

Lithuania's economic development and outlook

23 March 2021

While the ongoing COVID-19 crisis definitely has its toll on global economic activity, its current impact is not as severe as it was during the onset of the pandemic. Due to better adapting to the risks posed by the pandemic, both corporate and household sentiment has deteriorated to a lesser extent compared to the first wave of COVID-19. The experience gained in accumulating information on new cases and applied containment measures helped governments impose more appropriate restrictions on economic activities and mobility in order to reduce negative implications on the economy. Therefore, in recent months, in contrast to the beginning of the pandemic, manufacturing production in many countries continued to grow – same as global trade in goods. At the end of 2020, the latter already reached the level observed a year ago. However, in addition to the significant global improvement, the recovery of global trade in goods may also be determined by pent-up demand for goods that households and companies did not purchase during the previous months. The services sector is in a worse situation, especially when it comes to the euro area. During the second wave of the pandemic, it contracted once again, thus contributing to the overall economic downturn in the aforementioned group of countries. Compared to the levels recorded at the onset of the pandemic, further decline in euro area economic activity is quite limited. This is signalled by provisional indicators of both real GDP and the labour market, as the latter did not deteriorate at the end of 2020.

Although Lithuania's economic activity still lags behind its pre-pandemic levels, the country's economic contraction during the second wave of COVID-19 has been relatively mild. With recovering international trade in Lithuania's export partners and other countries, manufacturing production continued to grow substantially in late 2020 and early 2021. Manufacturing output volumes of many branches in this field have already exceeded the levels recorded before the pandemic. The overall manufacturing development is also supported by newly developed products oriented towards containing the pandemic situation. At the end of 2020, a rise in construction works also contributed to the growing levels of economic activity in Lithuania. Intensive use of EU funds and more active public sector investment allowed carrying out more civil engineering projects. With quite a substantial demand, there was also an increase in residential building construction. Having been in decline for a few quarters, non-residential building construction also started showing signs of recovery at the end of 2020. Construction of offices, warehouses and other buildings necessary for business development is most affected by the current crisis, therefore, its volumes exhibit the highest fluctuation. In contrast to the mentioned activities, the situation in the services sector deteriorated when the second wave of the pandemic gained momentum. The largest change was observed at the end of 2020 when more restrictions on economic activities and mobility were imposed. Retail trade volumes fell once again. In late 2020 and early 2021, their total decrease amounted to around 11% (compared to 17% during the first wave of the pandemic). A milder drop was recorded in many retail components. Fuel sales stood out the most: during the first wave, they slumped by around one quarter, whereas during the second one – by roughly 8%. This also indirectly suggests that the second wave of COVID-19 turned out to be less destructive in terms of the country's economic activity.

The labour market has also exhibited relatively few changes during the second wave of the pandemic. There are still no significant changes in employment, while the number of the short-term unemployed (those unemployed for up to 1 month) is also not increasing. And yet, it should be noted that during the downturn, the labour market and the overall economic developments tend to vary. In the second quarter of 2020, when Lithuania's economy experienced the hardest hit from the pandemic, employment did not decrease as much as real GDP. However, when the economy started recovering in the second half of the year, employment did not bounce back as much as the overall economic activity (at the end of 2020, economic activity almost approached its pre-pandemic levels, whereas more than half of residents who had

lost their jobs did not manage to find new ones). Such developments are likely to be influenced by the fact that only a short-term crisis was expected at the beginning of the pandemic. This, in hand with state measures supporting the labour market, contributed to employment. However, prolonged economic uncertainty deterred companies from hiring new employees even when economic activity started showing signs of recovery. The present situation has led firms to seek solutions for higher productivity, whereas recruitment has been postponed until sometime in the future.

The pandemic situation and its management will continue to have a significant effect on economic development throughout the projection horizon. In the nearest future, economic activity is projected to remain restrained, as there are still relatively severe restrictions on economic activities and mobility imposed both in Lithuania and abroad. The number of new COVID-19 cases varies quite significantly across different countries and still has no clear direction, whereas new medical solutions (vaccines) in most countries are only in the early stages of their rollouts. The baseline scenario of macroeconomic development assumes that the economic activity restrictions currently applied in Lithuania will be loosened in 2021, although some of them will still remain in place over the next few quarters. Moreover, the vaccination process is expected to gain considerable momentum this year. Should this scenario materialise, economic activity would be rather sluggish in the first quarter and should start to recover in the second quarter of 2021. Less restrictions imposed on both companies and households should lead to an evident rise in private consumption which could be further encouraged by pent-up demand. A consistently improving pandemic situation would give a boost to confidence of both the corporate and household sectors, which would result in new investments and recruitment. State measures that supplemented household income and provided aid to enterprises in 2020 are projected to be less extensive in 2021, yet last year's decisions should continue to support economic activity, since such measures usually have a lasting effect. Lithuania's major foreign trade partners are likely to experience similar economic development. It is assumed that in 2021 their pandemic and economic situations will also gradually change for the better, which in turn will have a positive effect on Lithuanian exports. Another factor to contribute to better prospects in the tradable sector is the EU-UK agreement on trade. After a 0.8% drop in 2020, Lithuania's real GDP is expected to return to a positive growth path in 2021, increasing by 2.9% this year and 5.1% the following year.

