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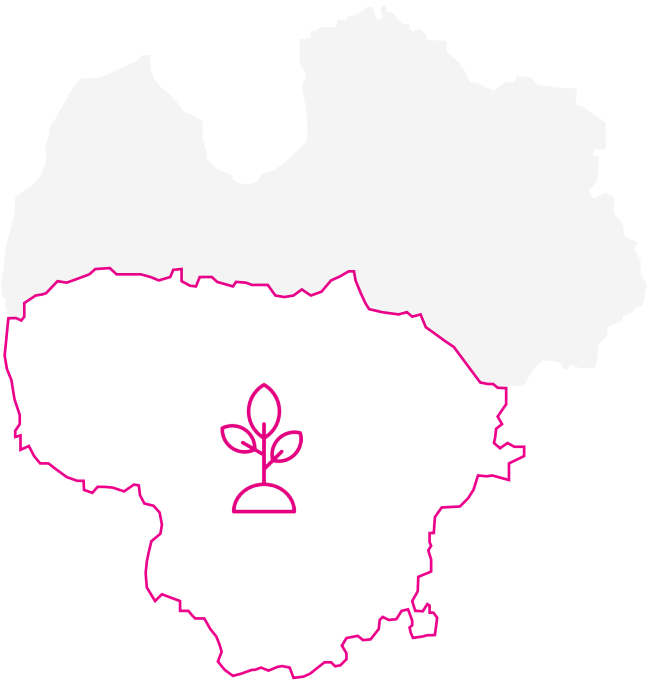

Good Luck or Good Policy?

The Economic Phenomenon of Lithuania

What can explain Lithuania's recent economic development?

Marius Jurgilas

Riga, May 2025

Good Luck or Good Policy? The Economic Phenomenon of Lithuania
What Can Explain Lithuania's Recent Economic Development?

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This policy brief was prepared for the LaSER Think Tank as an independent opinion based on economic data analysis, structured interviews with policy makers, and business leaders. The policy brief is not a scientific exercise in providing statistical causality analysis of the causes explaining the better economic performance of Lithuania, but rather an exposition of potential causes, based on professional insights, structured interviews and a compilation of insights from relevant studies.

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CONTENTS

FOREWORD

Aigars Rostovskis
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Lithuania's economic growth over the last decade and a half has been nothing short of astonishing.

In 2006, at the cusp of the Global Financial Crisis, the most severe since the Wall Street Crash in 1929, GDP per capita in Lithuania and Latvia was broadly similar. By 2024, Lithuania's GDP per capita had not just zoomed past Latvia but had also overtaken Estonia in 2018, long considered the leading economy in the Baltic states.

As Morten Hansen, the head of the Economics Department at the Stockholm School of Economics pointed out in 2023, if Latvia's economy had grown at the same rate as Lithuania's since 2006, then GDP would be 23% bigger (by around 10 billion EUR) and the national budget 3 billion EUR larger.[1]

This policy brief is the first analytical brief to attempt to unpack and understand the sources of this success. Marius Jurgilas, a senior U.S.-trained Lithuanian economist with experience in both public and private sectors, analyzes the key factors behind this impressive growth, offering data-rich and evidence-based insights.

In short, Lithuania's economic progress has been fueled by a combination of strategic reforms, effective governance, and integration into global markets, as well as a dollop of good luck. Investment in digital infrastructure and education bolstered its position as a hub for innovation and entrepreneurship, and today, Lithuania stands out as a leader in fintech and shared services, and attracts significant foreign investment. This analysis should serve as a valuable resource for Latvian, and other European, policy-makers seeking to replicate Lithuania's achievements.

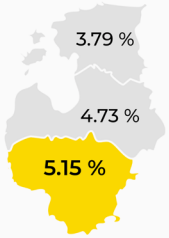
What are the most important lessons for Latvia? To quote from the conclusion, "Lithuania's success is rooted in a combination of **thoughtful policies, a strategic vision, and the capacity for adaptability**." Sound advice for Latvia's political leaders.

[1] Morten Hansen. 2023. How to increase tax revenue by 3 billion EUR without raising tax rates. https://ir.lv/2023/07/17/how-to-increase-tax-revenue-by-3-billion-eur-without-raising-tax-rates/

EXECUTIVE SUMMARY

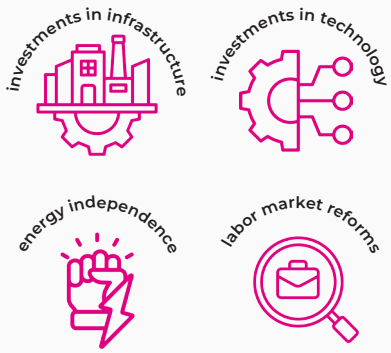
Robust Economic Recovery

Lithuania demonstrated a remarkable economic recovery after the global financial crisis, achieving a significant annual GDP growth rate of 5.15%, higher than its Baltic counterparts, Latvia (4.73%) and Estonia (3.79%).



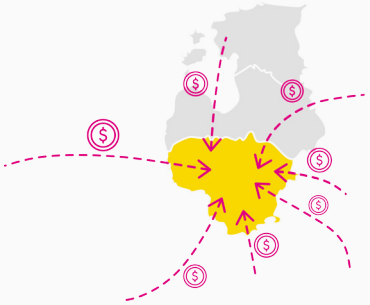
Policy-Driven Success

This report attributes Lithuania's economic success to strategic policy choices, effective governance, and innovative reforms rather than mere luck. Key areas of focus include public investments in infrastructure and technology, energy independence, and labor market reforms.



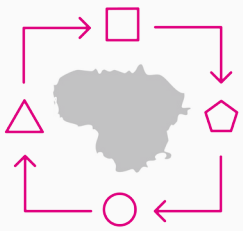
Foreign Direct Investment (FDI)

Lithuania's proactive foreign investment strategy, supported by a robust regulatory framework, has fostered business confidence and innovation, distinguishing it from its Baltic neighbors.



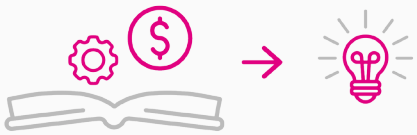
Adaptability in Response to External Factors

The analysis shows that Lithuania's proactive reforms have enabled it to adapt to regional and geopolitical developments effectively, mitigating potential adverse impacts from global economic volatility.



Education and Innovation

Interviews with policymakers highlight the critical need for continuous innovation and educational reforms to align workforce skills with market demands. A strong emphasis on integrating entrepreneurship into education is vital for fostering a culture of innovation.



Regional Lessons

The report draws comparisons with Latvia and Estonia, advocating for long-term planning, collaboration, and policies that address income inequality and labor market mismatches despite overall economic improvements.

Conclusion

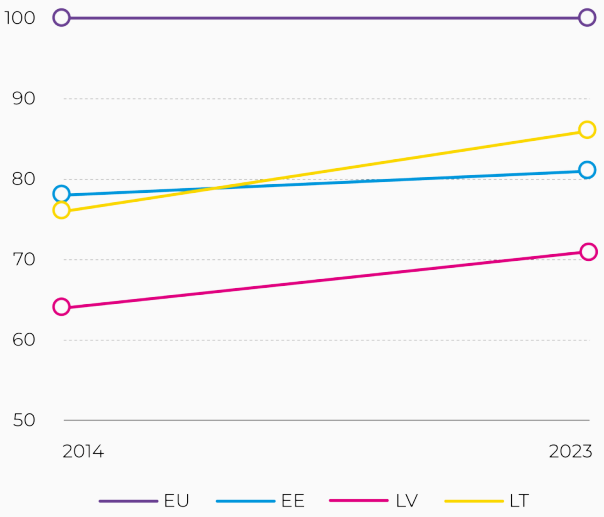
Lithuania's exceptional economic trajectory is fundamentally linked to deliberate, effective policy-making rather than fortuitous conditions. This report serves as an important resource for other nations in the region, promoting the adoption of well-informed governance strategies aimed at ensuring sustainable growth and reducing economic disparities.

INTRODUCTION

What could explain the diverging economic trajectories of the three Baltic states after the global financial crisis and what is the reason behind the **economic phenomenon of Lithuania**?

Figure 1
Volume Indices of Real GDP Per Capita (PPS) in 2014 and 2023 (% of EU27, EU27=100)

Source: Eurostat



Over the last decade **Lithuania** achieved one of the **fastest rates of convergence to the European Union (EU)** and overtook Estonia in terms of **PPP adjusted real GDP per capita.**

Purpose of the report

This report provides a plausible explanation for what is perceived as the comparatively better economic performance of Lithuania since the global financial crisis into the current day. First, we examine if this perception is grounded in economic data by comparing economic indicators of the three Baltic states between 2008 – 2023. Second, we analyze observable differences across the countries looking into various economic, social, and ranking indicators.

We employ growth accounting methodology to decompose the economic factors that can provide an explanation for the observed growth rates of the Lithuanian economy and put it into comparison with the same analysis for Latvia and Estonia. In doing so we follow the methodology of Comunale, Nguyen and Soofi-Siavash[2] updated with the latest economic data.

We analyze sectoral data and gain insights into the relative importance of various economic sectors across the three Baltic states as well as the dynamics of these sectors over the period of analysis. Even though Lithuania, Latvia and Estonia are very closely related and similar economies, they have distinctive differences in economic sectoral composition.

[2] Comunale, M., Nguyen, A. D., & Soofi-Siavash, S. 2019. Convergence and growth decomposition: an analysis on Lithuania. Bank of Lithuania Discussion Paper Series, 17. https://www.lb.lt/uploads/publications/docs/23954_448bc593842d7b37071047a4821aa9a5.pdf

The report overviews significant economic policy interventions and relevant economic reforms conducted in Lithuania. This provides background and hypothetical explanations to the perceived and observed economic phenomenon of Lithuania. It is important to point out that we take into consideration not only evidence based considerations but also subjective views of various supranational institutions that analyzed economic development in the Baltic states. We aggregate extensive institutional (European Commission, IMF, OECD, Bank of Lithuania) analysis that covered Lithuania, Latvia and Estonia and various public initiatives (BTI Country reports, World Bank doing business ranking, WIPO Global Innovation Index, IMD Competitiveness Ranking) that puts the countries in comparison with each other along relevant dimensions.

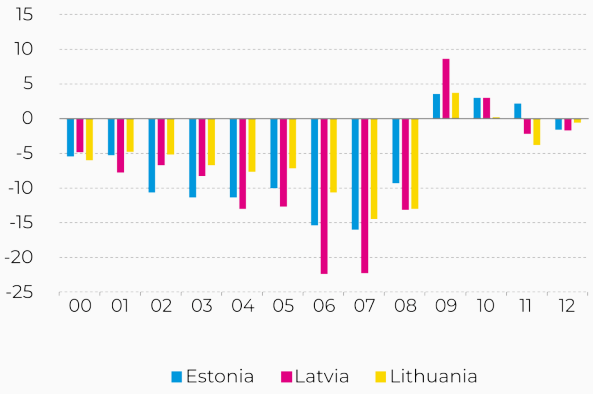
Finally we document multiple interviews with policy makers, business leaders, academics and economic experts conducted in order to verify the perceived 'economic miracle' status of Lithuania and document potential subjective (perceived) explanations for the "economic miracle" of Lithuania.

Setting the scene: The impact of the global financial crisis on the Baltics

The global financial crisis (GFC) of 2008-2009 profoundly disrupted the three Baltic states of Estonia, Latvia and Lithuania, leading to some of the most significant economic contractions in Europe. These economies, which had experienced robust growth rates in the early 2000s, were heavily dependent on international credit and capital inflows and had seen rapid expansions in credit, with annual growth rates averaging around 36% by 2007.

Figure 2
Current Account Balance 2000-2012 (% of GDP)

Source: Staeher, K. 2013.



Credit led growth and the accumulation of external and internal imbalances led to a hard landing in the Baltics.

Consequently, these countries accumulated **substantial household and corporate debt**. Current account deficits in these states were significant, ranging from approximately 13-14% of GDP, indicating a heavy **reliance on external borrowing**. Inflation rates were also high, reaching around 8-9%.[3] The **current account deficit** reached unprecedented levels of around 22% of GDP in Latvia during 2006-07 but was also very large in the two other countries. **Net foreign liabilities** grew rapidly, and by the end of 2007 they reached 72 % of GDP in Estonia, 75 % in Latvia and 56 % in Lithuania.[4]

[3] IMF. 2015. Republic of Lithuania: Staff Report for 2015 Article IV Consultation. IMF Country Report No. 15/138. https://doi.org/10.5089/9781513598871.002
[4] Staehr, K. 2013. Austerity in the Baltic States During the Global Financial Crisis. Intereconomics, 48(5), 293-302. https://doi.org/10.1007/s10272-013-0472-9

The crisis revealed and exacerbated the structural vulnerabilities of the Baltic economies. As global financial conditions tightened and capital inflows dried up, the Baltic states were among the hardest hit. Lithuania's GDP contracted sharply by 14.8% in 2009. Latvia and Estonia experienced similar downturns, with GDP declines reflecting the intensity of their dependence on external financing.

Figure 3
GDP 2000-2013 (Index 2005=100)

Note: Quarterly adjusted for seasonality and working days
Source: Staeher, K. 2013.

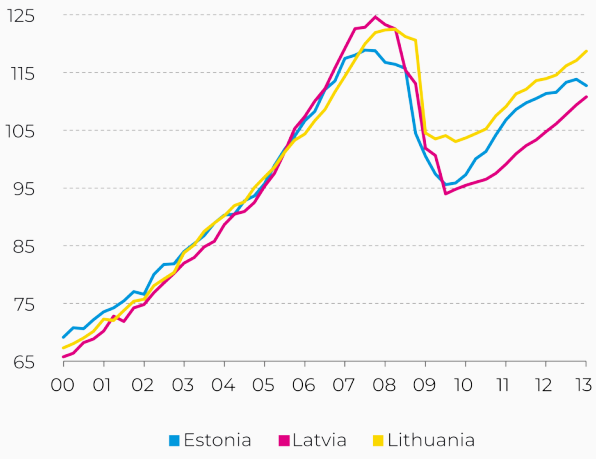
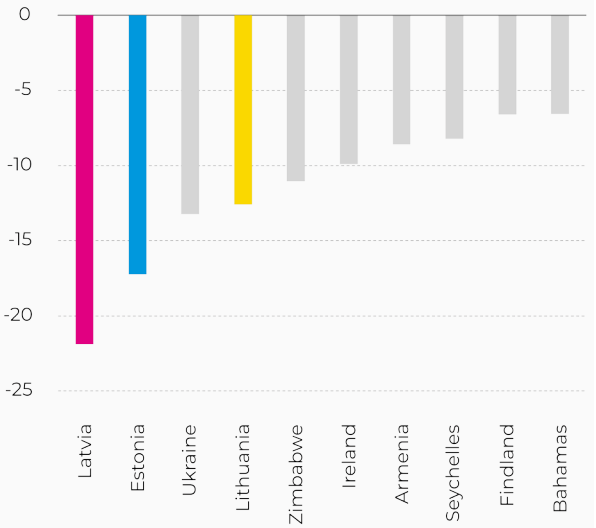


Figure 4
Output Declines 2008-2009 (cumulative % changes)

Source: Purfield, C. and Rosenberg, C.B. 2010.



2008-2009 cumulative output loss in Latvia was double the output loss in Lithuania: -21% vs -11.9%.

The cumulative output loss in 2008 and 2009 was 18.3% in Estonia, 21.0% in Latvia and 11.9% in Lithuania.[5] According to IMF data, Latvia faced the deepest recession, with its cumulative GDP contraction reaching nearly 25%, marking it as one of the most affected economies globally.[6] Estonia also suffered significantly during this period, with a GDP decline of around 18.6%. In comparison, Lithuania's economy contracted by 14.8%.[7]

The crisis had immediate and **severe impacts on Baltic labor markets**. In Lithuania, the unemployment rate soared to 18% by 2010, reflecting the depth of the recession and the collapse in domestic economic activities. The effect of the GFC led to a major dislocation in the labor market which lasted for a significant amount of time in Latvia and Lithuania. The unemployment rate in Estonia came down faster showing greater flexibility of the labor market conditions in that period. This period is also marked by significant emigration across the three Baltic states with the biggest effect in Lithuania.

Due to internal devaluation and other notable economic readjustments, 2008 was the year of peak inflation across the Baltics. Latvia saw inflation rise to 10.1% in 2007 with a further increase to 15.3% in 2008. Estonia saw only one year of double digit inflation of 10.6% in 2008. Similar to Lithuania, where inflation peaked in 2008 to 11.1%.

At the time this was viewed as an extraordinary adjustment, but 2022 energy price

[5] Staehr, K. 2013. *Op. Cit.*
[6] Purfield, C. and Rosenberg, C. B. 2010. Adjustment under a Currency Peg: Estonia, Latvia and Lithuania During the Global Financial Crisis 2008-09. IMF Working Papers, No. 10/213. https://doi.org/10.5089/9781455205448.001
[7] IMF. 2010. Republic of Latvia 2010 Article IV Consultation. IMF Country Report No. 10/356. https://doi.org/10.5089/9781455212798.002

Figure 5
Unemployment 2000-2023 (%)

Source: IMF

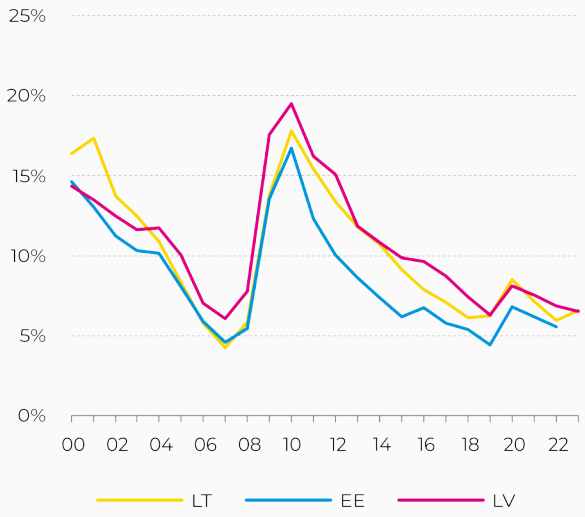
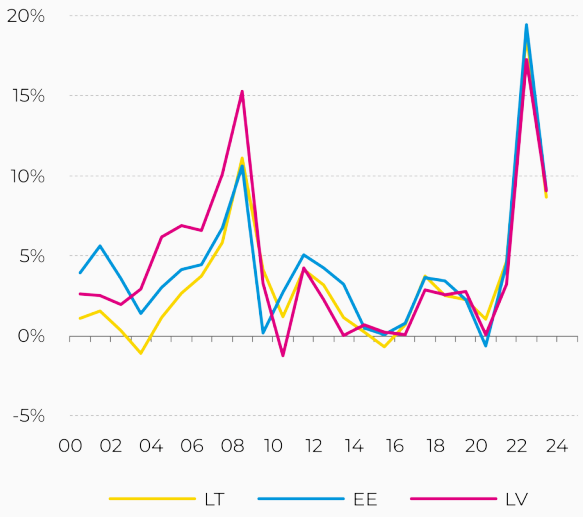


Figure 6
Inflation 2000-2023 (%)

Source: IMF



shocks and other geopolitical tremors proved that regardless of the exchange rate regime or even being in the same currency zone, price dynamics in a short period of time can exhibit some level of divergence driven by specific domestic conditions and the speed of adjustment to extraordinary shocks. In general, the story of the varying speed of adjustment to shocks is the underlying story providing the most fertile set of explanations for the observed differences between Lithuania, Latvia and Estonia.

