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Lithuania's economic development and outlook

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Global economic activity remains robust, although increasingly more heterogeneous across regions. Supported by the sizeable fiscal stimulus and higher expenditure in the private sector, activity growth in the US is on an upswing. Solid domestic demand boosts US imports, thus reinforcing global trade flows, which are nevertheless currently increasing at a slower pace than a few quarters ago. The slowdown in external trade growth has been especially pronounced in advanced economies, such as the euro area and Japan, where in 2017 economic activity saw the strongest rebound, thus bolstering global economic momentum. Recently macroeconomic indicators in these countries have become more subdued – manufacturing has moderated, imports and exports are decelerating, while downside risks took a toll on confidence.

Mounting uncertainty regarding future prospects weighs on international trade. The direct impact of trade restrictions is limited as they are placed on a rather small portion of global trade. However, the possibility of rising tensions over trade and retrogressive approaches to free trade has a much stronger effect on both trade flows and economic activity. Tighter trade restrictions could increase corporate costs and reduce the purchasing power of households, thereby affecting household consumption, investment and labour market indicators. Macroeconomic developments could be also undermined by declining sentiment, which dents household and corporate spending. Uncertainties over international trade flows might already have implications for corporate decision-making.

Weakening external demand has been a drag on Lithuania's exports. Compared to last year, exports of goods of Lithuanian origin have been decelerating. This was largely influenced by slowing EU demand. Re-exports have almost come to a standstill: Russian imports, which showed robust growth in 2017, have significantly lifted Lithuania's re-export to this country; however, this year, with Russian imports slowing down, re-exports are almost at a halt.

Unlike external demand, domestic macroeconomic indicators retain momentum. Having started to show clear signs of upward trend last year, investment has continued on its solid growth path. It should be noted, however, that investment into means of production (a large portion of which is imported) was more buoyant in 2017, while 2018 saw more robust investment in buildings and structures. This is linked to the anticipated increase in EU funding, which spurs construction of non-residential and engineering buildings. Construction picks up steam when economic activity already exceeds potential, i.e. growth in construction work boosts economic development and reinforces certain macroeconomic imbalances. It also determines changes beyond the boundaries of the sector – activity in related sectors speeds up, household income rises, which translates into stronger domestic demand as well as pressure on wage and other labour market-related indicators.

Higher immigration rates have eased tensions in the labour market only marginally. The main bulk of immigrants work in the transport sector, which saw a rapid increase in employees two years ago when immigration procedures for certain professions were simplified. The number of workers in this sector is rising quickly, with its annual growth rate nearing 5%. Many other sectors, however, find themselves on the other side of the spectrum, even though an increasingly larger share of companies states that labour shortages limit their activities. For example, the number of employees in manufacturing is growing only modestly, while trade and other services activities even report a decline in the number of workers. This reveals imbalances in the labour market, ultimately leading to rapid wage increases, which have outpaced the growth rate of labour productivity, and a rise in the labour share, which has reached historically high levels. Observed for quite some time, such imbalances are not likely to disappear in the near future, affecting economic development. Given the substantial growth in domestic demand and increasing – though at a slower-than-expected pace – exports, this year real GDP is projected to expand by 3.4%. On the back of narrowing growth of flows from EU funds and further weakening demand in external trade partners, economic expansion in 2019 should moderate and reach 2.8%.

Annual headline inflation has continued to evolve at a lower rate. The level of inflation is largely dependent on changes in global commodity prices. Amid a pick-up in global economic activity, stronger demand boosted oil prices, which are also underpinned by supply constraints. Oil prices in euro are now roughly 40% higher than a year ago. This exerted upward pressure on fuel prices, which, in turn, are currently increasing headline inflation more than prices of other major groups of goods and services. However, in recent months oil prices have been lower compared with the previous projection exercise (partly due to the agreement between oil-exporting economies to increase its extraction), contributing to the fact that the outlook for headline inflation has been revised down for 2018. Food prices also lent a lesser-than-expected support to inflation. With sufficient supply accumulated, the majority of global food commodity (except grain) prices are declining. As a result, the rise in consumer food prices is also less pronounced. In the near term, however, this downward trend might reverse as unfavourable weather conditions and potentially poor harvest might lift food prices. Underlying inflation – which covers prices for services and industrial goods – has also slightly moderated. This was largely influenced by air transport prices, which soared during the summer months of 2017, yet saw a significant drop this year due to the base effect. Eliminating the already-mentioned price contribution, underlying inflation remains rather stable, reflecting continued upward pressure from increasing labour costs and domestic demand. This year average annual inflation is expected to stand at 2.6%. In 2019, given the anticipated slide in oil price inflation, annual inflation is projected to average 2.2%.

Outlook for Lithuania's economy

	October 2018 projection[a]			June 2018 projection		
	2017	2018[b]	2019[b]	2017	2018[b]	2019[b]
Price and cost developments (annual percentage changes)						
Average annual inflation, as measured by the HICP	3.7	2.6	2.2	3.7	2.7	2.2
GDP deflator[c]	4.3	2.5	2.2	4.3	2.6	2.2
Wages[d]	8.6	8.7	6.8	8.6	7.6	6.0
Import deflator[c]	4.4	2.8	1.7	4.4	2.8	1.7
Export deflator[c]	5.4	2.5	1.6	5.4	2.5	1.6
Economic activity (constant prices; annual percentage changes)						
Gross domestic product[c]	3.9	3.4	2.8	3.9	3.2	2.7
Private consumption expenditure[c]	4.0	3.8	3.8	4.1	3.8	3.5
General government consumption expenditure[c]	1.0	1.1	1.1	1.0	1.1	1.1
Gross fixed capital formation[c]	6.7	7.7	5.2	6.7	6.9	5.2
Exports of goods and services[c]	13.7	5.3	4.6	13.7	5.7	4.6
Imports of goods and services[c]	13.6	6.2	5.5	13.6	6.9	5.4
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	6.5	6.3	7.1	6.7	6.6
Employment (annual percentage changes)[e]	–0.5	0.2	–0.3	–0.5	–0.1	–0.3
External sector (percentage of GDP)						
Balance of goods and services	2.3	1.4	0.7	2.3	1.2	0.5
Current account balance	0.7	–0.2	–0.8	0.7	–0.2	–1.0
Current and capital account balance	1.9	1.7	1.5	1.9	1.6	1.2

[a] Projections are based on information made available by 21 August 2018.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] The wage projection for 2019 excludes corrections made due to forthcoming changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.