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Lithuania's economic development and outlook

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The coronavirus outbreak and government restrictions imposed in order to sustain it have recently been putting increasingly more weight on the global economy. By now, it is already clear that Lithuania will also not be left unscathed, yet the duration and scope of the economic implications are a matter of great uncertainty. Therefore, the Bank of Lithuania has prepared three potential Lithuanian economic development scenarios for 2020 and 2021. Under these scenarios, the downturn in the country's economy in 2020 might range from -3.4% to -20.8% (-11.4% according to the baseline scenario). Following the two relatively more optimistic projections, economic growth could be back on track already in 2021. It is nevertheless important to note that the situation might considerably worsen if the world fails to effectively contain the pandemic, if restrictions last longer or if the global economy faces long-term economic challenges, although the latter developments are projected only in case of the most severe scenario.

The coronavirus outbreak has put a drag on global economic growth. When the virus first started to spread in China, it was expected to only cause short-term disruptions in the supply chains, while its effects on the global economy were believed to be rather limited. However, as an epidemic has turned into a pandemic and increasingly more cases are now being reported in developed economies, it becomes evident that the negative repercussions of the virus will inevitably reverberate throughout the global economy. It is already known that during the first two months of 2020 China's industrial output plunged by 13.5%, while retail sales dropped by 20.5%. Preliminary data, such as the halved number of restaurant visitors across the globe or a 30% decrease in passenger flows in the US major airports, show that the global economic activity suffered a sharp decline in March as a result of rigid restrictions imposed in the majority of Western states. These restrictions had a direct negative impact on the services sector, specifically businesses engaged in accommodation, catering, entertainment or other activities, as well as retail trade of non-food products. The manufacturing sector has also felt the consequences of the imposed restrictions – the announced quarantine and closed borders lead to disruptions in the supply chains of intermediate products, while some factories were forced to temporarily shut down. This sector, particularly production of non-essential durable goods, may in the long run suffer the outcomes of the deteriorating economic situation as well as declining labour market and consumer confidence indicators. In March 2020, one of the key leading economic indicators – the euro area composite purchasing managers' index (PMI) – hit its all-time lows since it was first recorded in 1998 (decreased to 31.4, compared to 51.6 in February). Having plummeted to the lowest level since early 2011, investors' sentiment indicators signal that the global economy might already be in recession.

Financial markets respond to the threats posed by the pandemic. With escalating concerns over the potential economic damage inflicted by the coronavirus, share prices in mid-March saw the most dramatic decline over the last 11 years. Sharp negative correction in financial markets is currently having a detrimental impact on corporate funding conditions, reducing the value of household assets and may bring negative knock-on effects on private consumption growth. Investors' retreat to safety resulted in spiking gold prices and lower yields of the safest government bonds (e.g. the US, German and Swiss). However, with escalating risks and markets preparing for a higher government borrowing demand, the yields of corporate bonds as well as those of more risky EU government bonds have sharply increased (e.g. the Italian government bond yields have doubled to reach 2.19% over the week as of 11 March). The coronavirus-led decrease in oil demand and the failure of OPEC countries to reach an agreement regarding oil production restrictions have initially slashed one-third of the oil price, and shortly reduced it to $25 per barrel – its lowest level in 20 years.

International organisations, governments and central banks have taken urgent action to mitigate the economic implications triggered by the coronavirus outbreak. The World Bank announced a $14 billion package of fast-track financing to assist countries in their efforts to prevent the rapid spread of the virus, while the International Monetary Fund stands ready to mobilise its $1 trillion lending capacity to help the affected countries. Most states have introduced large-scale fiscal measures aimed at providing the healthcare staff with the necessary equipment, preserving jobs and household income, maintaining business liquidity and aiding the worst-hit sectors. Central banks are also keeping abreast – in March 2020, the US Federal Reserve cut the basic interest rate twice to 0–0.25%, and announced unlimited bond purchases, while the European Central Bank launched a special €750 billion pandemic emergency purchase programme for both corporate and government bonds. Moreover, it will also ease the conditions for targeted longer-term refinancing operations. However, even with all of these measures in place, global economic recession seems to be imminent.

The accelerating spread of the coronavirus has also put a damper on the Lithuanian economy. In order to contain the outbreak of the virus, a nationwide quarantine in Lithuania was announced on March 16. The measures included closing the country's borders, limiting work-related travelling, suspending provision of a substantial part of various services, banning public gatherings, restricting the activities of caterers and shops. Although these measures are expected to slow down the spread of the virus in the country, their economic impact has already manifested itself in a visible form. Based on the estimates of the Bank of Lithuania, the adopted decisions have directly affected nearly one-fifth of employees in the non-financial sector. However, such consequences have been partly mitigated by the increased availability of medical certificates of absence – due to the current situation, the number of persons taking such certificates has drastically escalated (as a result of the closure of pre-school and school education institutions, more persons can take advantage of this opportunity), similarly to the rising number of those taking unpaid leave. Although both the number of redundancies and unemployed persons have not yet substantially increased, they might start to go up, should the current situation extend to a longer period of time.

