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Lithuanian Economic Review analyses the developments of the real sector, prices, public finance and credit in Lithuania, as well as the projected development of the domestic economy. The material presented in the Review is the result of statistical data analysis, modelling and expert assessment. The Review is prepared by the Bank of Lithuania.

During the preparation of the Lithuanian Economic Review, the data of the Bank of Lithuania, Statistics Lithuania, the European Central Bank, Eurostat, the International Monetary Fund, *Bloomberg* and other data published up to 29 October 2012 were used.

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Abbreviations

%	per cent
CIS	Commonwealth of Independent States
EC	European Commission
ECB	European Central Bank
EU	European Union
Eurostat	statistical office of the European Union
excl.	excluding
GDP	gross domestic product
HICP	harmonised index of consumer prices
IMF	International Monetary Fund
incl.	including
LTL	Lithuanian litas
p.p.	percentage point
rh scale	right-hand scale
US	United States of America
USD	United States dollar
VAT	value-added tax

ECONOMIC OUTLOOK

Recently, the development of Lithuanian economy was affected by one-off factors. Economic activity increased due to significantly higher value added in agriculture and industry. Changes in agriculture were a result of more abundant harvests, and in the industrial sector were due to increasingly rapid export development. This trade improvement, however, is short-lived. Economic growth in many Lithuanian foreign trade partners has weakened and is slower than expected. This is directly related to lower global economic growth as many countries, especially developed countries, pursue improvement of public and private sector balance sheets. With expectations of economic growth worsening worldwide, weaker economic prospects are expected in Lithuania as well. It is foreseen that the real GDP, having increased by 3.0 per cent in 2012, will grow next year by 3.1 per cent (previous forecasts were 3.0% and 3.4% respectively).

Less favourable development prospects are suggested by more cautious expectations. Lower levels of business activity compared to just a few months or a year ago are expected by trading and service companies. While having improved for quite some time, industry expectations are now becoming more pessimistic. Such assessment of outlook is significantly influenced by continued high uncertainty regarding the global economic situation. This significantly influences business expenditure for the investment. Although a large part of production capacity is already used, investment in machinery and equipment has been shrinking for some time. Investment in vehicles has also decreased. Over the projection period, investment growth should be moderate and it is expected that investment in 2012 will increase by 2.3 per cent, and in 2013—by 6.2 per cent, i.e., less than the average increase over the years after the start of data collection. Investment expenditure will be heavily dependent on external demand. If exports intensify, albeit gradually, this will promote the need to expand production capacity and contribute to the growth of expenditure for means of production.

Cautious business expectations are already affecting the labour market. While the number of employed persons in the country is growing and the unemployment rate is declining, the number of vacancies is lower than a year ago. Their decrease was particularly acute in the transport and storage sectors, manufacturing and construction. A prudent business approach is also demonstrated by the tendency to hire more part-time workers. In the short term, with the prevailing uncertainty regarding economic prospects, the labour market situation is only expected to change moderately. This insight is partially supported not only by the declining number of vacancies but also by the flow of newly unemployed remaining at similar levels. In the projected period, changes in the labour market will rely on the development of enterprises, especially in the tradable sector. Recently, the number of employed increased most in this particularly sector. While the economy becomes focused on the activity in the tradable sector, its development will significantly affect the outlook of entire economy.

Poor moods affect also the consumers. Both the future financial situation and the country's economic prospects are seen by consumers in a more unfavourable light than a year ago or a few months ago. This weakens the incentive to consume. Most noticeably there is less demand for non-food goods that mainly led to the growth in consumption in 2011. Consumption growth may continue to slow down and another negative factor affecting it will be the change of real labour income where the situation in the labour market, as mentioned above, might improve only moderately, while the expected rate of price increase will be almost the same as is observed now. With consumer confidence at less than its average level for more than a decade it is anticipated that private consumption will grow relatively slowly over the projection period—in 2012 it should increase by 4.4 per cent and in 2013 by 2.3 per cent.

Due to external factors, annual inflation had been previously declining, while more recently it increased somewhat. Most of these changes in inflation were determined by food prices dependent on worldwide market trends as their impact on inflation increased. Therefore, the overall impact of external factors remained highly significant. They may be linked to four-fifths of the total inflation: in addition to food prices, the greatest impact was due to administered prices and less noticeable due to fuel prices. The components of the consumer basket, linked specifically with the external environment, remain the source of the risk that inflation will be higher in the coming years. After all, the prospects of commodity prices in global markets remain uncertain. Currently, only a small share of inflation depends on domestic conditions; core inflation remains low. In addition, if during the projection period relatively slow growth in unit labour costs prevails as expected, inflationary pressures should be limited. With increasing influence of external factors on prices, it is foreseen that inflation will be slightly higher than previously forecasted: it should stand at 3.2 per cent in 2012 and 2.8 per cent in 2013.

Outlook of Lithuania's economy in 2012–2013

	November 2012 projection			August 2012 projection		
	2011	2012*	2013*	2011	2012*	2013*
Price and cost developments (annual percentage changes)						
Average annual inflation (based on HICP)	4.1	3.2	2.8	4.1	2.9	2.4
GDP deflator	5.4	2.1	3.0	5.3	3.2	2.4
Wages (compensation per employee)	4.0	3.0	2.6	4.0	3.1	2.9
Import deflator	12.8	4.7	2.4	12.8	4.4	1.8
Export deflator	11.7	3.6	2.5	11.7	3.9	1.9
Economic activity (constant prices; annual percentage changes)						
Gross domestic product**	5.9	3.0	3.1	5.9	3.0	3.4
Private consumption expenditure	6.4	4.4	2.3	6.1	4.2	2.8
General government consumption expenditure	0.5	0.7	1.9	0.2	0.7	1.9
Gross fixed capital formation	18.3	2.3	6.2	17.1	4.5	7.6
Exports of goods and services	14.1	7.0	6.0	14.1	4.4	6.5
Imports of goods and services	13.7	5.0	6.5	12.9	5.3	7.2
Labour market						
Unemployment rate (annual average as a percentage of labour force)	15.4	13.3	11.6	15.4	13.4	11.9
Employment (annual percentage change)	2.0	1.8	1.4	2.0	1.4	1.5
External sector (as a percentage of GDP)						
Balance of goods and services	-2.6	-2.0	-2.6	-1.3	-2.3	-3.0
Current account balance	-3.7	-2.4	-2.9	-1.6	-3.1	-3.5
Current and capital account balance	-1.3	-0.4	-1.2	0.9	-1.1	-1.9

* Projection.
** Changes in inventories are not included in GDP components.

I. INTERNATIONAL ENVIRONMENT

The global economic situation continues to deteriorate. Most of the latest published macroeconomic data is worse than expected, and the recent confidence indicators suggest that the global economy is at the brink of recession. Therefore, the latest forecasts of global economic growth predict somewhat more moderate economic growth in both developed and emerging countries. The financial system problems, high private sector debt levels and efforts to reduce public sector debt by implementing fiscal consolidation programs, as well as uncertainty about further political and economic decisions, further weaken the economic developments.

The US economy is growing slowly and there is a risk that the growth may be more suppressed next year. The risk is increased by the fiscal cliff: the tax cuts, many of which were introduced in 2001 and 2003, will expire in 2013. In addition, in accordance with the Budget Control Act of 2011, from the beginning of next year the US should reduce government spending. It is estimated that upon expiry of all the tax cuts and introduction of spending reduction, the fiscal consolidation measures would exceed 600 billion US dollars (about 4% of GDP) in 2013. It is most likely, however, that the majority of the tax breaks will be extended, and the spending cuts will be postponed.

Euro area problems still get the most attention around the world. The region continued to implement the programmes of international financial aid and economic reforms. In September-October, favourable reports were published on the programme implementation in Ireland and Portugal, and based on them those countries will be provided with further support, as planned. The programme mission in Greece that ended in mid-October agreed with Greece authorities only on core measures of economic policy. Programme implementation review and decision on further funding are expected in late November.

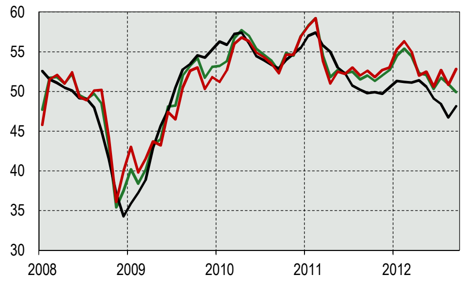
While the euro area is in a recession, it is difficult to reduce the Member States' budget deficits and improve the situation of the sovereign debt. Because of the economic downturn, a number of euro area countries will miss the general government deficit targets set for 2012. In addition, as Portugal and Italy face economic difficulties, their planned budget deficits for 2013 will also be higher than previously expected. In 2013, Spain has not changed its budget deficit target, although the country's capabilities to achieve it are publicly questioned, and the IMF October projections on Spanish budget deficit exceed the country's official targets.

Euro area implements the decisions aimed at stabilizing the situation in the region. On 8 October 2012 the European Stability Mechanism (ESM) was officially launched. It is an intergovernmental organization, one of the euro area crisis management mechanisms, which will provide financial assistance to euro area countries experiencing funding problems. ESM shareholders are all member states of the euro area, and the Board of Governors are their finance ministers. This organization is becoming one of the largest international financial institutions: its subscribed capital will total 700 billion euros (borrowing capacity—500 billion euros). Euro area countries agreed to cover the paid-in capital of 80 billion euros over a period of three years, of which 32 billion euros—by 12 October 2012. Other capital—620 billion euros—is the callable capital; the ESM may request these funds from the participating countries at any time, and the countries are obliged to meet the demand within 7 days.

Spain should be the first to take advantage of the ESM financial assistance. The European Financial Stability Fund (EFSF) has decided to provide Spain with the support of 100 billion euros, which will be transferred from the EFSF to the ESM. According to current estimates, the rescue of the Spanish financial sector will cost about 40-60 billion euros.

Confidence indicators imply that the global economy is at the brink of recession.

Chart 1. Purchasing managers' indices (PMI)



Source: Markit.

Forecasts of the US economic growth remained almost unchanged, while the euro area's economic projections continue to deteriorate.

Table 1. Macroeconomic indicators of the US and the euro area (in per cent)

	US	Euro area
Quarterly change in real GDP*		
2011 Q4	1.0	–0.3
2012 Q1	0.5	0.0
2012 Q2	0.3	–0.2
2012 Q3	0.5	–
Annual change in real GDP		
2011	1.8	1.4
2012**	2.2	–0.4
2013**	2.1	0.2
General government balance, per cent of GDP		
2011	–10.1	–4.1
2012**	–8.7	–3.3
2013**	–7.3	–2.6

Sources: Eurostat, IMF.
** Seasonally and working day adjusted data.*
*** Forecasts. While estimating the US budget deficit, the IMF assumed that decisions will be made to avoid the fiscal cliff.*

Officially launched in October, the ESM has become one of the largest international financial institutions.