A comparison of the Baltic countries in terms of nominal GDP reveals that Latvia experienced a period of faster economic growth before the global financial crisis of 2008. This is in line with the other indicators of credit growth and external imbalances that accumulated during the same period.

The **level of indebtedness** measured in terms of debt to GDP was a key indicator that set the Baltic states apart from the rest of the EU. Prudent fiscal management was a mantra followed in Estonia with extremely low debt to GDP levels unseen in the majority of the emerging economies of the time. Estonia, with 5% debt to GDP, clearly stood out compared to Lithuania and Latvia somewhere around 20%. Such **prudent fiscal management** allowed Estonia to provide a much bigger fiscal stimulus in the years after the GFC. In 2009, public expenditure to GDP went up from ~34% in 2007 to 42-46% across the three Baltic states. But what sets the fiscal response apart is the persistence of this adjustment in Estonia and a significant reduction in the following years in Lithuania with Latvia somewhere in between.

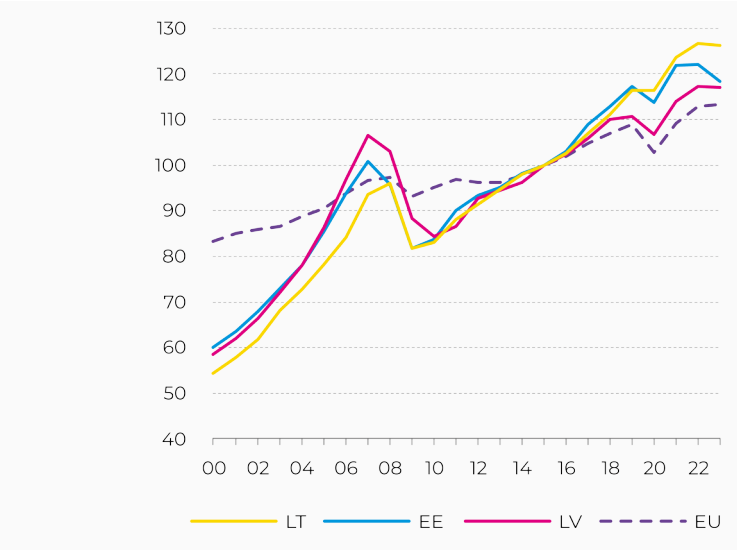
Before and after global financial crisis: Prudent fiscal management in Estonia before the crisis with the highest per cent of public expenditure after.

Focusing on Latvia, this pattern of contraction reflects differing levels of resilience and vulnerability within the Baltic states. Latvia's heightened sensitivity to the crisis stemmed from its excessive **reliance on external funding** and rapid credit expansion leading up to the downturn. This vulnerability was seen in both steep GDP declines and soaring unemployment rates, with Latvia experiencing unemployment levels of around 20% by the end of 2009.

The dramatic contraction in economic output was mirrored by significant **fiscal strain**. Public finances, already stretched by high

Figure 7
Chain Linked Volume Indices of GDP at market prices 2000-2023 (Index 2015=100)

Source: Eurostat



expenditure levels pre-crisis, deteriorated sharply. Fiscal deficits surged as tax revenues plummeted and social welfare demands increased due to rising unemployment and economic hardship.

Before the 2008-2009 crisis both **Lithuania and Latvia were running significant budgetary imbalances** improving only in the penultimate years before the economic collapse of 2008-2009. At the same time Estonia was running budgetary surpluses. Even in the crisis years of 2008-2009 Estonia had the lowest budgetary deficits in the region.

The financial sectors in these countries were particularly vulnerable due to **high loan-to-deposit ratios**, which exceeded 200% before the crisis, highlighting an over-reliance on external credit.

Figure 8
Public Expenditure 2000-2022 (% of GDP)

Source: IMF

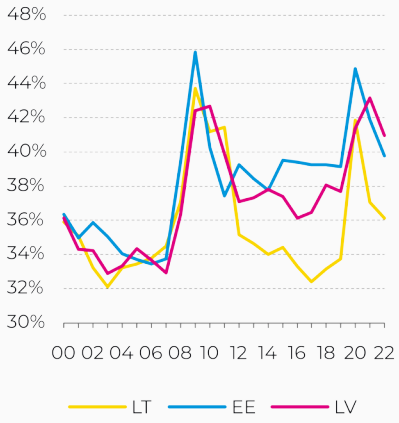


Figure 9
General Government Budget Balance 2000-2022 (% of GDP)

Source: IMF

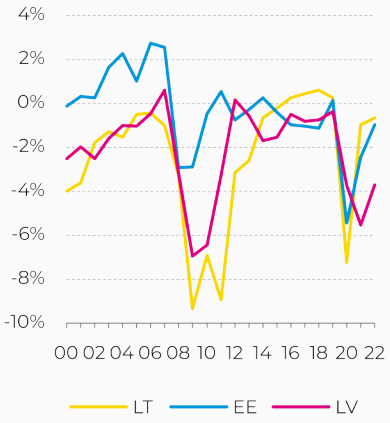
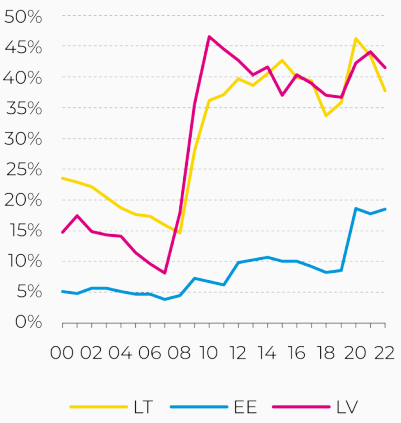


Figure 10
General Government Gross Debt 2000-2022 (% of GDP)

Source: IMF

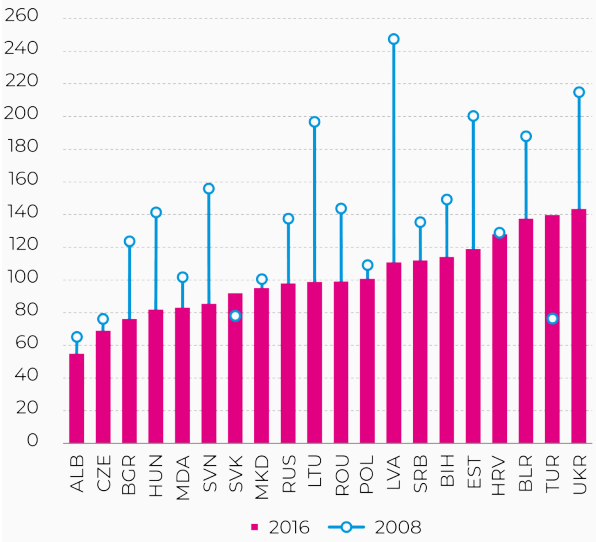


Inflationary pressures that had been prevalent before the crisis subsided swiftly as domestic demand collapsed. However, the initial high inflation preceding the crisis reflected overheating economies and increased the pain of subsequent internal devaluations. The severe **corrections in the real estate markets** across the Baltic countries further exacerbated the downturn, leading to significant declines in property values and exacerbating financial instability.

This period exposed the underlying economic imbalances, and the fragility associated with rapid credit-driven growth. The Baltic states' fixed currency regimes initially prevented them from utilizing currency depreciation as a tool for economic adjustment, compelling Lithuania, Latvia, and Estonia to undertake **internal devaluations**. These internal devaluations involved significant wage cuts and reductions in prices to regain competitiveness, further entrenching

Figure 11
Loan to Domestic Deposit Ratios in 2008 and 2016 (%)

Source: IMF



Excessive imbalances and fast credit led growth before the global financial crisis was followed by a protracted credit-less recovery in the Baltics.

In conclusion, the global financial crisis brought to the fore the vulnerabilities inherent in the Baltic states' economic models, characterized by high dependence on external financing and rapid, credit-fueled growth. The ensuing severe economic contractions witnessed in Lithuania, Latvia, and Estonia underscored the **structural weaknesses** and the need for substantial economic adjustments to stabilize and eventually recover from the deep recession induced by the global financial turbulence.

the economic contraction initially triggered by the abrupt cessation of capital inflows.[8]

[8] OECD. 2016. OECD Economic Surveys: Lithuania 2016. https://doi.org/10.1787/eco_surveys-ltu-2016-en; IMF. 2016. Central, Eastern, and Southeastern Europe: How to Get Back on the Fast Track. Regional Economic Issues. https://doi.org/10.5089/9781513590868.086

1. ECONOMIC DEVELOPMENT INDICATORS

Labeling Lithuania's recent economic development as an "economic miracle" might be based on perceptions formed over the last several years. Nevertheless, it is clear that Lithuania has outperformed Latvia and Estonia since the global financial crisis.

GDP

There is an ongoing debate as to whether Lithuania's economic performance following the GFC constitutes an "economic miracle", with contention stemming not only from varying interpretations of economic data but also from domestic political discourses and regional rivalries. Nonetheless, empirical evidence reveals significant growth: from the aftermath of the global financial crisis up until the invasion of Ukraine by Russia, **Lithuania achieved the highest GDP per capita growth rate in the euro area**, averaging close to 3% annually, in stark contrast to the euro area's (EA) growth rate of merely 0.3% during the same period. Furthermore, per capita GDP in Lithuania saw an increase from 55% to 86% of the EA average between 2007 and 2023, primarily driven by improvements in labor productivity. However, it should be noted that Lithuania experienced a contraction in labor productivity growth during the last two years of this period.[9]

Lithuania: GDP per capita in terms of euro area (EA) average rose from 55% in 2007 to 86% in 2023.

Figure 12
GDP Per Capita (PPS) in 2007, 2021 and 2023 (% of EA, EA=100)

Source: Eurostat, IMF

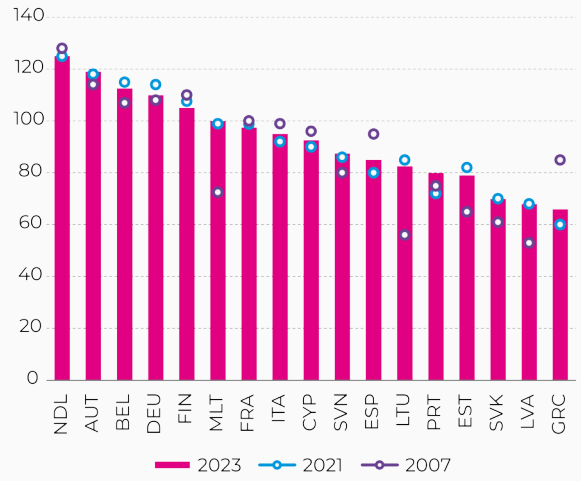
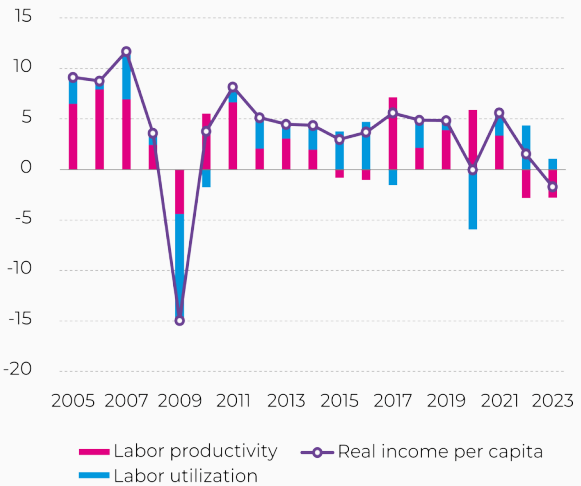


Figure 13
Real Income Per Capita Decomposed by Labor Productivity and Labor Utilization Rates 2005-2023 (% year on year)

Source: Eurostat, IMF



[9] IMF. 2024. Republic of Lithuania: Selected Issues. IMF Country Report No. 24/243. https://www.imf.org/en/Publications/CR/Issues/2024/07/23/Republic-of-Lithuania-Selected-Issues-552407

The relative performance of the Lithuanian economy becomes evident when examining the real GDP growth rate adjusted for purchasing power standards (PPS) as seen in comparison of actual individual consumption and comparison of real GDP indexed to EU 2020 levels. Conversely, real GDP per capita figures indicate that Estonia consistently outperforms Lithuania. This disparity highlights the **significance of relative price levels** and their dynamics across the three Baltic states when assessing economic performance, suggesting that a mere comparison of nominal figures may not present an accurate representation of each country's economic health.

Figure 14
Volume Indices of Actual Individual Consumption Per Capita (PPS) in 2014 and 2023 (% of EU27, EU27=100)

Source: Eurostat

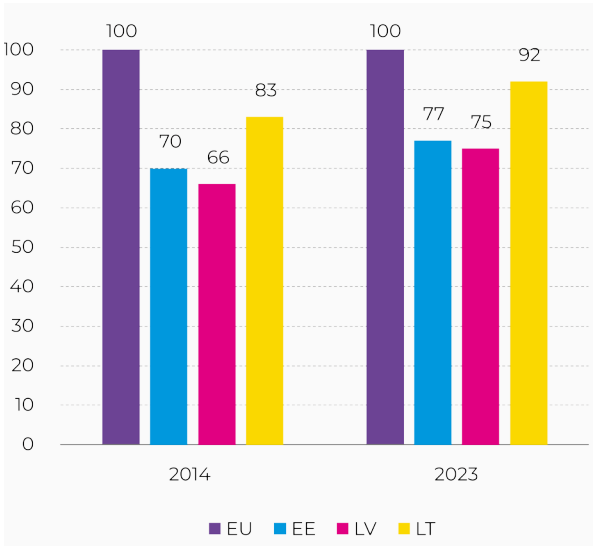
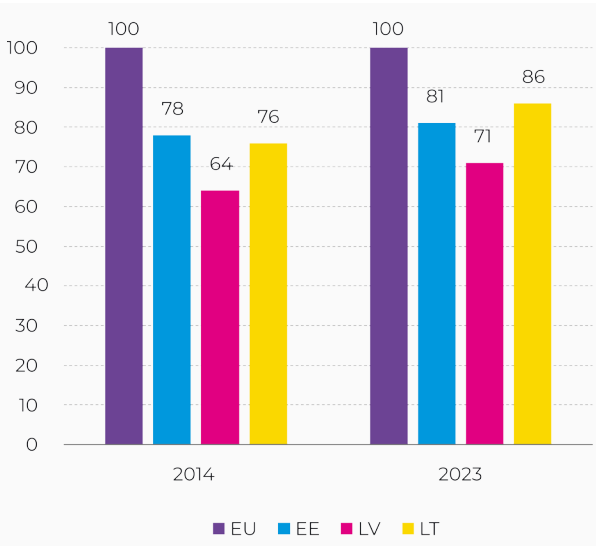


Figure 15
Volume Indices of Real GDP Per Capita (PPS) in 2014 and 2023 (% of EU27, EU27=100)

Source: Eurostat



Convergence towards the EU average has been remarkable across all three Baltic states both before and after the GFC. Comparisons of the countries using PPS show that since 2014 Lithuania has maintained the lead in terms of actual individual consumption per capita (PPS) and in 2023 has overtaken Estonia to also take the lead in terms of real GDP per capita (PPS). It is important to stress that this effect is very strongly influenced by the price level dynamics across the Baltic states. As a result, there is no “economic phenomenon” present in Lithuania when looking at real GDP per capita indexed to 2015 prices. Indeed, as will become evident in the perception analysis of various stakeholders and policy makers in the Baltics, there seems to be some evidence that it is Latvia that stands out as an economic phenomenon – albeit a negative one.

Income

Some economic commentators are skeptical of making inferences from the various measures of gross domestic economic activity. They emphasize that the thing that really matters is take home pay and what it can be used for. In this sense the Baltic states are the champions of the EU with disposable incomes doubling since 2010, while the EU experienced only a 20% increase in that same time period.

A look at the decomposition of disposable incomes across the Baltic countries reveals few glaring disparities in social transfers, except that pensions play a much more significant role in the EU. This clearly shows that the pension systems in the Baltic states are lacking in terms of the safety and replace-

ment rates that they offer retired persons. However, median equivalized total disposable income (post social transfers) is significantly higher in Estonia while Latvia has the lowest median disposable income across the Baltic states.

Median disposable income in Latvia is 33% lower than in Estonia.

Figure 16
Real GDP Per Capita (Chain Linked Volumes (2015)) 1995-2023 (EUR Per Capita)

Source: Eurostat

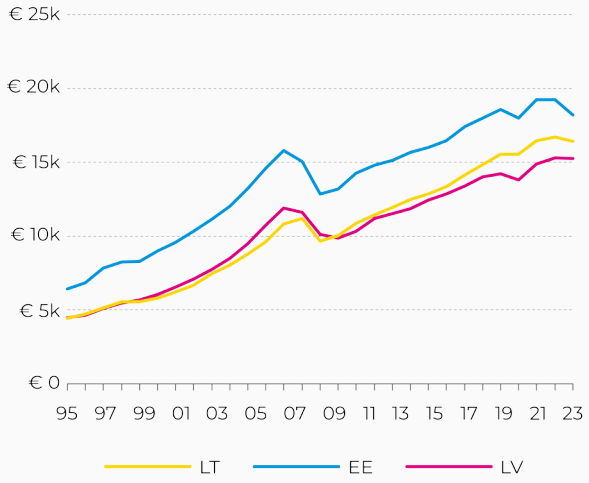


Figure 17
Real GDP Growth Rate (Chain Linked Volumes (2015)) 2012-2023 (% change on previous period)

Source: Eurostat

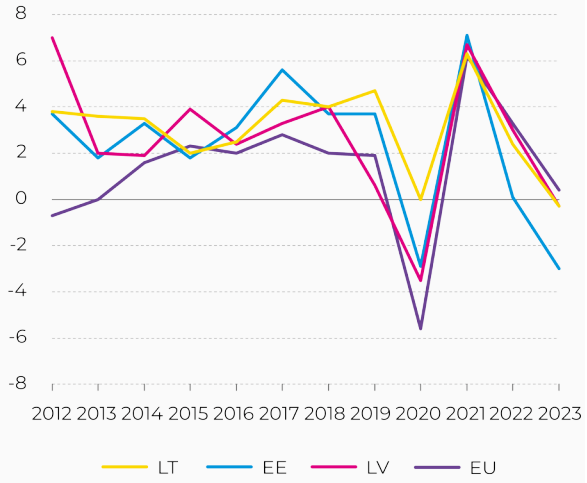


Figure 18
Median Equivalised Real Disposable Income in 2022 Compared to 2010 (index, 2010=100)

Source: Eurostat (EU-SILC)

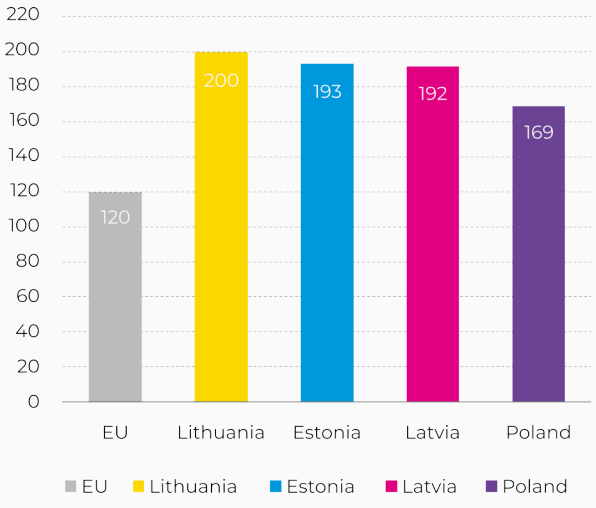


Figure 19
Median Equivalised Disposable Income and Magnitude of Social Transfers in 2022 (PPS Per Inhabitant)

