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Lithuania's economic development and outlook

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In February, when the Russian military invasion of Ukraine began, the world economy, still coping with the aftermath of the pandemic, was dealt another blow. The ongoing war in Europe and the increasing retaliatory actions of states are affecting the global economy through a variety of channels, namely, international trade, spikes in the prices of energy and other commodities, the financial sector, currency and capital markets, investor and consumer confidence. The continuing high uncertainty and volatility of these and other factors makes it extremely difficult to assess the development of the economies of Lithuania and other countries over the next few years. For this reason, the latest Lithuanian Economic Review presents three possible Lithuanian economic development paths: the conventional scenario and the shock and larger shock sensitivity analyses. The conventional scenario is based on the data and information available before 1 March, while the sensitivity analyses are built upon hypothetical assumptions based on more recent data and information. Also, in all cases it is assumed that military action will be limited to the Ukrainian territory.

Following the outbreak of Russian military action in Ukraine, Western democracies condemn it and impose economic sanctions against the Russian and Belarusian regimes. On 25 February, the European Commission adopted a wide-ranging package of sanctions covering not only individuals, but also various economic sectors such as finance, energy, transport and technology, as well as a visa issuance policy for citizens of the Russian Federation. In addition, the US and other countries around the world have also imposed sanctions on the Russian Federation for its military actions on the Ukrainian territory. As hostilities continue, on 2 March, the EU and other countries agreed on additional sanctions against the Russian Federation to isolate it and force it to end its military invasion of Ukraine. For its part, on 8 March, the US banned imports of Russian oil, liquefied natural gas and coal in a further extension of sanctions against the Russian Federation, thus further isolating the country's economy. On 9 March, the EU has also announced an additional package of sanctions against Belarus, which is complicit in the unprovoked and unmotivated military aggression against Ukraine. In addition to official sanctions by foreign countries, many multinational companies have put on hold or exited business activities in the Russian Federation, thus further reinforcing economic isolation. The international credit rating agency Fitch has downgraded the rating of the Russian Federation to C, indicating that the country is unable to meet its financial obligations. The impact of these sanctions is expected to affect both Lithuanian and EU economies through three main channels – foreign trade, raw material supply and prices, and business and household sentiment.

Russia's aggression in Ukraine will have a negative impact on Lithuania's economy through declining exports, a shortage of imported raw materials, an uncertain investment climate and rising energy prices. The negative impact of these factors on Lithuania is mitigated by the fact that Lithuania's foreign trade with Russia has changed considerably, and trade relations before the outbreak of the war were much less intense than they were a decade ago. Exports to Russia accounted for 6% of Lithuania's total exports, 3% to Ukraine and 3% to Belarus, according to the latest data available[1]. The largest share of exports to Russia and Belarus are re-exports of goods, the loss of which would not be very painful for the Lithuanian economy as a whole, and exports of transport services. Our main exports to Ukraine are of Lithuanian origin. The complete loss of these markets could lead to a slowdown in Lithuania's economic growth by up to 3 percentage points over the 2022–2024 period. Imports from these countries accounted for 15% of total Lithuanian imports, of which 44% are energy products. However, the restriction of import flows from these countries is likely to lead to temporary disruptions in production due to a shortage of the necessary raw materials, and the cost of acquiring these raw materials from alternative suppliers will be somewhat higher. Since 20% of metals and 45% of wood in

[1] Q4 2020 – Q3 2021.

2021 were imported from Russia, Belarus and Ukraine, supply shortages of metal raw materials as well as wood imports are likely to be the most acute, particularly important for the construction sector and some industries, such as metal processing and furniture sector. Due to the economic consequences of Russian military aggression in Ukraine on Lithuania's other export partners, the overall foreign demand will reduce, which will worsen the growth prospects for the rest of Lithuania's exports. Further increases in the price of oil and natural gas, as Western countries refuse to buy Russian resources, will raise the cost of electricity, heating and transport for all sectors of the economy and further fuel consumer price inflation. Increased uncertainty is likely to dampen business investment, at least in the short term, and also affect consumers' choice to consume less and save more. The crisis may also have an additional impact on the Lithuanian labour market, as the flow of refugees from Ukraine to Lithuania continues to increase. If some of these people were to stay in the country longer and enter the labour market, this would increase Lithuania's labour force and alleviate the labour shortages that have recently become more pronounced.

