



LIETUVOS BANKAS
EUROSISTEMA

Lithuanian Economic Review

2019

SEPTEMBER

The Lithuanian Economic Review analyses the developments of the real sector, prices, public finance and credit in Lithuania, as well as the projected development of the domestic economy. The material presented in the review is the result of statistical data analysis, modelling and expert assessment. The review is prepared by the Bank of Lithuania.

The cut-off date for the data used in the Lithuanian Economic Review was 20 August 2019. Chapter II "Monetary policy of the Eurosystem" is supplemented by data and information on decisions adopted by the ECB Governing Council on 12 September. Other chapters of the review are based on data made available by 6 September 2019.

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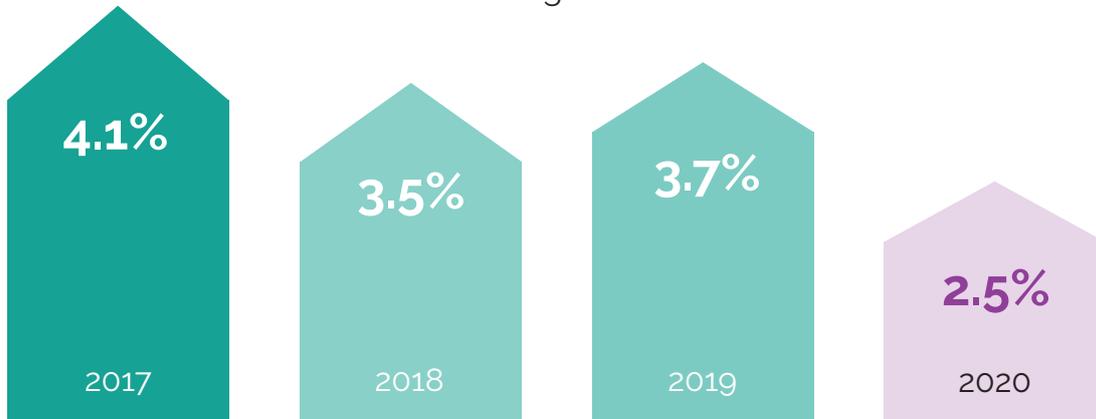
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ABBREVIATIONS

APP	asset purchase programme
CIS	Commonwealth of Independent States
EC	European Commission
ECB	European Central Bank
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurostat	statistical office of the European Union
FED	Federal Reserve Board
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
MFI	monetary financial institution
PMI	Purchasing Managers' Index
SSIFD	State Social Insurance Fund Board under the Ministry of Social Security and Labour
UK	United Kingdom
US	United States of America
WTO	World Trade Organisation

ECONOMIC GROWTH EXCEEDS EXPECTATIONS, YET IS SET TO MODERATE IN 2020

GDP growth



GROWTH DRIVERS IN 2019



Strong export growth despite the challenging international environment

EXPORTS



4.6%

2019



Growing investment due to higher absorption of EU funds

INVESTMENT



6.9%

2019

CONTRIBUTIONS TO SLOWER GROWTH IN 2020



Deteriorating international environment

EXPORTS



3.5%

2020



Weaker investment

INVESTMENT



4.1%

2020

RISKS TO ECONOMIC GROWTH REMAIN BALANCED



Increased employment growth
Improving absorption of EU funds
Higher agricultural yields



Further international trade restrictions
Hard Brexit
Reduced EU funding

LITHUANIA'S ECONOMIC DEVELOPMENT AND OUTLOOK

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 areas¹.

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 pace².

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 expectations³.

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

¹ Developments in the international economic environment and associated risks are discussed in detail in Chapter I "International environment".

² External trade developments are discussed in detail in Chapter V "External sector".

³ Developments in the real sector are discussed in detail in Chapter III "Real sector".

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 imbalances⁴.

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.

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 prices of services, 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 services⁵. 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.

⁴ Labour market developments are discussed in detail in Chapter IV „Labour market“.

⁵ Inflationary trends are discussed in detail in Chapter VI „Prices“.

Outlook for Lithuania's economy

	September 2019 projection ^a			June 2019 projection		
	2018	2019 ^b	2020 ^b	2018	2019 ^b	2020 ^b
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.5	2.3	2.2	2.5	2.4	2.3
GDP deflator ^c	3.3	2.8	2.2	3.3	2.4	2.2
Wages ^d	10.0	8.5	6.7	9.6	8.1	6.7
Import deflator ^c	4.7	2.0	1.8	4.7	2.1	1.8
Export deflator ^c	3.8	2.2	1.7	3.8	2.0	1.7
Economic activity (constant prices; annual percentage change)						
Gross domestic product ^c	3.5	3.7	2.5	3.5	3.2	2.5
Private consumption expenditure ^c	3.9	4.0	3.6	3.9	4.0	3.6
General government consumption expenditure ^c	0.8	0.9	0.6	0.8	0.9	0.6
Gross fixed capital formation ^c	6.7	6.9	4.1	6.7	5.6	4.1
Exports of goods and services ^c	5.0	4.6	3.5	5.0	4.0	3.5
Imports of goods and services ^c	4.4	4.6	4.3	4.4	4.4	4.3
Labour market						
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) ^e	1.5	1.1	0.0	1.5	0.8	-0.3
External sector (percentage of GDP)						
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

^a The projections are based on information made available by 20 August 2019.

^b Projection.

^c Adjusted for seasonal and workday effects.

^d The wage projection for 2019 excludes corrections made due to changes in the tax and pension systems.

^e National accounts data; employment in domestic concept.

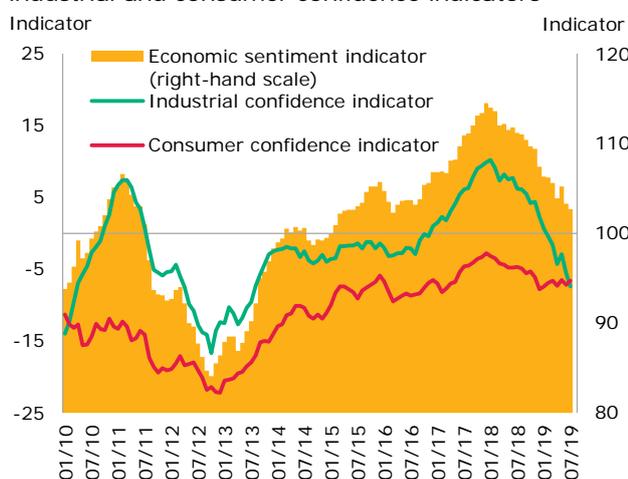
I. INTERNATIONAL ENVIRONMENT

Global economic growth continues to slow down. In the first half of 2019, growth was underpinned by favourable conditions in financial markets, accommodative monetary policy measures applied by central banks, strong performance of the labour market (low unemployment and rising wages), high consumer confidence indicators and, consequently, growing private consumption in advanced economies. However, this summer, due to heightened geopolitical and economic policy uncertainty, international trade restrictions, weak manufacturing (the global PMI below 50 indicates a declining manufacturing output), decreasing export orders and weakening economic situation in most countries, the IMF and the World Bank revised down their global economic growth projections for 2019. In response to worsening economic growth prospects, central banks are shifting towards looser monetary policy: in July, the FED cut its base interest rates for the first time in a decade, while financial markets expect both the FED and the ECB to further reduce their rates.

With the worsening situation in the euro area manufacturing sector, economic growth is losing momentum. Supported by real wage growth and the lowest unemployment rate in 11 years (which stood at 7.5% in June), internal demand led to 1.3% annual economic growth in the first quarter of 2019. It was also driven by temporary factors, namely the UK's stockpiling ahead of the original Brexit date and a rebound in car sales. The positive momentum of these factors weakened in the second quarter: according to the provisional data, the euro area economy expanded by 1.2%, recording its slowest pace in the last six years. The euro area economy is also undermined by the escalating trade dispute – the US threatening to impose duties on imports of cars and auto parts, which coupled with the EU unwillingness to negotiate on agricultural products – all this does not allow moving forward with the US-EU negotiations over trade liberalisation. In July, the worsening bloc's situation was also reflected by the lowest manufacturing PMI in nearly seven years (46.4). In the second quarter, amid the declining manufacturing output and export volumes, quarterly growth in Germany – the euro area's largest economy – became negative (-0.1%). Similar trends were also observed in the UK where quarterly economic growth turned negative for the first time since 2012.

Euro area confidence indicators are turning down.

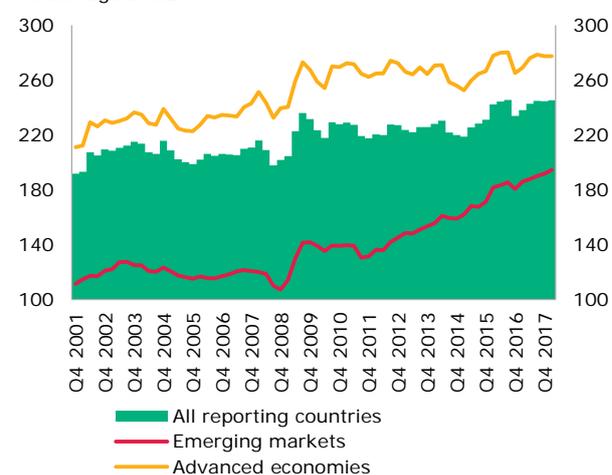
Chart 1. Euro area economic sentiment indicator, industrial and consumer confidence indicators



Source: Eurostat.

Indebtedness of emerging economies is rapidly increasing.

Chart 2. Credit to the non-financial sector from all the sectors in emerging and advanced economies
Percentage of GDP



Source: Bank for International Settlements.

Despite the longest economic expansion in US history, weakening manufacturing has become a matter of concern. The US economy has been growing for 123 consecutive months. However, amid the fading impact of fiscal stimulus implemented in 2017-2018, domestic economic growth has been moderating. In the second quarter of 2019, the US economy grew by 2.0%, i.e. 1.1 percentage points slower compared to the first quarter. Growth was supported by the 50-year low unemployment rate (3.7% in June-August) and increased household disposable income which, in turn, fuelled private consumption growth. The latter, coupled with government expenditure, somewhat offset the decline in business investment and slower growth in

exports. However, lower rail freight rates and the manufacturing PMI, which in July recorded its lowest reading in 10 years, reflect weaker manufacturing activity. All of these signs, along with the US government bond yield curve that inverted⁶ in August for the first time since 2007, point to high uncertainty surrounding the US external environment and rising expectations regarding weaker country's economic growth.

Although trade tensions are weighing on China's growth, the country's government is making efforts to boost its economic development. In the second quarter, China's annual economic growth stood at 6.2% – its slowest pace in 27 years. Such trends reflect declining international trade volumes on the back of trade conflicts and structural economic changes. When the Chinese yuan dropped to its lowest levels in over a decade (more than 7 yuan per US dollar) on 5 August 2019, the US accused the country of currency manipulation and China announced it would stop buying US agricultural products. Although a weaker yuan can help to mitigate the negative impact of trade tariffs, the US accusations may bring about additional ones. Tensions and uncertainty have also been escalated by unrest in Hong Kong with an increasing possibility of intervention by the Chinese government amid ongoing massive anti-government protests. In response to the weakening external environment, the Chinese government is expected to continue boosting economic growth – particularly consumption and investment in production – by implementing fiscal and monetary policy measures.

Russia's economic activity remains sluggish. Underpinned by the increasing manufacturing output, investment in government projects and higher oil prices, Russia's annual economic growth somewhat accelerated and reached 0.9% in the second quarter of 2019. Although the unemployment rate in the country was at a record low this June, wage growth is relatively modest, while real household disposable income is contracting. According to the IMF and the World Bank, Russia's economy is set to expand by 1.2% in 2019.

Economic growth in Latvia, Estonia and Poland is boosted by domestic consumption. Although waning business and consumer confidence in these countries reflects concerns over future prospects, economic sentiment indicators in Latvia and Poland remain above their long-term average. Tensions in the labour market support rapid wage growth in all the three countries and contribute to domestic consumption growth. However, higher costs are increasing risks to exporting industries which are also affected by slower economic growth in the main export markets.

