LIETUVOS BANKAS
EUROSISTEMA

Lithuania's economic development and outlook

11 June 2019

Global headwinds have increased. The ongoing tensions in international trade, uncertainty surrounding further policy measures and lower market confidence have led to a softening growth momentum. Although improved financing conditions and positive labour market developments have boosted global activity, it proved to be not enough to offset the sharp decline in investment growth and the slump in international trade. This year, world trade is expected to grow at the slowest pace since the financial crisis. Recently, it has been lagging behind real GDP growth, which, as historical data suggest, is an unusual phenomenon that may have adverse implications in the medium and long term. Due to its negative effect on competition, specialisation and knowledge spill-over, weaker trade may weigh on labour productivity and global growth.

Despite the current international climate, growth in Lithuania remains robust. A number of economic activity indicators have been growing at a fairly rapid pace. Despite the deteriorated international environment, exports have been gaining traction. Significant gains were recorded in exports of goods of Lithuanian origin, which last year weakened less than some other export components (e.g. exports of services and re-exports). Such trends are likely to be supported by the previous surge in business investment, which has boosted production capacity and increased corporate competitiveness, in turn allowing firms to expand production and exports. Domestic demand, particularly private consumption, has been also on an upswing. Its buoyant growth is underpinned by a number of factors, including wage increases, reduced deductions from wages and higher social transfers.

Labour market conditions are changing, though the overall market assessment remains unchanged. The share of firms claiming that labour shortage hinders their activities is no longer increasing. Wage growth in the private sector has been losing steam for several consecutive quarters, yet still remained high, outpacing growth in value added. In other words, the labour share has been increasing, reflecting tensions in the labour market. On the other hand, slower wage growth in the private sector comes as no surprise, since it has been outpacing labour productivity for the last few years, a trend that cannot last long.

Economic activity in Lithuania has been exceeding its potential. Interestingly, the weaker external environment is not only hampering domestic growth, but also prevents significant imbalances. Companies that are better positioned for competition and continue to prioritise investment and productivity growth find it easier to withstand emerging challenges. Even with weaker external demand and significant increases in labour costs, more vigorous growth in their labour productivity puts such companies on a stronger footing. Other firms are more dependent on domestic and external demand, hence a less favourable international environment may curb their development and activities. This is particularly important considering the fact that adverse trends in the global economy are not necessarily short-term.

Looking ahead, factors behind weaker global growth may persist over the next few years. Tariffs imposed by the US and China in 2018 have had both a direct and indirect impact on international trade flows. This year, the countries have announced a new round of tariffs. Uncertainty surrounding trade policy (in particular related to the US-China trade dispute and Brexit) remains high and continues to hinder global investment, thus bringing knock-on effects on international trade. Having slowed by nearly a fourth compared to 2018, growth in imports of Lithuania's trade partners, i.e. demand for goods and services exported from Lithuania, is expected to continue at a modest pace in the following years.

Although differences in Lithuania's and global growth momentum are expected to prevail for some time, economic growth in Lithuania will gradually slow. With economic activity above its potential, rapid economic growth becomes increasingly difficult to maintain. Even though investment could boost the growth potential, amid the current economic climate this is not particularly realistic – both uncertainty over global economic development and weaker growth in EU funds may constrain investment in Lithuania. Growth is also supported by labour resources. Recently, employment in the country has risen, however such tendencies may not be sustained in light of adverse demographic trends which might not be offset by intensified immigration flows. Having grown by 3.5% in 2018, Lithuania's real GDP is projected to increase by 3.2% in 2019 and 2.5% in 2020.

Outlook for Lithuania's economy

	June 2019 projection[a]			March 2019 projection		
	2018	2019[b]	2020[b]	2018[b]	2019[b]	2020[b]
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.5	2.4	2.3	2.5	2.4	2.3
GDP deflator[c]	3.3	2.4	2.2	3.4	2.4	2.2
Wages[d]	9.6	8.1	6.7	9.6	8.1	6.7
Import deflator[c]	4.7	2.1	1.8	4.7	1.8	1.8
Export deflator[c]	3.8	2.0	1.7	3.8	1.8	1.7
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.5	3.2	2.5	3.4	2.7	2.6
Private consumption expenditure[c]	3.9	4.0	3.6	3.9	3.9	3.6
General government consumption expenditure[c]	0.8	0.9	0.6	0.6	0.9	0.8
Gross fixed capital formation[c]	6.7	5.6	4.1	6.7	5.3	4.2
Exports of goods and services[c]	5.0	4.0	3.5	4.9	4.0	3.7
Imports of goods and services[c]	4.4	4.4	4.3	4.4	4.6	4.5
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.1	5.8	5.7	6.2	6.0	5.9
Employment (annual percentage change)[e]	1.5	0.8	-0.3	1.0	0.2	-0.3
External sector (percentage of GDP)						
Balance of goods and services	2.7	2.3	1.5	2.5	2.0	1.3
Current account balance	1.6	0.2	-0.7	-0.3	-0.5	-1.4
Current and capital account balance	3.1	1.8	0.9	1.2	1.2	0.1

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

Inflation has been fluctuating, yet its key determinants remain broadly unchanged. Given ongoing wage growth, service prices continue on their upward path. Currently they account for more than half of headline inflation. The main contributors to the rise in service prices include both basic services, such as repair and maintenance of vehicles, medical services, hairdressing, personal care and rental services, and services that are not considered to be basic necessities, e.g. restaurant and café services. Fluctuations in headline inflation are mainly driven by the steeper food and fuel prices. Growth in food prices is linked to the persistent increase in global food commodity (excluding cereals) prices, which can be attributed to the drop in production and stock of food commodities, high global demand and the surge in oil prices. This year, the latter have been spurred by the growing belief that oil-producing countries are adhering to the agreement to limit oil production, as well as sanctions imposed on Iran and production disruptions in Venezuela. Having been increasing for the past few months, oil prices have only recently approached the highs observed in 2018. Therefore, this year they are expected to remain at roughly the same level as the year before. In other words, having been an important driver of inflation for the last several years, oil prices are not expected to put upward pressure on headline inflation in 2019. More moderate shifts in oil prices should thus offset the rise in other, primarily food and some administered (electricity, gas), prices. According to current projections, average annual inflation, which stood at 2.5% in 2018, is expected to be 2.4% in 2019 and 2.3% in 2020.