The impact of these factors is only partially assessed in the conventional scenario, which is based on information available before 1 March. However, it already foresees a markedly slower GDP growth than forecasted in December and higher-than-previously-forecasted average annual inflation. Even before the outbreak of the war in Ukraine, Lithuania's real GDP growth forecast was undermined by declining exports to China, disruptions in the supply of raw materials, a slower development of the transport sector as a result of the EU's mobility package, and a slower growth in overall external demand. Continued disruptions in the supply chains due to the pandemic have led to stagnant growth in public investment and the construction sector. On the other hand, the financial situation of Lithuanian businesses and households was strong before the outbreak of the war, which mitigated the inflationary challenges facing households. The decline in the savings rate and the use of savings during the pandemic were expected to cushion the negative impact of inflation on household consumption in the future. As labour market shortages have become more pronounced, wage growth has been strong and was expected to continue this year and throughout the next year. In the run-up to the war, the impact of domestic factors on the price growth was becoming more pronounced, most notably in the form of accelerating growth in service prices. Relatively strong domestic demand has facilitated the pass-through of cost increases to the prices of consumer goods and services. Although the increased energy and raw material costs were extremely significant, the impact of domestic factors was strengthening too, mostly signalled by the growing prices of services. Higher-than-expected annual inflation data in January and February (strongly influenced by the faster-than-expected rise in energy prices due to heightened geopolitical tensions) and the revision of the CPI basket weights at the beginning of the year also contributed to the higher-than-expected inflation. The information available by 1 March on the consequences of the war in Ukraine and the sanctions that came into force at that time led to a significant deterioration in external demand developments and to a significant increase in assumptions for the development of energy commodity prices. This has further worsened the outlook for Lithuania's exports, investment and household consumption[2]. Household income and consumption decisions will also be affected by higher-than-expected inflationary pressures. The increase of inflation projections in this scenario is mainly due to the rise in energy commodity prices, for example, while in December 2021 the average oil price was expected to be close to USD 90 per barrel this year, in this scenario it is around USD 93 per barrel. The gas price assumption used in this scenario for 2022 has increased from EUR 53/MWh to EUR 102/MWh, based on the futures data, compared to the December assumption. Under this scenario, in 2022, Lithuania's real GDP would grow by 2.7% and average annual inflation would reach 10.5%.

[2] The March 2022 forecasts project stronger export growth in 2022 than the December 2021 forecasts. This export performance, even after a significant deterioration in the economies of Lithuania's main export partners, is due to significantly better-than-expected foreign trade performance in the last quarter of 2021, which has led to a very strong base effect in 2022.

As hostilities intensified and Western governments and businesses retaliated, uncertainty increased dramatically, and additional changes, which might have a significant impact on future economic development, began to emerge. Based on some of these, and on the information available on financial and commodity markets up to 17 March, the shock sensitivity analysis was drafted. The key assumptions for this, larger shock sensitivity analyses and the conventional scenario are summarised in Table 2. Under this sensitivity scenario, exports to Russia, Belarus and Ukraine could shrink by two-thirds due to the sanctions, the voluntary refusal of Lithuanian businesses to trade with the aggressors' markets, and difficulties in transportation or payment. Slower export growth will also be driven by slower economic development in Lithuania's main trading partners (based on the ECB's adverse scenario[3]) and the assumption that companies will not be able to find cost-effective substitutes for around one tenth of their imports of wood and metal raw materials. Increased uncertainty in global markets is expected to lead to a deterioration in household and business sentiment in Lithuania. In this sensitivity analysis, it is assumed that both household and business confidence will deteriorate significantly, and that the magnitude of the deterioration will be close to that observed in other crises (e.g. at the start of the COVID-19 pandemic, or at the onset of the global financial crisis). The oil and gas price assumption in this sensitivity analysis is based on the information available on 17 March on the prices in international markets and futures contracts, which provide an indication of the future evolution of these prices. Under this sensitivity analysis, the oil price reaches USD 107 per barrel and only starts to decline gradually towards the end of the year. Under these assumptions, Lithuania's real GDP growth in 2022 would be 2.3 percentage points slower than in the conventional scenario and average annual inflation would still be 10.5%.