The gold price hit six-year highs, while stock and oil prices have been fluctuating. Amid further escalation in trade conflicts, negative statements by the US President's administration on an excessively strong dollar, and deteriorating global economic outlook, stock markets saw high volatility in July and August 2019. Investors are increasingly opting for safe assets, i.e. bonds and gold. The increasing amount of negative-yielding bonds (currently about 27% of all bonds issued worldwide) reflects negative future expectations as well as the growing (according to market participants) need for accommodative monetary and fiscal policy. Against this backdrop, the gold price has been rising at a rapid pace – since the beginning of the year, it went up by about 17% and reached levels above 1,500 US dollars per troy ounce in mid-August. Higher oil prices were underpinned by supply factors (the US/UK conflict with Iran and the July agreement of the Organization of the Petroleum Exporting Countries (OPEC) to extend crude oil output cuts). However, on the back of increased expectations that moderating global economic growth could undermine growing demand, crude oil prices dropped below 60 US dollars per barrel in mid-August.

The risk balance of global growth outlook remains negative. Contracting external demand and the weakening manufacturing sector continue to pose risks to the euro area economy. There is a rising concern that economic growth slowdown in Germany may turn into a recession as well as an increased probability of a no-deal Brexit with Boris Johnson as the UK Prime Minister. Additional trade restrictions may cause wider slowdown in manufacturing and trade growth and further undermine business expectations, global value chains, investment and the stability of financial systems. Corporate indebtedness, particularly of low-investment-grade companies, is rapidly increasing – this may pose threats to financial stability and global

⁶ The yield on 10-year maturity bonds fell below the yield on 2-year maturity bonds, while normally it is the other way around.

economic development in case of risk assessment changes in financial markets and tighter financing conditions (see Chart 2). Other negative risks include China's slower economic growth and a limited space for accommodative monetary and fiscal policy in the key global economies. Tensions in separate regions are amplified by escalating geopolitical conflicts, more frequent extreme weather conditions such as heavy downpours in the US (particularly in the Central East), low water levels in the Rhine River caused by the drought in Europe, and Amazon rainforest fires. However, a more favourable monetary policy stance in advanced economies, new fiscal stimulus measures, especially in the US and some EU countries, the Brexit deal and successful trade negotiations between the US, China and the EU could result in stronger than projected global growth.

BOX 1

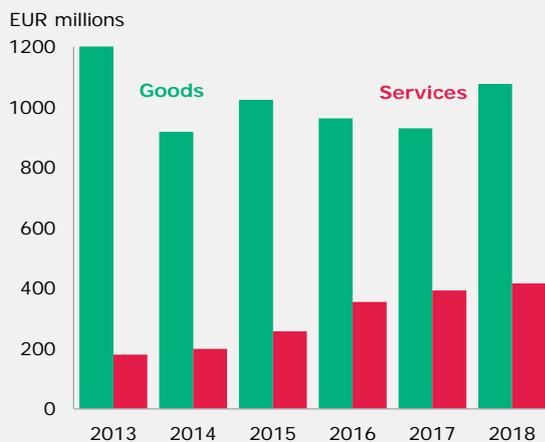
THE IMPACT OF BREXIT ON LITHUANIA'S ECONOMY

Although due to political turmoil in the UK only a prophet could predict the outcome of Brexit, the UK leaving the EU on 31 October – either with or without an agreement – is one of the possible scenarios. The major concern for the euro area is a high probability of a no-deal Brexit⁷. The IMF and the EC still consider an agreement between the EU and the UK and a gradual transition to new arrangements as the main Brexit scenario and project the annual growth of the UK economy to stand respectively at 1.3% and 1.8%. Although due to stockpiling ahead of the original Brexit date the UK's economic growth exceeded expectations in the first quarter of 2019, it contracted by 0.2% in the second quarter. According to the assessments of the IMF and the Peterson Institute for International Economics⁸, a no-deal Brexit could lead to a recession in the UK. Such an outcome would also have negative effects on Lithuania's economy.

The UK is an important Lithuania's export partner. In 2018, Lithuania exported over €1 billion worth of goods to the UK (3.8% of total exports of goods), mainly industrial ones – chemical, furniture, timber and plastic products (see Chart A). Lithuanian exports of services to the UK amounted to €415.5 million (4.2% of total exports of services), soaring by 131% over five years. Transport services account for more than half of services exported to the UK; therefore, this sector is likely to be most affected by Brexit – not only because of possibly shrinking external demand but also due to such disruptions as queues at the border and additional customs procedures (see Chart B).

Lithuania is exporting increasingly more services to the UK.

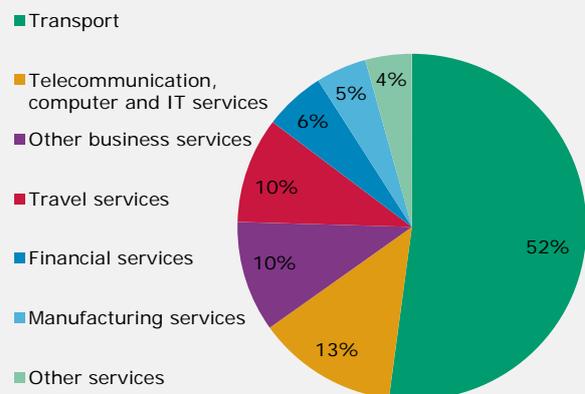
Chart A. Development of Lithuanian exports of goods and services to the UK



Source: Statistics Lithuania.

Transport services account for more than half of Lithuanian exports of services to the UK.

Chart B. Lithuanian exports of services to the UK in 2018 (by type of service)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Lithuanian immigrants in the UK would feel negative implications of Brexit through a deteriorated economic situation and changes in the legal regulation. The UK has long been the main migration direction for Lithuanian citizens, with almost half of all emigrants from Lithuania living in this

⁷ **Hard Brexit:** the UK gives up membership of the EU single market and can trade freely with its European partners without any tariff restrictions. Drawing up independent trade agreements will take time and force the country to apply less favourable WTO rules.

No-deal Brexit: unlike a hard Brexit which could include some type of agreement with the EU and a potential transition period to negotiate free trade deals, a no-deal Brexit presents no cushion whatsoever and its damage to the UK economy would be the most severe.

Soft Brexit is the least damaging path: the UK remains closely aligned with the EU by retaining some form of the bloc's single market. The EU requires that access to the single market should be maintained if all its principles are respected, including the free movement of people (Norway case). However, the UK is not willing to compromise on immigration.

⁸ Latorre, M. C., Olekseyuk, Z., Yonezawa, H., and Robinson, S. (2019). [Brexit: Everyone Loses, but Britain Loses the Most](#) // Peterson Institute for International Economics Working Paper 19-5.

country. The end of free movement of EU citizens in the event of a no-deal Brexit would increase the chances that Lithuanian citizens residing in the UK who have failed to apply for settled status in due time may be deprived of their right to stay in the country. Lithuanian citizens who would legally stay in the UK would probably face an increased threat of job losses: in addition to the above-mentioned transport services sector, it is particularly relevant to persons working in the industrial and agricultural sectors, as it would be significantly more difficult to export their production. As much as two thirds of UK agricultural products are exported to the EU, while 90% of seasonal agricultural workers come to the country from Eastern Europe. The depreciating pound would also erode euro savings of Lithuanian emigrants, which, in turn, would cut their remittances to Lithuania, accounting for more than 18% of all foreign remittances received in Lithuania in 2018.

The UK's withdrawal from the EU without an agreement would have other macroeconomic implications in Lithuania as well. Its impact would be felt not only because of Lithuania's direct and indirect trade links with UK businesses, partly resulting from Lithuania's intensive trade with other EU countries the UK is an important trade partner of, but also because of elevated economic and financial uncertainties. They would particularly intensify in the UK where companies would find it extremely difficult to develop investment, along with a pick-up in various risk premia and an increase in the cost of borrowing. Amid the worsening financial situation of households and higher borrowing costs, real estate prices in the UK are likely to drop. Financial environment indicators would also be affected in other countries or regions, including the euro area. The deteriorating international environment and increased uncertainty would bring down prices of equity instruments in the euro area and push up costs of corporate and household borrowing. This situation would negatively affect confidence indicators and, consequently, internal demand in Lithuania.

The deteriorated international environment and heightened uncertainty surrounding a no-deal Brexit would weigh on economic activity in Lithuania. The Bank of Lithuania estimates that under such circumstances over the next three years Lithuania's real GDP would increase by 0.8 percentage point less than in case of a soft Brexit.

II. MONETARY POLICY OF THE EUROSISTEM

Over the last half-year, the Eurosystem has strengthened the accommodative stance of its monetary policy in order to ensure the continued sustained convergence of inflation to its aim.

Additional stimulus was employed due to the fact that inflation rates, both recorded and projected, are still below levels that are in line with its aim – below, but close to, 2%.

This summer, the ECB Governing Council decided not to raise the key ECB interest rates at least through the first half of 2020. During the Governing Council meeting held in June 2019 in Vilnius, it was decided that the calendar element of forward guidance on interest rates should be extended from the end of 2019 to mid-2020. During this period, the key ECB interest rates are expected to remain at their current levels. During the July meeting, the Governing Council reinforced its forward guidance on policy rates and specified that during the said period of time interest rates would remain at their present or lower levels.

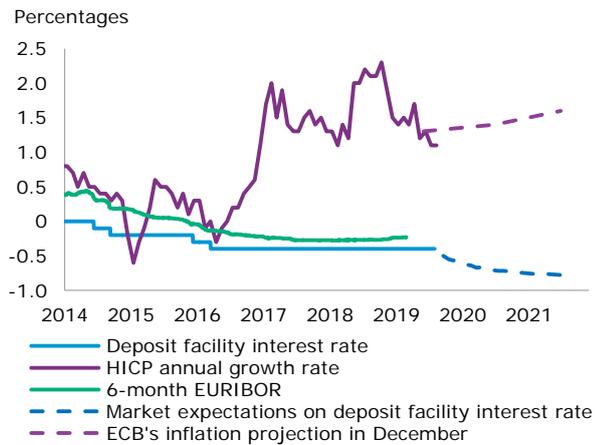
In September, the Governing Council decided to further support the accommodative stance of monetary policy.⁹ The interest rate on the deposit facility was lowered by 10 basis points to -0.5%. It is expected to remain at its present or lower level until the inflation outlook robustly converges to a level sufficiently close to, but below, 2% and such convergence is consistently reflected in underlying inflation dynamics. Part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate, which will assist in reducing banks' expenses caused by negative interest rates on reserves held with a central bank. At the same time, the modalities of the new targeted longer-term refinancing operations were improved by reducing borrowing interest rates and extending the maturity of operations. However, specific attention was drawn to the Governing Council's decision to restart net purchases under the APP at a monthly pace of €20 billion as of 1 November. It is important to note that the net purchases are expected to end only shortly before the Governing Council starts raising the key ECB interest rates. According to market participants, these interest rates may decrease even further (to -0.6% or even -0.7%), whereas their growth is not expected for at least another few years (see Chart 3).

The Eurosystem's accommodative monetary policy measures have continued to support exceptionally low interest rates on loans imposed by banks operating in the euro area and Lithuania. Interest rates in the euro area have been on a steady decline since mid-2014 when markets started expecting that the ECB would resort to non-standard monetary policy measures. During the recent years, interest rates on loans in the euro area have stabilised yet still remain close to the lowest on record. Average interest rates on new loans in Lithuania have risen over the recent years and remain higher than the euro area average, particularly those for non-financial corporations (see Chart 4). The rise in interest rates was likely caused by reduced competitiveness in the banking sector due to a recent surge in concentration and potentially elevated risks of new loans.

