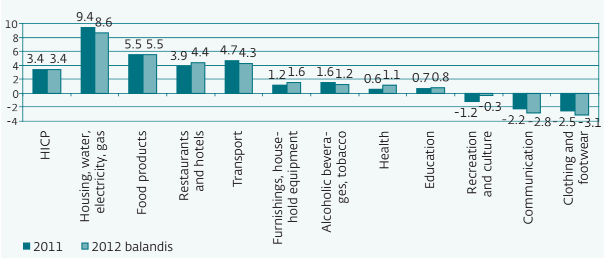
If we take the eurozone alone, the change in prices here was the largest since the introduction of the single currency and reached 2.7% in 2011. Under normal economic conditions, such a high inflation rate would show poor performance by the ECB which has a mandate to keep average inflation at around 2%. The ECB raised interest rates in the spring of 2011 but the fear of eurozone break-up and deflation forced the bank to return interest rates to their record lows in the autumn of the same year (see *Financial market*) Annual inflation has been above the target set by the ECB for 13 consecutive months, which indicates that curbing inflation is no longer the main objective of the central bank in the medium term. This behaviour by the ECB once again increases tension between the European core facing a real threat of inflation and its periphery which is most worried about the trap of deflation.

IMPORTED INFLATION: THE MAIN CAUSE OF HIGH PRICES IN LITHUANIA

At present, Lithuania faces the threat of inflation, not deflation, because the global price hike trends were also seen in our country. The average annual growth of the HCPI was 4.1% in Lithuania last year. As prices grew faster than wages, the purchasing power of the population continued to weaken. Still, the higher level of prices was not unique to Lithuania and was seen across the EU. The highest annual average inflation rate was recorded in Romania (5.8%) and Estonia (5.1%) in 2011. Prices of goods and services in Latvia went up by a margin similar to that of Lithuania (4.2%).

The main causes of inflation were the rising prices of oil and wheat in euro rather than administrative decisions in 2011. The price of fuel and virtually any service or product having fuel as one of its components rose because of higher prices of oil. More expensive wheat triggered a rise in food prices because other food crops followed in the footsteps of wheat. Therefore, Lithuania suffered greatly from the so-called imported inflation (see Diagram 4.1) in 2011.

Diagram 4.1
CONSUMER PRICES INDICES, END OF PERIOD, ANNUAL CHANGE, PERCENT

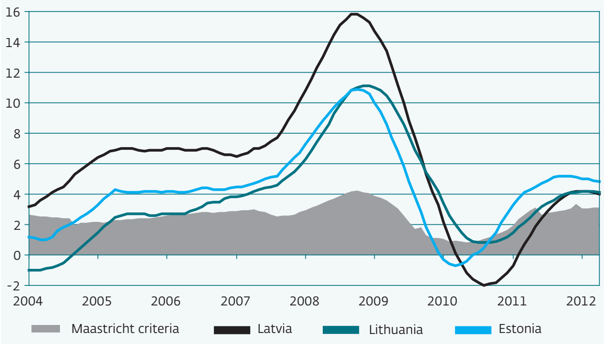


Source: Statistics Lithuania

INFLATION PERSISTS BECAUSE FOOD AND FUEL ACCOUNT FOR A LARGE SHARE OF THE LITHUANIAN CONSUMER BASKET

Looking at the period between 2002 and 2011 we can see that the impact of global prices of grain and oil was very strong in Lithuania. It means that prices cannot be expected to rise slowly in Lithuania when prices of wheat and oil are growing strongly on the global market. This can be seen from Diagram 4.2 as well. Interestingly, rising commodity prices have a much weaker effect on prices in Western Europe. This can be explained by the fact that an average European spends relatively less on food and fuel as he earns more. Therefore, the importance of changing commodity prices will decline in line with the rising incomes of Lithuanians.

Diagram 4.2
AVERAGE HCPI YEARLY INFLATION AND MAASTRICHT CRITERIA, %



Source: Eurostat

Because of the expectations of suppliers, the period of transfer of commodity prices to the final consumer is often quite short. For instance, a seller of buckwheat may begin selling products at higher prices even before he acquires more expensive products. Thus, last year's change in average commodity prices shows the direction of inflation but more accurate inflation forecast must also be based on changes in prices which took place a couple of months ago. This is reflected by changes in annual inflation in Lithuania in various months throughout 2011.

Annual inflation was on the rise in Lithuania until May 2011 when it reached 5%. At that point, the effect of imported inflation was extremely strong. In May 2011, the price of car fuel was 7.8% higher than a year ago, while the euro price of *Brent* crude oil rose by about 30% year-on-year. However, oil price remained at a similar level until the end of the year. In May 2011, food prices rose by 6.4% year-on-year (wheat prices were already at their peak and went down slightly in subsequent months).

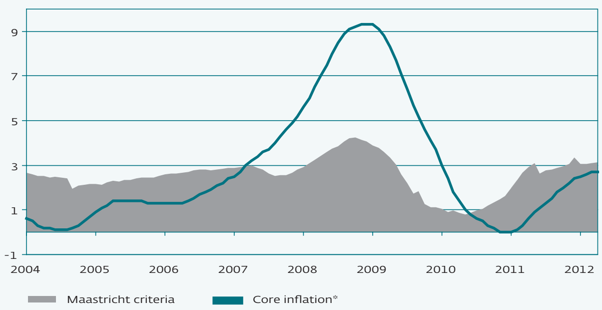
Inflation decelerated in the second half of the year in Lithuania but prices remained higher because of the 14–21% hike in natural gas tariffs for household consumers in July 2011. The price of electricity also went up in July. It should be noted that the price of solid fuel also rose sharply last year and increased by 26.8% annually by the end of 2011.

INFLATION FEEDS ON LITHUANIA'S ENERGY DEPENDENCY AND LACK OF ALTERNATIVES

Lately, Lithuania has suffered greatly from changes in the price of imported natural gas which was pegged to the prices of fuel oil and gasoline since these commodities correlate strongly with oil prices (correlation stands at 0.91). The projected oil price remains high while the global price of natural oil has been going down sharply because of the changing market structure and much stronger global supply. For instance, gas utility *Lietuvos Dujos* reported that it paid LTL 1,234 for 1,000 cubic metres of imported gas last year. If Lithuania had a natural gas terminal, the same quantity of natural gas would have cost LTL 411 on the New York Mercantile Exchange in July 2011. The use of prices quoted on the New York exchange is not quite accurate since the US export infrastructure will only be created in 2015 but this price reflects the general trend. Thus, if we added transportation costs (45% of the price for loading to a ship, 30% for transportation by sea and 25% for unloading) to LTL 411, the price of 1,000 cubic metres of imported gas would be LTL 822[1]. This price excludes the acquisition costs of the terminal itself but it is obvious that the price of imported gas could be lower by at least one-fifth. Moreover, newly discovered gas fields lowered gas prices on the global market to just LTL 191 per 1,000 cubic metres in late April 2012 (the final price in Klaipėda could be around LTL 400). Therefore, the liquefied gas terminal could bring a great relief to all consumers in Lithuania.

[1] The costs are published on the website of the US Energy Information Administration. Maximum percentages were taken from the published ranges..

Diagram 4.3
AVERAGE CORE INFLATION IN LITHUANIA AND MAASTRICHT CRITERIA



* Inflation rate after eliminating impact of energy and food products

Source: Eurostat

The mere fact of the existence of this terminal would force sellers of gas imported through the pipelines to lower the price of supplied gas.

LITHUANIA IS BARELY ABLE TO ENSURE PRICE STABILITY

As regards Lithuania's ability to meet the Maastricht price stability criterion in the nearest future, the glaring truth is that this criterion makes little sense in the context of the current monetary union as Lithuania's indicators for the accession in, for instance, 2014 would be compared against EU members in recession or just coming out of it. Therefore, these countries will have much lower inflation indicators. To be able to ensure compliance with the technical Maastricht inflation criterion, the Lithuanian government could simply purchase oil and gas options and use income from these options to subsidise food and fuel prices when the cost of these commodities begins to rise steeply. Of course, this piece of advice is difficult to implement and would contradict the idea of long-term price stability required by the Maastricht criterion. Nevertheless, it shows that Lithuania's compliance with the inflation criterion will largely depend on dealers of the Chicago Mercantile Exchange and not on us. Diagram 4.3 shows the comparison between basic inflation in Lithuania (net of oil and food price effect) and the Maastricht criterion which indicates that Lithuania could successfully comply with the price stability criterion in the coming years if it managed to avoid strong imported inflation.

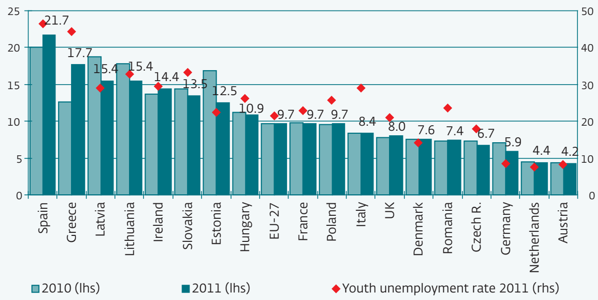
Latest data for 2012 indicate that the inflation rate remained high at the beginning of this year. The annual rate of inflation stood at 4.2% in April. Again, the main cause of inflation was oil whose price in euro rose by 6.6% year-on-year this April. Fortunately, the price of black gold has been declining and in May alone contracted by more than 5%. Still, even though oil prices began to slide down, households will receive massive heating bills in the coming winter because the average price of fuel remains high.

Nevertheless, we hope that the overall inflation rate will begin to decrease in the second half of the year in Lithuania. It should be helped by prices of grain which, in our opinion, should go down slightly on the global market at the end of summer. We expect the inflation rate to decline to 3.2% by the end of 2012. Potential decisions of politicians to cut VAT rates for separate groups of products before or after the elections to the parliament would have a doubtful effect on the final prices of products and inflation since it is not clear if the consumer would be able to benefit from the VAT reduction as the difference may simply be eaten by the producer or distributor.

5. Labour market and household income

Although economic growth in Lithuania has been one of the strongest in Europe, the situation on the labour market is still difficult. Despite a drop in the number of unemployed people (for the first time since 2007) in 2011, the real average wage also went down and the gap between pay for skilled and unskilled labour broadened even further. An increase in the unemployment rate in the first quarter of 2012 is partly caused by seasonality but also shows that labour demand is still weak. A disconcerting fact is that employers will face serious challenges looking for skilled labour as the national economy continues to regain strength because a large share of current jobless people will be abroad and others will simply lose motivation and will join the ranks of inactive Lithuanians.

Diagram 5.1
HARMONIZED UNEMPLOYMENT RATES, ANNUAL AVERAGE, %



Source: Eurostat

UNEMPLOYMENT FELL IN 2011, WILL CONTINUE TO DECLINE MORE SLOWLY

At the end of 2011, the unemployment rate went down to 13.9% and the average annual indicator stood at 15.4% in Lithuania. A year ago, the relevant indicators were 14.8% and 17.8%. It is important to note that this reduction in unemployment relied on new jobs created by companies which were breathing more freely and on relentless emigration. Most new jobs were created in the recovering transport and warehousing industry (36% of all new jobs) and manufacturing industry (19% of all new jobs). However, unemployment went up in the first quarter of 2012 to 14.5%. Still, it was a temporary seasonal development since the largest fall in the number of workers was recorded in retail trade and construction, and the Lithuanian Labour Exchange already reported a 0.7% monthly reduction in the number of registered jobless people in March 2012. The labour market is expected to continue on the road to recovery and unemployment should fall further in 2012 but fewer jobs will be created by the decelerating national economy and growth of employment will be slower than last year.

The stagnant number of the long-term unemployed (those looking for work for longer than a year) despite the falling jobless rate is disconcerting as the indicator stood at 7.3% in the first quarter of 2012 and rose by 0.2% year-on-year. These unemployed workers have made up one half of all people between jobs in Lithuania for quite some time and this is a hotbed of potential problems. In the future, as the Lithuanian economy continues to grow, long-term unemployed people may lack the necessary qualification and motivation to return to the labour market and the human resources in the country will start to dry up quickly.

The Lithuanian labour market still looks pitiful in the European context. For some time now, the country has been third from the bottom in the European Union in terms of the unemployment rate. Only Spain and Greece, which face more serious problems, had a higher average unemployment rate in 2011 (see Diagram 5.1) and the Latvian indicator was as high as the Lithuanian one but went down by a larger margin during the year. In Estonia, the unemployment rate was at the lowest level in the Baltic states and stood at 12.5% in 2011. The average annual unemployment rate of the entire European Union did not change during the year (9.7%) as problems on the labour markets in peripheral EU members outweighed positive changes in the north of Europe.

LABOUR PRODUCTIVITY GOES UP, REAL WAGES STAY PUT

In 2011, the average monthly gross wage went up by 2.5% in the country to LTL 2,175. It should be mentioned that the Lithuanian average monthly wage was the lowest among the three Baltic states in 2011. The indicator in Latvia and Estonia stood at LTL 2,474 and 2,959 respectively but all these countries were among the five EU members with the lowest average earnings. Because of inflation, the average real salary contracted for the third consecutive year and by a margin of 1.5% last year in Lithuania but is expected to go up this year. Wages mostly grew in communications and technologies, social and health care, agricultural and transport industries.

Average wages in the public sector grew at a faster pace than in the private sector[1] and remained higher by 12%.

In 2011, the net salary rose by a slightly smaller margin than gross earnings (2.4%). It is a normal development as net wages go up/down when gross wages rise/fall for those who are eligible for income tax exemptions, i.e. earn less than LTL 3,150 on paper. A smaller nominal increase in wages for lower-income earners is offset by lower taxes.

During the year, higher salaries rose by the largest margins in information and communications (+ 11.2%), human health care and social work (6.8%), finance and insurance (5.4%). Wages shrank only in administrative, services, artistic, entertainment and leisure organisation industries (by 0.8% each) but workers in these sectors are among the lowest-earning people. This broadening gap between the highest and lowest income earners has been observed for some time in other developing and developed countries as a consequence of globalisation (more liberal trading rules and imported technologies) which make countries specialise in areas where they are able to perform best and abandon non-productive industries.

In the next couple of years, the growth of earnings will continue to rely on the weakening supply of skilled labour and a period of moderate economic growth. The growth of nominal wages is expected to outpace inflation by the end of the year because of the projected lower inflation rate (3.2%) and further increase in gross earnings (4%). Next year may be the first year since 2009 to see wages grow faster than prices nationwide. Still we should note that the expected increase in earnings will boost the purchasing power of an average Lithuanian just fractionally by about 0.8%.

LABOUR MARKET MUST BE LIBERALISED TO INCREASE MINIMUM WAGES

Because the situation on labour markets remains tense, a wave of employment liberalisation has lately engulfed Europe, especially the countries in its periphery, as more flexible hiring and firing practices mean that companies will be less reluctant to take a risk and hire more workers. The ideas of a more flexible labour market also surfaced in Lithuania: employers, trade unions and government officials recently began to negotiate amendments to the labour code. Proposals include leaving more room for agreements between the employer and the employee, reducing the administrative burden, modification of definitions of paid leave and duration of an average working day, possibility to lay off a retirement-age worker without any reason, lower severance pay, etc. Of course, these potential changes are painful to trade unions and hard to swallow for the crisis-ridden public but they are vital for the stalling Lithuanian economy as a breath of fresh air. Uncertainty about the future and inflexible legal acts make businesses reluctant to hire new workers even when their activities gather momentum so this initiative of the current right-wing government is not surprising at all.

In exchange for concessions made by trade unions on some amendments to the labour code, the Cabinet has agreed to raise the minimum monthly wage (MMW) as long demanded by the unions. The MMW issue is a complex one as a higher minimum wage may turn against the lowest-skilled workers and small businesses working in the environment of low profit margins. And although an increase in the MMW should increase the amount of collected taxes, it also means higher administration costs as many public sector employees, especially in municipalities, earn a minimum wage. Still it should be mentioned that a higher minimum wage will motivate some economically inactive people to look for work and will support employment growth in the country.

The public discontent with the third lowest minimum wage in the European Union is also understandable (the minimum wage was smaller only in Romania and Bulgaria last year and made up LTL 1,000 in Latvia and Estonia). Since the last increase in the MMW in 2008, inflation has driven prices up and the relative amount of the MMW does not create a sufficient stimulus for some unemployed to look for work. Moreover, the current environment is extremely favourable for raising the MMW. According to rough estimates, over 200,000 workers in Lithuania earn minimum wages. Simply put, an increase of LTL 50 would translate into an extra burden of LTL 66.5 per worker for businesses (increase in the salary plus additional taxes to the budget). The total cost of this increase for employers would be equal to LTL 160 million annually. Accordingly, an increase of LTL 100 would add extra LTL 320 million to employers' costs. Currently, businesses would be able to incur such losses as companies earned LTL 8.4 billion in profit last year. Therefore, the potential advantages of a more liberal labour market coupled with a higher minimum wage would be beneficial both for the public and the economy of Lithuania.

YOUTH EMPLOYMENT PROBLEM IS ABATED BY STUDENTS

In the last quarter of 2011, youth unemployment (persons aged between 15 and 24) stood at 21.2% in the European Union. Lithuania had the fourth highest youth unemployment rate (31.7%) in the EU and managed to overtake only such struggling countries as Spain (45.8%), Greece (45%) and Slovakia (33.6%). The indicator stood at 28.2% and 22.2% respectively in the neighbouring Latvia and Estonia. Still, the Lithuanian indicator shrank by 2.2 percentage points in a year and dropped by further 3.3% in the first quarter of 2012 going down to 28.7%.

The underlying reason for this reduction is the changing youth activity on the labour market (see Diagram 5.2). Only less than 28% of all people from this age group were economically active (i.e. worked or looked for work), while the percentage was almost 30% a year ago. As many as 93% of unemployed young people study at higher, vocational training or general education institutions and only a third of those who did not study have no job. Roughly speaking, only about 10% of young people neither worked nor studied, which is a more optimistic estimate given the overall unemployment rate in the country.

[1] Including sole proprietorships.

Diagram 5.2
YOUTH (AGE 15-24) ECONOMIC ACTIVITY

Source: Statistics Lithuania

It is obvious that the concern over one of the highest youth unemployment rates in the EU is quite exaggerated because of the way Lithuanians treat higher education. The percentage of students among young people in the country is much higher than, let's say in Spain which has had the highest youth unemployment for some time now. Not many are eager to work and study at the same time.

A much more concerning factor is the slow integration of university graduates into the labour market. This can be explained by the persisting trend in Lithuania to choose occupation on the basis of the idea of future financial prospects rather than personal tastes. Such inadequate financial expectations and little knowledge of the nature of future work often end up in disappointment. Surveys show that a very large percentage of students have no plans to work in their professional field after graduation. Therefore, the government should be commended for its renewed effort to address the problem using the EU support. A new long-term youth policy strategy was developed in 2010, companies were offered tax incentives when they hire university graduates and investments were made in professional improvement of specialists working with youths. Sufficient attention was also paid to alternative options: youth entrepreneurship initiatives and activities of organisations were promoted. Still, it will take time before the results can be seen. The situation could be improved by educating young people about the labour market while they are still at secondary school where the choice of future occupation is usually made.

EMIGRATION IS ON THE RISE AND MAY SLOW DOWN ECONOMIC GROWTH

After a new requirement to declare compulsory health insurance contributions in annual tax returns was imposed in 2009, many emigrants who had left the country some time ago rushed to officially declare emigration in 2010. Therefore, last year's 35% drop in the number of registered emigrants (to 53,800) reflected by official statistics is misleading. If the effect of compulsory health insurance declaration duty is excluded, the number of emigrants went up in 2011 and was one of the highest in the last decade. It seems than only a handful of people felt the direct impact of the recovering national economy as Lithuania continues to have one of the strongest

Diagram 5.3
ANNUAL CHANGE OF LABOUR PRODUCTIVITY* AND WAGES, PERCENT

* Value added per employee at current prices

Source: Statistics Lithuania

flows of emigrants in the entire post-Soviet bloc even though the standard of living here is better than in other countries. We can only take comfort in the fact that the number of returning Lithuanians tripled from the previous year and stood at 14,000. Most people returned from the countries which are the most popular destinations for emigrants, i.e. the United Kingdom and Ireland. However, even this improvement should be taken cautiously. It seems that the returns were forced by circumstances as these countries were hit more severely by the crisis making it more difficult to find work there.

More intensive emigration manifests itself in the shortage of skilled labour which may hinder economic growth in Lithuania in the long run. Bringing in workers from other EU countries is virtually impossible because wages are too low even for potential immigrants from third countries. In 2011, the number of work permits issued by the Lithuanian Labour Exchange to foreigners doubled (3,327 permits) but the number was not very significant. The local market was not very popular and just a fraction of foreign workers renewed their employment contracts for a new term. These were mostly Belarus and Ukrainian nationals predominantly employed by the transport industry. Therefore, any significant increase in imported human resources is less than likely in the nearest future and efforts to improve productivity should focus on foreign direct investment so that foreign companies could come to Lithuanian bringing both new technologies and ability to work more efficiently.

In the long run, the reduction of unemployment and growth of real wages will depend on the competitiveness of the Lithuanian economy which has been quite encouraging lately. For the second year in a row, labour productivity outpaced rising salaries (see Diagram 5.3) as the increase in value added per worker (at current prices) rose by almost 4%. Measured in constant prices, the increase in labour productivity in Lithuania was the second best (after Bulgaria) in the European Union and stood well above the Latvian (2%) and Estonian (0.6%) indicators. However, the dwindling labour supply may soon enable workers to strengthen their negotiating position and the growth of salaries may once again start gaining momentum and outpace productivity growth. Therefore, it is extremely important for companies to improve their competitiveness by investing in more efficient plant and technology. We project that unemployment will go down by 12% by the end of the year and the majority of profitable industries will be hiring new workers.

