

# INVESTORS' CONFIDENCE INDEX FOR LITHUANIA (7), I QUARTER, 2016

**The investors' confidence index for Lithuania (ICIL) reflects the attitudes and expectations that the largest foreign capital businesses operating in Lithuania have for the country's business and investment climate. The purpose of the index is to evaluate the country's business environment and the attractiveness of Lithuanian economy to foreign investors based on the experiences and observations of market players already operating in Lithuania.**

Not only is the index used for assessing the conditions of the Lithuanian market, it also serves as a tool for identifying the most influential factors that shape these conditions. ICIL provides potential investors and other

stakeholders with principal information about Lithuanian economy, national market and short-term prospects for business development.

The index consists of three indicators that provide an overview of the business environment, factors that influence business and the investment plans of companies operating in the country. When measuring ICIL, the priority is given to the adequate and relevant information that reflects real market trends. With this in mind, only the heads of foreign companies and top tier management are invited to participate in the survey.

The ICIL survey is carried out by Investors' Forum, an association of Lithuania's largest investors. A total of 62 Lithuania's foreign capital businesses participated in this quarter's survey.

Index value	Interpretation
ICIL=2 (maximum value)	All participants indicate positive expectations (absolutely positive expectations).
ICIL>1	The percentage of participants with positive expectations exceeds the percentage of respondents with negative expectations.
ICIL=1	Equal numbers of participants indicate positive and negative expectations.
ICIL<1	The percentage of participants with negative expectations exceeds the percentage of respondents with positive expectations.
ICIL=0 (minimum value)	All participants indicate negative expectations (absolutely negative expectations).

