



## Economic Outlook for Lithuania

11 August 2011

**The growth of Lithuanian economy remains robust: according to preliminary estimate, real GDP increased by 6.1 per cent over the year in the second quarter of 2011. The recovery of Lithuanian economy is stimulated by the growth of domestic demand, whereas the influence of foreign demand ceased to increase.** The value added created in the activities related to the domestic economic development, such as construction, trade and financial intermediation, has been growing already for several consecutive quarters. The increase in the number of vacancies and the number of employed has been observed in many of these activities. The strengthening of domestic demand is confirmed by the volumes of industrial production sold in the domestic market, which have been rising already for more than six months. At the same time, foreign demand does not show any trends of strengthening. Due to the rise in the prices of commodities and production disruptions after the natural disaster in Japan, the recovery of the global economy slowed down. Weaker demand for imports was also observed in some of Lithuania's main foreign trade partners, such as Poland and Germany. Such development of economic indicators confirms earlier assessments of the Bank of Lithuania, therefore, the forecasts of Lithuania's economic growth have been revised insignificantly. It is expected that the real GDP of Lithuania will increase by 6.2 per cent in 2011 and by 4.8 per cent in 2012.

**After favourable changes at the end of the previous year, real private consumption is strengthening further, consumer expectations are improving as well.** Available retail trade data shows that real private consumption, which grew stronger in the first quarter of this year than in the previous quarter, is rising further noticeably. Changes in the labour market remain sluggish, whereas consumption is determined by the improvement of expectations regarding the financial situation of households and the state of the domestic economy. As the private consumption is growing slightly stronger than expected, a somewhat higher growth is projected in the nearest forecasting period. It is anticipated that household consumption will grow by 6.1 per cent in 2011 and by 5.2 per cent in 2012.

**Investment in the gross fixed capital formation is recovering.** In previous quarters, investment was growing mainly in the public sector, whereas in the beginning of this year investment went up in the private sector as well. Investments in the private sector are made both in the construction and reconstruction of buildings and in the acquisition of machinery and equipment. Investment in vehicles is growing particularly strong in the country. The latter underwent the largest downturn during the recession, whereas currently the recovery of the transport sector stimulated a rapid growth of vehicle investments. The growth of investment in machinery and equipment is related to the positive development of industry observed for some time as well as the rise in the production capacity utilisation level, which is approaching the pre-recession level. Therefore, the strong increase of investment confirms earlier assessments. The revised projections foresee further growth of investment over the whole forecasting period, albeit at a more moderate pace.

**Economic recovery is also evidenced by the improving situation in Lithuanian labour market: the number of the employed increased and the number of the unemployed decreased over the year for the first time after almost three years.** Although the number of those employed in construction is lower than a year ago, the number of the employed increased in industry and particularly in the services sector. The growth in this sector was mostly determined by the transportation and storage activity, which is related to the export expansion: the number of the employed in this activity increased by around one-fifth. Information and communication, education, accommodation and food service activities also contribute to this trend.

**However, the labour market recovery is quite uneven.** This is confirmed by different employment developments in urban

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and rural areas and among men and women. In urban areas, the number of the employed has been growing and the number of the unemployed has been decreasing already for two consecutive quarters. In rural areas, however, the number of the employed remains lower and the number of the unemployed remains higher than a year ago. The number of employed women continues to decrease, whereas the number of employed men has been higher than a year ago already since the end of 2010. Still, the unemployment among men, which grew rapidly during the recession, is substantially higher than among women.

**With the increase in the labour demand, the problem of the mismatch between the skills of the labour and the needs of employers is becoming evident.** Although the unemployment remains high, the number of enterprises, which indicate the labour shortage as a factor that limits their activity, has been increasing for some time. The emerging problem of the mismatch between skills and needs is also reflected by the increasing number of vacancies in certain activities. This stimulates the rise of the average wage in the country. The average wage is projected to rise further over the forecasting period. It should increase by 3.8 per cent in 2011 and 5.3 per cent in 2012. It is also foreseen that the number of the employed will continue to grow and the number of the unemployed will continue to fall, albeit slowly.

**With the rise in domestic demand, net export developments have become less favourable.** They are determined by the faster growth of imports, compared to exports, which has been observed for some time already. Import growth is increasingly stimulated by the rising demand for investment-related goods. At the same time, the growth of the import of goods used in production is slowing down. This is a result of a slower growth of exports, which is closely related to the developments of the import of intermediate goods. The slowdown is determined by a more sluggish growth of foreign demand in some of the main trade partners of Lithuania. This especially concerns the export of goods of the Lithuanian origin. In the forecasting period, foreign demand should further weaken slightly, therefore, somewhat lower growth of exports than that observed up to now is forecasted as well. Real export of goods and services should grow by 12.0 per cent in 2011 and 5.7 per cent in 2012.

