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Reindustrialising Europe

Member States' Competitiveness Report 2014

3.13 Cyprus

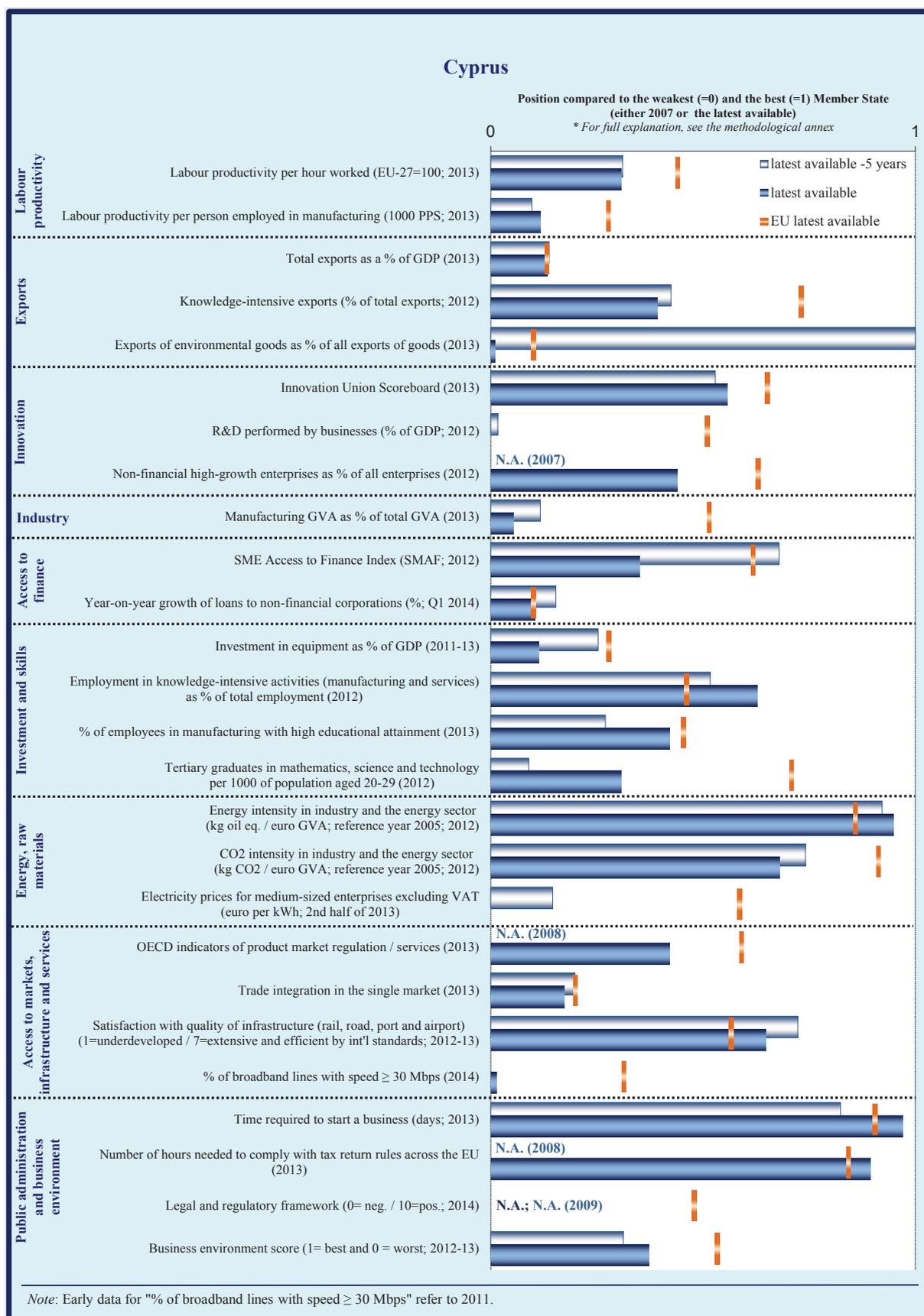
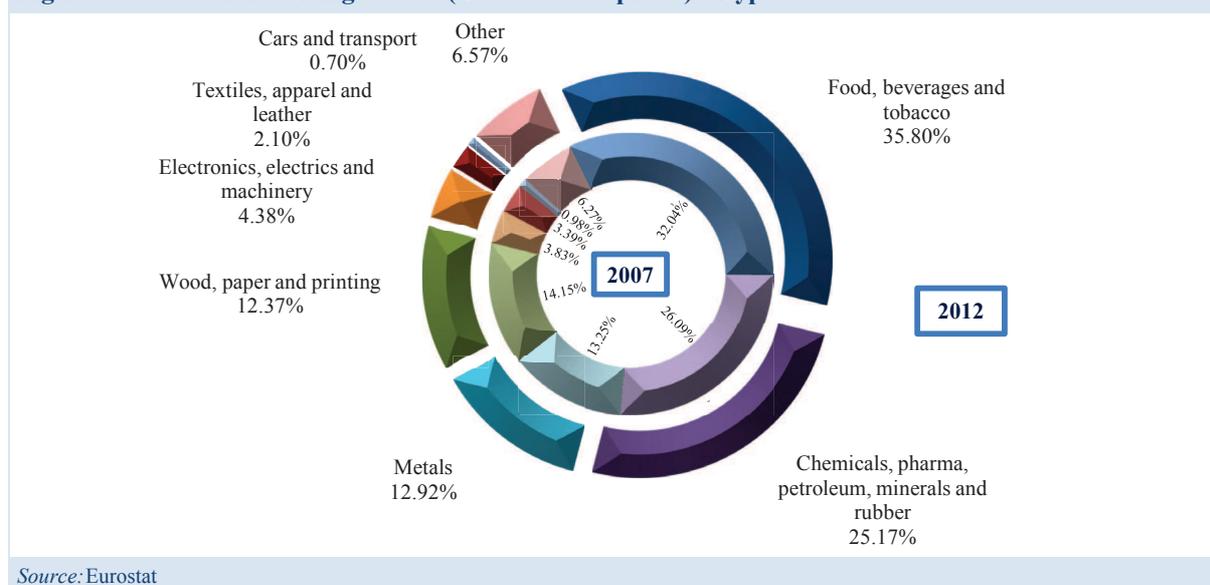


Figure 3.13.1: Manufacturing sectors (GVA at basic prices) - Cyprus

3.13.1 Introduction and performance

Economic performance and policy developments in Cyprus evolved in the context of the adjustment economic programme agreed in April 2013⁽³³⁴⁾ with the European Commission, the European Central Bank and the International Monetary Fund. While the recession is bottoming out real GDP has contracted by an estimated 5 % in 2013, though this result was better than expected. In the first five months of 2014, the index of industrial production averaged 68.3 (base 2010=100), with a further decrease of 3 % in comparison with the corresponding period of 2013. In manufacturing, the index for May 2014 reached 75,4 units, recording a decrease of 2,1% compared to May 2013.

However, corporate profits in manufacturing and in the more tourist-oriented industries have been holding up quite well. In particular, in manufacturing, this reflects a sharp decline in labour costs, to which the suspension of the application of a cost of living allowance contributed. According to Eurostat, Cyprus saw a decline in its nominal hourly labour costs of 6.5 per cent in Q4 2013 (industry -4.6 %), the sharpest adjustment in the Eurozone. Even business sentiment and consumer confidence indicators are on the rise.

Nevertheless, tight credit conditions, fiscal consolidation measures and weakening private

demand are among the factors that weigh on the economy.

3.13.2 Access to finance and investment

While the stabilisation of the banking sector is following its course, access to finance remains limited. This is mainly because of the high rate of non-performing loans (at 41.7 % and 47.5 % for banks and the cooperative sector respectively).

In the meantime, Cyprus managed to re-open current accounts, removing completely internal capital controls. In fact before this action, a newly opened account with cash could only be used as term deposit. Transfers to and from these accounts were not permitted, while the capacity to put money on them was also constrained by the banks' policy to impose cash withdrawal restrictions. Thus, payments within Cyprus are again totally free and only the cross-border capital controls remain in place.