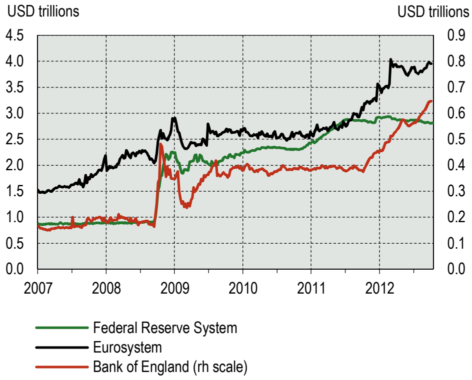
Table 2. ESM shareholders' contributions (billion euros)

	Subscribed capital	Paid-in capital
Germany	190.0	21.7
France	142.7	16.3
Italy	125.4	14.3
Spain	83.3	9.5
Netherlands	40.0	4.6
Belgium	24.3	2.8
Greece	19.7	2.3
Austria	19.5	2.2
Portugal	17.6	2.0
Finland	12.6	1.4
Ireland	11.1	1.3
Slovakia	5.8	0.7
Slovenia	3.0	0.3
Luxembourg	1.8	0.2
Cyprus	1.4	0.2
Estonia	1.3	0.2
Malta	0.5	0.1
Total	**700.0**	**80.0**

Source: www.esm.europa.eu.

Low key interest rates remain broadly unchanged for the fourth year. Because of non-standard monetary policy measures, the asset side of the world central bank balance sheets continues to grow.

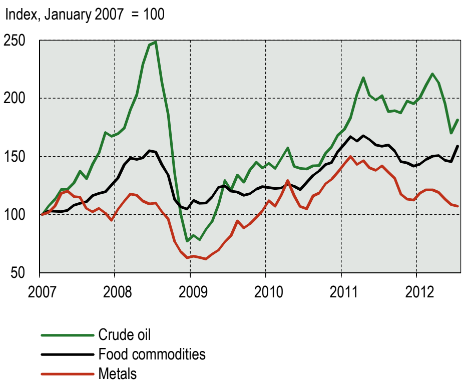
Chart 2. Asset side of the main central bank balance sheets



Sources: Federal Reserve System, ECB, Bank of England and Bank of Lithuania calculations.

Global commodity price trends diverged in the third quarter: the prices of energy and food commodities rose significantly, but metal prices fell.

Chart 3. Global commodity prices in US dollars



Sources: IMF and Bank of Lithuania calculations.

Russia's economic expansion is slowing down, but the annual growth rate is still relatively high.

Table 3. Macroeconomic indicators of Russia (in per cent)

Quarterly change in real GDP*	
2011 Q3	1.7
2011 Q4	1.6
2012 Q1	0.6
2012 Q2	0.1
Annual change in real GDP	
2011	4.3
2012**	3.7
2013**	3.8
Average annual inflation	
2011	8.4
2012**	5.1
2013**	6.6
General government balance, per cent of GDP	
2011	1.6
2012**	0.5
2013**	0.2

Sources: Federal State Statistics Service of Russian Federation, IMF.
** Seasonally and working day adjusted data.*
*** Forecasts.*

Currently, the Spanish bank recapitalisation and restructuring plans are being drafted, and should be approved by the EC. Then (most likely in November) the payment of the provided assistance will begin. The appeal of the Spanish authorities to international institutions for government sector support has been anticipated for several months, but the country has not yet issued a formal request. In view of this delay the international rating agency *Standard & Poor's*, in the first half of October, lowered Spain's credit rating by two notches.

As planned, in September EC presented the guidelines for the banking union. If this proposal is implemented, the joint supervision mechanism will involve the ECB and national supervisory authorities but the ECB will be responsible for the supervision of the participating banks. The guidelines suggest that the ECB can immediately take over the supervision of any bank in the euro area, especially if the bank receives the public support. Other banks should be taken under supervision gradually. Currently it is estimated that by the end of 2012 the agreement will be made on the necessary legislation, and the single supervisory mechanism will become operational in 2013. No agreements have yet been reached regarding other aspects of the banking union—deposit guarantees and bank recovery and resolution—as the euro area countries have not reached a compromise.

Due to the deteriorating global economic situation, the major central banks one after the other introduced additional monetary policy measures in September. The Federal Open Market Committee announced that by the end of this year it will purchase mortgage-backed securities worth 40 billion US dollars per month (including the existing programmes, the total mortgage-backed securities purchases will be about 85 billion US dollars per month). In addition, the Committee extended its commitment to keep low interest rates for additional six months until the middle of 2015, and hinted about the plans to extend the new securities' purchase programme if the labour market prospects do not improve. These measures are often called the third round of quantitative easing (QE3). In early autumn the ECB has announced a new Outright Monetary Transaction (OMT) programme. Under this programme, the government bonds with maturities of 1-3 years will be bought on the secondary market, and the size of the purchases is not limited. However, the ECB plans to buy bonds only of those countries that have asked for financial assistance from the EFSF or the ESM and committed to comply with the conditions of their programmes. In September-October, the Bank of Japan increased the size of its asset purchase programme by 21 trillion yen (up to 66 trillion yen).

In the third quarter of 2012, the global commodity price trends diverged: energy and food prices increased but metal prices fell. In September, crude oil prices from a relatively low level in June rose by more than 15 per cent. They were mainly affected by expectations of additional monetary stimulus measures, and by the geopolitical events in the Middle East—unrest in Iran and Syria, and the growing tensions between Turkey and Syria. Due to poor weather conditions and reduced supply, food commodities went up by almost one tenth from June to September, and approached the record level of early 2011. However, metal prices declined further in the third quarter, along with the weakening global economy.

Economic growth in Russia and other CIS countries is slowing down, but remains relatively strong. In Russia, inflation has recently accelerated despite slower economic growth. The main reasons were increased utility service costs and poor grain harvest, which was almost a quarter less than last year's crop. In an attempt to deal with the rising inflationary pressures, the Russian central bank tightened monetary policy in September and raised the key interest rate by 25 basis points. This unexpected decision was taken despite the slow economic growth, indicating the Bank of Russia's growing focus on inflation. This is related to its plans to change the monetary policy strategy by 2015 and adopt a strategy of inflation targeting, instead of exchange rate. This way, Russia would move from the managed floating exchange rate system towards a free-floating ruble exchange rate.

II. REAL SECTOR

For some time the increasing competitiveness of Lithuanian enterprises and sufficiently active, but receding, household consumption stimulated the growth of GDP in the second quarter of 2012. However, due to further uncertainty of the global economy development and the effects of the overhaul of AB ORLEN Lietuva oil refinery, the GDP grew by only 2.1 per cent. Uncertainty about the economic outlook had a stronger impact on domestic demand, with more cautious decisions made both by households and businesses. This is noticeable from the slowdown in the annual growth of household consumption and somewhat reduced gross fixed capital formation, as well as the private sector's saving, which had stopped decreasing. The overhaul of AB ORLEN Lietuva, which required a complete suspension of the factory's operations, mostly affected the declining inventory investment. The company's previously accumulated stocks of petroleum products were used to meet the domestic demand of oil products during the overhaul, some stock was also exported. This conjuncture led to a very positive contribution of net exports to the GDP growth, as the imports of crude oil and petroleum products fell more than the exports of petroleum products.

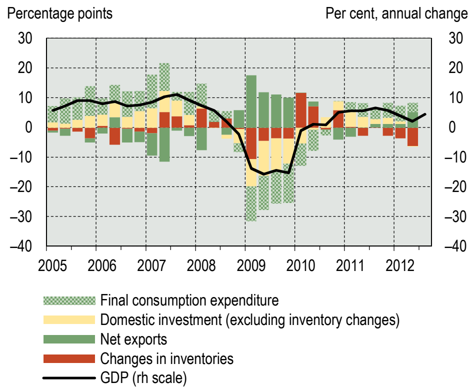
In assessing the net exports change, excluding the impact of the overhaul of AB ORLEN Lietuva, its positive effect on GDP growth is also noticeable. This trend was mainly due to the declining growth of domestic demand and the competitiveness of enterprises increasing for some period. The first factor did not encourage imports, while the second had a positive effect on exports. In Lithuania, most of the capital goods are imported from abroad, thus weaker investment negatively affected the imports of those goods. Similar effects on imports were exerted by the decline in private consumption that suppressed the growth of import of consumer goods. The effects of growing competitiveness as a factor influencing the development of export are observed for some time. It can be defined as the dynamics of production costs favourable to Lithuania, and best described by unit labour costs. These trends were shown by real effective exchange rates based on unit labour costs calculated by the EC that almost did not increase since the beginning of 2009. The growth of unit labour costs, slower than that of the main trading partners, was mostly affected by increasing labour productivity and sluggish wage growth.

Fears of a second wave of recession discourage enterprises from investing in larger projects and increasing production capacity, and they mainly invested only in equipment replacement. Slightly more resources were invested, primarily in non-residential buildings and structures, only by trade, transport, real estate, renting and other businesses. These investments are likely to be a consequence of decisions taken earlier, when the economic outlook was more favourable. Nevertheless, the industry survey shows that the manufacturing capacity utilization rate is slowly rising and approaching the highest level since the beginning of the publication of data. This could encourage companies to invest more, as well as increase economic activity. However, business sentiment on the economic outlook remains grim. It limits investment and discourages firms from financing investment projects using borrowed funds. One of the major disadvantages of internal financing of investment projects is a longer period of time required to accumulate the necessary funds. This hinders the development of investment and hence the economic development. Incidentally, recently the share of businesses funded by borrowed funds rose slightly, yet the change is negligible and has no significant impact on investment trends yet.

The same uncertainty regarding economic development, along with the slow improvement in the labour market situation, led to a slowdown in private consumption growth. Negative information on the European and world economy did not encourage households to increase consumption, so they were not so quick to increase spending for less basic items. Consumer spending on traveling and information technology was lower than a year ago, while spending on clothing and footwear increased

For some time, the increasing competitiveness of Lithuanian enterprises and sufficiently active household consumption continued to encourage economic growth in Lithuania.

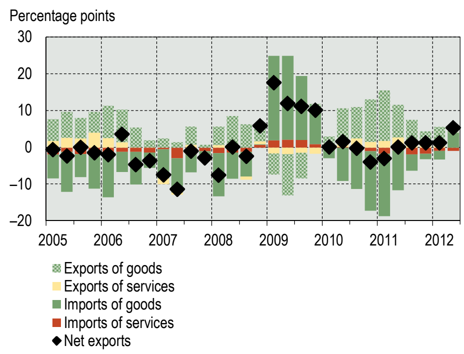
Chart 4. Real GDP growth contributions (expenditure approach)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Favourable changes in net exports were caused by increasing competitiveness of Lithuanian companies, weakening domestic demand and other transitory factors.

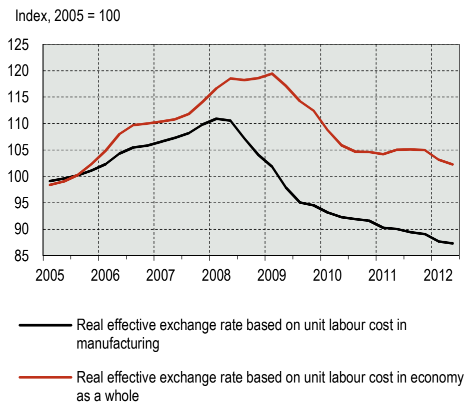
Chart 5. Contribution of real net exports to annual GDP growth



Sources: Eurostat and Bank of Lithuania calculations.

Increasing labour productivity and sluggish wage growth prevented the unit labour costs from rising faster than they did in trading partner countries.

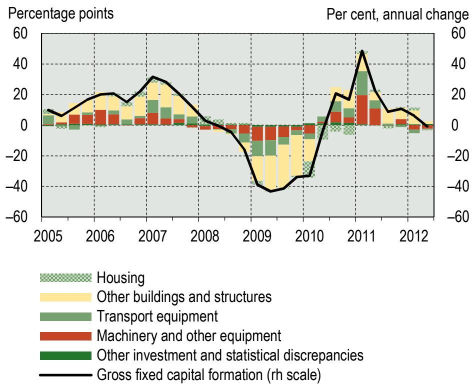
Chart 6. Real effective exchange rates



Source: EC.