6. Foreign trade

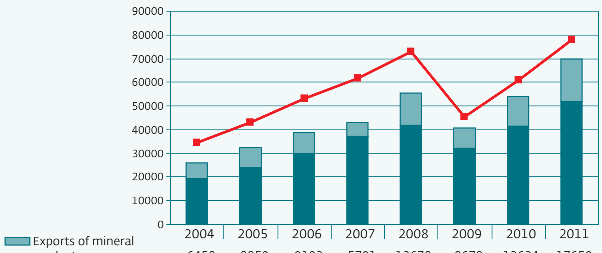
Once the construction boom eased off in 2009, Lithuanian exports and imports have been the driving forces of the economy in the medium term. In this respect, we are no different from other EU newcomers as most countries are trying to become strong exporters in the face of crisis.

According to the Bank of Lithuania, exports of goods and services at current prices made up LTL 82.6 billion in 2011 and the nominal annual growth was 27%. The real growth of visible and invisible exports at constant prices was 13.3%. Statistics Lithuania estimates that the volume of national exports of goods at current prices stood at LTL 69.9 billion in 2011 and rose by LTL 15.6 billion from 2010 (up by 28.9%), which was the second year of increasing exports of goods after 2009 when exports at current prices plummeted by 36%.

HIGHER PRICES OF IMPORTED PRODUCTION AFFECTED THE BALANCE OF TRADE

Despite a strong growth of exports in 2011, the balance of trade of Lithuania was negative and the deficit stood at 1.5% of GDP (see Diagram 6.1). The main culprit was the growth of imports which outpaced exports (the value of imported goods went up by 28.3% last year to LTL 78.2 billion) (see Diagram 6.2). The balance of trade was affected negatively by changes in the movement of prices of exported and imported products. In 2011, prices of imported goods rose by a larger margin (14.2%) than those of exported products (13.5%). Prices of imported goods climbed up on the back of rising oil prices and prices of commodities correlating with oil prices on the global market. Diagram 6.3 clearly shows a sharp rise in the value of imported goods for intermediate consumption in 2011. This value reflects the impact of more expensive commodities on the volume of Lithuanian imports.

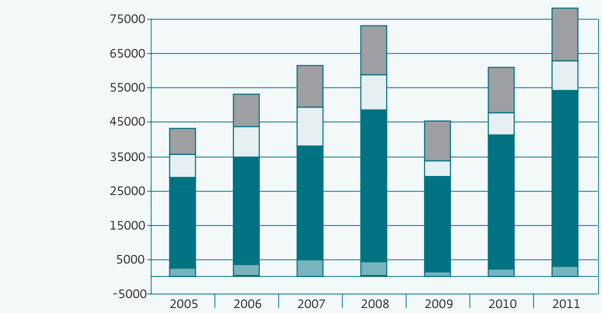
Diagram 6.2
EXPORTS AND IMPORTS OF GOODS, LTL MIO



	2004	2005	2006	2007	2008	2009	2010	2011
Exports of mineral products	6458	8859	9193	5791	13678	8678	12634	17650
Exports of other goods	19361	23908	29696	37402	41833	32054	41405	51993
Imports	34384	43152	53275	61504	73006	45311	60943	78160

Source: Statistics Lithuania

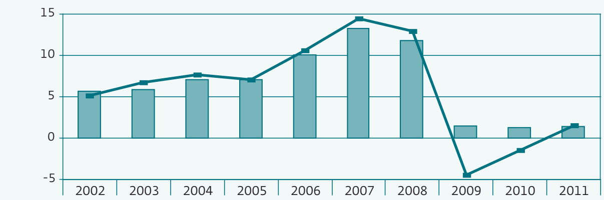
Diagram 6.3
IMPORTS BY BROAD ECONOMIC CATEGORIES, LTL MIO



	2005	2006	2007	2008	2009	2010	2011
Consumption goods	7439	9492	12196	14297	11558	13244	15369
Capital goods	6896	8974	11225	10197	4597	6331	8573
Intermediate goods	26332	31084	33137	44103	27562	39152	51085
Passenger cars	2259	3463	4731	4140	1504	2086	3034
Other goods	225	262	215	269	89	139	99

Source: Statistics Lithuania

Diagram 6.1
CURRENT ACCOUNT AND FOREIGN TRADE (GOODS AND SERVICES) DEFICITS, RATIO TO GDP, %



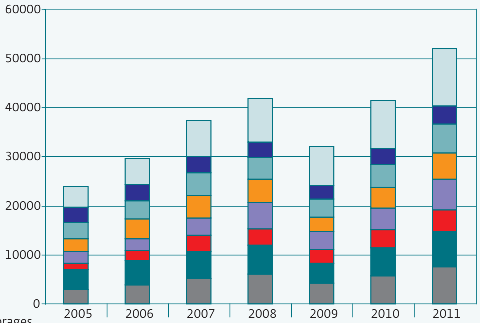
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
FTD	5.7	5.9	7.1	7.1	10.1	13.3	11.8	1.5	1.3	1.4
CAD	5.1	6.7	7.6	7.1	10.6	14.4	12.9	-4.4	-1.5	1.6

Source: Statistics Lithuania, Bank of Lithuania

TRADITIONAL SECTORS BOOSTED THE VOLUME OF VISIBLE EXPORTS. NON-EU MARKETS ARE BECOMING INCREASINGLY IMPORTANT

In 2011, Lithuanian exports were supported by traditional sectors (see Diagram 6.4). Excluding exports of mineral fuel (MF), excellent indicators were posted by the food industry as exports of foodstuffs rose by 19.1% last year and prepared foodstuffs made up 5.9% of national exports. Machinery and

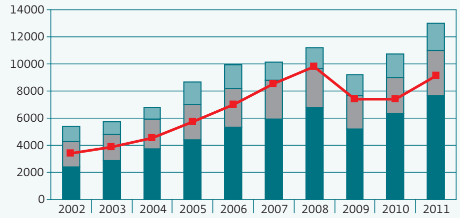
Diagram 6.4
EXPORTS BY COMMODITY GROUPS (MINERAL PRODUCTS EXCLUDED), LTL MIO



	2005	2006	2007	2008	2009	2010	2011
Food stuff and beverages	4209	5417	7346	8893	7979	9710	11565
Textile and textiles articles	3043	3228	3263	3059	2625	3225	3666
Wood and furniture	3304	3792	4650	4388	3742	4751	5893
Transport vehicles	2707	3948	4557	4757	2956	4196	5331
Products of the chemical industry	2390	2515	3477	5354	3695	4397	6384
Plastics and rubber	1186	2000	3430	3304	2751	3677	4323
Machinery and equipment	4079	4886	5589	5915	4078	5643	7184
Other goods	2990	3910	5089	6163	4228	5804	7648

Source: Statistics Lithuania

Diagram 6.5
EXPORTS AND IMPORTS OF SERVICES, LTL MIO



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Exports of other services	1133	940	873	1667	1763	1320	1511	1489	1764	1985
Exports of travel services	1870	1944	2164	2562	2844	2899	2903	2497	2685	3338
Export of transport services	2395	2852	3760	4413	5333	5902	6777	5188	6308	7665
Imports of services	3411	3848	4535	5715	6969	8530	9790	7388	7392	9147

Source: Bank of Lithuania

mechanical equipment sold abroad, which account for about a tenth of national exports, went up by 27.3% in 2011. Exports of the chemical industry, which also accounts for a tenth of Lithuanian exports, rose by an impressive margin of 45.2% last year. Exports of vehicles stood at 7.7% last year but the bulk of this volume was made up by car re-export to the CIS countries.

A look at export markets shows an increasing importance of the CIS countries even though the European Union has remained our largest export market. If exports of MF are excluded, the volume of sales in EU countries accounted for 56.7% of total exports. The significance of the EU has been clearly declining as the market took in 62.6% and 59.1% of exported goods in 2009 and 2010 respectively. At the same time, sales on Eastern markets have been gathering pace. In 2011, 33.3% of all exported products went to the CIS and the indicator increased in recent years from 27.1% in 2009 to 31.7% in 2010. This trend shows that Lithuanian businesses are able to adapt to the changing economic conditions. After the Russian crisis of 1998, businesses quite quickly switched to the EU markets. Now higher commodity prices support growth of the majority of CIS economies at a rate higher than in the EU countries and Lithuanian businesses are now targeting the markets that buy more and pay more.

EXPORTS OF SERVICES ROSE AT A RECORD PACE BUT OUR INVISIBLE EXPORTS REMAIN THE SMALLEST AMONG THE BALTIC TRIO

Diagram 6.5 shows that exports of services grew at a record rate of 21.1% in Lithuania last year. It was the strongest growth in the EU and the main role in the swelling volume of invisible exports was played by such traditional industries as transport and tourism (almost 90% of the total increase). The incoming tourism also benefited from the European Basketball Championships hosted by Lithuania last autumn.

Despite the strong growth of this type of exports, the persisting low level of exported services in Lithuania is a source of concern. In 2011, the value of exported services per capita was EUR 1,200 in Lithuania, while the Latvian indicator stood at EUR 1,600. Nevertheless, Estonia remained the major exporter of services among the Baltic states where invisible exports per capita were as high as EUR 3,000.

The growing volume of exports contributed to a stronger economic growth in Lithuania in 2011 and the development of exports will be the driving force of the economy in 2012 as well because domestic consumption will continue to recover at a snail's pace. Latest estimates indicate that the growth of exports is beginning to slow down. The annual growth of exports was 13.3% in January, 10.4% in February and 11.9% in March. We believe that the volume of exports of goods and services will increase by 6% in total in 2012, i.e. growth will be halved compared to last year. The main reason behind this slowdown will be, as mentioned on numerous occasions in this issue, weak expectations of economic growth in Western Europe. Lithuanian exporters will also be hurt by the low zloty exchange rate. It should be noted that the zloty exchange rate reacts sensitively to problems within the eurozone so the escalation of difficulties in the single currency area undermines exports of Lithuanian products to Poland.

7. Investments

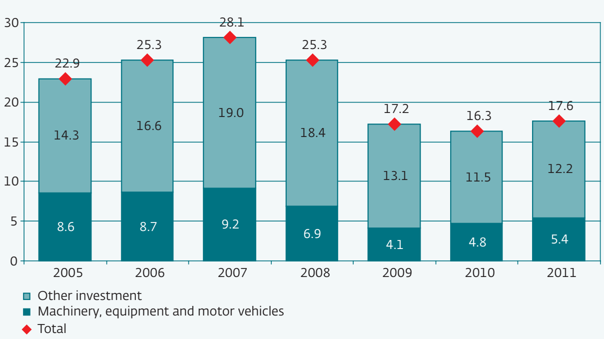
Capital investments are the basis for long-term economic growth in Lithuania. However, last year's uncertainty over the future of Lithuanian and European economies forced companies to postpone major investment projects and the level of capital investments rose marginally in 2011 despite an improved financial situation of companies. The level of investment went up from 16.3% of GDP in 2010 to 17.6% of GDP in 2011 in Lithuania. Last year, the level of investment was just below the EU average of 18.6% and also below the levels of the neighbouring countries as the volume of investments last year made up 23% and 22.2% in Latvia and Estonia respectively.

INVESTMENTS IN MACHINERY ARE STILL MEAGRE

Weak investments in equipment, machinery and vehicles, which accounted for just 5.4% of GDP in 2011 (see Diagram 7.1), are a source of concern in Lithuania. The Estonian indicator stood at 10.1% and the Latvian one was as high as 11.3% (see Diagram 7.2). Investments in machinery and equipment add to productivity of companies and ensure faster long-term growth of GDP, so small investments of this type in Lithuania pose a threat to Lithuanian business first of all since failure to increase production volumes now may result in lost orders in the future when sales volumes will grow rapidly and production capacities will be insufficient.

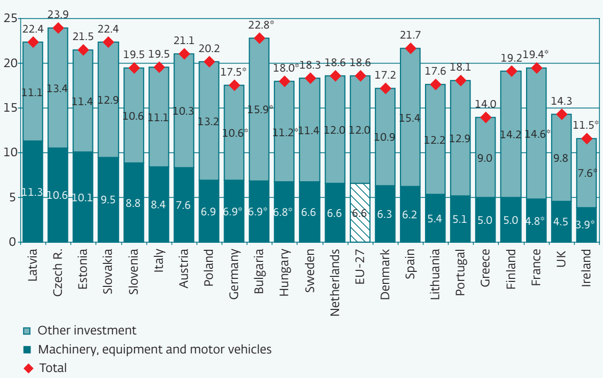
Economic uncertainty which makes businesspeople unwilling to invest and tighter bank lending policies have often been blamed for a low level of investment in Lithuania lately. However, both the economic environment and bank lending

Diagram 7.1
GROSS FIXED CAPITAL FORMATION, RATIO TO GDP, %



Source: Eurostat

Diagram 7.2
GROSS FIXED CAPITAL FORMATION IN 2011, RATIO TO GDP, %



* Estimated according to the data of 2010

Source: Eurostat

policies are virtually the same in all three Baltic states but the level of investment in Latvia and Estonia is much higher than in Lithuania.

IMPRESSIVE RISE IN INVESTMENTS IN THE MANUFACTURING INDUSTRY HIDES THE LOW REFERENCE BASE EFFECT

In 2011, the volume of investments in the manufacturing industry, which is one of the key exporting sectors in Lithuania, soared by 71.4%. An impressive growth of investments in the sector hides a rather fast rise of investments in almost every branch of the sector. The highest percentages in this investment basket were held by food and wood industries as the flow of investments grew by 50.1% and 55.3% respectively. Nevertheless, this increase reflects a very low reference base as 2011 was the first year after the crisis in which the volume of investments began to grow.

Investments in the manufacturing industry were painfully shrinking throughout the entire crisis period between 2008 and 2010. At the peak of the crisis in 2009, the volume of capital investments in the sector fell sharply by 42% compared to 2008. Therefore, 2011 was the year of recovery of capital investments in the manufacturing industry but uncertainty about the future of the economy hindered even faster increase in the level of investment.

Capital investments began to rise from the bottom level in the construction industry as well. They went up by 42% in 2011 but such a strong growth can also be explained by a very low reference base.

FOREIGN DIRECT INVESTMENTS ROSE LAST YEAR BUT WE STILL LAG BEHIND OUR NEIGHBOURS IN TERMS OF ACCRUED FDI

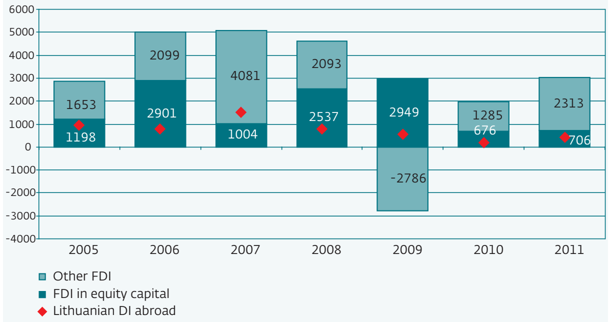
We often stress the importance of foreign direct investments (FDI) for the long-term economic development of Lithuania in this publication. This government lists FDI raising as one of its priorities and *Invest Lithuania* has been actively hunting for investments. However, as the saying goes that the farther the forest the thicker the trees, it is obvious that external action (maintaining good relations with investors, promoting the country, etc.) is not enough and we need to clean up our own backyard. We need to remove red tape barriers and fight corruption at municipal level. Most importantly, these measures will help attract foreign capital and will also bring relief to local business.

In 2011, the FDI flow stood at LTL 3 billion (2.8% of GDP) in Lithuania and increased by LTL 1.1 billion or 54% compared to 2010 (see Diagram 7.3). It has to be said though that FDI in Lithuania rose mainly because of the stronger flow of reinvestment as well as the sale of local pharmaceutical company *Sanitas* to Canadian pharmaceutical giant *Valeant*.

Canadians paid LTL 942.1 million for an 87.2% stake in *Sanitas*. It was the largest acquisition in Lithuania by value of the acquired company since 2007. Moreover, only around half of this amount was included in the Lithuanian FDI flow because other former shareholders of *Sanitas* were foreign investments funds.

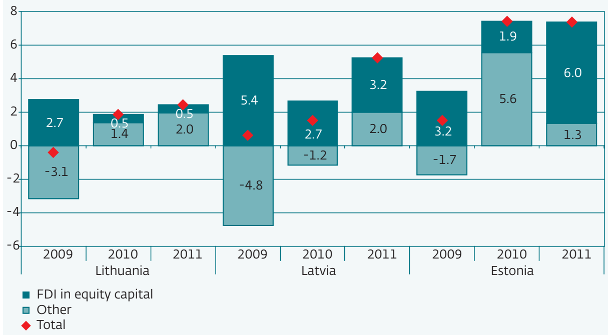
Invest Lithuania estimates that this agency brought 25 foreign investors to Lithuania in 2011 and they plan to invest around LTL 800 million, which is 30% more than in 2010. Companies which decided to start up business in Lithuania last year plan to create almost 2,400 new jobs in a period of three years. The relevant result in 2010 was slightly more than 2,200 new jobs. Last year, most investment projects in Lithuania were launched by financial, business services, industrial equipment, consumer product, electronic component as well as software and IT companies. Nevertheless, Lithuania still lags far behind its Baltic neighbours in terms of the flow of net foreign direct investments (see Diagram 7.4).

Diagram 7.3
FOREIGN DIRECT INVESTMENT FLOWS, LTL MIO



Source: Bank of Lithuania

Diagram 7.4
NET FDI FLOW TO GDP RATIO IN THE BALTIC COUNTRIES, %



Source: Eurostat

In can be concluded that 2011 was not a breakthrough year for investments in the country. If the investment level in Lithuania remains significantly lower than in other Central and Eastern European countries for a longer period of time, the effects will be felt by local businesses as Lithuanian companies may lose the competitive battle in the region once the global economy starts to recover. Still, the growing economy in the country will put increasing pressure on companies to invest in projects boosting their production capacities. We expect to see a slight increase in investments this year. Latest estimates indicate that the level of investments at current prices returned to the level of early 2009 in the first quarter of 2012 but investments in buildings and engineering works accounted for half of all investments.

8. Public finance

The austerity fatigue spreading across Europe which was well reflected by the results of Greek and French elections will undoubtedly affect the topics of the approaching elections to the Lithuanian parliament. Still any ambition to increase public expenditure should be set aside for now as the country does not have extra resources even though the financial situation of the public sector has stabilised lately in Lithuania.

GROWTH OF SOVEREIGN DEBT SLOWED DOWN

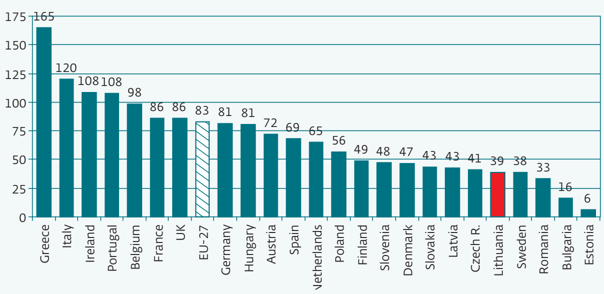
Between 2008 and 2011, the sovereign debt of Lithuania more than doubled from LTL 17.4 billion to LTL 43.2 billion and the debt to GDP ratio went up from 15.5% to 39.1%. Despite this steep rise, the government sector debt to GDP ratio in Lithuania is still twice as low as the EU average (82.5%) and three times lower than the ratios of minor players in the euro-zone (111.9%) (see Diagram 8.1). In the European Union, only five countries ended 2011 with a lower debt indicator than Lithuania. Last year, the debt of our country increased by nearly LTL 5 billion (up by 11.5%) but the debt to GDP ratio went up by just 0.5 percentage points to 38.5% at the end of 2011 because the national economy also grew strongly. The analysis of targets set by the Ministry of Finance shows that the gross national debt should be just above LTL 45 billion in 2012. This means that the debt will continue to outpace the nominal GDP growth despite the fact that inflation alone is likely to add at least 3% to the nominal GDP in 2012. The good thing is that the sovereign debt is swelling at a much slower pace and even some contraction is expected. The debt to GDP ratio is likely to be around 40% at the end of 2012 and the government wants to reduce this indicator to 35% of GDP by 2015. However, these targets can only be achieved if the austerity policy continues.

BUDGET REVENUE IS ON THE RISE, EXPENDITURE STOPPED SHRINKING

In 2011, general government revenue made up LTL 33.9 billion, or 32% of GDP. Diagram 8.2 shows that the relative level of budget revenue in Lithuania is low in the EU context (the EU average in 2011 was 44.6% of GDP). This revenue level in Lithuania results from both lower tax rates (for instance, Lithuanian taxes on capital are the lowest in the EU, while labour taxes are some of the highest taking into account all related taxes) and one of the highest unemployment rates in Europe. Budget revenue went up by 5.9% during the year and the increase was equal to the annual growth of the national economy, while tax revenue rose by an even larger margin (8.5%) thanks to improving results of companies and made up LTL 17 billion, i.e. half of the total revenue of the public sector (see Diagram 8.3). Efforts to boost revenue inevitably led to new taxes: a levy was imposed on luxury real estate worth more than one million litas, taxes on deposit interest and luxury cars were debated, ideas to raise the value added tax and introduce progressive taxes were once again put on the table. Still, we should remember that newly introduced or higher taxes do not stimulate the economy and even a zero unemployment rate would not translate into a dramatic increase in budget revenue (but expenditure on social benefits would go down).