However, credit to the private sector has continued to contract. Loans to non-financial corporations fell by about 10 % in the year to January 2014, with corporate credit falling by 12½ % (5 % for residents). The Bank Lending Survey indicates that this is the result of both tight supply conditions and weak demand. Although, lending rates have been declining from the peaks of 2013, they remain at around 6 %, which is over 3 percentage points higher than the Euro area average.

⁽³³⁴⁾ European Economy. Occasional Papers. 149. May 2013. Brussels. Paper and internet.

In this context, the government managed to put in place two financial instruments with the EIB in support of SMEs in Cyprus. A Cyprus Entrepreneurship Fund (CYPEF) (EUR 200 million made up of a EUR 100 million loan by the government and EUR 100 million by the participating local banks) establishes a fund mechanism on a risk-sharing basis with banks to support SMEs' investment and working capital needs. To support foreign trade activities, a EUR 150 million facility from the EIB is expected to re-activate credit lines with international banks and support the capacity of the Cypriot banking sector to provide short-term trade-related instruments such as letters of credit, despite the deterioration of its credit rating. By mitigating the risks involved in trade financing, the scheme will support export and import flows estimated at EUR 300-450 million per year, mainly by SMEs, which are suffering most from the credit squeeze. Finally, the Bank of Cyprus has signed an agreement with the EIF to continue the implementation of the financial instruments established under 2007-2013 programming period of the structural funds for the remaining EUR 8 million. Consequently, EUR 16 million in total will be made available to SMEs and each can benefit from a loan of up to € 100 000.

Two further initiatives are being developed to alleviate the acute lack of liquidity for businesses. The European Bank for Reconstruction and Development granted Cyprus the status of recipient country in May 2014 and is planning to provide financial assistance until 2020. This will strengthen the financial sector, support the government's privatisation programme and provide financing for SMEs. Finally, the government is focusing on establishing a development finance institution in a bid to channel financial assistance from foreign national and international financing organisations to SMEs.

3.13.3 Innovation and skills

Economic trends will undoubtedly affect the research and innovation sector that relies mainly on public expenditure.

Even though research and development intensity has almost doubled since 2000, (from 0.25 % in 2000 to 0.47 % in 2012), persistent stagnation has been observed since 2009, with intensity stabilising at 0.5 % of GDP in 2010 and 2011. This matched the

government's national target. However, this indicator started to decrease 2012, when severe fiscal cuts on public spending kicked in.

Nevertheless, the Innovation Union Scoreboard 2014 confirms that Cyprus is among innovation followers, i.e. countries in which innovation performance is around the EU average.

Indeed, while R&D expenditure in the business sector remain very low (weight on GDP is 5 % of EU average), Cyprus scores well above the EU average for non-R&D innovation expenditure, thanks to SMEs innovating in-house and cooperating with other enterprises or institutions. As a consequence, the performance is average in all but one of the indicators that try to capture economic effects of innovation (employment in knowledge-intensive activities, exports of high-tech products, sales of innovation).

The results of the entrepreneurial innovation scheme (EUR 4 million) launched by the Ministry of Energy, Commerce, Industry and Tourism indicated that Cyprus's SMEs were strongly committed to innovation activities. The resources of the scheme were completely absorbed, with 83 applications received and 41 projects funded, worth over EUR 6 million. The ICT sector (42 applications, 16 funded) can be identified as a major innovation driver throughout the economy.

On the policy side, there is now awareness that the participation of business in R&D activities might also have been hampered by institutional factors, complex and lengthy procedures in the system of incentives, as well as policies that favour academia rather than the need of enterprises to improve their competitiveness. As a result, a National Committee on Research, Innovation and Technological Development was set up in September 2013. This aims to review the national research and innovation system and to give relevant recommendations on its governance directly to the President. The work of the committee has been completed and its outcome was submitted to the President on 26 March 2014. While competences have been allocated to different ministries, the overarching goal of the review was to create a new single governance structure that would for the first time bring together research and innovation and entrepreneurship. This report, along with the smart specialisation strategy drafted for the programming period of European Structural and Investment Funds, is expected to feed into the national 2014-2020

research and innovation strategy. This should be finalised by the end of 2014.

3.13.4 Energy, raw materials and sustainability

High electricity prices drag down the competitiveness of industry. Latest data of electric prices for industrial consumers show that they are the highest in EU. Moreover, in Cyprus they are around 95% of the prices for domestic consumers, while EU average is around 65%.

The full liberalisation of the electricity market was formally achieved in January 2014, but has not yet been implemented in practice. The Electricity Authority of Cyprus, a semi-public body, is still the sole supplier.

In the meantime, the repeal of the extra charge imposed after the explosion that damaged Vasiliko electricity plant, as well as the downward trend of oil prices led to a fall in electricity prices, by 17% compared to end-2012. The Cyprus Energy Regulatory Authority is working on revising the tariff setting methodology to ensure that electricity tariffs reflect costs and are incentive-based and non-discriminatory.

Natural gas discovered off the southern coast is not expected to reach the island before 2019. An interim solution has been planned to supply electricity generation with natural gas until domestic natural gas reserves become available. A first invitation for expressions of interest for the supply of natural gas to Cyprus did not attract offers that would have reduced the price of electricity. A new tendering procedure on a 10-year supply contract for imported natural gas appears to be on track. According to the tender timeline, a contract can be signed in the second half of 2014, and gas supply should start in 2016.

Thus, in the medium-term, the energy mix will continue to be dominated by oil and petroleum products, though the currently modest share of renewable energy is expected to rise rapidly. Oil products represented 94.9% of gross energy consumption in 2012, with only 3.6% of electricity generated by renewables, despite remarkable potential in solar and wind. But renewables are

increasing their contribution to electricity generation. In 2012, electricity generation from renewables more than tripled compared to 2010 levels, mainly due to a rise in wind power generation. The percentage rose to 6.5% in 2013.

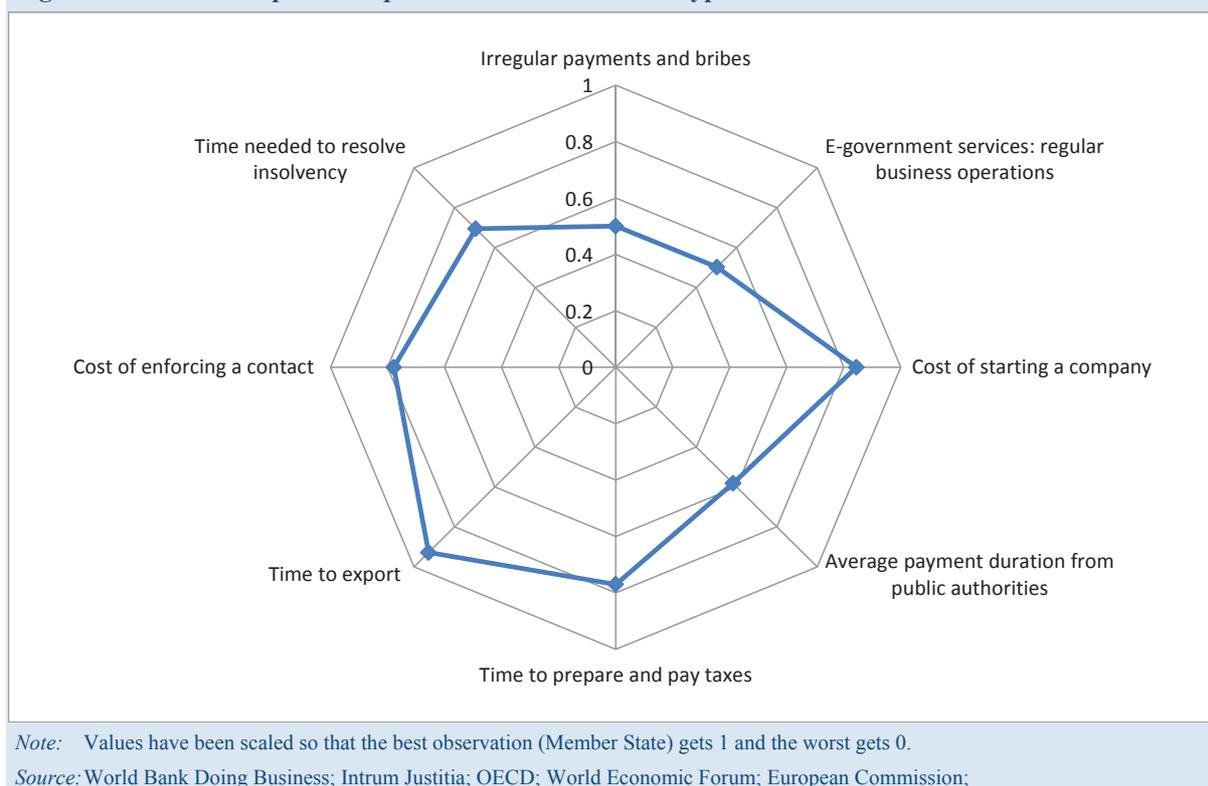
3.13.5 Access to markets, infrastructure and services

