LITHUANIA'S ECONOMIC DEVELOPMENT AND OUTLOOK

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The Bank of Lithuania has substantially upgraded its GDP forecast for Lithuania as a result of the better-than-expected economic performance observed in the first half of 2020. It now projects that the country's real GDP will fall by 2.0% in 2020. The damage sustained by Lithuania's economy has so far been relatively moderate. Despite rather stringent lockdown measures introduced in spring that put a hamper on some economic activities, the economic downturn in Lithuania in the second quarter of 2020 was among the mildest across the EU, as the country's real GDP declined only by 4% year-on-year.[1] Overall, the economic contraction in 2020 will be less pronounced than previously expected thanks to more favourable economic dynamics, less severe labour market conditions and additional fiscal, regulatory and monetary policy measures rolled out to support the economy. According to current forecasts, Lithuania's economy is expected to rebound as early as in the second half of 2020, and to reach its pre-crisis levels in 2021. Given the less pronounced contraction this year, growth trends for the year to come should unfold in a similar vein – Lithuania's real GDP is projected to increase by 3.1% in 2021. The economy will benefit substantially from fiscal measures, which may add 2.3 percentage points to the country's GDP growth in 2020 and 2.6 percentage points in 2021. These forecasts have been underpinned by the assumption of potential resurgence in COVID-19 infections in Lithuania and the rest of the world, which, however, this time round would not entail stringent virus containment measures, such as a nationwide lockdown. Scientists are not expected to introduce a medical solution to the general public before 2021, which implies that growth is set to be constrained by high epidemiological and economic uncertainty.

The COVID-19 pandemic has caused a major shock to the global economy. Millions of COVID-19 cases, growing hospitalisation rates, including overwhelmed hospitals in some countries, as well as a shortage of equipment and supplies prompted policymakers to take stringent measures to contain the spread of the virus. The threat of the pandemic and government restrictions led to an enormous slump in global economic activity, disruptions in production and supply chains, a fall in international trade flows as well as a decline in consumer and business expectations. The world's major economies failed to avoid a huge downturn despite large-scale fiscal stimulus and monetary policy measures that had been put in place. In the second quarter of 2020, the US economy plunged by more than 9% year-on-year, whereas the euro area and the UK recorded annual declines of 15% and more than 20% respectively. Nonetheless, the easing of restrictions on mobility and business across countries triggered some recovery in global trade, activity and economic outlook. Meanwhile, China – which recorded improvements in the epidemiological situation ahead of other regions – saw its economy return to positive growth rates already in the second quarter of 2020.

Weakening external demand has weighed on Lithuania's exports of goods and services, yet there already are some signs of recovery. The pandemic and its containment measures introduced by the governments of Lithuania's major export partners have led to a significant drop in external demand. As a result, Lithuania's real exports of goods and services slumped by more than 8% year-on-year in the second quarter of 2020. However, the decline was substantially less pronounced compared to external demand. This was determined by the structure of the country's exports, given that investment goods and travel services, i.e. the most affected categories, account for a relatively minor share of Lithuania's foreign sales. Moreover, Lithuania, contrary to some other countries, did not impose any operational restrictions on manufacturing during the lockdown. The country's imports of goods and services decreased more than exports, which in turn led to a rise in net exports that made a positive contribution to Lithuania's real GDP growth. The tradable sector has already started showing tentative signs of gradual recovery: since June manufacturing output volumes (excluding mineral products) have been rising, while the manufacturing capacity utilisation rate and

[1] Based on data adjusted for seasonal and workday effects.

exports of Lithuanian-origin goods (excluding mineral products) have increased. However, industry surveys suggest that local industrial firms still face insufficient demand. Exports are projected to fall by 3.8% this year, i.e. much less than previously expected. In 2021, the recovery of external demand will propel the growth of exports to 6.9%, which will become the key driver of economic recovery.

Despite heightened uncertainty and deterioration in the labour market, the slump in private consumption was less severe than feared at the onset of the pandemic. The restrictions imposed due to the health crisis and a rise in economic uncertainty have led to an annual fall of more than 5% in household consumption expenditure in the second quarter of 2020. However, household consumption has already switched to a very rapid recovery mode. As a result, retail trade turnover exceeded its last year's level already in May – this was mainly driven by the sound financial stance of the country's households, supported by the growing wage bill and social transfers, as well as improving consumer confidence after the end of the lockdown. Even though the labour market took a turn for the worse, unemployment rose less than projected, with its rates going up by mere 2.4 percentage points year-on-year, to reach 8.5% in the second quarter. A larger increase in unemployment was stifled by better economic releases, government support to the country's corporate sector affected by the pandemic and the rebound in economic activity. The more positive economic situation also suggests that the labour market development in the projection horizon should be more favourable than previously anticipated, and the economic recovery should send the unemployment rate on a downward path as early as at the end of 2020. The average wage in the country should increase by 6.8% in 2020 due to this year's hike in the minimum wage, rapid wage growth in the public sector and better-than-expected economic performance. In 2021, however, wage growth should slow down to 3.1%, on the back of the prevailing elevated uncertainty and less pronounced labour shortages. Private consumption is projected to shrink by a meagre 2.4% in 2020 and rise by 3.9% in 2021, i.e. less than previously expected, due to the higher comparative base.