Fig. 1 Index values and descriptions

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# SUMMARY AND CONCLUSIONS

**THE 7TH ICIL SURVEY: strong firm-specific factors lift the index value to a new high**

**ICIL<sub>Q1, 2016</sub> = 1,227**

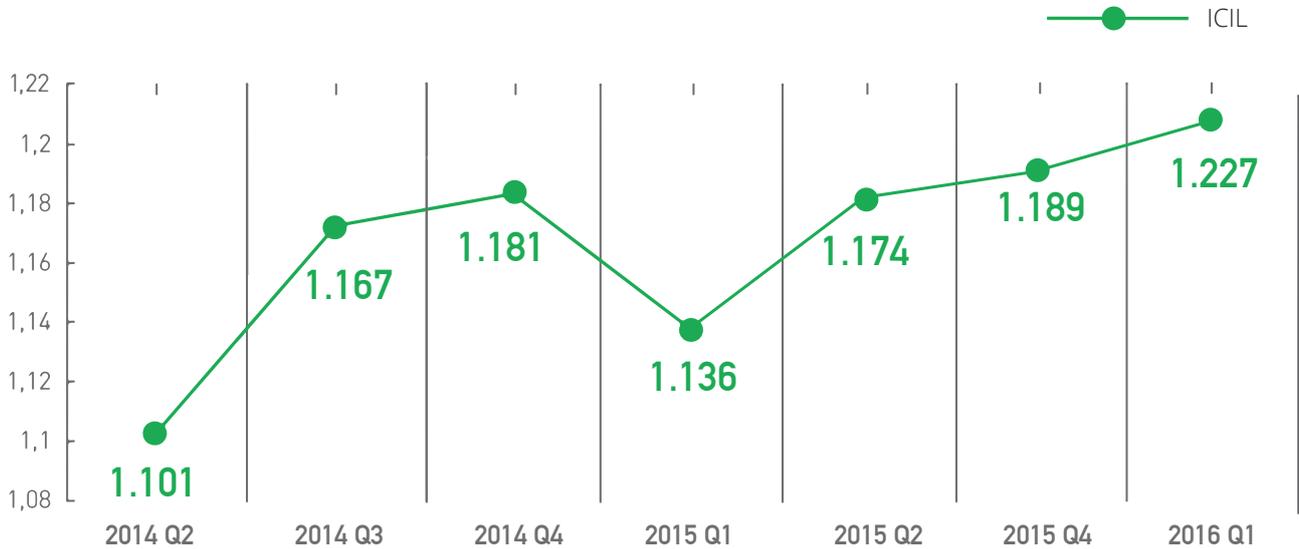


Fig. 2 : ICIL dynamics 2014 Q2 - 2016 Q1

Investors started the year 2016 with a positive outlook. In the first quarter of this year Investors' confidence index for Lithuania has reached a new record-high value – 1,227. It is yet another quarter when positive expectations outweigh the negative ones. This proves that investors present in the Lithuanian market continue to see economic conditions as favorable for business. Almost all of the factors included in the index push the index upwards. Macroeconomic stability is seen as high with a potential to rise further, the outlook on the company level is also affirmative with rising demand and profitability as well as plans for new investments and additional workplaces. The single exception is political stability, expectations for which continue to go downwards due to the upcoming Parliament elections in

the autumn of 2016.

Labour regulations continue to stay under the investors' spotlight as the top priority area requiring attention and improvement. As much as 50% of respondents occasionally and 47% frequently face problems caused by inflexible labour regulations. As the term of the current Parliament is approaching to the end, participants of the survey were asked to evaluate the most important government's achievements during 2015 and highlight decisions and results they expect from the government before their term in the office runs out. Investors gave a very clear and firm message – if the Government will manage to achieve only one task and this will be the reform of labour regulations, investors will be satisfied.

## KEY POSITIVE EXPECTATIONS

### Macroeconomic factors

The 7th ICIL survey revealed that after certain hiccups during the Russian-Ukrainian crisis and Eurozone's concerns over the situation in Greece, the confidence in Lithuania's macroeconomic stability has bounced back up: 62% of managers evaluate macroeconomic stability level in the country as moderate, while as much as 36% claim it is high. The latter value is the highest since the

introduction of this index. In comparison, a year ago only 12% of respondents gave such a positive evaluation. Moreover, merely 1 out of every 20 respondents (5%) expect the level of macroeconomic stability to deteriorate during quarter while the rest believe it will remain steady or even raise further.



Fig. 3 Level of macroeconomic stability and expectations for the next quarter, ICIL 2016 Q1

### Increasing tax system efficiency

Despite the slow pace, opinions about the efficiency of Lithuanian tax system are steadily improving. The proportion of respondents giving the lowest mark in this category has decreased almost twice from one third (31%) in Q2, 2014 to only 17% during the current survey. In addition, only 2% of top level managers foresee a deterioration in the tax system during this quarter, while the vast majority (90%) expect the situation to remain stable. In spite of the fact that the Government has been criticized for being passive, slower pace can sometimes have a positive side – stability allows companies to operate in a more efficient manner and plan their resources more accordingly. Therefore having no changes in the system

is better than facing poor and imprudent ones. State Tax Inspectorate is developing the smart tax administration system (iMAS) which should further contribute to the efficiency of the tax system. In the short term companies might come across certain inconveniences, especially caused by a lack of information about technical aspects of the system and the adaptation possibilities for the companies. During the transition period it will cost both time and investments, but in the long run it should improve the tax collection process and streamline information exchange between businesses and the STI.



Fig.4 Level of taxation system and expectations for the next quarter, ICIL 2016 Q1

### Firm-specific factors: the main source of optimism

One of the key reasons why the overall index value remained on the positive side during the last year was the fact that managers had a strong positive outlook in terms of firm-specific factors. Merely 2% of respondents are expecting a decrease in both demand for their products and profitability, while a staggering 98% expect to maintain or even further increase these indicators. None of the surveyed companies shared intentions to

reduce the volume of exports. Furthermore, two thirds of them expect to maintain export volume at the same level while one third is hoping for an expansion. Significantly, nearly half of respondents (45%) are planning to increase the number of workplaces and create new jobs. On the other hand, these good news are somewhat outweighed by the fact that finding qualified labor is becoming increasingly difficult: more than half (57%) of all interviewed managers claimed they face this obstacle on a daily basis.

