LIETUVOS BANKAS
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Macroeconomic projections

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Lithuania's economic development and outlook

19 December 2022

The world economy is so far outperforming expectations, but the outlook for its development is worsening. Reducing bottlenecks in supply chains and worldwide easing of pandemic prevention measures, which have enabled international tourism to recover, are among the key factors that have enabled the world economy to expand above expectations. The third quarter of this year saw better-than-expected developments in all the world's major economies, namely, the US, China and the European Union (EU). However, the persistence of unabated risks is leading to a more pessimistic view of the future development of the world economy. russia's war against Ukraine continues to be the biggest risk factor for developments in the world economy. Military action, sanctions and the response to them continue to have a significant impact on global commodity prices and volatility, especially of energy and food. The recovery of China, the world's second largest economy, will be hampered by renewed outbreaks of the COVID-19 pandemic, for which prevention measures are being put in place with the utmost vigour. These factors will keep inflationary pressures at an elevated level in many economies around the world for some time to come and will force monetary policymakers to further tighten financial conditions. This will adversely affect domestic demand in many countries, both in terms of household consumption and firms' investment decisions. All of this will affect economic activity and price developments in Lithuania through international trade and financial linkages.

Although the energy price shock has had a significant impact on the economic developments in Lithuania, the economy is still growing. Lithuania's economy grew by 0.5% in the third quarter of this year,[1] but only due to few activities – information and communication, agriculture and industry. Growth in value added in both agriculture and industry was due to one-off factors. The former was driven by a higher-than-normal (also last year) agricultural harvest, while the latter was fuelled by the resumption of production at AB ORLEN Lietuva from the beginning of July after two months of maintenance and repairs. Although a positive contribution of these factors will not be felt in the last quarter of 2022, there are early signs in the economy that only a relatively mild stagnation is expected at the turn of the year. For example, since August, sales of manufacturing excluding refined petroleum products have stopped declining for three consecutive months. This development is primarily attributable to favourable trends in the engineering and transport and food industries, which have a relatively small share of energy in their cost structure. On the other hand, manufacturing industries, which are more energy-intensive or which used to import a significant share of their raw materials from Ukraine, Belarus and russia before the war, are still facing difficulties. In real terms, retail and construction sales have not declined markedly in recent months, but the development of market services, in particular transportation, remains less favourable. Business and household confidence indicators also do not show any significant deterioration signs in the economy. The latter even improved vastly in October–November, in part due to published information about the measures the Government intends to take in 2023 to counter the energy price shock.

The economic slowdown has not yet had a profound impact on the Lithuanian labour market, where tensions remain high. The number of people in employment increased steadily in the first three quarters of this year and was 5.5% higher in the third quarter than at the end of last year. This strong employment growth was driven by a significant increase in the labour force, which grew both due to higher participation rates and an increase in the working-age population in Lithuania. Notably, in the third quarter of 2022, the labour force participation rate rose to its highest level since the start of data publication. While this reflects Lithuania's increasing utilisation of human capital, one should not expect additional strong contribution of this driver to further labour force growth. The main contributor to the increase in the working-age population has been the substantial increase in the number of immigrants. In

[1] Based on the data adjusted for seasonal and workday effects.

January–November this year, almost 52,000 more people entered Lithuania than left it. Refugees from Ukraine fleeing the war caused by russia account for a significant share of these arrivals. 25,000 of these people have entered the Lithuanian labour market, which is almost 2% of the Lithuanian labour force, impacting the reduction of tensions in the labour market. For example, in recent months, the share of industrial, construction and retail companies that identified staff shortages as a factor limiting their expansion has fallen to a level close to the long-term average. However, demand for workers remains very high, with the vacancy rate still at 1.9% in the third quarter of 2022, close to the historical highs recorded in 2008, a period when Lithuania's economy was in a state of overheating. This high demand for workers is the reason for the extremely low unemployment rate. Although it increased to 5.9% in the third quarter of 2022,[2] the unemployment rate remains very low. Only before the global financial crisis in 2008 and in 2018 have lower unemployment rates been recorded. The ultra-low unemployment rate and still strong demand for labour are also behind the rapid rise in wages, which rose by 12.6% year on year in the third quarter this year. Private sector wages rose significantly faster than public sector wages, by 13.9% and 9.7% respectively.

