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Macroeconomic projections

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Lithuania's economic development and outlook

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Russia's war against Ukraine, the renewed pandemic in China and monetary tightening in many major economies due to extreme inflationary pressures are dampening global economic growth. Russia's war against Ukraine, which started at the end of February, has significantly increased the prices of key energy and food raw materials. While prices of some energy and food raw materials have returned to the pre-war levels, other raw materials, in particular natural gas, remain at significantly higher levels and are particularly detrimental to the development of European economies. Due to the lack of generation and the algorithm used in the Nord Pool power exchange, many European countries have high final electricity prices set by natural gas-fired power plants, which has a significant negative impact on their competitiveness. China's zero-COVID-19 policy is due to the slow vaccination of the population. It has a negative impact on Chinese consumption and production, slowing down the country's economic growth and contributing to the persistent bottlenecks in supply chains. These factors have also contributed significantly to the global inflationary shock. It has forced most central banks in developed and developing countries to normalise monetary policy. Such central bank actions send signals that inflation expectations will not be allowed to drift away from the inflation levels consistent with price stability, even if they have a dampening effect on economic activity.

The effects of Russia's war against Ukraine and extremely high inflation are dampening economic activity in Lithuania. Lithuania's GDP contracted by 0.5% in the second quarter of 2022 compared to the previous quarter. The main contributing factor to this economic expansion is the sharp decline in real exports of goods and services. It was almost 5% lower than in the previous quarter. The main factors affecting the export trend were the sanctions on trade with Russia and Belarus, which restricted exports of transport services, the closure of AB ORLEN Lietuva for planned repairs and the temporary closure of AB LIFOSA due to the sanctions. Household consumption also fell significantly as a result of very high inflation. It was more than 2.5% lower than in the previous quarter, even in the context of relatively favourable developments in household disposable income. The war and accelerating inflation have worsened household sentiment and expectations, further reducing their willingness to consume. For example, consumer confidence in August this year was close to its lowest level in a decade. Further difficulties in Lithuania's economic development are also evident in other recent higher frequency indicators. Business sentiment, after the significant deterioration in March, has remained significantly unchanged for almost half a year. Meanwhile, monthly data on business turnover in the largest sectors of the economy, namely, industry, construction, trade and services, show signs of declining activity between June and July. These unfavourable factors can only be partly offset by the forecast of a 10% increase in this year's harvest.

Labour market tensions did not ease in the second quarter of 2022. The number of employed persons increased significantly during this period. In particular, the number of employees increased, but the share of self-employed also rose significantly. The surge in employment was driven by a strong increase in the labour force, especially for women. This is attributed to a particularly positive net migration balance. In January-August of this year, around 43,000 more people entered Lithuania than left. It is likely that the majority of immigrants are war refugees from Ukraine, who are successfully integrating into the Lithuanian labour market. The rapid growth of the labour force has not increased the unemployment rate, which dropped to 5.2% in the second quarter of this year, the last time such a low unemployment rate was recorded in Lithuania was before the global financial crisis in 2008. With fewer unemployed and more working persons, the country is facing a persistent labour shortage. Vacancy statistics for the second quarter of 2022 show that labour supply continues to fall short of rising demand, and the labour market situation in the country remains very tight: the job vacancy rate (the ratio of vacancies to total jobs) was 1.9%, almost on par with the record of 2% recorded in the third quarter of 2008 and the first quarter of 2022. Very high tension in the labour market has a significant impact on the country's rapid annual wage growth of almost 14%. However, rising energy costs are likely to limit the ability of companies to increase wages at a very fast pace. According to the monthly labour income data (seasonally adjusted) published by Sodra, labour income growth slowed down significantly in May-July.

The effects of Russia's war against Ukraine and its further course will be the main factors shaping the development of the Lithuanian economy in the coming years. The nature of this factor means that the country's economic outlook is currently shrouded by a high degree of uncertainty. The extreme volatility of energy commodity prices, in particular natural gas, has a negative impact on household and business sentiment and expectations, leading to more cautious household consumption and limiting the willingness of businesses to invest. This will dampen economic growth in both Lithuania and its main trading partners. Foreign demand for Lithuanian goods and services is projected to decline in 2022 and, although it is expected to start recovering from early 2023, it will not reach the level that existed before Russia's invasion of Ukraine during 2023. This evolution of external demand, together with the negative impact of high energy prices on competitiveness, will be the main contributors to the sluggish export growth. The less favourable development of the exporting sector is one of the main factors contributing to the weaker-than-expected development of investment, especially in 2022. However, the expected significant increase in government investment and the need for companies to reduce electricity and fossil fuel costs will allow investment to pick up this year and the next. Inflationary pressures, which will persist for longer than previously thought, will constrain domestic consumption not only in the main trading partners, but also in Lithuania. Even though nominal wages will continue to grow, higher inflation will lead to a decline in real wages and salaries in both 2022 and 2023. This, together with the expected normalisation of monetary policy leading to an increase in interest rates, will be the main factors limiting the growth of household consumption in Lithuania in 2022 and the decline in 2023. It is important to note that such assessment of developments in household consumption includes the measures to mitigate the effects of inflation and high energy prices adopted by the Government until 31 August 2022. If the Government decides on additional measures, household consumption would follow a more favourable path.