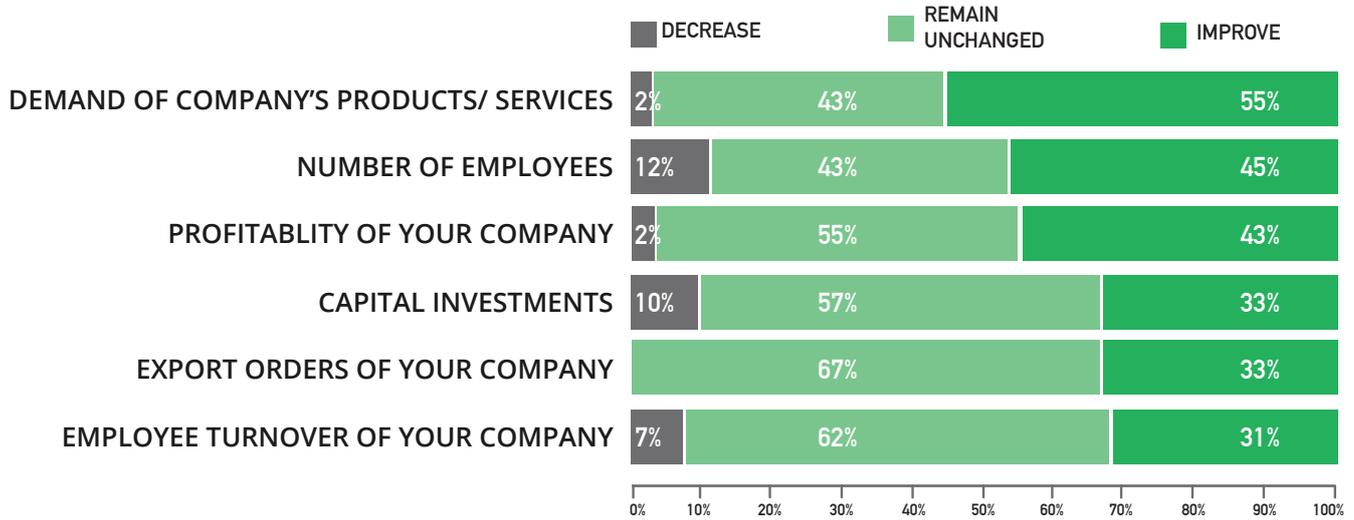


Fig. 5 Firm-specific factors, ICIL 2016 Q1

## KEY OBSTACLES

### Business environment

The only factor dragging the value of the index down in this quarter is expectations towards the level of political stability. Due to the upcoming elections investors do not expect the political year to be predictable and constructive. Compared to the previous quarter, the number of those predicting a decline of political stability has grown from 21% to 29%.

### Lack of qualified labour

One of the most worrying ICIL trends is the growing investors' concern over the lack of qualified labour. This problem has been mentioned constantly since the very first ICIL survey, moreover, concerns continue to grow steadily period after period. If previously this issue has been raised by only 26% of the survey participants, this quarter the number grew dramatically and reached 57%. If this problem is to evolve in the nearest future it will become a serious obstacle for successful economic development of Lithuania. The country can no longer remain competitive by offering a lower cost of labour therefore it is crucial to re-focus on labour force quality and talent pool. Otherwise attracting foreign direct investment will become an increasingly challenging task.

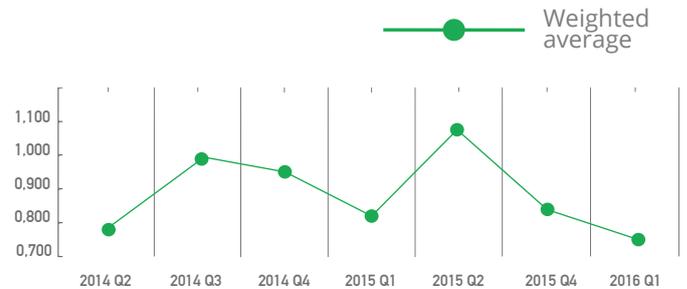


Fig. 6 – Expectations towards political stability, ICIL 2016 Q1

### Business transparency – another growing concern

Growing concerns over business transparency appeared to be yet another emerging trend among Lithuanian investors. Four-fifths of respondents (79%) refer to business transparency as an area that requires serious attention and improvement. In comparison to previous quarter alone, the number soared by ten percent. In addition, when evaluating achievements of the Government during the year 2015, numerous respondents highlighted that authorities should tackle the problem of transparency more seriously.

