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Lithuania’s economic development and outlook

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Russia’s war in Ukraine and the renewed pandemic in China are dampening global economic growth. With rising commodity prices, disrupted supply chains and geopolitical uncertainty, the war has affected many countries around the world, not only those that have close trade and financial ties to Russia and Ukraine. While these factors are primarily slowing down the growth of economies, they are also contributing significantly to rising inflationary pressures around the world, which will have a more profound impact on emerging market economies where expenditure on food and energy account for a bigger share of consumer spending. In developed economies, inflationary pressures are also being exacerbated by wage increases, driven by tight labour markets and strong domestic demand. The re-emergence of the pandemic and restrictive prevention measures in Asia, especially in China, have contributed significantly to increasing disruptions in supply chains, which had already shown signs of letting up. In many countries around the world, rapidly rising prices are forcing central banks to tighten their monetary policies, which will in turn tighten financial terms for households and businesses. All these factors, via international trade and financial links, have a bearing on economic activity and price dynamics in Lithuania, too.

Three months after the outbreak of Russia’s war against Ukraine, the Lithuanian economy is showing strong resilience. Monthly turnover data for the largest sectors of the economy – industry, construction, trade and services – showed no significant signs of decline in March and April. The daily updates of the number of insured persons for all types of social security, published by Sodra, also show that so far there has been no correction in the number of employed persons. Only relatively small corrections have been observed in sentiment among the population and businesses. Compared to previous crises, the current trends in both the consumer confidence indicator and the economic confidence indicator are more similar to those observed in 2014, when Russia imposed an embargo on some goods produced in the EU, rather than to those observed at the beginning of the COVID-19 pandemic or during the global financial crisis. It should be noted that in 2014 through 2015 the Lithuanian economy did slow down, but a contraction in economic activity was avoided. Although a more significant economic downturn in 2022 is still unlikely, disruptions to supply chains caused by the war and the pandemic and the rising inflationary pressures have led to a slight decline in household consumption in the first quarter of 2022 as compared with the end of 2021. On the other hand, investment and exports of goods and services saw a relatively strong expansion, despite the current negative factors. It should be noted that in the first quarter of 2022, the acceleration of investment was hampered by supply disruptions and higher commodity prices, which hindered the execution of investment projects by both the public and private sectors.

Labour market tensions did not ease in the first quarter of 2022. During this period, the number of employed persons continued to increase, and the unemployment rate fell to 6.3%[1], a level close to that observed before the pandemic. The fact that labour market tensions remain unabated is reflected in the share of companies reporting staff shortages as a limiting factor, which remains close to the highest level since the onset of the global financial crisis and can be observed in all major sectors of the economy, including construction, industry, trade and services. The current high demand for workers is also reflected in the job vacancy rate, which reached the record level of 1.9% in the first quarter of 2022. The last time such a high indicator was recorded was in 2008, a period when the Lithuanian economy was in a state of overheating. So far, the labour market tensions have been reduced only to a limited extent by the arrival of war refugees from Ukraine. Almost a third of the working-age Ukrainians who have arrived in Lithuania are currently employed, while another 6,300 have registered with the Employment Service. However, the skill set of the incoming migrants does not necessarily match the current labour

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

market needs; in addition, it is likely that a significant number of these immigrants will stay in Lithuania only temporarily. The current labour market situation is one of the main reasons behind the rapid increase in wages, which rose by 14.0% year-on-year in the first quarter of 2022. Salaries in the private sector grew significantly faster than in the public sector, by 16.2% and 9.7% respectively. It is likely that part of the acceleration in the nominal wage growth is related to higher inflationary expectations among employees.

In the coming years, the development of the Lithuanian economy will be mainly influenced by the course of Russia's war against Ukraine, global pandemic management and supply chain disruptions. The nature of these factors means that the country's economic outlook is currently shrouded in extreme uncertainty. The constantly evolving situation in Ukraine and the expanding sanctions against Russia, which have led to a significant increase in commodity prices, will dampen economic growth in both Lithuania and its main trading partners. Demand for Lithuanian goods and services in foreign markets is projected to decline in 2022 and, although it is expected to start recovering from the beginning of 2023 onwards, it may not reach the level reported before Russia's invasion of Ukraine until the end of 2023. This kind of external demand development will be among the key factors leading to a more sluggish export growth, which will be further dampened by the service-exporting transport sector as it is facing challenges of its own. The less favourable development of the exporting sector is one of the main factors behind the weaker-than-expected investment growth, especially in 2022. However, the expected significant increase in public sector investment and the momentum in the housing market will allow investment to pick up this year, while a recovery in private sector investment is anticipated in 2023. Rising inflationary pressures will constrain domestic consumption not only in major trading partners, but also in Lithuania. While nominal wages will continue to rise rapidly, higher inflation will cause real wages to fall in 2022 for the first time in a decade. This, together with the expected tightening of monetary policy and the resulting increase in interest rates, will be the main factors limiting the growth of household consumption. However, real disposable household income will continue to rise slightly this year, driven by the government's inflation impact reducing package and growth in incomes other than wages, to be followed by a faster pick up again next year as inflation starts falling. This, combined with a declining savings rate, will enable households to sustain relatively strong consumption growth. All of these factors should lead to economic growth in Lithuania in the coming years. Lithuania's real GDP is projected to increase by 2.1% in 2022 and by 3.4% in 2023. At the same time, it should be noted that such a forecast of economic development in Lithuania is subject to a high degree of uncertainty, and the balance of risks currently observed is strongly negative, i.e. there is a significantly higher probability of a downward rather than upward revision of the economic outlook.

