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Lithuania's economic development and outlook

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Lithuania's economic growth has picked up notably in 2017 on the back of strong support from improvements in the international economic environment. This year the global demand for investment goods has recovered substantially from its previously-recorded lows, giving a significant boost to international trade. Of all the components of aggregate demand, it is investment that usually has the closest relationship to external trade. That is why the increase in investment has made such a significant contribution towards the growth of imports and exports in various countries, including Lithuania's key trade partners, i.e. the euro area and other EU countries. The pickup of international trade has also been driven by the recovery of commodity-exporting countries that have benefitted from the rise of commodity prices in global markets. This has been one of the factors behind a sudden surge in Russia's imports that affected trade flows across the entire region.

Global trade, which has been growing rapidly this year, should continue its upward momentum. Even so, the pace of its growth in the coming years is not expected to match the level observed in 2017. The spike in global trade this year is seen as exceptional in particular as the growth in global trade volumes has well outpaced the growth of global GDP, reversing the trend from several previous years. A slower increase in demand for the imports of goods and services in the markets of Lithuania's key trade partners will translate into a slower growth of Lithuania's exports. This is one of the reasons why the pace of Lithuania's economic growth next year should be slower than this year.

Next year, however, a greater role in driving economic growth should be played by recovering investment. The manufacturing sector increased its spending on tangible investment substantially at the end of last year and early this year. The transport sector has also been investing rather heavily for some considerable time. Such investment strengthens the capacity of these sectors and, simultaneously, increases their competitive edge. This may partly explain why lately Lithuania's tradable sector has been taking over the ever increasing share of external markets. In addition to transport vehicles, other machines and equipment, Lithuania's economic operators have also stepped up investment in intellectual property products. Inflows from EU support funds, which slumped in 2016 and failed to pick up in 2017, are assumed to increase next year, which is expected to contribute to the further growth of investment that will bolster economic activity in both short and longer term.

Investment will emerge as a key supply-side factor that will exercise a crucial impact on economic growth. It will be decisive for mitigating the effects of worsening demography. Lithuania's working age population (aged 15 to 64) has been decreasing at an annual pace of 1.1 to 1.8 per cent in recent years and will continue to decline significantly. The labour force participation rate – the population of workers and jobseekers as a percentage of the working age population – has continued to increase to the advantage of the country's labour market. Nevertheless, this phenomenon is no longer sufficient to offset the effect of population decline since the workforce, which includes both workers and jobseekers, has been decreasing, as has been the employed population. A drastic improvement in this economic sector can hardly be expected, which implies that the worsening situation in the labour market will constrain economic growth.

Labour market developments will have a direct impact on the evolution of private consumption, which will decelerate gradually due to shrinking workforce and increasingly scarce opportunities for substantial wage increases. A shortage of workers and, in particular, of skilled labour leads to rather high tensions in the labour market. The growth of labour costs has outpaced the growth of the entire economy for several consecutive years, therefore, the share of added value created by wage earners has continued to increase and, compared to historical data, has already reached a substantially high level. Hence it should not be expected to maintain the same pace of growth as seen of lately. Against the backdrop of labour shortage, the wage is projected to grow at a rather robust pace, which, however, will be slower than in recent years. This will lead to a gradual slowdown in the growth of private consumption and, simultaneously, of the entire economy. Taking into account the abovementioned factors, real GDP is expected to increase by 3.6 per cent in 2017 and by 2.8 per cent in 2018.

Headline inflation in the country remains elevated. Current price developments are driven by both domestic economic factors and the evolving trends in global commodity markets. The latter, in particular, have pushed consumer prices to higher-than-forecasted levels in recent months. Lower-than-expected oil production lifted oil prices in global markets in the autumn, triggering an increase in fuel prices. Developments in global prices for food commodities have bolstered the growth of prices for certain food products, in particular milk and dairy products, oils and fats. The rise in consumer prices driven by changes in commodity markets has not been specific only to Lithuania given that recently increases in food and fuel prices have also been observed in both the euro area and other EU countries. The higher-than-expected pace of price growth has led to upward revisions to inflation forecasts for 2017 and 2018. Nevertheless, prices for both oil and food commodities are expected to grow at a slower pace next year, which will put downward pressure on headline inflation.

A substantial contribution to inflation has come from domestic economic developments. Prices for services, which have been on an upward path and which, of all consumer prices, are the most affected by the situation in the labour market and domestic demand, have accounted for nearly one-third of inflation. Given that wage growth, which has been quite robust and prolonged, has been outpacing the growth of labour productivity by a rather high margin, labour costs have had an inflationary effect on prices. Higher household income has also created pressure on prices through the growth of domestic demand. Prices, which are mostly driven by domestic economic developments, should continue their upward climb supported by wage growth that, as mentioned above, will maintain its rather robust pace. However, the growth of these prices should not exceed its recent pace as wage growth will also be less pronounced.

Inflation is expected to reach 3.7 per cent in 2017 before going down in 2018. As stated above, the growth of global commodity prices will moderate next year, reducing their contribution to headline inflation, which will also face weaker upward pressure from increases in excise duties, as compared to this year. Inflation is forecast to be 2.6 per cent in 2018.

Outlook for Lithuania's economy in 2017–2018

	December 2017 projection[a]			September 2017 projection		
	2016	2017[b]	2018[b]	2016	2017[b]	2018[b]
Price and cost developments (annual percentage change)						
Average annual inflation, as measured by the HICP	0.7	3.7	2.6	0.7	3.4	2.2
GDP deflator[c]	0.9	3.4	2.3	1.2	3.0	2.2
Wages	8.4	7.9	6.1	8.4	7.8	5.9
Import deflator[c]	–4.3	4.3	2.6	–4.3	4.9	1.9
Export deflator[c]	–2.9	5.8	2.3	–3.1	4.6	1.8
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	2.3	3.6	2.8	2.2	3.6	2.8
Private consumption expenditure[c]	4.5	4.2	3.6	5.2	4.2	3.6
General government consumption expenditure[c]	1.3	1.5	1.1	1.4	1.5	1.1
Gross fixed capital formation[c]	–0.1	4.7	5.4	0.1	5.5	6.2
Exports of goods and services[c]	3.4	9.4	4.5	3.4	7.3	4.3
Imports of goods and services[c]	2.2	11.8	5.2	2.4	8.4	5.5
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.9	7.1	6.8	7.9	7.3	7.0
Employment (annual percentage change)[d]	2.0	–0.3	–0.3	2.0	–0.3	–0.3
External sector (as a percentage of GDP)						
Balance of goods and services	1.3	0.8	0.0	0.9	–0.1	–1.0
Current account balance	–1.1	–1.1	–1.5	–0.9	–1.1	–1.9
Current and capital account balance	0.4	0.3	0.4	0.6	0.3	0.5

[a] These projections of macroeconomic indicators are based on information made available by 28 November 2017.
[b] Projection
[c] Adjusted for seasonal and workday effects
[d] National accounts data; employment in domestic concept