Investment has been hit by both the pandemic and the EU Mobility Package. In the second quarter of 2020, investment volumes in Lithuania fell by more than 11% year-on-year. The downward effect on private investment from the pandemic and the prolonged economic uncertainty was exacerbated by developments in the transport sector, triggered by the gradual rollout of the EU Mobility Package. As a result, investment in vehicles plummeted by an annual 75% in the second quarter of 2020. During the projection horizon, weak demand, heightened uncertainty and shrinking financial resources of the country's corporate sector are expected to further weigh on investment growth in the private sector. At the same time, public investment should boost investment growth thanks to the fiscal measures adopted by the authorities. However, a less effective than expected use of fiscal stimulus funds may bring up certain challenges. Investment is projected to decrease by 7.7% this year, before rebounding to 6.4% in 2021.

Since the country's economic outlook is clouded by high uncertainty, the Bank of Lithuania has set out two alternative scenarios – a severe and a mild one – in addition to the baseline scenario. The severe scenario assumes a significant deterioration in the global epidemiological situation at the end of 2020 and in early 2021, in response to which policymakers of the world's major economies would reintroduce restrictions on economic activity, albeit less stringent than in spring 2020. Other assumptions include the introduction of a medical solution to fight COVID-19 in mid-2021, which, however, would not be immediately effective, as well as the deterioration in the financial environment amid increased insolvency and the stalling of external demand early in 2021. Under this scenario, it would take until the second half of 2021 for Lithuania's economy to gather speed. In this case, the country's GDP would contract by 2.4% in 2020 and should remain unchanged in 2021. Meanwhile, the mild scenario assumes a stabilisation of the epidemiological situation across the globe after the current surge in COVID-19 cases, which would render stronger constraints on economic activity unnecessary, as well as the emergence of an effective medical solution in mid-2021. Business and household confidence rates would start improving, while the recovery of global economy would encourage the easing of financing conditions. Based on this scenario, the country's GDP would only decrease by 0.2% in 2020, before increasing to 5.0% in 2021. According to the mild scenario, the economy would get back to the pre-crisis levels already this year, yet it would take Lithuania until 2022 to return to this level under the severe scenario.

Weaker economic activity and lower energy prices will exert downward pressure on consumer prices. With the world still battling the pandemic, prices of crude oil and food commodities are projected to remain depressed this year, which will continue to dampen inflation. Next year, however, the recovery of global economy should accelerate the rise in crude prices. Meanwhile, the expected slower wage growth should diminish pressure on prices of services – the average annual growth in prices of services is projected to decelerate to 4% in 2020, whereas in 2021 it should increase at a rate slightly above 2%. Average annual inflation is expected to be 1.0% in 2020 and to reach 1.2% in 2021.

Outlook for Lithuania's economy

Indicators	September 2020 projection			June 2020 projection		
	2019	**2020[b]**	**2021[b]**	**2019**	**2020[b]**	**2021[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	2.2	1.0	1.2	2.2	0.6	0.9
GDP deflator[c]	3.0	0.7	1.4	3.0	-0.4	1.0
Wages[d]	8.8	6.8	3.1	8.8	-2.6	2.0
Import deflator[c]	-0.6	-5.5	1.3	-0.6	-3.8	0.6
Export deflator[c]	0.8	-4.1	0.8	0.8	-4.1	0.4
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	3.9	-2.0	3.1	3.9	-9.7	8.3
Private consumption expenditure[c]	3.2	-2.4	3.9	3.2	-12.5	8.6
General government consumption expenditure[c]	0.7	0.3	0.3	0.7	2.9	0.8
Gross fixed capital formation[c]	7.3	-7.7	6.4	7.3	-8.0	5.4
Exports of goods and services[c]	9.6	-3.8	6.9	9.6	-13.8	14.6
Imports of goods and services[c]	5.9	-6.1	8.4	5.9	-10.5	12.6
Labour market						
Unemployment rate (annual average as a percentage of labour force)	6.3	8.8	8.1	6.3	11.9	8.8
Employment (annual percentage change)[e]	0.3	-1.5	0.6	0.3	-5.0	3.1
External sector (percentage of GDP)						
Balance of goods and services	5.4	7.6	6.6	5.4	2.2	3.5
Current account balance	4.2	6.7	4.8	4.2	1.8	1.8
Current and capital account balance	6.0	8.9	6.9	6.0	4.2	3.7

[a] The projections of macroeconomic indicators are based on international environment assumptions based on information published by 18 August 2020 as well as other data and information made available before 31 August 2020.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] Wage growth for 2019 excludes corrections made due to changes in the tax and pension systems.
[e] National accounts data; employment in domestic concept.