Intensifying supply disruptions and rising energy and food commodity prices continue to exacerbate inflationary pressures across all markets. Annual inflation in Lithuania reached 18.5% in May, also rising in the neighbouring Baltic States and the euro area as a whole. After a slight reduction in supply chain tensions at the beginning of the year, Russia's war against Ukraine and the resulting changes in trade flows as well as an increase in COVID-19 cases in Asia have exacerbated supply chain tensions again. Supply problems, combined with rising energy and food commodity prices, have had a particularly strong impact on consumer prices for industrial goods, energy and food. Food prices have started to rise sharply in recent months, with prices in May almost 25% higher than a year earlier. The annual increase in global food commodity prices of nearly 30% in April, higher milk purchasing prices and disruptions to cooking oil supplies from Ukraine have all contributed significantly to food price hikes. Higher prices for food commodities, fertilisers and animal feed are expected to affect the prices of future harvests and livestock production, leading to further food price increases. Markets are also pricing in a faster-than-expected rise in crude oil prices, weighing on the outlook for energy prices. Based on assumptions derived from futures data, this year crude oil prices are expected to advance higher than previously thought – to an average of USD 106 per barrel – before falling back to USD 93 per barrel next year as the oil market gradually stabilises. With oil and gas prices falling, energy price increases are expected to subside in 2023. In addition to external factors, inflation in Lithuania is also affected by strong domestic demand, which facilitates the pass-through of cost increases to the prices of final consumption goods and services. This influence is reflected in service prices, which are most closely linked to domestic economic development. They are rising faster, recording an annual growth rate of 11.9% in May. Prices for services are projected to rise at an average annual rate of 10.6% this year, before slowing down to 5.7% in 2023. Given the evolving situation in commodity markets, the intensification of supply disruptions and the higher-than-expected pass-through of cost increases to the prices of final consumption goods and services, average annual inflation is projected at 15.2% this year, before declining to 4.6% in 2023 as supply disruptions fade away and the prices of energy resources decline.

Table 1. Lithuania's economic outlook

	June 2022 forecast[a]			March 2022 forecast		
	2021	**2022[b]**	**2023[b]**	**2021**	**2022[b]**	**2023[b]**
Price and cost developments (annual percentage change)						
Average annual HICP inflation	4.6	15.2	4.6	4.6	10.5	2.7
Gross Domestic Product deflator deflator[c]	6.6	15.2	5.0	6.6	8.4	3.3
Wages	10.6	11.9	8.1	10.5	10.7	7.7
Import deflator[c]	11.6	19.9	4.5	12.0	7.5	1.9
Export deflator[c]	5.7	13.7	5.6	5.9	6.3	3.0
Economic activity (constant prices; annual percentage change)						
Gross domestic product[c]	4.9	2.1	3.4	4.8	2.7	2.7
Private consumption expenditure[c]	7.3	5.4	3.8	7.2	4.7	4.9
General government consumption expenditure[c]	0.6	1.5	−1.3	0.5	0.0	0.0
Gross fixed capital formation[c]	7.0	4.1	3.5	7.0	5.6	3.6
Exports of goods and services[c]	15.9	7.4	2.9	14.1	5.2	1.9
Imports of goods and services[c]	19.4	9.8	2.8	17.8	5.3	3.6
Labour market						
Unemployment rate (annual average as a percentage of labour force)	7.1	7.3	7.2	7.1	7.1	7.3
Employment (annual percentage change)[d]	1.2	0.6	0.3	1.2	1.0	−0.8
External sector (percentage of GDP)						
Balance of goods and services	4.2	−1.9	−0.9	3.8	3.0	2.5
Current account balance	1.2	−4.5	−3.8	1.6	0.6	0.1
Current and capital account balance	2.7	−2.5	−1.8	3.0	3.3	2.8

[a] The projections for macroeconomic indicators are based on assumptions about the international environment and other data and information published by 18 May 2022.
[b] Projection.
[c] Adjusted for seasonal and workday effects.
[d] National accounts data; employment in domestic concept.

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