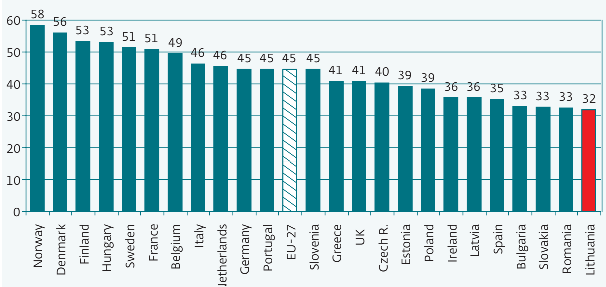
Therefore, more emphasis should currently also be placed on tackling other deeply rooted problems such as the spread of

Diagram 8.1
GENERAL GOVERNMENT REVENUE IN 2011, % OF GDP



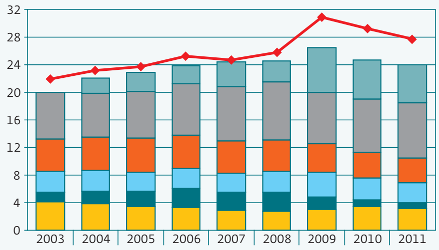
Source: Eurostat

Diagram 8.2
GENERAL GOVERNMENT DEBT IN 2011, % OF GDP



Source: Eurostat

Diagram 8.3
NATIONAL BUDGET REVENUE AND EXPENDITURE, RATIO TO GDP, %

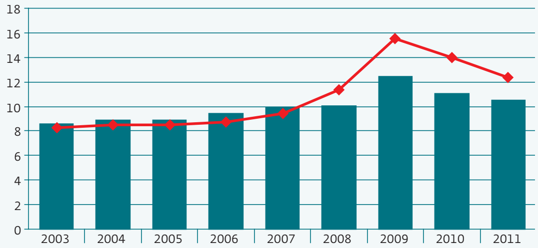


	2003	2004	2005	2006	2007	2008	2009	2010	2011
EU support		2.2	2.8	2.6	3.5	3.1	6.5	5.6	5.5
VAT	6.7	6.3	6.7	7.4	7.9	8.3	7.4	7.7	8.0
Income tax	4.7	4.9	5.0	4.9	4.6	4.6	4.1	3.7	3.6
Excise duties	3.1	3.0	2.8	2.9	2.8	3.0	3.6	3.2	3.0
Corporate income tax*	1.4	1.9	2.1	2.8	2.6	2.7	1.8	1.0	0.8
Other revenue	4.1	3.8	3.5	3.3	2.9	2.8	3.0	3.4	3.1
NB expenditure	21.9	23.2	23.7	25.2	24.7	25.7	30.9	29.2	27.7

* Including social tax

Source: Statistics Lithuania

Diagram 8.4
STATE SOCIAL INSURANCE FUND REVENUE AND EXPENDITURE, RATIO TO GDP, %



	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenue	8.6	8.9	8.9	9.4	9.9	10.1	12.4	11.1	10.5
Expenditure	8.3	8.5	8.5	8.8	9.4	11.4	15.6	14.0	12.4

Source: Statistics Lithuania

shadow economy and inefficiency of state-owned companies. Unfortunately, more active measures taken by the government on this front in recent years have not been as fruitful as expected. The promise to pull out one billion litas out of the 'shadow' has been delivered in half at best and the survey carried out by the *Baltic Institute of Corporate Governance* in May 2012 showed that Lithuania still had the worst indicators of management of state companies among the Baltic states, not to mention the Nordic neighbours. However, addressing these problems requires a lot of time and effort while rushed solutions may have detrimental consequences, so we can at least take comfort in the fact that the national government has recognised these faults of public finance and is looking for solutions. Hopefully, the new government will continue to work in this direction as well.

Last year, the public expenditure to GDP ratio went down to 36.8% from 41.3% in 2010 (the EU average was 49.1%). However, the nominal increase in budget expenditure by 2.1% to LTL 39.7 billion in 2011 from LTL 39.2 billion in 2010 means one thing: the cost-cutting period came to a close in Lithuania while most EU countries are just entering into this phase. Lithuania's austerity measures taken during the crisis, which have already been acknowledged globally, will ensure a more sustainable development of the economy in the future and make the economy less vulnerable to potential crises.

Last year, the largest share of budget expenditure (36%) went into the social security sector, while education and health care received 15% and 13% respectively. The social budget remains one of the biggest headaches for those who try to balance the national budget, even though the social budget deficit contracted last year (see Diagram 8.4). In twelve months of 2011, the social budget collected LTL 11.3 billion in revenue exceeding the level reached in 2008, which was one of the best years for the national economy (LTL 11.1 billion). The increase relied on the higher number of insured persons and rising level of their incomes. Meanwhile, the social budget expenditure shrank to LTL 13 billion in 2011 and was 3.9% below the target. That being said, the deteriorating demographic situation in the future caused by relentless emigration and population aging suggests that social security expenditure is unlikely to decrease markedly and will continue to take the largest slice of the national budget.

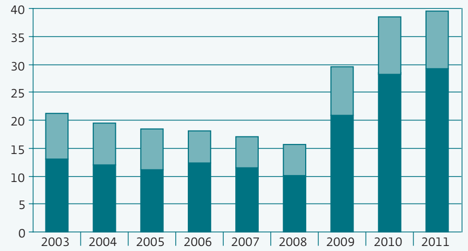
BUDGET DEFICIT IS SHRINKING BUT IT IS TOO EARLY TO RELAX

Efforts by the Cabinet to shore up the national budget have borne fruit as the fiscal deficit contracted in 2011 in Lithuania and stood at LTL 5.8 billion, or 5.5% of GDP. The downward trend continued for the second consecutive year as the indicator stood at 9.4% of GDP in 2009 and 7.2% of GDP in 2010. In addition, 2011 was the first year when the budget deficit decreased as a result of strong growth of the economy and income rather than cuts to public expenditure. Still, Lithuania remained behind other countries in the context of the European Union: the average budget deficit of the eurozone countries was 4.1% of GDP, while the EU average made up 4.5% last year. However, this gap can be explained by the fact that the Lithuanian economy contracted by a much higher margin during the crisis than other European economies so it needs more time and money to consolidate the budget.

DEBT REFINANCING PROBLEM ALMOST SOLVED IN 2012, MAJOR CREDITORS ARE ABROAD

According to the Ministry of Finance, the government plans to borrow LTL 10.3 billion in 2012 on the domestic and external markets (9% of GDP). LTL 6 billion is necessary to refinance the public debt and the remaining amount will cover this year's budget deficit. Lithuania has already successfully borrowed more than two-thirds of the necessary amount this year. In late 2012, the country placed a new USD 1.5 billion 10-year eurobond issue with the annual yield of 6.625%. Interestingly enough, the interest on this bond issue was lower, albeit just fractionally, than the yield offered by Latvia which, in contrast to Lithuania, decided to turn to the IMF for help. In April 2012, the Ministry of Finance of Lithuania also successfully supplemented its international EUR 400 million issue of previously placed bonds which will be redeemed in 2018, and DNB became the first Lithuanian bank to place an international bond issue with its foreign partner. The yield of this additional issue was 4.216% and was lower than expected. More than LTL 1 billion

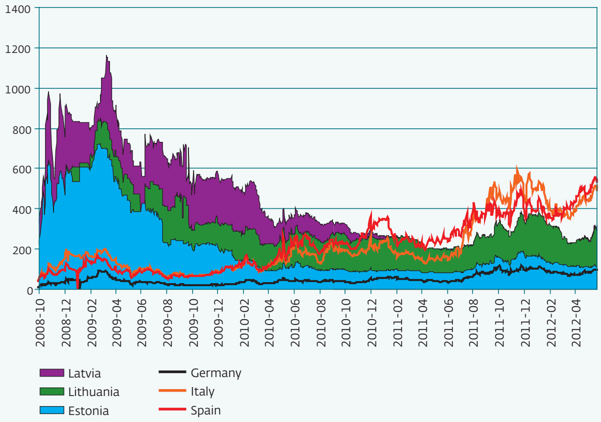
Diagram 8.5
STATE DEBT, RATIO TO GDP, %



	2003	2004	2005	2006	2007	2008	2009	2010	2011
Domestic debt	8.2	7.4	7.3	5.7	5.6	5.6	8.7	10.2	10.3
Foreign debt	13.0	12.0	11.1	12.3	11.4	10.0	20.8	28.3	29.2

Source: Statistics Lithuania

Diagram 8.6
5-YEAR CDS, BP



Source: Reuters

has already been borrowed this year on the domestic market through auctions of debt securities. As in the previous years, the bulk of the sovereign debt is financed on foreign markets (see Diagram 8.5).

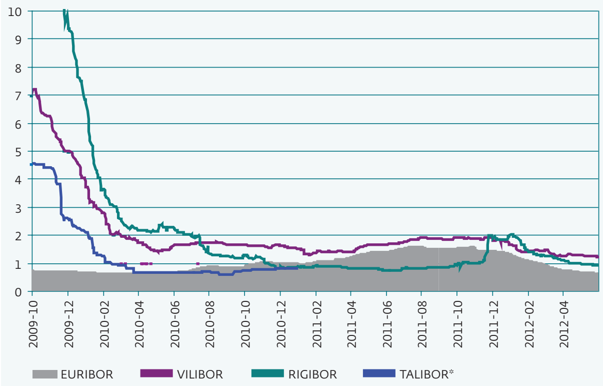
The country was able to borrow successfully because of the higher amount of money in the Lithuanian banking system and the West, successfully managed *SNORAS* bankruptcy and newly secured respect of investors. Thus, the government may breathe a sigh of relief after the first quarter of this year as both foreign and local investors approve of the country's efforts to manage public finances and are eager to lend. This year, the government has borrowed at much lower interest rates than in 2009 and 2010, and the price of hedging against the default of Lithuania (CDS contracts) has also gone down considerably (see Diagram 8.6). It is quite possible that the Cabinet will try to borrow on international markets one more time this year because of the approaching redemption of the EUR 1 billion issue in March 2013.

The Ministry of Finance projects that the budget deficit will be 3% this year, which is below the Maastricht threshold, and will be balanced next year as provided for in the new European fiscal stability compact. The data on budget revenue collection in the first quarter of 2012 published by the Bank of Lithuania indicate that budget revenue has been well above the target so far as the national budget deficit made up 0.5% of the projected GDP after the first three months of the year. These results stemmed from the budget revenue which was 1.3% above the target and better than expected GDP growth in the first quarter of 2012 in Lithuania (3.9% GDP growth year-on-year). Therefore, it seems that the targeted 3% budget deficit level will be reached this year but for Lithuania to keep moving towards a balanced national budget it is necessary that the incoming government stays committed to the responsible budget policy.

9. Financial market

The first half of 2011 did not look troubling for financial markets. In anticipation of the recovery of European economies, stock market indexes were rising, Lithuanian and European interbank market players showed confidence in each other and the European Central Bank (ECB) even raised the basic interest rate twice to avoid higher inflation. However, the summer of 2011 proved to be a real test for Baltic and Western financial markets. Once it became obvious in July 2011 that the write-off of Greek debt was inevitable, stock and bond prices began to fall and the liquidity in the European banking system decreased considerably. The situation was temporarily improved by the ECB which extended 'cheap' long-tem loans to European banks in November 2011 and February 2012.

Diagram 9.1
3-MONTHS INTERBANK LENDING RATES, %



* Since Estonia has adopted Euro on January 1st, 2011 Talibor rate is no longer being used

Source: Bloomberg

SNORAS BANKRUPTCY DID NOT TRIGGER A SYSTEMIC CRISIS

In November 2011, Lithuania saw an unexpected nationalisation and subsequent bankruptcy of *SNORAS* bank. In Latvia, the same fate was suffered by *Krajbanka* in which *SNORAS* was a majority shareholder. However, we can now safely say that the threat of a banking system failure in the aftermath of the bankruptcy was successfully reined in by quickly returning the deposits up to EUR 100,000 held in the bankrupt bank to the banking system as they were insured as required by EU legislation. Out of the insured amount of LTL 4 billion paid out to depositors, 77% was deposited in the accounts of companies and individuals in other banks and just 23% was paid in cash which shows that the public did not lose confidence in the banking system.

INTERBANK RATES REMAIN LOW DUE TO EXCESS LIQUIDITY BOTH IN EUROPE AND THE BALTIC STATES

At the beginning of 2012, there was excess liquidity on Lithuanian and Latvian interbank markets after a large amount of deposits was refunded which dragged interbank interest rates down (see Diagram 9.1). The 3-month RIGIBOR interbank rate in Latvia, which suddenly leaped to 2% in late 2011 after the above-mentioned bankruptcies, went down to below 0.93% at the beginning of 2012. The situation was very similar in Lithuania as the 3-month VILIBOR rate jumped to 1.9% after the collapse of *SNORAS*. Later, the banking system had excess liquidity after the deposits of individuals and companies were refunded and the Bank of Lithuania stepped in, which pushed the interbank rate down to a record low of 1.23% in early 2012. Both individuals and business with liabilities denominated in the national currency (28% of the loan portfolio) were able to breathe a sign of relief. This confidence in the national currency should remain in the nearest future but the potential break-up of the eurozone may put a spoke in its wheels.

Meanwhile, the 3-month EURIBOR interbank rate, which rose to 1.6% in the middle of 2011, began to go down later and stood at 0.675% in late February 2012 after the ECB handed out a second tranche of long-term loans. Such a broad gap between interbank interest rates of euro and litas/lats loans signals the risk of devaluation of local currencies even though this risk still is very low.

The fact that VILIBOR is higher than RIGIBOR can be explained by different ratios set by the national central banks and applicable to local commercial banks. The Bank of Lithuania does not limit the open currency position in the euro of commercial banks operating in the country (difference between assets and liabilities, including post-balance-sheet, of the bank). In Latvia, meanwhile, an open position in this currency may not exceed 10% of capital of the banks. Since credits in the national currency account for a much smaller share of the loan portfolio in Latvia and most deposits are held in lats, local banks prefer to lend to each other in the surplus local currency.

HOUSEHOLD CONSUMPTION IS ON THE RISE, COMPANIES ARE SAVING

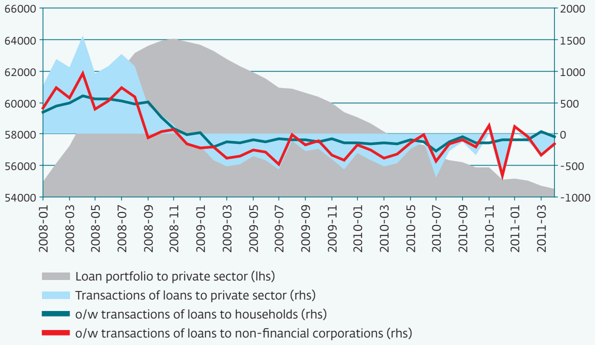
As the real economy continued to recover in Lithuania, the relevant amount of most liquid money M1 grew for the second year in a row. This monetary aggregate recorded a 13.4% annual growth. The fastest growing component was the amount of cash in turnover (up by 23%) followed by overnight deposits (9.6%). Meanwhile, the amount of time deposits comprising the M2 aggregate shrank by 3.3% annually, while household deposits, which is the main source of funding of the banking sector, contracted by nearly 0.5% in a year. It seems that the national population began to consume more and save less. Keeping in mind that unemployment has declined lately in the country and salaries have gradually gone up, this rising trend of household consumption is very likely to continue throughout this year.

On the other hand, the amount of deposits of non-financial corporations went up because of a steep increase in overnight deposits. Companies which are uncertain about the future behaved in a way opposite to households: they were not keen on investing into business development due to weak expectations and kept money in current accounts which can be accessed at any time. The amount of corporate deposits maturing in more than two years also soared by more than 80% in a year. This may mean that an increasing number of local companies are stocking up and delaying their growth plans.

CORPORATE BORROWING IS SLOWING DOWN AND WILL AFFECT ECONOMIC GROWTH

As regards assets of Lithuanian banks, the total loan portfolio went down by 7.6% in a year and the total balance of loans issued to the private sector shrank by around 6% to LTL 53.6 billion (see Diagram 9.2). This prolonged contraction of the loan portfolio shows the shortage of clients among households and businesses wishing to assume long-tem financial obligations and at the same time meeting the risk criteria laid down by credit institutions. Still it is encouraging to see that new mortgage loans issued to households rose by almost 23% year-on-year in the first quarter of 2012 even though the responsible borrowing regulations adopted by the Bank of Lithuania in 2011 and laying down the maximum loan for the value of mortgaged property and maximum costs of the borrower for debt administration slowed down the growth of mortgage loans. Currently, the number of mortgage loans issued in a month is 4–5 times lower than in the first half of 2008 but low interest rates and recovering domestic consumption suggest that this type of loans should continue to grow. It should be remembered that mortgage loans are large and are taken for a long period, which means that their portfolio grows very moderately.

Diagram 9.2
DYNAMICS OF LOAN PORTFOLIO TO PRIVATE SECTOR, LTL MIO



Source: Bank of Lithuania

On the other hand, the said increased cautiousness of businesses is reflected by the fact that the number of new corporate loans was extremely low in the first quarter of 2012 and we can at best expect only minimum growth of the loan portfolio. It should be noted that the fear of uncertainty has spread in both Lithuanian and EU business community, while the EU banking sector is also reluctant to increase its loan portfolio as it has to factor in more stringent capital adequacy requirements which will enter into force in a couple of years. Currently both banks and companies face a serious challenge of finding mutually acceptable financing solutions.

Although this weariness of companies is understandable as it reflects the lessons learned from the crisis, insufficient investments do not support creation of new jobs and have a direct negative effect on the real GDP growth. Therefore, promotion of investments by the companies should become a priority for the national government in the nearest future.

LITHUANIAN BANKS RAISE MORE FUNDS DOMESTICALLY

In the national banking system which is dominated by Scandinavian capital, the loans to deposits ratio stood at 129% at the end of 2011 and fell by 12 percentage points annually as banking operations became more balanced and most of the loans were financed from locally raised resources. Although liabilities of banks to their parent companies still make up a quarter of all liabilities in the banking system, the dependence on this financing source decreased by a third in a year. Financial resources available to banks internationally are more expensive than locally sourced funds from Lithuanian private and corporate clients.

BANKS WILL EARN LESS IN 2012 THAN LAST YEAR

Last year, shareholder equity of banks rose by 12.8%, or even by 27.6% if *SNORAS* is eliminated, and made up LTL 6.8 billion at the beginning of 2012. This result mostly relied on a profit of LTL 1.1 billion earned in 2011 which came very close to a record result of banks achieved in 2007. However, the bulk of the profit last year resulted from a significant reduction in provisions of all banks, so it is too early to claim that the profitability of banks has returned to the pre-crisis level. This is supported by quite poor start to 2012. In the first quarter of this year, the profit of banks fell by 43.2% year-on-year to LTL 144.6 million. This negative change in profits was mainly caused by new provisions for bad loans included by one bank, and we can expect

Diagram 9.3
OMX VILNIUS INDEX

Source: NASDAQ OMX Baltic

the results of other quarters to be better but below the levels of last year.

TENSION REMAINS ON STOCK MARKETS

Meanwhile, 2011 was a bad year for stock investors that like to play a high-risk game (see Diagram 9.3). The optimism at the start of the year was replaced by worsening mood across Europe in the second half of the year, while the likelihood of a new crisis and uncertain future of exports hampered investor activity on Baltic stock exchanges. In 2011, the OMXV index of shares listed on NASDAQ OMX Vilnius plummeted by 27% and the Estonian index fell by 24%. During the same period, the index of shares listed on NASDAQ OMX Riga contracted by the smallest margin in the Baltic states (6%), but this can be explained by the lowest liquidity among the three stock

Table 9.1
KEY INDICATORS OF LITHUANIAN FINANCIAL MARKET

		Outstanding amounts, end of period, LTL Mio				Ratio to GDP, %	Annual change, %	
		2008	2009	2010	2011	2011	2010	2011
Monetary aggregates								
M1		23321.9	22049.9	27398.7	31285.4	29.5	24.3	14.2
Currency in circulation		8520.4	6971.3	7847.2	9680.7	9.1	12.6	23.4
M2		43312.8	43633.9	47726.6	50000.9	47.2	9.4	4.8
M3		44062.9	44181.6	48117.3	50486.5	47.6	8.9	4.9
Loans of credit institutions granted to private sector		65914.5	61243.0	56429.9	53086.1	50.1	−7.9	−5.9
Non-financial corporations		35733.8	32369.8	29094.4	26980.5	25.5	−10.1	−7.3
By currency	LTL	11674.3	7788.4	7057.0	6941.9	6.5	−9.4	−1.6
	EUR	22321.4	22994.4	21057.2	18769.6	17.7	−8.4	−10.9
	Other currencies	1738.1	1587.1	980.2	1269.0	1.2	−38.2	29.5
Households		30180.7	28873.2	27335.5	26105.7	24.6	−5.3	−4.5
By currency	LTL	11578.2	8464.0	7277.5	6701.1	6.3	−14.0	−7.9
	EUR	18314.4	20137.0	19737.5	19105.9	18.0	−2.0	−3.2
	Other currencies	288.1	272.2	320.5	298.7	0.3	17.7	−6.8
By purpose	Housing loans	20908.4	20809.3	20658.4	20488.9	19.3	−0.7	−0.8
	Consumer credit	4368.3	3544.3	3216.8	2386.6	2.3	−9.2	−25.8
	Other	4904.0	4519.6	3460.3	3230.1	3.0	−23.4	−6.7
Banking credit portfolio quality indicators, %								
Non-performing loans	Impaired loans ratio to loan portfolio	3.4	15.8	16.6	16.3	–	–	–
	Portfolio share of loans overdue more than 60 days	1.1	3.6	3.0	2.5	–	–	–
Special provisions ratio to loan portfolio		1.2	7.7	7.9	6.9	–	–	–
Private sector deposits in credit institutions		33340.7	34931.8	38081.7	39190.1	37.0	9.0	2.9
Non-financial corporations		8648.0	9406.4	10960.5	12536.0	11.8	16.5	14.4
By currency	LTL	6170.5	6195.1	7524.9	8189.2	7.7	21.5	8.8
	EUR	2187.3	2914.2	3041.4	3641.7	3.4	4.4	19.7
	Other currencies	290.2	297.2	394.3	705.1	0.7	32.7	78.8
Households		24692.7	25525.3	27121.2	26654.1	25.1	6.3	−1.7
By currency	LTL	18107.3	17290.7	19188.5	20351.3	19.2	11.0	6.1
	EUR	5321.3	7067.8	6502.0	5013.3	4.7	−8.0	−22.9
	Other currencies	1264.1	1166.8	1430.8	1289.5	1.2	22.6	−9.9
Interest rates for new loans and new deposits, %								
Loans	LTL	10.08	8.14	5.62	5.26	–	–	–
	EUR	5.91	4.43	4.41	4.47	–	–	–
Deposits	LTL	7.65	4.94	1.53	1.62	–	–	–
	EUR	3.66	1.60	0.99	1.18	–	–	–

Source: Bank of Lithuania, Statistics Lithuania exchanges which caused weaker volatility. When the bankruptcy of *SNORAS* was declared on 16 November 2011, the OMVX lost 11.25% next day. Last year, the number of companies listed on the Baltic stock exchanges shrank from 87 to 84 and no new companies were added to the list. Total capitalisation of the Baltic stock exchanges fell by almost a quarter and turnover went down by 18%.

