Lithuania's economic development and outlook

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Global economic development has been strongly affected by the rapidly evolving pandemic situation, government decisions regarding business and movement restrictions, and heightened uncertainty reflecting the unusual situation for firms and households. Following the introduction of lockdown measures, restrictions on domestic and cross-border mobility as well as on international trade, many countries faced a dramatic fall in economic activity already in March 2020. According to available data, retail trade in the European Union (EU) – Lithuania's main trading partner – decreased by a monthly 10.4% in March, while manufacturing dropped by 11.1%.[1] The largest fall was observed in production of durable and investment goods, coupled with significant losses in output of non-durable consumer goods, energy and intermediate products. Manufacturing in advanced economies contracted by roughly 7% over the same period – this more than outweighed the rebound in production in China, which was the first to be hit by the pandemic and also the first to see vast improvements.[2] PMI measures reveal that in April global activity deteriorated even further, both in the manufacturing and services sectors.

The overall situation took a gradual turn for the better in the middle of the second quarter of 2020. In May, the state of the pandemic stopped deteriorating in many advanced economies, which led to a gradual easing of lockdown restrictions. Contrary to their introduction, containment measures are being lifted relatively slowly and at different stages, depending on the pandemic situation at hand and the ability to respond to potential threats. According to available information, economic activity in Europe is starting to pick up as evidenced, at least in part, by the slight increase in electricity consumption and improving mobility rates within the major EU Member States. Such trends, however, are yet difficult to assess since there are still many factors that will put downward pressure on economic growth in the upcoming months, including concerns that the pandemic might potentially get worse, an increase in household precautionary savings and further labour market disruptions. All this has been weighing on household and business sentiment: for instance, in April 2020, euro area sentiment indicators fell to unprecedented lows and, despite a moderate recovery in May, have remained well below their long-term average.

Although growth in Lithuania has also been dampened by operational restrictions and weaker demand, at the beginning of 2020 the economy was in a comparatively more favourable situation. During the first quarter of 2020, Lithuania's real GDP contracted by a meagre 0.3% (while the EU's real GDP fell by 3.3%).[3] Manufacturing and construction sectors also boasted better performance indicators compared to the rest of the EU. In March, particularly, the Lithuanian manufacturing sector managed to avoid contraction, with more positive output indicators in its relatively larger industries (e.g. the food industry) and more robust production growth in the highly volatile sectors (e.g. pharmaceuticals).[4] In the first quarter of 2020, the volume of construction works in Lithuania, contrary to other EU countries, did not contract, possibly thanks to the intensive use of EU funds. In fact, many of the new Member States where absorption of EU funds is active have also not seen a decrease in the volume of construction output.[5]

Lithuania's economy entered a much deeper recession in the second quarter of 2020, while

[1] Based on data adjusted for seasonal and workday effects.
[2] Based on seasonally adjusted data.
[3] Based on data adjusted for seasonal and workday effects.
[4] Based on data adjusted for seasonal and workday effects.
[5] Based on data adjusted for seasonal and workday effects.

further growth prospects are clouded with tremendous uncertainty. Despite various stimulus measures that have been applied in order to preserve jobs, support household income and ensure corporate viability both in Lithuania and abroad, the imposed lockdown restrictions as well as escalating concerns over future prospects have significantly worsened the economic indicators for the second quarter of 2020. There is still considerable uncertainty regarding the extent to which economic activity will decline in the second quarter as well as the magnitude and trajectory of its future recovery, hence the current update of the Bank of Lithuania macroeconomic projections includes the baseline and two alternative (mild and severe) scenarios.

The baseline scenario assumes that the global pandemic situation will not be managed immediately, as COVID-19 outbreaks are likely to reoccur in the upcoming months, which will in turn hamper Lithuania's and global recovery. Should this scenario materialise, Lithuania's economy would shrink by 9.7% in 2020 (see Table 1). The more favourable outlook, as compared to the previous forecast, is largely determined by stronger economic development in the first quarter of 2020, better than expected labour market conditions and additional fiscal measures aimed at stimulating economic growth. Although private consumption expenditure in 2020 is set to contract to a lesser extent than previously anticipated, it is still projected to see a double-digit decline due to the set containment measures, the deteriorating situation in the labour market and heightened uncertainty over future prospects. It should be noted, however, that projections have not been revised upwards for all economic sectors. In the event of a sharp drop in global activity, foreign demand, i.e. imports of Lithuania's trading partners, are expected to plunge more than previously expected, which may consequently lead to a stronger contraction in exports.

