Lithuania's economic development and outlook

19 December 2018

The global economic outlook is broadly unchanged – the economic expansion has remained buoyant, albeit showing signs of decreased momentum. While activity appears to have been mainly driven by the still favourable financing conditions, labour market improvements in most countries and regions as well as US fiscal stimulus, a number of factors have started to saddle the economy. Growth in investment – a major contributor to global expansion in 2017 – has been weaker, reflecting more restrained market expectations, escalating trade tensions and turmoil in some developing countries. All this has already weighed on global trade flows: trade growth in the euro area, CIS countries and developing countries in Asia and Latin America has significantly moderated, while international trade in goods has slowed by almost a fifth compared to the previous year.

Revisions to the global growth forecast have been marginal, yet a number of downside risks have risen. One of them is the potential tightening of monetary policy in the US, where activity has been high for quite some time, propelled further by looser fiscal policies. A sudden hike in interest rates would put a strain on both the US and other economies. Higher US interest rates would also strengthen the US dollar, which, in turn, would weigh on financially more vulnerable (in particular, developing) economies. For some of them, a large part of foreign debt is denominated in US dollars, thus the appreciation of the US dollar would entail higher debt servicing costs. The rapidly changing financial conditions and internal imbalances have already taken a toll on growth in some developing economies. The economic situation in advanced and developing countries is further aggravated by trade wars and the potential risk of their escalation. Usually the impact of such restrictions is most severe on those placing them; however, an intensification of trade tensions would mean that negative implications would spill over more broadly, thus slowing investment, trade and the spread of new technologies and ultimately lowering global productivity and welfare.

Domestic developments have remained largely in line with the previous assessment. Still some labour market indicators – primarily employment and labour force – have been rising more than expected. This might be partly explained by improved net migration, reflecting higher numbers of immigrant workers coming to Lithuania. Although such developments have had an effect on the latest labour market indicators, at least for now fundamental demographic trends have remained unchanged. The working-age population (15-64 years) continues shrinking as a result of negative net migration and mortality as well as declining replacement numbers as older cohorts leave the workforce in higher numbers than younger cohorts enter it. Such demographic trends, unfortunately, will prevail. The labour force is expected to decrease at a slower pace than the population on the back of ongoing increases in the participation rate, which, however, may still be moderate as the rate is already rather high. All this only shows that although the short-term outlook for employment is improving, the medium- and long-term prospects are still negative.

The labour market remains an important catalyst for domestic economic growth. Amid persistent labour shortage, employers are facing significant pressure to increase wages. Wage growth has been also driven by increases in the minimum wage and remuneration for workers in certain public sector areas. Growing household income boosts private consumption, which has long been an important contributor to economic activity and is likely to remain one in the near future. However, the outlook for other drivers of growth, notably exports and investment, has been clouded by uncertainty. Given weaker external demand and rising global headwinds, exports are expected to decelerate, contributing to a cool-off in investment. It should be noted, however, that until now exports (especially exports of goods of Lithuanian origin) have been keeping pace with foreign demand. In other words, the foreign market share taken by Lithuania's exporters has been gradually increasing, a trend that is likely to continue looking ahead. In view of recent data (which have been weaker due to lacklustre agricultural performance), the real GDP projection for 2018 has been revised down to 3.2%, from 3.4%. Due to the above-mentioned factors, economic expansion in 2019 should scale down to 2.8%.

The conjunctural situation in the labour market has an impact on both economic activity and prices. Increasing faster than labour productivity, wages contributed the most to growth of service prices, which have accounted for almost a third of headline inflation for the second consecutive year. The rise in service prices has been spurred not only by higher labour costs, but also domestic demand-led price pressures. The year-on-year deceleration in prices of services in 2018 is mainly attributed to the most volatile components, e.g. prices for air transport services, which soared in 2017, yet saw a drop this year in part due to the base effect. Should they be excluded, however, the overall growth in prices of services would not be seen as decelerating. Other inflation components are more dependent on changes in the external environment. For instance, concerns over the potential impact of sanctions against Iran on the oil market and the decision of oil exporters not to increase its production lifted oil prices at the beginning of autumn; however, they later dropped, reflecting market assumptions that oil demand is weaker than expected, while its supply is rather large. During the autumn months oil prices in euro were roughly 11-46% higher year on year, putting upward pressure on consumer prices, especially those for fuel. Global market developments have had a significant impact on food prices as well. In 2018 the global supply and stock of the majority of food commodities have expanded, hence, their prices (excluding cereals) have been falling. This had a dampening effect on consumer food prices. However, partly due to unfavourable weather conditions over the summer months, recently Lithuania saw a notable rise in unprocessed food – mainly vegetable – prices, which was one of the main reasons why the inflation forecast for 2019 has been revised up from 2.2% to 2.4%. The projected inflation rate for 2018 has been left unchanged at 2.6%.

Outlook for Lithuania's economy

	December 2018 projection[a]			October 2018 projection		
	2017	2018[b]	2019[b]	2017	2018[b]	2019[b]
Price and cost developments (annual percentage change)						
Average annual inflation, as measured by the HICP	3.7	2.6	2.4	3.7	2.6	2.2
GDP deflator[c]	4.4	2.6	2.4	4.3	2.5	2.2
Wages[d]	8.6	9.5	6.9	8.6	8.7	6.8
Import deflator[c]	4.4	4.1	1.8	4.4	2.8	1.7
Export deflator[c]	5.5	2.7	1.8	5.4	2.5	1.6
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	4.1	3.2	2.8	3.9	3.4	2.8
Private consumption expenditure[c]	3.6	4.2	4.0	4.0	3.8	3.8
General government consumption expenditure[c]	–0.4	0.4	1.0	1.0	1.1	1.1
Gross fixed capital formation[c]	6.3	7.8	5.3	6.7	7.7	5.2
Exports of goods and services[c]	13.6	4.6	4.2	13.7	5.3	4.6
Imports of goods and services[c]	12.8	3.8	4.9	13.6	6.2	5.5
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	6.3	6.1	7.1	6.5	6.3
Employment (annual percentage change)[e]	–0.5	0.6	0.0	–0.5	0.2	–0.3
External sector (percentage of GDP)						
Balance of goods and services	2.9	2.3	1.7	2.3	1.4	0.7
Current account balance	0.9	0.1	–0.2	0.7	–0.2	–0.8
Current and capital account balance	2.0	1.7	1.9	1.9	1.7	1.5

[a] The projections was based on information made available by 21 November 2018.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] The wage projection for 2019 excludes corrections made due to forthcoming changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.