Source: Eurostat (EU-SILC)

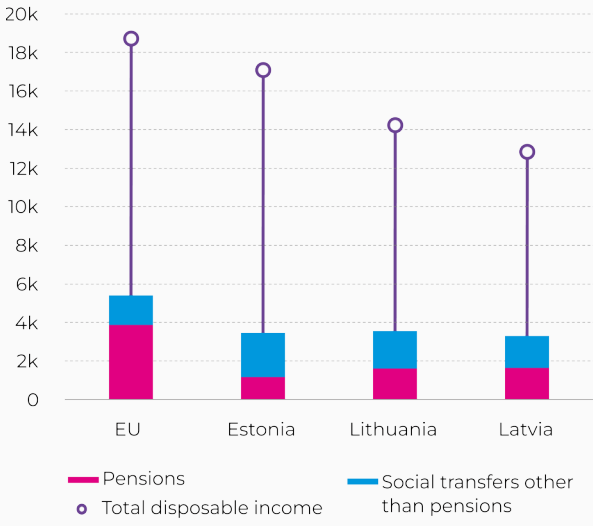
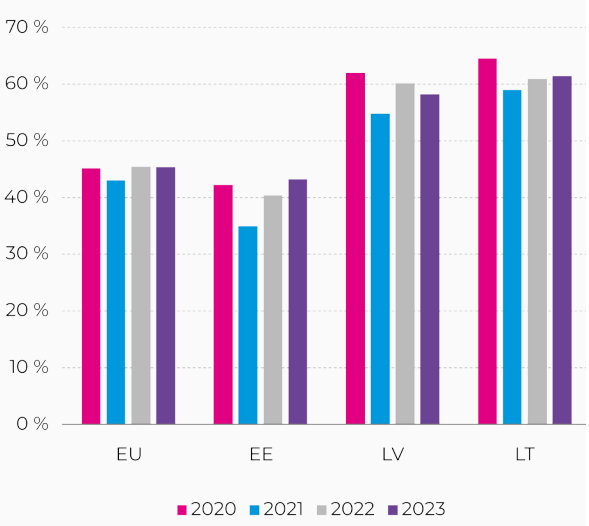


Figure 20
Households with Difficulty to Make Ends Meet 2020-2023 (% Reporting at Least Some Level of Difficulty)

Source: Eurostat (EU-SILC)



When comparing income levels across the Baltic states, Estonia clearly stands out as the country with the highest disposable income. There is another indicator that challenges the perceived "economic phenomenon" status of Lithuania. In 2023 Eurostat survey data 61% of respondents in Lithuania had at least some difficulty in making ends meet. Latvia was not too far behind at 58%, but Estonia again stands out at just 43%, which is below the EU average of 45%. It is not clear how the latest economic conditions impacted this measure and how this reconciles with consumer confidence indicators that show a different ranking of perceptions across the Baltic states.

Labor market

Since the onset of the GFC in 2008, Lithuania's labor market has undergone significant transformations which distinguish it from its Baltic neighbors, Latvia and Estonia.

At the peak of the crisis, in late 2009, Lithuania's unemployment rate skyrocketed to approximately 18%.[10] This figure is comparable to Latvia, where the rate reached around 20% at the same time, indicating

Figure 21
General and Youth (Aged 15-24) Unemployment Rate 2000-2023 (%)

Source: IMF, OECD

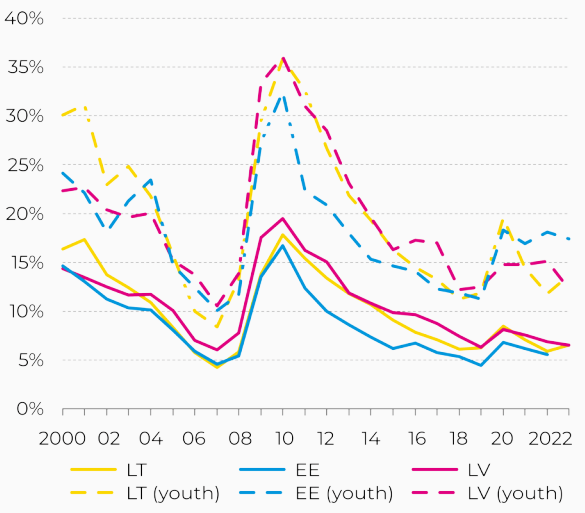
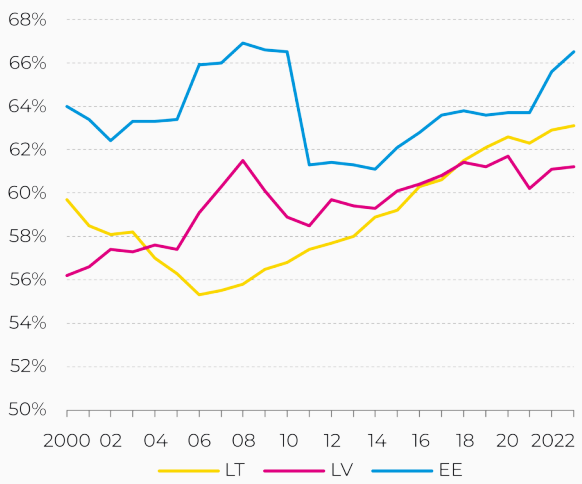


Figure 22
Labor Force Participation Rate 2000-2023 (%)

Source: OECD



[10] Bogužas, Ž., et.al. 2024. Anatomy of inflationary shock in Lithuania: causes, effects and implications. Bank of Lithuania Occasional Paper Series, No.50.
https://www.lb.lt/en/media/force_download/?url=/uploads/publications/docs/44073_2a8bbf39246c5d3b924481c6a221ec65.pdf

severe labor market distress in both countries.[11] In contrast, Estonia experienced a slightly lower peak unemployment rate of about 16%. The adjustment patterns reveal that while all three Baltic nations faced significant job losses, Lithuania's labor market demonstrated a robust recovery in subsequent years. After the GFC unemployment went down in Estonia much faster than in Lithuania or Latvia, but, interestingly enough, youth unemployment has shown increased stress, higher than in the other Baltic states.

Even though Lithuania has been lagging behind with labor force participation post GFC, labor market reforms and favorable macroeconomic conditions resulted in significant improvement. Lithuania caught up and moved past Latvia which now has the lowest labor force participation in the Baltics.

New Social Model or Brave New World?

In Latvia there are anecdotes that an informal consensus existed between Lithuania's business and political elites on strategies for economic growth and modernization. Alas, no substantive evidence exists to support this assertion. Indeed, he level of animosity between the state and the business sector has remained notably high. This tension began with an anti-oligarch campaign led by former President Dalia Grybauskaitė and was exacerbated by corruption scandals that contributed to the collapse of the once-popular Liberal and Labor parties. More recently, the imposition of windfall taxes on the banking sector further illustrated this adversarial relationship.

In the years preceding the COVID-19 pandemic, issues of inequality and social justice gained significant prominence. President Gitanas Nausėda's electoral platform was anchored in the slogan "Welfare State" ("*Gerovės valstybė*"), which garnered overwhelming public support. But the true essence of a concensus among stakeholders was reflected in the reforms enacted under the initiative known as the "New Social Model".

Lithuania underwent significant labor market reforms in 2016 – 2018 with comprehensive reforms aimed at modernizing labor laws, pensions, and the tax system. The **New Social Model of Lithuania** and new labor code improved labor market flexibility, investment incentives were introduced, and social insurance contributions were adjusted to enhance tax progressivity. These reforms increased labor market resilience and improved the business environment. Increases in teacher and medical staff salaries contributed to increased public sector efficiency.

The effect of higher public sector salaries on efficiency is based on several observations. First, increased salaries in the health sector decreased bribing and led to more efficient allocation of resources and shorter waiting times.[12] As regards educational outcomes, historic low PISA outcomes in Lithuania were explained by low teacher salaries, while recent positive trends are attributed to significant salary increases that align with empirical estimates that up to one third of the variation in PISA outcomes between OECD countries can be explained by differences in teacher salaries.[13]

The New Social Model in Lithuania was a comprehensive reform aimed at enhancing social and labor market policies, aligning with the principles of "flexicurity". This reform package was enacted in three stages, with pivotal changes introduced to labor relations, unemployment insurance, and the pension system. One of the key features of this model was the amendment of the Labor Code, which relaxed regulations regarding permanent and temporary employment contracts. Specifically, provisions concerning individual dismissals were eased, along with reductions in severance pay and notice periods for permanent contracts.

The New Social Model also aimed to improve unemployment benefits, broadening eligibility and increasing payment rates. The duration of unemployment benefits was extended from six to nine months, while the management of public employment ser-

[11] Purfield, C. and Rosenberg, C. B. 2010. *Op. cit.*
[12] OECD. 2020. OECD Economic Surveys: Lithuania 2020. https://doi.org/10.1787/62663b1d-en
[13] OECD. 2016. OECD Economic Surveys: Lithuania 2016. https://doi.org/10.1787/9a79736b-en

vices was centralized to enhance efficiency. Furthermore, the reform emphasized the importance of active labor market policies to facilitate job placement and training opportunities.

In terms of pensions, the model sought to ensure long-term sustainability by introducing a new pension indexation formula that aligned benefits with the overall wage dynamics in the economy, thus addressing concerns over increasing pension spending against a backdrop of demographic aging. The reform's approach included shifting the responsibility for basic pensions from social security funds to the general state budget, thus protecting the pensions against potential fiscal constraints.

One of the frequent arguments explaining the economic performance of Lithuania is the significant improvement in terms of competitiveness of Lithuanian economy. And the main driver behind this is **labor force efficiency**.

In the years following the crisis, Lithuania's **unit labor costs** (ULCs) showcased significant reductions relative to Western European competitors—approximately a 14.2% decline from pre-crisis levels. In contrast, Latvia experienced a more dramatic decrease of about 21.7%, while Estonia reduced its ULCs by 10.5%. These metrics are indicative of Lithuania's balanced approach to maintaining employment while realigning wages with productivity. But more recently Lithuania stands out as the country with the highest appreciation of ULC. This calls into question the long term competitiveness of the Lithuanian economy.

All three countries experienced a phenomenal growth in real wages with Lithuania providing consistently strong wage growth that allowed it to keep the lead position across the three Baltic states.

In the last two years we observe interesting dynamics with **wage growth being negative in Estonia** and Latvia showing the highest real wage appreciation in the region.

Figure 23
Nominal Unit Labor Cost Based on Hours Worked 2000-2023 (Index, 2015=100)

Source: Eurostat

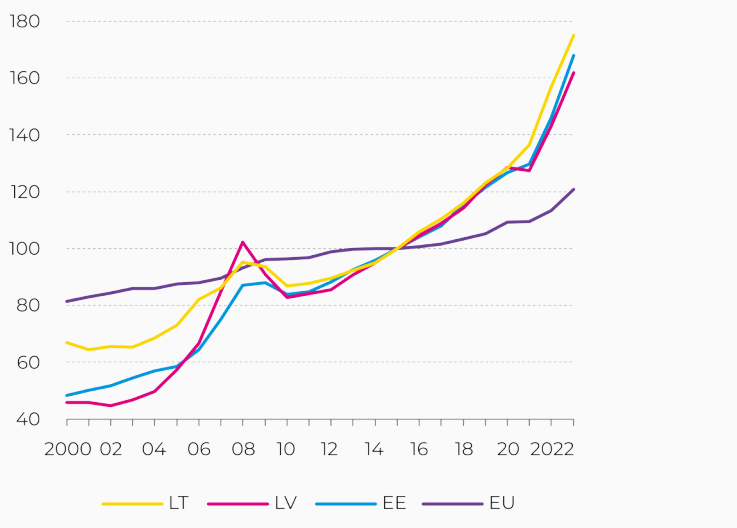
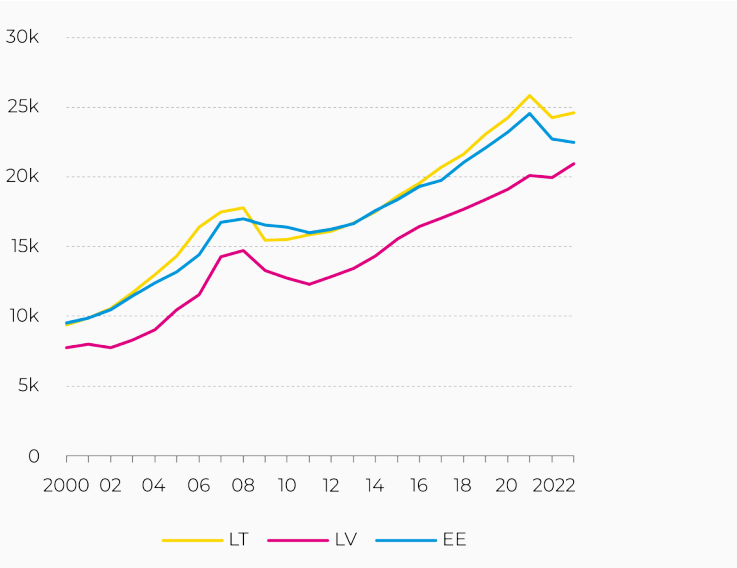


Figure 24
Average Annual Real Wages 2000-2023 (EUR, Constant 2022 Prices)

Source: Eurostat



Education sector

Education plays a crucial role as a key determinant of human capital, with far-reaching implications for long-term economic growth. The Baltic countries' varying approaches to educational investment highlight this importance. While all three Baltic nations have seen a decline in the share of GDP allocated to primary through tertiary education, **Estonia has consistently outperformed** its neighbors by maintaining higher educational spending.

Figure 25
Share of Total Government Expenditure on Education (Primary to Tertiary) 2008-2021 (%)

Source: OECD

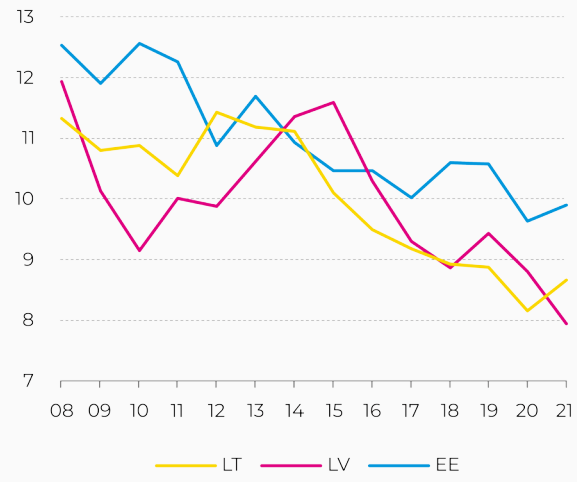
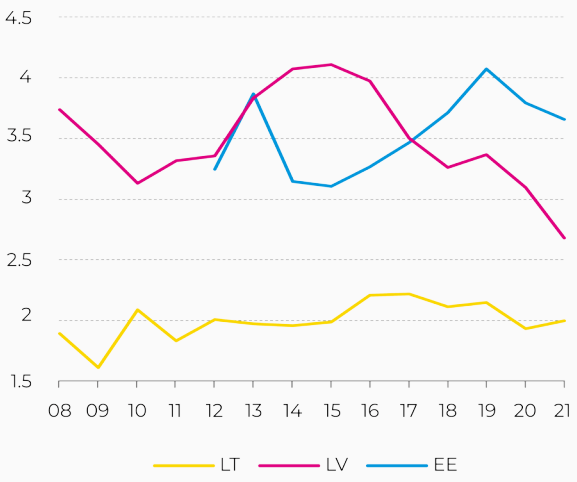


Figure 26
Share of Total Government Expenditure on Primary Education 2008-2021 (%)

Source: OECD



Poor educational outcomes in Lithuania and high skills mismatches.

Initially, in 2008, Estonia led by a percentage point, a gap that temporarily closed by 2015 but has since returned to its original margin. This commitment to education positions Estonia for stronger future economic performance. In contrast, **Lithuania's significant underinvestment** in primary education, lagging behind its Baltic counterparts by about 1.5 percentage points, is particularly concerning given the critical nature of early education. This perspective aligns with the seminal work of James Heckman and his colleagues, who have demonstrated the outsized impact of early childhood investments on future human capital development. Their research emphasizes that resources allocated to education in a child's formative years yield substantially higher returns compared to later interventions, both in terms of cognitive and non-cognitive skills.[14] This underscores the potential long-term economic consequences of Lithuania's underinvestment in primary education, as it may hinder the development of a robust human capital base necessary for sustained economic growth and competitiveness in the global knowledge economy.

According to OECD PISA scores, **Lithuania is among the bottom 25% of EU** countries having good quantitative educational outcomes but poor qualitative ones with the

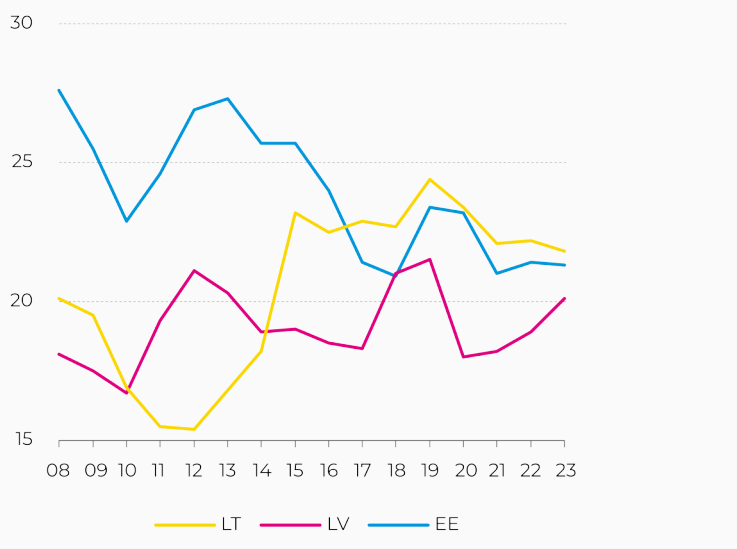
[14] Garcia, J.L., Heckman, J.J., Leaf, D.E. and Prados, M.J. 2020. Quantifying the Life-Cycle Benefits of an Influential Early-Childhood Program. Journal of Political Economy, 128(7), 2502-2541. https://doi.org/10.1086/705718

third highest skills mismatch in the labor market.[15]

The current state of human capital utilization in the Baltic labor markets can be further understood through the lens of skill mismatch, particularly focusing on over-qualification rates as defined in Eurostat Labor Market Survey.[16] Estonia has shown promising trends with declining over-qualification rates, suggesting an improving alignment between workers' skills and job requirements. In contrast, **Lithuania is experiencing an increase in skill mismatches**, indicating a growing disparity between the education level of workers and the demands of their jobs. Latvia, meanwhile, maintains a relatively constant level of skill mismatch. These divergent patterns have significant implications for each country's labor market efficiency and overall economic productivity. Increasing mismatch is problematic. For individuals, it often leads to job dissatisfaction, lower wages relative to their education level, and reduced productivity. From a macroeconomic perspective, widespread skill mismatch can result in suboptimal resource allocation, hampering overall economic growth and innovation. It may also contribute to brain drain as over-qualified workers seek opportunities abroad that better match their skills.