⁹ This paragraph introduces the decisions adopted by the ECB Governing Council during its meeting on 12 September 2019, which were not included in this projection phase.

The ECB interest rates remain at very low levels.

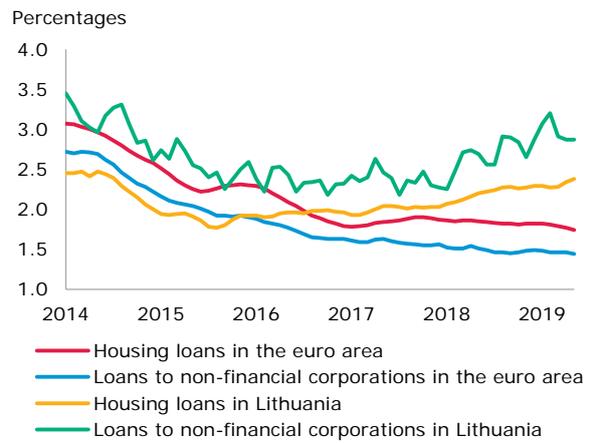
Chart 3. Factual ECB interest rate, inflation data and market expectations



Sources: ECB, Thomson Reuters Datastream, Bloomberg.
 Note: The chart reflects data as of 12 September.

Financing conditions remain favourable.

Chart 4. Average interest rates on new MFI housing loans and loans to non-financial corporations



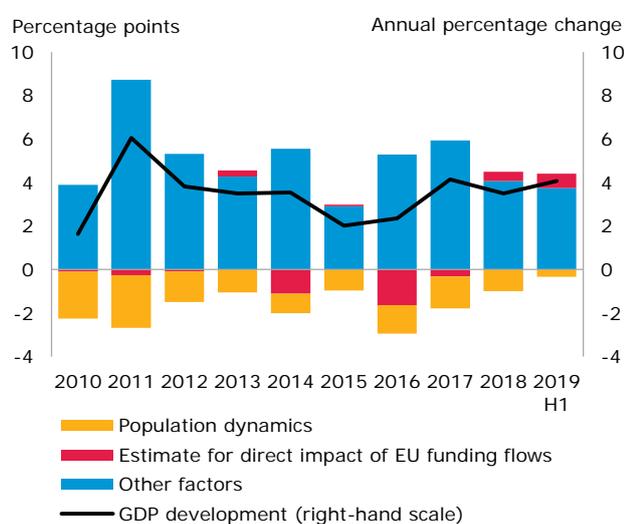
Sources: ECB and Bank of Lithuania calculations.
 Note: 3-month moving average.

III. REAL SECTOR

Lithuania's economic growth maintains its momentum amid global headwinds. Despite the slowdown in external demand for Lithuanian-origin goods and services, the pace of Lithuania's economic growth in the first half of 2019 was faster than a year ago, mainly on the back of recovering flows of EU funds and significantly more positive population growth. These factors could have led to up to 1.0 percentage point faster economic growth in the first quarter of 2019 (see Chart 5). Nevertheless, these trends have not changed the assessment of the cyclical position of the economy – relatively rapid economic expansion has led to a widening output gap that shows the extent to which the current economic development has deviated from its sustainable path (see Chart 6) and gives rise to certain imbalances. On the other hand, it should be noted that the expected economic slowdown along with more favourable population and labour force dynamics as well as relatively fast investment growth observed in recent years should ease pressure on further escalation of imbalances in 2020.

Improved flows of EU funds and more favourable demographic trends significantly contribute to economic growth.

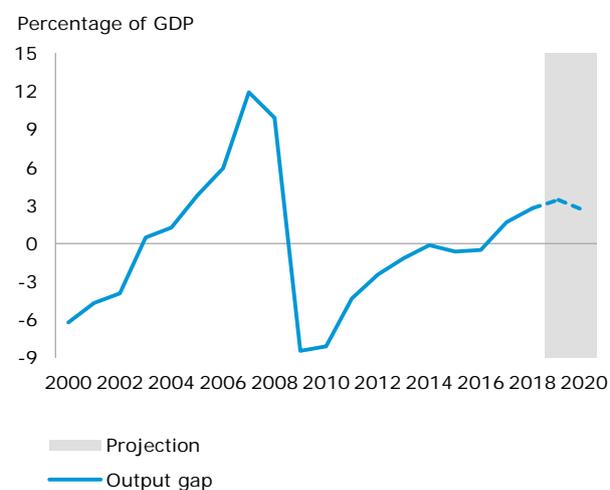
Chart 5. Contributions to real GDP



Sources: Statistics Lithuania and Bank of Lithuania calculations.

After widening due to rapid economic growth, the output gap will remain positive, yet should stabilise in 2020.

Chart 6. Output gap



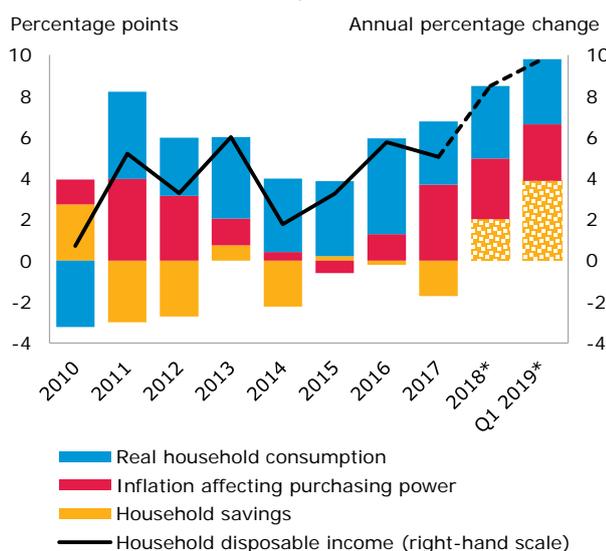
Sources: Statistics Lithuania and Bank of Lithuania calculations.

Increasing flows of EU funds significantly add to continuing investment growth. Investment in buildings and structures has recently been posting the largest increase. After buoyant growth last year, investment in engineering networks as well as industrial buildings and warehouses remains among the most important in this investment category in 2019. Intensified implementation of investment projects in recent years with a particular focus on the modernisation and development of engineering networks may be attributed to the recovery of EU funding flows, as they frequently constitute a major share in financing of such projects. In the first half of 2019, most of these funds were allocated for the modernisation and development of wastewater treatment as well as electricity and heating networks. In addition to these fields, EU funding flows have also significantly increased in such areas as transport infrastructure, education, public order and public security. The ongoing construction projects should also underpin investment growth in the second half of 2019. It should be noted, however, that activity in the construction sector may be affected by a more rigorous approach taken by financial institutions towards new real estate projects. Moreover, companies' willingness to invest will also be constrained by rising global uncertainty, less favourable than expected economic development of the main trade partners and manufacturing capacity utilisation trending down from historically high levels. Furthermore, next year should also see a slower increase in EU funding flows. All of these factors will lead to weaker investment growth in 2020.

Rising employment makes a positive contribution to expanding volumes of exports of goods and services but it has not yet boosted household consumption. In the first half of 2019, growth of exports of goods and services increased by almost a third compared to 2018. Such export developments were driven not only by rather buoyant investment which has expanded production capacities and improved the competitiveness of exporting companies (for more details, see Chapter V “External sector”), but also by increasing employment in the exporting sector, particularly in transportation and storage activities¹⁰ (for more details, see Chapter IV “Labour market”). Most of all new jobs created in the country were established in this particular sector. Nevertheless, employment gains were not sufficient to boost household consumption growth. It probably mirrors the willingness of households to increase their saving rates (see Chart 7), given that the overall household saving rate in 2017 was negative and, according to the preliminary assessments, close to zero in 2018. However, it should be noted that both household income and expenditure have recently been rising at a rather brisk pace. Households are particularly optimistic about the current situation, which is also reflected by household sentiments. For example, the consumer confidence indicator is currently at its highest level since the end of the crisis. However, next year it is expected to be less favourable for households. The Bank of Lithuania estimates that the growth of household consumption expenditure will be held down by more moderate wage growth and stagnating employment.

With households setting aside a significant share of income gains for savings, disposable income growth is outpacing household consumption.

Chart 7. Household nominal disposable income and its uses (at current prices)

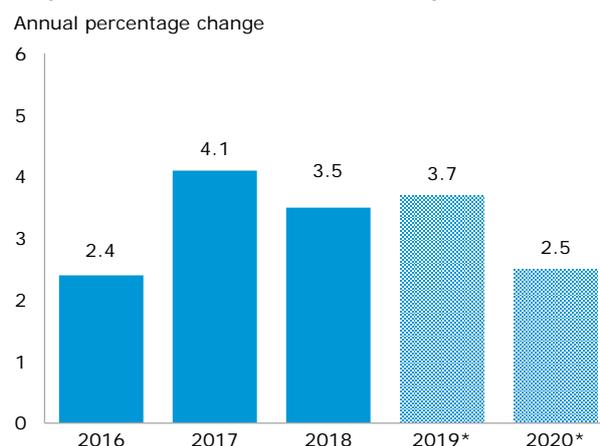


Sources: Eurostat, Statistics Lithuania and Bank of Lithuania calculations.

*Dotted line and dotted columns indicate projections by the Bank of Lithuania.

Economic growth projections for 2019 are revised upwards due to better than expected data for the first half-year.

Chart 8. GDP evolution and projections (adjusted for seasonal and workday effects)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

*Bank of Lithuania projection.

According to the estimations of the Bank of Lithuania, domestic economic growth will remain rather robust but it is set to moderate in the second half of 2019 and next year (see Chart 8). Due to better than anticipated data for the first half-year, June growth projections for 2019 have been revised up to 3.7%. However, weakening EU funding flows, high global uncertainty and less favourable economic development of the main trade partners will weigh on Lithuania’s economic growth in 2020. There are also a number of risks that may lead to quite different economic development trends which would not be consistent with the latest projections. Such risks may include further international trade restrictions, slower expansion of the main export partners or a worse Brexit outcome than currently projected.

¹⁰ For more details, see Box 2 “The impact of the transport sector on Lithuania’s economy and reasons of its development”.

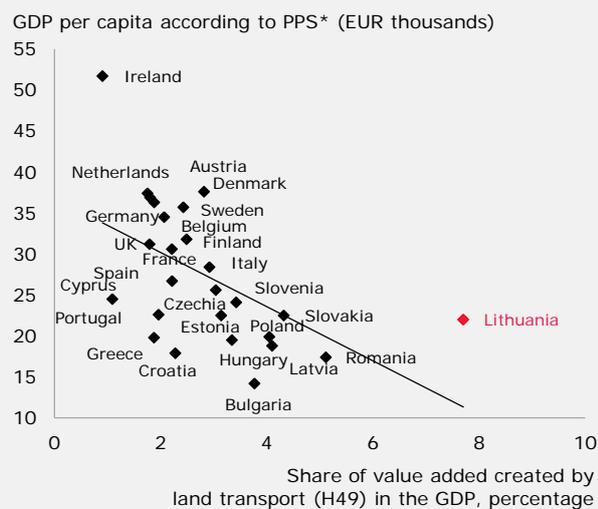
BOX 2

THE IMPACT OF THE TRANSPORT SECTOR ON LITHUANIA'S ECONOMY AND REASONS OF ITS DEVELOPMENT

With upward trends in the standards of living across the EU, the economic importance of the transport sector tends to decline. However, this is not the case in Lithuania. As regards the link between the GDP per capita and the value added created in the land transport sector¹¹, Lithuania is an exception in the EU context (see Chart A). It is the leading EU country in terms of the number of employees working in this economic sector. In the period from 2008 to 2018, the average number of employees in this sector comprised 5.2% of all the employed in Lithuania, compared to the EU average of 2.7% (according to the statistics of occupied jobs, the share of those employed in the transportation and storage activities was even higher, reaching, on average, 8.3% in 2008-2018 and 10% in 2018). Despite the rising standard of living, the Lithuanian transportation sector is growing. Such trends are also supported by the investment share of the transportation sector which is the largest in the EU (see Chart F). In 2014-2016, the share of tangible investment in the land transport sector comprised, on average, 14.2% of total business investment (excluding financial and insurance activities) – 9.4% more compared to the EU average. So what determines such a prominent impact of this sector on the Lithuanian economy and why its growth rates remain some of the fastest across the EU?