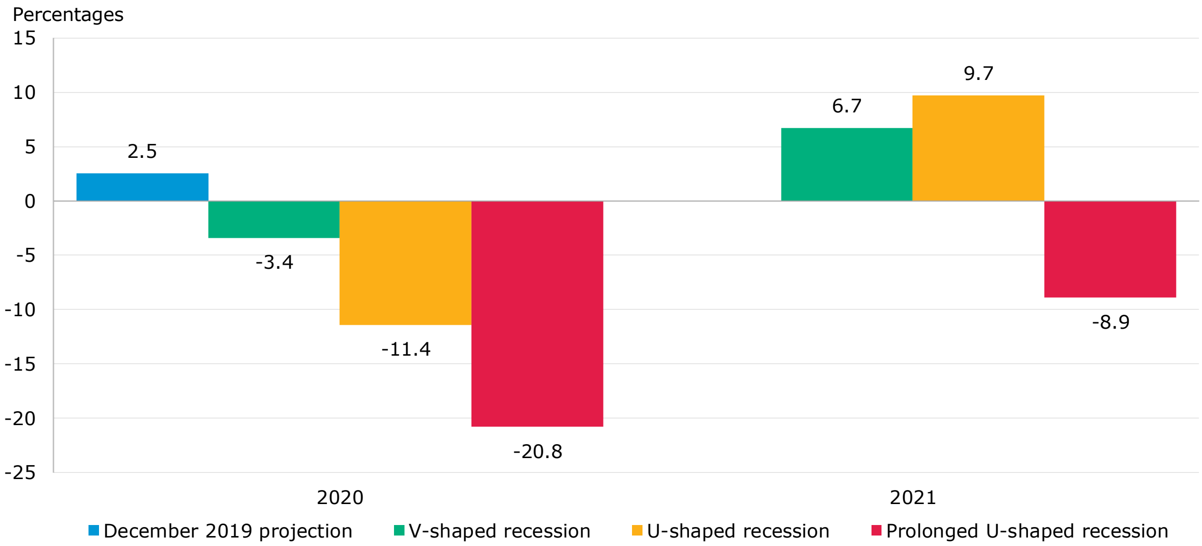
Lithuania's economy to be affected through several key channels. The adverse impact will first of all materialise through a decline in demand for goods and services. The restrictions on free movement and certain activities imposed in Lithuania's export partners as well as fading economic activity will dampen the demand for Lithuanian exports, which, in turn, will result in a lower demand for transportation services. The measures that have been undertaken in order to contain the spreading virus will also have their toll on internal consumption. With restrictions put on shopping centres, services and other facilities, consumption of non-essential goods and services will plummet, while lingering uncertainty as well as weaker labour market and consumer confidence indicators might curb consumption as well. The country's economy will also be affected through the supply channel. Disruptions in global production and supply chains may reflect adversely on Lithuanian manufacturers importing intermediate products from abroad. With the growing number of the infected or quarantined, the production volumes might also be restricted by labour shortages. Cross-border traffic restrictions, which are hampering international trade, are weighing on the activities of exporters and transport sector enterprises, while free movement restrictions tend to hit hardest the tourism and air travel sectors.

The economic stimulus measures proposed by the Lithuanian government and the Bank of Lithuania should mitigate the negative consequences of the coronavirus. Having declared a nationwide quarantine, the Lithuanian government, together with the Bank of Lithuania, announced a plan of economic and financial measures comprising €5 billion (or 10% of the country's GDP), where €500 million will be allocated to ensure the efficient operation of public health and safety systems, as well as to preserve jobs, household income and maintain business liquidity. Twice the amount (€1 billion) is to be allocated for economic stimulus through more favourable conditions for public and private sector investment. The package of the Bank of Lithuania, comprising nearly €2.5 billion, is aimed at easing capital adequacy requirements imposed on credit institutions, liquidity buffers and other supervisory measures, as well as at the application of the Eurosystem's accommodative monetary policy measures.

According to Bank of Lithuania calculations, these measures will boost economic growth by 1.1 percentage points in 2020 and 1.5 percentage points in 2021. However, due to the uncertainty surrounding the coronavirus outbreak and duration of social distancing measures, it is difficult to estimate whether this stimulation package will be sufficient enough to significantly mitigate the economic consequences induced by the current shock.