Because of current (nearly) complete dependence on imported oil products, Cyprus has a large deficit on its energy trade balance. However, the current account adjustment continued in 2013. This was largely due to a significant decline in imports (-16.2%), combined with better export performance, reflecting higher tourism receipts. However, this was partly offset by a further decline in exports of financial and other business services. As a result, the current account recorded a deficit of 1.9% of GDP in 2013, compared to a deficit of 6.9% in 2012.

Exports of goods to non-EU countries have slowed, while EU exports are showing some signs of stabilisation.

The Cyprus privatisation plan, adopted by parliament in March, may boost the country's role in international trade. Severe restrictions in key transport sectors in terms of working hours (e.g. ports, warehouses) have been one of the major sources of complaints among stakeholders. Just two weeks after the parliament gave its green light, the Council of Ministers launched privatisation procedures for the port of Limassol by liberalising the port's commercial arm.

In addition, Cyprus is also committed to removing the entry and exercise of regulated professional services where there are fixed or minimum tariffs (including lawyers and architects). Improving the quality and reducing the cost of professional services could have a multiplier effect on the economy in the medium term, as these play an important role in a variety of contractual and legal obligations for businesses and citizens.

Figure 3.13.2: Overall profile of public administration — Cyprus

3.13.6 Public administration and business environment

Under the Economic Adjustment Programme, Cyprus is also pursuing the modernisation of public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services.

One of the axes of the action plan for reforming the civil service is to improve the regulatory framework and to introduce e-government. The strategy will build on the national plan for better regulation adopted in 2007 based on three pillars: 1) legislative simplification; 2) reduction of administrative burden; 3) impact assessment of legislation. It will also include also smart regulation. In the meantime, a package of measures to cut the administrative burden by an estimated 20 % has almost been completed, but there has been no evaluation, so it is difficult to assess whether the EUR 150 million of savings claimed were really achieved.

To speed up the deployment of e-government, Cyprus is considering the establishment of a task force, bringing together all the relevant services, to promote

the digital strategy as laid down in the national digital agenda of 2012.

Civil justice is also receiving some attention. The establishment of an administrative court is being evaluated and the Supreme Court is revising procedural rules to reduce the length of proceedings.

3.13.7 Conclusions

The financial crisis that hit Cyprus marked the collapse of an economic model heavily dependent on financial services. Although the economic adjustment programme is on track and the recession is milder than expected in real terms, a number of sectors that played a leading role in the high growth rates of previous years have been affected. Tight credit conditions, fiscal consolidation measures and a worsening labour market are among the factors that are slowing down economic recovery.

Cyprus could now take advantage of the European structural and investment funds for the new programming period 2014-2020 to provide partial funding to reorient the economy towards a more sustainable economic model along the lines of the Europe 2020 strategy.

3.14 Latvia

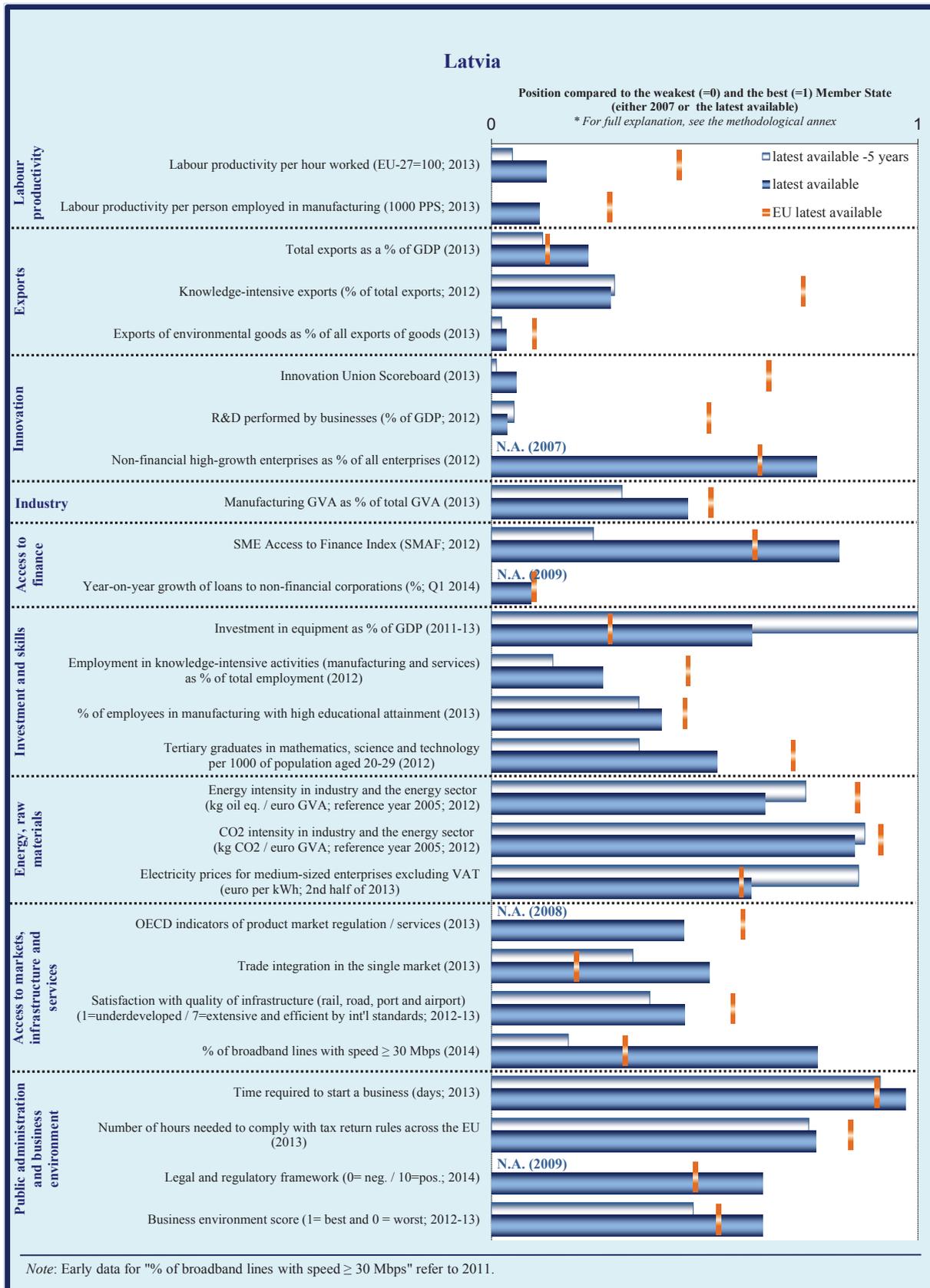
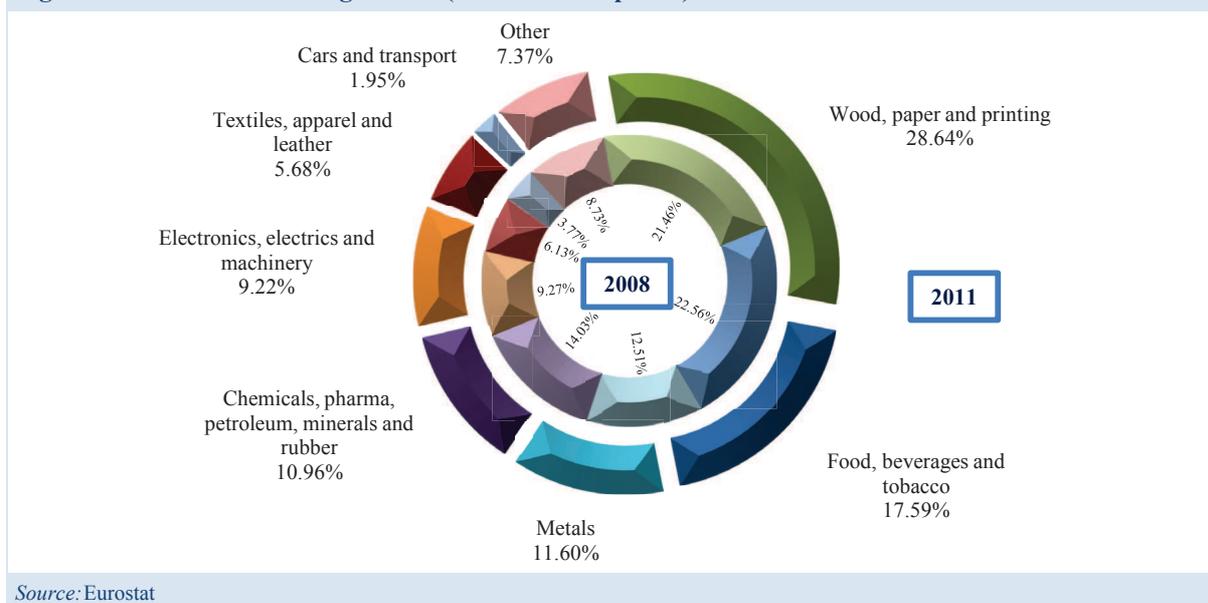