The first quarter of 2012 was more successful to investors and the OMXV stock exchange index rose by 18% and more than two-thirds of all listed companies reported better than expected results in the first quarter of the year. However, a more significant positive movement on the Baltic stock exchanges is not very likely as the agenda is still dominated by the escalating sovereign debt crisis in Europe, economic recession and possible Greek exit from the eurozone.

2011 was a challenging year for the Baltic financial markets as the crisis of confidence in the eurozone and bankruptcies of local banks shattered the foundations of trust among the banks and the public. Since the systemic risk in the banking sector was successfully mitigated in Lithuania in the aftermath of the *SNORAS* bankruptcy by refunding the deposits on time, all local banks complied with all prudential ratios in the first quarter of this year. In 2012, local banks can expect some stability as their assets and liabilities should not change considerably.

10. Agriculture

Before analysing the Lithuanian agricultural sector, attention should be drawn to global processes in the food industry which also affect farmers and food companies in our country. In its outlook, the Organisation for Economic Cooperation and Development (OECD) projects the growing demand for agricultural products in the coming decade because of the growing population, rising food consumption per capita in the developing countries such as India and China as well as a shift in diets in these countries to more meat, dairy products and products containing sugar. In addition, an increasing percentage of crop production will be used for energy generation. Lately, it was manufacture of biofuel that has mostly driven the demand for crop production upwards. It is estimated that 30% of corn output in the USA and 30% of rapeseed yields in the European Union (EU) will be used for energy.

Meanwhile, supply of agricultural output will grow more slowly than before. It is expected that global volumes of agricultural production will grow by 1.7% annually on average during the next decade (growth was 2.6% in 2000–2010). Supply of most crop products is likely to weaken by the largest margin mainly because of slower growth of productivity, shrinking volumes of unused land and fertility. Developed countries have also exhausted the potential of available technologies. Global climate change may have a considerable impact on agriculture in the medium and long term. Some scientists estimate that climate change may reduce the area suitable for crop and animal production by as many as 10–15%. However, it is difficult to predict the future climate change impact on agriculture and experts often have opposing views on this issue.

It is not surprising that **prices of agricultural output will stay at a high level** when demand outpaces supply. Although they should dip slightly from the peak reached at the beginning of 2011, prices of cereals will be by 30%, meat by 20% and dairy products by 25% higher on average in real terms (i.e. without the general price rise effect).

PRICE VOLATILITY WILL BE THE MAIN THREAT TO AGRICULTURE IN THE NEXT DECADE

In addition to increasingly unpredictable climate conditions, major price fluctuations will be caused by rapidly changing prices of energy commodities and depleting resources necessary for agriculture such as land and freshwater. Lower price sensitivity of consumers in the developing countries will be another factor contributing to price instability. In previous decades, even a slight increase in product prices would trigger a steep fall in consumption because of lower population income balancing out demand and supply. However, higher income of the population in emerging economies means that much higher price hikes will be required for consumer demand to go down to match the available supply.

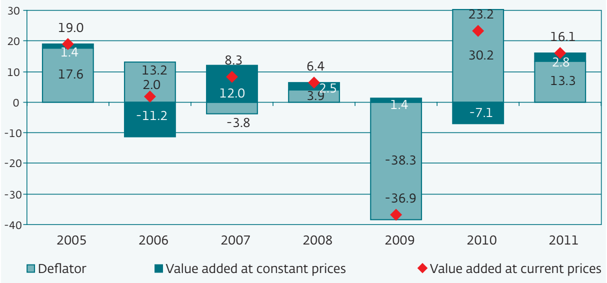
In summary, it can be said that global trends will be favourable for agriculture in the next decade. The growing demand and rising food prices should make it much easier for farmers to operate. However, the Lithuanian food industry will have to find ways to access the emerging markets in order to be able to benefit from the circumstances.

Historically, agriculture has been one of the key sectors of the Lithuanian economy. Its importance, however, gradually declined throughout the last decade. The share of industry's value added shrank by more than half between 2000 and 2009 but the process stabilised in a couple of previous years and agriculture's share stood at 3.5% of value added of the entire economy. The indicator is still about twice as high as the EU average.

In the last decade, agriculture developed unevenly undergoing both steep falls and sharp rises. During the crisis, first product prices plummeted and were later followed by production volumes. But the sector recovered strength last year. Value added at current prices rose by 16% on the back of significant upward pressure of prices, while industry's growth at constant prices stood at almost 3% (see Diagram 10.1).

AGRICULTURAL RENAISSANCE CONTINUES, INVESTMENTS WILL GRADUALLY IMPROVE PRODUCTIVITY

Diagram 10.1
VALUE ADDED CREATED BY AGRICULTURE, ANNUAL CHANGE, %



Source: Statistics Lithuania

The headcount of the agricultural industry, which gradually fell between 2000 and 2008 by nearly 60%, rose during the crisis as redundant workers from other sectors flooded the agricultural industry. It is a normal development both in Lithuania and abroad. However, economic recovery was followed by the declining number of workers in the agricultural sector for the last two years. In 2011, it shrank by 4% to 117,000 (see Table 10.1). The share of workers employed in the industry (over 11%) is higher than in most EU members and is double the EU average. Therefore, the headcount of the industry is expected to decline further. Labour productivity in agriculture remains extremely low and makes up just a third of average productivity of the economy. Although agricultural productivity is below the economy's average in all EU member states, Lithuania has one of the broadest gaps.

Capital investments, which shrank several times during the economic downturn, increased by more than 50% last year but the volume was almost twice as low as in 2008. The capital investments to value added ratio in agriculture stood at 9% and was much lower than the economy's average of 14%, even though the latter was also clearly affected by the crisis. This indicator is calculated as the ratio between expenditure on capital investment and value added of the sector at current prices. Therefore, the indicator goes down when value added increases faster than investments and vice versa.

Investment processes were positively affected by prices of investment products such as equipment, buildings, etc., which fell almost by half in 2008–2010 and remained quite low. They went up by a fifth last year but were still by a third lower than three years ago. In 2011, prices of machinery rose by a sixth and prices of agricultural buildings, which plunged 6 times during the crisis, rose by 50% but were still much lower than in 2008.

Last year, capital investments were boosted by more active involvement of the Rural Credit Guarantee Fund under the Rural Development Programme. The Fund issued guarantees for LTL 124.8 million for LTL 203.9 million in credits extended by credit institutions. Compared to 2010, the amount of guarantees rose by a third in 2011 and so did the amount lent by credit institutions to guarantee receivers.

Agriculture has been unable to raise significant foreign direct investment, mostly because of strict environmental requirements applicable in the country. Besides, foreign businesspeople wishing to invest in agriculture in Lithuania often have to face public discontent which is related to interests of rivals in many cases. One of the examples is unsuccessful efforts by Danish businessmen to develop the pig farming industry. Interestingly enough, the number of pigs raised in Denmark, whose area is by a third smaller than Lithuania and which is very advanced in environmental protection, is 15 times (!) higher than in our country. Therefore, fears that the expansion of pig farming may cause irreparable damage to the environment in Lithuania have no basis.

GOOD CROP PRODUCTION PROSPECTS OVERSHADOW OTHER AGRICULTURAL SEGMENTS

Although Lithuania has been traditionally regarded more favourable for animal farming, the relative weight of crop production has increased considerably in the value added structure of agriculture. In 2011, the share of crop production output rose from 54% to 59%, while the share of animal farming output fell to 41%.

More active development of crop production has been obvious lately in Lithuania as higher yields and product prices pushed sales volumes up by 42% last year. The total crop area grew more than 1.5 times since 2003 and increased by 2.5% last year. Crop production peaked in the country in 2009 after global grain prices reached their record highs in 2008. Once they went down, grain yields in Lithuania also decreased. However, crop production volumes were on the rise again last year following the global trends of soaring prices.

The yield of grain crops went up by 15% in 2011 to LTL 3.3 million. Although the yield of winter cereals shrank by a quarter because of last year's cold winter to 1.2 million tonnes, the yield of summer cereals rose by close to 70% to 2 million tonnes. The highest increase (twofold) was in the yield of summer wheat and barley yield rose almost 1.5 times compared to 2010. Crop productivity also improved markedly last year. Cereal productivity went up by a tenth and that of legume crops, rapeseed and potatoes increased by about a fifth.

Table 10.1
KEY STATISTICAL INDICATORS OF AGRICULTURE, HUNTING AND FORESTRY

				Ratio to the economy's indicator, %		Annual change, %	
	2009 m.	2010 m.	2011 m.	2010 m.	2011 m.	2010 m.	2011 m.
Value added (at constant prices), LTL Mio	3226	2998	3081	4.3	4.2	–7.1	2.8
Value added (at current prices), LTL Mio	2313	2849	3307	3.3	3.5	23.2	16.1
Labour productivity, LTL thou[1)]	17.7	23.5	28.4	27.1	30,8	32.4	21.2
Number of persons employed, thou	130.5	121.4	116.6	12.3	11.3	–7.0	–4.0
Average monthly earnings, LTL	1699	1655	1732	79.8	81.8	–2.6	4.7
Fixed investments, LTL Mio	190	193	295	1.7	2.1	1.9	52.7
Foreign direct investments (end of period), LTL Mio	303	319	351	0.9	0.9	4.9	10.3

[1)] Value added per employee at current prices
Source: Statistics Lithuania

Prices of crop production output rose impressively for the second year in a row, especially cereal prices. In June 2011, they were more than 1.5 times higher than a year ago and exceeded record highs of 2008. However, after Russia lifted grain export ban in the middle of last summer, markets were flooded with cheap grain from this country and prices fell instantaneously by more than 10%. This cheap Russian and Ukrainian grain poses the biggest threat to cereal growers in our country which offer higher quality products at a higher price.

In the short term, grain prices are mostly affected by weather conditions which are extremely difficult to predict. So it is hard to say what the prices of grain will be this summer. Still, we can assume that grain will be slightly cheaper this year. The UN Food and Agriculture Organisation forecasts that grain yield will be record high in 2012 and inventories of products will increase. Despite the anticipated reduction of prices, they will still be at a high level measuring by their historical standards.

Last year was less successful to livestock farming than to crop production and a slight dip in production volumes was seen. Although the prices of products soared for the second year in a row in 2011, it did not have a strong effect on buying-in volumes. In 2011, buying-in prices rose by 12%. A considerable increase was seen across nearly all categories of livestock farming products. Prices of cattle and poultry went up sharply by nearly a fifth. It should be noted that buying-in prices of livestock farming output were 10% above the pre-crisis level of 2008. Despite higher buying-in prices, the quantities of cattle and poultry (by live weight) went down by 1% in 2011 compared to 2008. Egg buying-in fell for the fourth consecutive year contracting by almost 8% last year. The positive impact of prices helped the value of livestock farming sales go up by 13% last year.

Dairy farming is one of the key agricultural sectors in Lithuania. It generates about a quarter of value added of the industry and its one of the priority sectors of the national economy. However, dairy production volumes increased marginally in the last 10 years. Last year, milk output made up 1.75 million tonnes in Lithuania, which is almost half of the output before the restoration of independence. Although milk prices were on average by 60% higher last year than in 2009, milk buying-in quantities rose by just 3% in the period of two years. Buying-in prices of milk rose on the back of shortage of raw milk in Lithuania and higher global prices and because increasingly smaller quantities of milk are bought from small farms which were paid lower prices because of collection costs. Further development of dairy farming in the country is hampered by several factors. On the one hand, unfavourable demographic trends lead to the aging of rural population and development of dairy farming is a time consuming and investment intensive activity, and there are few young people wishing to work in agriculture in rural areas. On the other hand, relatively small milk processing companies dominate in Lithuania. During the economic downturn such as in 2009, they are not able to maintain sufficiently high buying-in prices and farmers are forced to keep smaller herds which then take time to restore during the upturn period.

In Lithuania, the buying-in price of milk is still slightly lower than the EU average. Last year, the average price of milk in Lithuania was just below LTL 1,000 per tonne of whole milk, and a very similar price was paid in Poland and Latvia and a slightly higher one in Estonia. In most other EU members the indicator ranged between LTL 1,000 and LTL 1,300. It must be mentioned that smaller farms are paid a lower buying-in price for milk (about 20%) because of higher milk buying-in costs and the buying-in price has been growing because the share of milk purchased from small farms has been shrinking. Buying-in prices should be positively affected by the influx of Russian capital to the Latvian milk processing market which should increase milk demand in the region considerably.

Last year, the Lithuanian pig farming sector was hit by the swine fever outbreak which resulted in around LTL 5 million in losses for pig farmers and culling of around 40,000 pigs out of a less than a million animals farmed in the country. After inspectors of the Veterinary Service detected an outbreak of classic swine fever in Jonava district in mid-2011, pig imports and exports were banned immediately. Pig meat buying-in prices were lower in the third quarter but returned to the pre-epidemic level by the end of the year. The European Commission lifted the ban on exports to EU countries in September but Poland began accepting live pigs at the end of 2011 only, while Russia has not yet lifted the relevant ban. Keeping in mind that in 2010 Russia was the main sales market of pigs farmed in Lithuania (because of much higher buying-in prices), it was a severe blow to pig farmers in our country. Another unfavourable factor was the increase in the price of feedingstuffs because of higher prices of grain as feed accounts for around 75–80% of pig farming costs.

Further outlook for pig farming in the country is quite complicated. Although there is shortage of pig meat in Lithuania, the growth of production volumes is hampered by strict environmental requirements and public pressure. Moreover, pig farmers receive no direct payments or reimbursement of fuel excise in contrast to crop production farms. Another unfavourable factor is the preferential VAT regime applicable to livestock farming in neighbouring Poland: 3% on unprocessed and 7% on processed meat products, which makes it very hard to compete against Polish products. In addition, the Polish zloty and euro exchange rate has been much lower lately and products of the neighbouring country became even more competitive. Long-term prospects of sales in Russia are not clear as farmers in this country are expected to strengthen. However, barriers for exports to the Russian market should decrease in the nearest future. Last December, the country finally, after fifteen years of negotiations, joined the World Trade Organisation which limits trade barriers and will entitle Lithuanian farmers to complain to the WTO against trade restrictions imposed by Russia.

Food sector plays an important role in Lithuanian foreign trade. The group of agricultural and food products is one of the few to have a positive foreign trade balance in Lithuania. Our main export goods are milk and dairy products as their sales abroad made up LTL 1.7 billion last year and trade surplus stood at over LTL 1 billion. Exports of cereals can also boast large volumes which stood at LTL 857 million last year. The bulk of cereal is exported to Latvia, Germany and Middle East.

EU SUPPORT INJECTIONS ARE VALUABLE UNTIL THEY BECOME ADDICTIVE

Support of the European Union and Lithuanian Government is very important for agriculture. Funds are received through two main channels: most reach farmers in the form of direct payments for agricultural land (arable land areas, pastures, etc.), animals and milk sold to processing companies, while the remaining funds are disbursed under rural development programmes aimed at modernisation and improved competitiveness of agriculture.

According to preliminary estimates, direct payments to farmers increased by 2% last year from LTL 1.17 billion to LTL 1.22 billion. The share of national co-financing fell from 25% to 15% and the remaining amount of support was disbursed from EU structural funds. The Ministry of Agriculture projects that around LTL 1.27 billion will be paid out in both 2012 and 2013, while the national contribution will fall to 0%. Since one of the main priorities of the EU agricultural policy is to preserve rural culture, traditional lifestyles and avoid demographic decline in rural areas, a larger percentage of support will be paid to smaller family farms in the nearest future.

Last year, LTL 170 million was earmarked under the Rural Development Programme for farm modernisation and purchase of new equipment. However, the national government plans to bridge the gap to the requested amount of LTL 650 million by transferring some resources from other support funds. Even all these measures will not be sufficient and an extra LTL 200–250 million would still be needed to satisfy all applications.

In recent years, the European Commission has been discussing the agricultural policy for 2014–2020 and amounts of direct payments. Currently, support for farmers in various countries differs considerably. The Ministry of Agriculture estimates that Lithuania will remain among the EU countries receiving the smallest amount of EU support in terms of the total amount of direct and rural development payments (239 EUR/ha) in 2013 (the EU average is 345 EUR/ha). Currently, the largest amounts of total support are paid to Greece (563 EUR/ha), Slovenia (528 EUR/ha) and Cyprus (513 EUR/ha). On the other hand, the relative weight of agriculture is much smaller in these countries than in Lithuania so the amount of support received is not so much different in terms of GDP.

Lithuania has been proactive trying to ensure that direct payments to all members of the EU are equal by 2020 but representatives of European institutions suggest that payments should be adjusted gradually. According to their proposals, support to farmers in the Baltic states would grow by 30% this decade. However, larger payments would not necessarily increase production volumes in our country, while an additional injection of money would put upward pressure on inflation because of potentially higher prices of land and growth of wages in the agricultural industry. Attention should also be drawn to the fact that a large share of European support comes back to the old members of the EU in the form of payments for purchased agricultural machinery. We cannot also dismiss the likelihood that the debt crisis in Europe will change the approach to generous payouts to member states in the long term, so it is very important to ensure viability of the sector without additional support.

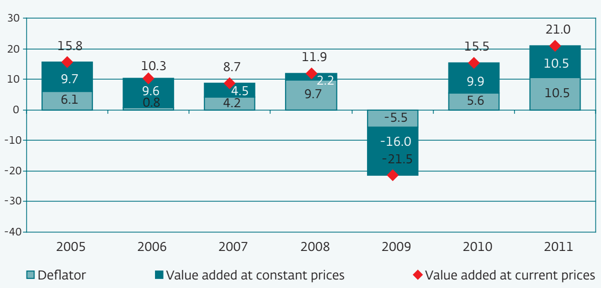
Fragmentation of the sector is one of the major problems of agriculture in Lithuania which is one of the leading countries in the EU in terms of the share of small farms. This makes it more difficult to absorb European support and raises product buying-in costs. Large farms dominate in Western Europe because of achievable economies of scale and higher efficiency as large farms can afford to invest in and use the latest agricultural technologies.

The outlook for agriculture is good for the immediate future. Representatives of the sector will be able to expand their production volumes because of the rising global demand for agricultural output and its prices. The environment is particularly favourable for crop production as its output is easier to export and it is less dependent on local processing entities. This year, grain prices are expected to dip but will remain at a relatively high level. Next year should also be a good year for livestock farming. Exports to the eastern neighbour should be easier after Russia's accession to the WTO and because of the strengthening rouble, while representatives of dairy farming will benefit from higher demand for raw milk in the region driven by the injection of Russian capital into the Latvian milk processing market.

11. Manufacturing industry

The manufacturing industry (MI) is one of the main drivers of the national economy and one of the fastest-growing sectors of the economy. In 2000–2011, the national economy grew by 60% and value added of the MI at constant prices doubled during the period rising by 6.4% on average every year. In addition, the manufacturing industry was the first sector to recover after the crisis. Last year, value added generated by the sector at constant prices went up by 10% and was equal to the increase recorded in 2010 (see Diagram 11.1). Last year saw the prices of MI output soar: prices of products sold in Lithuania went up by 11% and those sold on foreign markets by 17% on average. As a result, value added at current prices jumped by more than a fifth and the share of the manufacturing industry rose from 16.8% of GDP in 2008 to 20.4% last year.

Diagram 11.1
VALUE ADDED CREATED BY MANUFACTURING INDUSTRY, ANNUAL CHANGE, %



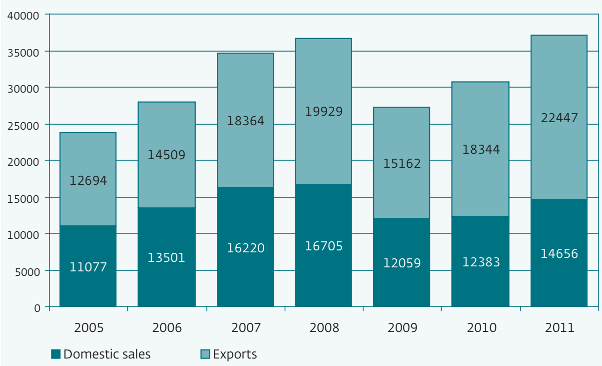
Source: Statistics Lithuania

MANUFACTURING INDUSTRY GREW IN 2011

In contrast to 2010, export was not the only reason behind the growth of the sector concerned last year. Sales on the domestic market began to recover relying on strong growth of the national economy and increase in investment projects. Sales rose by 27% abroad and by more than 20% in Lithuania last year. As a result, the share of exports in the sales structure increased marginally from 67% to 68% (see Diagram 11.2).

In 2011, growth in the industry mostly relied on the wood industry and light industry as well as stable development of the food industry, which is one of the largest sectors of the MI. Individual sectors of the MI will be reviewed in more detail in subsequent sections.