Lithuania's and global economic developments start being reflected in inflation dynamics. Having previously plummeted, oil prices shoot up quite significantly in the last few months, driven by both improved expectations of global development in the near future and reduced oil output. It is currently assumed that after a 35% drop recorded last year, oil prices in euro will increase at almost the same rate in 2021. This will fuel headline inflation and be the key factor behind its growth this year. In contrast to crude oil prices, prices that are most closely linked to domestic economic developments usually tend to change to a lesser extent. When economic activity went down in 2020, underlying inflation that includes prices of services and manufactured goods declined, but only gradually. Besides other factors, underlying inflation was supported by a rather significant wage growth that outpaced productivity. Substantial wage growth is projected to continue in the near future, although not at the same rapid pace as in the recent years. Therefore, growth in prices that are most closely linked to domestic economic developments is expected to be more moderate. Lithuania's inflation rate, which stood at 1.1% in 2020, is projected to amount to 1.6% in 2021 and 1.9% in 2022.

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

	March 2021 projection ^a			December 2020 projection		
	2020 ^b	2021 ^b	2022 ^b	2020 ^b	2021 ^b	2022 ^b
Price and cost developments (annual percentage change)						
Average annual HICP inflation	1.1	1.6	1.9	1.1	1.1	-
GDP deflator ^c	0.7	1.8	2.0	0.7	1.3	-
Wages	10.2	6.3	5.5	7.0	2.2	-
Import deflator ^c	-5.2	3.4	1.7	-5.5	1.0	-
Export deflator ^c	-3.5	2.8	1.5	-4.1	0.6	-
Economic activity (constant prices; annual percentage change)						
Gross domestic product ^c	-0.8	2.9	5.1	-2.0	1.9	-
Private consumption expenditure ^c	-1.5	4.8	6.7	-3.5	2.5	-
General government consumption expenditure ^c	0.1	0.0	0.0	0.3	0.2	-
Gross fixed capital formation ^c	0.1	5.0	5.0	-7.7	2.1	-
Exports of goods and services ^c	-1.3	5.9	5.9	-3.8	4.2	-
Imports of goods and services ^c	-6.4	9.8	6.7	-8.5	4.8	-
Labour market						
Unemployment rate (annual average as a percentage of labour force)	8.5	8.4	7.0	8.7	9.3	-
Employment (annual percentage change)	-1.5	0.5	1.5	-1.6	-0.9	-
External sector (percentage of GDP)						
Balance of goods and services	9.5	7.0	6.4	9.3	8.8	-
Current account balance	7.9	5.3	4.0	8.0	7.3	-
Current and capital account balance	10.0	8.1	6.6	10.3	9.4	-

^a The projections of macroeconomic indicators are based on international environment assumptions based on information published by 16 February 2021 as well as other data and information made available by 1 March 2021.

^bProjection.

^c Adjusted for seasonal and workday effects.

The pandemic situation is difficult to predict, as it may shift in a different direction than anticipated under the baseline scenario of macroeconomic development, thus alternative scenarios have also been set out. The mild scenario assumes that the number of COVID-19 cases diminishes more rapidly and effective medical solutions (new vaccines) are implemented faster than under the baseline scenario. This scenario may materialise if, for example, potential COVID-19 mutations turn out to be less threatening and the vaccination process faces less challenges. It would allow for a quicker easing of the restrictions imposed on economic activities and mobility, which would be essentially removed in 2021, thus boosting the economy in the nearest year. Most of economic activities would see improvement, especially those more oriented towards services, as they were most negatively affected during the downturn. The labour market would also recover faster and unemployment could reach its pre-pandemic levels as soon as in 2022. Under the mild scenario, Lithuania's real GDP is projected to increase by 3.8% in 2021 and 6.0% in 2022. The severe scenario assumes that the containment of the pandemic is limited and new COVID-19 clusters continue to emerge. It also foresees that the vaccination process, as an important means in fighting the crisis, takes a relatively long time, i.e. about two years. Such a prolonged vaccination process may be determined, for instance, by new COVID-19 strains that vaccines would need to be adapted to. The severe scenario would mean that the restrictions imposed on economic activities and mobility, which weigh down on the economy, would stay in place longer and their mitigation process would require more time. This would affect many macroeconomic indicators – domestic demand would take a lot longer to recover, household income would increase less, while unemployment would also remain heightened for a longer period of time. It is estimated that under the severe scenario, economic activity would not actually decrease, yet its growth rate would be quite meagre, with Lithuania's real GDP increasing by 1.1% in 2021 and 3.5% in 2022.

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

	March 2021 mild scenario ^a			March 2021 severe scenario ^a		
	2020 ^b	2021 ^b	2022 ^b	2020 ^b	2021 ^b	2022 ^b
Price and cost developments (annual percentage change)						
Average annual HICP inflation	1.1	1.7	2.1	1.1	1.6	1.7
Wages	10.2	8.0	8.0	10.2	5.7	4.0
Economic activity and the labour market						
GDP (constant prices; annual percentage change) ^c	-0.8	3.8	6.0	-0.8	1.1	3.5
Unemployment rate (annual average as a percentage of labour force)	8.5	8.0	6.4	8.5	9.0	8.0
Employment (annual percentage change)	-1.5	1.0	1.8	-1.5	0.0	1.1

^a The alternative scenarios are based on international environment assumptions based on information published by 16 February 2021 as well as other data and information made available by 1 March 2021.

^b Projection.

^c Adjusted for seasonal and workday effects.