Lithuania’s economic development and outlook

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Global growth has seen great volatility this year due to the coronavirus (COVID-19) pandemic. Despite greater confidence in the assumption that the current crisis will be tackled through successful implementation of medical solutions, the second coronavirus outbreak and the consequent movement and business restrictions have once again slowed down economic development in many countries. Global activity had already rebounded before the second wave of the pandemic. The economic recovery was driven, in particular, by stronger private consumption. During the first wave of COVID-19, households were saving up more (both voluntarily and involuntarily due to fewer spending opportunities after certain restrictions were introduced in various countries), and in the summer months, with less containment measures in place, consumer spending increased. As a result, retail trade saw a rapid recovery, with its turnover even surpassing pre-pandemic levels. This, however, only reflects the trends of trade in goods, as trade in services did not return to its pre-crisis levels. Risks associated with the pandemic continued to affect both the supply and demand of services. The rebound in economic activity also had a positive, albeit heterogeneous, impact on manufacturing production growth. It bounced back in emerging market economies, but grew relatively less in advanced economies, failing to reach pre-crisis volumes before the second wave of the pandemic. Sectors orientated towards production of capital goods struggled to recover, probably as a result of uncertainties related to business investments.

The pandemic had a severe impact on the most important trade partner of Lithuania – the euro area. The contraction in euro area real GDP in 2020 is projected to be among the strongest compared to other advanced economies, which is likely due to the fact that the coronavirus outbreak in the euro area had started somewhat earlier, while movement and business restrictions were tighter. The situation in euro area economies also started to deteriorate faster during the second wave of the pandemic. This is particularly evident in the services sector, where activity is declining. Having suffered a stronger impact, the euro area is likely going to take slightly longer to recover than some other countries. In these circumstances and taking into account that some of the European countries have limited fiscal space, investment- and reform-orientated financial support from the European Union (EU) will be particularly important. The Eurosystem’s accommodative monetary policy also has contributed to more favourable financing conditions for both the public and private sector.

Before the start of the second wave of the pandemic, neither Lithuania nor most other countries had reached their pre-crisis activity levels. Lithuania and the rest of the EU have successfully recovered around two-thirds of the value added that was lost in the first half of 2020. Among key economic sectors in Lithuania, manufacturing saw a marked improvement. Due to prior investments and long-term business relations, output volumes in certain manufacturing segments increased even above their pre-crisis levels. Overall, the situation in Lithuania’s manufacturing sector improved far more than in the rest of the EU. However, the same could not be said for most other economic activities. The private services sector managed to successfully recover only somewhat more than half of its value added that was lost during the first wave of the pandemic. The construction sector was in an even worse state before the second wave hit: in the second quarter of 2020, construction activities suffered a sharp decline, later making only a modest recovery.

The current crisis had a less drastic impact on Lithuania’s labour market than previously expected. Labour market developments were considerably influenced by the decisions adopted by Lithuania’s government. With state support, a portion of workers were sent to downtime and maintained their jobs. In the second quarter of 2020, such workers accounted for around 4% of the overall labour force. This quite significantly limited the increase in unemployment at the onset of the crisis. State aid aimed at job preservation was also a common practice in other European countries (e.g. in euro area countries, where the economic decline was sharper compared to Lithuania, the unemployment rate did not go up at the beginning of the crisis mainly due to the policies in place to support the labour market). Later, with the economic recovery gaining traction, the situation in Lithuania's labour market started to improve. Labour market conditions varied considerably in different economic areas (employment in economic activities that were most severely hit by the crisis, such as accommodation and catering, remained low), but in general the number of employees started to slowly rise. Nonetheless, the unemployment rate did not drop; quite the contrary, it even increased. This was likely due to the aid offered for job seekers, which motivated some of the population to sign up as active job seekers.

The further course of the pandemic and adaptation to it will determine future economic developments. The second wave of the pandemic has already gained momentum in both Lithuania and many other countries. It is still believed that the current wave will have a less severe impact on economic activity compared to the first one. This might be attributable to the fact that businesses and people are better prepared to work under the conditions of the pandemic and are overall better equipped to work remotely, as well as ready to work in shifts. Contrary to the first wave, kindergartens are open in the majority of countries, and schools do not teach only on a remote basis. This offers better working conditions for the employed parents. Most countries have so far experienced less stringent economic restrictions, as compared to the spring months, which is why at the end of 2020 economic growth in Lithuania and its main trade partners might see a less pronounced decline compared to the second quarter of the year. The baseline scenario assumes that in the short term the pandemic situation will be dealt with only in part. It is also expected that an effective medical solution will become available already in the nearest future and successfully implemented by early 2022. These assumptions imply that at the beginning of 2021 economic growth will be rather subdued both in Lithuania and its main trade partners, and will only start to rebound throughout the course of 2021. Under the baseline scenario, Lithuania's real GDP is thus expected to decline by 2.0% in 2020 before increasing by 1.9% in 2021.

