



LIETUVOS BANKAS
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Lithuania's economic development and outlook

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With vaccination rates rising, the global economy is recovering from the pandemic slump. The global GDP is projected to grow by 6% this year and by 4.9% next year.¹ However, the recovery of various national economies has been uneven, with variations in recovery rates across countries mainly resulting from different paces of vaccination and volumes of fiscal support. The advanced countries, which have inoculated almost half of their populations, are expected to return to the pre-pandemic growth levels as early as in 2022, whereas the developing countries, which have only vaccinated approximately one-tenth of their populations and have limited fiscal stimulus potential, will take much longer to get back to those levels due to recurrent outbreaks of COVID-19. The coronavirus infection remains the biggest risk to the global economic recovery, given that the global economy will only be able to fully recover once the spread of the pandemic is halted all over the world. Hence the slower-than-expected pace of vaccination and the potential emergence of new vaccine-resistant COVID-19 strains as well as their outbreaks continue to be seen as the key risks to the currently expected recovery in the global economy. The ongoing COVID-19 pandemic also impedes efforts to correct other imbalances that have developed in the global economy. For instance, supply chain bottlenecks that have arisen as a result of the pandemic hamper efforts to resolve the problem of commodity shortages, which has been identified as one of the main factors behind the slower-than-expected growth of the world's top economies – the United States and China – in the second quarter of this year. It is also worth noting the challenges to sovereign debt sustainability: on the one hand, it is important for governments not to withdraw fiscal support too early in order to avoid a wave of corporate insolvencies amid the continuing pandemic, on the other hand, such support can make it more difficult for heavily indebted governments and businesses to keep their debts and related costs under control in the future, once the major world economies enter the cyclical upswing stage and interest rates get back on the path towards normalisation. Economic activity in Lithuania also feels the effect of all these factors via international trade and financial linkages.

The second lockdown failed to knock Lithuania's economy off its growth path. GDP growth recorded in both the first and the second quarters shows that Lithuania's undertakings managed to make adequate preparations for the new wave of the pandemic. Lithuania's exporters continued to increase their sales volumes in external markets, benefitting from the recovery of demand in main trade partners in the process of their reopening. Even though the biggest boost to the growth of exports came from chemical and furniture industries, many other manufacturing industries also contributed to higher export volumes. Many of these industries reached the highest output level in the history of the data series in the second quarter of this year. Successful expansion in external markets, robust financial health of the country's undertakings and new highs in terms of industrial capacity utilisation had a positive effect on business expectations, which in turn fuelled the recovery of the private sector's investment. A fall in external demand following the onset of the pandemic and uncertainty over the global economic outlook triggered a slump in investment. Even though investment entered the recovery mode in the second half of 2020, it was then mostly driven by the public sector, while the private sector waited until the beginning of this year to start stepping up its investment. Favourable dynamics in the tradable sector facilitated the continuation of labour market developments favouring workers. This coupled with the reopening of other activities and general government decisions led to improvements in household disposable income as well as in household expectations. All these factors contributed to an increase in household consumption, which followed an upward trend in both the first and the second quarters of this year. However, an increase in household consumption expenditure was rather moderate in the second quarter of this year, even though the government eased the lockdown restrictions substantially and

¹ IMF forecasts as of July 2021.

household disposable income continued to far exceed the expenditure. At the same time, according to the Bank of Lithuania, the country's households maintained their saving rate at a historically high level.

Economic growth leads to improvements in the labour market. Employment has been growing in the country since the beginning of this year, reversing the slump suffered in 2020. On top of that, the number of people at work got back to the pre-pandemic level in the middle of the year. However, job creation has varied significantly across economic activities. Employment in the activities less affected by the pandemic, such as information and communications, transport and warehousing or manufacturing, set on an upward path in early 2021. Meanwhile, it took until the second quarter of this year for employment in more affected activities, such as accommodation and catering services, to enter recovery, after the beginning of a gradual easing of lockdown restrictions imposed on those sectors. The pickup of hiring has increasingly brought to light the problem of labour shortage, which was evident even before the pandemic and has also been one of the main causes behind particularly rapid wage growth. Even though the average wage in the country has been already growing at a rather rapid pace before the pandemic, its growth picked up further after the first lockdown and, starting from the third quarter of 2020, salaries recorded double-digit growth on average in both the private and the public sectors. Such average wage dynamics were driven considerably by the government's decisions to raise salaries in the public sector and for the lowest-income earners. Wage growth was also likely supported by the disbursement of jobseekers' allowances, which possibly acted as a disincentive to search for work. The room for such rapid wage growth was also provided by the decisions made during the pandemic to bolster operational efficiency and to adapt to the pandemic conditions, which enabled Lithuania's businesses to achieve significant productivity gains. In fact, the pace of productivity growth in Lithuania was among the fastest across the EU in 2020.

