

## Lithuania's economic development and outlook

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**The outlook for global growth is worsening.** A prolonged period of uncertainty, deepening protectionism, and the fragile economic situation in developing countries are taking a toll on global confidence indicators. This, in turn, weighs on economic activity, especially in the tradable sector. Having begun to trend downwards last year, international trade in goods has almost come to a standstill in 2019. The deceleration (currently, even a contraction) of international trade is particularly sharp in developing economies, namely China, other Asian countries and Latin America, with spillovers to advanced economies on account of close economic ties. This is one of the reasons hampering development in the open euro area economy. For quite some time, export growth in euro area countries has been weakening, manufacturing output stagnating, and some investment indicators deteriorating. Such economic trends are likely to prevail in the near future as so far there are no apparent factors that could reverse them. Although the labour market and the non-tradable sector in major advanced economies still demonstrate resilience to the challenges observed in the tradable sector, declining sentiment and difficulties in the latter may also spill over to other economic areas.

**Less favourable international environment has negative effects on Lithuanian trade partners, yet Lithuania's export expansion continues on a rather strong footing.** Demand for imports of goods and services has been scaling down. This is partly reflected in somewhat slower growth in exports of goods of Lithuanian origin, excluding oil products, over the recent quarters. The slowdown was also likely driven by the fading effect of previous investment growth in the industrial sector, where for the past several years investment boosted production capacities and improved competitiveness. Nevertheless, exports show considerable growth, albeit at a somewhat slower pace. Recently, exports of goods of Lithuanian origin, excluding oil products, in real terms have been approximately 5% higher than a year ago. This is one of the reasons why Lithuania's economic growth remains exceptionally rapid. It should also be noted that the overall export performance is strengthened not only by local production but also services provided in the transportation sector, with re-exports of goods rising much faster than last year and volumes of other freight transport in foreign countries continuing to grow at a healthy pace.

**Contrary to many foreign trade partners, Lithuania's economy maintains momentum, with annual real GDP growth reaching 4% in the first half of 2019.** As mentioned above, this is underpinned by previously booming investment into production capacity and modernisation, which allowed exporting companies to win over new markets and ensure sustainable development even amid heightened uncertainty and negative global expectations. Strong growth has also been fuelled by domestic demand – both investment and consumption. Recently, construction-related investment, such as construction of residential and non-residential buildings and engineering structures, has been more pronounced, which is likely to be considerably driven by the increasing use of EU funding. Over the last two years, the value added created in the construction sector accounted for approximately 16% of overall economic growth (usually this sector generates about 7% of the total value added). At the same time, private consumption growth is supported by rising household disposable income, growing employment and high consumer expectations.

**However, the Lithuanian economic landscape is fragmented – some indicators point to the onset of a slowdown.** Companies are closely following the protracted deterioration in the international economic environment, which affects their confidence and decisions. For example, this has already resulted in a slight increase in the number of industrial enterprises concerned about the lack in demand. Investment in capital goods, namely machinery and equipment, has lost some of its momentum. Shifts in

sentiment also seem to have effects on labour market indicators. Although tensions are still palpable in the labour market, wages continue to rise, yet at a slower pace than before. However, this is partly due to the fact that the labour share is currently at historical highs and continues to rise. Tensions in the labour market are also somewhat eased by changes in international migration trends. Net international migration has become positive, thus contributing to the recovery of labour force growth, which at least partly mitigates labour market imbalances.

**Economic deceleration will persist in the coming years.** Private consumption will gradually slow down due to the softening pace of wage growth. The envisaged weaker increase in EU funding will have a dampening effect on investment growth, which will also be affected by global uncertainty. Lithuania's real GDP is projected to increase by 3.7% this year and 2.5% in 2020. However, there are many uncertainties regarding the economic outlook. Global headwinds may intensify in the near future, which would have implications for both global and Lithuanian economic development. The US and China, constantly considering and/or announcing new or higher trade tariffs, are still unwilling to start de-escalating tensions in international trade. Although Lithuanian producers have not yet reacted much to the deteriorating international environment, it cannot be excluded that noticeably weakening economic development in various trade partners, particularly Germany (the largest economy in the euro area), would also dampen activity in Lithuania. This would particularly be seen in investment development. It would also affect the labour market and, consequently, household income and private consumption.

### Outlook for Lithuania's economy

	September 2019 projection <sup>a</sup>			June 2019 projection		
	2018	2019 <sup>b</sup>	2020 <sup>b</sup>	2018	2019 <sup>b</sup>	2020 <sup>b</sup>
<b>Price and cost developments (annual percentage change)</b>						
Average annual HICP inflation	2.5	2.3	2.2	2.5	2.4	2.3
GDP deflator <sup>c</sup>	3.3	2.8	2.2	3.3	2.4	2.2
Wages <sup>d</sup>	10.0	8.5	6.7	9.6	8.1	6.7
Import deflator <sup>c</sup>	4.7	2.0	1.8	4.7	2.1	1.8
Export deflator <sup>c</sup>	3.8	2.2	1.7	3.8	2.0	1.7
<b>Economic activity (constant prices; annual percentage change)</b>						
Gross domestic product <sup>c</sup>	3.5	3.7	2.5	3.5	3.2	2.5
Private consumption expenditure <sup>c</sup>	3.9	4.0	3.6	3.9	4.0	3.6
General government consumption expenditure <sup>c</sup>	0.8	0.9	0.6	0.8	0.9	0.6
Gross fixed capital formation <sup>c</sup>	6.7	6.9	4.1	6.7	5.6	4.1
Exports of goods and services <sup>c</sup>	5.0	4.6	3.5	5.0	4.0	3.5
Imports of goods and services <sup>c</sup>	4.4	4.6	4.3	4.4	4.4	4.3
<b>Labour market</b>						
Unemployment rate (annual average as a percentage of labour force)	6.1	5.8	5.7	6.1	5.8	5.7
Employment (annual percentage change) <sup>e</sup>	1.5	1.1	0.0	1.5	0.8	-0.3
<b>External sector (percentage of GDP)</b>						
Balance of goods and services	2.7	2.7	1.9	2.7	2.3	1.5
Current account balance	1.6	0.8	-0.4	1.6	0.2	-0.7
Current and capital account balance	3.1	2.5	1.3	3.1	1.8	0.9

<sup>a</sup> The projections are based on information made available by 20 August 2019.

<sup>b</sup> Projection.

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

<sup>d</sup> The wage projection for 2019 excludes corrections made due to changes in the tax and pension systems.

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

**Headline inflation indicators have not changed much for quite some time – food and fuel prices show greater volatility, whereas underlying inflation is rather stable.** The worsening global outlook weighs on energy raw material prices. Amid escalating tensions in international trade, global oil

prices have declined over recent months, turning out lower than expected. It also puts downward pressure on headline inflation in Lithuania. Unlike prices for energy raw materials, food prices are rising at a more rapid pace. Processed food prices are growing somewhat faster than at the beginning of the year, but particularly significant increases have recently been observed in unprocessed food (namely vegetable) prices. In July, annual growth in food prices accelerated to 5.2%. As before, headline inflation is significantly driven by service prices, i.e. prices which are most closely related to domestic economic trends. They continue to go up by almost 5% per year, accounting for around half of headline inflation. This is directly related to increasing labour costs – although economic activity is elevated and labour productivity is improving, the latter is far outpaced by wage growth, exerting pressure on prices, especially in economic activities related to services. Headline inflation in Lithuania is projected to remain broadly unchanged: after standing at 2.5% last year, it is set to reach 2.3% in 2019 and 2.2% in 2020.