Due to the prevailing uncertainty, the Bank of Lithuania has prepared three economic development scenarios which entail a V-shaped, U-shaped and prolonged U-shaped recession. These scenarios differ in terms of three underlying assumptions: the size of the contraction in foreign demand, the duration of the quarantine and the pace of economic recovery. The V-shaped recession scenario entails that foreign demand for Lithuanian goods and services will decrease by nearly 4%, the quarantine will be revoked in 2 months, and the economy will start to recover in the third quarter of 2020. Should these assumptions materialise, the country's GDP would contract by 3.4% in 2020 and is then expected to increase by 6.7% in 2021. According to the U-shaped recession scenario, Lithuanian export volumes would decline to a similar extent as during the 2009 global financial crisis, i.e. by around 13%. While it is also assumed that the quarantine will last for 2 months, due to significantly deteriorated external environment, sluggish household consumption and weaker investment, the country's economy will only recover in the medium term. Should this scenario unfold, the country's GDP would decrease by 11.4% in 2020 and then rise by 9.7% in 2021. Under the most severe – prolonged U-shaped recession – scenario, external demand would also contract to a similar extent as during the global financial crisis, yet the duration of the quarantine will be twice as long, i.e. 4 months. This will lead to an extremely sharp decline in internal demand – both in household consumption and investment – which will jeopardise a more significant economic recovery in 2021. In case of this scenario, the country's GDP would plummet by 20.8% in 2020 and another 8.9% in 2021. However, it must be noted that the latter scenario is most unlikely.

Economic development scenarios of March 2020 compared to December 2019 projections



Sources: Statistics Lithuania and Bank of Lithuania calculations.

At the time of publishing these projections, the Bank of Lithuania is considering the U-shaped recession scenario as baseline. Under this scenario, the quarantine will have a particularly strong limiting effect on economic growth – the activities of certain businesses, such as restaurants and non-food stores, have been temporarily suspended, while some economic activities have been put under certain restrictions. Such businesses alone employ around one-fifth of all the employees in the non-financial sector, while with indirect relations taken into account, an even higher share of the employed will be affected. Although measures introduced by state institutions are aimed at retaining the largest possible number of jobs, it is not possible to preserve all of them, thus redundancies in the current situation cannot be avoided. As a result, the unemployment rate in 2020 is expected to increase to 12.5%. The income of persons engaged in suspended or restricted activities will also shrink, only to be partly compensated by the measures anticipated by the government. This, together with reduced financial potential of other companies, will contribute to a 2.6% decline in average wages. A steeper fall will only be prevented by the effect of the minimum monthly wage increased at the beginning of the year and the commitment to raise salaries for public sector employees, such as medical personnel. Combined with the increased uncertainty, these factors will put a squeeze on household expenditure: in 2020, household consumption is expected to contract by 15.2% year on year – the last time it declined to such an extent was during the global financial crisis. The economy will also feel a similar shock coming from Lithuania's key trade partners, where the announced quarantine will have a similar effect on the demand for goods and services. With shrinking number of orders from abroad, Lithuania's exports of goods and services are also set to decline. In 2020, the country's export volumes are expected to fall by 13.4%, as compared to 2019. There is no doubt that such environment is highly unfavourable to investment. Disruptions in global supply chains, contracting orders, restricted activities, diminishing liquidity and high degree of uncertainty are forcing businesses to take a very prudent approach regarding their expansion potential. While the economic stimulus package introduced by the Lithuanian government will promote investment flows, it will not be sufficient enough to prevent them from decreasing, especially in the private sector. A sharp decline in internal demand in 2020 will hinder the recovery – the economy is expected to return to the level observed at the end of 2019 only in the medium term. Yet it has to be noted that the low comparable base will encourage a rapid economic growth in 2021, which should reach 9.7%.

The prices of goods and services are expected to rise at a slower rate this year. Under the U-shaped scenario, inflation is projected to stand at 0.4% in 2020. Compared to previous projections, a significant decrease in inflation relates to the expected decline in economic activity, smaller wages and slumping oil prices. The persisting tensions in the labour market should subside this year, as the unemployment rate should pick up, while wages are set to fall by 2.6% and thus lift the pressure from service prices. With limitations put on a wide range of services and a decline in wages, the demand for services should also diminish, giving no grounds for an increase in service prices. The growth in prices of industrial goods, particularly durable commodities, will be further dampened by the lingering uncertainty regarding the future. On the other hand, the demand for food as an essential commodity should remain stable even amid the significantly deteriorated economic environment. The quarantine-driven food purchases in larger than usual quantities and a potential shortage of employees in various food production and supply chains might lead to a somewhat stronger price growth compared to 2019. Following the economic activity improvement expected in 2021, price increases should take traction and inflation is projected to reach 1.5%.