Table 1. Outlook for Lithuania's economy – baseline scenario

	June 2020 projection[a]			**March 2020 projection**		
	2019	**2020[b]**	**2021[b]**	**2019[b]**	**2020[b]**	**2021[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.2	0.6	0.9	2.2	0.4	1.5
GDP deflator[c]	3.0	-0.4	1.0	2.8	-0.4	1.0
Wages[d]	8.8	-2.6	2.0	8.8	-2.6	2.0
Import deflator[c]	-0.6	-3.8	0.6	-0.7	-1.9	1.4
Export deflator[c]	0.8	-4.1	0.4	0.8	-2.0	1.1
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.9	-9.7	8.3	3.9	-11.4	9.7
Private consumption expenditure[c]	3.2	-12.5	8.6	3.2	-15.2	11.2
General government consumption expenditure[c]	0.7	2.9	0.8	0.7	2.9	0.8
Gross fixed capital formation[c]	7.3	-8.0	5.4	7.3	-8.0	5.5
Exports of goods and services[c]	9.6	-13.8	14.6	9.3	-13.4	15.1
Imports of goods and services[c]	5.9	-10.5	12.6	6.7	-12.9	13.6
Labour market						
Unemployment rate (annual average as a share of labour force)	6.3	11.9	8.8	6.3	12.5	9.1
Employment (annual percentage change)[e]	0.3	-5.0	3.1	0.3	-6.6	3.5
External sector (percentage of GDP)						
Balance of goods and services	5.4	2.2	3.5	4.8	4.2	5.2
Current account balance	4.2	1.8	1.8	3.7	3.6	3.5
Current and capital account balance	6.0	4.2	3.7	5.4	5.6	5.4

[a] The projections are based on information made available by 19 May 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] Wage growth for 2019 excludes corrections made due to changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.

If the country's economy follows the baseline scenario, it should start gradually improving already in the second half of 2020; however, it is not expected to reach its pre-crisis levels before 2022. Similarly to the previous crisis, economic recovery this time round should be also largely driven by the exporting sector. With declining domestic demand and rather limited internal market, further expansion is likely to be directed to existing and new foreign markets. Therefore, after a significant drop observed in 2020, exports should pick up by more than 14% in 2021. This will boost both private sector investment and labour market indicators. Although recovering trade should also support the rest of the economy, domestic demand-oriented sectors are not expected to reach their pre-crisis levels any time soon. One of the reasons behind such trends is the slow rebound of the labour market. Amid high uncertainty surrounding the economic outlook, employers might be more cautious in terms of recruiting new staff and raising wages. In other words, they may rather tap into existing resources to boost productivity and only start increasing wages when the labour market tightens. This would ultimately hold back recovery in private consumption, which is expected to return to its pre-crisis levels later than the overall economic activity.

The severe and sudden shock currently faced by the Lithuanian economy will have long-term repercussions. Even though the projected recovery should be quite strong, private sector investment is expected to see a relatively steep fall in 2020, thus it would take several years for it to return to the levels observed before the crisis. This in turn should dampen Lithuania's growth potential, which might also be negatively affected by recent international developments. The current and any future trade restrictions are expected to have an adverse impact on the global competitive environment and, consequently, productivity, which might curb economic activity in many countries, including Lithuania.