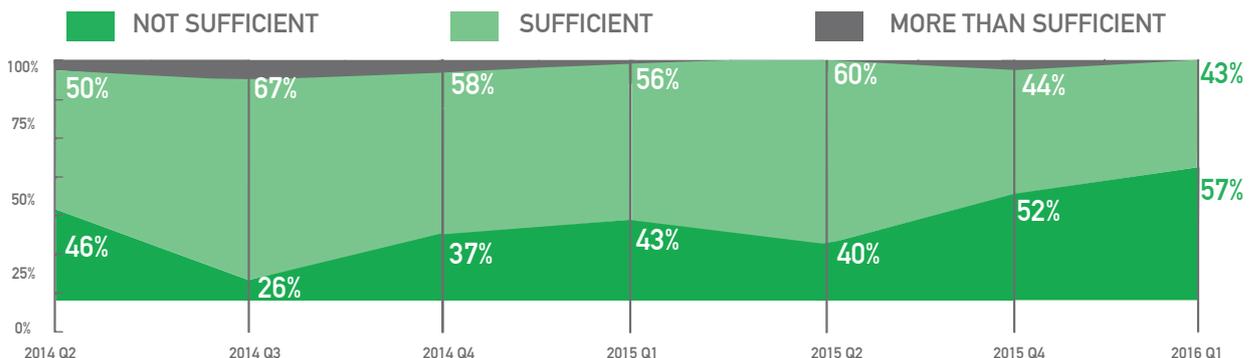


Fig. 7 Availability of qualified labour, ICIL 2016 Q1

**Firm-specific obstacles**

The survey participants were also asked to indicate key factors restricting their business development. Traditionally, three factors stood out: low demand, the lack of qualified labour, and excessive regulation. It is important to note that low demand for company's products or services has been mentioned by 43% of managers and in contrast to previous quarters seems to lose its importance. The lack of qualified labour, on the contrary, is becoming a more significant obstacle, also mentioned by 43% of respondents. The major limiting factor for growth according to investors is excessive regulation. It was mentioned by half (50%) of the top-level managers and reached the highest value since the creation of the index.

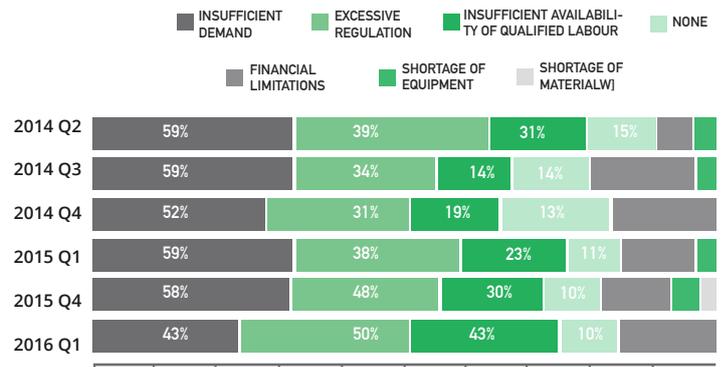


Fig. 8 Main factors limiting business, ICIL 2016 Q1

# COMPETITIVE ADVANTAGES OF LITHUANIA

**Low costs are not enough to attract investors**

Another important trend that emerged since the start of Investors' confidence index surveys shows that labour costs are gradually losing their significance as a competitive advantage. With rising standards of living as well as growth of both minimal and average wages it becomes increasingly difficult to attract potential investors by only offering lower labour costs. Current survey was the first since the introduction of this index to not identify low labour costs as the main competitive advantage of Lithuania. In Q2 2014 low labour costs were highlighted by 74% of managers, but the rate has gradually declined to 48% during Q1 2016.

Survey results have also revealed that the main factor positively differentiating Lithuania in international arena is a well-developed infrastructure, praised by every second company manager (50%). However, only one fifth of respondents (21%) mentioned infrastructure as a key determinant when it comes to investment decisions. In other words, respondents believe that it is great to have good infrastructure, but it is not enough to secure foreign direct investment.

The greatest impact on potential investors is made by the potential of domestic market growth – it was mentioned

—●— Labor costs as main advantage



Fig. 9 Labour costs as main competitive advantage of Lithuania, ICIL 2016 Q1

by 71% of the respondents. Unfortunately in this case Lithuania has limited chances of competing against bigger and wealthier economies of the region.