Figure 3.14.1: Manufacturing sectors (GVA at basic prices) - Latvia



3.14.1 Introduction and performance

In 2013 Latvia's GDP growth was 4.1 % and the economic situation remains strong despite a slight slowdown compared to 2012. The unemployment rate dropped to 11.9 % in 2013 from 15 % in 2012 and youth unemployment went down from 28.5 % to 23.2 % in the same period. Manufacturing's contribution to the Latvian economy increased to 14 % in 2013 from 10.8 % in 2008 and is adding considerably to growth and employment. Processed products based on natural resources such as wood and food, as well as metals, chemicals and machinery, are the main contributors to exports and to Latvia's attractiveness to investors. Foreign direct investment stock in manufacturing sectors reached EUR 1.4 billion in 2013, from EUR 1.2 billion in 2012. Productivity remains relatively low, mainly due to the prevalence of low-tech and medium-low-tech industries. Nevertheless, the growth rate of the past five years has been sustained and labour productivity increased from 54 % of the EU average in 2007 to 66.3 % in 2012.

3.14.2 Access to finance

Most indicators of access to finance are considerably better than the EU average. They include access to public financial support, the perceived willingness of banks to give a loan, the strength of legal rights and the interest rate difference between loans above or

below EUR 1 million. The World Bank ranks Latvia among the top performers for ease of getting credit and the legal rights for borrowers and lenders. The traditional financial instruments in place are: loans aimed at increasing competitiveness and growth, credit and export guarantees, venture capital, seed capital and start-up capital funds, 'mezzanine' loans, start-up loans and grants.

The Mortgage and Land Bank (MLB) completed the sell-out of its commercial portfolio and is now fully focused on development financing. In December 2013, the government also completed the first phase of setting up a single development institution (SDI) merging the Latvian guarantee agency, the rural development fund and Altum (the former MLB).

Bank lending

Obtaining credit is not among the major issues for companies; however, small and medium-sized enterprises (SMEs) and in particular start-ups continue to face challenges in getting access to finance. As deleveraging in commercial banks continues, the government has taken some measures to improve the effectiveness of public support for financing.

According to a market gap analysis, which pointed to the need to focus finance programmes more on micro and small companies, the 'Financial engineering instruments' have been reorganised, a new micro financing programme for loans up to EUR 25 000

added and a new call for financial intermediaries specialised in micro lending launched to improve the offer for start-ups. In addition, the ‘mezzanine’ programme has been refitted, interest rates for the start-up lending programme cut and the limits on government intervention in lending operations reduced.

Venture capital and other finance

To improve the availability of equity financing, the government has supported the creation of the Baltic innovation fund, which has operated at macro-regional level since 2012. In 2013 three financial intermediaries became operational and three new risk capital funds were launched to provide growth capital for micro, small and medium-size enterprises and promote the development of Latvia’s venture capital market. Finally, a new pilot project for a business accelerator has been publicly funded.

3.14.3 Investment, innovation and skills

R&D investment developments

In 2012, total expenditure on research and development activities accounted for 0.66 % of GDP, down from 0.7 % in 2011. While these results are still far below Latvia’s 2020 target of 1.5 %, in the last five years R&D expenditures grew at an average annual rate of 3.1 %. Corporate R&D funding accounted for 23.8 % of the gross domestic expenditure on R&D, corresponding to 0.15 % of GDP, compared with 0.19 % in 2011.

Innovation

The Innovation Union scoreboard identifies Latvia as a modest innovator, with an aggregate score below the EU average. Latvia’s main challenges include continuing the transition to higher value-added products, boosting convergence between R&D and innovation and reducing the skills mismatch through a structural reform of higher education.

To address these issues the government has established incentives to increase investment in innovation activities, including corporate income tax rebates on large-scale projects, new beneficial depreciation ratios for specific R&D expenses such as technological equipment, a carry forward of losses and several labour-related incentives at different

stages of the hiring process. Additional financial incentives include state and EU supported loans, credit guarantees and venture capital.

The effectiveness of public funding was until recently undermined by a lack of independent, external evaluation of scientific institutions. The results of the first independent assessment undertaken by the Nordic Council became available at the end of 2013 and showed that only 10% of the research units evaluated can be considered high level international research centres.

Skills

Shortage of qualified staff, poor and fragmented infrastructure and the lack of cooperation between research institutions and businesses are hampering Latvia’s capacity to innovate, resulting in inadequate commercialisation of research results.

To address these issues the government has adopted the Science Technology and Innovation Development guidelines and the Education Guidelines, which include a number of policy measures for integrating research more closely with industry and higher education. A new financing model for higher education and research institutions is currently being devised in cooperation with the World Bank. This aims to ensure that higher education is better targeted at providing skills that are needed for in the labour market. However, this measure is unlikely to enter into force before 2016.

In addition, several measures have been taken to make vocational education and training more relevant to the labour market and to increase the provision of quality work-based learning. These measures include modernising infrastructure and redesigning curricula with the close involvement of social partners. If properly implemented, these measures may represent a first step in promoting effective work-based learning in Latvia.

3.14.4 Energy, raw materials and sustainability

Energy use and price

Several projects set out in the Baltic energy market interconnection plan are scheduled for the coming years. Major projects concern the development of

infrastructure and the liberalisation of the energy market. In the electricity sector, the interconnector Estlink 2 was inaugurated in March 2014, the third Estonian-Latvian interconnection has reached the implementation phase and the first stage of the 'Kurzeme Ring' has been completed. This is part of a major project to improve the stability of supply and network interconnections between Latvia and Lithuania.

Resource efficiency

The share of renewables in final energy consumption reached 35.8 % in 2012. Renewable energy's share of the heating sector has slightly increased due to investments in the renovation of district heating networks and the substitution of fossil fuels in regional co-generation plants. The transport sector accounted for 27 % of total greenhouse gas emissions in 2011 and around 30 % of total energy consumption. The major concerns in this sector are the inadequate public transport network, poor vehicle fuel efficiency, a relatively low level of excise duties and an ageing car fleet.

Some investments in transport sustainability have been made, such as extending and developing tram lines in larger cities, while a comprehensive overhaul of the public transport planning system is also being prepared. Latvia has also implemented a number of measures to reduce CO₂ emissions in the transport sector, such as increased taxes on fuels, exemptions for biofuels and the introduction of a registration tax for passenger cars based on emission levels. More recently, the government has taken action to promote electric vehicles by adopting, in February 2014, a short-term electro-mobility strategy that focuses on developing recharging infrastructure and the electric vehicle market. Finally, the Latvian railway network electrification project is planned for the programming period 2014-2020, with the support of cohesion funds and the Connecting Europe Facility.