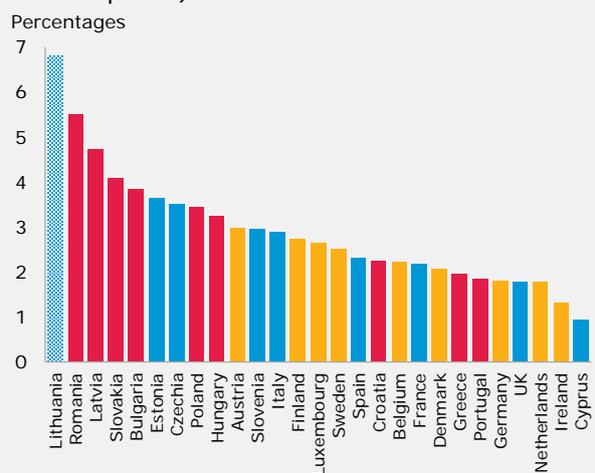
The share of GDP created in the transportation sector is lower in more developed EU Member States with higher standards of living

Chart A. GDP per capita and contribution to GDP by the land transport sector in 2016



Sources: Eurostat and Bank of Lithuania calculations.
Note: Data for Luxembourg is excluded as an outlier.
Data for Malta is not available.
*PPS – purchasing power standard.

Chart B. Share of GDP created by land transport and transport via pipelines (H49) (2000-2016, at current prices)



Sources: Eurostat and Bank of Lithuania calculations.

* Yellow – most developed EU states,
blue – EU states of average development level,
red – least developed EU states.

Before the Russian embargo, the geographical location of Lithuania was favourable to the transport sector expansion. Accession to the EU and the single market allowed Lithuania to take

advantage of the absence of trade barriers and free movement between the states. The increased territory for the movement of goods and production as well as the rise in manufacturing in order to satisfy the demand of new markets determined the rapidly growing demand for transport services. Lithuania's central location between the Western Europe, the Nordic countries, Russia and the CIS may have also had an impact on the sector's growth: in the period from 2000 to 2016, it comprised 6.8% of Lithuania's GDP – the

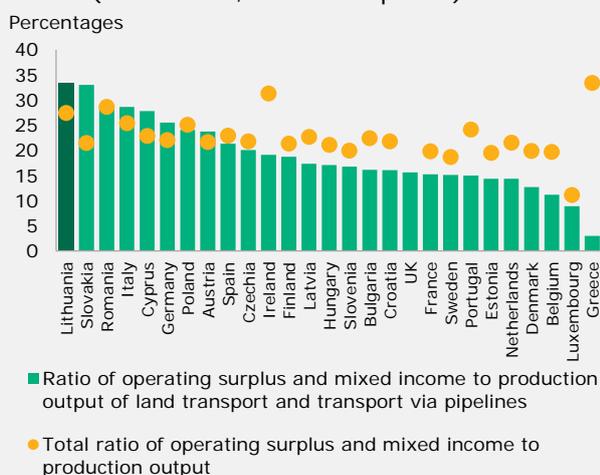
¹¹ According to the statistical classification of economic activities, the two-digit breakdown is the most detailed. Therefore, the equivalent of land transport is category H49 or 'land transport and transport via pipelines'. In this review, this category is referred to as land transport due to low value added created by transport via pipelines.

largest share in the EU (see Chart B). The development in 2005-2007 was supported by new opening markets, whereas in the post-crisis period it was driven by the recovery in international trade. In 2009, the GDP share of services of land transport rose by 14%. Despite the global economic recovery, Lithuania and its transport sector encountered a serious issue – the economic recession in Russia and bilateral sanctions. Prior to the introduction of sanctions, Russia was the main export direction for land cargo transport services. The closing of the largest export market for these services led to the rapid sector's reorientation to the West and allowed the country to find competitive advantages in the EU. In 2016, the growth of the value added created by land transport activities recovered, making up 7.5% and continuing on an upward trend.

The market share of Lithuanian transport services has been growing at a particularly strong pace since 2011. The largest share of these services consists of road cargo transport services (28% of all exports of services in 2018). In 2015-2017, Lithuania's market share in the EU road cargo transport services each year on average increased by almost one-fifth. Having started from mediation between the East and the West, this expansion was later reoriented towards the EU. Since 2016, it has been significantly influenced by rapidly growing investment in tangible assets. With the rising importance of the EU market, Lithuanian transport companies invested in their vehicle fleet (by purchasing newer trucks and semi-trailers) and borrowed to maintain investment growth. As of 2012, the share of cargo loaded and unloaded in Lithuania in the composition of the Lithuanian road transport services has declined, whereas the share of cabotage¹² and cross-border transportation recorded a strong upward trend. Investment flows do not fully explain such a robust expansion of the sector in the EU market. However, it can be explained by comparison with the results of the transport sector expansion in the countries where wage costs are relatively lower (e.g. Romania, Poland and Bulgaria).

Besides being the highest in the EU, the ratio of operating surplus and mixed income to production output in the Lithuanian transport sector also exceeds the country's average.

Chart C. The ratio of operating surplus and mixed income to production output in the EU states (2015-2017, at current prices)



Sources: Eurostat and Bank of Lithuania calculations.

Chart D. Dynamics of production costs (services provided) of companies involved in the activities of land transport



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The Lithuanian transport sector stands out in the EU context with its low personnel costs and high ratio of operating surplus and mixed income to production output. The ratio of operating surplus and mixed income to production output of Lithuanian land transport companies is among the highest in the EU (see Chart C). However, the share of wages in production output lags below the EU average. In 2015-2017, the ratio of operating surplus and mixed income to production output in the Lithuanian land transport sector comprised 33.4% (EU average¹³ – 19.0%), whereas the share of wages in

¹² Engagement in transport activities in another state where a cargo loaded in a foreign country is transported to another foreign country.

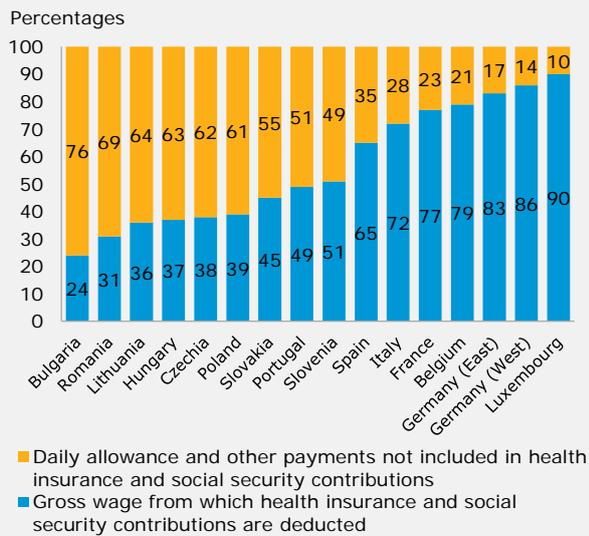
¹³ The average EU ratio of operating surplus and mixed income to production output in 2015-2017, excluding Malta due to insufficient data.

production output was equal to 21.0% (EU average – 24.3%). The lower value, compared to most developed EU economies, may also contribute to competitiveness of the transport sector in the Western Europe. According to the survey conducted by the French National Road Committee, Lithuania was one of the cheapest EU countries in terms of costs per one long-haul truck driver in 2016 (lower costs were recorded only in Bulgaria and Romania). According to the data on corporate production costs, along with fast-growing sales of services, personnel costs have also been increasing since 2017, although at a significantly slower rate (see Chart D).

The lower share of wages in production output is determined by its payment features and daily allowance. All employers in Lithuania are obliged to pay daily allowance to their employees on business trips and compensate their travel expenses (up to 50% of the monthly salary for the actual time worked). Although the law allows paying higher daily allowance, in such case the employer is unable to include the part of the daily allowance exceeding the established amount in the allowable deductions reducing the company’s taxable profit. However, if the wage is higher than 1.3 of the minimum monthly wage, the daily allowance is not taxed additionally. This procedure creates the wage payment practice where part of the wage is paid as daily allowance that is not taxed by the personal income tax and to which social security and health insurance contributions are not applicable (see Chart E).

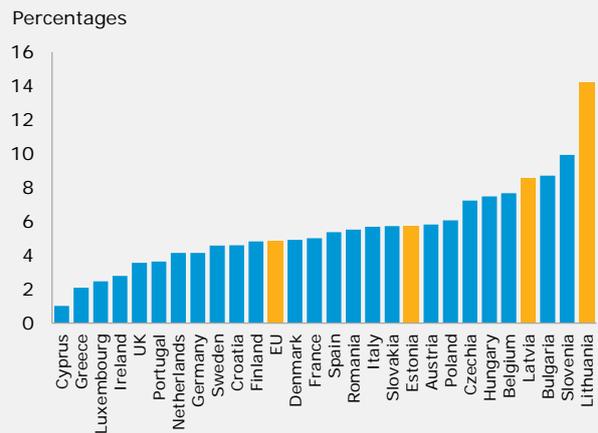
The growth rate of tangible investment by Lithuanian land transport companies was the highest in the EU, whereas the share of wages from which health insurance and social security deductions are calculated was among the lowest across the EU.

Chart E. The wage share of a driver engaged in cross-border transportation from which social security contributions were calculated in 2016



Source: European Studies of the Council of National Research (CNR).

Chart F. The share of investment in land transport and transport via pipelines in total tangible business investment, average of 2014-2016



Sources: Eurostat and Bank of Lithuania calculations.

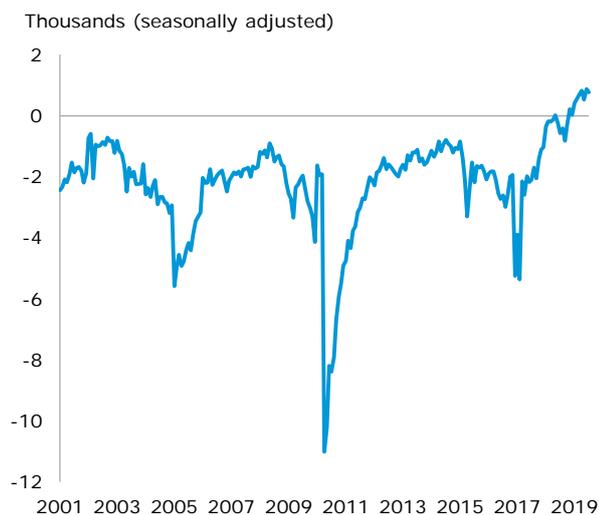
IV. LABOUR MARKET

Persisting tensions in the labour market have not been escalating for almost a year. Such stabilisation in the labour market is underpinned by the fact that companies now tend to take a more moderate view on growth prospects as well as by quite favourable migration trends. Levelling off tensions and the fading effect of administrative decisions resulted in a somewhat slower wage rise in the private sector. However, wages in the public sector grew at a particularly rapid pace.

A more favourable migration balance has been contributing to moderating tensions in the labour market. This year, during the period from January to July, the number of immigrants to Lithuania exceeded the number of emigrants by 6.1 thousand (see Chart 9) and thus the total population has for a few months been on an upward path. Should similar migration trends persist in the second half of the year, Lithuania's population is expected to increase for the first time since 1992. However, the working age¹⁴ population is likely to further decline, albeit at a significantly slower pace. Such trends will be driven by the fact that older cohorts will leave the workforce in higher numbers than younger cohorts will enter it. More favourable migration trends are determined by several factors. The migration balance of Lithuanian citizens is mainly improved by Brexit and favourable labour market conditions in Lithuania, while the rapid expansion of the transport sector and changes in the Lithuanian immigration policy have led to approximately three times the usual number of immigrants from non-EU countries.