Domestic demand and export are expected to contribute to economic recovery. Despite the fact that uncertainties are clouding the short-term perspective, thus limiting household and business decisions in terms of consumption and investment, domestic demand is expected to increase already in 2021. Private consumption should be boosted by household savings (which increased since it was difficult to purchase goods and services given the pandemic situation) and reduced restrictions on mobility. On the other hand, a lack of improvement in labour market conditions in the nearest future may put a damper on private consumption. Weaker economic activity at the end of 2020 and the beginning of 2021 is likely to increase unemployment, reduce the number of employed persons and limit wage growth. As a result, the rise in disposable income is expected to be much slower next year than in 2020. The uncertain domestic and international environment will also weigh on investment, which will depend not only on the constantly changing pandemic perspectives, but also on the financial health of firms. Nevertheless, it is expected that investment processes will be spurred by government investments financed in part from EU support funds. A number of government decisions aimed to increase investment and support businesses and households are likely to boost economic activity: it is estimated that these decisions will reduce the rate of contraction by around 2.4 percentage points in 2020 and increase economic growth by 2.9 percentage points in 2021. Economic recovery will also be driven by exports. In the short term, the export sector is likely to face challenges, as Lithuania's main export partner – the euro area – has been hit hard by the pandemic. In addition, it is assumed that the EU and the UK will be unable to reach a deal on favourable trade conditions. Nevertheless, Lithuania's longer-term growth perspectives are expected to be similar to those recorded before the onset of the crisis, when the export sector was among the fastest-growing economic sectors.

Contrary to economic activity, inflation is not projected to increase over the next year. Price changes, particularly in terms of those prices that are closely linked to domestic economic developments, tend to materialise later than economic shifts. The labour market – employment, the unemployment rate and wages – is the first to react to economic developments; only then do labour costs affect prices. This is why some of price increases, in particular the rise in services prices, did not immediately reverse as a result of the deteriorating economic situation. Services price inflation showed clear signs of deceleration only throughout the course of the year; in the short term, it is likely to decrease further. Unlike the prices closely linked to domestic economic developments, commodity prices are quicker to react to changes in global economic activity. Thus energy resource prices saw a sharp and rapid decline in 2020, which in turn reduced headline inflation in most countries, including Lithuania. In the upcoming year, the fall in energy resource prices should not be as pronounced, meaning that they will not reduce inflation to the same extent as in 2020. Therefore, developments in inflation components are expected to be uneven, but headline inflation in Lithuania is not likely to see major changes over the projection horizon. Headline inflation is expected to stand at approximately 1% in 2020 and 2021.

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

	December 2020 projection[a]			September 2020 projection		
	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	1.1	2.2	1.0	1.2
GDP deflator[c]	2.8	0.7	1.3	3.0	0.7	1.4
Wages[d]	8.8	7.0	2.2	8.8	6.8	3.1
Import deflator[c]	-0.7	-5.5	1.0	-0.6	-5.5	1.3
Export deflator[c]	0.8	-4.1	0.6	0.8	-4.1	0.8
Economic activity (constant prices; annual percentage change)						
GDP[c]	4.3	-2.0	1.9	3.9	-2.0	3.1
Private consumption expenditure[c]	3.4	-3.5	2.5	3.2	-2.4	3.9
General government consumption expenditure[c]	0.1	0.3	0.2	0.7	0.3	0.3
Gross fixed capital formation[c]	6.2	-7.7	2.1	7.3	-7.7	6.4
Exports of goods and services[c]	9.5	-3.8	4.2	9.6	-3.8	6.9
Imports of goods and services[c]	6.3	-8.5	4.8	5.9	-6.1	8.4
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.3	8.7	9.3	6.3	8.8	8.1
Employment (annual percentage change)[e]	0.3	-1.6	-0.9	0.3	-1.5	0.6
External sector (percentage of GDP)						
Balance of goods and services	5.3	9.3	8.8	5.4	7.6	6.6
Current account balance	3.3	8.0	7.3	4.2	6.7	4.8
Current and capital account balance	5.2	10.3	9.4	6.0	8.9	6.9

[a] The projections are based on information made available by 19 November 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effect.
[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.

In the event of a different pandemic situation than the one foreseen under the baseline scenario and with a possibility of implementing medical solutions at a different pace, macroeconomic developments could also diverge from the ones described above. The mild scenario assumes that the pandemic situation, which was worsening up until now, stabilises and is handled successfully. It is also projected that an effective medical solution is found quickly and implemented with success by the end of 2021. This could imply lower movement and economic restrictions, a more positive economic outlook in the short term, and a stronger recovery in both Lithuania and abroad in 2021. Under the mild scenario, Lithuania's real GDP is expected to decline by 1.4% in 2020 before increasing by 4.5% in 2021. In several years, the economy would bounce back to its pre-pandemic trajectory. In other words, the impact of the pandemic on economic activity would be minimal in the longer term. Conversely, the severe scenario assumes limited containment of the pandemic situation in the nearest future, whereas an effective medical solution becomes available during the first half of 2021 and is successfully implemented only by early 2023 (e.g. due to potential logistics issues or a lack of public support). This scenario implies that movement and business restrictions are imposed for a longer period of time, and uncertainty regarding future pandemic and economic developments is higher. Economic activity would start to recover already in 2021, but only to a small degree and only in the second half of the year. Under the severe scenario, Lithuania's real GDP is projected to decline by 2.7% in 2020 and by 3.3% in 2021. In such context, labour market conditions would deteriorate more and investment processes would be more disturbed, which would lead to larger economic losses in the longer term.

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

	December 2020 mild scenario[a]			**December 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	1.4	2.2	1.0	0.8
Wages[d]	8.8	7.2	4.0	8.8	6.9	0.3
Economic activity and the labour market						
GDP (constant prices; annual percentage change)[c]	4.3	-1.4	4.5	4.3	-2.7	-3.3
Unemployment rate (annual average as a percentage of labour force)	6.3	8.3	7.3	6.3	9.0	11.9
Employment (annual percentage change)[e]	0.3	-1.3	0.9	0.3	-2.0	-3.4

[a] The alternative scenarios are based on information made available by 19 November 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.