Other sustainability issues

Reducing the infrastructure gap and improving the regulatory framework for the collection and recycling of waste are still considerable challenges for Latvia. In 2012, the rate of landfilled municipal waste was 84 %, against an EU average of 33 %, while only 12 % was recycled and 4 % composted (EU averages: 27 % and 14 %). Meeting the 2020 landfill diversion target of 75 % and the re-use and recycling target of

50 % is unlikely under the current framework. Moreover, the 'National Waste Management Plan 2013-2020' does not seem to provide a convincing national strategy for achieving these targets. Further action seems to be needed to encourage private investment in waste management, ensure competitive neutrality and sustain resource efficiency and waste diversion from landfill.

3.14.5 Access to markets, infrastructure and services

Internal market

While the government has proposed some measures to reduce the administrative burden in certain markets, customs and public procurement procedures, discriminatory technical regulations and relatively low protection of industrial property still hamper the competitiveness of Latvian businesses. The government's strategy to address these issues is composed of an industrial policy plan, a set of guidelines for promoting exports and attracting foreign investment and an annual action plan for improving the business environment. Measures included in these documents, such as fostering the digitalisation of customs documents or implementing the 'International freight logistics and port information system', are likely to increase the country's openness to trade if properly implemented.

The bottleneck in regulation of the construction sector has been addressed by the government with the adoption of a new construction law. This amends and clarifies rules on construction plans, design, responsibility and supervision, as well as procedures for certifying specialists, classifying merchants and defining the involvement of institutions in the sector. In addition, the law reduces from 152 to 68 days the time needed to obtain a construction permit and establishes a 'State building control office', clarifying the responsibilities in overseeing construction processes and compliance with legislation. These amendments should enter into force in October 2014 and constitute a substantial step forward for the competitiveness of Latvia's construction sector.

Internationalisation

Among the measures to improve access to export markets, the government has set up a scheme of guarantees coupled with an advisory service. At the

same time, the integration of businesses into international supply chains is being promoted by a network of foreign economic representative offices, which encourage and support the participation of firms in international exhibitions and trade missions. This network was expanded to 21 offices in 2013.

Business service, network industries and infrastructure

Latvia is increasing the accessibility to the country and the Baltic Sea region by continuing to develop Riga's international airport. In addition, the Rail Baltic railway infrastructure is a priority for Latvia and is to be submitted for funding from the Connecting Europe Facility. However, as a result of the three Baltic States' different priorities, there have been significant delays in the overall process. Latvian authorities are showing their commitment to the project by actively participating in the negotiations, with the aim of reducing scope for further delays.

The poor quality of road infrastructure is a major concern as it makes logistics more difficult for business and contributes to a high rate of road accidents. While structural and cohesion funds are helping to improve the situation gradually, there is still a need to increase national funding and develop a viable long-term funding mechanism for road maintenance. The plan for improving national roads seems to rely excessively on EU funding and appears insufficient to remedy infrastructural weaknesses and achieve the government's ambitious objective of having between 90 and 100 % of state main roads and 75 % of regional roads in good condition by 2020.

3.14.6 Public administration and business environment

To improve Latvia's business environment the government needs to continue strengthening the efficiency of the legal system and modernising the public administration. The former is particularly crucial as lengthy civil and commercial case proceedings in the first instance and low clearance rates have caused a significant backlog of court cases in recent years and there are still shortcomings in insolvency proceedings, including lack of transparency and accountability of insolvency administrators. In addition, corruption remains a risk, particularly in public procurement.

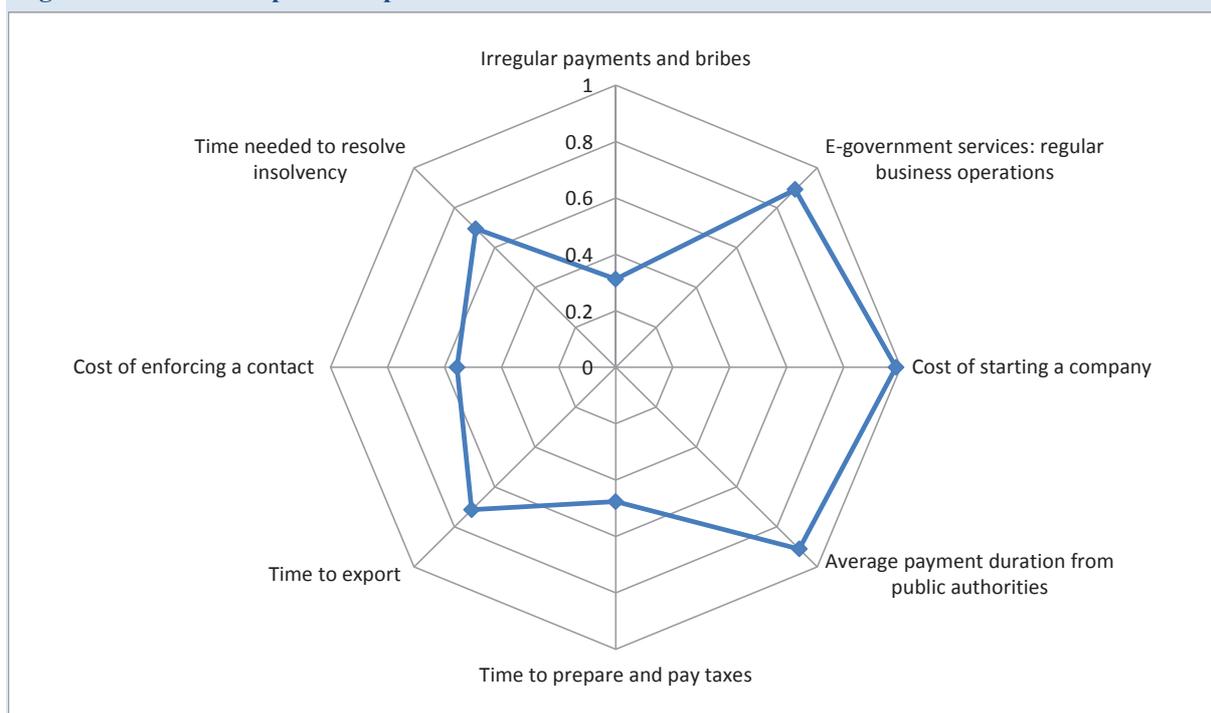
The European Commission's released an EU anti-corruption report on Latvia in February 2014. The Commission welcomed the searchable online database of political donations and the track record of investigations by the bureau for preventing and combating corruption. The report also suggested strengthening the bureau's independence to protect it from potential political interference, especially regarding supervisory and budgetary procedures, and further stepping up efforts to detect corruption in public procurement

Administrative modernisation

The government is acting to strengthen the regulatory framework and enhance the capacity of the Latvian justice system of the judiciary. The code of civil procedure has been amended to streamline the judicial process. The law on mediation has been adopted, while parliament is continuing its work on the insolvency law and the arbitration law. The length of proceedings has been reduced and the capacity of courts to handle their workload has been increased through the allocation of additional judges and administrative staff to the Riga court. Furthermore, professional evaluation of judges started in January 2013 and the use of information and communication technologies has improved the registration and management of cases as well as accelerating the information flow between courts and parties in judicial proceedings. A number of amendments to the code of administrative violations are now in force, establishing administrative sanctions for violations of procedures in public procurement, public-private partnerships and the award of concessions.

Requirements for local governments to use centralised procurement and publish small procurement contracts online have also been established, while penalties for suppliers who fail to deliver according to procurement contracts have been increased. The Competition Council has prepared amendments to the Competition Law as regards greater institutional and financial independence. One of the key proposals refers to independent budgeting of the institution, which would ensure greater financial independence similar to other regulators (e.g., financial, utilities regulators).

There is considerable additional scope for reforming the public administration, in particular to increase its efficiency, reduce corruption and increase the motivation of civil servants. Present reform efforts

Figure 3.14.2: Overall profile of public administration - Latvia

Note: Values have been scaled so that the best observation (Member State) gets 1 and the worst gets 0.