Fears of a second wave of recession keep firms from investing in projects that increase production capacity, and essentially they invested only in facility replacement.

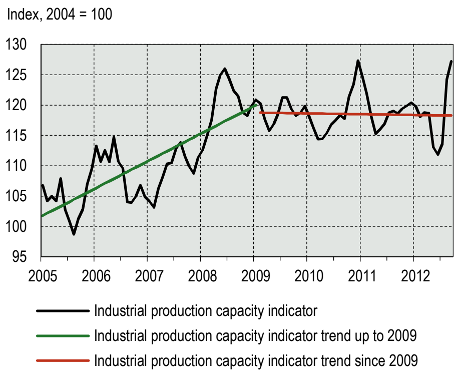
Chart 7. Gross fixed capital formation growth contributions



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Industrial production capacity was essentially unchanged in 2009-2012.

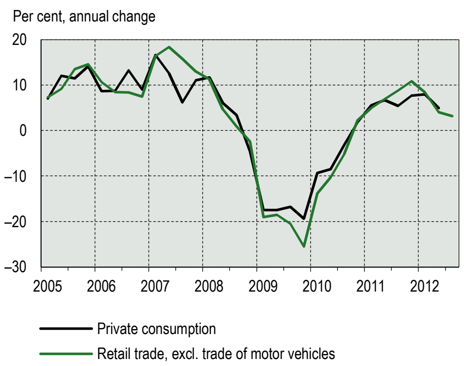
Chart 8. Industrial production capacity indicator (three-month moving averages)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Uncertainty regarding the economic development, along with not very rapid improvement in the labour market situation, determines the slower private consumption growth.

Chart 9. Development of retail trade and private consumption



Sources: Statistics Lithuania and Bank of Lithuania calculations.

only slightly; there was slower growth in consumer purchases of household and home décor items. Household purchasing power was reduced by inflation which exceeded wage growth. These factors were likely to encourage households to save relatively more.

The ability of Lithuanian businesses to compete on international markets and one-off factors led to a significant growth rate in the third quarter of the year. It exceeded economic growth rates in many EU countries. The first GDP estimate for the third quarter of 2012, published by Statistics Lithuania, shows that GDP grew by 4.4 per cent, the highest rate this year. This increase was mainly driven by abundant agricultural harvest and manufacturing growth. According to the Ministry of Economy of the Republic of Lithuania, this year's harvest is expected to double grain exports compared to a year ago. The growing demand of Lithuanian industrial production abroad is likely to contribute to the more rapid development of export. These factors will positively influence net exports, which, together with increasing inventory investment, should be the main factors contributing to the development of GDP in the third quarter of 2012. Meanwhile, the domestic demand is likely to be in decline. Slower growth in private consumption is likely to be a result of less favourable expectations and higher inflation rate. Continued uncertainty regarding further economic development leaves no expectations for investment recovery.

III. LABOUR MARKET

The labour market situation is improving but at a slower pace than before. Unemployment levels shrunk to 13.3 per cent (in the first quarter it totalled 14.5%)—mostly due to the decreasing number of unemployed. Although the unemployment rate in the second quarter was significantly lower than a year ago (2.3 p.p.), it declined more slowly than in previous quarters. The labour force continued to shrink due to continuing emigration.

The level of long-term unemployment (lasting one year or more) also fell during the year (to 6.4%). This downward trend has been observed since the fourth quarter of 2011. However, nearly half of all unemployed people in the country have been looking for a job for a year or more. The youth unemployment level that increased during the crisis is now falling faster and fell by 8.4 p.p. during the year (to 25.2%). The decrease is attributed to the general improvement in the country's economic situation and it is also likely to be affected by the projects initiated by the EC and implemented by the Government aimed at reducing youth unemployment in 2012-2013.[1] These projects aim to reduce unemployment among young people by promoting the training of low-skilled young unemployed people, extending exemptions to social security contributions for young persons employed for the first time, providing concessional loans to start their own businesses, etc. A major part of the project is financed by the structural funds of the EU.

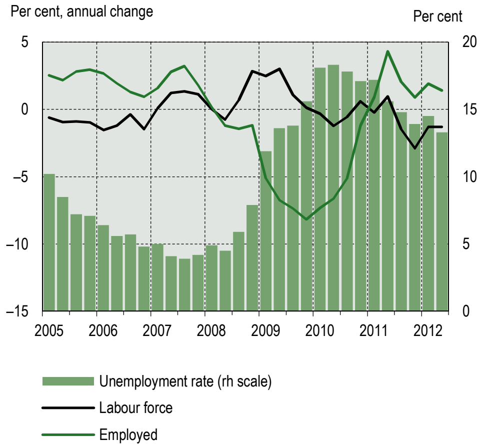
The growth of the economy continues to facilitate employment. The number of employed persons during the year increased by 1.4 per cent. The recent rapid development of industry has led to the most rapid growth of employment in this sector of economy which accounts for about one-third (0.5 p.p.) of the total increase in the number of employed persons. Employment in other sectors of the economy is also rising. Services significantly contributed to the growth of the number of employed (0.4 p.p.), contribution of construction was slightly lower (0.2 p.p.). The number of persons employed in the agricultural sector rose over the year (3.0%) for the first time since the fourth quarter of 2009. The biggest impact (1.3 p.p.) to the increase in the number of workers is made by their growing numbers in the private sector. Employment in the public sector has been declining for three consecutive quarters, but in the second quarter it increased and also had a positive impact (0.1%) to the growth in the number of employed persons. As in previous quarters, flexible forms of work, especially part-time work, yielded most of the employment growth in the private sector.

Employment was largely influenced by the increases in the number of self-employed persons (contributed 0.9 p.p. to the growth of total employment). The number of employees accounting for the majority of total employment increased slightly and contributed 0.2 p.p. to the total employment growth. However, this may be related to the growth of the employee base a year ago, so in the future the increase in the number of employees should again determine most of the employment growth.

With unemployment rate still high, the average wage growth is low. It has increased over the year (2.2%), but grew slower than in the previous quarter. This is mostly due to the slower wage growth in the public sector. Here, the basic salary grew at a slower rate than earlier, and the growth of irregular payments, additional payments and other one-off cash payments was negative. In the public sector wages rose by 2.2 per cent and in the private sector 2.4 per cent during the year. As for the four previous quarters, wages in the public sector grew faster than those in the private sector. Slightly less than half of the wage increases in the private sector were determined by irregular payments. The growth in wages continues to be attributed to its increase in the service sector (1.4 p.p.), followed by the industry (0.7 p.p.).

The unemployment rate in Lithuania is now lower than was a year ago, but it is decreasing more slowly than before.

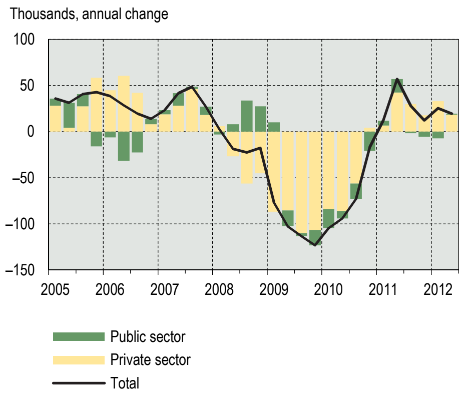
Chart 10. Employment and labour force developments, unemployment rate



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The growing economy leads to the continuing growth of employment, mainly due to the increase in the number of employed in the private sector.

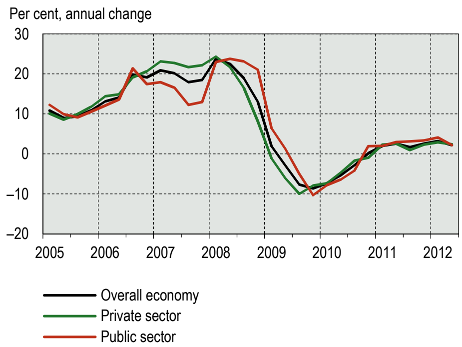
Chart 11. Employment developments by sectors



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Wages increased slightly; their growth was faster in the private sector than in the public sector.

Chart 12. Wage developments

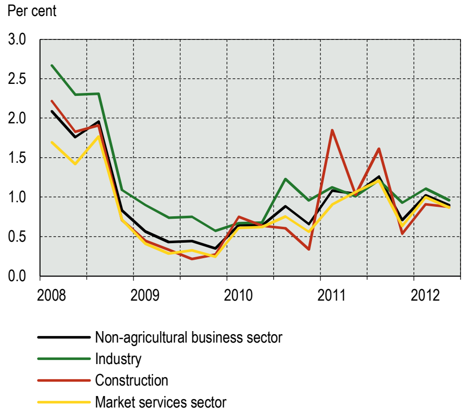


Source: Statistics Lithuania.

[1] See the website of the Lithuanian Confederation of Industrialists (http://www.lpk.lt/sites/default/files/2000000859_g-3234_2012-03-152.pdf).

Being lower than a year ago, the vacancy rate indicates that the labour market is likely to recover slower in the future.

Chart 13. Level of job vacancies



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Similar trends are likely to prevail in the future: the labour market situation will improve, but at a slower rate. Monthly unemployment figures published by the Labour Exchange show that the registered unemployment rate in the third quarter is declining at a slower rate. A similar situation is shown by the declining vacancy rate. The survey of industrial enterprises conducted by the Lithuanian Confederation of Industrialists on a quarterly basis indicates that more than half of industrial enterprises (57%) do not envisage changing the number of employees or wages (64%) in the nearest future. More than one-third of companies plan to increase the number of employees and wages in the near future, while there is only a small number of companies planning to reduce them. Similar trends should prevail in other sectors of the country's economy.

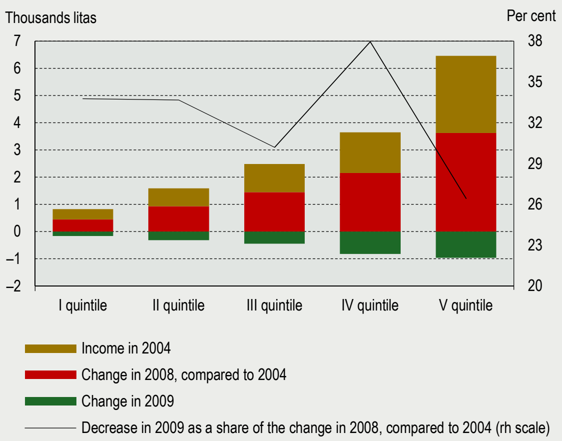
Box 1. Effects of the crisis on income inequality in Lithuania

It is generally believed that during the economic downturn, the situation of the less affluent population deteriorates disproportionately in comparison to those who are better off, i.e. poorer households are affected more by the recession, which increases the income inequality. These phenomena are seen in a negative light: although the perceived income inequality may motivate people to improve their financial situation by working more or acquiring new skills, greater inequality is often linked to higher crime and social exclusion. In this box, outlining the income change and distribution in 2004-2009, we sought to determine the effect of economic crisis in 2009 on the distribution of income in Lithuania.[1]

During economic upheaval the country's income per capita has been growing rapidly (see Chart A). According to Statistics Lithuania, disposable monthly income per household[2] in 2008 was about 2.3 times (1.6 thousand litas) higher than in 2004. Income changes by income quintiles (i.e. five equally-sized groups, consisting of households arranged by ascending income, or fifths) counted in times, varied relatively little, but the least (2.2 times or 0.5 thousand litas) increase was in the income of the poorest (the first quintile). The income of the second, third and fourth quintiles in 2008 was 2.4 times greater than in 2004, while the highest-income group households had 2.3 times (3.6 thousand litas) higher incomes.

