LIETUVOS BANKAS
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Macroeconomic projections

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Lithuania's economic development and outlook

19 December 2023

Global economic activity is subdued. The global economy rebounded at the beginning of the year, with China opening following pandemic restrictions and increasing demand in many countries for services that experienced difficulties during the pandemic. At the same time, another important sector, industry, was doing poorly. Not only at the beginning of the year but also in the following quarters, industry contracted in the United States and the euro area, while it stagnated in China. Higher interest rates, subdued investment, declining activity in real estate markets, and accumulated inventories reduced manufacturing output. This negatively affected foreign trade and overall economic activity in many countries, including Lithuania. In the second half of the year, this also affected the services sector. Its expansion was also dampened by the fading positive impact of the post-pandemic opening. Recently, there have been fewer negative signals in non-euro area countries, and their growth outlook remains largely unrevised. However, the outlook for euro area countries is worse than expected. The projected development of the exporting sector of the countries of this group is particularly worse.

The Lithuanian economy has stalled. It is neither growing nor shrinking and has been subdued for about two years. The economy is not growing at a time when Lithuania's population has increased, real income is rising, and inflows from European Union (EU) support funds are increasing. The economy's growth potential appears not to be fully exploited due to the lack of sufficient domestic and external demand.

Economic growth structure is rather unusual this year. Private consumption is declining sizeably, with exports falling significantly, while only investment is on the rise. The use of EU support significantly contributes to growing investment. Projects funded by the new (2021–2027) EU financial perspective are gaining momentum and Recovery and Resilience Facility (RRF) projects are being gradually implemented. In the first nine months of this year, inflows from the EU funds that are used for investment increased by around a quarter compared to a year ago. This contributes to the growth of both the general government and private sector investment and increases the volume of construction work.

Recently, the largest economic activity, industry, which had previously fallen a lot, has been stabilising. Production in some industries is significantly lower than a year ago (e.g. furniture, other wood products, rubber and plastic products). However, compared to the previous few months, the volume of manufacturing production is no longer decreasing. Such developments in this economic activity seem to be driven by declining global inflation, the real income of the population in foreign countries starting to recover, and stabilising foreign demand. This is broadly in line with previous assessments, i.e. it was previously assumed that the exporting sector would stop shrinking at the turn of the year before recovering gradually.

Economic activity is hampered by the cautious behaviour of households. History shows that in the event of major shocks, the population becomes more cautious. Households start to save more and limit their consumption. For example, in 2009, with the advent of the global financial crisis and households' real disposable income dropping by 11.8%, the population immediately began to change their consumption behaviour. They cut consumption and saved 5.2% of their income. Households also became very cautious in 2022. At that time, the real disposable income of the population decreased by 4.6%, while they saved as much as 4.8% of their income. Households are still extremely cautious and are not in a hurry to consume more, even though their real income has been growing for some time. In addition to the drop in the overall real private consumption in Lithuania, the average consumption per capita is also decreasing. The latter is now close to the level observed in 2019.

The situation in the labour market remains largely unchanged – it is particularly favourable for the employed. Having deteriorated for some time, hiring expectations are improving. The hiring mood has improved in the industry as well as in the construction sector. This possibly does not imply that the number of employees will increase significantly in the near future. However, it suggests that the total number of employees is likely to stay elevated. Companies are trying to retain existing employees because there is a broad consensus that the economic situation in foreign countries and Lithuania will begin to improve shortly – in 2024. As a result, the total number of persons employed is not decreasing, even though the economy is not growing, and the overall unemployment rate is relatively stable and low. The unemployment rate is just above 6%. It is almost the same as before the shocks of the last few years. However, there are negative signs as well. There has been an increase in the number of newly unemployed, i.e. the number of people who are unemployed for up to one month. If economic growth recovers, then the overall unemployment rate is not likely to increase. However, if economic recovery were to take longer, then the job search for the newly unemployed would take longer and the overall unemployment rate would possibly increase.

For business entities, however, the current labour market situation is not good. The current situation is rather unusual. Real wages are rising and labour productivity is falling. In other words, real unit labour costs (in short, real labour costs) are increasing. This worsens the competitiveness of companies. The prolonged rapid increase in real labour costs would not be sustainable. Historically, there have been cases when real labour costs have risen but after some time they started to decline.