Source: World Bank Doing business; Intrum Justitia; OECD; World Economic Forum; European Commission

are limited to a strategic framework for human resource development in public administration approved in February 2013. This applies only to the central public administration and has been insufficient to lead to credible reforms to recruitment and career development. In the 2014 budget additional financing has been granted to the lowest pay grades as well as for further equalisation of salary levels for similar work across different ministries/institutions.

burdensome regulation in many sectors, the inefficiency of the judicial system and corruption; however, additional measures are required, in particular to modernise the public administration and the education system, foster innovation, increase the quality of infrastructure and facilitate the transition to a more sustainable and efficient use of resources.

3.14.7 Conclusions

Latvia is among the fastest growing economies in the EU, with the Commission's latest forecast pointing to 3.8 % growth in 2014. The transition to manufacturing with higher added value and technology intensity is the main challenge for Latvian industry as productivity and labour costs are moving towards the EU average. While SMEs benefit from favourable financing conditions, the increasing skills gap, coupled with insufficient investment in innovation and fragmented infrastructure, are hampering Latvian industry's competitiveness.

The government is increasing its efforts to improve the business environment, addressing issues such as

3.15 Lithuania

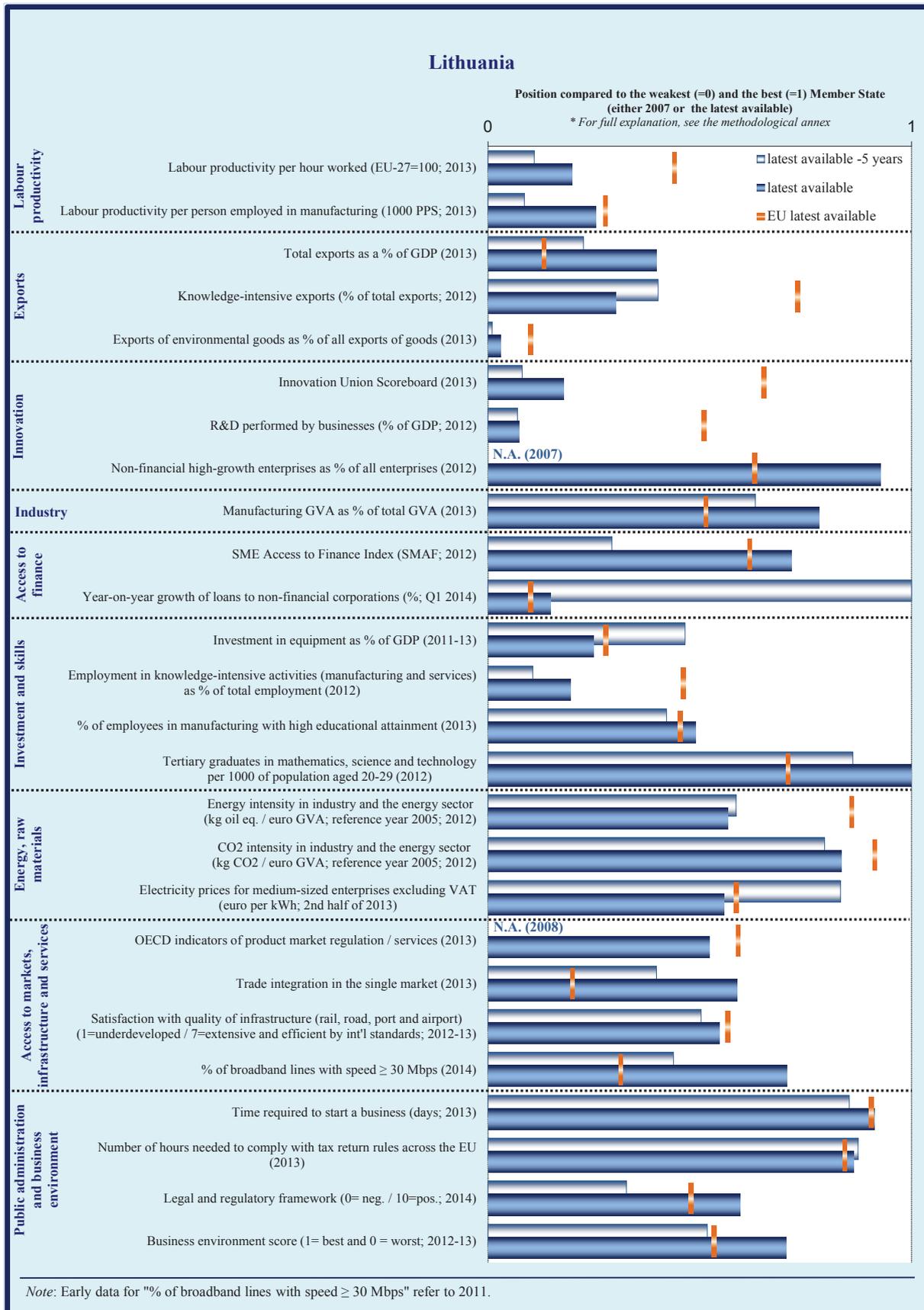
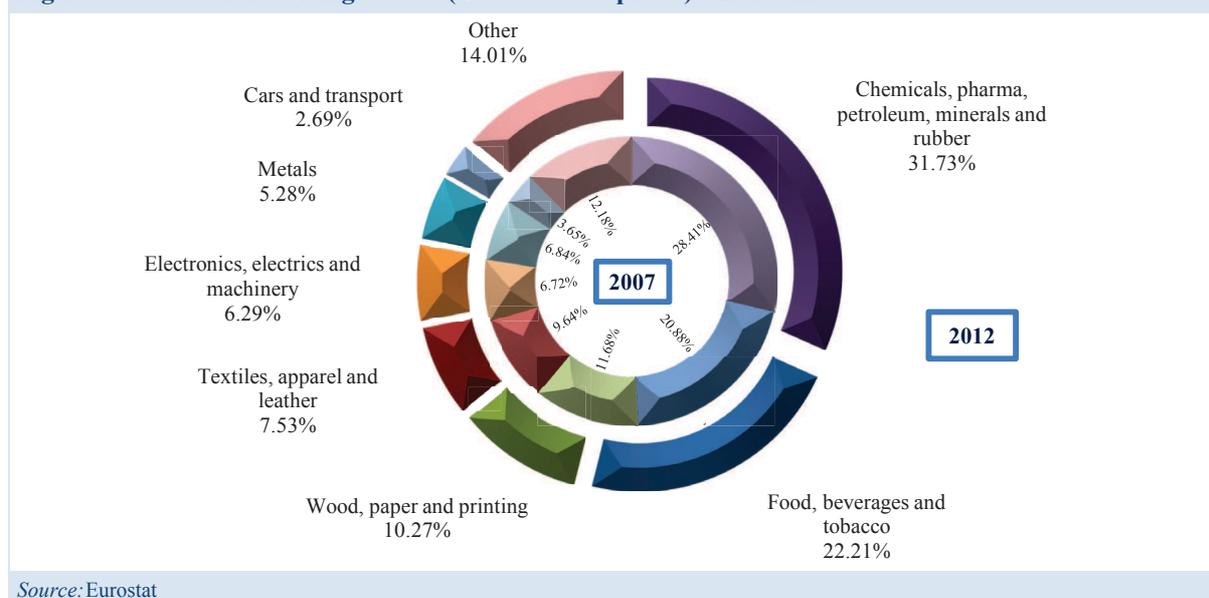


Figure 3.15.1: Manufacturing sectors (GVA at basic prices) - Lithuania

Source: Eurostat

3.15.1 Introduction and performance

Lithuania has a large manufacturing sector compared to the EU average; it represented around 21 % of GDP in 2012. In contrast to the downward trend in the EU as a whole, the proportion of manufacturing to GDP in Lithuania increased between 2000 and 2012, by two percentage points. This was the third largest increase in a Member State in this period. Lithuania's manufacturing sector is based mainly on low- to medium technology industries.