The migration balance was positive.

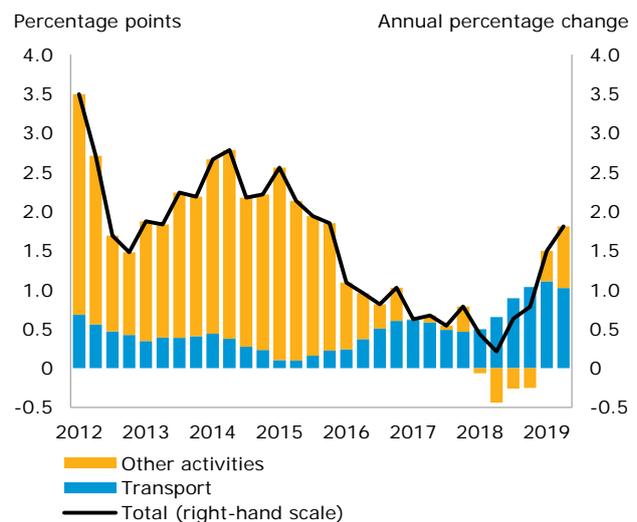
Chart 9. Migration balance



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Over the last two years, the transport sector accounted for the major share of job growth.

Chart 10. Contributions to job growth



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Foreign immigration has been contributing to employment gains which to a large extent are determined by one economic activity, namely transport (see Chart 10). In the first half-year, employment in this activity was nearly 11% higher year on year – such growth is particularly robust as it usually does not exceed 5% in a separate major activity. It has been driven by expanding exports of transport companies in the EU market and simplified immigration procedures for drivers from non-EU countries. This simplification means that transport companies are much less constrained by tensions in the Lithuanian labour market. As regards non-transport activities, new jobs are being created at a sluggish pace. Such developments can be partly explained by a very low unemployment rate in major cities. Therefore, companies looking for new workers often have to attract them from other firms, which subsequently implies that there cannot be any significant increase in the total number of workers. However, job growth in certain fields, e.g.

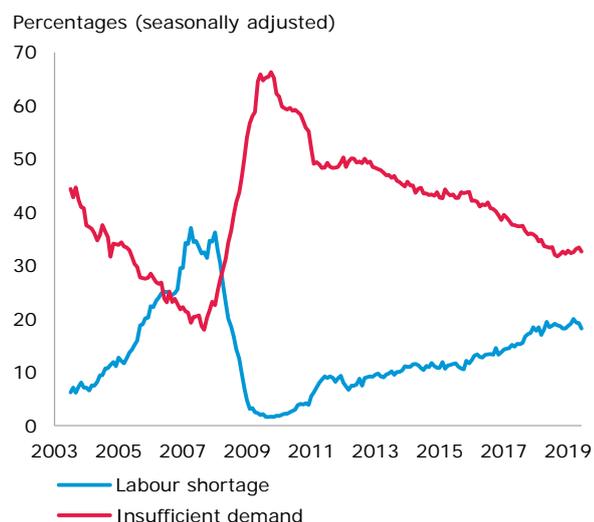
¹⁴ Aged 15-64.

in the manufacturing and construction sectors, is relatively strong. This may also partly reflect the fact that companies engaged in these activities tend to also hire foreign immigrants.

More reserved future expectations could also play a role in the stabilisation of tensions in the labour market. Nearly 19% of firms currently claim that labour shortages are restricting their activities (see Chart 11). This share has remained broadly unchanged over the year. Companies, particularly industrial ones, may be prompted to be more cautious about their demand for workers by escalating risks to global and EU economic growth. However, some indicators that are directly or indirectly related to hiring have slightly deteriorated, while other indicators have not worsened at all. For example, the share of industrial companies experiencing insufficient demand has increased by a similar degree as during the Russian financial crisis in 2014. A number of confidence indicators of the services sector have also shown a slight deterioration, mainly due to the transport sector which was more cautious about economic prospects. The vacancy rate remained fairly stable. However, despite the increased cautiousness of companies and improving migration trends, tensions in the labour market remain rather high, while a particular shortage of highly qualified workers¹⁵ remains a frequently highlighted problem.

Less optimistic business sentiment has been contributing to the stabilisation of tensions in the labour market.

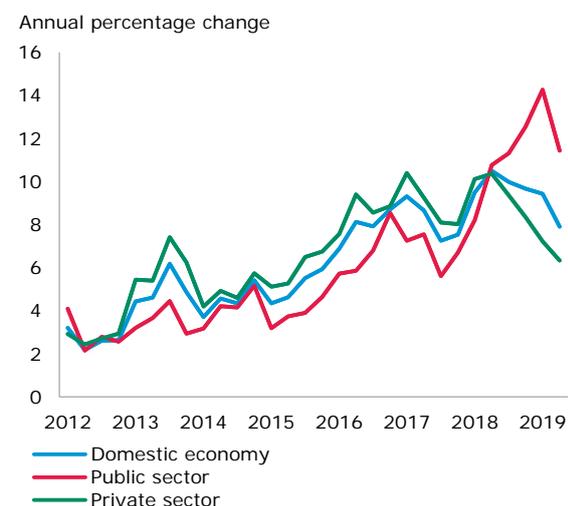
Chart 11. The share of companies whose activities are restricted by labour shortages and insufficient demand



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Wage growth trends in the private and public sectors have diverged.

Chart 12. Wage dynamics



Sources: Statistics Lithuania and Bank of Lithuania calculations.

As tensions in the labour market have levelled off, wage growth has moderated yet still remains quite strong. In the first half of 2019, it stood at 8.7% (see Chart 12). Wage growth in the private sector moderated from 8.8% to 6.8% and this may be partly attributed to the fact that labour shortages are no longer increasing; however, this moderation was also underpinned by the fading effect of the floor for social insurance contributions introduced at the beginning of 2018. An opposite trend was observed in the public sector where wage growth significantly accelerated, currently being almost twice as fast as in the private sector. This comes on the back of around 11-15% increases in wages for all main groups of the public sector, namely public administration, education and healthcare workers. In 2019, wages in Lithuania should rise at a slower pace than a year ago, going up by 8.5%, as labour shortages have stabilised and the effect of administrative decisions has faded out. However, decisions to raise public sector wages at a rapid pace will support wage growth in the country, yet there is a risk of slower than projected wage growth, mainly on account of weaker economic growth than previously expected.

¹⁵ For more details on human capital quality indicators, see Box 3 “The quality of human capital: are Lithuania’s human capital indicators in line with the economic development level?”.

BOX 3.

THE QUALITY OF HUMAN CAPITAL: ARE LITHUANIA'S HUMAN CAPITAL INDICATORS IN LINE WITH THE ECONOMIC DEVELOPMENT LEVEL?¹⁶

The new economic growth theory proposes that the quality of human capital is one of the key economic development factors. Theoretical models used to assess the impact of human capital on economic growth suggest that their improving quality increases labour productivity and the capacity of the economy to adopt and develop new technologies.¹⁷

Empirical economic studies often use the share of the population or labour force with secondary or higher education as an equivalent to the quality of human capital. This type of indicator is used by Ehrlich (2007)¹⁸ to explain why the US overtook European countries in the 20th century in terms of both overall and per-capita GDP. On the basis of this indicator, Žuk and Savelin (2018)¹⁹ claimed that the quality of human capital had an impact on growth rates in Central, Eastern and South-Eastern European economies.

Another indicator, which is rather frequently used to assess the quality of human capital in a particular country, is the United Nations' Human Development Index (HDI). It is a geometric average of three sub-indices: life expectancy, educational attainment and the standard of living. Research shows that the connection between the HDI and economic growth is strong and possibly two-way, i.e. improvements in the HDI have a positive effect on growth and, respectively, accelerating economic growth favourably affects the evolution of the HDI. Therefore, economic growth will not become sustainable unless accompanied by improvements in the quality of human capital.²⁰

In 2017, Lithuania's HDI exceeded the indices of one-fourth of EU countries, while its education indicators were the most favourable (see Chart A). As regards sub-indices, Lithuania's performance is weakest in terms of life expectancy. In 2017, its value in Lithuania stood at 0.843²¹, being almost the lowest indicator among all EU countries. The value of the sub-index of the standard of living is also below the EU average. This sub-index is compiled by measuring gross national income per capita, i.e. an alternative indicator for GDP per capita in assessing a country's standard of living.²² In the context of HDI sub-indices, Lithuania performs best in the field of education. It ranked 11 among the countries analysed, and the value of this sub-index for 2017 was 0.879 and stood somewhat above the average of the analysed countries. The fact that education indicators in Lithuania are relatively high is also evidenced by the share of the population aged 25-64 with higher education, which accounted for 40.3% in 2017 (see Chart A). The latter indicator ranks among the top third of indicators of EU countries and is notably above the average EU value. It should be noted, however, that both of the above-mentioned indicators cover the quantitative assessment of education rather than its qualitative parameters which, in Lithuania's case, have been increasingly brought into question. For example, according to the Global Competitiveness Report 2018, in terms of skills of secondary and university graduates, Lithuania ranked 107 out of 140 countries assessed.

¹⁶ For more information on the quality of human capital and its impact on Lithuania's economic development, see the Bank of Lithuania's publication "Convergence factors of Lithuania's economy and the importance of the labour market" to be published at the end of 2019.

¹⁷ Mankiw, N. G, Romer, D., ir Weil, D.N. (1992). Contribution to the Empirics of Economic Growth // The Quarterly Journal of Economics, Vol. 107, No. 2 (May, 1992), pp. 407-437; Romer, P. (1990). Human Capital and Growth: Theory and Evidence // Carnegie Rochester Conference Series on Public Policy 32, p. 251-286; Pistorius, C. (2004). The Competitiveness and Innovation // Elektron, Vol. 21, No. 3.

¹⁸ Ehrlich I. (2007). The Mystery of Human Capital as Engine of Growth, or Why the US Became the Economic Superpower in the 20th Century // NBER Working Paper No. 12868.

¹⁹ Žuk P., Savelin L. 2018: Real Convergence in Central, Eastern and South-Eastern Europe // ECB, Occasional Paper Series No 212.

²⁰ Ranis, G., Stewart, F., Ramirez, A. 2000: Economic Growth and Human Development // World Development, No 28(2), p. 197-219.

²¹ The HDI and sub-indices range between 0 and 1. In 2013-2017, the values of these indicators in EU countries ranged between 0.75 and 0.98.

²² Gross national income is equal to a country's GDP minus income earned by non-residents plus income of the same type earned by the country's residents in other countries.

Lithuania's current HDI is quite close to the values of other countries at the time they reached a similar level of development²³, although the values of sub-indices vary considerably (see Chart B). The value of Lithuania's HDI sub-index of life expectancy for 2017 was by more than one standard deviation lower than the average values of countries at the time they reached a similar level of development, while the value of its HDI sub-index of education was by more than one standard deviation higher. The share of the population aged 25-64 with higher education also significantly exceeded the average values of other countries at the time they reached a similar level of development.

The values of Lithuania's indicators defining the quality of human capital vary significantly compared to EU countries.