Tax system, Government incentives and especially business regulations are the main areas where the differences between the significance of factors and Lithuania's strength in those areas are the biggest. As an example, as much as 60% of company leaders indicate business regulations as a critical factor determining investment-related decisions, however only 7% of survey participants believe that current business regulation is a competitive advantage of Lithuania.

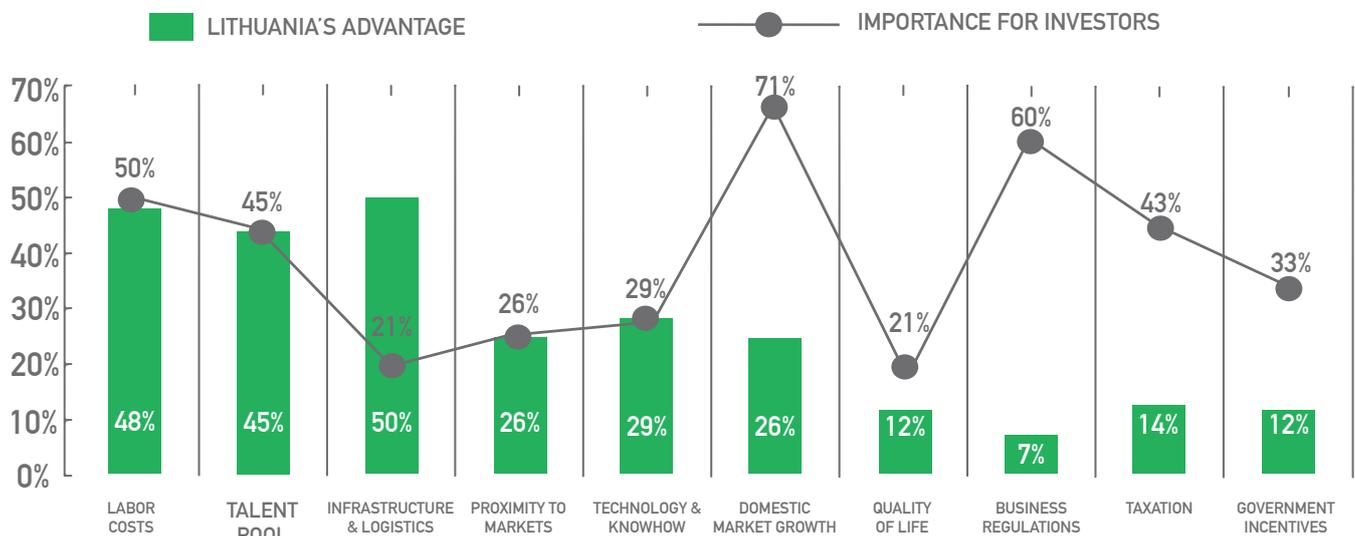


Fig. 10 - Investment determinants and Lithuania's competitive advantages, ICIL 2016 Q1

# ADDITIONAL INSIGHTS

## Government performance and expectations for 2016

For the very first time participants of the ICIL survey were asked to evaluate the performance and achievements of the Government. Investors were fairly reserved in terms of rating the Government. The grade was usually around average and the most common critique was the lack of initiative and promises that have not been kept yet.

### Unfavourable decisions of the Government

Expressing critique towards the Government, numerous investors have pointed out the adverse effects of a hasty raise of the minimal monthly wage (MMW). According to investors, increasing MMW cultivates irrational wage expectations and causes the average salaries to rise promptly beyond the economically justifiable level. Therefore without raising the price of the products or services it is becoming increasingly challenging to stay in business and sustain the workplaces. Investors also pointed out that Government officials should listen to experts' recommendations and approach the issue of small wages by increasing the level of non-taxable income.

The topic a not-fully-transparent competition of state-owned enterprises with the private sector has been raised as well. Investors noted some instances when state-owned companies were trying to enter competitive sectors where a number of private companies have been successfully operating and fulfilling the demand. Credit bureaus, payments for utility services, providing mobile internet, and other cases were specifically mentioned.