Diagram 11.2
MANUFACTURING INDUSTRY (EXCEPT MINERAL PRODUCTS) SALES, LTL MIO



Source: Statistics Lithuania

Companies operating in the manufacturing industry were able to enjoy excellent financial indicators last year. Operating profits rose by 10% last year to LTL 2.4 billion and pre-tax profits surged by 32% to LTL 2.2 billion (see Table 11.1). The percentage of profitable companies, which made up just 50% in 2009, increased to 67% last year and was well above the national average. Assets of companies rose by 7% to LTL 33,3 billion and liabilities went up by a similar margin to LTL 15.8 billion. The profitability ratio increased fractionally last year to 3.7% but the return on assets improved significantly to 6.7% and was 1.5 times higher than the national average. The debt ratio remained virtually the same for the third year in a row (47%) and was just above the average indicator of the national economy.

Last year, the MI was among the sectors of the national economy which created most new jobs. The headcount in the industry, which fell for three consecutive years, went up by 8% in 2011 to 145,000. This made up about a seventh of the total workforce in the country. In recent years, the manufacturing industry showed a remarkable increase in labour productivity as companies had to optimise production and cut costs during the crisis. As a result, value added per worker generated at current prices (which increased by 12% last year) rose for the fourth consecutive year and exceeded the national average by 44%. In 2011, the average monthly gross wage increased by 2.7% to LTL 2,088 in the industry but was still below the average wage of the national economy.

Table 11.1

KEY STATISTICAL INDICATORS OF MANUFACTURING INDUSTRY

				Ratio to the economy's indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Value added (at constant prices), LTL Mio	12953	14234	15729	20.6	21.5	9.9	10.5
Value added (at current prices), LTL Mio	13877	16024	19396	18.8	20.4	15.5	21.0
Labour productivity, LTL thou[1)]	99.4	119.5	133.8	138.2	144.9	20.2	11.9
Number of persons employed, thou[2)]	139.5	134.1	145.2	13.6	14.1	−3.9	8.3
Average monthly earnings, LTL	2033	2032	2088	98.0	98.6	−0.1	2.7
Fixed investments, LTL Mio	1266	955	1676	8.5	12.0	−24.5	75.4
Foreign direct investments (end of period), LTL Mio	8920	9942	11070	28.0	29.8	11.5	11.3
Sales of goods and services, LTL Mio	39345	47675	59904	29.5	31.3	21.2	25.7
Gross profit, LTL Mio	5673	7052	7756	23.2	21.9	24.3	10.0
Operating profit, LTL Mio	918	2143	2365	34.4	28.4	133.4	10.4
Profit before tax, LTL Mio	81	1691	2230	31.6	26.4	1991.4	31.9
Number of enterprises	5163	5060	5277	11.1	10.7	−2.0	4.3
Share of profitable enterprises, %	50	59	67	106.5	108.7	16.8	14.1
Assets (end of period), LTL Mio	30240	30968	33256	17.6	17.8	2.4	7.4
Liabilities (end of period), LTL Mio	14473	14621	15784	20.1	21.3	1.0	8.0
Return on sales, %	0.21	3.55	3.72	107.3	84.4	1626.0	5.0
Return on assets, %	0.26	5.58	6.74	184.3	151.5	2048.0	20.6
Debt ratio (end of period), %	0.48	0.47	0.47	114.3	120.2	−1.4	0.5

[1)] Value added per employee at current prices

[2)] Excluding individual enterprises

Source: Statistics Lithuania

CAPITAL INVESTMENTS ARE SCARCE BUT FDI FLOWS ARE ENCOURAGING

Last year, the flow of capital investments to the MI rose considerably but did not reach the level of 2008 yet. The capital investments to value added ratio of the manufacturing industry was much lower than the average of the national economy. Last year, capital investments were insufficient both because of tighter lending policies of banks and reluctance of companies to assume risks by borrowing and investing in the environment of high uncertainty about the European debt crisis and unclear growth prospects in the EU. Even companies which could afford to make investments from their own resources were deterred from efforts to boost their production capacities by these factors.

Still an encouraging fact is the ability of the sector to raise significant amounts of foreign direct investment (FDI). The manufacturing industry absorbs nearly 30% of the total FDI inflow to the country. The level of accrued FDI did not go down even during the crisis and rose by more than 11% last year to LTL 11 billion. The bulk of FDI goes to oil refinery *Orlen Lietuva* and a large share of foreign capital is concentrated among food, vehicle and plastics companies. Last year, the flow of foreign direct investment to the Lithuanian MI companies made up LTL 1.38 billion and rose by 16% from 2010. The majority of new investments went to the pharmaceutical industry (LTL 500 million), chemical industry (LTL 330 million) and food and tobacco industry (LTL 150 million). The impressive result of the pharmaceutical industry relied on the sale of Kaunas-based pharmaceutical company *Sanitas* to Canadian pharmaceutical giant *Valeant Pharmaceuticals*. Foreign investors are attracted to Lithuania by one of the cheapest and highly skilled labour in Europe. Still the complex tax system, inefficient public procedures and widespread corruption are the main barriers to a stronger FDI flow.

EXPORTS WILL CONTINUE TO FEED MI GROWTH

Exports of the manufacturing industry are dominated by petroleum products. Last year, their sales abroad stood at LTL 16.5 billion and accounted for around 38% of total exports of the MI. If exports of mineral fuel are excluded, other major export goods were food products (LTL 5.4 billion), wood and wood products (LTL 5.1 billion), plastic products and fertilisers (LTL 3.2 billion each). These indicators made up 20%, 19%, 12% and 12% respectively of total exports of the MI (net of petroleum products).

Last year, there was little change in the main export markets of the manufacturing industry which are quite diverse geographically. Although nearly three quarters of production go to the EU, which is expected to go into economic stagnation this year, Lithuanian products are sold on the markets which have quite good prospects. Last year, exports to Germany made up 16.5%, to Poland 6.5% and to Latvia 6% of total AP exports. Considerable amounts of products are sold on Nordic markets: 8% in Sweden, 4.5% in Norway and Denmark each. About 5.5% of exports of the manufacturing industry go to the struggling economies in Southern Europe – Italy, Spain and Greece. Exports to the CIS countries, whose markets are likely to grow quite strongly this year, are weak as these markets absorb just over 10% of total exports of the manufacturing industry.

MAD POLKA OF EXCHANGE RATES MAKES MI NERVOUS

Manufacturers in our country have been hit by a sharp fall in the Polish zloty and euro (and the litas accordingly) exchange rate in recent years. This made it more difficult to export products to this country and increased competition on the domestic and other neighbouring markets. These negative trends had the strongest impact on the light industry, food industry, chemical and furniture industries. Being unable to compete on price, manufacturers in our country have been forced to be more flexible and develop higher quality and high value added products. Representatives of the Lithuanian manufacturing industry have been successfully competing with Polish producers on Scandinavian markets where emphasis is on the quality of products and reliability of manufacturers. Although the zloty exchange rate rose rapidly at the beginning of this year, the currency weakened again as concerns over the European debt crisis returned. The zloty is likely to remain weak until the situation in Europe is resolved because its exchange rate is highly dependent on investors' willingness to acquire higher risk assets which lose much of their value in times of uncertainty.

The prospects of the Russian rouble look very similar. The currency was gaining strength since last October but began to slide down in April this year. More than 7% of total exports of the MI go to Russia. The largest share of Lithuanian exports to Russia is made up by food products. Last year, exports of food manufacturers to this country stood at LTL 1 billion. Other major export goods included wood and wood products, various types of equipment and vehicles. There is however a small risk that the Russian economy may overheat in the medium term and economic growth may slow down in this country. In addition, the Russian government pays increasing attention to supporting local manufacturers which will strengthen competition.

Last year, exports of the MI were affected negatively by devaluation of the Belarus rouble which made it more difficult to sell products in this country. Most sectors of the manufacturing industry such as chemical and food industries, equipment and building materials manufacturers export their production to Belarus but total volumes are quite small. In 2010, they were below LTL 0.5 billion and made up less than 2% of total exports. Last year's crisis in the neighbouring country pushed down the share of exports to Belarus to 1.6%.

In recent years, the manufacturing industry has suffered from rapidly rising prices of energy products such as natural gas and electricity. In 2011, the production volume of the manufacturing industry rose by more than 10% but production costs soared by nearly a third. The costs of companies operating in the manufacturing industry increased by hundreds of millions of litas because of more expensive electricity, gas and heating. Keeping in mind that energy costs are lower in the neighbouring countries such as Russia, Belarus, Ukraine, even Latvia and Estonia, Lithuanian producers are losing their competitiveness.

GOOD START TO THE YEAR; THE MI IS EXPECTED TO GROW

The beginning of this year was favourable for the manufacturing industry in Lithuania. In the first four months, production volumes rose by nearly 6% year-on-year. The first months of 2012 were particularly successful for machinery and plant producers, metal and wood industries, chemical and plastic industries. Major MI sectors – food industry and light industry – also went up but by a smaller margin.

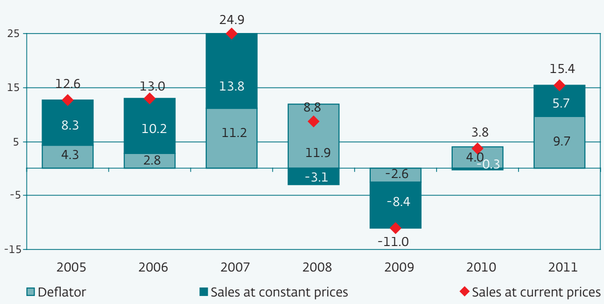
Recently, the mood across the manufacturing industry has been excellent. The index of expectations for the second quarter of 2012 reached 71 points rising by 17 points from the previous quarter and was very close to the indicator of the second quarter of 2011 when the manufacturing industry was growing at an impressive pace. Despite a slow beginning to the year, the mood in the food industry has improved markedly in recent months. The gloom and doom in Europe over the economy which has been balancing on the brink of contraction and the ongoing debt crisis made the prospects of MI exports seem worse than at the beginning of the year. The number of respondents expecting their exports to go up rather than down is increasing. On the other hand, respondents believed that their sales on the domestic market would rise.

The manufacturing industry is a very complex sector of the economy making it a challenging task to asses its prospects. Still we believe that the sector will grow this year although by a smaller margin than last year (10%). During the crisis, companies streamlined their production and boosted competitiveness. Therefore, the sector is now able to make products of a rather high value added and to compete on both price and quality. Industry in our country is flexible and can adapt to market changes. Businesses quickly set their sights on the EU market after the Russian crisis but lately exports to the rapidly growing CIS countries have been on the rise. However, the MI is highly dependent on exports and the prolonged debt crisis in Europe would slow down the sector's growth compared to the average indicator of last decade. In the medium term, growth of the manufacturing industry will depend largely on the ability to raise foreign direct investment as the industry will be forced to focus more on exports because of the small domestic market. Stronger FDI flows would support this process significantly.

Food products and beverages

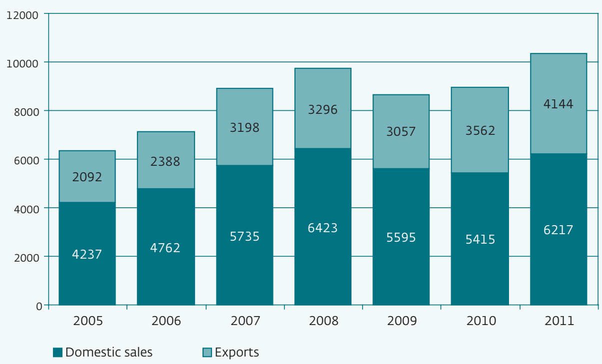
In the last decade, production volumes of the food industry grew at a rather moderate pace. Between 2000 and 2010, value added of the sector concerned at constant prices rose by 28%. In the same period, the national economy grew 1.5 times and the manufacturing industry increased 1.8 times. However, rapidly rising prices of food products doubled the sector's value added at current prices during the same period and the increase was virtually the same as that of the entire

Diagram 11.3
SALES OF FOOD PRODUCTS AND BEVERAGES, ANNUAL CHANGE, %



Source: Statistics Lithuania

Diagram 11.4
SALES OF FOOD PRODUCTS AND BEVERAGES, LTL MIO



Source: Statistics Lithuania

MI. Manufacture of food and beverages has remained one of the largest sectors of the manufacturing industry as its share in the value added structure stood at 24% in 2010 and did not change much during the decade.

Last year was successful for the sector concerned. Production volumes, which shrank for two consecutive years, went up by nearly 6% in 2011. Sales income was supported by soaring food prices and leaped by 15% last year (see Diagram 11.3). In addition, domestic sales also recovered last year and increased by a margin similar to growth in export volumes. As a result, the share of exports in the income structure remained unchanged and stood at 40% (see Diagram 11.4).

For the first time in two years, the number of workers finally stabilised as the headcount in the industry concerned stayed almost the same. In total, the food industry employs about a quarter of workers of the MI. The average wage also did not change last year and stood just above LTL 2,000, a fraction below the MI average (see Table 11.2).

The flows of capital investments, which plummeted by 60% during the crisis, soared by 45% last year but were still below the level of 2008. Although the level of investment is not very high, the food industry is similar to other economic sectors in this regard. On the other hand, the food and beverages industry is able to raise quite considerable flows of foreign direct investment (FDI). Last year, the volume of accrued FDI rose by 2% to LTL 1.4 billion and the investment flow comprised LTL 150 million.

Companies operating in the food industry have some of the most stabile financial indicators as the sector concerned was profitable even during the downturn. Last year, the operating

Table 11.2
KEY STATISTICAL INDICATORS OF MANUFACTURE OF FOOD PRODUCTS AND BEVERAGES

				Ratio to the manufacturing indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Production sold (at constant prices) LTL Mio	7038	7020	7422	18.8	18.0	−0.3	5.7
Production sold (at current prices) LTL Mio	8652	8977	10362	19.6	18.1	3.8	15.4
Exports (at current prices), LTL Mio	3057	3562	4144	11.7	10.7	16.5	16.3
Number of persons employed, thou[1) 2)]	34.9	33.6	33.8	25.1	23.3	−3.7	0.7
Average monthly earnings, LTL[2)]	1969	1994	2009	98.1	96.2	1.3	0.7
Fixed investments, LTL Mio	315	276	400	28.9	23.9	−12.3	44.7
Foreign direct investments (end of period), LTL Mio[2)]	1514	1370	1397	13.8	12.6	−9.5	2.0
Sales of goods and services, LTL Mio	9461	10225	12046	21.4	20.1	8.1	17.8
Gross profit, LTL Mio	2045	2001	2131	28.4	27.5	−2.1	6.5
Operating profit, LTL Mio	528	495	521	23.1	22.0	−6.2	5.2
Profit before tax, LTL Mio	427	439	484	26.0	21.7	2.9	10.3
Number of enterprises	587	593	636	11.7	12.0	1.1	7.2
Share of profitable enterprises, %	68	65	69	111.0	103.4	−4.6	6.4
Assets (end of period), LTL Mio	6134	6441	6686	20.8	20.1	5.0	3.8
Liabilities (end of period), LTL Mio	2905	3054	3395	20.9	21.5	5.1	11.2
Return on sales, %	4.51	4.29	4.02	121.1	108.0	−4.8	−6.4
Return on assets, %	6.70	6.95	7.42	124.5	110.2	3.8	6.7
Debt ratio (end of period), %	0.47	0.47	0.51	100.4	107.0	0.1	7.1

[1)] Excluding individual enterprises
[2)] Manufacture of food products, beverages and tabacco
Source: Statistics Lithuania

profit of the companies rose by 5% and pre-tax profit went up by 10% to LTL 521 million and LTL 484 million respectively. The return on assets (pre-tax profit to assets ratio) stood at 7.4% in 2011 and was by a tenth higher than the average of the manufacturing industry. The percentage of profitable companies reached the lowest point in 2008, which was still relatively high at almost 60%, and nearly 70% of companies in the food industry, which is slightly more than the MI average, returned a profit last year. Assets of companies grew for the second year in a row going up by 4% last year to LTL 6.7 billion but liabilities increased even faster at a rate of 11% to LTL 3.4 billion. As a result, the debt ratio (liabilities to assets ratio) went up to 51% and was much higher than the MI average.

IN THE NEXT THREE YEARS MORE THAN HALF OF FOOD INDUSTRY'S OUTPUT WILL BE EXPORTED

The food industry is undergoing an inevitable shift of focus towards exports. The market in our country is small and processing entities would not be able to benefit from economies of scale and would lose their competitive edge if they produced for the domestic market only. In addition, the Lithuanian market has contracted lately because of the shrinking population and growth without exports is very difficult to achieve in these conditions. Therefore, it is hardly surprising that export volumes soared during the decade. The value of products sold abroad rose from LTL 1.1 billion in 2000 to LTL 4.1 billion in 2011. The share of exports in the sales structure increased from 16% to 40% in the same period and should climb over the 50% threshold in the medium term.

Last year, around 27% of food exports went to Latvia and Estonia, which together with Lithuania should be among the strongest growing economies in the EU next year. Other EU countries that are active trading partners of Lithuania – Germany which takes in 12% of total exports and Poland (7%) – also have quite good growth prospects. Struggling states in Southern Europe accounted for nearly 4% of total food exports last year. However, the export portfolio of the food and beverages industry could be more diversified.

Last year, the volumes of food products sold in Russia, especially meat and meat products, rose to more than LTL 1 billion despite a ban, which was in place for part of the year, of meat product exports from our country after the swine fever outbreak. Last year, Russia accounted for 23% and all CIS countries for 27% of total exports of food products. The prospects of exports to Russia are complex as the market remains quite a high-risk destination. On the one hand, the country has put in place the national food provision programme aimed at ensuring that more than 90% of food products consumed in Russia are produced locally. On the other hand, Russian producers are not yet able to meet the rapidly rising demand. Moreover, exports to Russia should be facilitated and become cheaper after the country's accession to the WTO.

The export portfolio would be more stable if much higher volumes of products were exported to such emerging markets as China, India, Brazil and Arab states. This would dramatically reduce the likelihood that virtually all export markets will fall during a downturn as we saw in 2009. Such development of exports would benefit greatly from stronger FDI flows. Cooperation with foreign corporations would give access to global distribution channels and higher production volumes would make it easier to work with large shopping centres interested in large orders. The arrival of investors with well-known brands would also help.

GROWTH OF THE DAIRY INDUSTRY IS HAMPERED BY SMALL FARMS AND PROCESSING ENTITIES STRUGGLING TO COPE WITH COMPETITION

Milk processing is the largest sector of the food industry by turnover. Last year, sales of the dairy sector rose by a quarter to LTL 3.5 billion. Sales on the domestic market and abroad grew at the same pace and the relative weight of exports stayed at the same level of 46%.

Milk processing companies have faced the shortage of raw milk for some time in the country. Last year, milk production volumes were by 45% lower than in 1990 and production has declined lately as well. In 2007–2010, production volumes shrank by 3% annually on average and stabilised last year only.

Because of the ongoing shortage of raw milk in the country, about 20% of milk processed in Lithuania is imported, mostly from Latvia. However, milk has already been in short supply across all Baltic states. The situation on the raw milk market may be further aggravated by the fact that a large Russian investor purchased two major Latvian milk processing entities. The investor has plans to invest quite heavily into production and expand business operations as the Russian market should be much more easily accessible. In this case, the flows of raw milk may divert from Lithuania to Latvia.

Shortages of milk correlate strongly with the decreasing number of animals in the country. The number of cows plunged by nearly 60% from 1990. Moreover, the negative trends have prevailed strongly in recent years. Since 2008, the number of cows has fallen by 4% annually on average. The reasons are quite simple: small family farms are on the brink of extinction and they are not replaced by large livestock farms. Lithuania is one of the leading EU countries in terms of the percentage of cows in small farms (only Romania is ahead of us). Very often these farms are owned by elderly people living in rural areas. When these farmers leave agriculture, they are not replaced by new people. Small and fragmented agriculture is not prospective as it generates low income making it too difficult to expand activities by investing. In addition, small-scale agriculture has high production and buying-in costs and is not competitive. At the same time, larger scale livestock farming requires considerable financial and time input. Rapidly shrinking populations in rural areas and smaller towns as well as youth emigration erode the entrepreneurship potential of these areas as there are fewer and fewer people able to develop modern and competitive livestock farming.

Growth of the dairy industry is also hindered by relatively small companies. For instance, two major producers in Poland process the same amount of milk as the entire dairy industry in Lithuania. Consequently, production costs are much lower in the neighbouring country.

Last year, the results of milk processing companies were good. Net profit of *Pieno žvaigždės* soared by almost 40% in 2011 to LTL 25.7 million and sales went up by 13% to LTL 700 million. Growth mainly relied on successful exports. This year, the company plans to retain profit at a similar level and hopes to boost revenue by 5%. Investments in 2012 will comprise over LTL 40 million.

Last year, the Rokiškio Sūris group earned a net profit of LTL 27.7 million, up by 13% from 2010, and saw its turnover rise by 24% to LTL 688 million. The improvement of indicators was caused by higher prices of milk and dairy products, especially on export markets.

Maximum utilisation of production capacities, higher prices of exported products and wider export geography enabled *Vilkyškių Pieninė* to boost its income by 19% to LTL 290 million. However, higher expenditure on the marketing and advertising strategy pushed the net profit of the company down by 11% to LTL 10.5 million. In the first quarter of this year, sales of the company went up by 8.5% year-on-year to LTL 69 million.

Last year, income of the *Žemaitijos Pienas* group grew by 14% to LTL 494 million but its net profit shrank by half to LTL 10 million. In 2011, sales increased by 11% to LTL 277 million in Lithuania which is the largest market of the company, 13% to LTL 127 million in Latvia, Estonia and CIS countries and by 31% to LTL 84 million in other European states. The company which employed almost 1,500 people at the end of last year plans to expand operations in Great Britain.

Agricultural cooperative *Pienas Lt* faced fresh difficulties and postponed the opening of the new milk processing plant at least to the middle of 2013. Although the cooperative managed to secure structural support from the EU, it was unable to convince banks that the project was low-risk.

MEAT PROCESSING COMPANIES FOCUS ON FASTER ENTRY TO FOREIGN MARKETS

Last year, sales income of meat processing companies rose by 17% to LTL 1.8 billion. Faster growth of the meat processing industry requires much higher export volumes. Last year, sales on foreign markets went up by 28%, which is twice as fast as domestic sales so the share of the latter in the total structure of sales fell from 74% to 71%.