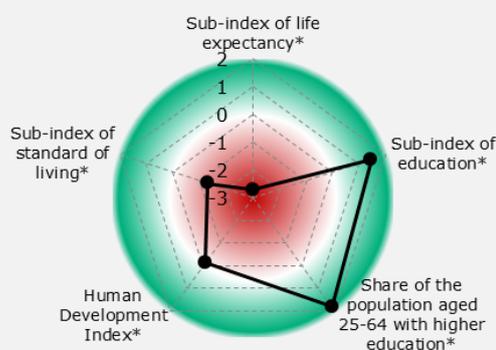
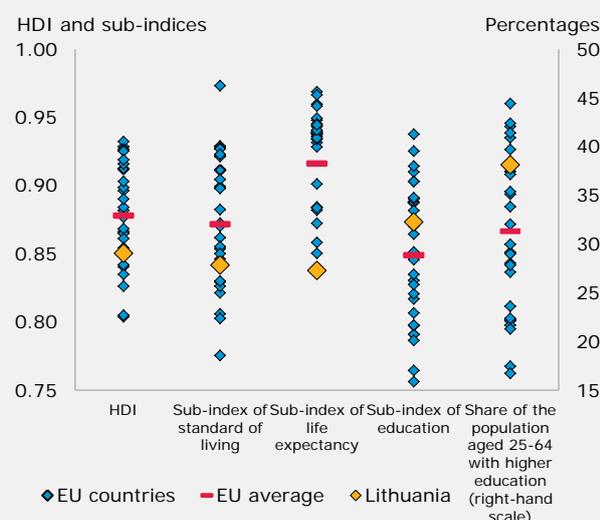
Quality indicators of Lithuania's human capital for 2017 differ from values of other countries at the time they reached a similar level of development.

Chart A. Comparison of the HDI and the share of the population aged 25-64 with higher education in Lithuania and the EU

Chart B. Conformity of Lithuania's quality indicators on human capital with the values of indicators of other countries at the time they reached a similar level of development

Averages of 2013-2017

Lithuania's data for 2017



Sources: United Nations, Eurostat and Bank of Lithuania calculations.

Sources: United Nations, Eurostat and Bank of Lithuania calculations.

*Standardised deviation from the average value of indicators of other countries at the time they reached a similar level of development.

The indicators analysed in this box do not allow a straightforward assessment as to whether the quality of human capital in Lithuania is in line with the country's development level. Compared with the relevant indicators of other countries that have (previously) reached a similar level of development, some Lithuania's indicators are higher (e.g. education indicators), while some of them – lag behind (e.g. the HDI sub-index of life expectancy). All this implies that Lithuania's economic development has not yet been limited by the quality of human capital. However, it should be noted that high quality of human capital is a necessary but insufficient condition for a country to achieve a high standard of living. It is particularly important that the existing human capital and its quality should match the country's labour market needs at that time. The efficient use of the education system, with a focus on improvement of the quality of graduates' skills, as well as active labour market policies could be some of the possible ways to achieve this goal.

²³ A similar level of development is a level that falls within the interval of 23,500 ± 2.5%. Lithuania's GDP per capita in purchasing power parity terms stood at €23,500 in 2017. In 1995-2017, observations of 11 countries fell within this interval, namely: Ireland, Czechia, Estonia, Greece, Spain, the UK, Cyprus, Malta, Portugal, Slovenia and Finland.

V. EXTERNAL SECTOR

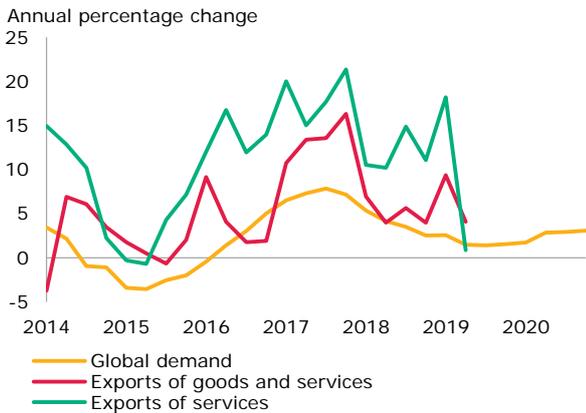
Despite the deteriorating external environment, Lithuanian exports continue to grow (see Chart 13). In the first half of 2019, the real annual growth of exports of goods and services amounted to 6.6% (compared to 5.1% in 2018). The rapid growth of exports is supported by higher production capacity which, in turn, was boosted by substantial rise in investment. Analysis of Lithuanian exports of goods in terms of the complexity of goods shows that growth of Lithuanian exports has recently been underpinned by less complex goods, e.g. articles of wood, fertilisers or plastics – products unaffected by trade wars. Furthermore, amid uncertainty in the international environment, growth of exports of low or medium complexity goods may result from naturally shorter production chains. Looking into more specific groups of exports, it should be noted that grain exports to Saudi Arabia and other non-EU and non-CIS countries in the first half of 2019 acted as an additional contributor to export growth of Lithuanian-origin goods. Development of the transport sector, supported by previous corporate investment flows, is the main contributor to growth in exports of services. Such trends are also closely linked to relatively lower labour costs that have decreased on account of lower wages as well as the system for covering expenses of business trips which is based on daily allowance. Export growth has spillover effects on Lithuania's labour market since most of the new jobs have lately been created in the exporting sector.

Growth of Lithuanian exports has been outpacing external demand, whereas competitiveness among EU exporters continues to improve (see Chart 15). Over the last decade, the average annual growth rate of the Lithuanian export market (in goods and services) stood at 2.7 percentage points (compared to 1.2 percentage points in Latvia and 1.3 percentage points in Estonia). Based on this indicator, Lithuania has achieved some of the best results when compared to other EU Member States. This fact points to Lithuania's competitive advantage and attractiveness of Lithuanian-origin goods and services in foreign markets. This might partly be explained by lower production expenses due to cheaper labour costs. However, less favourable external conditions could not be excluded as well: e.g. Brexit, recent developments in the German car industry and trade wars that have had a relatively lower impact on Lithuania's exporters than its key EU partners. All this, alongside with various one-off factors, stifled the growth of exports and manufacturing in major EU economies. However, supported by the stable labour market, domestic demand and consumption remain strong. This allows EU market-oriented countries, such as Lithuania, to maintain a relatively more robust export growth.

Growth of re-exports to the EU is a new recently observed trend in Lithuania. In the first half of 2019, Lithuania's re-exports increased by 7.3% (in 2018 – 2.5%). The growth is stimulated by the recovery in vehicle trade with CIS countries (Kazakhstan and Belarus) as well as rising machinery and equipment re-exports to Russia, Croatia, Estonia and Poland (see Chart 16). Such developments are likely to be underpinned by growing investment rates in these countries. It should be noted that re-exports of other land vehicles to such Western European countries as Belgium, Germany and France are increasing as well. In the first half of 2019, the growth rate of re-exports to the EU amounted to 8.2% (in 2018 – 4.7%).

Lithuanian exports have been outpacing the external demand.

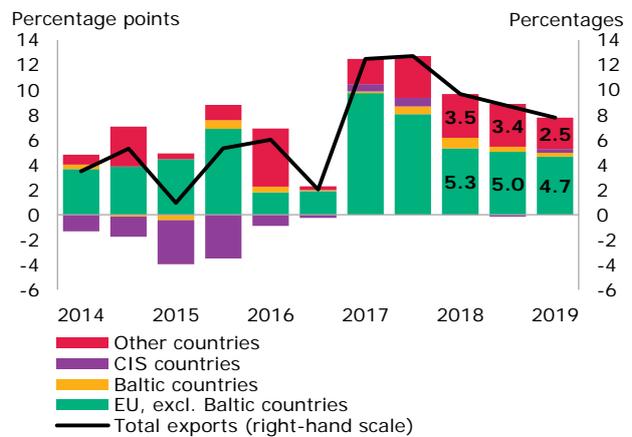
Chart 13. Annual growth of real exports of Lithuanian-origin goods and services and external demand for Lithuanian exports



Sources: Statistics Lithuania, ECB and Bank of Lithuania calculations.

Exports of Lithuanian-origin goods both to the EU and other markets have been moderating.

Chart 14. Growth of exports of Lithuanian-origin goods excluding mineral products, by country group



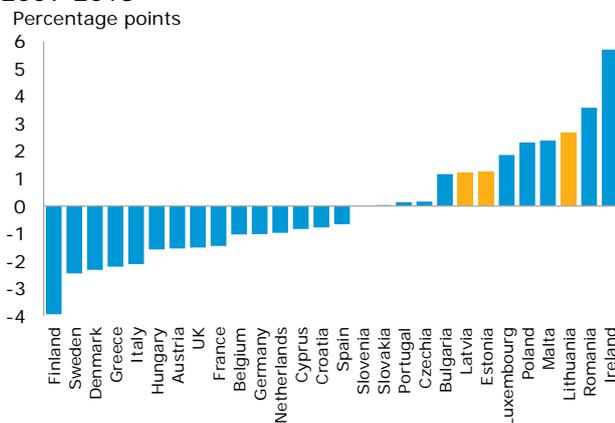
Sources: Statistics Lithuania and Bank of Lithuania calculations.

The growth rate of exports of Lithuanian-origin goods both to the EU and other markets has been moderating.

The annual growth of exports of Lithuanian-origin goods, excluding mineral products, amounted to 7.8% in the first half of the year (in 2018 – 9.2%). Growth of exports to the EU scaled down by 1.1 percentage points, while exports to non-EU and non-CIS countries shrank by 4.8 percentage points. However, exports to CIS countries showed a more rapid growth that reached 10.5 percentage points (see Chart 14). The reason behind slower export growth in other markets was the decreased exports of tobacco and its products as well as chemical reagents but such trends were redeemed by one-off factors. Lithuanian companies managed to enter into direct trade agreements with Saudi Arabia; therefore, a large part of grain yield was exported without intermediaries. Grain exports to such markets as South Africa and Turkey were rapidly increasing as well. In terms of European markets, the highest growth pace was recorded in Lithuanian exports to the UK, Poland, the Netherlands, France and Germany. In all of these markets, furniture is one of the main groups of exported goods. Besides furniture, exports of plastics and fertilisers are the key contributors to the growth of exports of Lithuanian-origin goods. This year, the largest Lithuanian fertiliser manufacturers ordered three additional shipments of gases used as a raw material in producing fertilisers. This may be seen as a sign of preparation for further expansion of exports.

The annual growth of Lithuania’s export market shares is one of the most rapid in the EU.

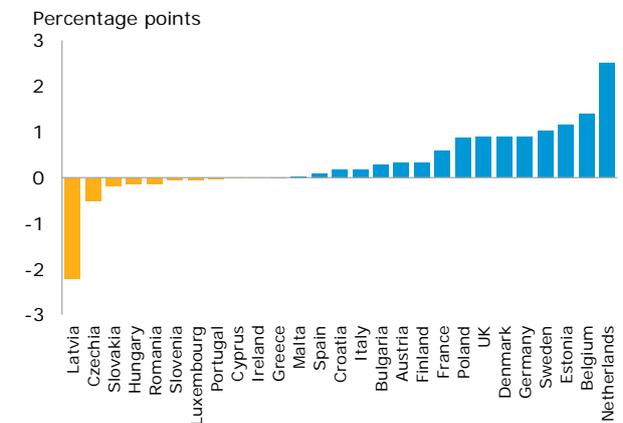
Chart 15. Average annual change in market shares of exports of goods and services in 2009-2018



Sources: Eurostat and Bank of Lithuania calculations.

Re-exports are gaining traction and are now oriented not only to the East but the EU as well.

Chart 16. Annual growth of re-exports to the EU in the first half of 2019



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Export rates of Lithuanian goods and services will continue to grow in the second half of 2019, albeit at a slower pace. The level of uncertainty over international trade developments is increasing, whereas one of Lithuania's key trade partners – the euro area – has experienced the slowest growth in five years, as preliminary data shows. Issues related to the outcome of Brexit and trade restrictions are also yet to be resolved, therefore businesses will continue taking on a cautious approach to investing in expansion. Growing at a slower pace, external demand may result in a diminishing volume of orders for Lithuanian exports and, even though export rates have been outpacing external demand, their convergence may be expected. According to estimations of the Bank of Lithuania, the real exports of goods and services are going to increase by 4.6% in 2019 and 3.5% in 2020.