In 2009, during the severe economic downturn, the average income fell by about 16 per cent. The greatest decline (22%) was seen in the fourth quintile income, while the other quintiles, except the fifth, were only slightly behind (their income decreased by 18-20%). The least (15%) decline in income was seen among households with the highest income.

Chart A. Developments of disposable monthly income in cash per household by quintiles



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The calculation of the share of increase in income (in 2008, compared to 2004) which was lost in 2009 shows that the largest share—38 per cent of income gains—was lost by the fourth quintile households (see Chart A). About one third of the gains were lost by the first and second quintiles, about 30 per cent—by the third, and only about 26 per cent by the fifth. The average household income of all quintiles, except for the fifth, in 2009 decreased to levels that were lower than in 2007. For the fifth quintile it was slightly higher than the level in 2007.

The following section addresses the Eurostat data. Its database contains not the average disposable household income but equivalised disposable income data. This indicator eliminates the impact of household size and composition on income, because in calculating it the household income is divided by the household equivalent size.[3] When income is calculated in such a way, the percentage of income received by certain groups (quintiles, deciles, etc.), compared with the total income, is the share of equivalised income of these quintiles, compared with the national equivalised income.

The large income share in Lithuania is concentrated in the small share of the population. In 2004-2008, one-fifth of the population earning the highest income earned 42.0 per cent of all income. One-fifth of the population earning the lowest income received only 6.7 per cent of total income. When examining in more detail, it appears that the most affluent 10 per cent of people received 26.5 per cent of the total income, the twentieth part—16.5 per cent, 1 per cent—5.3 per cent of income.

In 2009, during the economic downturn, income was even more concentrated in the hands of the highest-earning section of the population. Compared with the average of 2004-2008, only the income share of highest-earning one-fifth of the population increased—their income totalled 43.5 per cent of the total income. This share could increase due to the decrease of the shares of other groups, especially the poorest: the share of the first quintile fell by 0.7 p.p.; of the second and the third—by 0.3 p.p. each; of the fourth—by 0.2 p.p. Therefore, the residents earning least in 2009 received only 6 per cent of the total income. When examining the smaller parts of the income distribution we can see that the share of one-fifth of the population with the largest income increased more because of the tenth decile (tenth population of the country with the highest-income), and the latter was mostly affected by the upper part of the income distribution—5 per cent of the highest-income residents.

The discussed changes in the income distribution imply that income inequality increases during a crisis. This is reflected also by the income inequality indicators widely used in the literature—the ratio of quintiles (the ratio of income received by the fifth and the first quintile) and the Gini coefficient. The quintile ratio, which in 2004-2008, on average, was 6.3 times, during the recession peaked to 7.3 times. Thus, the fifth of the population with the largest income earned 7.3 times more income than the poorest fifth. The calculated income ratios of other groups also show increased inequality: in 2004-2008 the amount of income received by the tenth decile exceeded the income of the first decile by 11 times while in 2009 by already 14.4 times, among the last and first 5 per cent, this ratio was 21.2 times (2004-2008) and 34.4 times (in 2009). The Gini coefficient is an indicator, the zero value of which indicates absolute equality of income

Table A. National equivalised income shares in 2009 (in per cent)

		EU	New EU member states	Lithuania
Lowest income	The first quintile	8.0	8.0	6.0
	The first decile	2.9	3.1	1.9
	The first 5 per cent	1.0	1.2	0.5
	The first 1 per cent	0.0	0.1	0.0
Highest income	The fifth quintile	38.6	38.4	43.5
	The tenth decile	23.9	23.6	27.4
	The last 5 per cent	14.8	14.4	17.2
	The last 1 per cent	5.0	4.6	5.5

while its 100 per cent value indicates absolute inequality. In 2004-2008, this indicator in Lithuania was 34.9 percent, in 2009—36.9 per cent.

Lithuanian income inequality indicators—the ratio of quintiles and the Gini coefficient—were among the highest in the EU in the previous years, and during the recession they were the highest, being significantly higher than the EU average (EU quintile ratio was 5 times, and the Gini coefficient was 30%). Comparing the income distribution indicators with both the EU and the new EU member states we can see that in Lithuania less income is received by the population in the bottom part of the income distribution, and more by those on the top (see Table A).

[1] The results of the income and living conditions survey are published much later than the survey is carried out. Eurostat provides data on the income distribution according to the data collection period. For example, the data of 2010 is the information received about income in 2009. Statistics Lithuania provides revenue data for the period when it was received, i.e. the information received during the survey of 2010 about the income in 2009 is the data of 2009. In this box, income is analysed by the period in which it was received.

[2] Statistics Lithuania defines household disposable income as the total income after individual income tax, fixed property taxes, compulsory social insurance contributions of employees, the self-employed and the unemployed (if applicable), and regular remittances to other households.

[3] In calculating the equivalent household size, the first member of the household is given a weight of 1; each subsequent adult—0.5; and each child under 14 is given 0.3. Upon combining the weights of all household members, the equivalent household size is obtained.

IV. EXTERNAL SECTOR

CURRENT ACCOUNT AND ITS FINANCING

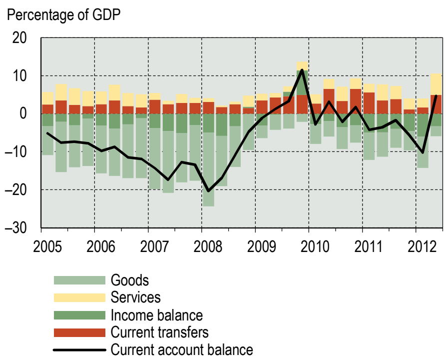
The current account balance was improved by favourable changes in all the structural components—deficit reduction of both goods and income, and surplus increases of services and current transfers. However, most of the factors that led to this development were temporary. The current account surplus in the second quarter of 2012 was 4.6 per cent of GDP. The significant quarterly current account surplus was mostly formed by the trade surplus on goods and services, the largest in the history of data collection (3.0% of GDP). The exports of services alone were higher than a year ago by one fifth—mainly due to the positive impact of transportation services. Reduction of the trade of goods deficit was caused by the trade in mineral products that was affected both by seasonal factors and repairs in the oil refinery. Income account deficits also declined in the second quarter, especially because of change in reinvestment flows. Another part of the current account—current transfers—increased due to the aid of EU structural funds.

In the second quarter the EU structural funds flow was one of the largest since the beginning of data collection for balance of payments and led to almost a double flow of current transfers than that a year ago. The main contribution to this increase was by restored payments of the EU structural funds, which have been temporarily suspended in the first quarter of 2012 because of the EC's investigation. In May alone, more than 0.5 billion litas of funds frozen in February were transferred to Lithuania. Transfers of individuals also contributed to the increase in current transfers: such transfers to Lithuania increased, while from Lithuania they declined. Thus, the net result of private transfers was positive.

The current account surplus implies the net financial outflow from Lithuania, much of which was yielded by the temporary decrease of the government's international liabilities. In the second quarter of 2012 the Ministry of Finance of the Republic of Lithuania redeemed 1 billion Eurobonds and despite additional borrowing during the same period, it saw the largest decrease in net foreign liabilities from the beginning of data collection. Such change in the public sector foreign liabilities (along with the foreign assets increase of the private sector) determined the highest quarterly reduction of investment portfolio since 2008. However, it should be noted that while government liabilities are covered by refinancing them on international markets, the portfolio investment changes offset themselves in the longer term. In the second quarter, significant changes were seen in another part of the financial account—the foreign direct investment account: their negative flow was the highest since 2009. This development was caused by dividends paid by the foreign owned companies (mainly in manufacturing) to investors for the financial year 2011.[2] Commercial banks continued to reduce their liabilities for parent financial institutions,[3] but the negative flow of other investments, compared to the first quarter, was lower—mainly for short-term foreign loans repaid to local banks.

One of the biggest current account surpluses after the end of the recession was mainly due to one-off factors.

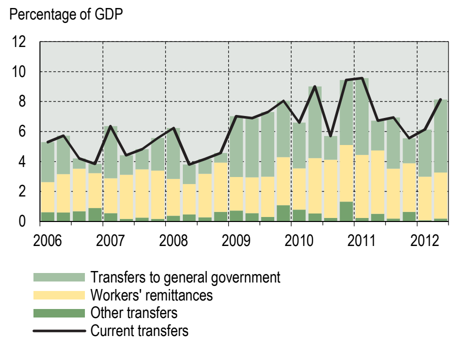
Chart 14. Components of the current account balance



Sources: Statistics Lithuania, Bank of Lithuania and Bank of Lithuania calculations.

EU funding has greatly contributed to the current transfer flows to Lithuania, however, a significant share of them were payments suspended in the last quarter.

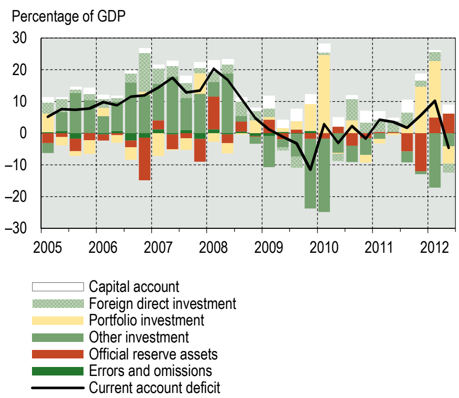
Chart 15. Current transfers to Lithuania



Sources: Statistics Lithuania, Bank of Lithuania and Bank of Lithuania calculations.

Net financial flows from Lithuania were mostly determined by the redemption of Government Eurobonds.

Chart 16. Current account deficit financing sources



Sources: Statistics Lithuania, Bank of Lithuania and Bank of Lithuania calculations.

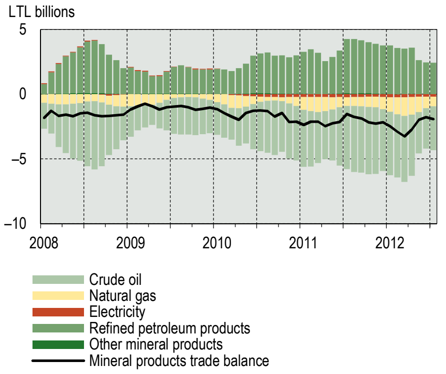
2 The reinvestment specified in the income account is also included in the foreign direct investment account, however with an opposite sign.

3 Other investments are the ones that do not subscribe to the categories of direct investment, portfolio investment, financial derivatives or reserve assets. Other investment includes debts for goods and services, cash and deposits, and other foreign assets (liabilities).

FOREIGN TRADE AND COMPETITIVENESS

Fluctuations in the foreign trade of mineral products were due to the scheduled overhaul of AB ORLEN Lietuva refinery, which affected the demand for raw materials, and the scale of production traded to foreign markets.

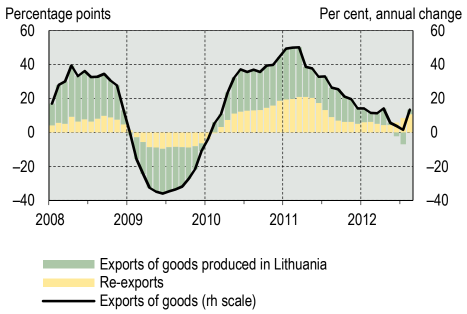
Chart 17. Mineral products trade balance (three-month moving sums)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Exports expansion was affected by reduced refined petroleum sales on foreign markets, and re-export, which currently has significant growth rate due to the comparative base effect.

