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## Lithuania's economic development and outlook

19 March 2018

**Global economic expansion remains strong.** A pick up in global economic activity has been driven by the recovery in investment and, in turn, more robust international trade. It is also supported by the continuing transmission of the accommodative policy stance. Stronger-than-expected economic growth has been broad-based, accelerating past its previous projections in advanced economies, notably the euro area and the US. The US outlook and its growth trajectory are supported not only by positive shifts in the international environment and the depreciation of the US dollar. The tax reform is also likely to provide some impetus already in the upcoming years, spurring corporate investment and household consumption. The accommodative policy stance and the changed economic situation – higher consumer and corporate confidence, improved labour market conditions, and expanding external trade – are also feeding into higher growth in the euro area. The economic outlook for developing countries has been relatively stable, although commodity-exporting economies, for example Russia, are likely to see somewhat stronger-than-anticipated growth momentum.

**The international economic environment should boost Lithuania's exports; nonetheless, relative to last year's performance, they are projected to grow at a slower pace.** In 2018, economic activity in the European Union (EU) is expected to match the growth rates recorded in 2017, yet some of Lithuania's key trading partners, such as Latvia and Poland, will face a slowdown. Last year, real GDP in Latvia and Poland increased more than 4.5%. It was reinforced by more pronounced external trade and burgeoning domestic demand, which is projected to see milder growth in 2018. As economic activity in these countries loses steam, import growth should be more restrained as well. Imports are also expected to cool off in Russia, another key trading partner. In 2017, due to inventory restocking and favourable developments in domestic demand, it saw a spike in import, which increased by around a sixth. According to current projections, economic activity in Russia will continue to gradually strengthen, nevertheless imports are expected to decelerate compared to last year.

**Investment will be the mainstay of Lithuania's economic development.** Firming export demand will prompt corporates to spur investment, especially in production capacity. Expansion in the exporting sector is usually followed by a ramp up in investment in machinery and equipment, which, in turn, reinforces imports since the bulk of capital goods are imported from other countries. Consequently, production capacity is increased, creating value added, which is also boosted by construction-related investment. They drive an upturn in capital – a factor of production – and fuel short-term activity in the construction sector. Having previously slumped, such investment started to recover in 2017 supported by construction of non-residential buildings and engineering structures, which might be linked to expanding economic activity and higher government spending on investment. The latter should continue to firm this year as the influx of EU funds enhances following a two-year trough. It is expected to be the key determinant of the year-on-year increase in domestic investment.

**Compared to last year, economic expansion will be less robust, although solid.** It will be underpinned by a rebound in export and investment momentum, as well as in private consumption. Even though labour costs are already significantly higher, declining unemployment and mounting tensions in the labour market will give impetus for wage growth, which will be additionally supported by the rise in minimum wage. Hence household income should continue on its upward path, boosting consumption. Over the past few years, growth in private consumption has been relatively stable, recording an annual rate of 3.9–4.5%. Workers have benefited from further improvements in labour market conditions, pocketing an increasing gain in income on an annual basis. Similar economic conditions will prevail over the projection horizon, thus private consumption dynamics will exert strong upward pressure on the overall economic activity. According to current projections, real GDP will expand by 3.2% in 2018 and 2.7% in 2019.

**Annual headline inflation remains at elevated levels, yet it shows signs of a downward trend.** Several months ago, inflation stood at 4.6%. Currently it is down by approximately 1 percentage point. Such a shift is neither random, nor characteristic only of Lithuania. Global food commodity prices have recently been less volatile than in mid-2017. Given considerable food commodity supply and its rather sizeable stock, food commodity prices are rising at a slower pace than at the end of 2016 and the beginning of 2017. As a result, increases in consumer food prices are less pronounced than a few months ago. The same holds true for prices of

meat, milk and dairy products, and non-alcoholic beverages. Global oil prices are continuing their upward climb, albeit at a somewhat slower rate than before, bringing more moderate rise in fuel prices. These factors curb inflation not only in Lithuania, but also in the neighbouring countries, i.e. Latvia and Estonia.

**Not only the prices related to commodity markets are moderating, the rise in prices of services is losing momentum too.** A few months ago, the annual growth rate of prices for services exceeded 7%, yet recently it stood at around 5%. Such price dynamics so far only imply attenuating short-term price fluctuations rather than underlying changes in economic activity. This change was largely driven by prices for air transport, which recently have been rather subdued (in mid-2017, conversely, they rose by 20–30%). With the impact of the most volatile prices eliminated, the overall rise in prices of services is unwinding slowly and is still relatively large. Such a trend reflects the continuing increase in labour costs and contribution of the strengthening domestic demand.

**In 2018, annual headline inflation in Lithuania is projected to slide below the level recorded last year.** Price developments in global commodities (both food and energy) already are and will continue to be a drag on inflation rates. Compared to last year, both excise duties and prices of services should record more modest rises. Reaching 3.7% in 2017, inflation in 2018 is projected to stand at 2.7%.

### Outlook for Lithuania's economy in 2017–2019

	March 2018 projection <sup>a</sup>			December 2017 projection		
	2017 <sup>b</sup>	2018 <sup>b</sup>	2019 <sup>b</sup>	2017	2018	2019
<b>Price and cost developments (annual percentage changes)</b>						
Average annual inflation, as measured by the HICP	3.7	2.7	2.2	3.7	2.6	–
GDP deflator <sup>c</sup>	4.0	2.6	2.2	3.4	2.3	–
Wage	8.5	6.7	6.0	7.9	6.1	–
Import deflator <sup>c</sup>	4.1	2.6	1.7	4.3	2.6	–
Export deflator <sup>c</sup>	5.8	2.3	1.6	5.8	2.3	–
<b>Economic activity (constant prices; annual percentage changes)</b>						
Gross domestic product <sup>c</sup>	3.9	3.2	2.7	3.6	2.8	–
Private consumption expenditure <sup>c</sup>	4.2	3.7	3.5	4.2	3.6	–
General government consumption expenditure <sup>c</sup>	1.5	1.1	1.1	1.5	1.1	–
Gross fixed capital formation <sup>c</sup>	5.1	6.3	5.5	4.7	5.4	–
Exports of goods and services <sup>c</sup>	11.0	5.7	4.6	9.4	4.5	–
Imports of goods and services <sup>c</sup>	13.2	6.0	5.4	11.8	5.2	–
<b>Labour market</b>						
Unemployment rate (annual average as a percentage of labour force)	7.1	6.7	6.6	7.1	6.8	–
Employment (annual percentage change) <sup>d</sup>	–0.5	–0.3	–0.3	–0.3	–0.3	–
<b>External sector (as a percentage of GDP)</b>						
Balance of goods and services	1.1	0.6	–0.1	0.8	0.0	–
Current account balance	–0.1	–0.8	–1.6	–1.1	–1.5	–
Current and capital account balance	1.1	1.1	0.6	0.3	0.4	–

<sup>a</sup> These projections of macroeconomic indicators are based on information made available by 14 February 2018

<sup>b</sup> Projection

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

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