BOX 4

COMPLEXITY OF LITHUANIAN GOODS EXPORTS²⁴

The structure and specialisation of exports are important as they can explain the differences of development levels between different countries. In countries specialising in production and exports of more complex, technology-intensive and higher value-added goods the per-capita income levels and their growth are higher (e.g. Hausmann, Hwang, Rodrik 2007²⁵, Hidalgo, Hausmann 2009²⁶). More complex and higher quality products are usually related to greater labour productivity; therefore, in countries specialising in these products, the per-capita income levels (and, respectively, convergence) rise faster than in countries producing relatively simpler goods. Economic development is led by countries' ability to change their economic structure by both progressing towards more efficient economic activities (sectors) and companies in individual sectors, production of more complex new goods and by improving the quality of goods that are already being produced (Henn et al 2015²⁷). The pace of such structural transformation while progressing from less efficient activities towards more effective ones indicates why some countries are able to converge faster than others (McMillan, Rodrik 2011²⁸).

In Lithuania, exports of low and medium complexity goods are predominant, whereas the share of exports of most complex goods has broadly remained unchanged over the recent years.

However, the share of least complex goods has been shrinking. Chart A shows exports of Lithuanian-origin goods in 2008 and 2017 in terms of their complexity²⁹. The horizontal axis represents product categories, whereas the vertical one represents their complexity. The size of the circles matches the share of exports of Lithuanian-origin goods. The chart only depicts those product categories where Lithuania has a revealed comparative advantage³⁰. It shows that the share of exports of more complex exported goods (mostly machinery, equipment and vehicles) is relatively small, while the largest share of exports consists of food, furniture (articles of wood) and chemical products, the complexity of which is considered to be lower (although chemical products may be fairly complex). It should be noted that the structure of Lithuanian exports in 2017, compared to a decade ago, has broadly remained unchanged: the largest groups of exported products have not changed and distribution by complexity remained similar, yet diversification has been increasing. Therefore, progressing towards manufacturing of more complex goods is rather slow-paced. It is worth noting that even though diversification in Lithuania is comparatively high and it is classified as a country that should naturally move towards higher-complexity exports and industries (Freire 2017³¹), this is a long-term process. Moreover, growth of exports of medium-complexity rather than high-complexity technologies is the most robust in Lithuania's export structure.

²⁴ For more information on the complexity of Lithuanian exports and their structural changes, see the Bank of Lithuania's publication "Convergence factors of Lithuania's economy and the importance of the labour market" to be published at the end of 2019.

²⁵ Hausmann R., Hwang J., Rodrik D. 2005: *What You Export Matters*. National Bureau of Economic Research, Working Paper No. 11905.

²⁶ Hausmann R., Hidalgo C. 2009: *The Building Blocks of Economic Complexity*. PNAS, Vol. 106, No. 26, 10570-10575.

²⁷ Henn C., Papageorgiou C., Spatafora N. 2015: *Export Quality in Advanced and Developing Economies: Evidence from a New Dataset*. WTO, Working Paper ERS-2015-02.

²⁸ McMillan M. S., Rodrik D. 2011: *Globalization, Structural Change and Productivity Growth*. NBER Working Paper No. 17143.

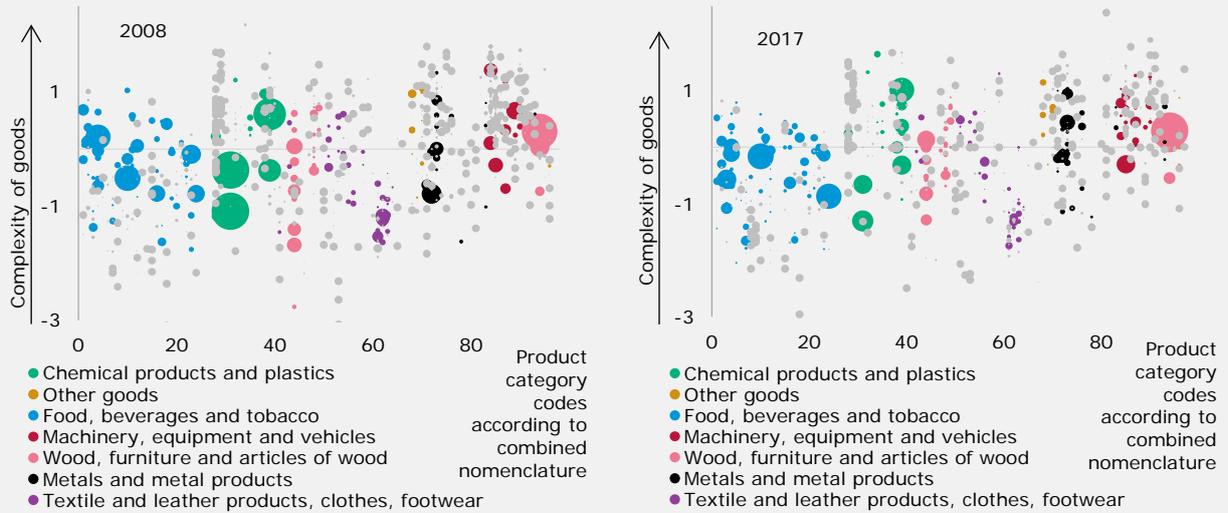
²⁹ For more details on this index, see <https://atlas.media.mit.edu/en>.

³⁰ A country has a revealed comparative advantage in a particular product if the ratio of exports of this product exceeds the total world trade that the product represents (based on Balassa's (1965) methodology). It reveals the country's manufacturing specialisation.

³¹ Freire C. 2017: *Promoting Structural Transformation: Strategic Diversification vs. Laissez-faire Approach*. United Nations, DESA Working Paper No. 151.

The structure and complexity of exported goods remained largely unchanged over the last decade: Lithuania specialises in medium-complexity product groups, yet diversification is gaining momentum.

Chart A. Lithuanian exports* classified by complexity**



Sources: Statistics Lithuania, Atlas of Economic Complexity and Bank of Lithuania calculations.

Sources: Statistics Lithuania, Atlas of Economic Complexity and Bank of Lithuania calculations.

* Of Lithuanian origin, excluding mineral products.

** Grey colour marks product categories that are not exported and in which Lithuania does not have a revealed comparative advantage (it means that the ratio of exports of that product in the country does not exceed the ratio in total world trade).

Even though growth of the complexity of Lithuanian exports is low, up until now it has put no significant limitations to convergence. On the one hand, the complexity of exports is only one of many factors determining convergence as other important factors, including the quality of human capital and institutions, investment, and structural changes in the economy, play an important role as well. On the other hand, the complexity index does not fully include such aspects as changes in the quality of manufactured goods, improving labour productivity and efficiency in companies or the benefits of economy of scale. Lithuanian exports are quite well diversified and a significant amount of more complex goods is exported, even though their share in the whole structure of exports is still modest. It suggests that the country has the capacity and competence to produce more complex goods as well. Aiming for further income convergence, this potential has to be significantly increased.

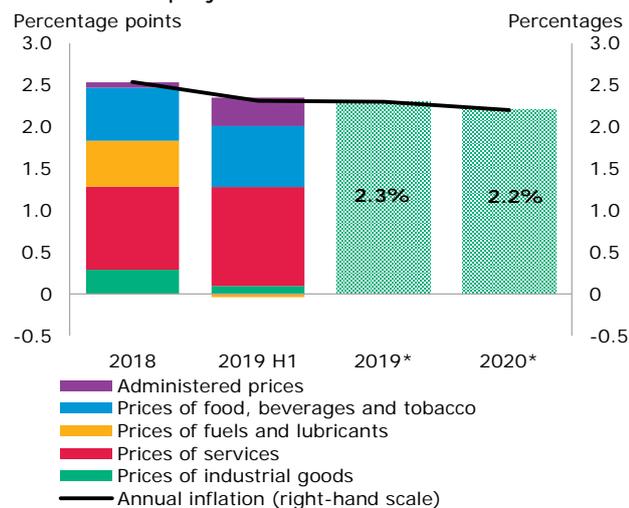
VI. PRICES

In the first half of 2019, volatility in headline inflation reflected recent developments in food, fuel and energy prices. Annual inflation stood at around 1.6% in the beginning of the year but later picked up due to stronger increases in food prices (including alcohol and tobacco). Administered prices had a much greater impact on annual inflation during the first half-year compared to 2018, whereas the effect of oil prices on headline annual inflation decreased. Such developments led to a 2.3% average level of headline inflation in the period from January to July, which is 0.7 percentage point higher than the level recorded in early 2019. Even though this year's annual inflation is more strongly affected by food prices (including alcohol and tobacco) as well as administered prices, rapidly rising prices of services remain the main inflation driver in Lithuania (see Chart 17).

A stable rise in prices of services accounts for around half of headline inflation. The growth in prices of services, standing at almost 5%, is related to high domestic demand. The latter is underpinned by the strengthening purchasing power of households reflecting continuing rapid wage growth and increasing social benefits. However, robust wage growth is projected to slow down in the future. According to the Bank of Lithuania's projections, this year's wage growth should moderate³² to 8.5%, whereas in 2020 it should remain rapid, yet slow down to 6.7%³³. Despite this fact, even if next year's wage growth moderates as projected, the purchasing power of the employed will keep increasing which, in turn, will further stimulate both the demand and prices of goods and services (see Chart 18).

Prices of services remain the main driver of inflation in Lithuania.

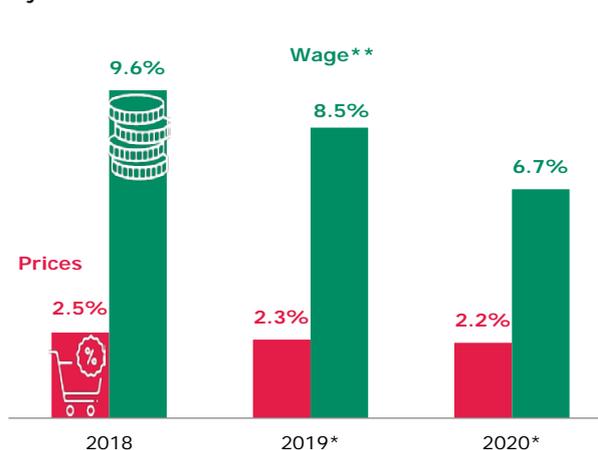
Chart 17. HICP inflation, contributions to HICP inflation and projections



Sources: Statistics Lithuania and Bank of Lithuania.
*Bank of Lithuania projections.

The gap between price and wage growth remains significant.

Chart 18. Annual inflation, wage growth and projections



Source: Statistics Lithuania
*Bank of Lithuania projection.
**Wage projection for 2019 excludes corrections made due to changes in the tax and pensions systems.

The growth of food prices, including alcohol and tobacco, has followed a steady upward trend since early 2019. Adverse weather conditions led to a reduced supply of some vegetables and their increased farm-gate prices. These developments resulted in roughly 20% higher vegetable prices compared to the previous year. More rapidly increasing prices of meat products had a somewhat weaker yet still noticeable upward impact on food prices as well. The growth rates of meat prices escalated with an outbreak of swine fever in China that drove pork prices up. However, it was not only external factors that contributed to growing food prices. For example, another driving factor is an excise duty rate for tobacco and ethyl alcohol that was increased in March 2019. Taken together, these factors push up inflation by nearly 0.1 percentage point.

³² The Bank of Lithuania's wage projection for 2019 excludes corrections made due to changes in the tax and pension systems.

³³ For more information on the reasons behind the potential slowdown in wage growth, see Chapter IV "Labour market".

However, there has been some good news for consumers this year as fruit prices went down by almost a tenth, while milk and eggs were slightly cheaper on average when compared to 2018. Furthermore, this year's grain yield is also expected to be higher than a year ago³⁴ and this may lead to more consumer-friendly prices of grain products in the future.

This year, the impact of energy prices on inflation has been uneven. In the beginning of 2019, electricity and gas prices that increased by more than 10% due to the changed market conditions³⁵ exerted the strongest upward pressure on inflation in the last five years. However, the Brent crude oil market saw slightly different trends – having fallen to less than 60 US dollars per barrel around the turn of the year, the crude oil price later increased, yet has again recently been fluctuating around 60 US dollars. Based on oil price futures, market participants seem to expect average oil prices this year to remain at the same level as in 2018. In this case, the influence of crude oil prices on inflation would be very limited. Nevertheless, amid high uncertainty in the geopolitical arena, crude oil prices may become even more volatile than expected.