Figure 27
Overqualification Rates (Age 20-64 Years) by Citizenship (Reporting Country) 2008-2023 (%)

Source: Eurostat



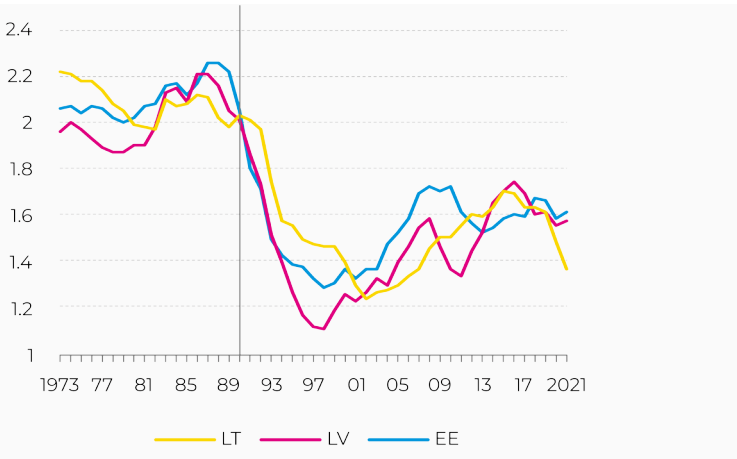
Demographics

The three Baltic countries have experienced similar trends in fertility rates since the 1990s. All three nations have seen a **dramatic decline in fertility**, with rates stabilizing around 1.6 children per woman in recent years. This low fertility rate is significantly below the replacement level of 2.1, raising concerns about the long-term demographic sustainability and economic growth prospects for these countries.

While the fertility patterns are similar, **mortality trends reveal notable differences among the Baltic states**. Estonia has shown the most positive trajectory, successfully reversing its crude death rate to some extent. Latvia has managed to stabilize its mortality rate, indicating some progress in public health outcomes. However, Lithuania stands out as significantly underperforming

Figure 28
Total Fertility Rate 1973-2021 (Births Per Woman)

Source: EU Health for All Database



[15] IMF. 2019A. Republic of Lithuania 2019 Article IV Consultation. IMF Country Report No. 19/252. https://doi.org/10.5089/9781513509235.002
[16] The over-qualification rate is calculated for employed persons with a tertiary level of educational attainment (ISCED levels 5–8). The rate shows what proportion of these people are employed in occupations for which a tertiary level of education is not required (equivalent to ISCO major groups 4–9). It is based on the correspondence between occupations and level of education as proposed by ILO in the International Standard Classification of Occupations; Structure, group definitions and correspondence tables. Cases, where the variable on occupation has no answer, are excluded from the denominator.

in this area. Unlike its Baltic neighbors, Lithuania's crude death rate continues on an increasing trajectory, suggesting persistent challenges in healthcare, lifestyle factors, or other social determinants of health. This divergence in mortality trends could have far-reaching implications for each country's population structure, healthcare systems, and overall socioeconomic development in the coming years.

Figure 29
Crude Death Rate 1981-2019 (Deaths Per 1000 Population)

Source: WHO

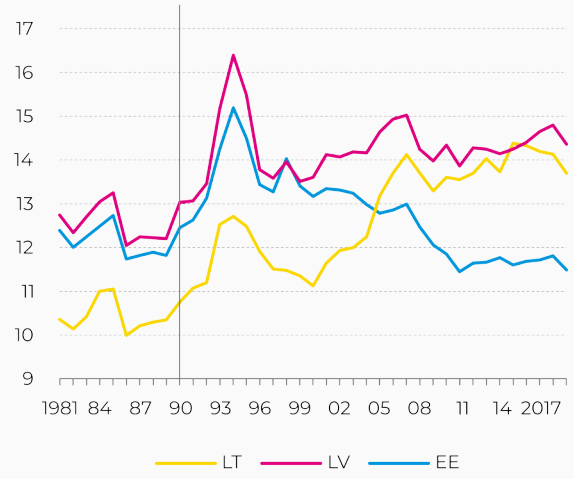
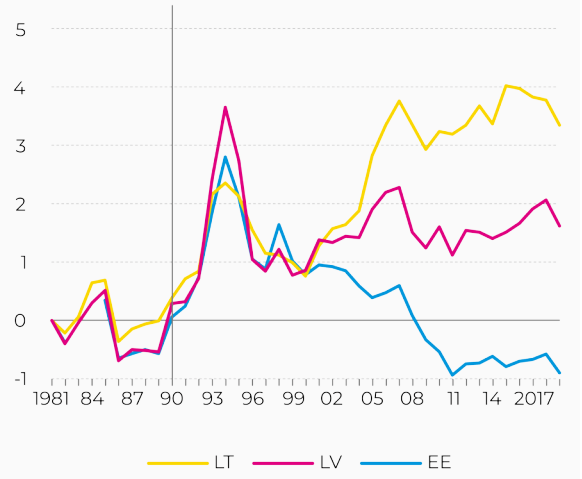


Figure 30
Normalized Crude Death Rate 1981-2019 (Excess Deaths Per 1000 Population Compared to 1981)

Note: Normalization means that death rate in 1981 is normalized to 0
Source: WHO



Social comparison

Figure 31
Self-perceived Long-standing Limitations in Usual Activities Due to Health Problem for People Aged 16 Years or Over, 2010-2023 (% with Some or Severe Activity Limitation)

Source: Eurostat (EU-SILC)

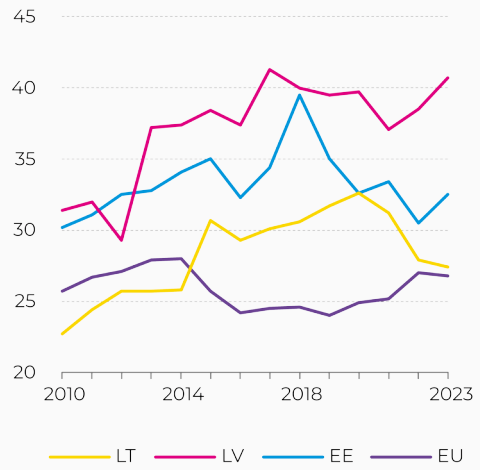
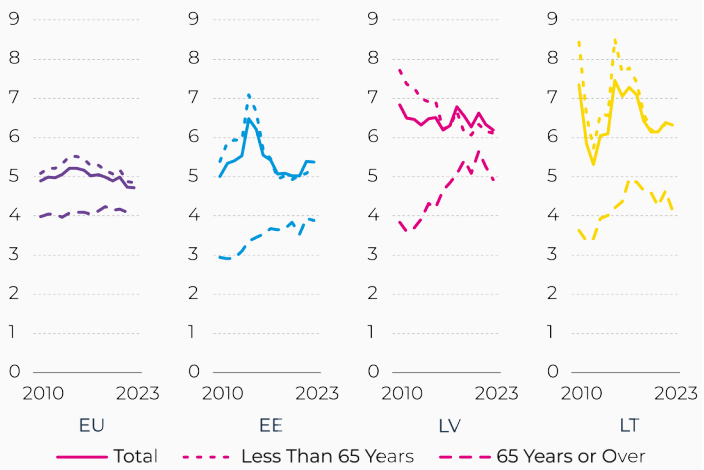


Figure 32
Income Inequality by Age Group 2010-2023 (Income Quintile Share Ratio S80/S20 for Disposable Income)

Source: Eurostat (EU-SILC)



When looking at the social indicators of the three Baltic states the main story that jumps out is that the working age population in Lithuania has incomes of comparatively higher levels. But those dependent on social safety nets have greater difficulties compared to the other Baltic countries. In general, income inequality even though improving across all the countries, has been consistently the biggest problem in Lithuania for those under 65 years of age. Old age inequality (65 years or over) is the biggest in Latvia.

Income quintile share ratio (S80/S20) compares the income received by the 20% of the population with the highest income (top quintile) with the income received by the 20% of the population with the lowest income (bottom quintile). High values for this ratio reveal considerable disparities in the distribution of income between the highest and lowest income groups. High income inequality is observed in Lithuania and Latvia but at the same time Lithuania has shown highest variability across time. Estonia has the lowest inequality for the 65 years and older population.

This fits another observation that the share of public expenditure measured as a % of GDP has remained consistently at a higher level in Estonia (~40% post GFC) compared to Latvia and Lithuania (the lowest level across the Baltics).

When looking at other measures of life quality the **highest level of reported disability of 41% in Latvia** stands out across the Baltic states (proxied by activity limitation[17]). The high discrepancies between the countries, with Lithuania reporting only 27%, is very hard to explain and requires a separate investigation. On the one hand it could show higher social inclusiveness and cultural acceptance and a lack of stigma associated with disability reporting and measurement. On the other hand, it could show a less effective health care system or cultural differences in terms of work ethics which may have an impact on labor productivity, which has been identified as the main factor driving economic growth in Lithuania.

Prices

Economic catch up to EU levels is not only observed in real economic indicators but also in prices and is a phenomenon of its own. There is a significant appreciation in price levels in Estonia almost reaching the EU average, while Lithuania still has a 17% lower price level than Estonia. This explains the differences between the countries when comparing PPS adjusted and unadjusted measures of GDP, income and so on. In comparative terms, from 2012 to 2023 the price level increase was the highest in Estonia at 30%, while Latvia saw an 18% increase and Lithuania a 25% appreciation. Prices are a very contentious issue that requires a separate study. In 2016 Lithuania was engulfed in the **scandal of cauliflower prices** (due to excessively high prices at the time) which took social media by storm and was branded as "je suis cauliflower" with retailers seeking "protection" from the State Security Department. This shows the level of sensitivity to prices.

Recently inflation has emerged as a pressing challenge across the Baltic states, with implications for competitiveness. The relationship between real wages and productivity is complex; while productivity growth has supported competitiveness in Estonia and Lithuania, **rising wages have exceeded productivity growth in Latvia**, potentially impacting its competitive stance.[18] Sustaining competitiveness in the context of rising inflation and tightening labor markets remains a critical challenge for all three nations.

According to a study conducted by the Bank of Lithuania (Bogužas, et al., 2024), firms have expressed varying inflation expectations since 2020, closely monitoring wage growth alongside inflation.[19] In **mid-2020, firms anticipated wage decreases** at the national level, indicating a negative outlook on economic recovery during that turbulent

[17] **Activity limitation – disability** (self-perceived long-standing limitations in usual activities due to health problems). Activity limitation: the concept is operationalized by using the Global Activity Limitation Indicator (GALI) for observing limitation in activities people usually do because of one or more health problems. The limitation should have lasted for at least the past six months. Three answer categories are possible: 'severely limited', 'limited but not severely' or 'not limited at all'.
[18] IMF. 2023A. Republic of Latvia 2023 Article IV Consultation. IMF Country Report No. 23/330. https://doi.org/10.5089/9798400255212.002
[19] Bogužas, Ž., et.al. 2024. *Op. cit.*

period. However, **by 2022, expectations for wage increases surged** to an average of 6.3%, reflecting a recovery in economic confidence.

The **strong correlation between wage growth and inflation** underscores the potential risks to competitive positioning when wage increases are not aligned with productivity enhancements. In particular, the Bank's findings emphasize that long-term productivity growth is essential to sustaining wage increases without eroding competitiveness. This highlights the importance of monitoring both inflation rates and wage expectations closely, as outpacing productivity growth through wage increases without corresponding productivity gains could threaten Lithuania's competitive position relative to its Baltic neighbors.

Figure 33
Comparative Price Level in 2012 and 2023 (% of EU27, EU27=100)

Source: Eurostat

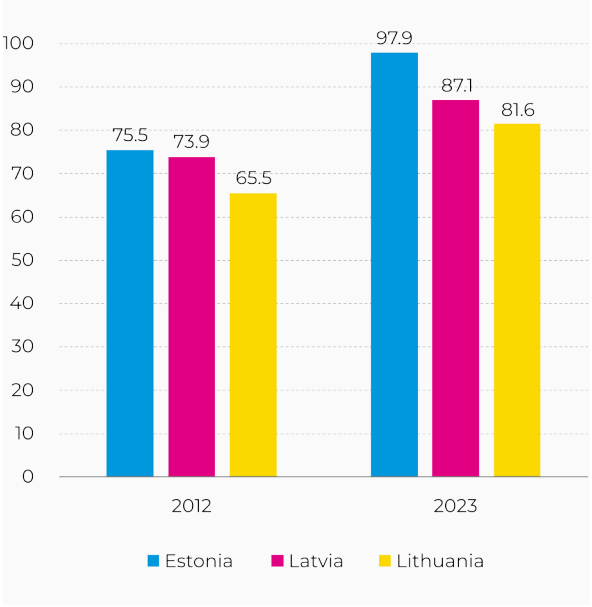
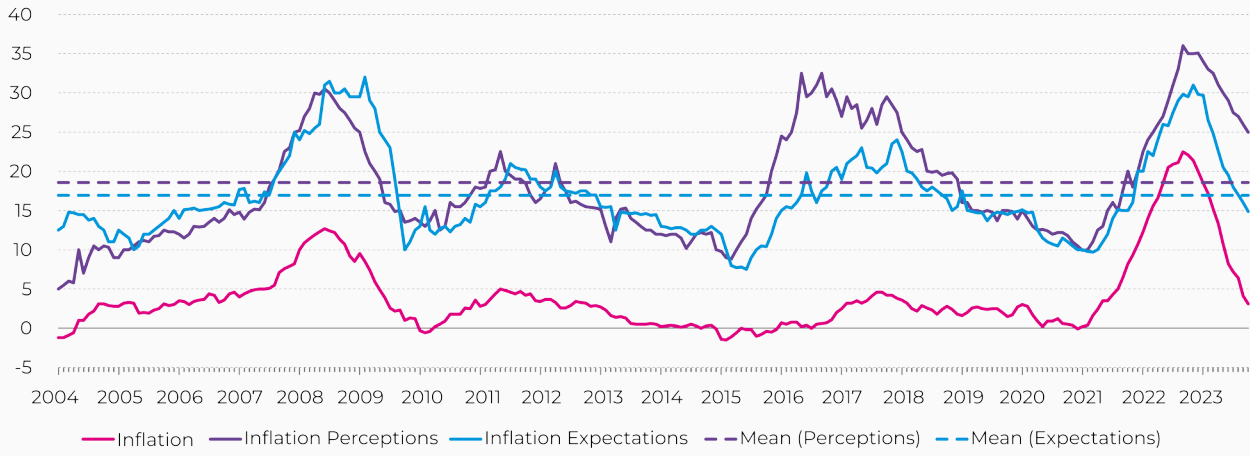


Figure 34
Lithuanian Consumers' Inflation Perceptions and Inflation Expectations 2004M01-2023M10 (%)

Source: Bogužas, Ž., *et.al.* 2024.



Capital

Foreign Direct Investment (FDI) has critically influenced capital accumulation across Lithuania, Latvia, and Estonia, contributing to the economic development of these Baltic states. FDI inflows have been significant in each country, with **Estonia generally attracting the largest investments** relative to GDP, bolstered by substantial foreign capital from Finland and Sweden. The evolving geopolitical landscape following the war in Ukraine has prompted a diversification of investment sources, thus enhancing resil-

ience in FDI flows. For Lithuania, the recent **uptick in gross capital formation** seen can be attributed to several key factors. Various reports indicate that government expenditures, particularly through EU funding directed towards infrastructure development and green transitions, have increased significantly. Additionally, in 2023, Lithuania experienced substantial gross national investment relative to its GDP, reflecting an expansionary fiscal stance amidst **economic recovery efforts** from COVID-19 and the imperative to address escalating energy costs.

Figure 35
Gross Capital Formation (All NACE Activities) 2014-2022 (Current Prices, Million EUR)

Source: Eurostat

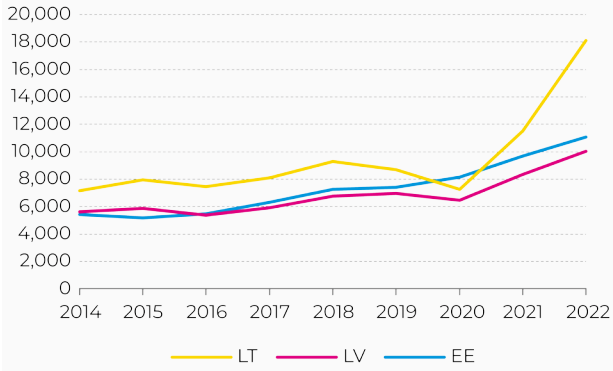
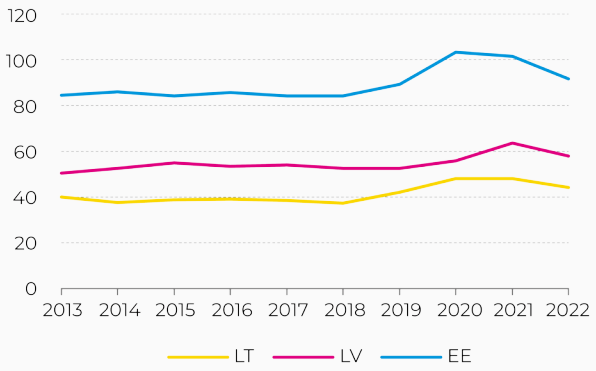


Figure 36
Inward FDI Stocks (Direct Investment in The Reporting Economy) 2013-2022 (% of GDP)

Source: Eurostat



In terms of specific strategic initiatives to make Lithuania more attractive in terms of FDI a clear focus was set for policy makers to ensure high "ease of doing business" and similar rankings that foreign investors take into consideration when making decisions on greenfield investments. A dashboard of "blockers" to higher rankings were identified with specific goals set for specific ministries to ensure an increase in the ranking score (which de facto meant an elimination of inefficiency or an improvement in specific public service, e.g. the time to connect to electricity, permits, immigration of high skilled labor). The "Invest Lithuania" foreign investment development agency was tasked with specific sectoral priorities (number of new workplaces created due to FDI) and dedicated teams. Major cities (Vilnius and Kaunas) set up respective promotion agencies (Go Vilnius and Kaunas IN) that worked hand in hand with the national development agency. Sector-specific initiatives also played a crucial role in attracting foreign investment. In particular, Lithuania has strategically focused on technology, fintech, and sustainable energy sectors to align with global investment trends. The government has actively supported the emergence of a vibrant startup ecosystem, facilitating access to venture capital and entrepreneurship via financial instruments and clear national strategies that reduced uncertainty and provided clarity for foreign investors in terms of the direction of the country.

Even though a clear priority was established to alleviate skills mismatches and workforce qualification via educational reforms and a focus on human capital development, measurable impact and results are lacking. Finally, Lithuania received a Christmas present in the form of an approved "Lietuva 2050" strategy on December 23rd 2023 which set out a cohesive long term vision for the development of society, the state and economy with the underlying theme being "The state where I want to live and create, the one that I want to defend".[20]

While Estonia has historically maintained a higher FDI-to-GDP ratio, the landscape has evolved, with Lithuania catching up due to **strategic initiatives** that have improved its

[20] Valstybės pažangos Strategija "Lietuvos Ateities Viizija, "Lietuva 2050", https://lrv.lt/media/viesa/saugykla/2023/12/pkvNdKVl0fk.pdf

business environment. The Lithuanian government has focused on sectors such as technology, finance, and sustainable energy, which have drawn considerable interest from international investors. Additionally, Lithuania's efforts to **diversify its investment base**, particularly in the context of geopolitical shifts since the war in Ukraine, have at the same strengthened (for some) and weakened its attractiveness as an alternative investment destination.

