LIETUVOS BANKAS

Economic Outlook for Lithuania

6 August 2009

The first GDP estimate of the second quarter, announced by the Department of Statistics, revealed a very abrupt 22.4 per cent drop of GDP. According to this data, the economic contraction did not slacken within the second quarter. However, this allows expecting substantially softer quarterly changes in the second half of 2009. The presumption that the real economic activity is higher due to the growth of the shadow economy also should not be rejected; however, it is currently difficult to quantify this. Moreover, in the autumn of 2009, as annually, the Department of Statistics will review data of the recent years, which may cause substantial changes in the GDP growth. The data dynamics permits to expect a smaller adjusted GDP for 2008, meaning also a lower than currently announced GDP drop and more optimistic projections of economic indicators.

The economic downturn in Lithuania, associated with intense changes in external and domestic demand, strengthened the uncertainty of economic development prospects substantially. Lower precision of the projections can be attributed to a continuous downgrading of economic forecasts of the main foreign trade partners in recent quarters, as well as to the latest statistical data. For example, recently the changes in stocks have grown eminently: in the first quarter of 2009 the changes in stocks amounted to 12.7 per cent of the nominal GDP (in comparison, in 2005-2008 – approximately 3 per cent on average). As this GDP component partly covers the statistical mismatch between GDP evaluated by production and expenditure approaches, its increase entails a much higher uncertainty when projecting GDP and other macroeconomic indicators.

Compared to the projections of May, changes in the real sector indicators are expected to be more sizeable. However, taking into account the intense GDP drop in the first half of 2009, a considerable deceleration of the downturn is expected for the second half of the year, with GDP this year shrinking by 19.3 per cent. The stabilisation scenario is supported by boosted sentiment in global markets. A recent rise in the stock and commodity markets, better than expected US GDP indicator for the second quarter, positive news in manufacturing and real estate market show stronger signs of the start of the global recovery. Higher external demand would activate the Lithuanian tradable sector and be a significant factor of the overall economic recovery.

The projected economic downturn in 2009, bringing Lithuania's real GDP back to the 2004-2005 level (4-5 years backwards), is historically comparable. For example, Scandinavian countries in 1993 lost the real GDP gain of 5-6 years because of the credit crisis, in 1998 the economy of Indonesia returned to the level last seen 4-5 years ago, the same year Russia's GDP was the lowest from the start of the statistical data calculation (1987).

The projected further 5.2 per cent fall of Lithuania's GDP in the next year is associated with worse domestic demand trends due to still declining wages and an increased unemployment rate.

Compared to May, assessments of price developments remain broadly unchanged – in 2009-2010 inflation will account for 3.9 and -2.0 per cent, respectively. The impact of VAT rate increase from September should be compensated by cheapening of electricity and natural gas, reduction of the excise duty on diesel fuel, and heating energy price changes due to cheaper natural gas. Higher prices of electricity from 2010 will push inflation up; however, this effect should be outweighed by the general deflationary trends related to a strong economic downturn and decreasing wages.

An alternative scenario envisaging a slower economic activity stabilisation compared to that in the baseline scenario should not be rejected. Key risk factors that may entail worse projections are persisting uncertainty in terms of a further economic development of foreign countries, a more profound decrease in private consumption and investments, and a higher unemployment rate. According to this scenario, GDP might shrink up to 2 percentage points more.

A steeper private consumption drop may be induced by unfavourable labour market trends and a curtailing loan flow. A more intensive unemployment growth and more robust wage decline should drive stronger changes in disposable income of the population. A negative impact on household expenditures is also caused by changed trends in the flow of loans for house purchase and consumer loans. Tighter lending conditions, expectations related with a further fall of real estate prices, and a substantially more circumspect assessment of future income contributed to a shrinking portfolio of household loans – in the first quarter of this year, households repaid more loans than took new ones. In the case of a slower economic activity stabilisation scenario, pessimistic expectations may weaken the demand for loans and stimulate households to limit expenditures more than currently forecasted.

If the assumption of a robust external demand recovery does not fulfil, a stronger downturn than that envisaged in the baseline scenario is possible. At the beginning of the year, given strong uncertainty of economic development prospects, investments into the means of production experienced a particularly intensive drop. A protracted recovery in global markets would contribute to a further decrease of these investments. Investments are also limited by unfavourable borrowing conditions, while a fallen share of profitable enterprises demonstrates fewer opportunities for enterprises to finance investments by their own funds. A less favourable development of the global economy would in turn entail a subsequent recovery in international financial markets and would allow planning of a stronger than currently projected curtailment in the flow of the loans to enterprises in Lithuania.

A deeper contraction in domestic and external demand would also change the assessment of the foreign trade development. Imports and exports this year would drop more than envisaged in the baseline scenario. Next year changes of these indicators will be softer – the growth of exports would be encouraged by a subsequent start of the recovery of Lithuania's trade partners, while the downturn of imports would be eased by an increasing imports of natural gas or electricity after the closure of the Ignalina Nuclear Power Plant.

ECONOMIC OUTLOOK FOR LITHUANIA IN 2009–2010

	July 2009 projection			May 2009 projection		
	2008	2009*	2010*	2008	2009*	2010*
Price and Cost Developments (annual percentage changes)						
Average annual inflation (based on HICP)	11.1	3.9	-2.0	11.1	3.9	-2.1
GDP deflator	10.3	-3.4	0.0	10.3	-3.1	0.3
Wages (compensation per employee)	18.0	-9.8	-8.1	18.0	-12.3	-5.2
Import deflator	8.1	-11.9	1.8	8.1	-6.1	3.4
Export deflator	12.2	-13.3	1.8	12.2	-5.5	3.9
Economic Activity (constant prices; annual percentage changes)						
Gross Domestic Product	3.0	-19.3	-5.2	3.0	-15.6	-4.5
Private consumption expenditure	4.7	-18.2	-7.0	4.7	-17.5	-8.2
General government consumption expenditure	4.3	-2.7	-4.6	4.3	-14.9	-3.6
Gross fixed capital formation	-6.1	-42.2	-5.8	-6.1	-39.0	-8.5
Exports of goods and services	11.3	-19.3	2.4	11.3	-14.4	4.0
Imports of goods and services	10.0	-32.9	-0.9	10.0	-28.0	-0.8
Labour Market						
Unemployment rate (as a percentage of labour force)	5.8	15.7	19.3	5.8	11.6	13.4
Employment (annual percentage changes)	-0.9	-10.2	-7.0	-0.9	-7.1	-4.5
External Sector (as a percentage of GDP)						
Balance of goods and services	-11.2	-0.2	1.7	-11.2	0.5	3.9
Current account balance	-12.2	0.2	1.9	-12.2	0.9	4.2
Current and capital account balance	-10.5	4.7	6.6	-10.5	2.8	6.7

*projection