

## Lithuania's economic development and outlook

15 June 2016

**Global economic development continues to be uneven, but the economies of Lithuania's major trading partners are on the rise or their economic activity is not declining to the extent it did last year.** The euro area economy continues to recover: after beginning to recover in 2013, it has currently achieved such a level that annual GDP growth, driven by private consumption and investment, has been above 1.5 per cent for four consecutive quarters. Economic growth entails the improvement of labour market indicators, growth in household income, increase in demand for goods and services from other countries and, thus, from Lithuania. This boosts Lithuanian exports. Increasingly more goods are exported to euro area and other EU countries, the exports of services increases as well. The freight activity, carried out by Lithuanian enterprises, has contracted significantly, when Russia imposed trade restrictions and its economy began to fall; however, at the end of 2015, Lithuania's transport sector posted growth again. Major contribution to the improvement of this sector's economic activity stemmed not from carrying freights into/from Lithuania, but carrying them from country to country. After a previously substantial contribution to the deceleration of economic growth in Lithuania, the transport sector currently contributes markedly to its recovery.

The East-oriented export situation is relatively stable. After contracting significantly in 2015, the value of exports to Russia currently remains basically unchanged. The economic situation in Russia is less volatile as well. After dropping by 3.7 per cent last year, Russia's real GDP fell by 1.2 per cent year on year in the first quarter of 2016. Domestic demand in Russia continues to decrease, though not as strongly as before; consequently, the fall in Russian imports is not as marked as last year. The share of the exports of goods to Russia in total exports of Lithuania has contracted substantially. Previously it used to account for a fifth of the country's total exports, while now it only accounts for slightly more than 12 per cent. Nevertheless, even this share is not small; hence, the absence of recovery in exports to Russia has been affecting Lithuania's overall export performance.

**Economic growth in Lithuania is driven to a large extent by domestic demand.** The employment and unemployment indicators have been improving for approximately five years already. Lower exports to Russia have only marginally affected the labour market; only two economic activities — trade and transport — have been affected somewhat negatively. However, the employment rate within these sectors did not decrease; it only increased weaker than in previous periods. The deteriorating construction sector situation contributes negatively to demand for employees within this sector, affecting overall employment in the country relatively marginally as well. The employment rate within other economic activities increases further quite strongly. Survey data suggests that an increasingly larger share of enterprises, except for those engaged in the construction activity, have been facing the staff insufficiency issue. The job vacancy rate has been rising gradually. This has an obvious effect on wage dynamics. Wages used to rise by approximately 5 per cent in recent years, while this year, with unemployment declining further and minimum wage rising, its growth rate is likely to accelerate even more. Such labour income dynamics affects private consumption and it continues to increase amid moderate price level growth. In addition, low interest rates on loans provide the conditions for this growth. With low interest rates, the payment burden of households with loans becomes easier and the amount of new loans being granted increases.

Investment grew until the end of 2015 as well, driven not only by the low interest rate environment but also more active use of EU support funds. As the time for using funds from the 2007–2013 EU financial perspective was running out, last year the use of funds intensified. Investment continued to be underpinned by the need to expand production capacity. The level of the use of manufacturing capacity has been above its long-term average for four years already. It should be noted, however, that recently investment in machinery and equipment grew the most, while investment in buildings and constructions decelerated. This had a downward effect on construction activity, which previously had contributed significantly to economic development. Out of all types of construction activities, only residential construction contributed positively to economic activity of construction.

**Domestic demand will remain an important factor behind economic expansion during the projection horizon of 2016–2017.** The labour market situation suggests that labour income is likely to increase further, which will encourage consumption. Investment dynamics is likely to change though: after the possibility to use the funds of the previous EU financial perspective ends, investment growth is not likely to be as strong as before.

**Unlike last year, exports will contribute to economic growth as well.** A more favourable international environment is likely to

improve export performance and accelerate the development of the domestic economy. Lithuania's real GDP is projected to increase by 2.6 per cent in 2016 — markedly more than in 2015 (1.6%). In the following period (i.e. in 2017), economic development is likely to accelerate even more due to the transmission of future improvement in the economic development in a number of regions across the world.

**Inflation is still low and is expected to get close to a 2 per cent rate in 2017.** The prices of some groups of goods and services have been rising, but the aggregate price level has been increasing marginally: the consumer price indicator for the initial four months of this year is 0.7 per cent above the level of the previous year. Similar to last year, the increase in the prices of services is more pronounced, reflecting markedly increasing domestic demand and labour costs. The increase in the latter is driven by strong wage increases in the services sector. Wages have been outpacing labour productivity longer than in other sectors — for four years already. Food prices are also on the rise this year; however, prices that are anyway characterised by permanent fluctuation — of vegetables and fruit — have been posting the highest increases. The increases in other food prices are relatively marginal. The aggregate price level is still being reduced by prices related to global energy commodity markets: fuel and administered prices, notably heat energy prices, continue to be lower than a year ago. However, oil prices are now higher than in previous macroeconomic projections. This is one of the major reasons for the projected higher inflation rate in 2016. According to current projections, inflation will be 0.9 per cent in 2016 (previous projection — 0.5%) and 1.9 per cent in 2017 (previous projection — 1.8%).

### Outlook for Lithuania's economy in 2016–2017

	June 2016 projection <sup>a</sup>			March 2016 projection		
	2015	2016 <sup>b</sup>	2017 <sup>b</sup>	2015 <sup>b</sup>	2016 <sup>b</sup>	2017 <sup>b</sup>
<b>Price and cost developments (annual percentage changes)</b>						
Average annual inflation, as measured by the HICP	-0.7	0.9	1.9	-0.7	0.5	1.8
GDP deflator <sup>c</sup>	0.3	0.9	2.0	0.1	0.8	2.0
Wages	5.1	5.7	5.5	5.1	5.3	5.3
Import deflator <sup>c</sup>	-6.9	-4.0	1.5	-6.4	-3.1	1.4
Export deflator <sup>c</sup>	-3.9	-3.2	1.4	-3.8	-2.7	1.4
<b>Economic activity (constant prices; annual percentage changes)</b>						
Gross domestic product <sup>c</sup>	1.6	2.6	3.3	1.7	2.6	3.4
Private consumption expenditure <sup>c</sup>	4.8	4.3	3.9	4.9	4.2	4.0
General government consumption expenditure <sup>c</sup>	1.9	1.2	1.2	2.1	0.9	1.2
Gross fixed capital formation <sup>c</sup>	10.9	1.3	7.2	9.6	2.4	7.4
Exports of goods and services <sup>c</sup>	-0.1	2.9	4.2	1.0	2.9	4.8
Imports of goods and services <sup>c</sup>	6.0	2.9	5.2	6.9	3.2	5.7
<b>Labour market</b>						
Unemployment rate (annual average as a percentage of labour force)	9.1	8.3	7.9	9.1	8.6	8.3
Employment <sup>d</sup> (annual percentage change)	1.3	0.7	0.0	1.2	0.2	0.1
<b>External sector (as a percentage of GDP)</b>						
Balance of goods and services	-0.2	0.4	-0.3	-0.5	-0.5	-1.2
Current account balance	-1.7	-0.1	-0.6	-2.1	-1.9	-2.7
Current and capital account balance	1.3	1.9	1.8	0.9	0.2	-0.1

<sup>a</sup> These projections of macroeconomic indicators are based on information made available by 17 May 2016

<sup>b</sup> Projection

<sup>c</sup> Adjusted for seasonal and workday effects

<sup>d</sup> National accounts data; employment in domestic concept