Furthermore, the continued inflow of investment aimed at strengthening the digital economy, financial technology sector and energy security has bolstered investor confidence, encouraging both public and private sector growth.

Phenomenon of Estonia's startup ecosystem

It is known that an inportant driver of innovation is access to risk capital. Even though Lithuania and Estonia rank among #1 startup jurisdictions in the word, access to venture capital has not been plentiful. In terms of investment rounds in early stages of investment Lithuania and Estonia have been dominating with the Latvian startup ecosystem generating smalest number of early investment rounds. Moving into Series A the dominance of the Estonian startup ecosystem is unquestionable with Latvia producing an even smaller share of investment opportunities.[21]

What is trully phenomenal in this context, is the VC industry intensity measured as a share of total GDP showing a massive over-perfromance of Estonia.[22]

Figure 37
Pre-seed and Seed rounds 2019-2024 (Number of Rounds)

Source: Firstpick Baltic startup funding report

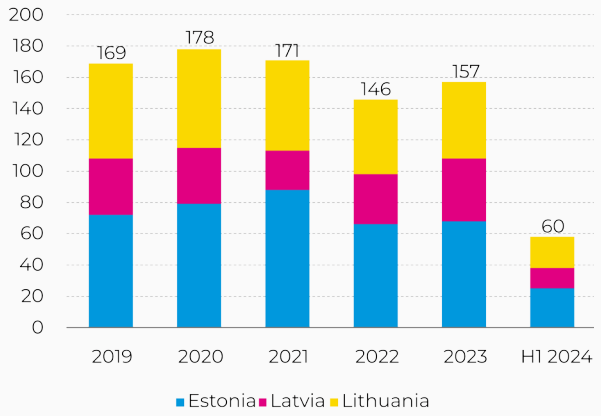
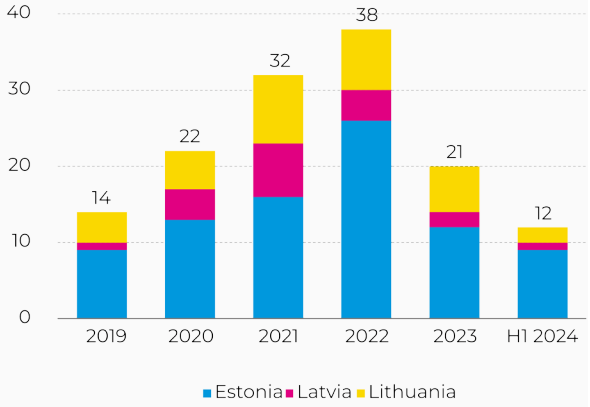


Figure 38
Series A and Growth Rounds 2019-2024 (Number of Rounds)

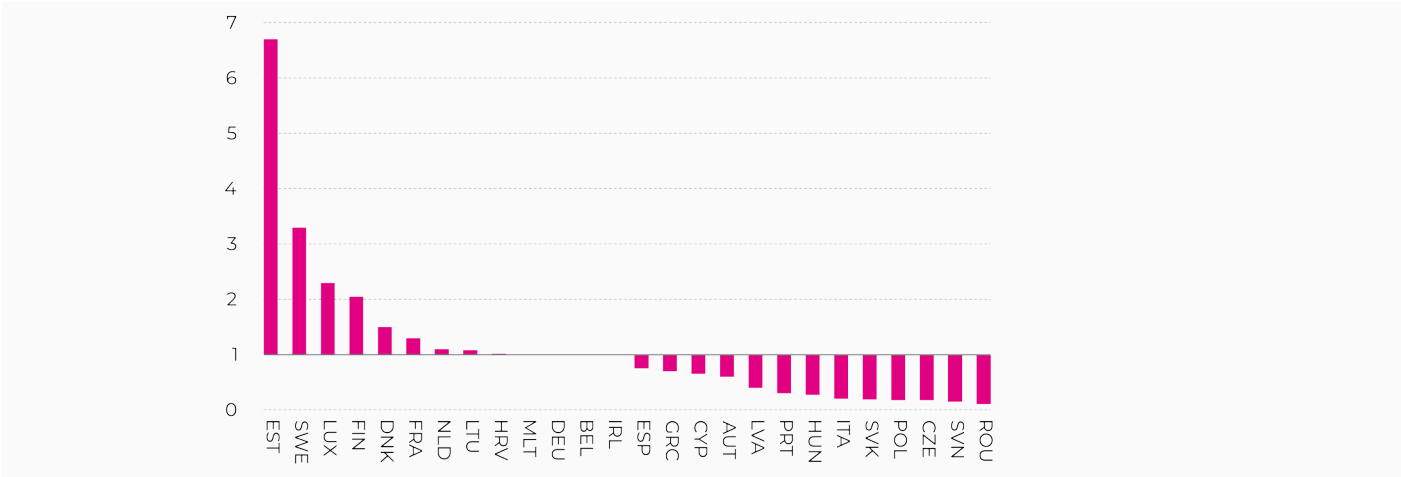
Source: Firstpick Baltic startup funding report



[21] Firstpick. 2024. Firstpick Baltic startup funding report: H1 2024 Update. https://firstpick.vc/baltic-startup-funding-report/
[22] Arnold, N., Claveres, G. and Frie, J. 2024. Stepping Up Venture Capital Finance Innovation in Europe. IMF Working Papers, No. 24/146. https://doi.org/10.5089/9798400280771.001

Figure 39
VC Intensity 2019-2023 (Average Share of EU's Total VC Over Share of Total EU GDP)

Note: Countries above 1 contribute to EU27 VC disproportionately compared to their share of EU27 GDP
Source: Arnold, N.G. *et.al.* 2024.



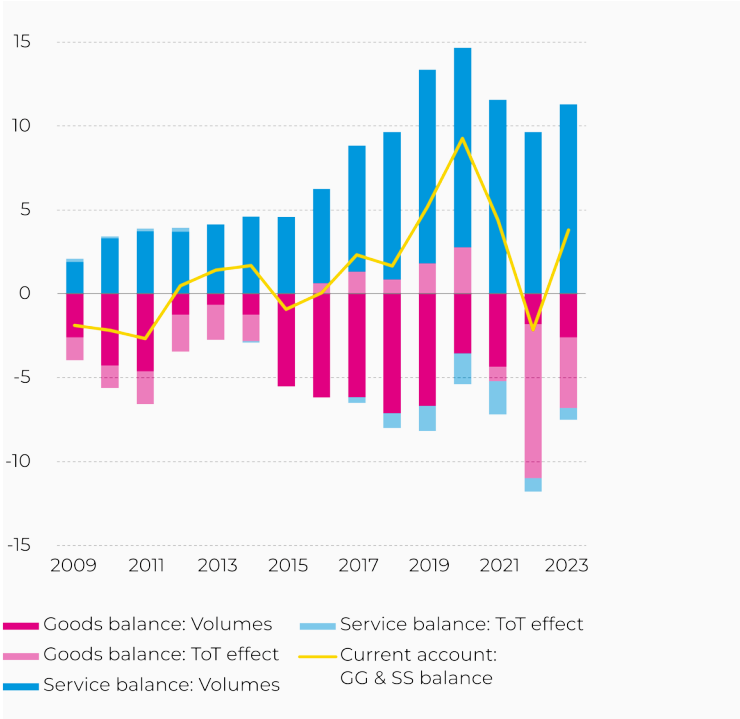
Trade

In the post GFC period the most brutal year was 2015 when Lithuania lost 10% of export market share in a single year. This was primarily driven by a combination of external demand shocks and sanctions imposed on Russia and Belarus as demand from key trading partners contracted, particularly in sectors that relied heavily on re-exports. Two-thirds of this market share loss stemmed from **weakened external demand rather than competitiveness-related factors**, highlighting the impact of the geopolitical landscape on Lithuania's export dynamics. Somewhat similar effects were observed in Estonia and Latvia but 2015 marked a fundamental turning point for the reorientation of Lithuanian exports.

The export share loss was concentrated in goods, while services continued to perform strongly, underscoring a gradual structural shift towards higher value-added services in the economy. Although Lithuanian exporters demonstrated resilience amidst a challenging external environment, the impact of the trade restrictions led to significant adjustments, necessitating a focus on diversifying markets and enhancing the competitiveness of their exports beyond merely price-based factors. Thus, while the **challenges faced in 2015 were considerable**, they prompted **necessary transformations** in the country's export strategies to adapt to shifting global market conditions.

Figure 40
Lithuania's Goods and Services External Balance 2009-2023 (% of GDP)

Source: Eurostat, IMF



The second key driver shaping Lithuania's trade was increasing international competitiveness as manifested in a **three-fold world export share increase**. Neither Estonia nor

Latvia have shown anything close to this unparallel growth in international trade. Somewhat counterintuitively (Lithuania is the most industrialized economy of the Baltic states) particularly strong performance was observed in the tradable services sector. While a politically sensitive topic in Lithuania, it is clear that the **internal devaluation of 2008 and 2009** was the basis for this spur in trade competitiveness.

Latvia is the biggest trading partner for Lithuania in terms of export constituting 11.3% of export (No. 1 export trading partner) and 7.8% of imports (No. 3 import trading partner) in September 2024. Estonia is No. 5 and No. 10 in terms of export/import trading with Lithuania.

Lithuania's exports are diverse, with significant contributions from mineral, chemical, agricultural, and wood products. Notably, chemical products and machinery form the backbone of its exports, with the share of services increasing recently. The country has successfully expanded its service export sector, particularly in information technology and transport services, which have been integral in offsetting slower growth in goods exports.

Latvia's exports have historically been concentrated in wood products, machinery, and food goods. The agricultural sector plays a vital role, with food products forming a substantial part of its exports. However, Latvia generally has a lower share of high-technology exports compared to Estonia and Lithuania.

Estonia shows a strong specialization in **high-tech and high value-added sectors**, particularly in machinery and transport equipment. This focus on technological goods has enabled Estonia to maintain robust productivity growth in its export sector. Estonia also has a considerable share of service exports, particularly in digital services.

Lithuania relies heavily on **energy imports,** with oil and gas comprising a significant portion of its import basket. This dependency on energy imports makes Lithuania particularly vulnerable to global price fluctuations. The large trade openness ratio also indicates a significant volume of imported goods, reflecting its integration into global supply chains.

Figure 41
World Export Market Shares 2000Q1-2023Q4 (%)

Source: IMF

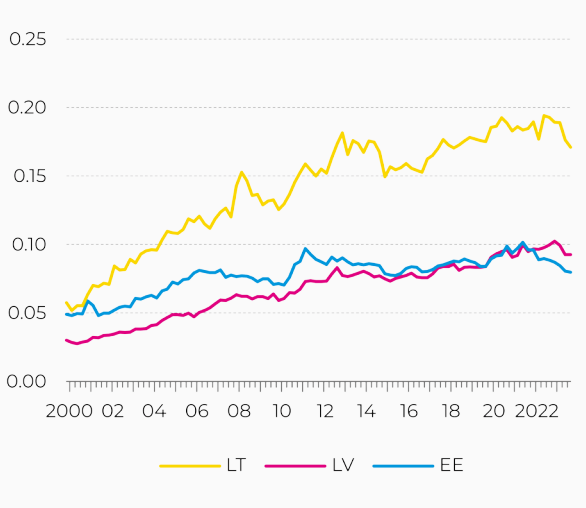
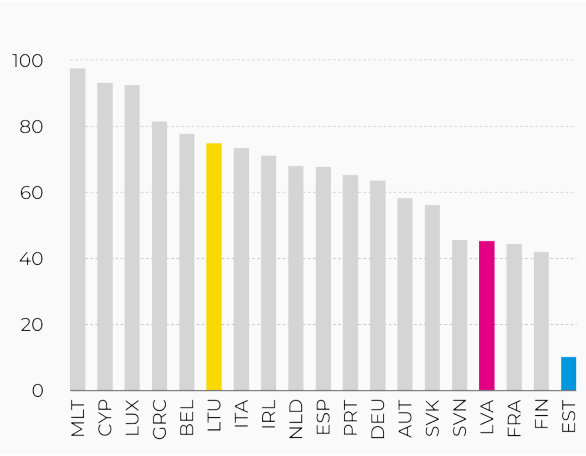


Figure 42
Energy Import Dependency (%)

Note: Import Dependency = (Imports – Exports) / Gross Available Energy
Source: IMF



Latvia's import composition mirrors its export structure to some extent, with significant **imports of food products and wood**, alongside machinery. Latvia has a balanced mix of imports but remains sensitive to changes in the trade environment, particularly in its energy supplies.

Estonia's imports are characterized by high levels of **machinery and equipment**, reflecting its focus on technology and industrial production. Like Lithuania, Estonia has a notable import share from energy-related sectors, but it maintains a more diversi-

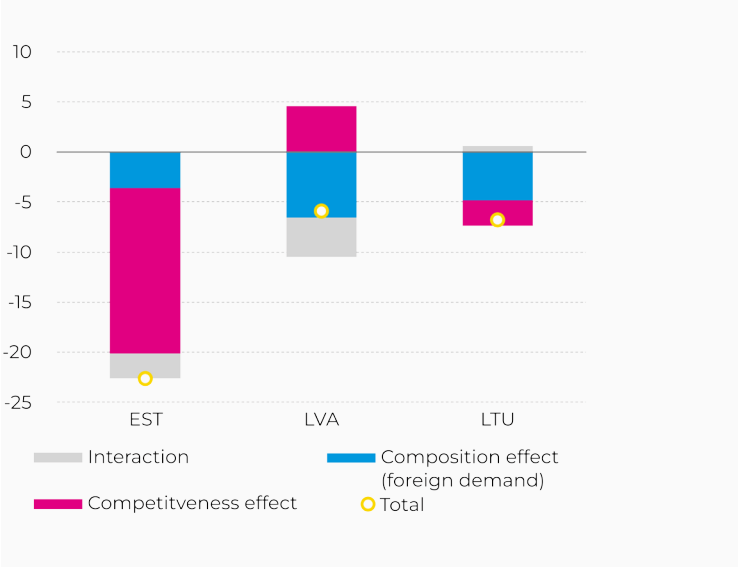
fied energy profile with a growing share of renewables.

These trade dynamics as well as a multitude of institutional reports leads to the conclusion that **Estonia continues to lead in high-technology exports**, leveraging its strong ICT sector and innovation-driven entrepreneurial culture, which enhances productivity and resilience in maintaining export market shares.[23] In contrast, both **Lithuania and Latvia are relatively more reliant on traditional sectors** such as agriculture, food products, and wood, with Lithuania transitioning gradually towards higher value-added services like IT, while **Latvia has made strides in diversifying its export portfolio** but remains predominantly focused on low-technology sectors.[24] Despite the growth in higher-tech sectors, Latvia's overall export structure still shows a significant proportion of low-complexity products.[25] **Lithuania's heavy reliance on energy imports** continues to make it sensitive to global price changes, while Estonia benefits from a more diversified energy mix to support its export activities.

2021 -2023 has proven to be yet another difficult period for the Baltic states. Lithuania and Latvia lost around 7% export market share while Estonia had a brutal reduction of 23% in just two years.[26] Interestingly the majority of the contraction in Lithuania and Latvia is attributed to developments in trading partners and sanctions on Russia and Belarus. The significant loss of export market share in Estonia on the other hand is attributable to **lost competitiveness**.

Figure 43
Contribution to Export Share Decline in Goods 2021Q3 - 2023Q4 (Percentage Points)

Source: IMF



Export share contraction of -23% in Estonia due to lost competitiveness

This is clearly picked up in the IMD **Competitiveness rating** which saw **Estonia dropping** from 22nd place in 2022 to 33rd in 2024. **Lithuania in 30th** and Latvia in 45th are on a positive trajectory.[27] Besides general economic performance, the declining Estonian competitiveness ranking was significantly influenced by a **loss in government efficiency** (public finance and Institutional framework). This just shows how quickly governance frameworks can erode with significant macroeconomic effects.

Competitiveness story

Estonia is recognized for having the **most flexible labor market** among the three Baltic nations, facilitated by early reforms enacted after the global financial crisis (2009-2010). These reforms have resulted in a labor market characterized by lower employment

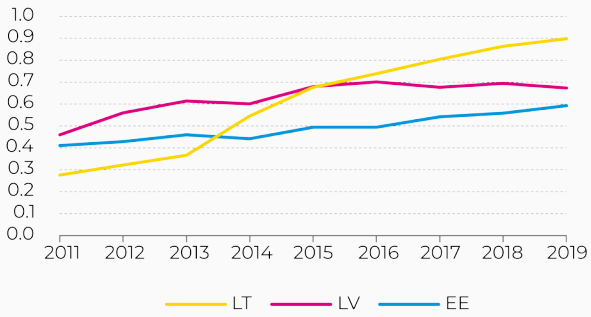
[23] OECD. 2024. OECD Economic Surveys: Estonia 2024. https://doi.org/10.1787/33e6beee-en
[24] IMF. 2023A. Republic of Latvia 2023 Article IV Consultation. IMF Country Report No. 23/330. https://doi.org/10.5089/9798400255212.002
[25] OECD. 2024. OECD Economic Surveys: Latvia 2024. https://doi.org/10.1787/dfeae75b-en
[26] IMF. 2024. Republic of Lithuania: Selected Issues. IMF Country Report No. 24/243. https://www.imf.org/en/Publications/CR/Issues/2024/07/23/Republic-of-Lithuania-Selected-Issues-552407
[27] IMD. 2024. World Competitiveness Ranking: Comparison. https://www.imd.org/centers/wcc/world-competitiveness-center/rankings/world-competitiveness-ranking/compare-results/

protection legislation and a greater responsiveness of wages to market conditions. Conversely, **Latvia has some of the strictest labor market regulations in Europe**, which hampers wage adjustments and flexibility, thereby limiting its competitive edge.[28] Lithuania occupies a middle ground, having improved its labor market conditions following significant reforms in 2017-2018, allowing for better alignment of wages and productivity compared to Latvia.[29]

Productivity levels have evolved differently across the Baltic states. **Estonia** consistently **outperforms** its neighbors in terms of **labor productivity**, benefiting from a strong emphasis on technology and innovation, particularly in the information and communication sectors.[30] Conversely, **Latvia has lagged in productivity growth**, which has not kept pace with wage increases, thus eroding competitiveness.[31] **Lithuania's productivity** trajectory is more favorable; while real wages have risen, they have been generally in line with productivity increases, indicating a sustainable growth pattern.[32]

Figure 44
Enterprises in Knowledge-Intensive High-Tech Services 2011-2019 (% of EU)

Source: IMF



Phenomenal 32% increase in Lithuania's export share in services.