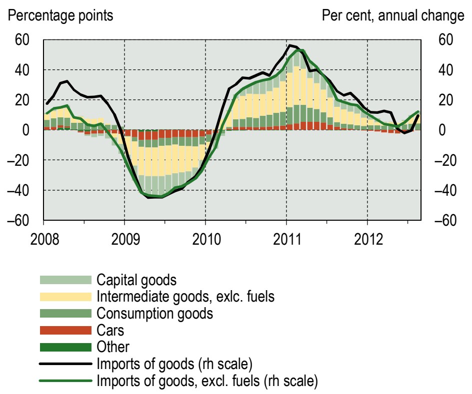
Chart 18. Contributions to export growth by origin of goods (three-month moving sums)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Imports regain momentum—mainly due to intermediate goods, the demand for which is maintained by reasonably good industrial activity results.

Chart 19. Contributions to import growth by macroeconomic categories (three-month moving sums)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

One-off mineral product trading factors resulted in erratic evolution of the foreign trade deficit—in the second quarter of 2012 it was less than half of what was a year ago. This was largely determined by the overhaul of the AB ORLEN Lietuva refinery, which started in May and lasted for more than a month. During this overhaul the factory's production was halted, hence this affected the cycle in the trade of mineral products—both raw material imports and product exports. The overall effect on the second quarter balance of foreign trade was positive due to the stocks accumulated during the previous period. Foreign trade, excluding the trade in mineral products, in the second quarter of 2012 was characterized by some of the largest historical surpluses. Incidentally, greater deficits in mineral products in the coming quarter should be at least partially offset by higher surpluses in other groups of foreign trade.

In the second quarter of 2012 the annual export growth was lower due to one-off factors in the oil refining industry. Since mineral products account for more than a quarter of exports, the oil refining sector has a significant impact on export trends. The published foreign trade data as of July-August suggests that in the third quarter, export growth should be improved significantly. Such a perspective should be determined both by re-exporting,[4] and the export of goods of Lithuanian origin. According to the Lithuanian Ministry of Agriculture, Lithuania's grain exports this year should be at least twice as high as in 2011. Given the global food prices being still on the high side, and a good harvest of not only grain but also other agricultural products, we may project that exports of goods of Lithuanian origin will be one of the most important export catalysts in the second half of 2012.

An important factor in the development of exports was the competitiveness of Lithuania's exporters—this is confirmed by further increasing market shares in the key markets. However, marketing trends by markets in the second quarter of 2012 varied, for example, the growth of exports to the EU, in particular to the euro area countries, has slowed significantly (mainly due to the temporary reduction in the exports of mineral products), and accelerated to the CIS markets.

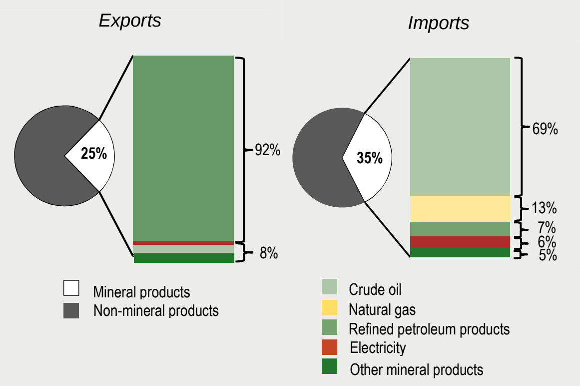
Changes in mineral product trade affected imports more strongly than exports—in the second quarter it suffered a slight decline. However, the imports, excluding mineral products, increased, while the rates of their growth also accelerated. Imports were favourably affected by strong industrial production as well as slightly faster imports of consumption and investment goods compared to the first quarter. However, more rapid development could be achieved only by increasing the domestic demand, and yet, customer expectations do not indicate this for the subsequent months.

[4] The pace of re-export development is mainly defined by last year's low comparison base, which is due to the reduction of vehicle resale to Belarus and Kazakhstan shortly after July 2011. The main cause of this reduction was higher customs duties for second-hand vehicles were imposed in these countries.

Box 2. Development of mineral products foreign trade and its impact on the current account balance

Lithuania's foreign trade structure is dominated by mineral products[1]—in 2011, they accounted for a quarter of the country's total exports and over a third of imports (see Chart A). This structure shows the need for energy resources for the national economy and particularly the Lithuanian oil refining industry's raw materials imports and products exports. The dependency of Lithuania's economy on the supply and demand factors of global energy resources is one topic widely discussed by energy experts and economists. However, the effects of prices of global energy resources, important in terms of macroeconomic stability to the country's current account, have been considered in quite general terms—without analysing the structural factors of mineral products' exports and imports. This analysis aims to demonstrate the trade development of dispersed mineral products in terms of changes in trading volumes and nominal values, as well as assessing the effects of trade on the Lithuanian current account by separate categories of mineral products. Data of foreign trade volumes and nominal values from the first quarter of 2006 till the second quarter of 2012 published by Statistics Lithuania are used for this analysis. The first part of this analysis reveals the development of structurally different categories of trade in mineral products, and the second part measures the effect of changes in mineral commodity prices and quantities on the country's current account balance.

Chart A. Mineral products in the Lithuania's foreign trade in 2011

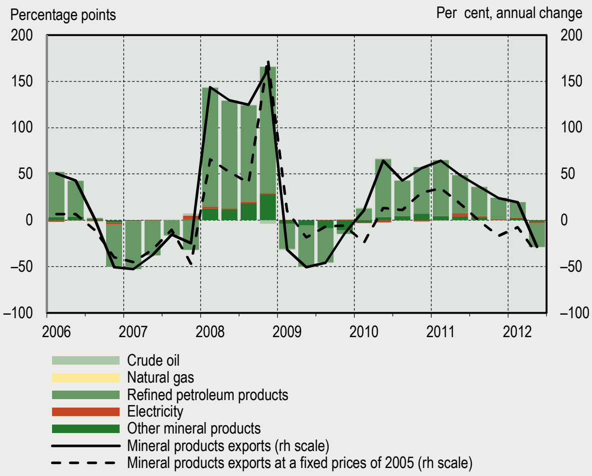


Sources: Statistics Lithuania and Bank of Lithuania calculations.

Development of foreign trade in mineral products

There are several major product categories in the structure of Lithuania's foreign trade in mineral products such as imported energy resources (natural gas, electricity, crude oil and oil products) and exports of products of the oil refining industry. The importance of oil and its refined products is exceptional—it is the only significant category of exports of mineral products; the total export and import volume of oil and oil products in 2011 accounted for about 80 per cent of all trade in minerals. During the analysis period, the trading results of this category of products were markedly influenced by the development phases of the major refinery AB ORLEN Lietuva. The following should be distinguished: 1) 2006-2007—the production decline because of the supply chain and technological shocks, 2) 2008—operation stabilization and rapid development, 3) 2009—production decline caused by external demand shocks, 4) since 2010—recovery of operations and relatively stable development. Subsequently, these steps are evaluated by their impact on the exports and imports of mineral products, by structurally analysing the mineral product trade data from the beginning of 2006 till the middle of 2012 (see Chart B and C).

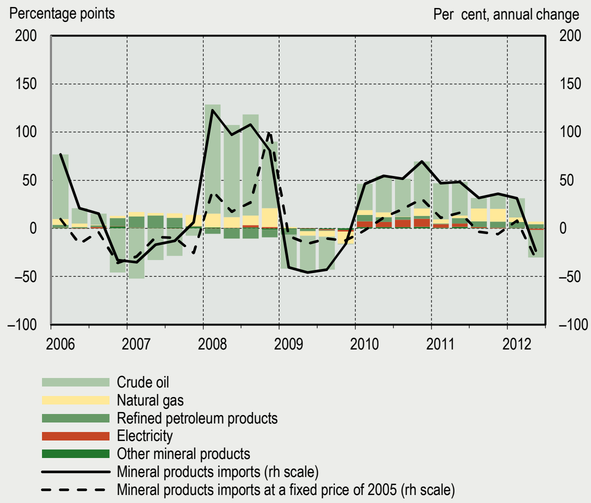
Chart B. Contributions to mineral products exports change



Sources: Statistics Lithuania and Bank of Lithuania calculations.

In July 2006, AB ORLEN Lietuva refinery foreign trade was disrupted after the interruption of crude oil supply by pipelines,[2] and in autumn the production facilities caught fire. These contingencies, along with repairs and modernization carried out in 2007, affected the refinery product offer: oil product exports in that year were nearly half as less compared to 2005. After the restoration of the technological capabilities and rapidly rising global oil prices, the events proceeded more favourably—in 2008 both exports and imports were growing quite rapidly. However, in 2009, with the intensification of the global financial crisis, the oil price had a negative effect—the foreign trade of mineral products produced in the country declined. Since the beginning of 2010 one could once again witness fairly steady growth in exports of Lithuanian oil refin-

Chart C. Contributions to mineral products imports change

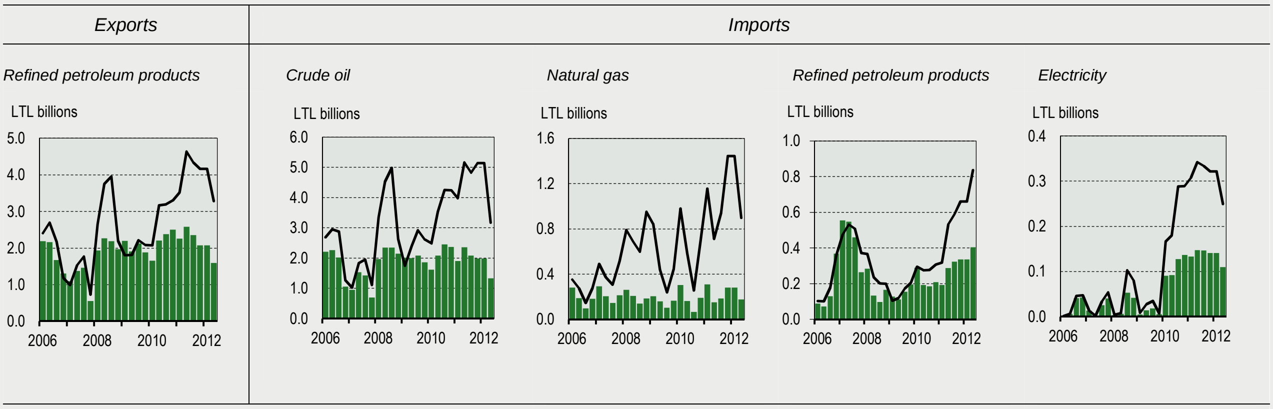


Sources: Statistics Lithuania and Bank of Lithuania calculations.

ery industrial production. It was very much affected by changes in oil prices, and higher negative fluctuations were due to temporary factors.[3]

In addition to oil and oil products, changes in natural gas and partly electricity imports have significant influence on the development of trade in mineral products. As indicated by the analysis of the mineral product categories (see Chart D), the price was the most important factor for the trade development of these products.[4]

Chart D. Exports and imports of key categories of mineral products at nominal values and at fixed prices of 2005



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The charts depict the import and export flows of key mineral products at nominal values and at average prices in 2005 and provides a good demonstration of the effects of price and quantity on trade flows. Oil and oil product trading changes can be explained by the discussed development phases of the oil refining sector, while changes in the imports of natural gas and electricity should be explored separately. Import trends in both categories were different—natural gas volumes have been relatively stable (mostly affected by seasonal factors), while electricity imports increased significantly due to the structural break, which took place in 2010 upon the final decommission of the Ignalina nuclear power plant. Developments of imported natural gas and electricity prices were influenced more by external factors. It should be noted that these trends are extremely unfavourable for the country's natural gas importers—recent cost for the same amount of natural gas is several times higher than in 2005.