With Lithuania's economy growing rapidly and converging with Western European countries, the annual inflation rate is projected to exceed 2%. According to the Bank of Lithuania's projections, annual inflation in 2019 should remain at the similar level as in the first half of the year and stand at around 2.3%, whereas next year it should slightly decrease to 2.2%. According to the available data, headline inflation is not expected to show larger or long-lasting fluctuations. However, unexpected developments in global commodity prices may always occur due to geopolitical uncertainties and adverse weather conditions.

³⁴ Information is based on the projections of the Lithuanian Institute of Agrarian Economics as of 20 June 2019.

³⁵ For more details, see Box 2 "[Impact of higher energy prices on inflation and household consumption](#)" of the Lithuanian Economic Review (March 2019).

VII. FINANCING OF THE ECONOMY

With savings exceeding investment rates, net lending is prevalent in Lithuania's economy.

Moreover, it has been increasing for the last couple of years. National disposable income has been rising more rapidly than final consumption expenditure, which means that savings in the country are increasing and, along with capital transfers from abroad, are exceeding net capital formation which results in net lending of the economy (see Chart 19). According to the latest financial accounts, net lending has in recent years been characteristic of both the private and the public sectors. With the growth of financial assets surpassing the growth of liabilities, conditions for the decrease of net financial liabilities (the difference between financial liabilities and assets) remain favourable. The public sector has been successfully reducing net financial liabilities, whereas non-financial corporations' ratio of net financial liabilities to GDP has been rather stable for the last five years. Financial assets of households are exceeding their financial liabilities – in the first quarter, the ratio of net financial assets to GDP was the highest since 2004 when such data was first compiled.

Growth in the MFI corporate loan portfolio decelerated for the first time in four years. The annual growth rate of the MFI corporate loan portfolio decreased in the beginning of 2019. At the end of the second quarter, its annual rate shrunk by 3.6%. These trends might have been led not only by the base effect³⁶ but also by tighter financing conditions of some credit institutions³⁷ as well as high concentration in the banking sector. Greater concentration strengthened banks' ability to choose their clients and may have also contributed to the increasing interest rates on new corporate and household loans. For example, in the first half of 2019, the average interest rate on new loans issued to non-financial corporations stood at around 2.9% (a year-on-year increase of nearly 0.35 percentage point). Looking at individual activities, it should be noted that during the first half of the year credit institution loans, on average, mostly increased for companies engaged in transportation and storage (around 16%) as well as accommodation and catering (6%), whereas they decreased for information and communication (19%) and energy supply (20%) companies. However, despite the shrinking MFI corporate loan portfolio, financial account data suggests that corporate funding from other sources (e.g. trade credit, loans from other non-financial corporations, debt securities) is growing. On the other hand, despite increasing non-bank lending, banks remain an important source of funds for financing long-term investments. For example, in 2018 their share in the financing structure of corporate investment increased from 23% to 26%, making banks the second most important source of financing (own funds accounted for 53%).

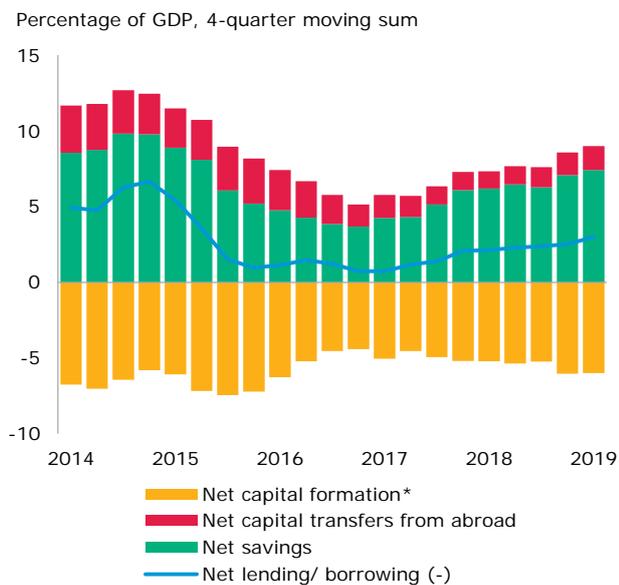
Fuelled by housing loans, growth in the household loan portfolio remained robust. In the first half of 2019, the average annual growth of household loan portfolio accounted for more than 8% (a year-on-year increase of about 1 percentage point). Its rapid growth was supported by the housing loan portfolio which grew by nearly 9% during the same period, whereas the growth of consumer and other loans portfolio stood slightly above 6%. Growth in household loans continued to be mainly driven by relatively low unemployment and rapid wage growth. This had a positive impact on household expectations – consumer confidence kept improving, as did the prospects of purchasing more expensive items. On the other hand, growth in new housing loans might be limited by their rising interest rates the average of which stood at around 2.4% in the first half of 2019 (a year-on-year increase of nearly 0.2 percentage point). However, interest rates on consumer loans are following a downward path – during the same period, their annual average stood at around 10.8% (a year-on-year decrease of about 0.7 percentage point).

³⁶ A year ago, crediting of companies engaged in professional, scientific and technical activities (including holding companies) significantly increased but it was a one-off factor.

³⁷ As shown by [the Review of the Survey of Enterprises](#) conducted by the Bank of Lithuania.

More savings than investments are recorded in the country; net lending to foreign countries prevails.

Chart 19. Drivers of net lending

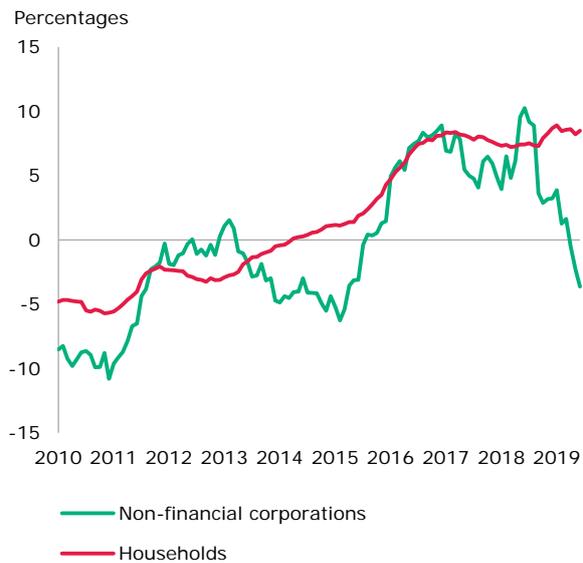


Sources: Statistics Lithuania and Bank of Lithuania calculations.

*Gross capital formation reduced by fixed capital consumption; a negative figure means that capital formation exceeds its consumption.

The MFI corporate loan portfolio was shrinking, while the growth rate of household loan portfolio remained high.

Chart 20. Annual growth rate of the portfolio of MFI loans issued to non-financial corporations and households



Source: Bank of Lithuania.

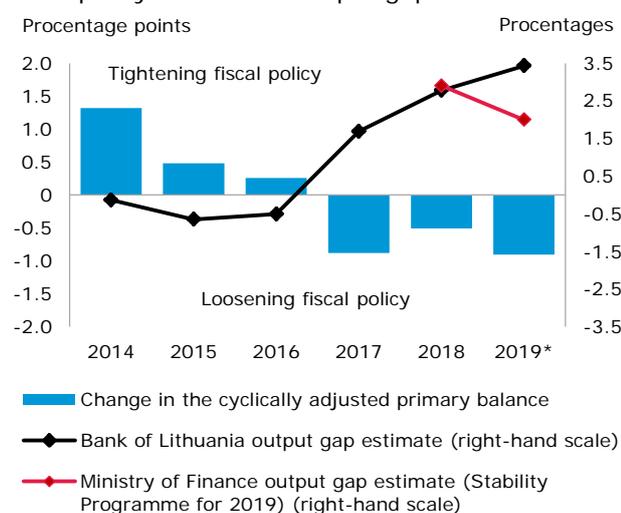
VIII. GENERAL GOVERNMENT FINANCE

In recent years, Lithuania's fiscal policy tends to be pro-cyclical: although the economy is at its peak, fiscal policy remains accommodative. This means that when economic activity is above its potential level, fiscal incentives give an additional boost to economic activity rather than put a damper on it. Fiscal loosening is reflected by the deteriorating cyclically adjusted primary balance³⁸ (see Chart 21). This stance is determined by discretionary decisions affecting both general government revenue and expenditure. The decisions taken in 2019 include the increase of the tax-exempt income threshold, the reduction of personal income tax and social insurance contribution rates (in total 1.55 percentage points) as well as rising public sector wages and higher social benefits. As a result, at the beginning of the year, general government expenditure grew at a similar pace as last year (about 10%), with slower growth on the revenue side (standing at 4.6% in the first quarter).

Expansionary (loosening) fiscal policy pursued during the economic upswing points to pro-cyclicality of fiscal policy.

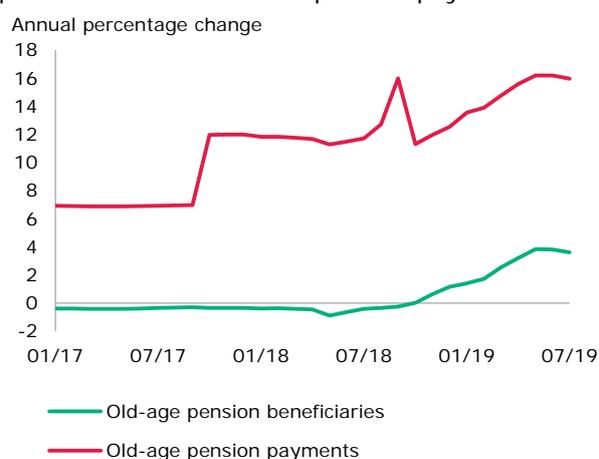
Old-age pension payments have recently been rising at a solid pace on account of increases in old-age pensions and the number of beneficiaries.

Chart 21. Dynamics and projection of Lithuania's fiscal policy stance and output gap



Sources: Statistics Lithuania and Bank of Lithuania calculations.
*Bank of Lithuania projection.

Chart 22. Dynamics of the number of old-age pension beneficiaries and pension payments



Sources: SSIFB and Bank of Lithuania calculations.

It may not be easy to maintain fiscal discipline in the medium term due to the projected economic deceleration and authorities' decisions relating to additional expenditure. The expected weaker economic growth, an increase of the tax-exempt income threshold envisaged for 2020-2021 and the lowering of a ceiling on social insurance contributions will weigh on growth of general government revenue, while pressures on expenditure growth are likely to persist. Recently, higher social payments and wage-related expenditures have been among the main drivers contributing to the robust expenditure growth. The rising social payments are mainly underpinned by increases in old-age pensions due to indexation and adjustment as well as by the expanding number of old-age pension beneficiaries. Although the latter this year mainly reflects the fact that after the pension system reform a greater share of persons started receiving higher old-age pensions instead of disability or invalidity pensions, the impact of the population ageing will become increasingly hard to ignore. Expenditure on wages in the public sector should also continue to grow, especially if a strategy for financing the remuneration of public sector employees³⁹ will be implemented (it has not been approved yet). The strategy, among other things, foresees the rise of wages to 3 average wages for medical doctors and to 1.2-1.3 average wages for teachers as well as the increase of the basic monthly salary rate. Accordingly, this should also put an upward pressure on expenditure growth.

³⁸ The cyclically adjusted primary balance is calculated by adjusting the nominal general government balance for the cyclical position of the economy and interest payments. This allows assessing what the balance would be when cyclical revenue and expenditure are excluded; therefore, it shows the underlying situation of general government finance.

³⁹ http://lr.v.lt/uploads/main/documents/files/Strategijos%20projektas_2.pdf