Lithuania's economic development and outlook

27 March 2019

Global growth is gradually losing momentum. Uncertainty surrounding international trade is one of the key factors that contributed to the slowdown in global economic activity. Global manufacturing has been scaling down, which, in turn, also weighed on global trade. It is likely that the underlying growth pattern of international trade is even weaker than indicated by latest data since so far it has been reinforced by uncertainty regarding future escalation of trade restrictions. Other headwinds to global growth, however, have also been at play. Given signs of weaker growth, at the end of 2018 China's investment indicators deteriorated, bringing about knock-on effects on other economies in the region. Among advanced economies, the slowdown in Germany was partly related to disruptions in the car industry caused by the sluggish adaptation to new regulations on vehicle emissions tests. Adverse trends have also been observed in Italy, where concerns over government finances have had a dampening effect on domestic demand and, particularly, investment.

Less favourable external climate has been partly offset by strong domestic demand. This is primarily related to the situation in the labour market. Last year, due to declining unemployment and rising labour shortages, wages in the private sector saw one of the highest increases since the onset of the economic recovery, rising by more than 9%. Even stronger wage growth was recorded in the public sector. All this and other government actions, such as the decision to increase tax-exempt income, pensions and other social benefits, have provided a positive boost to household income, which is expected to continue rising and, in turn, further stimulate private consumption. On the other hand, investment dynamics are projected to take a different course. Over the last two years, investment in Lithuania has been expanding at a particularly rapid pace, boasting an annual growth rate of 6-7%. Growth in investment has been spurred by the previously favourable international economic environment and recovering EU capital flows that increased by roughly a third last year. However, the impact of these factors is likely to start fading in the upcoming years. High global uncertainty and deteriorating economic sentiment will affect investment decisions both at a domestic and global level. Investment growth is likely to be supported by EU funds, albeit to a lesser extent.

Economic activity will still be strongly underpinned by labour market developments. According to various data sources, last year employment in Lithuania increased, although a few projection exercises before such a pattern had not been anticipated. Rising employment was driven, among other things, by more favourable migration flows, which are difficult to predict. However, even if net migration continues to improve, the employment rate is not expected to pick up over the next several years due to adverse demographic trends (as older cohorts leave the workforce in higher numbers than younger cohorts enter it). Another important point is that the changing migration flows have only a limited impact on labour market conditions. The labour market is still clouded by significant tensions, which means that wage pressures will prevail. Wage growth is expected to weaken since the labour share has almost reached its historical highs. Nevertheless, wages should still rise substantially, continuing to support domestic demand.

Economic growth is set to slow down. For a number of years, economic activity in Lithuania has been exceeding its potential. This is evidenced by relatively low unemployment, wage growth which has been outpacing labour productivity, and the significantly increased labour share. With the economy above its potential, economic development should moderate since many factors of production have already been exploited. Another important aspect is also the deteriorating international environment. Uncertainties related to global trade and broad-based downward surprises in economic releases are diminishing the prospects for Lithuania's trade partners, and, as a result, weighing on the country's export sector. Having grown by 3.4% in 2018, Lithuania's real GDP is projected to increase by 2.7% in 2019 and by 2.6% in 2020.

Outlook for Lithuania's economy

	March 2019 projection[a]			December 2018 projection		
	2018[b]	2019[b]	2020[b]	2018[b]	2019[b]	2020[b]
Price and cost developments (annual percentage change)						
Average annual inflation, as measured by the HICP	2.5	2.4	2.3	2.6	2.4	–
GDP deflator[c]	3.4	2.4	2.2	2.6	2.4	–
Wages[d]	9.6	8.1	6.7	9.5	6.9	–
Import deflator[c]	4.7	1.8	1.8	4.1	1.8	–
Export deflator[c]	3.8	1.8	1.7	2.7	1.8	–
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.4	2.7	2.6	3.2	2.8	–
Private consumption expenditure[c]	3.9	3.9	3.6	4.2	4.0	–
General government consumption expenditure[c]	0.6	0.9	0.8	0.4	1.0	–
Gross fixed capital formation[c]	6.7	5.3	4.2	7.8	5.3	–
Exports of goods and services[c]	4.9	4.0	3.7	4.6	4.2	–
Imports of goods and services[c]	4.4	4.6	4.5	3.8	4.9	–
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.2	6.0	5.9	6.3	6.1	–
Employment (annual percentage change)[e]	1.0	0.2	–0.3	0.6	0.0	–
External sector (percentage of GDP)						
Balance of goods and services	2.5	2.0	1.3	2.3	1.7	–
Current account balance	–0.3	–0.5	–1.4	0.1	–0.2	–
Current and capital account balance	1.2	1.2	0.1	1.7	1.9	–

[a] The projections are based on external assumptions, constructed using information made available by 12 February 2019, and other information made available by 1 March 2019.
[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.

Inflation will remain subdued. Unlike last year, the decline in oil prices should put downward pressure on inflation in 2019. It is expected that compared to 2018 oil prices in euro will decline by nearly a tenth. Having reached their four-year peak, oil prices dropped sharply at the end of last year, reflecting escalating market concerns about global economic outlook and higher-than-projected oil supply. However, food commodity prices are expected to follow a different path. Amid sufficient supply and stock, they remained low for the most part of 2018, yet at the end of the year started to increase. This can be explained by the drop in production of such commodities (partly due to weather conditions) and substantial global demand. Since heat energy prices regained traction at the end of 2018 and electricity and gas prices notably increased at the beginning of 2019, administered prices will provide a stronger boost to headline inflation than they did last year. Service prices, which are most closely linked to domestic economic developments, will account for nearly half of headline inflation, reflecting the impact of rising wages and domestic demand-led pressures. According to current projections, average annual inflation is expected to decline from 2.5% in 2018 to 2.4% in 2019 and 2.3% in 2020.