Meat processing companies face problems similar to those of dairy processing entities – they need more raw materials. Since 1990, the number of pigs and cattle has shrunk threefold and has not grown in recent years either. The number of poultry also fell drastically during the first years of independence and made up 5.6 million in 2001, or just a third of the level of 1990. However, it began to rise sharply later and reached 9.5 million last year.

A favourable development for meat processing companies was the ban on imports of live animals imposed by Russia in the middle of the year which has not been revoked until now. As a result, animal exports to Russia plunged by almost 60% to LTL 44 million. At the same time, there was a steep rise in animal exports to Israel and Turkey. Last year, exports to these two countries comprised LTL 75 million (LTL 30 million in 2010). However, it must be pointed out that cattle exports to Turkey were banned last October after an outbreak of the foot-and-mouth disease in this country.

Lithuanian meat processing companies find it very difficult to compete with Polish producers. The latter country imposed a preferential 5–8% VAT rate on food products, while the Lithuanian tariff is 21%. Another major factor is the Polish zloty exchange rate which has been quite low recently and made Polish products much more competitive. At the beginning of this year, the zloty went up steeply against the euro, and litas respectively, but has been declining lately. The zloty exchange rate should not be expected to rise in a stable manner until a breakthrough in the European debt crisis is achieved as the crisis deters investors from directing financial flows to Poland which is viewed as a high-risk country.

DEPLETING FISH STOCKS MAKE THE EU, THE LARGEST FISH CONSUMER, DEMAND INCREASING QUANTITIES OF FISH PRODUCTS AND ENSURE STABLE DEMAND

Last year, income of Lithuanian fish processing companies grew by 10% to LTL 1.2 billion. Sales on the domestic market and abroad grew at almost the same pace and the relative weight of exports stayed at the same level of 79%.

Vičiūnų Įmonių Grupė (*VĮG*), the largest seafood processing company in the country, continued to expand its activities successfully . The company leaped over the turnover threshold of LTL 2 billion last year and expects its income to rise by 20% this year (a large share of income is generated by production plants operating abroad). In 2011, *VĮG* invested LTL 47 million and plans to spend LTL 70 million this year on construction of three new production facilities which will work with orders of major foreign retail chains. These plants will create 400 new jobs in Lithuania. One of the largest *VĮG* projects is the construction of a plant which will process fish caught in the Baltic Sea and will employ 180 people in Kaunas. *VĮG* is in negotiations with Brazilian retail chains, which were delayed by plant certification procedures, and also *Sainsbury's*, one of the largest retail chains in the United Kingdom with a network of more than 900 stores.

Norvelita, another major seafood processing company which employs about 700 people, planned to boost its sales volumes by 8% last year to LTL 320 million. In addition, the company intends to build salmon processing lines and create 100 jobs using assistance from the EU. This project would increase annual sales by LTL 40–50 million and almost the entire output would be exported.

Sales of bakeries and pastry makers increased by 11% last year to LTL 863 million. This sector has very modest export volumes which rose by a mere 4% last year and comprised just a third of an increase in domestic sales pushing the relative weight of exports further down to just 14%. Confectioners note that last year was very challenging because of the dramatic increase in the prices of raw materials, especially eggs, and energy costs.

Last year, sales of prepared animal feed stood at LTL 1.3 billion and rose by an eighth compared to 2010. Although export volumes shrank by almost 9%, domestic sales went up by a third and their relative weight in the structure of sales increased to 57%. Demand for feed on the domestic market has been affected negatively by unfavourable livestock farming trends and the above-mentioned reduction of animal herds. The situation is further complicated by competition with cheaper products of Polish origin.

DOMESTIC DRINKS MARKET CONTINUES TO SHRINK, NO EXPORT BREAKTHROUGH IN SIGHT

Last year, sales of beverage producers increased fractionally by 1% to LTL 1.5 billion, which makes up less than an eighth of total sales of the food industry and this share has been declining gradually. Sales on the domestic market even contracted slightly but exports rose by 28% and boosted their share in the sales structure to 16%. Last year, production of vodka and liqueur went up by 4.3% to 932,000 decalitres (dal). Wine production grew marginally by less than 1% to 437,000 dal, while beer production went up by 4.5% from 2010 to 30.5 million dal.

Last year, producers of alcoholic beverages were hit by rapidly rising prices of raw materials such as oil and grain which drove the production cost up. In addition, wine yields were moderate in many countries. The quantities of grapes fell by a third in France, Italy and Spain from their usual level, while yields in the USA and Germany were only half their usual size. This put an upward pressure on grape prices which had a negative effect on wine and brandy makers.

Brewers were embittered by the growing imports of cheap products from Belarus which nearly doubled last year. Now Belarus beer has a 6% share of the Lithuanian market. Exports from the neighbouring country were helped by the weaker Belarus rouble and strong support of the Belarus government to local breweries.

Last year, the results of individual beverage producers were quite good. In 2011, the net profit of *Švyturys-Utenos Alus*, the largest brewery in the country, comprised almost LTL 39 million, down by 28% from 2010, even though sales volumes increased by 3% to LTL 443 million. Turnover on the domestic market fell by 0.4% and exports rose by almost a third. The company sells about 15% of its products abroad. Last year, the company invested LTL 4 million into its brewery in Klaipėda and plans to spend LTL 7 million on the expansion of production capacities this year. LTL 3.5 million was invested into renovation of the packaging line at the production plant of *Utenos Alus*.

The *Kalnapilis–Tauras* group owned by Danish *Royal Unibrew*, which is the second largest beer producer in the country, earned LTL 145 million in income last year, which was slightly less than in 2010. This year, the group plans to invest LTL 8 million into renovation of production equipment. New investments will boost its production capacities and improve quality and strengthen the position on foreign markets. The company, which employs almost 350 people, entered the Belgian and Finnish markets last year and increased its export volumes by more than a third.

Kaunas-based brewery *Volfas Engelman* controlled by Finnish *Olvi*, which has about an eighth of the national beer market, boosted its sales by 12% last year to LTL 102 million. The profit of the company went down 3.5 times to LTL 1.4 million. The fall was caused by investments into restoration of its historical name and new equipment erected in order to optimise production and cut costs. The profit was also affected by strong competition and more expensive raw materials which drove the cost of beer up by about a tenth. The company believes that the name change was a success and investments paid back twice as fast as expected.

Šiauliai-based kvass and beer marker *Gubernija* increased its sales income by a fifth last year to LTL 42 million but incurred a loss of LTL 0.26 million because of much higher prices of raw materials. In 2010, *Gubernija* earned a profit of LTL 0.68 million.

Income of *Stumbras*, the largest maker of strong drinks in the country controlled by *MG Baltic*, went up by 5% in 2011 to LTL 105 million, while the net profit remained virtually the same at LTL 16.6 million. The company expects similar results this year. In 2011, *Stumbras* launched production operations in Belarus circumventing this country's quota and customs barriers and secured access to the customs union of Russia, Belarus and Kazakhstan as all previous attempts to export to Russia were unsuccessful.

Last year, losses of *Vilniaus Degtinė* increased 8.5 times to LTL 2.84 billion. The profit indicator was mostly undercut by the reduction of the value of real estate by more than LTL 2 million. Sales of the company shrank by 1.8% last year to LTL 41 million as market demand for vodka weakened and volumes of imported vodka increased.

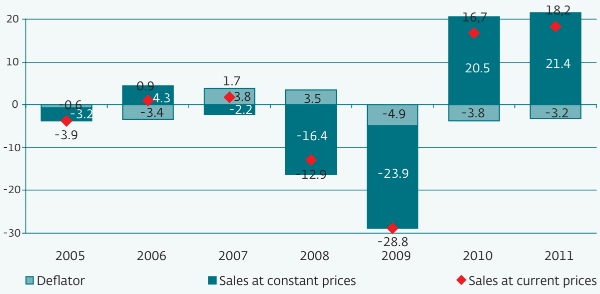
Alita, which produces strong drinks, has been unable to shrug off its troubles. It incurred a loss of LTL 80 million after an unsuccessful investment in Serbia two years ago. In 2011, sales dipped by 5% to LTL 83 million and the company incurred a loss of almost LTL 4 million.

Anykščių Vynas, which is controlled by *Alita*, also struggled. Sales of the company fell by 8% last year to LTL 19 million and losses soared 1.6 times to LTL 3.9 million. The company put in place a cost cutting and efficiency improvement programme and laid off about a third of its workforce last year. *Alita* hopes to sell *Anykščių Vynas* this year.

The food industry can be expected to grow further this year. This forecast is supported by the results of the beginning of the year as production volumes rose by almost 5% year-on-year in the first four months of 2012. In addition, prices of product rose and pushed sales income up by 7%.

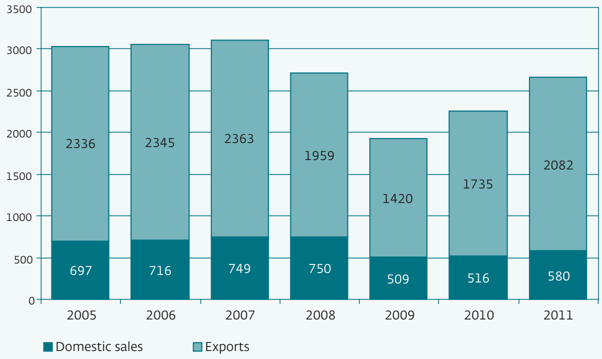
The long-term outlook for the food industry is quite good as the national economy is expected to grow quite strongly

Diagram 11.5
SALES OF TEXTILES AND WEARING APPAREL, ANNUAL CHANGE, %



Source: Statistics Lithuania

Diagram 11.6
SALES OF TEXTILES AND WEARING APPAREL, LTL MIO



Source: Statistics Lithuania

which means stronger demand for food products. Latvia, Estonia, Germany and Poland, which are the main export markets of the food industry, also have good prospects of development. Some uncertainty surrounds the Russian market as the country has an ambitious goal to produce as many food products locally as possible. However, Russian producers are not yet able to meet the soaring demand, while Russia's WTO membership should facilitate exports to this country. The shortage of raw materials is the main problem faced by the Lithuanian food industry. Despite the rising prices of dairy and meet products, their production grows slowly and food processing companies operate below their full capacity.

Wearing apparel and textiles

The first decade of this century was very challenging for the Lithuanian light industry. Stronger competition from Asian manufacturers contributed to a gradual decline in value added of the sector generated at constant prices in 2001–2007, which was followed by a sharp fall of around 30% in a couple of years. However, this branch of industry showed an impressive recovery in 2010 thanks to new investments as production volumes rose by a fifth during the year. In 2011, the volumes rose by a further 21%. Because of a slight fall of product prices on the market, sales revenues rose more slowly in 2011 at a rate of 18% (see Diagram 11.5).

Last year, production volumes of all branches of the light industry grew strongly. Compared to 2010, production of textiles increased by 25%, apparel by 20% and leather and leather products by 14%. Sales volumes went up by 22%, 16% and 15% respectively.

The decline of the sector concerned in the previous decade was to a large extent caused by stronger competition from Chinese manufacturers as their companies had access to cheap labour and began to displace European producers. Still, the trends have been reversed in recent years. The standard of living rose in China and the cost of labour in its coastal provinces has grown steeply since 2005. Similar trends should prevail in the future. Some analysts predict that production costs may at least double in the country by 2020. Therefore, it is hardly surprising that customers are beginning to return to European producers, especially given the fact that delivery from China takes three to four months. Despite the complex economic situation in the old continent and lingering uncertainty about the future of the European economy and ongoing debt crisis, the current environment is quite favourable for the development of light industry in our country. As the EU sinks deeper into recession, customers tighten their budgets and try to avoid stocking up on large inventories. As a result, they turn their sights away from Chinese specialising in bulk orders towards more flexible European manufacturers. This is a situation favourable for growth of Lithuanian producers which are able to manage their production quickly.

BROAD SALES GEOGRAPHY OFFSETS RISKS

Since 2008, growth of the light industry has relied on exports. In the last three years, exports outpaced sales on the domestic market, although some recovery in Lithuania was also seen last year. In 2011, exports rose by a fifth and domestic sales increased by 12% (see Diagram 11.6). As a result, the percentage of exports in the sales structure went up from 72% in 2008 to 78% last year. Because the European Union is in recession, the light industry will face serious difficulties this year as almost 80% of its exports are sold to the EU. Around 16% of exports of the sector concerned go to Germany, 11% to the United Kingdom and 7% to France. The good thing is that the sector maintains close commercial ties with economically strong Nordic countries: 11% of exports go to Denmark, 8% to Sweden and 7% to Norway. Over 7% of total exports are sold to the struggling countries in Southern Europe: Italy, Spain, Greece and Portugal. Less than 5% of exports were sold to CIS countries mostly to Belarus (2%), Russia (2%) and Ukraine (1%).

The headcount in the sector concerned, which shrank by more than a quarter during the crisis, went up by 12% last year to 22,000. It is one-sixth of the total number of workers in the manufacturing industry (see Table 11.3). Growth of the average wage in the sector was marginal last year. The indicator stood at LTL 1,543 which accounts for just three quarters of the average wage in the manufacturing industry. Shortage of

Table 11.3

KEY STATISTICAL INDICATORS OF TEXTILES AND WEARING APPAREL MANUFACTURE

				Ratio to the manufacturing indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Production sold (at constant prices) LTL Mio	1972	2377	2887	6.4	7.0	20.5	21.4
Production sold (at current prices) LTL Mio	1929	2251	2662	4.9	4.6	16.7	18.2
Exports (at current prices), LTL Mio	1420	1735	2082	5.7	5.4	22.2	20.0
Number of persons employed, thou[1)]	20.3	20.0	22.4	14.9	15.5	−1.4	12.4
Average monthly earnings, LTL	1503	1515	1543	74.5	73.9	0.8	1.9
Fixed investments, LTL Mio	30	34	91	3.6	5.4	12.0	166.7
Foreign direct investments (end of period), LTL Mio	397	360	404	3.6	3.7	−9.4	12.4
Sales of goods and services, LTL Mio	1649	1860	2097	3.9	3.5	12.8	12.7
Gross profit, LTL Mio	346	395	469	5.6	6.0	14.2	18.7
Operating profit, LTL Mio	65	105	160	4.9	6.8	61.6	52.6
Profit before tax, LTL Mio	38	93	147	5.5	6.6	143.9	58.4
Number of enterprises	671	637	674	12.6	12.8	−5.0	5.8
Share of profitable enterprises, %	55	65	70	111.0	104.8	19.0	7.7
Assets (end of period), LTL Mio	1527	1536	1633	5.0	4.9	0.6	6.3
Liabilities (end of period), LTL Mio	635	605	627	4.1	4.0	−4.7	3.6
Return on sales, %	2.31	5.00	7.02	140.9	188.6	116.1	40.6
Return on assets, %	2.40	5.96	9.04	106.7	134.2	148.4	51.6
Debt ratio (end of period), %	0.42	0.39	0.38	83.5	80.9	−5.2	−2.6

[1)] Excluding individual enterprises

Source: Statistics Lithuania

skilled labour is one of the main problems faced by companies in the light industry. Last year, dressmaking was among the most sought out trades on the labour market. There were 4,200 vacant jobs for sewers and the supply was twice as low. This misbalance is caused by our education system which prepares too many university graduates and too little workers with vocational training background leading to structural unemployment and shortages of workforce in the production sector. Needless to say that the problem is also aggravated by students themselves and their choices. Vocational training must be promoted in the country as it often offers much better employment prospects than university education. The willingness of young people to choose a dressmaker's qualification would also be boosted by higher wages (at least equal to the national average).

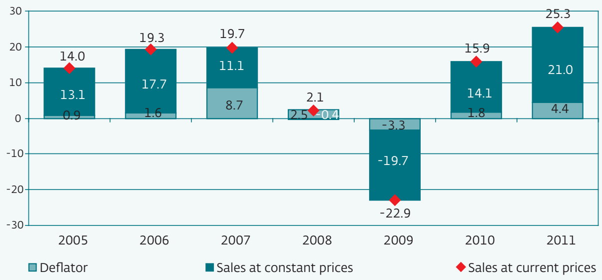
As demand continued to go up, companies began to borrow and increase their production capacities. The flow of capital investments, which contracted by two thirds in 2009, increased 2.7 times last year returning to the level of 2008 (LTL 91 million). In addition, the sector concerned managed to raise considerable foreign investments last year as accrued FDI went up by 12% in 2011 to LTL 404 million and also returned to the level of 2008.

Companies operating in the light industry faced major difficulties at the beginning of last year when cotton prices reached record high levels. This led to a significant increase in production costs and was followed by weakening demand for the sector's products. However, the price of raw materials subsequently plunged and shrank by more than half between March and the end of the year. Prices fell on the back of much stronger supply in the USA, which is the largest exporter of cotton, and deteriorating consumption projections for China whose economic growth has slowed down and which is one of the largest importers of cotton. Similar trends are expected to prevail this year as demand is likely to dwindle and supply will most likely go up. Cotton production should exceed consumption by 3 million tonnes this year so there will be no premise for prices to rise in the nearest future.

Despite high cotton prices, financial results of the light industry were very impressive last year. Wearing apparel and textiles was one of the few economic sectors to retain quite decent profit indicators during the crisis and last year's operating profit and pre-tax profit grew more than 1.5 times to LTL 160 million and LTL 147 million respectively. Moreover, the return on assets (pre-tax profit to asset ratio) increased 1.5 times to 9% and exceeded the average of the manufacturing industry by more than a third. The percentage of profitable companies, which was well below the MI indicator, rose to 70% last year and exceeded the MI average. The sector concerned was one of the few that borrowed a lot in 2011 as its liabilities went up by 4% to LTL 627 million. Nevertheless, assets of companies grew faster and went up by 6% to LTL 1,633 million. As a result, the debt ratio (liabilities to assets ratio) fell for the third consecutive year dropping to 38% and making the wearing apparel and textile sector one of the least indebted sectors in the MI.

In 2011, major apparel makers in the country had different fortunes. *Audimas*, the largest sportswear maker in the Baltic states, boosted its turnover by a third last year to LTL 66 million. Its sales of *Audimas*-branded products rose by 18% to LTL 26 million. Net profit of the company stood above LTL 6 million and went up 1.5 times compared to 2010. The company expects its sales to reach LTL 70 million this year.

Diagram 11.7
SALES OF WOOD, PAPER PRODUCTS AND FURNITURE, ANNUAL CHANGE, %



Source: Statistics Lithuania

Last year, the *Utenos Trikotažas* group earned LTL 1.1 million in net profit, down by 29% from 2010, and saw its turnover shrink by 13% to LTL 61 million. The result of the company was lower by LTL 7.7 million because of additional provisions for investments made and amounts receivable from its subsidiary *OAO MTF Mrija*.

Revenues of the *Linas* group shrank by 5% last year to LTL 33.8 million and pre-tax profit plummeted 4.8 times to LTL 1.65 million. It should be pointed out that 70% of profit in 2010 was generated by investment activities. The deterioration of results last year was caused by both weaker market demand and higher prices of raw materials.

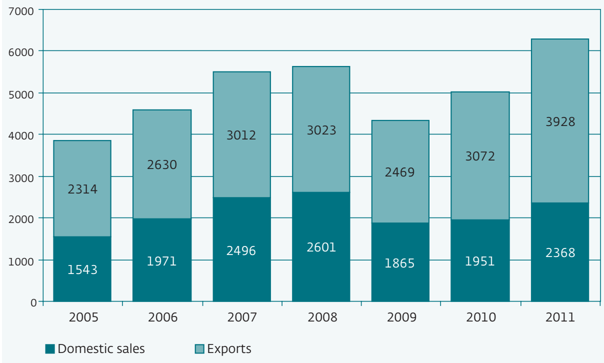
This year, the wearing apparel and textile sector will run into difficulties because of recession in the EU as reflected by the results at the beginning of the year. In the first four months of 2012, production volumes rose by a mere 1.2% year-on-year and a steep fall was recorded in April. That being said the prospects of the sector for the coming years are quite good. Our companies are flexible and able to offer quality products, which makes them competitive on the European and CIS markets. Nevertheless, many companies are in dire need of skilled labour which may hinder their ability to develop activities successfully.

Wood, wood and paper products and furniture

In the last decade, the wood industry was one of the most dynamic sectors of the economy. Between 2000 and 2010 value added of the national economy rose 1.5 times, the manufacturing industry went up 1.8 times, while the wood industry almost tripled.

Growth of the sector was strong last year as well. The volume of production rose by more than a fifth in 2011. Manufacture of wood and wood products (except for furniture) increased by a tenth, manufacture of paper by 12% and manufacture of furniture soared by 34%. It should be noted that structural changes in the industry have also been positive as the strongest growth has been recorded by manufacture of higher value added products (furniture and paper).

Diagram 11.8
SALES OF WOOD, PAPER PRODUCTS AND FURNITURE, LTL MIO



Source: Statistics Lithuania

Prices of wood and wood products, which fell sharply in 2009, grew last year for the second year in a row. Although prices of furniture increased fractionally, the cost of wood and wood products as well as paper went up by 6–7% in 2011. Because of higher prices, sales grew faster than production volumes at a rate of 25% in 2011 (see Diagram 11.7).

Although both production volumes and sales income rose impressively in the wood sector, the number of companies operating in the industry increased by a small margin in 2011 (it even contracted according to the wood industry association). Experts believe that there are too many small and insufficiently modern and insufficiently cost-effective wood processing enterprises in the country. They also note that experience of Western Europe and Scandinavia shows that manufacture of timber, plywood and boards can only be cost-effective in larger companies with automated production lines.