In the coming years, developments in Lithuania's economy will be mainly influenced by the course of russia's war against Ukraine and the efforts of governments to mitigate the negative economic effects of the war. The war, the sanctions imposed and the response to them have led to a significant increase in global commodity prices and volatility, especially for energy and food. This, through the declining purchasing power of households, the loss of competitiveness of exporting firms and the need to tighten monetary policy, has a particularly adverse impact on both the development of Lithuania's economy and on that of many of Lithuania's main trading partners, especially those in the EU. As these adverse factors can lead both to a short-term slowdown in economic growth and to a significant longer-term recession, government efforts to mitigate the negative effects of these factors are crucial in this period. In the case of Lithuania, the decisions taken on the 2023 State Budget will allow to mitigate the negative impact of the factors discussed to a large extent and are a key factor behind the more optimistic than previously expected outlook for the economic developments in Lithuania in 2023. The amount of the budgeted funds to compensate for the share of gas and electricity prices for households and businesses is expected to amount to 1.2% of gross domestic product (GDP) and to 1.7% of GDP for the increase in income of households, whereas expenditure on public investment projects is expected to rise by 0.6% of GDP. This suggests that both household consumption and investment developments in 2023 will be markedly more favourable than projected in the September macroeconomic projections. Similar household and business support packages will be applied by many of Lithuania's main trading partners. Therefore, demand for Lithuanian goods and services abroad, which was still declining at the end of 2022, is expected to start recovering from the beginning of 2023, and should reach the pre-Ukraine invasion level by the end of the year. This development in demand in Lithuania's main trading partners will also lead to a more favourable development of exports of goods and services. Lithuania's real GDP is projected to increase by 2.5% in 2022 and by 1.3% in 2023. At the same time, it should be noted that such projection is subject to a high degree of uncertainty, and the balance of currently observable risks is on the downside, i.e. there is a higher probability of a downward revision than an upward revision in the future economic outlook.

If there are no unexpected shocks in commodity markets, the peak in annual inflation will be a thing of the past. Annual inflation is expected to continue to decline, amid the strengthening of the higher comparative base effect, the impact of lower commodity prices and the easing of supply chain frictions. In November, annual inflation in Lithuania fell for the second consecutive month to 21.4%. Energy price developments have been the main contributor to both the September surge in inflation to 22.5% and its decline in recent months. Compared to August, the fall in oil, electricity and gas prices on the markets and the optimisation of the fuel mix for heat generation were the main factors behind the

[2] Based on the data adjusted for seasonal and workday effects.

reduction in energy price increases. Although energy prices rose at an annual rate of 48% in November (down from 73% in September), energy prices are projected to remain the main driver of inflation this year. Energy price increases are expected to moderate significantly next year, with food prices, including alcoholic beverages and tobacco, being the main driver of inflation. Following the acceleration in the fourth quarter of 2021, the purchase prices of raw milk and cereals were 47% and 45% higher in October this year compared to the same period a year ago. Increased purchase prices of food commodities in Lithuania and higher energy costs have contributed significantly to food price rises this year and will have an impact on food price developments in 2023. As Lithuania’s economic activity moderates and supply chain bottlenecks diminish, net inflation, which excludes the most volatile energy and food commodities, will also decline in 2023. Against this background, headline inflation is projected to be 18.9% this year, before falling to 9.5% next year.

Outlook for Lithuania’s economy

	December 2022 projection[a]			September 2022 projection		
	2021	**2022[b]**	**2023[b]**	**2021**	**2022[b]**	**2023[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	4.6	18.9	9.5	4.6	18.3	8.4
GDP deflator[c]	6.5	16.2	8.5	6.6	16.6	6.8
Wages	10.6	12.8	9.1	10.6	12.7	6.3
Import deflator[c]	10.7	25.7	6.2	11.6	22.2	4.4
Export deflator[c]	5.3	15.1	4.6	5.7	15.4	6.8
Economic activity (constant prices; annual percentage change)						
GDP[c]	6.0	2.5	1.3	4.9	2.1	0.9
Private consumption expenditure[c]	8.0	0.8	0.5	7.3	1.0	-0.8
General government consumption expenditure[c]	0.9	0.2	0.0	0.6	0.3	0.0
Gross fixed capital formation[c]	7.8	2.3	5.1	7.0	3.0	3.4
Exports of goods and services[c]	17.1	11.5	3.8	15.9	6.4	1.6
Imports of goods and services[c]	20.2	11.3	4.3	19.4	7.5	1.3
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	6.1	6.7	7.1	6.3	7.1
Employment (%, annual percentage change)[d]	1.2	4.8	-0.5	1.2	4.0	-0.6
External sector (as a percentage of GDP)						
Balance of goods and services	4.6	-2.4	-4.0	4.2	-1.3	0.9
Current account balance	1.5	-6.0	-7.1	1.3	-6.6	-2.1
Current and capital account balance	3.0	-4.4	-4.5	2.7	-4.7	-0.2

[a] The macroeconomic projections are based on external assumptions, constructed using information made available by 24 November 2022, and other data and information made available by 1 December 2022.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] National accounts data; employment in domestic concept.

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