Effects of mineral commodity prices on Lithuania's current account balance

The mineral product trade deficit in 2006 was below 5 per cent of the country's GDP, while in the first half of 2012 it already exceeded 10 per cent of GDP (see Chart E). Consequently, trade in minerals increasingly affects Lithuania's current account balance, and the country's macroeconomic vulnerability along with it. In the first part of the analysis, while discussing the development factors of trade in mineral products, we singled out the importance of price impact, and now will proceed to close examination of the effects of changes in prices for the mineral trade balance. In such impact assessments, it is important to take into account the mineral product imports and exports, and use data in the calculations which are comparable with the summarized foreign trade data.

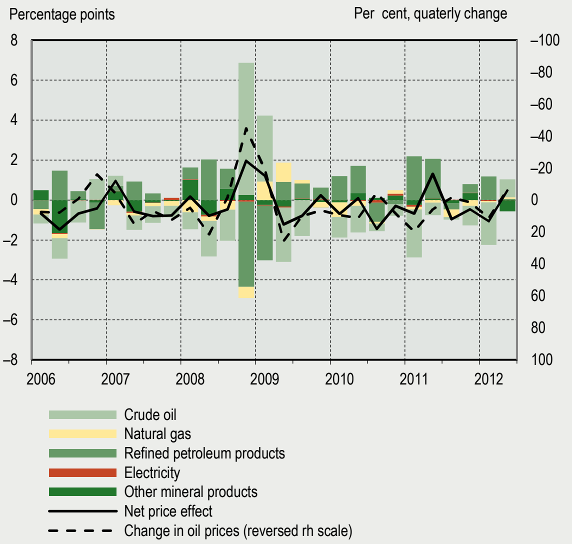
Chart E. Lithuanian mineral products trade deficit and the total foreign trade deficit

Sources: Statistics Lithuania and Bank of Lithuania calculations.

The discussed data of foreign trade volumes and nominal values were used for the cost impact analysis. Price effects of different categories were evaluated by subtracting the product of nominal value and quantity ratio of the previous quarter and the quantity of the current quarter from the nominal value of the current quarter. The resulting values of product group cost factors are aggregated, yielding the price impact on exports and imports. Net price effect is calculated by deducting the price effects on exports by the price effects on imports, and indicates the extent to which the foreign trade balance is affected by quarterly changes of prices. The analytical results are presented in Chart F upon structurally breaking down the defined price factor, along with the quarterly change in the price of oil announced by *Bloomberg*.

It should be noted that the effect of oil price changes on exports and imports has reverse effects, for example, the decrease in the price of oil leads to the decrease in the cost of acquisition of mineral imports, but also the sales income from the exports of minerals (the opposite effect is with the growth of oil prices). Nevertheless, the value of Lithuanian imports of mineral products is much higher than exports so the effects of price changes for imported commodities are much stronger. This is shown by the correlation analysis—the general price index effect has a strong negative correlation with the quarterly changes in the price of oil seen in the global commodity markets.[5] Therefore, it is possible to postulate with some confidence that the increase in global oil prices leads to a negative effect of prices of mineral products on the Lithuania's foreign trade balance.

Chart F. Impact of the net price factor of mineral products on foreign trade balance and the change in the oil prices in global markets



Sources: Bloomberg, Statistics Lithuania and Bank of Lithuania calculations.

It is worthwhile to examine these effects in different time periods in more detail. In the fourth quarter of 2008, the price of oil fell by 40 per cent (compared with the previous quarter), the Lithuanian mineral product price change factor had an almost 2 per cent GDP positive impact on the country's foreign trade deficit. The fall in the crude oil prices had a beneficial effect on the trade balance, while less expensive refined petroleum products resulted in a lower export revenue stream, bringing the total positive cost impact of the fourth quarter of 2008 on the foreign trade balance. This example shows that the one-way effect only partially offsets the impact of the opposite direction, and this leads to the increase or reduction of mineral product trade deficit. Analysis of other periods shows that the discussed relationship can be different. This is due to both the changing structure of trade (some mineral product categories are more dependent on global oil price changes) in different periods of time and possible shift in pricing policies of oil producing and exporting companies. It is likely that in the first half of 2012 there was a significant change in the price of oil that, in turn, led to Lithuania's current account volatilities. Chart F shows that in the first quarter of 2012 the net price factor accounted around –1.1 per cent of GDP, and therefore was one of the key determinants of the current account deficit increase to 10.0 per cent of GDP while in the second quarter it markedly contributed to the current account surplus (0.5% and 4.6% of GDP, respectively). This suggests that the recent Lithuanian macroeconomic stability is highly dependent on the supply and demand factors of global energy resources. Therefore, in the assessment of the country's energy development strategy it is important to note the transmission channels and consider the effects of potential solutions to reduce the country's vulnerability to external macroeconomic factors.

[1] The mineral products category is defined by the Combined Nomenclature manual (annually approved by EC; latest version no. 1006/2011), in the fifth chapter, which includes highly significant for Lithuanian foreign trade energy products (oil, refined petroleum products, natural gas, electricity).

[2] After the interruption of crude oil supplies from Russia, AB ORLEN Lietuva has been receiving raw materials through Būtingė reverse import-export terminal.

[3] In the second quarter of 2012 the sale of mineral products decreased due to scheduled repairs: AB ORLEN Lietuva factory suspended its operations in the end of April for more than a month.

[4] An exception is the import of electricity. The import volumes of this product group were strongly affected by the decommissioning of the Ignalina nuclear power plant, followed by significant increase in demand for imported energy in 2010.

[5] The correlation coefficient of common effect of mineral prices and the impact of global oil price change (from the first quarter of 2006 till the second quarter of 2012 inclusive) is –0.6; individual assessment of the relation between the factors of mineral product export and import prices to the oil price movements shows even higher correlation (in both cases, the correlation coefficient exceeds 0.8).

V. PRICES AND COSTS

After declining in the first half of the year, the annual inflation increased in the subsequent months as part of the prices related to external factors, namely food and fuel prices, were rising faster. In September, the annual inflation rate was 3.3 per cent, and 3.2 per cent in the third quarter. Inflation was higher than anticipated, especially due to greater-than-expected rise in fuel and food prices (including beverages and tobacco). A faster than expected rise in the prices of fuel is associated with the rise in the price of oil on the global markets, meanwhile food price trends differed from the forecast due to the price developments of seasonal products—vegetables and fruits. For the faster than expected price increase in the third quarter, the short-term inflation forecast was increased.

In the third quarter, as before, the biggest share of annual inflation was related to external factors—they were responsible for roughly 80 per cent of total inflation. The biggest influence is still attributed to higher food and administered prices—each of them accounted for a third of inflation in the third quarter. The effect of the rise of fuel price was smaller—it accounted for about 15 per cent of inflation. The share of inflation related to domestic price trends remained of little importance. Prices for industrial goods and market services included in the calculation of core inflation rate contributed only about a fifth of the total inflation, even though these goods and services comprise nearly half of the consumer basket by weight.

Producer price pressures on inflation continue to decline. The annual rise in producer prices on the domestic market in the third quarter of 2012 was 5.2 per cent—less than in the previous quarter (5.6%). This has resulted from a slower growth rate of prices of energy products, which constitute the largest share of producer price index (about half), and non-durable consumer goods. Prices of durable consumer goods in the third quarter were still lower than a year ago. One may expect that the pressure on consumer prices arising from the production chain will not be high.

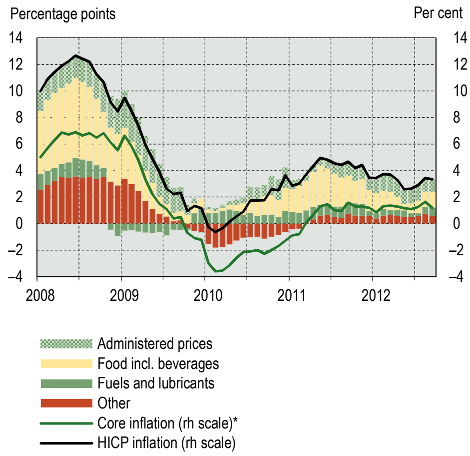
Labour cost changes and changes in import prices remains favourable for consumer prices. Since the first quarter of 2012 the unit labour costs are higher than a year ago, as gross wages are rising faster than the labour productivity. However, unit labour costs rose moderately, and no rapid growth is expected in the near future. The import price developments reflect decreasing inflationary pressures from external sources: in the second quarter, the import prices of all major commodity groups, except for durable consumer goods, rose more slowly than in the first quarter with the growth of energy prices slowing down the most. Import prices of durable consumer goods were rising more rapidly in the second quarter, but in July their growth slowed down.

Annual core inflation is still low, and if in the short term, as expected, there is no strong economic growth, it should not increase significantly. However, in the third quarter, it was higher than expected, as the price trends of seasonal industrial goods—clothing and footwear—changed compared to the previous years. Usually in summer the sale of these goods is organised and new collections are presented for the market in autumn, but this year clothing and footwear prices boosted significantly in August. Clothing retailers indicate that it is associated with the Western practice of more frequent updates of collections (at least four times a year) that started to be more actively applied in Lithuania.

Food price trends in Lithuania are related to developments in global markets. According to the information from the United Nations Food and Agriculture Organisation, world food commodity prices in the third quarter were still lower than a year ago, but not as much as before. In June they decreased by about 14 per cent over the year, while in September (according to preliminary data)—by 4 per cent. September saw lower prices than a year ago for all commodity groups except cereals. Prices for

In July and August 2012 the annual inflation rose because of faster growth of food and fuel prices.

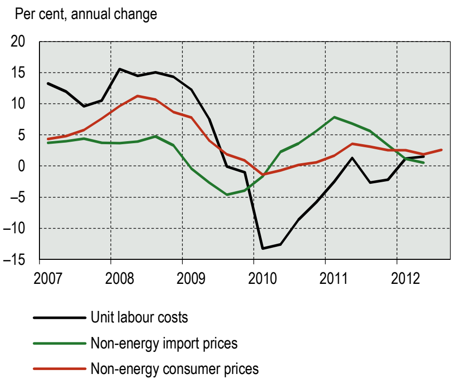
Chart 20. Contributions to annual inflation



Sources: Statistics Lithuania and Bank of Lithuania calculations.
** Change in HICP excl. food, fuels and lubricants, and administered prices.*

Unit labour costs increased slightly over the year, while the growth of non-energy import prices was slowing down.

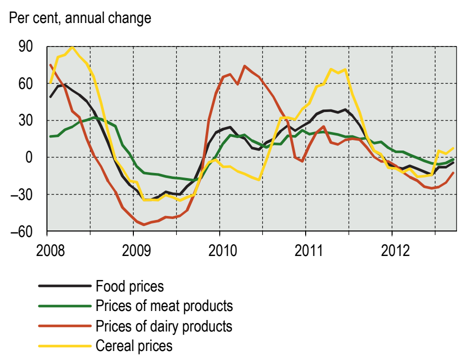
Chart 21. Unit labour costs, non-energy import prices and non-energy consumer prices



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Annual decline in food commodity prices in the world had a slower pace than before.