**The widening deficit of trade and income determines a negative current account balance.** Trade of goods deficit is gradually widening due to a more rapid growth of the import of goods. Substantially higher than a year ago income deficit reflects the rise in the profits of foreign investors earned in Lithuania. Contrary to 2010, this year the largest share of these profits is reinvested and only an insignificant part of the profits is paid in dividends. This shows growing confidence of foreign investors. A positive impact on the current account balance is exerted by current transfers, which cover the EU support and remittances of emigrants. The balance of services is also positive, as it is especially improved by the growth of travel services provided to foreigners.

**The annual inflation in Lithuania is elevated mostly due to the rise in the prices of food products, which grew stronger than earlier, and the start of the rise in the prices of industrial goods and market services.** The growth in food prices determines the largest part (more than a half) of the inflation in Lithuania and is related to the rise in food commodity prices in global markets. Core inflation, which includes the prices of industrial goods and market services, is mostly related to domestic demand; therefore, it had declined strongly during the recession, while started to increase recently. Its impact on the overall inflation is not yet significant; however, with a rapid recovery of private consumption, it may increase noticeably. Other components of consumer basket, administered prices and fuels, also contribute to the overall annual inflation. In several recent months, fuel prices have been declining, however, their annual growth remains significant. Owing to the earlier rise in the prices of oil products, the price of imported natural gas is rising, which affects administered prices. They grew over the year largely due to a constant rise in the price of heat energy recently. In general, the prices related to both external factors and domestic economic developments are growing more than expected. Therefore, the forecasted price developments were revised. It is projected that the average annual inflation in Lithuania will be 4.4 per cent in 2011 and 4.1 per cent in 2012.

**Several factors may also determine a different development of the real sector and prices in Lithuania.** The foreign demand of Lithuania may be unfavourably affected by the ongoing fiscal consolidation in some EU countries, which will also take place in the future. Less favourable macroeconomic indicators in the developed countries (US, UK, Japan) might also

have a negative impact on major trading partners of Lithuania. Weaker foreign demand would have a direct impact on the tradable sector of the economy of Lithuania, as well as an indirect impact on the activities of the non-tradable economic sector. Different economic developments could also be determined by the persisting large fluctuations of energy and food prices.

More information is available in the presentation of the “Recent Economic Developments and Outlook for Lithuania”.

#### ECONOMIC OUTLOOK FOR LITHUANIA IN 2011–2012

	August 2011			May 2011		
	2010	2011*	2012*	2010	2011*	2012*
<b>Price and Cost Developments (annual percentage changes)</b>						
Average annual inflation (based on HICP)	1.2	4.4	4.1	1.2	3.8	3.9
GDP deflator	2.1	5.6	4.0	2.1	5.5	3.4
Wages (compensation per employee)	-0.1	3.8	5.3	-0.1	2.9	5.4
Import deflator	9.2	13.6	2.6	9.2	11.4	2.5
Export deflator	10.9	12.6	2.4	10.9	11.8	2.3
<b>Economic Activity (constant prices; annual percentage changes)</b>						
Gross domestic product**	1.3	6.2	4.8	1.3	5.6	4.8
Private consumption expenditure	-4.5	6.1	5.2	-4.5	5.3	4.8
General government consumption expenditure	-3.4	-0.4	2.9	-3.4	-1.1	2.5
Gross fixed capital formation	0.0	17.7	11.7	0.0	17.9	11.3
Exports of goods and services	17.4	12.0	5.7	17.4	11.1	5.0
Imports of goods and services	17.9	14.9	6.2	17.9	13.9	5.5
<b>Labour market</b>						
Unemployment rate (annual average as a percentage of labour force)	17.8	15.5	13.0	17.8	15.5	13.2
Employment (annual percentage changes)	-5.1	2.3	2.7	-5.1	2.7	2.6
<b>External Sector (as a percentage of GDP)</b>						
Balance of goods and services	-0.7	-3.0	-4.2	-0.7	-2.7	-3.2
Current account balance	1.8	-1.5	-2.7	1.8	-1.2	-1.8
Current and capital account balance	4.5	0.9	-0.6	4.5	1.2	0.4

\* Projection.

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