Further growth of Lithuania's economy will continue to depend on the global handling of the pandemic situation, the increasing recovery of domestic demand and the development of export-oriented activities. The scale of the pandemic and the adjustment thereto will continue to have a decisive impact on economic activity, both in Lithuania and abroad. It is assumed that Lithuania will continue vaccinating its population successfully in the coming months, which, alongside other measures, will reduce the incidence of COVID-19 and, accordingly, will make it possible to avoid restrictions on everyday life and businesses, which could significantly affect economic activity. This will open up more opportunities for households to purchase the desired goods and services. Their appetite for consumption has been growing recently, which can be seen from the share of households considering major purchases that has hit the highest level since the beginning of the global crisis. The return to more normal consumption habits and the decline of excess savings should emerge as one of the key factors driving the rapid growth of household consumption, which should outpace even the increased growth of disposable income in the years to come. The expected economic recovery in advanced countries, which comprise a significant share of Lithuania's major trade partners, will fuel demand for Lithuanian-origin goods and, accordingly, will benefit the country's exporters. External demand for the goods of Lithuanian origin is currently expected to exceed its year-earlier level by more than 8% this year, but its pace of growth would halve in subsequent years. Demand is expected to increase in both domestic and external markets, boosting business expectations. This will continue to fuel the private sector's investment, which will also be driven by the intensified inflows of EU support funds. All these factors are expected to translate into rather substantial economic growth in the coming years, with Lithuania's real GDP projected to increase by 4.9% in 2021 and by another 3.5% in 2022.

The rapid recovery of the Lithuanian and global economy has been accompanied by rising inflation. Inflation has been pushed up mainly by the rising prices for crude oil, their low comparison base and higher prices for other commodities, such as metals. Longer than expected supply disruptions and tensions in the global commodity market have contributed to a pickup in the growth of prices for industrial goods. An increase in the supply of commodities should bring the demand and supply of many

commodities back into balance, which should be similar to their pre-pandemic equilibrium in the future, whereas the reduced level of inventories should be restored, which makes it likely that prices for many commodities will tend to go downwards in the future. However, prices for industrial goods are expected to continue their rapid growth both in the remaining months of this year and early next year. Higher global prices for food commodities, a poor vegetable harvest and higher other costs, including higher wages, will trigger a pick-up in the rate of food inflation. Nonetheless, food inflation will be lower on average than before the pandemic in both 2021 and 2022. The expected rapid wage growth, which will be mostly driven by the labour shortage, convergence and built-up savings that will be increasingly channelled to the services sector, will also have repercussions for the services inflation, which will go up. Inflation is expected to reach 3.3% in Lithuania this year, exceeding the previous forecast by around 1.1 percentage points. Year-on-year, the inflation rate will increase by 2.2 percentage points, mostly due to rising prices for energy products and industrial goods. Next year, inflation will go down to 2.2% due to a lower upward pressure from energy prices. At the same time, it will come under a stronger impact from services prices that are more closely linked to domestic economic developments. Inflation may also be pushed up next year by stronger food inflation.

Table 1. Outlook for Lithuania's economy

	September 2021 projection ^a			June 2021 projection		
	2020	2021 ^b	2022 ^b	2020	2021 ^b	2022 ^b
Price and cost developments (annual percentage change)						
Average annual HICP inflation	1.1	3.3	2.6	1.1	2.2	2.1
GDP deflator ^c	1.1	3.9	2.5	1.1	2.0	2.0
Wages	10.2	9.4	7.6	10.2	7.0	5.9
Import deflator ^c	-5.2	4.3	1.8	-5.2	3.9	1.5
Export deflator ^c	-3.5	2.9	2.1	-3.5	2.8	1.3
Economic activity (constant prices; annual percentage change)						
Gross domestic product ^c	-0.8	4.9	3.5	-0.8	5.1	4.1
Private consumption expenditure ^c	-2.1	5.6	6.6	-2.1	6.2	6.5
General government consumption expenditure ^c	0.5	0.1	0.0	0.5	0.3	0.0
Gross fixed capital formation ^c	0.1	11.1	6.3	0.1	8.5	5.5
Exports of goods and services ^c	0.0	11.4	4.6	0.0	8.2	5.9
Imports of goods and services ^c	-5.7	14.8	7.4	-5.7	11.4	7.9
Labour market						
Unemployment rate (annual average as a percentage of labour force)	8.6	7.2	6.8	8.5	7.1	6.6
Employment (annual percentage change) ^d	-1.7	0.6	0.2	-1.5	0.7	0.4
External sector (percentage of GDP)						
Balance of goods and services	10.0	7.4	5.8	10.0	7.7	6.3
Current account balance	8.3	5.4	3.6	8.4	5.6	3.6
Current and capital account balance	10.4	8.0	6.3	10.4	8.2	6.3

^a The projections of macroeconomic indicators are based on international environment assumptions based on information published by 18 August 2021 as well as other data and information made available before 31 August 2021.

^b Projection.

^c Adjusted for seasonal and workday effects.

^d National accounts data; employment in domestic concept.

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