In terms of export dynamics, each Baltic state has carved out distinct niches. **Lithuania** has made significant gains in exports of services, achieving a **phenomenal 32% increase in export share primarily in high-value sectors such as financial services**.[33] The share of manufacturing in terms of gross value added is highest in Lithuania while the share of high technology exports is highest in Estonia. But Latvia has recently made significant improvements both in terms of share of manufacturing and share of high technology exports. Latvia's GVC participation, however, remains lower compared to its Baltic counterparts, impacting its competitiveness signal.[34]

Something strange happened in Lithuania over the last two years. **Lithuania experienced a terms of trade shock resulting in the largest current account deficit since the global financial crisis**. But Lithuania's loss of export market share over the last two years was smaller than in Latvia and Estonia, despite facing worse terms-of-trade shock.

Previous studies report that **Latvia has exhibited a more pronounced reliance on**

[28] IMF. 2014. Baltic Cluster Report: Staff Report for the 2014 Cluster Consultation. IMF Country Report No. 14/116. https://doi.org/10.5089/9781484377741.002; IMF. 2023A. *Op. cit.*
[29] IMF. 2023B. Republic of Lithuania: Staff Report for 2023 Article IV Consultation. IMF Country Report No. 23/316. https://doi.org/10.5089/9798400254048.002
[30] IMF. 2024. *Op. cit.*
[31] IMF. 2019B. Republic of Latvia: Selected Issues. IMF Country Report No. 19/265. https://doi.org/10.5089/9781513510057.002; IMF. 2023A. *Op. cit.*
[32] IMF. 2023B. *Op. cit.*
[33] IMF. 2024. *Op. cit.*
[34] IMF. 2019B. *Op. cit.*

Figure 45
Gross Value Added in Manufacturing 1996-2023 (% of GDP)

Source: IMF

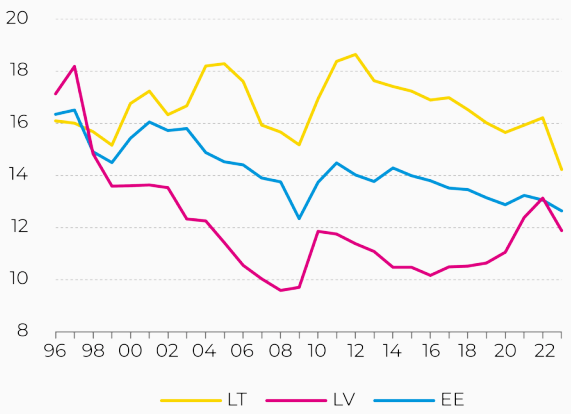
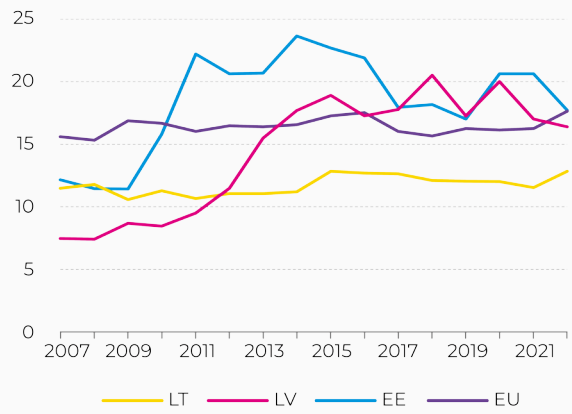


Figure 46
High-Technology Exports 2007-2022 (% of Manufactured Exports)

Source: IMF

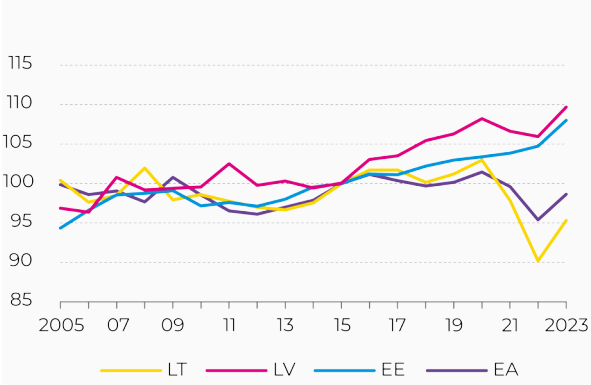


labor force participation post-crisis, while its **total factor productivity (TFP) growth has lagged** behind both Estonia's and Lithuania's. Estonia, although initially suffering from a steep decline in GDP, demonstrated a faster recovery with relatively stable contributions from TFP and capital accumulation, emphasizing its effective resource allocation and utilization. An IMF report that delves into productivity growth, investment recovery, and TFP within the Baltics suggests that prior to the global financial crisis, TFP and capital accumulation significantly contributed to GDP growth. However, in the aftermath of the crisis, the recovery in investment was slower in Latvia compared to Estonia and Lithuania, leading to disparities in productivity growth.[35]

While **Estonia** has shown consistent **resilience in TFP growth** through technological improvements and efficient resource allocation, Latvia has lagged significantly. This is attributed to lower investment levels and weaker productivity gains. Lithuania managed to maintain a balanced approach, recovering faster than Latvia, thanks to its diversified economic structure and improved labor productivity.[36]

Figure 47
Terms of Trade 2005-2023 (Index, 2015=100)

Source: IMF



[35] IMF. 2014. *Op. cit.*
[36] Purfield, C. and Rosenberg, C.B. 2010. Op. cit.; IMF. 2019B. *Op. cit.*

2. WHERE HAS THE GROWTH COME FROM?

Growth accounting

To assist policymakers in understanding the dynamics of economic growth in the Baltic nations, we conducted a growth accounting analysis for Lithuania, Latvia, and Estonia. Our methodology, based on the approach developed by the economists at the Bank of Lithuania[37], examines how different factors—capital accumulation, labor force participation, and total factor productivity (TFP)—have contributed to GDP growth since the 2008 global financial crisis. This framework is essential for assessing how efficiently various input factors convert into economic output and provides valuable insights into the performance of these economies.

Lithuania has achieved the highest average real GDP growth rate per capita during this period, with a rate of 5.15%, compared to 4.73% for Latvia and 3.79% for Estonia. While these differences may seem modest at first glance, the compounding effects over several years lead to significant disparities in overall GDP growth, particularly favoring Lithuania.

Delving deeper, we decompose the sources of growth into components attributable to employment rates, labor force participation, capital per capita, and TFP. Notably, the analysis reveals that TFP has had the most substantial positive impact on economic growth in Lithuania, whereas capital per capita contributed the least to growth in Latvia. Labor market factors exhibited minimal variation among the countries.

We also calculated the GDP growth rate differentials relative to average growth across the Baltic states, yielding values of + 0.59% for Lithuania, + 0.18% for Latvia, and - 0.77% for Estonia. This analysis illustrates that TFP has been the critical driver behind the growth disparities between these nations. Specifically, TFP contributed 0.54% to growth in Lithuania, 0.41% in Latvia, and - 0.95% in Estonia. Consequently, nearly 1.5 percentage points of the growth rate differential between Estonia and Lithuania can be attributed to the varying effects of TFP.

The growth accounting decomposition reveals notable differences in the contributions of capital, labor, and TFP to GDP growth among Lithuania, Latvia, and Estonia in the wake of the financial crisis. For instance, in **Lithuania, TFP accounted for a substantial portion of GDP growth before the crisis**, contributing approximately 4.15 percentage points during the period of 1998-2008. However, post-crisis TFP growth in Lithuania has noticeably slowed, averaging around 2 percentage points during 2010-2018. In this same period, **improved labor force participation** rates emerged as a significant driver of growth, contributing around one-third of GDP growth.[38] Finally, throughout the analysis period the contribution of capital to economic growth has been consistent showing the **importance of capital accumulation in Lithuania** as the core driving force of economic growth. Even during the GFC, capital contributed as a balancing factor counteracting a significant deterioration of labor and TFP.[39]

[37] Comunale, M. et. al. 2019. *Op. cit.*
[38] OECD. 2016. OECD Economic Surveys: Lithuania 2016: Economic Assessment. https://doi.org/10.1787/eco_surveys-ltu-2016-en
[39] IMF. 2024. *Op. cit.*

Figure 48
Decomposition of The Growth of GDP Per Capita 2004-2023 (%)

Source: Author's calculations

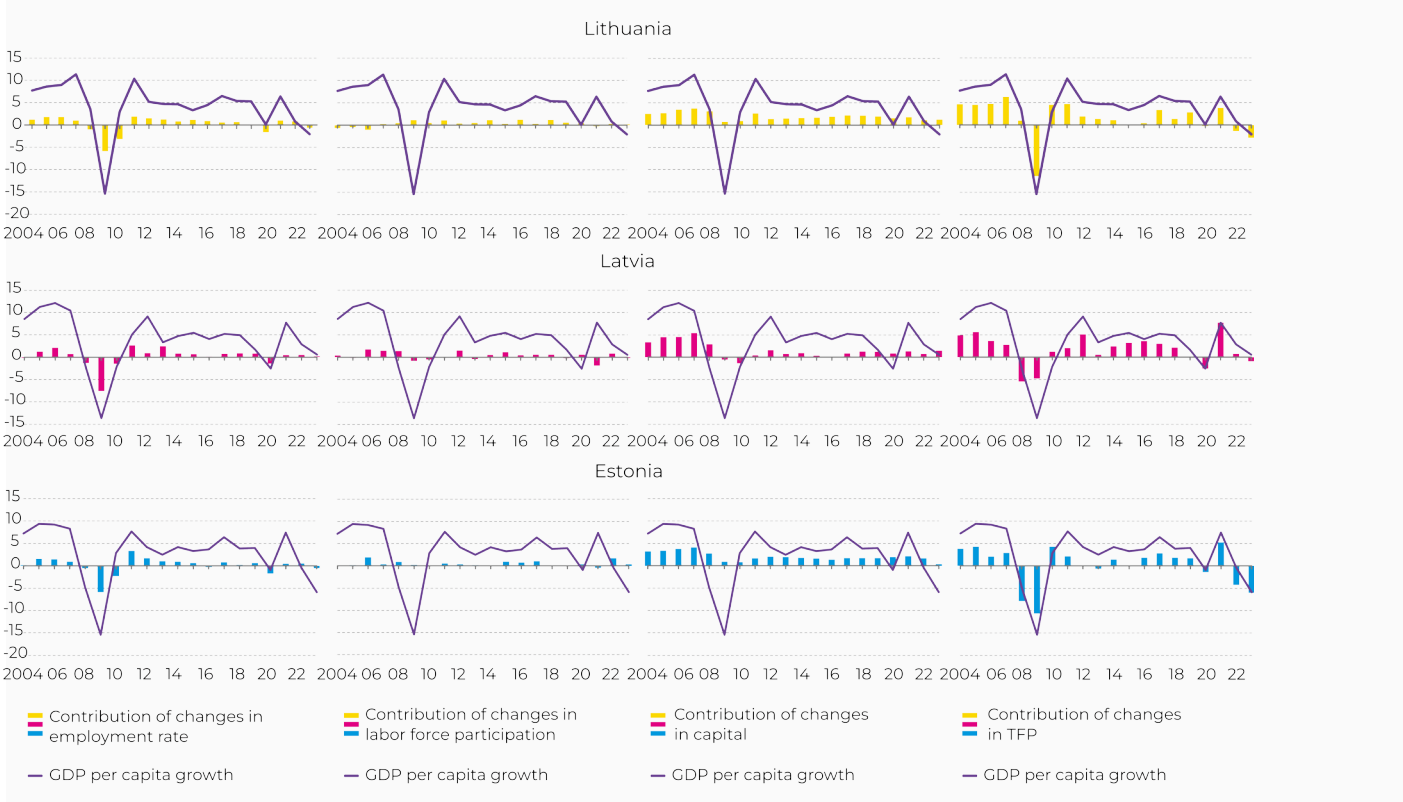
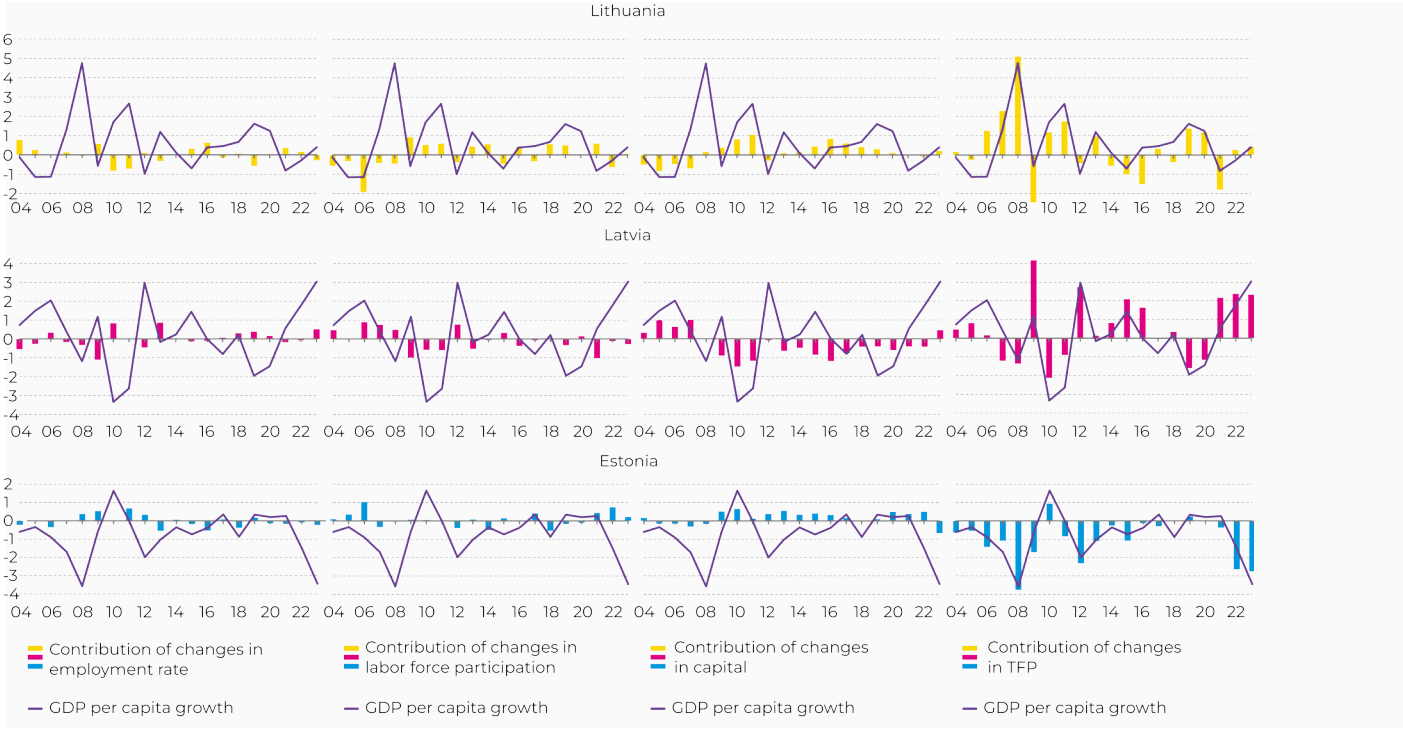


Figure 49
Decomposition of The Difference Between The Growth of GDP Per Capita in Each Country Relative to The Corresponding Average of The Three Baltic Countries 2004-2023 (%)

Source: Author's calculations



Sectoral decomposition

If we compare the three Baltic states in terms of distribution of **value added created across various economic sectors**, it is very difficult to see any significant differences. These are in fact very similar economies. The key difference is the **significance of the transportation sector in Lithuania** (24.6% of total value added) and which is captured under "Wholesale and retail trade, transport, accommodation and food service activities". This is in comparison to 18.0% and 17.3% in Latvia and Estonia. Interestingly, the importance of **agriculture is the highest in Latvia** contributing 4.2% of value added while in Estonia and Lithuania agriculture contributes 2.2% and 2.9% respectively. Real estate added value (5%) in Lithuania is twice less important compared to Latvia and Estonia (10% and 9% respectively).

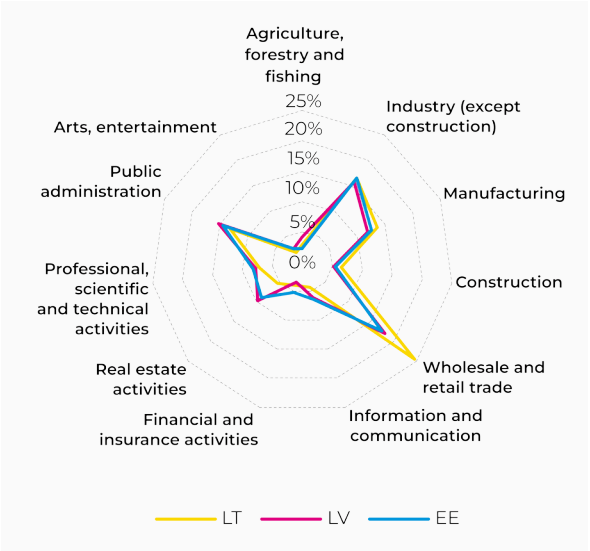
So where is the main story of growth? If we look at the change in the value added by sector we can see a **glaring outlier in Lithuania** in terms of the growth of value added in the **financial and insurance activities** (+358% from 2014 to 2023), **information and communication** (+213%) and **Professional, scientific and technical activities & administrative and support service activities** (+166%). In line with the Global innovation index finding (discussed below) Latvia stands out in terms of creative goods and services.

If we zoom into the four sectors that differentiate the three economies (**finance, IT, professional services and agriculture**) we can find interesting dynamics in terms of the **number of employees**. Between 2014 and 2023 Lithuania saw a significant reduction in terms of employees working in the agriculture sector, a trend also observed in the EU, but not shared with Estonia or Latvia. Lithuania also saw a break in trend growth of the employees in IT and related sectors, clearly breaking away from the rest of the Baltic states. And finally, we see a significant increase in employment in the finance and insurance sector in Lithuania starting in 2019.

The story of the transformation of the agriculture sector requires a separate study but it is a very vivid example of how **transformative policies can lead to major improvements in productivity unleashing potential growth and supply of labor for the other sectors of the economy**.