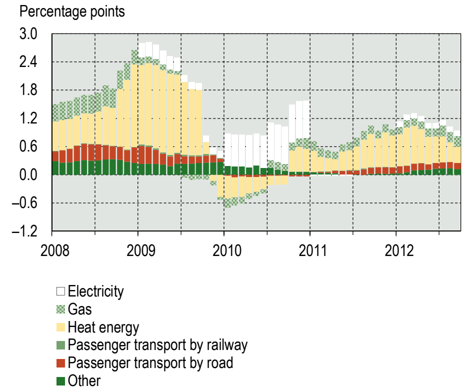
Chart 22. Global food prices



Sources: Food and Agriculture Organization of the United Nations and Bank of Lithuania calculations.

Impact of administered prices on inflation declined due to slower growth of heat energy prices.

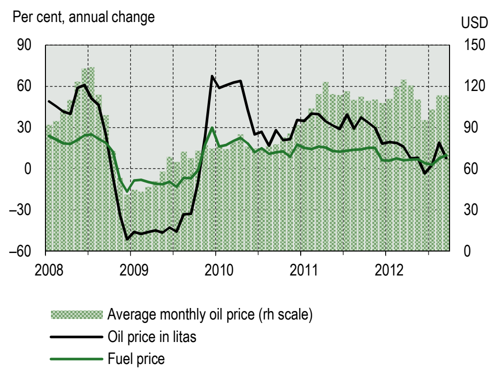
Chart 23. Contribution of administered prices to annual inflation



Sources: Statistics Lithuania and Bank of Lithuania calculations.

In the third quarter the price of oil increased.

Chart 24. Global oil price and fuel prices in Lithuania



Sources: Bloomberg, Statistics Lithuania and Bank of Lithuania calculations.

sugar (25%) and dairy products (13%) decreased the most, fat and meat prices also declined. Cereal prices that were 14 per cent lower than one year ago in June, were 7 per cent higher in September. This is due to the changes in July—then, because of the expected poor harvest in some key grain producing regions (corn in US, wheat in Russia) prices of cereals went up by 17 per cent. In subsequent months, cereal prices stabilized as weather conditions improved in the US, and Russia decided not to impose grain export restrictions. However, in August and September the previous rise in grain prices affected other food commodity prices: more expensive feed caused higher prices of meat and dairy products. Compared with June, the annual growth of meat and dairy consumer prices in Lithuania has also accelerated. This, combined with seasonal food prices, contributed the most to the acceleration of food price growth. The annual change of food and non-alcoholic beverage prices in June was 1.7 per cent and in September—3.0 per cent.

The annual increase of administered prices was losing momentum since April 2012 because of the slower price growth of heat energy which is the most important component of this price category. At mid-year, the slowdown was somewhat dampened by the price of natural gas, which jumped up by one-fifth for household consumers. Annual growth of heat energy prices declined due to the base effect: recently heat energy prices were continuously climbing up, but the calculations of the annual change no longer included their rapid growth during the corresponding period of the previous year. The heat energy price in June 2012 was 14.7 per cent, in September—8.3 per cent higher than a year ago. According to the National Control Commission for Prices and Energy, in October the heat energy price should decline significantly because of lower prices for natural gas and biofuels. Heat will become cheaper almost everywhere in Lithuania, in particular in Alytus and Šiauliai, as thermal power plants fired with biofuels will be put into service. When the heat energy price falls, its annual change will decrease further.

Oil price in US dollars, which dropped significantly in the second quarter, rose slightly in the third quarter (0.9%), while the annual decline has slowed down. The rise in oil prices was suppressed by anxiety about the future global economic growth and oil demand. The oil price in litas supported by the strengthening of the US dollar was higher in the third quarter than a year ago. As the oil price went up in the third quarter, fuel prices in Lithuania increased. Their annual growth rate increased from 4 per cent (in June) to nearly 10 per cent (in September).

VI. CREDIT AND DEPOSITS[5]

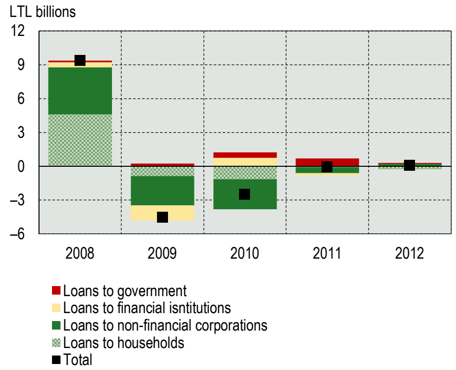
While shrinking during the first two months of 2012, starting from March to September, the banking loan portfolio grew by 0.4 billion litas. The demand of borrowing from banks is gradually increasing because of the stronger financial position of the private sector, attractive borrowing conditions (interest rates remained at record low levels, while lending conditions to certain sectors were eased). In September 2012 the banking sector's loan portfolio was 0.1 per cent, or 0.1 billion litas, greater than in December 2011. This was mostly due to the growth of lending to non-financial companies. However, the corporate economic assessment and consumer confidence indicators are still lower than a year ago, which could result in the postponement of plans to finance investment and consumption from borrowed funds, and restrict the growth of the loan portfolio. On the other hand, commercial banks expect credit portfolio growth.[6] According to them, during 2012 the loan portfolio may increase an average of 1 per cent, while in 2013 the average growth rate can reach about 3 per cent over the year.

The biggest debtor of the banking sector—non-financial corporations—continued to consolidate their financial position. In the second quarter of 2012, sales revenues and business company profits before tax were the highest since the start of the economic downturn. However, their profits should be treated with caution, as more than one-third of it could be attributed to prior periods with a less characteristic result of financial and investment activities of head offices and management consultancy enterprises. In the second quarter of 2012 the sales profitability was 6.2 per cent and two-thirds of all companies operated with profit. With an increasing number of orders for production (basically in the non-Lithuanian market), non-financial companies increased production capacity utilization while the growing need for investment to replace obsolete equipment was largely met by using their own resources—increasing profits enabled them to do so. However, some non-financial companies, considering extremely low interest rates and easier lending conditions, increased liabilities to banks (part of the business financed via borrowed funds has been increasing, and this is confirmed by the increasing financial leverage ratio), while lending to businesses has become an essential factor in the growth of the banking sector loan portfolio. With a slight decline in the first quarter of 2012, in the second and third quarters the portfolio of loans to non-financial companies jumped up by more than 0.5 million litas and grew by a quarter billion of litas or 0.9 per cent since the beginning of the quarter. In the second quarter, major debtors had the biggest impact on the developments in non-financial corporations' liabilities to banks: the decrease of liabilities was contained by construction, trading, and real estate companies, but grew because of manufacturing companies.

While activities of non-financial companies are increasing, companies of some economic sectors, mainly construction and industrial, encountered shortages of highly qualified labour which might lead to the increase in demand of labour, remuneration and strengthening of the financial position of households. Nevertheless, the population was cautious about the future (consumer confidence index was worse than a year ago) and refrained from assuming additional financial commitments; only in the third quarter of 2012 the situation began to change. The banking sector loan portfolio to households in January-July continued to decline (shrank by 0.3 million litas or 1.3%), but in August-September increased by 40.0 million litas, due to the growing lending for housing purchase. The use

The banking sector's loan portfolio is slowly recovering.

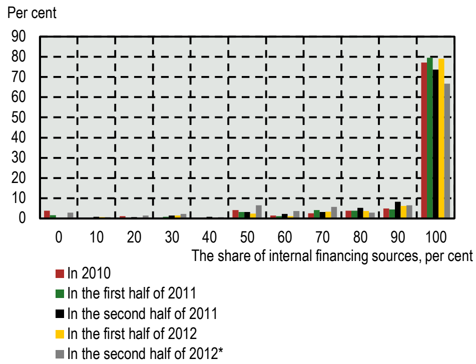
Chart 25. Factors for changing the banking loan portfolio in January-September



Source: Bank of Lithuania calculations.

Improving results of non-financial enterprises lead to the recovery of moderate borrowing from the banks because a major part of activities can be financed from internal financing sources.

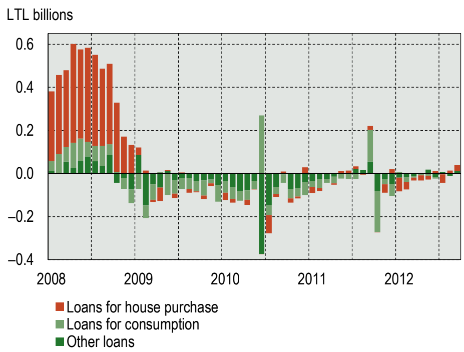
Chart 26. Breakdown of enterprises by the source of satisfying financing needs of businesses



Sources: Survey of Non-Financial Enterprises on Business Financing ordered by Bank of Lithuania and Bank of Lithuania calculations.
** Enterprises planning business expansion.*

Households are still cautious in assuming new financial liabilities.

Chart 27. Changes in loan portfolio to households per month



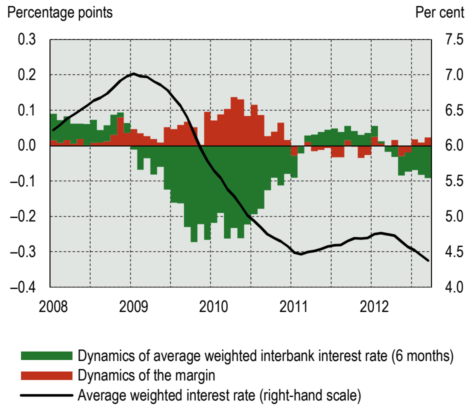
Source: Bank of Lithuania calculations.

[5] In this part, for the evaluation of loans and deposits, the data used is from statistics of monetary financial institutions, presented by the Department of Statistics of the Bank of Lithuania, and excludes AB bankas SNORAS data.

[6] Bank lending survey, October 2012.

In August 2012, interest rates of new loans to the private sector reached historical lows through the entire period since the start of observations in October 2004

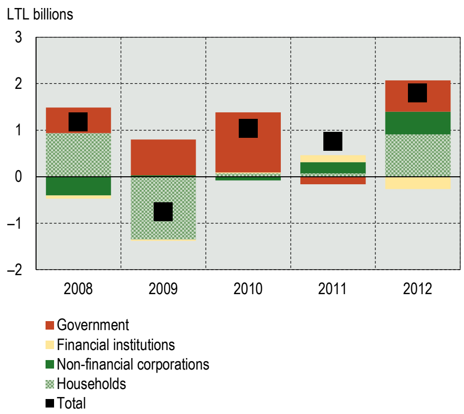
Chart 28. Contributions to changes in weighted average interest rate on new loans to the private sector (twelve-month moving average)



Sources: www.euribor.org and Bank of Lithuania calculations.

Active withdrawal of deposits in the beginning of the year was later replaced by rapid increase that was mainly caused by households and the government sector.

Chart 29. Factors for changing the deposits in the banking sector in January-September



Source: Bank of Lithuania calculations.

of banking services for the acquisition of housing could have been encouraged by extremely low interest rates on loans. In addition, the activity of the real estate market is gradually increasing: a growing amount of transactions, new building permits, except that the average price of housing remains unchanged for more than two years.