Another critique points mentioned in the ICIL survey were poor absorption of the EU funds, deteriorating level of business transparency, excessive business regulation, and an overall passiveness on the governmental level that prevents the biggest challenges from being tackled.

### Favourable decisions of the Government

Unquestionably the most appraised achievement of the current office was the smooth transition to Euro. In terms of the mass of currency in circulation, substitution of Litas with Euro was one of the fastest since the creation of the latter currency. In addition, numerous public initiatives advocating for a transparent recalculation of prices have helped to avoid bigger scandals related to dishonest attempts of business to exploit the circumstances for their gain. The benefits of euro were felt all over the country, starting with the opportunities for the Government to borrow at a lower cost, reduced currency conversion costs and, most importantly, improved image of Lithuania as a reliable and stable partner in the eyes of investors. The Government also deserves a credit for sustainability of long-term strategic projects. Among those mentioned were energy interconnections with Poland (LitPol) and Sweden (Nord Balt). Lithuania's commitment to international obligations, such as increasing the defence budget, were evaluated positively as well.

### Investors' expectations for 2016

Investors have reached a solid agreement in terms of expectations for an upcoming year. If there was only one single task the Government would be able to achieve this year, it should be a successful adoption of the new social model. Despite the fact that a large pack of law amendments, prepared by scientists, had a significant political support, the social model reforms got stuck in the Parliament. Due to inconsistent changes the project is departing from the original proposal. Investors expressed concerns that due to the upcoming Parliamentary

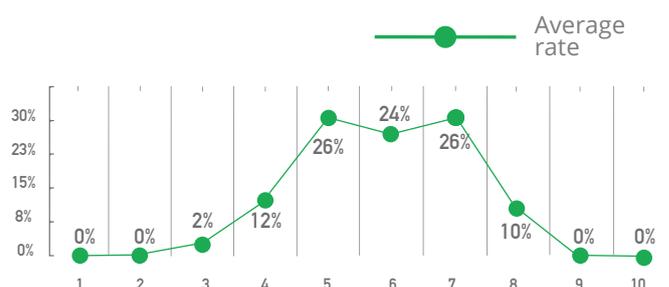


Fig:11 Evaluation of Government's performance in 2015, ICIL 2016 Q1

elections the social model reform might fail and be postponed far into the future.

Investors are also expecting the Government to act responsibly with public finances and stay aware of the importance of its long-term sustainability which means refraining from temptation to engage in populist spending.

Moreover, participants of the survey noted the importance of public sector effectiveness, pointing out the necessity to restructure public services, reduce bureaucracy and ensure its efficiency. According to investors, enhancing business transparency is an area requiring specific attention, especially the public procurement procedures.

Education system was mentioned as a challenge of critical importance. The lack of qualified labour will not be solved without a comprehensive education system reform as well as improvement of immigration policy that would allow to bring professionals from foreign countries. Another option could be attracting back young Lithuanian professionals residing in other countries.

### Business ethics and transparency

Finally it is important to note that investors feel negatively about the possibility of new taxes, especially ones related to labour, and hope for a more rational approach towards the transfer of the EU directives into the national law, which means avoiding too robust requirements and restrictions.

As mentioned, business ethics and transparency causes significant concerns among investors. As an area requiring attention and improvement it was mentioned by 79% of respondents. Therefore, investors were asked to identify the key drivers of ethical behaviour in their business. One factor stands out – protection of company brand and reputation (83%). Second most important factor is public acceptance/recognition (57%). This proves that the greatest power to motivate companies to act in an ethical way lies in the hands of consumers, since companies strive to stand out in their eyes as more socially responsible than their competition.

In addition, the main drivers and barriers impacting business ethics in Lithuania today were asked to be identified. Investors highlighted corporate social responsibility initiatives (64%) and high social values (57%) as the main drivers that positively contribute to ethical behaviour in business. Paradoxically, social values are also indicated as a barrier (57%), but the biggest obstacle to ethical business is seen as the shadow economy (88%).

Finally, managers were asked to specify the measures that are taken to ensure ethical behaviour in their companies. 83% of surveyed managers identified that their companies have a code of conduct, corporate social responsibility programs (71%) and business ethics trainings (67%).