EXPORTS WAS THE ONLY SALES CHANNEL FOR FURNITURE MAKERS AS THE HOUSING MARKET IS IN STANDSTILL

The recovery of the sector concerned largely relied on successful post-crisis sales on foreign markets. In 2011, export revenue rose by 28% and increased by a much larger margin than sales on the domestic market (see Diagram 11.8). The percentage of the latter dropped to 38% in the structure of sales (46% in 2008). Almost 80% of exported wood and wood products are sold in the European Union. Last year, 16% of exports went to Germany, 7% to Poland, 6% to the United Kingdom and France each. The sector maintains very close commercial ties with the Nordic countries which took in about 30% of wood industry exports in 2011: 13% went to Sweden, 9% to Norway and 7% to Denmark. Last year, 6% of exports went to the struggling countries in Southern Europe and the bulk of these exports were sold in Italy and Spain. Rapidly developing CIS markets absorbed 5% of exports last year and Russia was the most active trading partner. The portfolio of wood industry exports is quite diversified so sales abroad should grow this year despite recession in Europe, mainly due to close cooperation with the successfully operating Swedish giant *Ikea*.

Table 11.4

KEY STATISTICAL INDICATORS OF WOOD AND WOOD PRODUCTS. PAPER AND FURNITURE MANUFACTURE

				Ratio to the manufacturing indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Production sold (at constant prices) LTL Mio	4034	4603	5568	12.4	13.5	14.1	21.0
Production sold (at current prices) LTL Mio	4334	5023	6296	11.0	11.0	15.9	25.3
Exports (at current prices), LTL Mio	2469.1	3071.5	3928.0	10.1	10.1	24.4	27.9
Number of persons employed, thou[1) 2)]	33.0	32.4	36.6	24.2	25.2	−1.9	12.9
Average monthly earnings, LTL[2)]	1760	1821	1893	89.6	90.6	3.4	3.9
Fixed investments, LTL Mio	201	203	377	21.3	22.5	1.1	85.9
Foreign direct investments (end of period), LTL Mio[3)]	657	632	683	6.4	6.2	−3.9	8.1
Sales of goods and services, LTL Mio	4935	5687	6621	11.9	11.1	15.2	16.4
Gross profit, LTL Mio	924	1081	1166	15.3	15.0	17.0	7.9
Operating profit, LTL Mio	189	355	366	16.6	15.5	87.3	3.3
Profit before tax, LTL Mio	90	286	300	16.9	13.4	219.6	4.7
Number of enterprises	1634	1561	1603	30.8	30.4	−4.5	2.7
Share of profitable enterprises, %	49	59	68	99.9	101.0	18.5	15.3
Assets (end of period), LTL Mio	4102	4140	4387	13.4	13.2	0.9	5.9
Liabilities (end of period), LTL Mio	2463	2316	2540	15.8	16.1	−6.0	9.7
Return on sales, %	1.81	5.03	4.52	141.9	121.6	177.3	−10.1
Return on assets, %	2.11	7.00	6.98	125.3	103.6	231.6	−0.2
Debt ratio (end of period), %	0.60	0.56	0.58	118.5	122.0	−6.8	3.5

1) Excluding individual enterprises

2) Manufacture of wood and wood products, paper and furniture; publishing

3) Manufacture of wood, wood products and paper; publishing

Source: Statistics Lithuania

Interestingly, Lithuania is one of then major suppliers of products to *Ikea*. Many wood products of Lithuanian origin are sold as being made in Nordic countries. If furniture makers want to increase their profit margins in the future, they will have to pay more attention to marketing and sales abroad without intermediaries. Lithuanian furniture makers are able to manufacture high quality furniture and now have to learn to sell it directly and take the entire value added themselves.

The number of workers in the sector, which shrank by a quarter during the crisis, went up by 13% last year (see Table 11.4). In total, the wood industry employs about a quarter of workers of the MI. The average wage rose for the second year in a row. It increased by 4% last year to LTL 1,893 but still was by a tenth below the average of the manufacturing industry.

Companies in the wood industry cut their investments dramatically during the crisis but began expanding their production capacities last year. Although expenditure on capital investments soared by 86% to LTL 377 million, it was still well below LTL 528 million invested in 2008.

Last year's financial results of wood, wood and paper products and furniture companies were quite good. Operating profit of the companies rose by 3% and pre-tax profit went up by 5% to LTL 366 million and LTL 300 million respectively. More than two thirds of companies were profitable last year (less than 50% in 2009). The percentage of profitable companies in the entire MI sector is the same. The return on assets did not change much in 2011 and stood at 7%, which is almost the same as the MI average. Large investments in the wood industry signal that the sector borrowed a lot last year as liabilities of wood companies went up by 10% to LTL 2.5 billion. Assets grew more moderately (6%), so the debt ratio (liabilities to assets ratio) jumped to 58% in 2011 and was much higher than the MI average. Last year, operating costs of companies increased significantly because of more expensive raw materials. The price of wood rose by almost a fifth in Lithuania in 2011. This year, however, no drastic changes in prices are expected and problems related to raw materials should ease off.

WOOD SHORTAGE SHOULD FORCE FORESTRY ENTERPRISES TO REVIEW THEIR PERFORMANCE

The shortage of raw materials is one of the major threats in the wood industry. In recent years, export volumes of raw wood grew much faster than exports of furniture and paper. In 2011, more than a quarter of wood cut in Lithuania was exported, mostly to Asian countries and especially China. Total exports of wood made up LTL 387 million last year. It should be noted that China used to import wood from Russia until the latter introduced export duties. Lithuania, meanwhile, is unable to independently impose trade restrictions because of its EU membership. Local producers often find it difficult to compete with wood sales agents which export Lithuanian wood abroad and are able to offer higher prices. It is one of the reasons why major Lithuanian furniture makers such as *Vakarų Medienos Grupė* and *SBA* have expanded their production facilities in Belarus where raw materials are much cheaper. Intensive exports of raw wood result in weakening competitiveness of Lithuanian wood processing companies, loss of development potential and new jobs.

Wood supply problems also stem from inefficient management of state forests. It was found in the previous years that the majority of forestry enterprises were loss-making and some of them had extremely high wood preparation costs. However, more stringent controls of activities of these enterprises contributed to a 6% increase in wood supply from state forests.

WOOD COMPANIES ENJOYED GROWING SALES

We will briefly review the results of individual companies operating in the wood industry. Last year, sales of *Vakarų Medienos grupė* (*VMG*) rose by 15% to LTL 308 million. At the beginning of last year, *VMG* began construction of manufacturing facilities in Belarus and plans to start some production there this year. Total investments in these facilities will make up LTL 255 million and annual sales are expected to be LTL 240–275 million. *VMG* has plans for more projects in Belarus as the country has plenty of skilled labour and easily available raw materials which are often in short supply in Lithuania. Moreover, Belarus is a member of the customs union that includes Russia, Ukraine and Kazakhstan which makes it easier to sell products in CIS countries.

In the previous financial year ended 31 August 2011, *Swedspan Girių Bizonas*, Kazlų Rūda-based fibreboard maker owned by *Ikea*, saw its sales rise by 38% from the previous financial year to LTL 248 million and losses shrink by 29% to LTL 3.2 million. This year, the company expects to earn a profit and boost its revenue by a tenth to LTL 273 million. During the same financial year, the turnover of *Swedwood Kazlų Rūda* which is also owned by Ikea stood at LTL 164 million and fell by 18% from the previous year and profit shrank by a third to LTL 7.2 million. The company expects its sales to reach LTL 173 million this year and earn LTL 4.5 million in profit.

Last year, net profit of the *Vilniaus Baldai* group dropped by 4% to LTL 27.8 million even though sales went up by more than a fifth in 2011 to LTL 238 million as turnover was boosted by orders placed by Swedish giant *IKEA*. Profit indicators of the company were affected by higher prices of raw materials and investments as well as changes in the structure of finished products.

Kaunas-based furniture maker *Freda*, which previously belonged to the *Baltijos Baldai* group and now operates independently, saw its sales rise 1.5 times last year to LTL 235 million and hopes to boost its turnover to LTL 260 million in 2012. Virtually all products manufactured by the company are sold to *Ikea* either directly or through other Lithuanian furniture makers. *Freda* signed a long-term contract with *Ikea* this year and will manufacture furniture for almost a billion litas in the next five years for the Swedish giant. The Kaunas-based company continuously invests in its production capacity. Its capital investments made up LTL 3 million last year and LTL 6 million will be invested this year. New technologies enable the company to manufacture products of higher value added and take over some orders from its rivals in Germany.

Last year, sales of parquet maker *Boen Lietuva* owned by the *Libra* group went up by 27% to LTL 234 million.

Furniture maker *Klaipėdos Baldai* controlled by *SBA* concern earned a net profit of LTL 5.6 million last year which was by a third higher than in 2010 and increased its sales by 26% to LTL 189 million. *Germanika*, another furniture maker owned by *SBA*, invested LTL 36 million in the production plant in Šilutė district, created 240 jobs and plans to boost its turnover this year from LTL 54 million to LTL 100 million. Under a five-year contract, the company will be selling furniture to *IKEA* for the total amount of LTL 750 million. Consolidated sales of SBA, which controls six furniture production companies, made up LTL 515 million last year and rose by 16% from 2010. Its turnover is expected to reach LTL 700 million this year. Over 90% of products manufactured by *SBA* companies are exported to nearly 40 countries including the European Union, USA, Russia, Ukraine, Japan, Australia, etc. *SBA* is also expanding its production activities in Belarus. Its subsidiary *Mebelain* will invest LTL 48 million in construction of a production facility in Belarus and plans to start manufacture this September.

The results of the *Grigiškės* group exceeded expectations. In 2011, sales rose by a quarter to LTL 308 million and pre-tax profit stood at LTL 8.7 million increasing by 9% from 2010. This year, the group plans to boost its sales by 7% and profit by 25%. *Grigiškės* intends to invest more than LTL 60 million in production of tissue paper and cardboard packing materials in 2012–2014.

The outlook for the wood industry companies is good as they managed to retain their export markets during the crisis which had seen an impressive growth of their sales in recent years. The exports portfolio of the industry concerned is quite diversified and sales on foreign markets can be expected to rise this year. In addition, large furniture makers have long-term contracts with Ikea. Domestic sales have also improved supported by the recovering national economy and falling unemployment. The results at the beginning of 2012 are also encouraging. In the first four months of the year, production volumes rose by nearly 12% year-on-year. Since prices of products went down by a fraction, sales income grew at a slower pace of 10%.

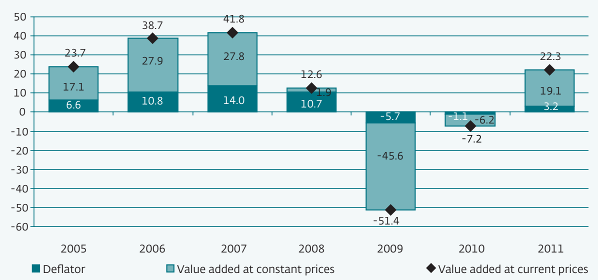
12. Construction and real estate

The construction industry, which grew at a staggering pace before the crisis, underwent the steepest decline of all sectors of the economy in a period of two years after the collapse of the real estate market in 2009 and contraction of capital investments. A wave of layoffs engulfed the sector as one in five redundant workers in the country was from the construction industry in 2009. The construction costs, especially wages, and rates of work fell sharply, investment indicators worsened and financial indicators deteriorated dramatically. Nevertheless, 2011 was quite a successful year as recovering investments by companies fuelled demand for construction, while lower rates for work and growing employment revitalised the housing market in the country. Still, 2012 can offer slow growth at best since the uncertainty about the European debt crisis subdues the willingness of companies to invest and public sector contracts are also few and far between.

CONSTRUCTION INDUSTRY IS RECOVERING AFTER THE CRISIS KNOCKDOWN

The industry concerned was the most dynamic economic sector of the previous decade. Between 2000 and 2008, its value added at constant prices increased almost 3.5 times which is double the indicator of the entire economy. However, construction went into the deepest decline during the crisis as production volumes in the industry contracted by half in a period of two years. The decline was even more pronounced at current prices and stood at 55% in 2008–2010 because of much lower rates for construction work during the crisis.

Diagram 12.1
VALUE ADDED CREATED BY CONSTRUCTION SECTOR, ANNUAL CHANGE, %



Source: Statistics Lithuania

In 2011, construction began to recover as its value added rose by 19%, while growth at current prices was even faster because of higher rates for construction work (see diagram 12.1). The sector concerned benefited greatly from higher temperatures at the end of 2011 which allowed companies to complete orders on time and save the costs of cold protection of structures.

The results at the start of 2012 were also quite good. In the first quarter of this year, construction work completed by Lithuanian companies made up LTL 976 million and rose by 16% year-on-year. Domestic sales went up by 17% but exports grew just by 2%. Exports accounted for a mere 7% of total sales, which is slightly below the indicator of the first quarter of last year.

The flow of capital investments, which contracted almost fivefold in the construction industry in 2008–2010, soared by 50% last year to LTL 314 million. However, the indicator made up just a third of the amount invested in 2008. After the construction bubble went bust, investments by the industry have been among the smallest in the economy lately. Last year, the capital investments to value added ratio stood at a mere 5%. The relevant indicator was 9% in the manufacturing industry and agriculture, while the national average stood at 15%. This shows that investments in the construction industry are very modest given the size of the sector concerned. Moreover, this industry has been unable to raise significant foreign direct investments (FDI) as the ratio between the accrued FDI and value added in the sector is more than two times lower than the economy's average.

The number of workers, which fell by more than 40% in two previous years, went up by 13% last year (see Table 12.1). Unfortunately, as wages plummeted and demand for workers weakened during the downturn, many skilled workers left the country and companies operating in the construction industry have already faced lack of skilled labour. In the second half of last year, when construction picked up, a number of managers of companies identified the shortage of labour as the main factor restricting growth. Although the problem abated at the beginning of this year following a drop in the number of orders, growing demand may turn the shortage of workforce into a serious obstacle for business development.

Last year, financial indicators of companies began to improve and the flood of bankruptcies started to step back. In the first half of 2011, 141 bankruptcy procedures were initiated, which

Table 12.1

KEY STATISTICAL INDICATORS OF CONSTRUCTION SECTOR

				Ratio to the economy's indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Value added (at constant prices), LTL Mio	4604	4320	5146	6.3	7.1	−6.2	19.1
Value added (at current prices), LTL Mio	5475	5079	6212	6.0	6.5	−7.2	22.3
Labour productivity, LTL thou[1)]	87.3	87.5	94.2	101.1	102.0	0.1	7.7
Number of persons employed, thou[2)]	62.7	58.1	65.7	5.9	6.4	−7.4	13.2
Average monthly earnings, LTL	1965	1804	1852	87.0	87.4	−8.2	2.7
Fixed investments, LTL Mio	474	215	314	1.9	2.2	−54.7	46.0
Foreign direct investments (end of period), LTL Mio	1034	1071	1059	3.0	2.9	3.6	−1.1
Sales of goods and services, LTL Mio	8477	8656	10408	5.3	5.4	2.1	20.2
Gross profit, LTL Mio	1300	1335	1518	4.4	4.3	2.7	13.7
Operating profit, LTL Mio	−164	44	231	0.7	2.8	-	419.2
Profit before tax, LTL Mio	−417	−38	139	−0.7	1.6	-	-
Number of enterprises	5874	5637.75	5609	12.4	11.4	−4.0	−0.5
Share of profitable enterprises, %	40	45	53	81.0	86.1	12.5	19.0
Assets (end of period), LTL Mio	11949	10988	10663	6.2	5.7	−8.0	−3.0
Liabilities (end of period), LTL Mio	6958	6270	6343	8.6	8.6	−9.9	1.2
Return on sales, %	−4.91	−0.44	1.33	−13.2	30.2	-	-
Return on assets, %	−3.19	−0.33	1.31	−11.0	29.4	-	-
Debt ratio (end of period), %	0.58	0.57	0.59	138.2	150.6	−2.0	4.2

[1)] Value added per employee at current prices

[2)] Excluding individual enterprises

Source: Statistics Lithuania

is down by 25% compared to the first six months of the previous year. At the heat of the crisis, the indicator stood at 244. Still bankruptcies in the construction sector accounted for a fifth of all bankruptcies in Lithuania during the first half of last year even though companies operating in the industry concerned make up slightly more than a tenth of all businesses in Lithuania, which means that the rate of bankruptcies here is double the national average.

Other financial indicators of companies also improved last year. Sales income rose by a fifth, operating profit and pre-tax profit was positive and made up LTL 231 million and LTL 139 million respectively. After an interval of two years, profitability (ratio between production sold and pre-tax profits) and return on assets (pre-tax profit to assets ratio) returned to the positive territory (1.3% both) but still accounted for less than a third of the economy's average. During the year, the percentage of profitable companies rose from 45% to 53% and was by a seventh lower than the national average. Assets of companies contracted for the third consecutive year falling by 3% last year to LTL 10.6 billion and liabilities went up by 1% returning the debt ratio (liabilities to assets ratio) to a record high level of 59%, which is 1.5 times higher that the average indicator of the economy.

To be able to increase income, construction companies had to cut their costs considerably during the crisis. Compared to the peak level reached in the middle of 2008, total construction input went down by 17% and wages plunged by 33% at the beginning of 2010. However, the construction input index stopped falling last year and went up by 5%. Prices of materials rose by 4%, operation of machinery and plant by 5% and wages rose by 3%. Wages in the construction industry were very higher before the crisis and exceeded the national average by a tenth. Between 2008 and 2010, earnings fell by more than a quarter. Last year, the average wage in the construction industry totalled just LTL 1,852 and was quite lower than the national average.

EXPORTS OF CONSTRUCTION INDUSTRY WERE MODEST

Last year, Lithuanian construction companies carried out construction work for LTL 6.9 billion (annual increase of 27%). Of them 95% was carried out domestically even though competition within the sector is fierce as companies still have excessive production capacities, real estate prices are slow to recover and the market itself is quite small. All these factors contribute to low profit margins, so companies will have to pay more attention to exports in order to survive and grow.

Representatives of the construction sector believe that exports of construction services could be boosted by state guarantees. They take Estonia as an example where exporting builders receive state guarantees and the ratio between exports of construction services and GDP is three times higher. Of course, a favourable geographic location also adds to better indicators of this neighbouring country which exports much of construction services to Finland.

CONSTRUCTION ENGINEERING HELPED THE INDUSTRY STAY AFLOAT BUT PUBLIC ORDERS WILL BE FEWER IN THE FUTURE

For the last two years, construction engineering was the driving force of the construction industry as it generated more than half of sector's turnover. In 2011, construction of engineering works amounted to LTL 3.6 billion in Lithuania and rose by 24% from 2010. Although construction of engineering works was still below the volumes reached in 2007 (LTL 4 billion) and 2008 (LTL 4.8 billion), the same can be said about all types of structures. Construction engineering is closely related to the public sector and most of public contracts, as usual, were awarded for road network maintenance and development. However, state funding is gradually declining. Last year, less than LTL 1.2 billion was earmarked for road building and maintenance in the Lithuanian budget and EU structural funds, down by 15% from 2010, and the fall was mostly caused by a 50% reduction in the use of EU funds. The volume of completed engineering works was boosted by cooperation with the private sector last year, even though the latter is considered to be a high-risk partner.

This year, road maintenance and development companies will receive around LTL 1.2 billion (LTL 916 million from the national budget and LTL 270 million from EU structural assistance), i.e. almost the same amount as in 2011. However, profits of construction companies will be slightly lower because of the higher cost of work, and the public sector is unlikely to provide any stimulus for engineering works this year.

In 2013, the volume of public contracts will contract considerably. Out of around LTL 2.3 million allocated by the EU for 2007–2013, just some LTL 100 million will be left unused after this year. As the national government also pursues austerity policies, more support from the national budget is quite unlikely, and engineering work contractors will have to collaborate more with the private sector or look for orders abroad to be able to sustain growth.

CONSTRUCTION OF BUILDINGS IS RECOVERING

Although construction of buildings generates just about 45% of turnover of the industry concerned after the crisis, this sector is showing the first signs of life. Last year, construction of buildings amounted to LTL 3 billion and rose by 32% from 2010. Construction of non-residential buildings within the country made up LTL 2.5 billion last year and rose by 35% from 2010. It also exceeded the volume of residential construction 5.4 times. An increase in capital investments, preparation for the European Basketball Championships and emerging deficit of office space in Vilnius served as a stimulus for non-residential construction. Last year, 3,330 non-residential buildings were completed, which is a drop of 6% compared to 2010, but the overall floorspace increased by 6%. So fewer but larger buildings were erected. This year is likely to see opposite trends as the gross floorspace of buildings was lower by a quarter in construction permits issued last year despite a 31% increase in the number of permits compared to 2010.

Construction of residential houses also began to regain strength. Last year, construction of residential houses amounted to LTL 466 million and went up by 14% from the previous year. In 2011, 3,733 new residential houses were completed, which is a 29% increase from 2010, and the number of flats in these houses grew by 38% to 5,066. The built gross useful floorspace increased by 37%. Although the number of newly built houses is very close to the pre-crisis level, it was mostly supported by construction of family homes which had been reinvigorated by lower cost of construction work. Last year, 3,675 family homes were built which is by 28% more than in the previous year and almost the same as in 2008. Compared to the pre-crisis period, the share of family homes soared in the structure of newly built useful floorspace as it stood at 87% last year (compare to 58% in 2007). Consumer preferences were also adjusted by the crisis as demand for smaller homes increased. An average useful floorspace of a detached family house fell from 171 sq. m in 2009 to 161 sq. m in 2011. Construction of apartment buildings still makes up just a third of the indicator of 2008. Nevertheless, this segment was also more active last year as the number of new apartment buildings almost doubled from 2010 and stood at 55.

REAL ESTATE MARKET CAME ALIVE

According to *Newsec*, the real estate market showed signs of new life last year as interest in commercial properties and demand for housing increased.

Recovery was also felt in the office space segment as the vacancy rate fell and rent prices went up. The market is expected to rise gradually and prices, especially within class A segment, are likely to grow further in 2012.