The weighted average interest rates for banking loans to the private sector were the lowest for over nearly eight years of observation. Given that the interest rate for the majority of new loans are fixed for a period of less than 1 year, it can be concluded that the most significant impact on the change of the loan interest rate was made by the drop in interbank interest rates (both in litas and in euros). The drop of interbank interest rates in litas was influenced by the reduction in the interbank euro interest rates that are closely related to them, and the cheaper alternative source of funding for banks—deposits. In January-September 2012, the new lending rates from the banking sector to the private sector dropped by 0.8 percentage point to 3.9 per cent. A slightly faster decline in the loan interest rates was dampened by the still conservative assessment of credit risk assumed by banks and a slight increase in lending margins.

Having declined at the beginning of the year, the banking sector's deposits later began to rise. Rapid growth of deposits in the banks was only slightly influenced by heavy declines in interest rates. While bank lending activity remained subdued, the need to attract more funding sources was low, so the interest rate for deposits was at its lowest level in eight years. In September 2012 the interest rate for private sector's new deposits was at 1.0 per cent and 0.8 p.p. lower than at the beginning of the year. However, future expectations of households and non-financial firms remained poor, households were not inclined to consume, and companies were not inclined to invest, and it could lead to the increase in deposits. In January-September 2012 deposits held in banks have increased by 1.8 billion litas, or 4.3 per cent, mainly due to the increase of deposits from households. The falling interest rate for deposits changed the structure of the private sector's deposits in the banking sector: with a decrease in the difference between the interest rates paid for term and overnight deposits, term deposits during this period have not changed much, while overnight deposits significantly increased.

VII. GENERAL GOVERNMENT FINANCE

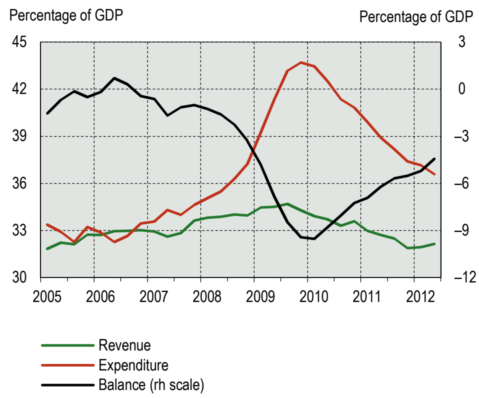
Restricted spending and fairly strong income growth rising out of the growing economic activity continued to improve the situation of the Lithuania's general government finance. In the second quarter of 2012, the four-quarter general government deficit to GDP ratio has shrunk by one fourth on an annual basis and totalled 4.4 per cent. The reduction of the deficit should mostly be attributed to the virtually unchanging general government revenue-to-GDP ratio for the third consecutive quarter while general government expenditure-to-GDP ratio of the general government was declining steadily. This shows that the annual revenue growth rate was rapid and consistent with the overall growth of economic activity, while spending increased considerably slower. Prerequisite to revenue growth was improved labour market situation that boosted remuneration fund, the changes in it had a positive impact on the domestic demand. These factors in particular increased tax revenues and social contributions. Changes related to spending could be attributed to state government expenditure limitation introduced in 2012 in the National and Social Insurance Fund Budgets' laws. While assessing the impact of different budgets on the general government balance, it can be seen that the lower state budget deficit might have the greatest influence on it. The deficit of the social security funds also fell during the year whereas the local government surplus increased.

Increased domestic consumption and bigger remuneration fund led to the rapid growth of the general government revenue in the second quarter of 2012. In the second quarter of 2012, the general government revenue increased by 7.4 per cent during the year. One of the most important factors for the growth were social contributions where the annual growth rate was slightly slower than in the first quarter, but still significant. During the year the growth was mainly driven by income from social insurance contributions of insurers and the insured. This was mainly due to an increase in employee wages because their numbers remained essentially unchanged in the second quarter. Social contributions from self-employed persons were nearly a tenth less in the second quarter. It is likely that this reduction was due to lower income of self-employment as their numbers increased over the year by nearly one tenth. In the second quarter the general government revenue mostly increased from non-tax revenue, of which the greatest role was played by higher income from assets rising out of the transferred profits of the Bank of Lithuania and dividends of state managed companies, and higher income from the sales of goods and services along with current receivable transfers. The latter were growing due to the increased inflows of EU funds. In the second quarter, a higher number of employees and average wages increased the remuneration fund, creating the prerequisites for the growth of general government revenue from direct taxes by more than a tenth during the year. Most—by more than a quarter—grew the revenue from profit tax, but it was influenced not only by higher declared profits, but also by the fact that part of the advance profit tax for the first quarter was received in the second quarter. This factor will also have an impact during the third quarter. According to the advance profit tax declarations submitted for the State Tax Inspectorate, it can be assumed that the profit tax in 2012 will be greater by about one fifth.

The remuneration fund, higher than a year ago, had an impact on the annual increase of household consumption expenditure and retail trade turnover. For the second quarter, the latter factors were the main sources of the increases of general government revenue from indirect taxes. Most annual increases in the revenue were from VAT while reduced levels of excise duties were collected in the second quarter primarily due to the decline in revenue from excise taxes on alcoholic beverages and tobacco

Restricted spending and fairly strong income growth arising out of the growing economic activity continued to improve the situation of the Lithuania's general government finance.

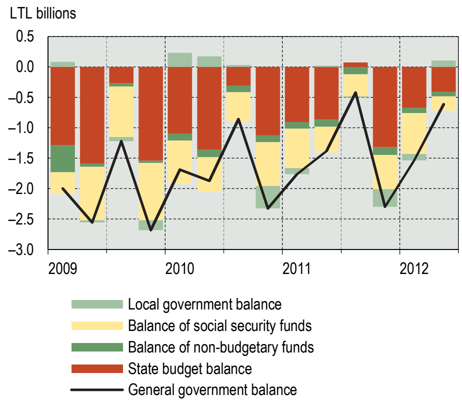
Chart 30. General government revenue, spending and balance



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Increased tax revenues mostly reduced the state government deficit. Increased revenue from direct taxes improved local government balance while a more favourable labour market situation and revised payment arrangements reduced the deficit of social security funds.

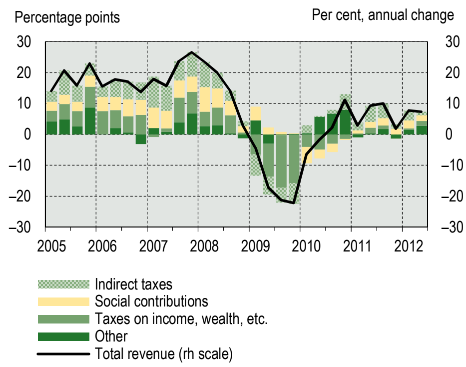
Chart 31. Contributions to general government balance



Sources: Ministry of Finance of Republic of Lithuania and Bank of Lithuania calculations.

Increased domestic consumption and a higher remuneration fund in the economy led to a strong increase in general government revenue in the second quarter of 2012.

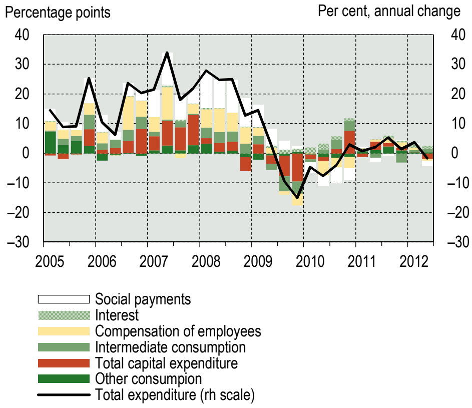
Chart 32. Contributions to general government revenue



Sources: Statistics Lithuania and Bank of Lithuania calculations.

General government expenditure reduced due to the decrease in social benefits and public investment.

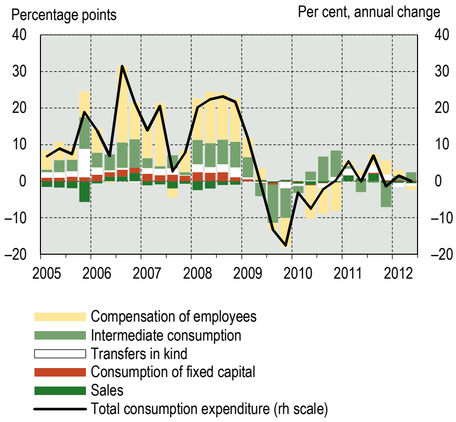
Chart 33. Contributions to general government expenditure



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Public consumption expenditure during the year remained largely unchanged.

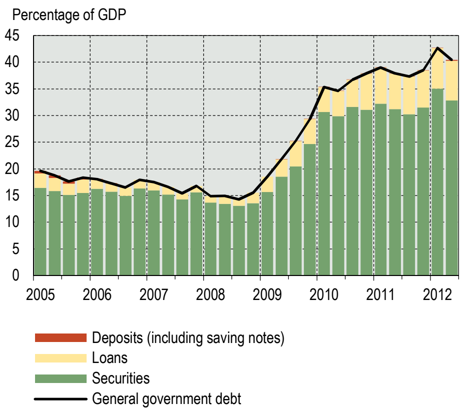
Chart 34. Government consumption expenditure growth and contributions



Sources: Statistics Lithuania and Bank of Lithuania calculations.

General government debt fell mostly because of redeemed large issue of bond.

Chart 35. General government debt by instruments



Sources: Ministry of Finance and Bank of Lithuania calculations.

products. In the second quarter, tobacco excise duty changes were driven by the lower number of cigarettes supplied to the domestic market. In February it went up approximately by 2-fold for fear that in March higher tax rates will take effect. There were no significant cigarette sales volume fluctuations in the second quarter compared to the corresponding quarter in 2011. According to the data regarding the national budget and the social security funds in July and August, it is expected that the annual growth of general government revenue in the third quarter will be slower due to the weaker growth in tax revenue and social contributions.

In the second quarter, general government spending declined (by 1.7%) due to reduced social benefits and public investment. Social benefits were mostly reduced by smaller pension insurance and maternity (paternity) benefit during the year. It is likely that the latter were influenced by stricter benefit payment procedure introduced from July 2011 as it adjusted the work incentives of benefit recipients. It is assumed that the annual decline in public investment in the second quarter is temporary, since the Law on National Budget in 2012 provided approximately one-tenth higher allocations for the acquisition of assets than a year ago, and public investment. Compensation for employees also reduced spending. A positive impact on the overall general government expenditure growth should mostly be attributed to the increase in interest payments. Their growth is associated with intensive government borrowing in 2011. Intermediate consumption expenditure also grew over the year, mainly due to higher co-financing costs related to bigger EU funding, higher food costs, pharmaceutical costs and costs for hired experts.

General government debt in the second quarter was reduced by the 1 billion euro bond issue redeemed in May. Debt and the four quarters GDP ratio declined to 40.1 per cent. Incidentally, the debt reduction was achieved not from the available excess but from borrowed funds, i.e. the debt was refinanced. Debt reduction of less than 1 billion euros is due to a new bond issue in the second quarter for the financing of the redemption of the stated issue, while the other part of necessary funds was borrowed in the first quarter of the year. The general government debt-to-GDP ratio was also reduced due to the negative differential between the implicit interest rate payable for the entire debt and the economic growth. The central government debt was reduced most during the quarter. Local government debt remained basically unchanged, while the debt of the social security funds increased by 0.6 billion litas because of long-term borrowings. The data from July-August suggests that general government debt in the third quarter should increase by about 1.1 billion litas (0.9% of GDP) as a result of borrowings in the German and Swiss financial markets. It is planned that these funds will be used in March 2013 to redeem the Eurobond issue of 1 billion euros that was issued in 2003 and complemented in 2004.