In 2011, Lithuania had a revealed comparative advantage in wood and wood products, furniture, tobacco, food, beverages, paper, clothing, refined petroleum, chemicals, rubber and plastics, and furniture. For services, it has a revealed comparative advantage in transport and travel.⁽³³⁵⁾ The challenge for Lithuanian industry is to move up the technology ladder for manufactured products, and to develop more knowledge-intensive services. The Lithuanian government has set a strategic goal to become a northern European services hub by 2015, and to do this it has developed a high standard of ICT infrastructure.

Lithuanian industry has scope to boost competitiveness in terms of labour productivity. Although its performance has improved relative to that of other Member States since 2008, productivity in terms of output per hour worked is well behind the

best performing Member State. There is also still scope for further gains in labour productivity per person employed in manufacturing. Labour productivity (output per person employed) in Lithuania reached 72 % of the EU average in 2012.

The real effective exchange rate (REER)⁽³³⁶⁾ increased by 1.7 % between December 2012 and December 2013, reversing the decrease over the previous four years. This can be partly linked to the falling currencies of several trading partners in most notably Russia and the Ukraine. The CIS makes up 31.6 % of Lithuanian export demand. Export growth started to stabilise in 2013, and the competitiveness gains achieved since 2009 are under pressure as a result of increasing labour costs and falling currencies in the CIS. In real terms, monthly earnings have started to increase, though partly because of a one-off increase in the minimum wage. Unit labour costs have risen slightly. Rising labour costs should be offset by further gains in productivity if Lithuania's competitiveness is to stay at its current level. There is a need to increase business investment and to continue to undertake reforms to improve the business climate. Labour supply could also be improved through more active labour market policies. The net migration rate in Lithuania is the highest in the EU and includes a high proportion of young people. The long-term impact of this population movement is unclear, but it may result in skills shortages in the labour market and hence act as a drag on competitiveness.

⁽³³⁵⁾ EUIS report 2013.

3.15.2 Access to finance and investment

The banking sector remains stable and applies strict lending standards. Uncertainty about the external economic environment has dampened demand for credit. At the same time many companies have sufficient cash reserves to finance investments internally. In 2013, there were signs that lending continued to grow following a rise in 2012. It is expected that demand for credit will increase without a further tightening in lending conditions.

According to the most recent research carried out by the Lithuanian business support agency (2013), the most common barriers to obtaining credit are tight financing requirements, lack of collateral and the high cost of obtaining finance (interest rates, guarantee fees, administrative costs, etc.). There is also a reluctance to lend to start-up companies. Over three-quarters of SMEs that received external funding with supplementary conditions indicated that they had to pledge additional assets, provide additional personal guarantees, provide state guarantees or guarantees from other institutions, or had to increase their capital share in an investment proposal. The SME Access to Finance Index improved significantly in 2012 compared to 2008.

Lithuania runs several programmes that support access to finance for SMEs, primarily the INVEGA Fund, the Jeremie Guarantee Fund and the Entrepreneurship Promotion Fund, which are supported by EU structural funds. The Jeremie Guarantee Fund supports the provision of risk capital through a variety of instruments. The INVEGA Fund provides debt instruments for SMEs to support business expansion. The Jeremie Guarantee Fund finances guarantees for SMEs, and the Entrepreneurship Promotion Fund provides microcredit for the purpose of starting-up businesses. Up to the end of 2013, 626 SMEs have received more than EUR 450 million, including financing from EU structural funds and the banking sector.

In order to improve access to credit, Lithuania strengthened its secure transactions system by: broadening the range of movable assets that can be used as collateral; making it possible to include a general description in the security agreement of the assets pledged as collateral; and permitting out-of-court enforcement.

3.15.3 Innovation and skills

Based on the Commission's Innovation Union Scoreboard 2014, Lithuania still lags behind other Member States. Lithuania's performance measured by the indicator on R&D carried out by businesses, as a percentage of GDP, is one of the lowest in the EU.

The Lithuanian economy is categorised as a 'moderate innovator', having been upgraded from the lowest performance group of 'modest innovator' several years ago. Lithuania can still improve its science base and the research links between academic and private-sector organisations. Lithuania's smart specialisation strategy should encourage more cooperation between business and academia in the field of R&D and innovation. Priority should be given to key technologies or processes that have a high potential to transform the Lithuanian economy. R&D spending remains well below its 2020 target of 1.9 % of GDP.

The Lithuanian authorities are currently drafting recommendations for public authorities on organising and implementing innovative public procurement, including the pre-commercial procurement of innovative services. In 2013, the Agency for Science, Innovation and Technology started a new project on pre-commercial procurement, financed by EU structural funds. Several new projects have recently been launched by the Agency for Science, Innovation and Technology. These include a new technological entrepreneurship project called 'Innovative Business Promotion' which will promote technological start-ups and development in Lithuania. The project brings together the largest Lithuanian universities, science- and technology parks, and other academic and research institutions.

There are indications of possible skills shortages in the labour market. Structural unemployment remains high, there has been a large outflow of the working age population, and wage levels started to increase during 2013. There is also a low level of entrepreneurship and self-employment. Although Lithuania has already reached the Europe 2020 15% target to lower the percentage of "low achievers in reading" the Europe 2020 target to have at least 40% of 30-34 years old with tertiary education, it scores below EU average in PISA (in reading and mathematics).

⁽³³⁶⁾ Based on statistics from the Bank of Lithuania.

Lithuania should address the current skills shortages in the labour market through training and active labour market policies. This should include improving the education system to better meet the demands of the labour market, and promoting entrepreneurial skills and self-employment opportunities.

3.15.4 Investment

At the start of the crisis in 2009, gross fixed capital formation fell by around 40 %. Investment rebounded rapidly in 2010 and 2011, before stabilising in 2012. It increased by around 13 % in 2013. Compared to the best performing Member State, investment in equipment as a percentage of GDP has fallen since 2008. Private-sector investment growth should remain positive due to a range of factors: historically low interest rates; growth in enterprise cash reserves; survey data suggesting that businesses are planning new investments as the economic outlook improves; and increasing the use of existing industrial capacity above the long-term average. It is expected that public investment will be supported by projects co-financed by the EU. The stock of foreign direct investment in Lithuania has been growing since 2000. Foreign direct investment inflows have slowed in recent years, from 3.4 % of GDP in 2010 to 1.5 % of GDP in 2012, but are expected to have increased in 2013.

3.15.5 Energy, raw materials and sustainability

Lithuania still operates a relatively old electricity distribution network, which was designed around centralised and large-scale electricity generation. The lack of diversified energy supply infrastructure hinders competition. Electricity and gas networks also have weak interconnectivity with continental Europe and Nordic networks, meaning that energy can be imported from relatively few countries and that natural gas is imported from a single external supplier (Russia). Until 2013, Lithuania paid the highest price for natural gas in the EU, and electricity prices were above the EU average.

The Lithuanian authorities are supporting: the ongoing construction of new advanced power