Figure 50
Gross Value Added by Sector in 2023 (%)

Source: Eurostat

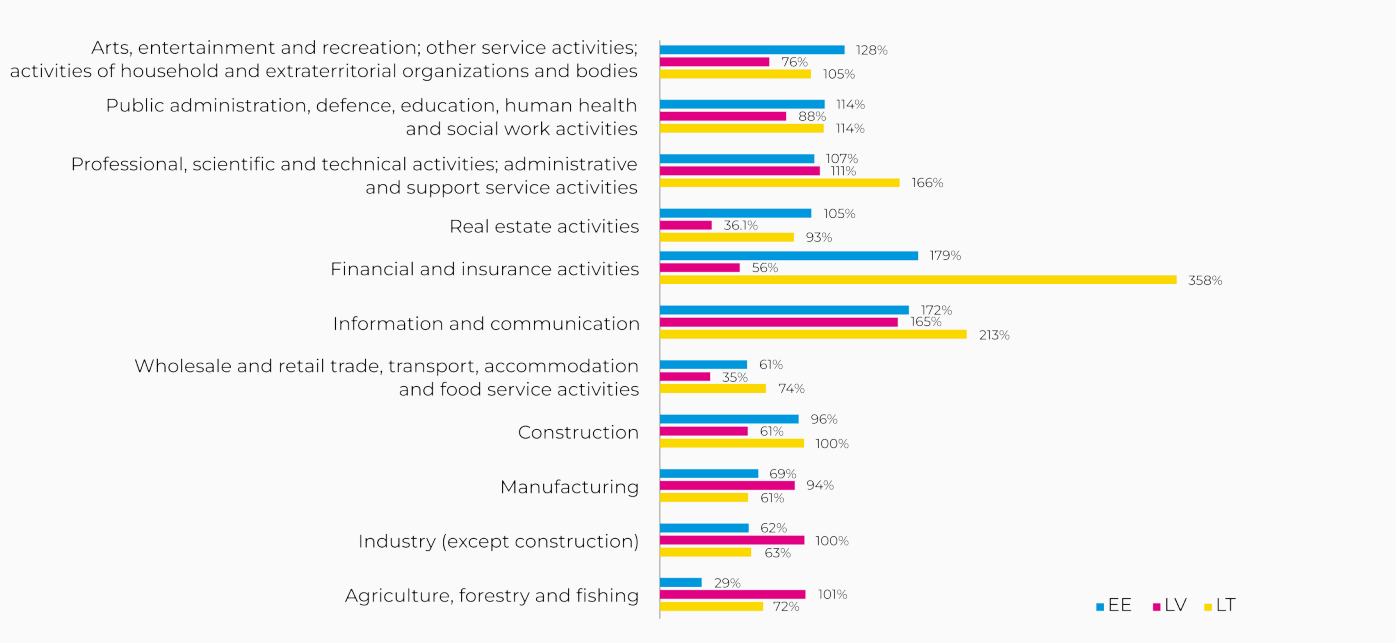


Lithuania had implemented a clear strategy to grow high value added economic sectors and IT was one of them. It can be viewed as a coincidence but enabled by a clear policy to **attract significant numbers of IT related businesses from Ukraine and Belarus**, something that was not viewed favorably in Estonia and Latvia due to different attitudes to Russian speaking minorities.

Part of the growth of the IT sector, as well as professional services, relates to the phenomenal growth in the finance and insurance sector. It is hard to pinpoint this, but it is clear that the majority of growth is attributed to the **fintech initiative of Lithuania** that generated a completely new economic sector with positive side effects on other related sectors of economy.

Figure 51
Change in Gross Value Added by Sector 2014-2023 (%)

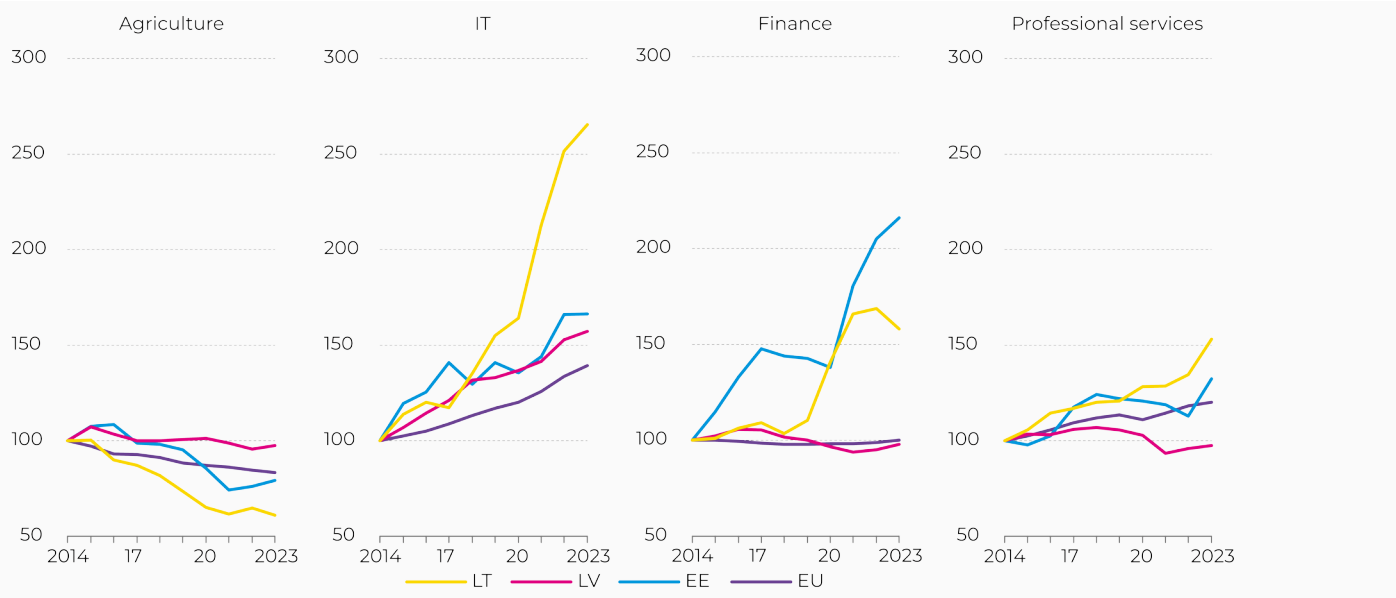
Source: Eurostat



358% growth of value added in financial services in Lithuania.

Figure 52
Employment by Sector 2014-2023 (Index, 2014=100)

Source: Eurostat



Phenomenal labor force shift in Lithuania
from agriculture to IT, fintech and professional services.

3. GOOD LUCK OR GOOD POLICY?

Possible explanations of the Lithuanian economic miracle

There has been a clear consistency in Lithuanian strategic objectives, regardless of the stability of the political system. **Failure to adopt euro** at the first go in 2007 mobilized public and private sector decision makers and provided a clear national agenda. One of the key arguments for not admitting Lithuania was a lack of competitiveness that would derail economic transformation in Lithuania if there was premature access to the single currency area.

Lithuania's **strategic objectives** have been driven by closer **cohesion to the European Union**. **National security and economic independence** (also energy independence) have set the policy agenda, providing clarity, but at the same time producing unintuitive results such as the confrontation with China and Taiwan.

Balancing between the welfare state and the free market economy was not implemented via swings from the right to the left and vice versa, but by moderation of policies. Examples include labor market reform that was implemented under the left leaning government, while significant discussions and improvements in human rights were led by the conservative government. Having said this, Lithuania is still behind Latvia in terms of the rights of same sex couples, a very sensitive domestic political issue.

Failure to join the eurozone exposed Lithuania to a possible devaluation that would have hit hard the domestic interests exposed to foreign-exchange risks due to the prevalent use of euro denominated credit. Hard decisions to adopt **internal devaluation** policies led to significant social costs, emigration and economic hardship. However, there is evidence that economic contraction in Lithuania post GFC period was the smallest across the Baltic states. Restoration of competitiveness led to faster economic recovery.

Commentators point out that Lithuania benefited from REER undervaluation before the Covid-19 pandemic and thus attribute at least part of the successful economic outcome to mere coincidence. But **economic interventions during the pandemic** proved to be more targeted and effective providing better outcomes and creating automatic stabilizers that switched off support faster compared to blanket policies introduced in other countries.

The shocking experience of fiscal imbalances that led to pensions and other budgetary cuts (now deemed unconstitutional) left a clear mark in the psyche of the Lithuanian population and more importantly the decision makers. There was little resistance to implement the straight jacket of **fiscal sustainability rules** under the leadership of EU.

At the private sector level Lithuanian firms as well as households did not reach a high level of indebtedness compared to their counterparts in Estonia and Latvia which gave support to **macroprudential policies** even before the adoption of these policies across the EU.

The prevalence of Russian interests in the Lithuanian economy was reduced significantly through a **clean sweep of the banking sector** which later proved to be forward-looking in terms of avoiding the golden cage of the AML trap of East-West money flows.

Somewhat overlooked is the **reform of the credit union sector** with the reintroduction of cooperative banking incentive structures that led to internalization of risks and successful self-governance of the sector via coinsurance scheme. This provided at least some competitive pressure on the banking sector at least in terms of SME access to credit and development of the regions.

A major political corruption scandal led to **higher political transparency standards** as well as a redesign of lobbying and clear limits on peddling various interests through financial support for political parties.

Establishing **Enterprise Lithuania** in 2009 and **Invest Lithuania** in 2010 provided focal points for consolidating various initiatives to promote the internal and external competitiveness of Lithuanian businesses. A clear strategy to attract foreign direct investment proved very important in instilling a change in public sector culture.

The emergence of **shared service centers** was not a random phenomenon but a clear strategic objective implemented via various incentive schemes and economic diplomacy to ensure Lithuania plugged into GVC of tradeable services market.

Fintech came out of nowhere and due to some lucky coincidences and dedication of public sector employees it made a clear mark in the identity of the Lithuanian economy, placing Lithuania on the map and, as discussed above, providing the highest growth in terms of value added over the period.

The annexation of Crimea was a big trigger for Lithuanian trade to reorient its flows and **diversify away from the East**. This proved to be a pivotal point, something that was not appreciated to such an extent in the other Baltic countries who happened to maintain trade relationships for longer.

In line with the trade reorientation a major effort to ensure **energy independence** was set in motion generating big political tensions but proving forward-looking in hindsight. **Reforms of the energy sector**, decoupling production from distribution, provided the basis for higher efficiency in the public sector.

A reform of state owned enterprises (SOEs) reduced their number from 150 in 2010 to 50 in 2020 and proved to be one of the most important interventions introducing higher transparency, governance and accountability standards.

Fast economic growth introduced tensions across income distribution which in combination with macroeconomic shocks after the GFC led to a gaping budget hole in the pension system. **New social model reform** was crafted addressing the majority of recommendations from the OECD, EC, and IMF. This provided yet another stimulus for labor market competitiveness and introduced greater progressiveness in tax system.

Reforming R&D and innovation sector was overdue but has so far failed to lead to significant results and here Lithuania still has a competitive disadvantage.

Education sector reform was on the right track but derailed due to political infighting and a lack of political will to push through with desperately needed restructuring of primary and higher education system. A revised teacher education model failed to lead to better outcomes leading to lower

Figure 53
Profit Share 2013Q4-2023Q4 (Ratio of Gross Operating Surplus to Gross Value Added)

Source: IMF

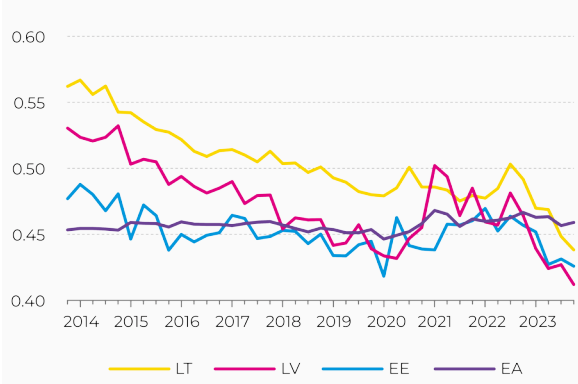
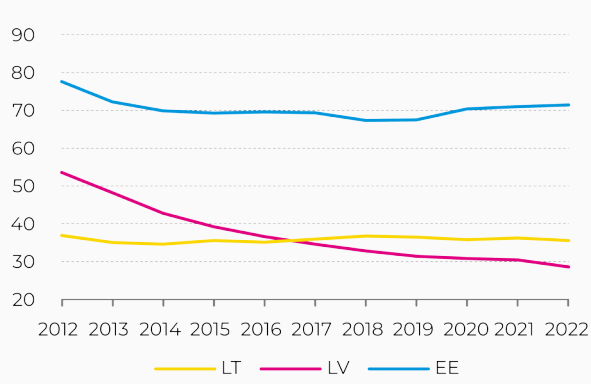


Figure 54
Gross Debt-to-Income Ratio of Households 2012-2022 (%)

Source: Eurostat



quality educational outcomes when compared to our neighbors.

Health care system reform entered the implementation phase in 2023 and has the potential to lead to much needed efficiencies across very inefficient and costly system.

Lithuanian firms have been building up significant retained earnings due to a higher level of profitability while households maintained significantly lower levels of indebtedness. This was a ***lucky combination*** when faced with the various economic shocks of the past decade. Having a pillow always helps but at the expense of efficient allocation of capital. To make arguments for optimality we need to delve into different risk preferences and inherent economic-geopolitical uncertainty that each country faces.

Policy objectives

One way to answer the question of luck versus good policy is to review the policy priorities that countries expressed via monetary allocations towards specific goals and issues. EU cohesion funding allocations provide fertile ground to get a glimpse of how those priorities differ across Lithuania, Latvia and Estonia.

2014-2020 budgets

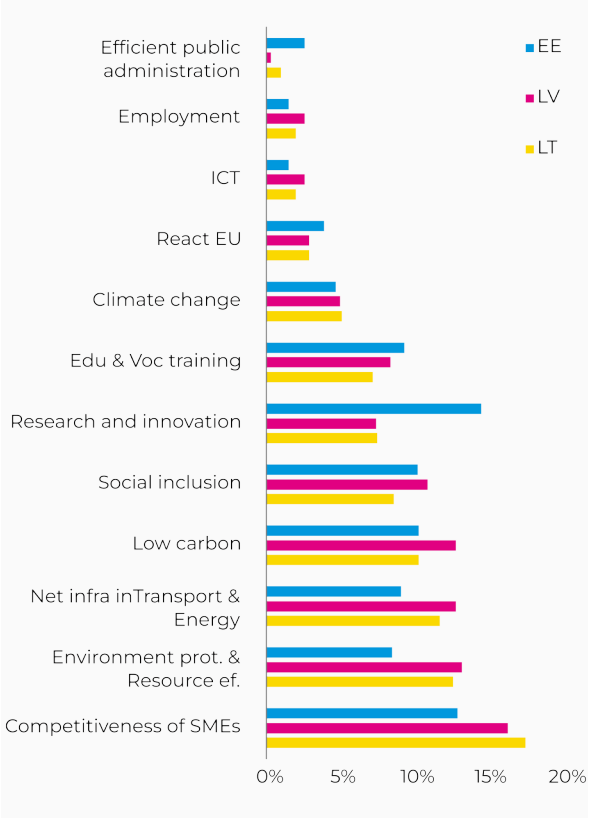
Clear differences in terms of policy priorities are visible in terms of how countries allocated their cohesion and other forms of EU funding. **Estonia stands out with funds allocated to improving the efficiency of public administration** (something that is picked up also in the global innovation index inputs). But the biggest divergence of allocation of funding is in terms of **research and innovation**, where Estonia stands out with more than double the funding allocation for this group of expenditure. Clearly this did not show up in the observed economic dynamics, but it may put Estonia on a better footing going forward.

What is also visible is a clear focus on SME competitiveness in Lithuania. In combination with other SME friendly policies, this could be a potential explanatory factor for observed economic dynamics between the three countries.

Lithuania stands out as the country with the highest skills mismatch and worst outcomes in terms of vocational training. Indeed, Lithuania stands out as the country with the smallest proportion of funding allocated for education and vocational training. Again, something that may be not creating immediate adverse outcomes, but will impact structural differences in terms of long term competitiveness and quality of the labor force.

Figure 55
55 Cohesion Policy EU Financing by Themes 2014-2020 (%)

Source: EU Cohesion open data platform https://cohesiondata.ec.europa.eu/

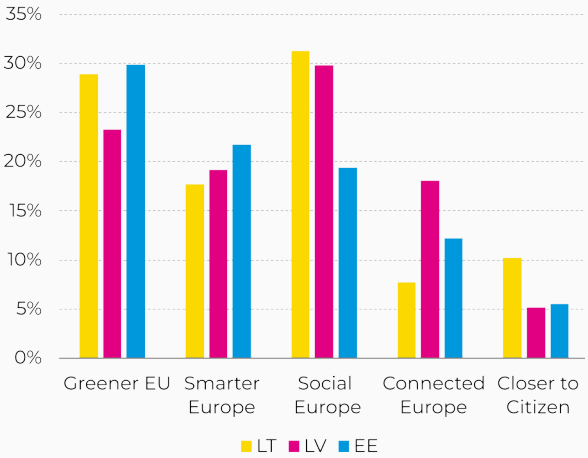


2021-2027 budgetary planning

When looking at the **planned budgetary allocations** for the 2021-2027 period, Lithuania appears more socially oriented. In contrast, Latvia puts emphasis on connectivity (both physical infrastructure as well as connectivity to the single EU market). Consistent with the previous planning period, Estonia allocates resources to "Smarter Europe". Smart as it is, it needs to start paying observable dividends not to lose political support from the broader society.

Figure 56
Policy Objectives of EU Budgets 2021-2027 (%)

Source: EU Cohesion open data platform https://cohesiondata.ec.europa.eu/



Innovation

The **2023 Global innovation index** of WIPO (World Intellectual Property Organization) ranks Lithuania at #34 Latvia at #37 and Estonia at #16. In the 2023 GII, the cumulative value of unicorns is scaled by GDP. After scaling, **five economies tie in first place**, namely, Estonia, Israel, Lithuania, Senegal and the United States.[40]

In terms of weaknesses Lithuania lacks in corporate R&D investments, gross capital formation, and domestic credit to GDP, software spending % of GDP and global brand

Figure 57
R&D Expenditures 2000-2022 (% of GDP)

Source: Eurostat

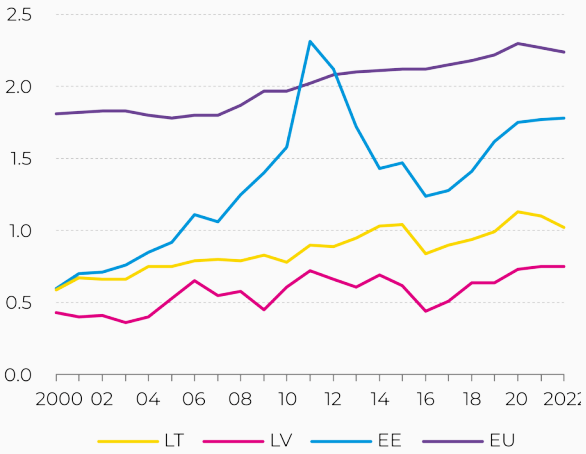
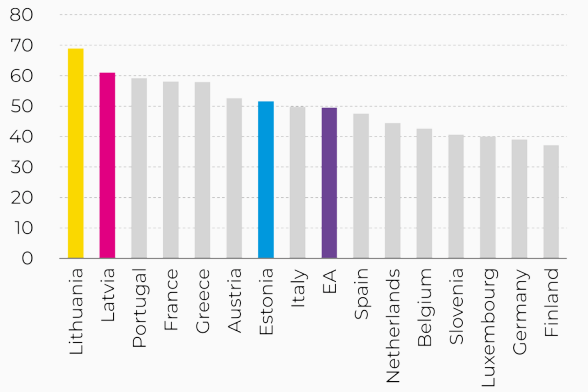


Figure 58
Low-Tech Enterprises in Manufacturing 2015-2019 (Average % of Total Manufacturing)

Source: IMF



[40] WIPO. 2023. Global Innovation Index 2023: Innovation in the face of uncertainty. https://doi.org/10.34667/tind.48220

value. **Lithuania stands out in entrepreneurship culture**, pupil-teacher ratio, and finance for startups and scaleups and FDI net inflows, % GDP, and females employed with advanced degrees (No.1).

Latvia lags in terms of policies for doing business, graduates in science and engineering, corporate R&D investments, domestic credit to GDP, software spending, and global brand value. **Latvia stands** out very strongly in terms of **creative goods and services** (No.1 in the World) and national feature films (No.1).

The key weaknesses of Estonia are domestic market scale, software spending as % GDP and global brand value. But **Estonia is No 1 in** several categories – **ICT services imports % total trade, Government online services, VC investments**.