Economic activity will be subdued in the near term. The real gross domestic product (GDP) grew by 2.5% last year, this year it is forecast to fall by 0.2%, and next year it is expected to grow by 1.8%. Such a forecast means that the Lithuanian economy has been experiencing strong shocks for a long time and that it will grow poorly for the third consecutive year. Considering the weaker international economic environment, the economic growth forecast for 2024 is revised downwards (from 2.1% to 1.8%). The export outlook is revised the most negatively. Economic growth in 2024 will depend heavily on domestic demand. The situation in the labour market should not deteriorate. The real income of households is expected to increase significantly and there will be room for an increase in private consumption. However, the dynamics of consumption will also depend on the mood of consumers. If they remain cautious, then consumption may rise less than currently expected. Investment is projected to further boost economic activity, as inflows from the EU support funds are expected to continue to grow. Investment, nevertheless, is not expected to grow as much as this year.

Economic growth is expected to accelerate in the subsequent years. As global inflation decreases and economic activity in various countries strengthens, international trade, which will also affect economic developments in Lithuania, is expected to increase more significantly. In 2025 and 2026, Lithuania's real GDP is projected to increase by 3.1% and 3.3% respectively. Such a growth rate would exceed the potential output growth, and the output gap would narrow gradually, but the economic expansion would not be as strong as before the shocks of the last few years. Major economic fluctuations, higher uncertainty, and weaker investment growth will continue to have an impact on economic activity in both foreign countries and Lithuania.

Inflationary pressure is weakening. In the wake of the turmoil in the Middle East, energy prices were subject to significant fluctuations but remained largely at previous levels. Oil and food price assumptions remain broadly unchanged compared to the previous projections. This suggests that external price pressures remain subdued. It is one of the main reasons why the overall price level in Lithuania has been almost unchanged for more than half a year, while headline annual inflation is falling rapidly. There also seems to be less pressure from domestic economic developments. Although (nominal) labour costs are rising rapidly and this has an upward effect on prices, the rise in these costs is starting to slow down. In addition, domestic consumption is shrinking, which has a restrictive effect on prices. The rise in the prices of services, which are usually more related to domestic economic situation, is decreasing. The average annual inflation rate is expected to be 2.5% next year, after reaching 8.8% this year. Lower energy prices will have a dampening effect on headline inflation, while higher prices of services and industrial goods will contribute the most to the overall price increase. A similar growth rate of prices will be retained in the coming years. In 2025 and 2026, the average annual inflation is expected to stand at 2.5% and 2.4% respectively.

Table 1. Outlook for Lithuania's economy

	December 2023 projection[a]					September 2023 projection				
	'22	'23[b]	'24[b]	'25[b]	'26[b]	'22	'23[b]	'24[b]	'25[b]	'26[b]
Price and cost developments (annual percentage change)										
Average annual HICP inflation	18.9	8.8	2.5	2.5	2.4	18.9	8.8	2.6	–	–
GDP deflator[c]	16.6	7.7	2.9	2.9	2.9	17.0	8.8	2.8	–	–
Wages	13.3	12.2	9.4	8.7	8.3	13.3	12.4	9.8	–	–
Import deflator[c]	24.9	-5.5	0.0	2.9	2.5	24.8	-5.6	-0.1	–	–
Export deflator[c]	15.4	0.0	1.1	2.9	2.5	15.6	-1.5	0.5	–	–
Economic activity (constant prices; annual percentage change)										
GDP[c]	2.5	-0.2	1.8	3.1	3.3	1.9	-0.6	2.1	–	–
Private consumption expenditure[c]	2.0	-1.7	2.4	3.5	3.6	0.5	-0.4	2.7	–	–
General government consumption expenditure[c]	0.4	0.3	0.2	0.0	0.0	0.5	0.4	0.0	–	–
Gross fixed capital formation[c]	3.6	8.6	3.9	4.0	6.0	2.6	6.7	3.3	–	–
Exports of goods and services[c]	12.2	-5.3	0.5	3.2	3.4	11.9	-2.4	2.4	–	–
Imports of goods and services[c]	12.4	-7.2	1.4	3.6	4.3	12.4	-4.3	3.1	–	–
Labour market										
Unemployment rate (annual average as a percentage of labour force)	5.9	6.7	6.5	6.4	6.3	5.9	6.7	6.5	–	–
Employment (annual percentage change)[d]	5.1	1.0	-0.1	-0.5	-0.5	5.1	-0.4	-0.6	–	–
External sector (as a percentage of GDP)										
Balance of goods and services	-2.0	4.0	4.0	3.7	3.1	-1.9	3.1	3.0	–	–
Current account balance	-5.5	1.3	0.9	0.6	0.0	-5.1	0.0	-0.4	–	–
Current and capital account balance	-4.0	2.8	2.6	2.7	1.4	-3.6	1.6	1.4	–	–

[a] The macroeconomic projections are based on external assumptions, constructed using information made available by 23 November 2023, and other data and information made available by 30 November 2023.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] National accounts data; employment in domestic concept.

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