Outlook for Lithuania's economy according to the U-shaped recession scenario

	March 2020 projection[a]			**December 2019 projection**		
	2019[b]	**2020[b]**	**2021[b]**	**2019[b]**	**2020[b]**	**2021[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.2	0.4	1.5	2.3	2.3	–
GDP deflator[c]	2.8	-0.4	1.0	2.8	2.4	–
Wages[d]	8.8	-2.6	2.0	8.5	6.7	–
Import deflator[c]	-0.7	-1.9	1.4	1.0	1.7	–
Export deflator[c]	0.8	-2.0	1.1	2.1	1.6	–
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.9	-11.4	9.7	3.7	2.5	–
Private consumption expenditure[c]	3.2	-15.2	11.2	3.6	3.4	–
General government consumption expenditure[c]	0.7	2.9	0.8	1.2	0.4	–
Gross fixed capital formation[c]	7.3	-8.0	5.5	7.0	4.7	–
Exports of goods and services[c]	9.3	-13.4	15.1	8.8	4.0	–
Imports of goods and services[c]	6.7	-12.9	13.6	6.9	4.5	–
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.3	12.5	9.1	6.2	6.2	–

Employment (annual percentage change)[e]	0.3	-6.6	3.5	0.5	0.0	–
External sector (percentage of GDP)						
Balance of goods and services	4.8	4.2	5.2	4.0	3.6	–
Current account balance	3.7	3.6	3.5	2.0	1.5	–
Current and capital account balance	5.4	5.6	5.4	3.8	3.4	–

[a] The macroeconomic projections are based on data and information made available by 17 March 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] The wage growth rate for 2019 excludes corrections made due to changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.

The V-shaped recession scenario foresees a markedly faster economic recovery both on a national and global level. Contrary to the U-shaped recession scenario, in this case the world is expected to successfully contain the coronavirus outbreak and preserve the majority of jobs. While under this scenario the unemployment rate in Lithuania is projected to increase to 8.7% this year, in 2021 it should return to a level similar to the observed before the pandemic. Yet it should be noted that the average wage dynamics will still be substantially affected. Although in case of the V-shaped recession scenario the average wage is not expected to decrease in 2020, its growth is set to moderate and reach 2.4%. Such developments in the labour market, together with tightly restricted consumption, will cause a 6.5% decline in household expenditure. The Lithuanian economy will also suffer a milder shock in terms of the international environment. As a result of a successful fight against the adverse outcomes in the country's key trade partners, foreign demand for Lithuanian goods and services should also diminish to a smaller extent as compared to the U-shaped recession scenario. This will significantly mitigate the drop in Lithuania's exports, as it is estimated to incur a year-on-year fall of 4.7%. However, such an improvement in the internal and external environment will not be sufficient to provide a positive boost to investment growth. In this case, similarly to the U-shaped recession scenario, investment flows are set to decline in 2020, albeit rather marginally. The recession is not expected to last long, as economic growth should be back on track already at the end of 2020 and increase to 6.7% in 2021.

According to the V-shaped scenario, inflation in 2020 is projected to stand at 1.7%. Compared to the U-shaped scenario, the higher level of inflation will be supported by growing, albeit at a slower pace, service prices. Domestic consumption, which will decrease at a more moderate rate, and slightly rising wages will also play their role in this respect. Under this scenario, price increases will gain momentum in 2021 and inflation will return to its 2019 level and reach 2.2%.

Outlook for Lithuania's economy according to the V-shaped recession scenario

	March 2020 projection[a]			December 2019 projection		
	2019[b]	2020[b]	2021[b]	2019[b]	2020[b]	2021[b]
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.2	1.7	2.2	2.3	2.3	–
GDP deflator[c]	2.8	2.2	2.2	2.8	2.4	–
Wages[d]	8.8	2.4	3.6	8.5	6.7	–
Import deflator[c]	-0.7	-0.7	1.8	1.0	1.7	–
Export deflator[c]	0.8	-0.7	1.6	2.1	1.6	–
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.9	-3.4	6.7	3.7	2.5	–
Private consumption expenditure[c]	3.2	-6.5	8.5	3.6	3.4	–
General government consumption expenditure[c]	0.7	2.9	0.8	1.2	0.4	–
Gross fixed capital formation[c]	7.3	-0.5	2.3	7.0	4.7	–
Exports of goods and services[c]	9.3	-4.7	6.0	8.8	4.0	–
Imports of goods and services[c]	6.7	-5.2	5.1	6.9	4.5	–
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.3	8.7	6.9	6.2	6.2	–
Employment (annual percentage change)[e]	0.3	-2.6	1.7	0.5	0.0	–

External sector (percentage of GDP)						
Balance of goods and services	4.8	5.0	5.3	4.0	3.6	–
Current account balance	3.7	3.7	3.4	2.0	1.5	–
Current and capital account balance	5.4	5.5	5.1	3.8	3.4	–

[a] The macroeconomic projections are based on data and information made available by 17 March 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] The wage growth rate for 2019 excludes corrections made due to changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.