Between 2015-2019 Lithuania was leading in a negative sense in terms of share of enterprises engaged in so called **low-tech manufacturing**. Low tech manufacturing stood at 70% of all firms compared to the EU average of around 50%. While still below the share of EU high tech manufacturing, Estonia was leading across the Baltic states.

4. EXPERT INTERVIEWS

To source empirical and data-driven insights regarding the divergence of economic indicators between Lithuania and the other Baltic states, we conducted multiple interviews with policymakers, economic commentators, regulators, and business leaders who possess experience in the economic and business environments of both Lithuania and Latvia. Only a minority of respondents were able to provide their perspectives on Estonia as well. The interviews were conducted under Chatham House rules, ensuring that no attribution could be made to individual respondents or the institutions they represent, thereby facilitating open, unfiltered, and candid discussions.

Opinions

One key observation emerging from these discussions was the significant impact of Lithuania's **diversified economic structure**. While Estonia and Latvia showcase strengths concentrated in specific sectors, Lithuania's economy is recognized for its greater variety, which allows for resilience and adaptability in changing economic conditions. One participant remarked, "Our diverse sectors—ranging from fintech to manufacturing—have created a more robust economic framework, enabling us to pivot quickly when needed." This adaptability not only bolsters Lithuania internally but also enhances its appeal to foreign investors. As another respondent succinctly put it, "Investors see a **wider marketplace** here; it's about more than just technology; it's about a balanced mix that **attracts different forms of investment**." Additionally, one respondent emphasized that "Lithuania is becoming a European hub for technology startups," highlighting how strong growth in these areas has attracted significant foreign investment. Another participant remarked, "The range of industries allows us to weather economic fluctuations more effectively," encapsulating the general sentiment that diversification fosters economic stability.

The transitioning economic environment following the 2008 financial crisis has been cited as pivotal in shaping Lithuania's current success narrative. Several participants underscored the importance of **counter-cyclical policies** that were established in the wake of the crisis. One expert highlighted, "The **structural reforms** we enacted after 2008, particularly in the energy sector, were critical in shielding us from future shocks." This proactive stance has been linked to successful strategies aimed at reducing dependency on Russian energy sources, helping to create a **climate of stability** that fosters further investment. "Now we are seen as a reliable partner in Europe, partly due to our **energy independence**," stated another participant, pointing out how these reforms have solidified Lithuania's position in the regional market.

Yet, the interviews revealed a **balance of pride and caution** among respondents. While Lithuania's achievements in recent years were widely acknowledged, numerous individuals highlighted areas where expectations might not be fully met. For instance, some experts expressed sentiments like, "The current numbers may look strong, but let's not forget that they are partly due to **external factors**." This statement reflects a broader concern that while Lithuania's economic indicators are impressive, they do not uniformly reflect progress across all sectors, especially ongoing issues like **income inequality**. As one interviewee pointed out, "We must address our internal disparities before we can claim complete success." This acknowledgment of gaps indicates a recognition of the importance of ensuring that economic growth translates into broad-based benefits for society.

Moreover, several participants vocalized a **common theme regarding Lithuania's leadership** within the Baltic region, with

many asserting that "Lithuania has taken the reins and set the pace for growth." However, they also highlighted the importance of carefully navigating future challenges. As expressed by one participant, "We cannot just rely on good fortune; **systemic issues need addressing to sustain and enhance our competitive edge**." This perspective underscores not only the recognition of achievements but also the necessity of strategic planning and proactive policy-making that both diversifies the economy and adapts to external changes.

While this view was not shared among many, several respondents did not agree that Lithuania was such an economic phenomenon, but rather made arguments for an **"economic phenomenon of Latvia"**, but in a negative sense – that there is nothing exceptional happening in Lithuania, but in the meantime Latvia has shown exceptionally weak performance.

Perception of Divergence

The interviews offered profound insights into the distinct economic trajectories of Lithuania and Latvia. Respondents revealed a range of perceptions anchored in both economic performance and cultural attitudes. A frequent point of discussion was the differing **approaches taken toward EU directives** and economic policies, which many perceived as pivotal distinguishing factors between the two countries. Lithuania is viewed as more proactive and innovative in interpreting and implementing EU guidelines. One participant shared, "Lithuania has a knack for adapting EU guidelines creatively, whereas Latvia tends to stick closely to the original text." This observation underscores how Lithuania's dynamic approach to EU integration has been a foundation for its economic progress, highlighting a stark contrast with Latvia's more cautious stance.

Entrepreneurship and the business environment were also recurring themes in these discussions. It was suggested that Lithuania fosters a more **supportive atmosphere for small and medium enterprises** (SMEs), while Latvia struggles with bureaucratic hurdles that stifle growth. One business leader noted, "In Lithuania, I feel supported by both local and national policies that understand the needs of small businesses," whereas the sentiment regarding Latvia was often that "the bureaucratic landscape can be a minefield for entrepreneurs." The **differences in perceptions regarding governmental support** highlighted a critical divergence in the economic ecosystems of the two countries.

Another divergent theme that emerged, albeit more in comparison with Estonia, was that both Lithuania and Latvia suffer from the poor quality of scientific **research and innovation**. One respondent pointed out the "lack of a link between academia and entrepreneurial activity". Another one commented that the "closed clubs" approach in academia is limiting competition and the quality of education at universities.

The theme of **energy independence** emerged throughout the conversations. Lithuania's successful establishment of an LNG terminal was contrasted with Latvia's ongoing reliance on Russian energy sources. Observations indicated a significant **difference in public opinion towards renewable energy** initiatives, with a consensus leading to the conclusion that "Latvia has been notably resistant to embracing renewables." This resistance stands in sharp contrast to the more favorable public sentiment towards renewable projects in Lithuania, suggesting a divergence in long-term strategic thinking.

Lithuania's approach to public finances and **EU funding management** was generally praised. Interviewees frequently commended the effective organization and transparency in utilizing EU funds. One participant remarked, "Lithuania's **centralized management system** has been a game-changer; it has led to a more coherent and effective allocation of resources." This contrasts sharply with criticisms directed at Latvia's comparatively decentralized management of EU funds, which was described as inefficient and prone to leading to "ineffective reconstruction projects that lack long-term strategic foresight."

Cultural aspects have also played a role in observed divergences. Some interviewees indicated that Latvia's strong focus on

preserving national identity might be impeding necessary reforms. As one pointed out, “Latvians are careful and plan long into the future," suggesting that this cautious approach may create challenges when rapid change is required to adapt to economic realities. Such insights underscore the cultural narratives that influence the pace of reform and adaptability within each country.

Business Culture

The interviews revealed several insights regarding cultural differences in work ethics and managerial styles across Lithuania, Latvia, and Estonia. A frequent observation was that **Lithuanian managers** exhibit a more results-driven approach compared to their Latvian counterparts. Comments included statements like, “We seem **aggressive** to Latvians because we have clear points on what we will do and by when; to them, that is unacceptable.” This captures a broader cultural inclination in Lithuania towards assertiveness and clarity of objectives, distinctly contrasting with the more deliberative style observed in Latvia.

Furthermore, significant distinctions in **managerial ambition** and responsiveness to change became apparent. Participants noted that Lithuanian professionals tend to embrace change and rapid decision-making. In contrast, Latvians displayed a more cautious demeanor, with one participant noting that “Latvians have much fewer ambitions and less concern for results,” suggesting that the introduction of Lithuanian managers tends to accelerate progress. This cultural underpinning suggests a prioritization of efficiency and quick adaptation in Lithuania.

In comparison, Estonian managers are characterized by their organization and methodical approaches, often influenced by Finnish management practices. However, a sentiment that resonated among interviewees is that Estonian managers may focus on maintaining existing systems rather than pursuing transformative changes. One comment illustrated this tendency: “Everything is going well, so there’s little need for change,” indicating a perception of a stable but potentially stagnant environment.

Estonian management practices generally score around the average for high-performing work practices, reflecting a reasonable level of organizational efficiency. In contrast, Lithuania's rising success in sectors like fintech can be attributed to effective management combined with a **proactive approach to innovation and entrepreneurship**, characteristics that seem less pronounced in Latvia and Estonia.

This disparity in work ethics and managerial styles reflects deeper business culture narratives in each Baltic state: Lithuania’s drive for results, Latvia’s deliberative process focus, and Estonia’s structured organization shape how firms operate and compete in the region. Understanding these cultural variables is crucial for businesses operating across these nations, highlighting the necessity for tailored management approaches that respect and leverage these differences.

Political Stability

Perceptions of political stability also surfaced, with interviewees frequently regarding **Lithuania's political landscape as a comparative strength**. Participants suggested that Lithuania has maintained significant consistency and resilience, remarking, "Those who come into power do not change what is already established." In contrast, the instability experienced in Latvia has been more pronounced, especially in light of governmental coalitions and ethnic tensions affecting political discourse.

Estonia, while exhibiting strong democratic institutions, faces challenges related to **political polarization**, particularly after the rise of the far-right Conservative People's Party (EKRE). Overall, the sentiment among interviewees is that, while all three Baltic states have made strides since independence, unique circumstances continue to shape their trajectories. **Lithuania's relatively sta-**

ble political environment is viewed as a positive factor in fostering economic growth, while Latvia and Estonia illustrate the complexities of navigating political dynamics amid societal divisions and emerging populist sentiments.

Ignorance is Bliss

A notable theme from the interviews was the **apparent ignorance** displayed by many respondents about the political and economic conditions prevailing in the other Baltic states. Many Lithuanian interviewees (with decision making roles at critical policy institutions) demonstrated a limited understanding of the specific challenges faced by Latvia and Estonia, often focusing primarily on Lithuania's achievements. This lack of awareness suggests missed opportunities for cross-regional learning and collaboration.

Comments such as, "We are clearly leading in innovation and reforms," reflect a tendency to overlook the nuanced socio-political challenges that Latvia grapples with or the advanced digital governance models associated with Estonia. One informed respondent pointed to a widely accepted belief at a prominent economic policy institution in Estonia that “Lithuanians have been cooking numbers for some time,” suggesting **skepticism toward Lithuania's reported successes**. Such perceptions highlight the shallow understanding of economic drivers among the Baltic states.

Moreover, several business leaders pointed to **corruption levels as a distinctive factor**, despite data indicating similar levels of perceived corruption in Lithuania and Latvia. This suggests that perceptions do not always align with statistical realities, emphasizing the need for greater knowledge exchange and understanding within the region.

Many **responses often lacked critical analysis** on broader issues that various public institutional reports, such as those from the IMF, OECD, and the European Commission, commonly highlight when evaluating the economic situations of the Baltic states.

One significant observation from these reports is the emphasis on **income inequality** and **demographic challenges**, which were notably absent in the interview responses. While many interview participants acknowledged economic growth in Lithuania, with several exceptions they frequently overlooked the issues surrounding high levels of income inequality and regional disparities within the country. Reports indicate that Lithuania has one of the highest Gini coefficients in the EU, reflecting significant income disparities that concern long-term economic stability and growth.

Another critical element emphasized in professional reports was the **need for structural reforms in** key areas such as **education and healthcare**. The interviews highlighted general satisfaction with economic policies but did not sufficiently address (with one exception) the ongoing need for educational enhancements to match labor market demands, which is noted as a significant barrier to improving productivity and economic resilience. The IMF and OECD stress that demographic changes and a shrinking workforce present challenges that must be proactively addressed through education and training programs. But such issues as the abysmal track record of Lithuania in terms of vocational training (at the bottom of EU)[41] were never brought up.

Perception is reality

Overall, the insights gathered from these interviews underscore a complex interplay of perceptions that articulate the economic and political landscapes of Lithuania and Latvia. Key themes of **proactive policy-making, an entrepreneurial environment, energy independence, and political stability** emerged as defining characteristics of Lithuania's growth story. Meanwhile, the **cultural attitudes that shape business**

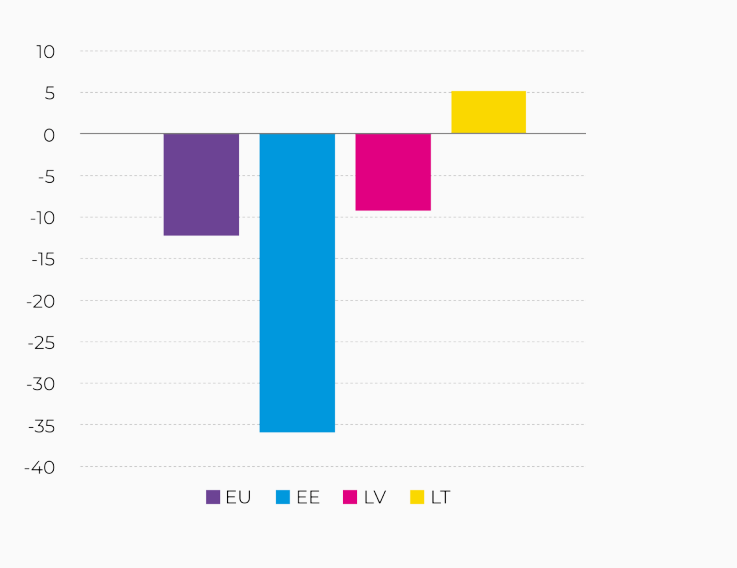
[41] Based on reports provided by European Centre for the Development of Vocational training https://www.cedefop.europa.eu/

behaviors and responses to change provide vital context for understanding the divergences seen within the Baltic region. Addressing gaps in knowledge and fostering collaborative opportunities can further enhance economic resilience and shared growth among the Baltic states as they navigate their distinct yet interconnected trajectories.

To conclude, in the world of marketing, communications, and politics, reality matters less than people's perceptions of it. This definitely extends to "comparing" such complex and multifaceted subjects as countries that are not only unique with complex histories but are morphing over time along unique development paths. Therefore, ensuring all the necessary due diligence is conducted and grinding through all economic indicators will be meaningless without taking into consideration and maybe even focusing on ... the perceptions. Because, as the famous American political strategist Lee Atwater said "perception is reality". And what is the main perception of Lithuania's economic status quo "as one number"? Consumer confidence number seems like a good measure and it speaks volumes for the **perceived economic phenomenon of Lithuania**.

Figure 59
Consumer Confidence in August 2024

Source: Eurostat



CONCLUSIONS AND RECOMMENDATIONS

Policy recommendations for Latvia

In light of this analysis, several key recommendations emerge that center around three fundamental principles: **thoughtful policies, a strategic vision, and adaptability**.

To begin with, implementing **THOUGHTFUL POLICIES** is essential for stabilizing Latvia's economy in the face of inflationary pressures. Adopting a tighter fiscal stance can help maintain public finance stability. The International Monetary Fund (IMF) advocates for flexible fiscal policies while gradually tightening expenditures to align with an overall neutral stance. This approach closely mirrors Lithuania's recent commitment to fiscal discipline, which has bolstered its economic resilience. Latvia can benefit from refining its energy support mechanisms to better target vulnerable households and sectors, thereby reducing unnecessary fiscal deficits while addressing pressing social needs.

Next, Latvia must develop a **STRATEGIC VISION** that emphasizes enhancing public investment for long-term growth. The Organization for Economic Cooperation and Development (OECD) has highlighted the significance of smart public investments, especially in the areas of green and digital transitions. By capitalizing on the EU Recovery and Resilience Facility funds, Latvia can invest in infrastructure projects that not only promote economic stability but also attract foreign investors. Following Lithuania's example in prioritizing digital infrastructure, fintech and renewable energy investments can create a favorable business environment, positioning Latvia to meet future challenges.

ADAPTABILITY within structural reforms is crucial in addressing Latvia's productivity challenges and skills shortages. A thorough **reevaluation of education and training systems** is needed to ensure alignment with labor market demands, particularly in the STEM fields. This strategy reflects Lithuania's ongoing efforts to enhance vocational education and strengthen partnerships between schools and industries, thereby fostering a more flexible and skilled workforce. Additionally, **integrating entrepreneurship education into academic programs** can cultivate a culture of innovation and business acumen from an early age, preparing future generations for an evolving economic landscape.

Moreover, it is important for Latvia to embrace a **contemporary national identity** that acknowledges its history while fostering innovation and adaptability. By looking beyond immediate neighbors for trade and investment opportunities, Latvia can mitigate risks related to regional economic fluctuations and bolster its economic resilience.

Improving the business environment through **regulatory reforms focused on small and medium-sized enterprises (SMEs)** is essential for cultivating entrepreneurship and innovation. **Reducing regulatory burdens and enhancing access to finance for SMEs are decisive steps** that Latvia can implement to promote economic diversification and withstand external shocks. By adopting policies similar to those in Lithuania, which provide financial support to startups and SMEs, Latvia can further encourage innovative initiatives that drive economic growth.

A strong focus on **long-term planning** is crucial for aligning national objectives. Establishing clear strategic goals within a comprehensive framework that integrates economic, social, and environmental considerations will enable Latvia to create a cohesive vision for development that resonates with its citizens.

Finally, enhancing energy security through the promotion of renewable energy sources

remains a critical strategic objective. The OECD emphasizes improving investment and permitting processes for renewable projects to ensure a transition toward a sustainable and resilient energy framework. Lithuania's significant progress in increasing its renewable energy share serves as a valuable example for Latvia, which can leverage similar efforts to achieve greater energy independence and stability.

Conclusion

Lithuania’s success is rooted in a combination of thoughtful policies, a strategic vision, and the capacity for adaptability.

As we synthesize insights from this analysis, it is clear that Lithuania’s success is rooted in a combination of thoughtful policies, a strategic vision, and the capacity for adaptability. These elements have allowed Lithuania to navigate economic challenges effectively and emerge stronger, thereby providing valuable lessons for its Baltic neighbors.

Foremost, fostering an entrepreneurial spirit in education must be a priority. By instilling innovation and business acumen in the youth, Latvia can cultivate a workforce that is well-equipped to thrive amidst change. Additionally, while cultural heritage is important, it is vital to adopt a forward-looking perspective that prioritizes innovation over nostalgia. Expanding economic partnerships beyond immediate neighbors will further diversify opportunities and strengthen resilience.

The necessity for long-term planning cannot be overstated. It is the framework that unifies national objectives and guides future development. Historically, a lack of cohesive strategy has hindered growth; thus, adopting a comprehensive policymaking approach is crucial.

In summary, while good fortune has played a role in Lithuania's success, it is a combination of thoughtful policies, strategic vision, and a willingness to adapt that truly defines its economic miracle. This narrative serves as an important reminder to Latvia—as well as other nations aspiring for growth—that while luck may be a fleeting companion, **good policy and smart governance are the true engines of sustained economic success**.

AUTHOR

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brings over 15 years of expertise in central banking, financial supervision, and innovation. He previously served as a board member at the Bank of Lithuania, chaired the BIS Innovation Network's CBDC working group, and was a member of the ECB Digital Euro High-Level Task Force. Marius has also held positions at Norges Bank (the Central Bank of Norway) and the Bank of England. He is a Professor of Partnership at Vilnius University and was recently elected to its Council. Additionally, he serves as the Chair of the Science and Studies Committee of the Lithuanian Research Council. Recognized as a prominent global voice in fintech, institutional finance, decentralized finance (DeFi), digital currencies, and financial infrastructure, Marius is currently the Co-Founder and CEO of Axiology, a capital market infrastructure platform operating under the EU DLT Pilot Regime Regulation.

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