The economic downturn is also reflected in price developments both on a national and global scale. The economic slump has first of all affected energy commodity prices, which were dragged down by declining global demand (and uncertainty clouding its recovery) as well as the exhausted potential for further increases in oil stocks due to a lack of storage capacity. Oil prices in euro are expected to see a year-on-year decrease of approximately 42% in 2020, which will significantly reduce headline inflation in Lithuania and the rest of the world. The unfolding recession is likely to be already weighing on the prices of industrial goods and services in Lithuania – key components of underlying inflation. These prices are expected to rise at an increasingly moderate pace or even fall in the upcoming quarters, when growth in labour and other costs will start decelerating and then eventually drop, while diminishing household purchasing power will no longer put pressure on prices on the demand side. Downward shifts in underlying inflation are usually not abrupt – after the onset of the previous economic crisis, underlying inflation was slowly edging down for roughly a year. In the current environment, it is likely to continue correcting downwards for quite some time, thus containing headline inflation both in 2020 and 2021. Food prices have been rising at a relatively steady rate, largely driven by last year's rapid rise in meat and meat product prices, partly owing to expanding import volumes in China. Food price inflation is also boosted by the rise in excise duties in 2020, both on tobacco products and spirits. Under the baseline scenario, inflation in Lithuania is projected to stand at 0.6% in 2020 and 0.9% in 2021.

The alternative mild scenario assumes that the global spread of the COVID-19 pandemic should be contained in the second quarter of 2020, leading to a more rapid recovery of Lithuania's and global economies. Should this scenario materialise, Lithuania's real GDP would fall by 7.0% in 2020 (see Table 2) and bounce back to its pre-crisis levels already in 2021. In this case, the international economic environment would deteriorate less than projected under the baseline scenario. As a result, export volumes would also decline to a lesser extent – slightly over 9%. A relatively more favourable situation would lead to a smaller decline in private sector investment and private consumption as compared to the baseline scenario. The labour market would also be affected less, yet employment rates would nevertheless be set to decrease in the course of 2020, coupled with growing unemployment and stagnating wages. Lower labour and other costs as well as weakening domestic demand would put a halt on price growth, yet inflation would still remain higher than under the baseline scenario. In 2020, inflation in Lithuania would amount to 1.1%, in 2021 – 1.6%.

The alternative severe scenario assumes that the worldwide spread of COVID-19 will not be controlled until a medical solution to combat the virus is found. Therefore, global and Lithuania's economic activity should be relatively more muted both in the second and subsequent quarters of 2020. Economic growth would be curbed by prolonged restrictions on business activities and mass gatherings as well as considerably lower market expectations. Under this scenario, Lithuania's real GDP would contract by 17.0% in 2020 and it would take several years for it to bounce back on track. In such context, exports and domestic demand would see a significantly stronger decline compared to the baseline scenario, which would worsen the situation in the labour market. Moreover, with protracted recession, labour market conditions would keep deteriorating throughout the course of this year and in 2021. This might also have long-standing effects that would increase the equilibrium unemployment rate and reduce Lithuania's growth potential, in which case potential output in the country would suffer more than under the baseline scenario.

Table 2. Outlook for Lithuania's economy – alternative scenarios

	June 2020 mild scenario[a]			June 2020 severe scenario[a]		
	2019	2020[b]	2021[b]	2019	2020[b]	2021[b]
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.2	1.1	1.6	2.2	0.6	-0.3
Wages[d]	8.8	0.0	2.8	8.8	-9.7	-7.5
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.9	-7.0	10.1	3.9	-17.0	0.0
Private consumption expenditure[c]	3.2	-9.8	10.4	3.2	-20.2	-2.1
General government consumption expenditure[c]	0.7	2.9	0.8	0.7	2.9	0.8
Gross fixed capital formation[c]	7.3	-4.6	5.8	7.3	-13.9	-4.8
Exports of goods and services[c]	9.6	-9.1	15.7	9.6	-19.9	12.7
Imports of goods and services[c]	5.9	-6.4	13.1	5.9	-15.5	9.7
Labour market						
Unemployment rate (annual average as a share of labour force)	6.3	9.7	8.3	6.3	14.0	17.3
Employment (annual percentage change)[e]	0.3	-2.7	1.2	0.3	-7.3	-4.2

[a] The alternative scenarios are based on information made available by 19 May 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] Wage growth for 2019 excludes corrections made due to changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.