

## Lithuania's economic development and outlook

20 September 2017

**Economic activity in Lithuania has intensified.** Improved economic development in foreign countries contributes to a substantial share of stronger economic expansion. In the euro area – a region of particular importance for Lithuanian manufacturers – economic expansion is spurred by a recovery in the labour market and household consumption, whereas improved confidence indicators, higher production capacity utilisation levels and increased orders have been encouraging investment. More active foreign trade also adds up to more intensive activity in the euro area. An improvement has been observed in the economies of commodity exporting countries. For example, following a recession in Russia, which lasted for two years, the country's real GDP starts growing, and investment and imports are on the rise after a three years' decline. The change in the economic development in this country at least partly reflects commodity price increases in global markets. Russia is no longer as important trade partner of Lithuania as it was several years ago; however, its economic expansion affects other CIS and neighbouring countries with which Lithuania's trade partners have trade and financial relations.

With the improvement of the international economic situation the demand for Lithuanian exports has been growing; hence, foreign trade has expanded substantially. It should be noted though that a substantial increase in exports is not only due to higher demand but also a recovery in investment, which contributed to the manufacturing potential. For example, recently the tangible investment in manufacturing rose significantly, and not only in the largest branches of production (food, chemical products, plastics, furniture) but also in production smaller in size (paper, metal products). Thus, the branches smaller in size contribute markedly to higher manufacturing expansion as well. The transportation sector has been posting quite substantial growth as well. Having much invested, this sector continues to increase its exports of services and firmly establishes itself in European markets.

Higher economic activity also stems from more abundant construction. An increase in the demand for investment entailed construction of more non-residential buildings. Nevertheless, construction growth does not surpass the decline in construction observed in previous years. As it is known, in 2016, flows from the international support funds declined by 49.1 per cent. It was expected that these flows would recover to a great extent in 2017; however, in the first half-year these funds even contracted by 14.0 per cent year on year. Therefore, construction works funded from the EU support funds have not been growing in number so far.

**The labour market situation remains complicated.** This market is subject to a number of factors. The major ones include the demographic trends. In recent years, the most active population in the Lithuanian labour market (aged 15–64) decreases by 1–2 per cent per year. A contribution to this stems not only from a lower birth rate but also continuing emigration. The impact of shrinking population on general economic development is reduced by residents' more active participation in the labour market, with the retirement age lengthening and favourable employment possibilities contributing to that. Participation rate is likely to increase even more over a certain period; however, this factor will not be so strong as to offset the trend of shrinking population. In other words, even though the population's involvement in the labour market has increased and is likely to increase further, the labour force, comprising of working people and those in search for work, will decline.

Such labour market situation restricts business development possibilities, which significantly affects wage developments. Employees and persons in search for work have more possibilities to negotiate higher wages, and thus they rise very fast in recent quarters (more than 9% over a year). The increasing labour share, which is above its historical average for the third consecutive year, indicates the labour market tensions. The rise in minimum wage, however, contributed quite substantially to wage growth too.

**The improved international economic environment, employee-conducive labour market situation and a recovery in investment will affect economic development over the projection horizon.** The expansion possibilities for the export sector will be improved by a better economic situation across different regions of the world and a pick-up in investment. Rising household income and an expected recovery in the flows of EU support funds will be conducive to economic activities oriented towards domestic demand. However, economic expansion will be increasingly curbed by a decrease in labour force, whereas significant growth in labour costs may pose a threat to corporate competitiveness. It is now projected that Lithuania's real GDP will expand by 3.6 per cent in 2017, and by 2.8 per cent in 2018.

**Global developments increased headline inflation at the beginning of the year; they entailed fuel and food price increases. Meanwhile recently prices related to internal economic development started rising to a greater extent.** The rise in the latter prices – the so-called core inflation, which comprises the prices of services and industrial goods – contributes to approximately half of headline inflation. The other share of headline inflation is largely due to a rise in the prices of alcohol and tobacco (recently they are more than one-tenth higher than a year ago) and have picked up substantially due to raised excise duties.

Core inflation has now been the highest since the beginning of economic recovery. In addition, it is higher than in neighbouring countries Estonia and Latvia. The increase in core inflation is primarily related to labour market developments. Wages in Lithuania rose significantly of late, and this rise exceeded the increase in labour productivity. The gap between wage developments and labour productivity developments in Lithuania was more pronounced than in the neighbouring countries; therefore, the price pressures in Lithuania were higher. A more favourable economic environment observed for some time – rising income and increasingly higher domestic demand – contributes to price pressures as well. However, this year the prices for some services are characterised by particularly significant fluctuations, for example, the prices of passenger transport by air services, which are likely to be subject to other supply and demand factors than those discussed above. The forecast for inflation in 2017, due to services inflation rising above expectations, is revised to 3.4 up from 3.2 per cent.

It is projected that next year the inflation will fall. It should be reduced by the same factors which increased it this year, i.e. it is projected that global oil prices will not rise next year, whereas food commodity prices are expected to rise only marginally. Moreover, next year it is not intended to raise excise duties as much as this year. All this will suppress headline inflation. It is projected that inflation will stand at 2.2 per cent in 2018.

#### Outlook for Lithuania's economy in 2017–2018

	September 2017 projection <sup>a</sup>			June 2017 projection		
	2016	2017 <sup>b</sup>	2018 <sup>b</sup>	2016	2017	2018
<b>Price and cost developments (annual percentage changes)</b>						
Average annual inflation, as measured by the HICP	0.7	3.4	2.2	0.7	3.2	2.2
GDP deflator <sup>c</sup>	1.2	3.0	2.2	1.2	2.5	2.2
Wages	8.4	7.8	5.9	7.9	6.5	5.7
Import deflator <sup>c</sup>	-4.3	4.9	1.9	-4.3	5.0	1.9
Export deflator <sup>c</sup>	-3.1	4.6	1.8	-3.1	3.9	1.8
<b>Economic activity (constant prices; annual percentage changes)</b>						
Gross domestic product <sup>c</sup>	2.2	3.6	2.8	2.2	3.3	2.8
Private consumption expenditure <sup>c</sup>	5.2	4.2	3.6	5.2	4.2	3.6
General government consumption expenditure <sup>c</sup>	1.4	1.5	1.1	1.4	1.5	1.2
Gross fixed capital formation <sup>c</sup>	0.1	5.5	6.2	0.1	5.5	5.7
Exports of goods and services <sup>c</sup>	3.4	7.3	4.3	3.4	3.9	4.3
Imports of goods and services <sup>c</sup>	2.4	8.4	5.5	2.4	4.8	5.3
<b>Labour market</b>						
Unemployment rate (annual average as a percentage of labour force)	7.9	7.3	7.0	7.9	7.3	7.1
Employment (annual percentage change) <sup>d</sup>	2.0	-0.3	-0.3	2.0	0.0	0.0
<b>External sector (as a percentage of GDP)</b>						
Balance of goods and services	0.9	-0.1	-1.0	0.9	-0.5	-1.3
Current account balance	-0.9	-1.1	-1.9	-0.9	-1.5	-2.1
Current and capital account balance	0.6	0.3	0.5	0.6	0.4	0.4

<sup>a</sup> Projections of macroeconomic indicators are based on information made available by 14 August 2017

<sup>b</sup> Projection

<sup>c</sup> Adjusted for seasonal and workday effects

<sup>d</sup> National accounts data; employment in domestic concept