Vilnius has the most active office space market. As only one new project was completed here last year, supply of office space grew by just 2,500 sq. m in 2011, which is the smallest increase since 2000. Last year, new tenants rented 30,000 sq. m in class A and B offices, down by 30% from 2010. Market activity is expected to be similar this year: about 25,000 sq. m will be re-rented as major market players will move out of their own premises into the leased ones. Moreover, several large telecommunications and services companies consider the possibility to relocate from their old and inefficient premises which should strengthen demand significantly.

In the first quarter of 2012, the vacancy rate in the office space segment was 12%. The vacancy rate shrank marginally last year in the class A office space segment from 5.5% to 5.4%. The percentage of free offices also decreased in the class B segment where the relevant indicator fell from 15.5% to 13.8%. The cost of rent of office premises rose by around 10% last year.

Demand for retail premises also increased significantly in 2011. The volume of movement by tenants was 17,000 sq. m. The most active movement was seen at *Akropolis* retail centres in major cities across Lithuania. All largest shopping malls managed to attract new tenants and the strongest demand was for small and medium-sized premises. The retail market was also active at the beginning of this year.

In 2011, not a single large project was completed in the retail space segment in Vilnius and no new major projects are scheduled for this year. However, the sales network of major food retailers grew last year and new small-box stores and small shopping centres were opened. Next major projects will be completed in Vilnius no sooner than in 2013 when a new 25,000 sq. m shopping mall will be added to the Lithuanian market by Swedish furniture giant *Ikea*.

In 2012, domestic trade will go up supported by the growing national economy and lower unemployment so demand for retail premises should continue to strengthen.

The housing market also showed signs of recovery last year. The number of flats sold in Lithuania rose by a small margin and more activity was seen in all major cities. The number of deals increased by 8.4% last year compared to 2010. In Vilnius, the indicator went up by 2.5% and rose by 0.5% in Kaunas. The largest increase was recorded in Šiauliai where the number of deals grew by 5.5% annually. Although market activity weakened in the first quarter of 2012, the number of flats sold during this period increased by 2.3% year-on-year. After the Bank of Lithuania published its responsible lending rules, demand in the segment of large and luxury flats fell sharply.

Housing prices did not move much in major cities last year. They rose by 2.4% in Vilnius and increased by larger margins in resort towns of Palanga, Druskininkai and Nida, where prices went up by 5–15%. This year prices are unlikely to rise.

Last year, the housing market was also reenergised by the collapse of *Snoras* which triggered stronger demand for smaller economy class flats as people lost confidence in banks and chose real estate as an alternative to deposits. In Vilnius, there was an increase in interest in flats with 2 to 3 rooms in bedroom communities offered for LTL 150,000–200,000.

RENOVATION IS STALLING

In 2011, housing renovation failed to gather any momentum. The total housing renovation budget under the *JESSICA* programme is LTL 516 million (including LTL 438 million contributed by the EU and LTL 78 million by the national budget). According to the approved scheme, households are granted preferential loans with 3% annual interest and receive additional support for design documentation and technical supervision, while energy efficient projects are eligible for reimbursement of a larger percentage of expenditure. However, the offer was not attractive enough to persuade people that renovation has advantages. By now, only around 50 credit agreements have been signed under *JESSICA* for the total value of less than LTL 20 million.

Some municipalities took a more active stance in the renovation process. The Zarasai municipality decided to use the model tested in Poland and did not ask housing owners to assume any obligations to banks. Instead, a body set up by the municipality will take out a preferential loan and savings on heating costs will be used for loan repayments. The advantage of this scheme is the possibility to avoid direct commitment to banks as many people are reluctant to deal with banks. If the renovation scheme in Zarasai proves to be successful, other municipalities may follow suit and the housing renovation process is likely to pick up speed gradually.

Although past year was indeed successful for the construction industry, there are many reasons to be more cautious about the future. The mood in the industry has been quite gloomy lately and the number of orders has fallen. The shortage of skilled labour poses a real threat to the development of the sector. Demand for construction services is unlikely to strengthen by much this year. Although the national economy is expected to grow quite strongly, especially in the European context, growth of the construction industry will be more modest than in other sectors which focus on the domestic market. There will be no sharp increase in public contracts, which are a major driving force of the construction industry, either this or next year. This will affect construction engineering contractors. The renovation process may finally get moving but is unlikely to accelerate this year. Investments by companies will be more modest because of the uncertainty about the European debt crisis and tighter bank lending policies. Therefore, an impressive leap of the construction industry in 2011 may at best be followed by moderate growth this year.

13. Transport and storage

Transport and storage is one of the driving forces of the national economy. The sector which exports most of its services was quick to recover after the crisis and managed to grow strongly in 2010 already. Last year, especially in its first half, the sector grew rapidly but a significant slowdown was seen at the end of the year. This year, the transport and storage sector will grow marginally or come to a halt because of the stagnating economy of the European Union and sector's focus on exports.

The industry concerned **is one of the largest sectors of the economy**. In the last decade, it grew much faster than the entire national economy. As a result, its share in the value added of the national economy rose from 8.5% in 2000 to almost 12% in 2010.

Last year, the volumes of **freight carried by all types of transport** in tonne-kilometres (volume of transported freight in tonnes multiplied by the distance) went up by 11% and already exceeded the level of 2007–2008. Growth was secured not only by larger quantities of freight but longer distances as well. In terms of tonnes, the volume of freight rose by 5% in 2011 to 121 million tonnes but was still much lower than the record level of 2007 (139 million tonnes).

FINANCIAL INDICATORS SEEM ATTRACTIVE AND LEAVE ROOM FOR SALARIES GROWTH

In 2011, companies operating in the transport sector enjoyed excellent financial indicators. Income from services rose by a fifth last year to LTL 16 billion and already went above the level of 2008. Operating profit soared and pre-tax profit doubled to LTL 1 billion (see Table 13.1). The percentage of profitable companies, which made up just 50% during the downturn, increased to 68% last year and was well above the national average. Assets of companies increased marginally by 2.6% to LTL 18.5 billion, while liabilities continued to shrink dipping by 1.4% to LTL 6 billion. As a result, the debt ratio (liabilities to assets ratio) fell for the third consecutive year and stood at just 32% at the end of 2011, which was much lower than the economy's average. Both profitability and return on assets

Table 13.1
KEY STATISTICAL INDICATORS OF TRANSPORTATION AND WAREHOUSING SECTOR

				Ratio to the economy's indicator, %		Annual change, %	
	2009	2010	2011	2010	2011	2010	2011
Value added (at constant prices), LTL Mio	7599	8143	:	11.8	:	7.2	:
Value added (at current prices), LTL Mio	8849	9953	:	11.7	:	12.5	:
Labour productivity, LTL thou[1)]	144.9	172.9	:	199.9	:	19.4	:
Number of persons employed, thou[2)]	61.1	57.6	63.6	5.8	6.2	−5.8	10.4
Average monthly earnings, LTL	2115	2025	2080	97.7	98.2	−4.3	2.7
Fixed investments, LTL Mio	919	1234	1833	11.0	13.1	34.3	48.5
Foreign direct investments (end of period), LTL Mio	676	779	864	2.2	2.3	15.2	10.9
Sales of goods and services, LTL Mio	11341	13419	16234	8.3	8.5	18.3	21.0
Gross profit, LTL Mio	1922	2595	3113	8.5	8.8	35.0	19.9
Operating profit, LTL Mio	107	676	1136	10.9	13.6	531.9	68.0
Profit before tax, LTL Mio	−50	540	1049	10.1	12.4	-	94.3
Number of enterprises	3884	4006	4464	8.8	9.1	3.1	11.4
Share of profitable enterprises, %	45	61	68	110.9	110.4	35.5	11.3
Assets (end of period), LTL Mio	17616	18010	18469	10.2	9.9	2.2	2.6
Liabilities (end of period), LTL Mio	6436	6084	6001	8.4	8.1	−5.5	−1.4
Return on sales, %	−0.44	4.02	6.46	121.7	146.5	-	60.6
Return on assets, %	−0.29	3.04	5.70	100.5	128.3	-	87.4
Debt ratio (end of period), %	0.37	0.34	0.32	81.8	82.3	−7.5	−3.8

[1)] Value added per employee at current prices
[2)] Excluding individual enterprises
Source: Statistics Lithuania

soared last year to 6.5% and 5.7% respectively. Both were much higher than average indicators of the economy.

After the decline which lasted two years, the number of workers finally stopped falling in the sector and went up by a tenth last year. In total, transport and storage employs about 6% of workforce of the country. The sector concerned is also one of the most productive in the Lithuanian economy: value added per worker is about twice as high as the national average. But wages in the industry have growth slowly. Last year, the average monthly wage before taxes went up by 2.7% to LTL 2,080 and was below the economy's average.

The flows of capital investments, which plummeted by two thirds in 2009, went up steeply for the second year in a row jumping 1.5 times in 2011 to LTL 1.8 billion coming close to the pre-crisis level. On the other hand, the industry raises very little foreign direct investments (FDI). Although transport generates more than a tenth of total value added of the national economy, the industry attracts just 2% of all FDI incoming to Lithuania. One of the reasons is that a large number of major transport companies are state-owned (Kaunas and Vilnius airports, Lithuanian Railways).

THIS YEAR, IMPROVED FINANCIAL INDICATORS OF ROAD TRANSPORT COMPANIES WILL BE UNDERCUT BY HIGH FUEL PRICES AND STRONGER COMPETITION

Road transport is the largest branch of the sector concerned. It creates more than half of total value added of transport industry and generates about 45% of income. Last year, turnover of road transport in tonnes rose by just 3% but turnover in tonne-kilometres went up by 11% due to much longer distances travelled. Domestic transportation increased fractionally but turnover of routes to and from Lithuania grew by about 15% and transportation between other countries rose by a tenth. The majority of income of road transport companies is generated on international routes which account for nearly 90% of turnover in tonne-kilometres. Routes between third countries account for more than 40% of turnover of transported freight.

Last year, financial indicators of road transport companies were positive. Assets of companies rose by 2.6% to LTL 5 billion and liabilities dipped by 6.5% to LTL 2.8 billion pushing the debt ratio down from 62.1% to 56.6%. The ratio however was still much higher than the economy's average. In 2011, sales income went up by a sixth to LTL 7.4 billion and the cost of sales rose by a similar margin to LTL 5.9 billion. Operating profit soared by more than 60% to LTL 481 million and a smaller loss of financial and investment activities allowed pre-tax profit to rise by more than 80% to LTL 421 million. The share of profitable companies, which stood at 43% in 2008, went up to 68% last year.

There are several factors posing a treat to transport companies in 2012. The most concerning of them is the potential weakening of demand. Carriage of goods to the EU countries accounts for about two-thirds of turnover of international transport and the other third is transported to the CIS countries. Since the economy of the European Union will be stagnant this year, the volumes of transport to the EU countries are unlikely to increase compared to 2011 and may even go down. The strengthening domestic consumption in the CIS may boost the volumes of transport to this region but will not be sufficient to ensure significant growth in the sector. Moreover, falling prices of raw materials pose a threat to the Russian economy. Although the price of oil remained high for some time (and lowered profits of transport companies), it has gone down quite considerably lately because of uncertainty about the economy in the old continent. It is difficult to make projections about further movement of prices. The ongoing debt crisis in Europe will continue to push prices down while the threat of a potential military conflict with Iran will put upward pressure. Still it is likely that the negative impact will be stronger and oil prices will not go above the current level (about USD 100 for a barrel of Brent oil) and may even continue to dip.

More stringent control procedures applicable to transport to Russia also pose a threat to Lithuanian carriers. Our largest neighbour began using new carrier inspection measures which require special permits for carriage of non-Lithuanian origin goods from Lithuania to Russia. This may turn into an additional burden for local transport companies and slow down the development of logistics centres as more freight shipments could go directly to Russia without transhipment in Lithuania. Since more stringent controls are consistent with international trade agreements, Russia's membership in the World Trade Organisation will not improve the situation of our carriers.

TARGETED INVESTMENTS SUGGEST CONSISTENT DEVELOPMENT OF THE MAIN SEAPORT IN THE FUTURE

Last year was successful for companies providing auxiliary transport services such as freight handling, warehousing, etc., most of which are provided by the sea. Freight handling at Lithuanian seaports rose by 13% last year. Although handling volumes at the Būtingė Oil Terminal dipped, a record high volume of freight was handled at Klaipėda state seaport amounting to 36.6 million tonnes (up by 17% from 2010). The steepest increase was in the handled volumes of fertilisers, petroleum products, ro-ro cargo (products carried by trucks) and container handling. Exports by Lithuanian companies rose gradually but the main push was made by transit freight which made up 44% of total volumes handled at the seaport. The amount of collected charges was also at a record high last year and stood at LTL 147 million going up by 16% from 2010.

Excellent results of Klaipėda seaport allowed it overtake Tallinn seaport which was stagnant last year and handled 36 million tonnes of freight as well as Riga seaport which saw its freight handling rise by 13% to 28 million tonnes. In addition, Klaipėda seaport remains the leading handler of containers in the Baltic states and boosted the volumes of handled containers by nearly 30% last year to 382,000 standard container units (TEUs). By comparison, the volume was 300,000 TEUs at Ryga port and 200,000 TEUs at Tallinn port in 2011.

The seaport authority reported that it expects freight handling volumes to rise by 4% this year to 37 million tonnes but the start to the year was not successful for the port. It is estimated that 11.2 million tonnes of freight was handled in the first four months of the year which represents a 7% year-on-year contraction. This relative decline was caused by the high reference base effect as handling indicators improved markedly after March.

The authority constantly invests in higher capacity of the port to ensure its sustainable growth. Last year, LTL 215 million was invested in the port which is 1.5 times more than in 2010. This year, the operating capacities will also increase. Currently, the authority is carrying out the largest investment project in the history of Klaipėda seaport to dredge the bed of the port to 14.5 metres so that it can serve much large vessels. The project is worth more LTL 130 million. In addition, LTL 113 million will be invested by 2013 in the new passenger and freight terminal which would increase the annual handling capacity of the port by 2–3 million tonnes and boost passenger flows to 500,000 people.

The main factors which will affect the development of the port in the future are the same: it is the northernmost seaport in the east of the Baltic Sea, it has excellent access to such eastern markets as Belarus, Ukraine and Russia, and it can offer well-developed intermodal connections. Increasingly larger ships will be able to dock at the port if dredging works continue.

As the volume of operations of Klaipėda seaport grows very strongly but its location limits the development potential of the port, the idea of construction of a new deep-water port seems more attractive. However, construction might start after 2020 when Klaipėda seaport could reach its potential handling limit of 60 million tonnes.

Passenger and freight transport by ships of Lithuanian companies increased markedly last year but the volumes of these activities remain negligible as they generate just 3% of total value of the entire transport sector. Last year, freight transport grew by 6% to a record level of 7 million tonnes. Passenger transport in passenger kilometres (number of passengers multiplied by kilometres travelled) also reached record highs last year going up by 14% from 2010. Still, sea carriers found the year difficult and incurred losses in the second half of 2011. Losses were caused by lower transport charges due to strong competition and higher fuel prices. The number of Lithuanian companies transporting freight by sea may decrease considerably in the next few years.

SMART KLAIPĖDA PORT AND RAILWAY DUO IMPROVED THE RESULTS OF THE LATTER

Last year, the railway segment became more active in the country. The volume of transported freight in tonne-kilometres went up by 12% and exceeded the record level of 2007. The increase mostly relied on the higher volumes of freight incoming to the country because of the recovering domestic market as the share of this type of transport went up to 45%. Domestic transport also grew by a quarter and railway exports were on the rise. The above-mentioned increase in the volumes handled by Klaipėda seaport also contributed positively to better results of railways. The volume of passenger transport in passenger kilometres went up for the second year in a row and rose by 4% in 2011. The majority (about two thirds) of routes operated by Lithuanian Railways is made up of domestic transport which increased by a tenth. However, there was a 7% drop in transit volumes which generate about 30% of passenger transport turnover but this indicator should not be taken too seriously as transit operations are loss-making for the national railways.

The national railway company continues to develop its eastbound projects which should contribute considerably to the economic development of the country in the future. At the end of last year, intermodal container train *Saulė*, which should become part of the connection between Western Europe and China, began shuttling between Klaipėda and the Chinese and Kazakh border. While it now takes up to 40 days for freight to travel from China to Europe by sea, the shuttle container train will shorten the voyage to 10 days. *Vikingas* train shuttling between the Baltic Sea and Black Sea increased the volume of transported containers by 30% to a record level of 56,000 TEUs, or one seventh of all containers transhipped in Klaipėda. In 2011, Georgia and Moldova joined the project and negotiations continue with Turkey, Syria and Azerbaijan as well as Finland, Sweden and Norway. The project, which was launched eight years ago, is expected to attract increasing flows of freight between Europe and Asia. Soon the train should begin to shuttle regularly twice a week and then daily. Currently, the main obstacle to regular trips of *Vikingas* is the lack of freight to be transported on the way back from Ukraine to Klaipėda. The flows of westbound freight are expected to intensify after the Nordic countries join the project.

Lately, freight forwarders in our country have faced shortages of carriages which drove railway transport charges up and affected negatively both freight forwarders and Klaipėda seaport. In an attempt to address the problem, Lithuanian Railways plan to purchase 200 new carriages for LTL 50 million this year to add to the existing fleet of 1,000 carriages.

LITHUANIAN AIR TRANSPORT SHOWS IMPRESSIVE GROWTH FOCUSING ON LOW-COST FLIGHTS

In 2011, airports in the country saw a considerable increase in activity. The flow of incoming and outgoing passengers increased by 18% to the record level of 2.7 million last year and exceeded the level of 2008. Vilnius airport, which struggled really hard after the bankruptcy of the national airlines a couple of years ago, showed impressive growth in 2011 and was among the fastest developing airports in Europe. The flow of passengers soared by a quarter to 1.7 million and was very close to a record indicator of 2008. Just like several years earlier in Kaunas, the activities of Vilnius airport were reenergised by low-cost carriers. In the middle of April, Hungarian Wizz Air operated the first flights and was joined in May by Ireland-based Ryanair. In 2011, losses of Vilnius airport decreased considerably from LTL 8 million to LTL 1 million and the airport operator hopes to earn a profit this year. The company plans to invest LTL 100 million into runway cover reconstruction and expansion of the northern platform as well as construction of a new runway by 2015. Kaunas airport grew for the ninth year in a row. Two years ago, the flow of passengers soared and growth was more modest last year. The passenger flow increased by 8% to 870,000 after six new flight destinations were added. Airports started 2012 with different fortunes. In the first four months of this year, the flow of passengers increased more than 1.5 times year-on-year in Vilnius, while the relevant indicator of Kaunas airport fell by 5%. Nevertheless, both airports hope to see passenger flows to reach record levels.

2012 will be a challenging year for the transport and storage sector. At best, the industry can see a moderate increase in its activities and any major improvement could be expected at the end of the year. Road carriers will suffer greatly from the stalling economy in the European Union. As a result, the volume of westbound transport is unlikely to grow this year. The Russian market will hardly be able to offset this decline as its economy is threatened by falling prices of oil as well as more stringent border controls. Klaipėda seaport is already close to its current freight handling potential and freight volumes will change by a small margin this year but should start growing again at the end of 2012 after dredging work will be completed and the EU economy begins to regain strength.

Comments

ABBREVIATIONS

BMW	basic monthly wage;
BoL	the Bank of Lithuania;
CAD	current account deficit;
CIPI	construction input price index;
CIS	Commonwealth of Independent States;
CPI	consumer price index;
dal	decalitre;
DI	direct investment;
ECB	European Central Bank;
ESI	economic sentiment indicator;
EU	European Union;
EUR	Euros;
EURIBOR	Euro Interbank Offered Rate;
EUROSTAT	Statistical Office of the European Commission;
FDI	foreign direct investment;
Fed	Federal Reserve System;
FTD	foreign trade deficit;
GDP	gross domestic product;
HICP	harmonized consumer price index;
ITC	information and communication technologies;
LFS	Labour Force Survey;
LG	Lietuvos geležinkeliai;
MI	manufacturing industry;
MME	minimum monthly earnings;
MF	mineral fuel;
NACE	(Nomenclature Générale des Activités economiques dans les Communautés Européenes) – the official European Community classification for economic activities.
NB	national budget;
NP	nuclear plant;
OECD	Organisation for Economic Co-operation and Development;
OL	Orlen Lietuva;
PPI	producer price index;
RE	real estate;
RIGIBOR	Riga Interbank Offered Rate;
ROE	return on equity;
SODRA	State Social Security Fund;
t	ton;
TALIBOR	Talin Interbank Offered Rate;
USD	the US dollar;
VAT	Value Added Tax;
VILIBOR	Vilnius Interbank Offered Rate;

Symbols in the tables:

:	no data available;
-	the ratio has no sense.

TERMS

Equity – equity including grants and subsidies.

Profit – profit before tax.

Profitability or return on sales – profit before tax divided by sales, %.

Return on equity – profit before tax divided by equity, %.

Debt ratio – total liabilities divided by total assets, %.

Turnover and sales – sales of goods and services.

Sales of goods and services of a sector – consolidated sales of goods and services of the companies classified to the particular sector according to their basic activity.

Sales of industry sector – consolidated income from sales of the companies that indicate this industry sector as the basic in their statistical reports.

Visible export – exports of physically tangible goods, involving the export of goods at various stages of production.

Invisible export – exports of physically intangible items such as services.

STATISTICAL DATA

Number of employed stands for average number of hired employees converted in full-time units, except for agriculture, where number of employed includes self-employed persons. Number of employed in a particular sector is estimated based on the data of Statistics Lithuania and SODRA.

SOURCES OF STATISTICAL DATA

Statistical data on individual companies are obtained from the mass media – basically from Baltic News Service (BNS) and Verslo žinios daily newspaper.

The data on the balance of payments is obtained from the Bank of Lithuania.

The rest of statistical data is provided by the Statistics Lithuania, the Government of the Republic of Lithuania and Eurostat (if not otherwise indicated).

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