The larger shock sensitivity analysis includes a more hawkish assessment of economic developments, based on weaker assumptions about the international economic situation, the domestic economy and tougher sanctions. Under this sensitivity analysis, Lithuanian businesses practically stop exporting to Russia, Belarus and Ukraine, while demand from EU countries slows down even more (based on the ECB's severe scenario). Also, for around a fifth of imports of wood and metal raw materials, firms are unable to find economically viable substitutes, and household and business confidence falls twice as much as in the shock sensitivity analysis. It was also assumed that the prices of the raw materials assessed would equal to the highest daily level observed between 28 February and 17 March. This could be the case, for example, if Western countries were to refuse oil and gas imports from Russia and fail to agree on a significant increase in alternative supply. Under these assumptions, in 2022, Lithuania's GDP would decline by 1.2 %, and average annual inflation would rise to 11.1%.

[3] ECB staff macroeconomic projections for the euro area, March 2022, available online here.

Table 1. Projected economic developments in Lithuania based on the conventional scenario

	March 2022 forecast[a]			December 2021 forecast		
	2021	2022[b]	2023[b]	2021[b]	2022[b]	2023[b]
Price and cost developments (annual percentage change)						
Average annual HICP inflation	4.6	10.5	2.7	4.5	5.1	–
Gross Domestic Product deflator[c]	6.6	8.4	3.3	4.5	3.4	–
Wages	10.5	10.7	7.7	10.0	8.2	–
Import deflator[c]	12.0	7.5	1.9	8.5	5.4	–
Export deflator[c]	5.9	6.3	3.0	4.2	4.9	–
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	4.8	2.7	2.7	5.1	3.6	–
Private consumption expenditure[c]	7.2	4.7	4.9	6.1	5.8	–
General government consumption expenditure[c]	0.5	0.0	0.0	0.3	0.0	–
Gross fixed capital formation[c]	7.0	5.6	3.6	8.7	6.3	–
Exports of goods and services[c]	14.1	5.2	1.9	12.6	4.8	–
Imports of goods and services[c]	17.8	5.3	3.6	16.2	6.6	–
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	7.1	7.3	7.1	6.7	–
Employment (annual percentage change)[d]	1.2	1.0	–0.8	0.7	0.2	–
External sector (percentage of GDP)						
Balance of goods and services	3.8	3.0	2.5	5.1	3.6	–
Current account balance	1.6	0.6	0.1	2.3	1.3	–
Current and capital account balance	3.0	3.3	2.8	4.2	4.1	–

[a] The projections for macroeconomic indicators are based on international environment assumptions based on information published by 28 February 2022 as well as other data and information made available before 1 March 2022.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] National accounts data; employment in domestic concept.

Table 2. Comparison of the conventional scenario and the sensitivity analyses assumptions

	Conventional scenario	Shock sensitivity analysis	Larger shock sensitivity analysis
Decline in exports to RU, BY and UA	No additional expert assessment applied	Export volumes fall by 2/3	No exports to these countries
Declining demand in EU countries	Consistent with the evolution of the ECB baseline scenario	Consistent with the impact of the ECB's adverse scenario	Consistent with the impact of the ECB's severe scenario
Shortages and rising costs of imported raw materials	No additional expert assessment applied	LT companies are unable to find substitutes for 10% of raw materials imported mainly from RU, BY and UA. Prices of these raw materials increase by a third	LT companies are unable to find substitutes for 20% of raw materials imported mainly from RU, BY and UA. Prices of these raw materials increase by a third
Rising energy and food prices	Based on market prices on 28 February	Based on market prices on 17 March	Prices correspond to the highest daily level reached between 28 February and 17 March
Impact of increased uncertainty about the future	No additional expert assessment applied	Confidence deteriorates to a similar extent as in previous crises	Double the deterioration in confidence than in shock scenario

Table 3. The conventional scenario and the shock and larger shock sensitivity analyses for economic and inflation developments in Lithuania

	2022	2023
Gross domestic product		
Conventional scenario	2.7	2.7
Shock sensitivity analysis	0.4	2.1
Larger shock sensitivity analysis	–1.2	1.5
Average annual HICP inflation		
Conventional scenario	10.5	2.7
Shock sensitivity analysis	10.5	2.7
Larger shock sensitivity analysis	11.1	3.0

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