Lithuania's real GDP is projected to increase by 2.1% in 2022 and 0.9% in 2023. At the same time, it should be noted that this outlook for Lithuania's economic development is subject to a high degree of uncertainty, and the balance of currently observable risks is even more negative than it was at the time of the June projections, i.e. there is a significantly higher probability of a downward revision than an upward revision in future economic projections. If the severely adverse risks materialise, the country's economic growth could slow by up to 3.8% percentage points in 2023 and inflation could be up to 5.1% percentage points higher than in the baseline scenario.

Inflationary pressures have increased as risks related to gas supply have materialised. Following Russia's restriction of gas supplies to Europe, gas prices on the markets in August were more than five times higher than in the same period a year earlier. As gas is used as a feedstock for electricity and heat energy generation, it also contributes significantly to the increase in electricity and heat energy prices. The increase in gas prices on the market has led to a significant increase in demand for solid fuels, mainly firewood, as an alternative energy source. This has further boosted the already rapidly rising prices of solid fuels, with solid fuel prices up 166% year-on-year in August. Energy prices for customers are forecast to rise at an average annual rate of 56% this year. Energy price increases will moderate next year but will remain a key driver of inflation. Overall, the revision of energy price forecasts for both 2022 and 2023 has had the largest impact on the revision of inflation projections. As for food prices, which have made a significant contribution to inflation in recent months, they will also be affected by changes in the energy markets. Although global food commodity prices fell in August and were already only 8% higher than in the same period a year ago, food prices are projected to rise at an average annual rate of 21% this year, while next year food price growth is expected to moderate, but remain fairly strong at 10%, taking into account the fact that commodity price changes do not reach consumers immediately and that the cost of food commodities is significantly influenced by the sharp increase in energy prices. Meanwhile, growth in the core inflation components such as industrial goods and services stabilised in August. While subdued economic growth will ease the pressure on core inflation, growth in industrial goods in particular will be supported by a significant increase in producer prices, with producer prices for manufacturing, excluding refined energy products, 30% higher in August than a year earlier. Thus, while the prices of some commodities such as oil, food and metals are currently depressed on world markets compared to their peak at the outbreak of the war, record high energy prices will accelerate the increase in both energy prices for customers and the cost of other consumer goods and services. Against this background, average annual inflation is projected at 18.3% in 2022 and 8.4% in 2023.

Outlook for Lithuania's economy

	September 2022 forecast[a]			June 2022 forecast		
	2021	**2022[b]**	**2023[b]**	**2021**	**2022[b]**	**2023[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	4.6	18.3	8.4	4.6	15.2	4.6
Gross domestic product deflator[c]	6.6	16.6	6.8	6.6	15.2	5.0
Wages	10.6	12.7	6.3	10.6	11.9	8.1
Import deflator[c]	11.6	22.2	4.4	11.6	19.9	4.5
Export deflator[c]	5.7	15.4	6.8	5.7	13.7	5.6
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	4.9	2.1	0.9	4.9	2.1	3.4
Private consumption expenditure[c]	7.3	1.0	-0.8	7.3	5.4	3.8
General government consumption expenditure[c]	0.6	0.3	0.0	0.6	1.5	-1.3
Gross fixed capital formation[c]	7.0	3.0	3.4	7.0	4.1	3.5
Exports of goods and services[c]	15.9	6.4	1.6	15.9	7.4	2.9
Imports of goods and services[c]	19.4	7.5	1.3	19.4	9.8	2.8
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	6.3	7.1	7.1	7.3	7.2
Employment (%, annual percentage change)[d]	1.2	4.0	-0.6	1.2	0.6	0.3
External sector (percentage of GDP)						
Balance of goods and services	4.2	-1.3	0.9	4.2	-1.9	-0.9
Current account balance	1.3	-6.6	-2.1	1.2	-4.5	-3.8
Current and capital account balance	2.7	-4.7	-0.2	2.7	-2.5	-1.8

[a] The macroeconomic projections are based on external assumptions, constructed using information made available by 22 August 2022, and other data and information made available by 31 August 2022.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] National accounts data; employment in domestic concept

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