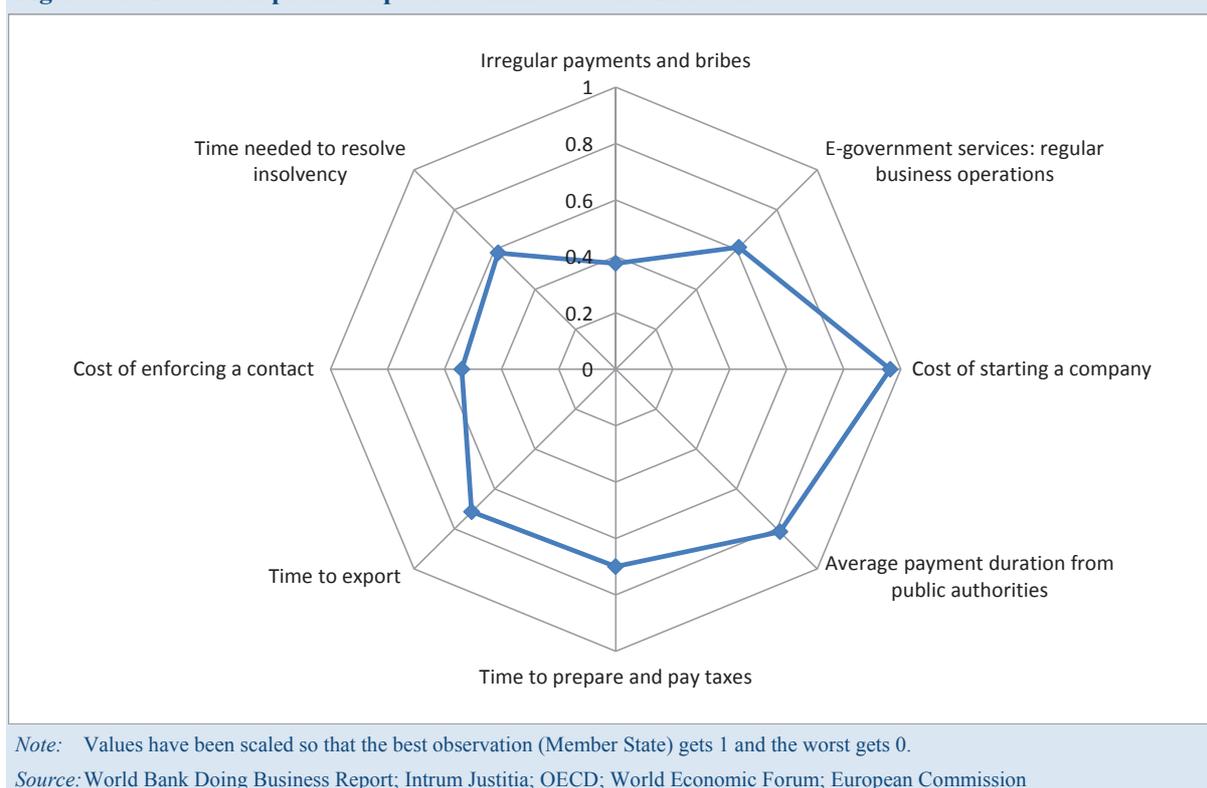
transmission lines to build interconnectivity with Poland and Sweden; the reconstruction and modernisation of existing power transmission lines to ensure reliable power supply to consumers; and the renovation of internal gas transmission and distribution networks. A liquefied natural gas terminal in Klaipėda is expected to be operational by the end of 2014. These activities will help reduce costs and improve the security of the energy network.

Given Lithuania's large industrial sector, its economy is heavily reliant on the supply of raw materials, particularly crude oil, natural gas, sulphur, caustic soda and cast iron. As noted above, the authorities are undertaking projects to improve the security of energy supply. In addition, Lithuania's industry has significant scope to improve its resource efficiency and production methods, which would reduce its reliance on imported raw materials.

In terms of energy intensity, the Lithuanian economy is around twice as intensive as the EU average, while the level of environmental taxation is below the EU average. This is partly on account of the emission-intensive transport sector, but also due to the residential and service sectors. Household heating, particularly in apartment blocks, is inefficient and in need of renewal. Although there has been some progress in renovating old apartment buildings under a government-supported programme, it is estimated that several thousand apartment buildings still need to be renovated.

Although the quantity of waste per capita in Lithuania is below the EU average, the waste management system remains dependent on landfilling, and recycling levels are low. Eleven regional non-hazardous waste landfills have been constructed and old, unexploited landfills and waste-polluted territories are in the process of re-cultivation. To improve biodegradable waste management, green waste composting facilities are being built, containers for individual composting are being provided, and sewage sludge treatment plants are being constructed. One mechanical sorting plant and nine mechanical-biological sorting plants are planned to start operations from 2016. Mixed municipal waste treatment plants will be introduced and waste sorting and recycling capacity will be increased. The amount of waste going to landfills is gradually decreasing (in 2011 it was 1 million tonnes compared to 1.092 million tonnes in 2009).

Figure 3.15.2: Overall profile of public administration - Lithuania



3.15.6 Access to markets, infrastructure and services

Lithuania is an open economy, partly due to its well-established industrial base. It has one of the highest rates of exports as a percentage of GDP in the EU, at around 83 %. Its main export partner is the EU (57 %), followed by the CIS (31 %). Since 2009, the increase in exports to the EU has been lower than the increase of exports to CIS countries, mainly due to weak demand from the euro zone. Service exports are a small proportion of overall exports, but have been growing rapidly in recent years.

Lithuania's international competitiveness in the transport and logistics sector is to a large extent determined by its geographical position, as east- and west-bound freight flows cross the country connecting the Baltic Sea region, the CIS and Western Europe. This makes the transport sector the largest contributor to the Lithuanian economy (around 13 % of GDP).

Lithuania is linked to the CIS' railway network because it uses the same (1520 mm) railway gauge. This is advantageous for the national logistics market, especially for long-distance routes, for example from

Asia. Lithuania is working with Latvia and Estonia to implement the Baltica railway project, involving the construction of a new European standard gauge railway line (1435 mm) to connect the Baltic States with the rest of Europe.

Road infrastructure is a very important component of the transport network, carrying over half of the freight that crosses Lithuania and nearly all passenger travel. Lithuanian road hauliers carry a significant amount of freight between the EU and neighbouring markets, particularly Russia, Kazakhstan and other CIS countries.

Klaipėda Sea Port is the most northern ice-free deep-water port, and handles long-distance shipments travelling from Eastern to Western Europe, and other continents. The port includes facilities for handling containers, oil products, fertilisers, roll/on-roll/off cargo, and has the capacity to handle 'Panamax' vessels, making it a regional container-distribution hub.

The three international TEN-T airports in Lithuania (Vilnius, Kaunas and Palanga) that have become the economy's main gateways for business and tourism. The Lithuanian airport cargo hub provides an

integrated supply chain system comprising airport infrastructure, a cargo terminal, and logistics services.

3.15.7 Public administration and business environment

Lithuania scores quite high in terms of the efficiency of its public administration and how this affects the business environment. In comparative terms, it is closer to the best-performing EU Member State for: the time required to start a business, the number of hours needed to comply with tax return rules across the EU, and the overall business environment score. For the legal and regulatory framework, Lithuania is roughly equidistant between the worst- and best-performing EU Member States. Compared to 2008, it has also made significant improvements in the time required to start a business, the legal and regulatory framework, and its business environment score. Since 2012, impact assessments have been compulsory for all new draft business legislation, with the potential to increase the administrative burden on businesses. In 2013, impact assessments were carried out on nearly fifty items of legislation was assessed.

The Lithuanian authorities are currently preparing a plan for the consolidation of business inspection agencies. In addition, an ongoing reform process is helping inspection agencies introduce such measures as: checklists, to ensure inspections are consistent; risk management, to reduce inspection burdens for trustworthy businesses; and key performance indicators to measure agencies' progress. In 2013, Lithuania continued its process of reducing the administrative burden, which began in 2012. The process encompasses 24 measures, of which several were implemented in 2013, for example the procedures for acquiring land for business purposes were reduced and the possibility of submitting applications electronically was introduced. In 2012, the authorities began to screen all licenses and permits needed to start a business, and finished the exercise by the end of 2013. Draft legal amendments to existing legislation on licences and permits will be submitted in November 2014.

Lithuania made it easier to start a business by creating a new form of private limited liability enterprise with no minimum capital requirement — a 'small partnership'. Like the other, most common, forms of legal business entities in Lithuania, it may be set up online. Lithuania reduced the time needed to register a company as a VAT payer from 13 to three days. In some cases, the online company registration procedure makes it possible for a company to open a bank savings account online at the same time as registering the company. With regard to obtaining credit, Lithuania strengthened its secure transactions system by: broadening the range of movable assets that can be used as collateral; allowing a general description of the security agreement of the assets pledged as collateral; and permitting out-of-court enforcement. With respect to trading across borders, it reduced the number of export and import documents needed and the cost of export and import procedures. It also reduced the time required to obtain a construction permit (from 142 to 105 days).

3.15.8 Conclusions

Sustainable strong growth will require improving long-term competitiveness. Lithuania must continue reforming its energy market in order to improve the security of energy supply and to bring down prices. Industry's use of energy should also be made more efficient to lower costs and increase sustainability. There is a need to boost skills in the labour market and to encourage more self-employment and entrepreneurs. The Lithuanian authorities have continued to improve the business environment and the recent reforms of public administration should bear fruit in the medium-term.