

Macroeconomic developments and outlook for the Lithuanian economy

24 January 2008

Conjectural Developments

In the third quarter of 2007, the economic growth accelerated to 10.8% (compared to 8.1% in the first half of 2007) reflecting the impact of temporary factors such as a strong performance of the agricultural sector and higher level of activity in the oil-refining sector. Due to these factors export growth accelerated and current account deficit decreased to 12.3% of GDP.

The economic growth remains robust due to fundamental factors, which is in line with the Bank of Lithuania October projections. Supported by household disposable income, private consumption growth continues to be strong and is close to the 4-years average. Disposable income developments reflect credit growth and fiscal stimulus. Against the background of low interest rates and expectations about high profitability rates investment growth remained robust.

Labour force increased for a second consecutive quarter on the back of rising participation rate. There was an increase in employment in construction and several service sectors and a decrease in agricultural sector. However, the tensions in the labour market remain sizeable as the number of vacancies reached its historical highs. In the private sector (excluding agriculture) the vacancy rate stood at 2.5%. The overall wage level continued to rise, reflecting labour market tightness and institutional factors. However, the growth rate of the average wage slowed down in the third quarter of 2007.

In the second half of 2007, the annual headline inflation rate was rising. The increase was mainly driven by food price inflation, which in turn resulted from high growth in milk and milk products prices and an increase in bread and meat prices. The developments in food prices reflect global trends: excess demand for agricultural products and processed food in the developing countries is supported by strong economic growth. The contribution of fuel prices to the headline inflation increased in September 2007 influenced by high oil prices. Persistent growth in services prices, supported by both, domestic demand pressures and supply-side factors also had an upward impact on the headline inflation rate.

Outlook for 2007-2009¹

Real Sector

The overall assessment of the medium-term economic growth trends and outlook for the main factors of the projected cyclical downturn remains the same as in the October projection. Economic growth will steadily slow down in 2008-2009 and converge to a potential level. This will be mainly driven by a slowdown in domestic demand due to a declining credit flow and resource constraints in the labour market. The changes in the GDP growth outlook are mainly driven by short-term factors related to developments in specific sectors. In 2007-2008, the real GDP growth is forecasted to exceed 8%, and a slowdown is expected in 2009 when the GDP growth rate is expected to decrease to 6%, reflecting more balanced growth.

The acceleration in the growth rate in the third quarter of 2007 was due to one-off factors and a low base effect. The economic growth is projected to slow down in the fourth quarter of 2007, but the outlook for the real GDP growth rate in 2007 remains unrevised since October projection round (8.5%). The projections for real GDP growth in 2008-2009 were increased slightly, reflecting stronger export and government consumption growth rate, which is expected to be partly offset by more negative outlook for investment.

¹ January 2, 2008 is the cut-off date for data used in these projections.

The growth rate of gross fixed capital formation is projected to decrease from 14.7% in 2007 to about 7-8% in 2008-2009. The investment forecast was revised downwards against the background of lower profitability expectations in the transport and real estate sectors.

The projection of private consumption for 2007 is in line with the previous outlook. Despite the fact that nominal disposable income is expected to grow faster than projected earlier, due to employment growth and government transfers, the projection for real disposable income is unchanged, against the background of higher inflation rate. In 2008 private consumption growth is expected to remain robust, and slow down gradually over the medium term.

The projected development of foreign trade and current account deficits are more favourable compared to the previous October forecast. In 2007-2009 current account deficit is expected to remain at 13.5 – 14% GDP. As the projected recovery of the capacity in the oil refining sector is postponed to the first quarter of 2008 instead of the previously expected fourth quarter of 2007, the real export growth projections for the year 2008 are revised upwards. Due to a rise in prices for agricultural goods and food in the world markets, forecasts of export prices and nominal export growth are revised upwards. Import developments in 2008-2009 will be reflecting a slowdown in investment and a recovery of oil import. The income balance is projected to be widen (-4.2% of GDP) due to higher return on foreign investment. Over the projection horizon the income imbalance is projected to increase to -3.8% of GDP, reflecting the cyclical downturn.

In the context of a continuing growth of the participation rate in the second half of 2007, a faster growth in labour force and employment is projected. Compared to the previous forecast the projection for unemployment rate is slightly lowered. A slowdown in transport, construction and real estate sectors should influence the labour market and the growth in wages in these sectors is projected to slow down in the nearest quarters. Later, as the labour demand-supply gap will narrow, the same tendencies should be transmitted to the other sectors. Meanwhile, the growth in wages in 2008 will still remain strong partly due to institutional decisions.

Price developments

Due to a rapid growth in food and fuel prices, the average HICP annual inflation in 2007 exceeded the October projection by 0.5 p. p. and it is projected that in 2008 inflation will be higher due to these factors as well as administrative decisions. In 2008, the average annual inflation is forecasted to reach 7.9%, but is expected to slow down in 2009 to 4.9%.

As the gap between the global food demand and supply and higher demand for biofuels is expected to remain, in 2008 around half of the average annual inflation is expected to result from food prices. The effect of food prices on inflation in 2008 will be strong not only due to these factors but also due to an increase in the excise duties on beer and other alcoholic drinks (expected impact is about 0.2 p. p.) and cigarettes (expected impact is about 0.4 p. p.).

Due to institutional decisions the inflation forecast for 2008-2009 was revised upwards by 0.6 and 0.9 p. p., respectively. In January 2008, prices on natural gas for final consumers were increased. In the end of 2008, heating prices also should go up due to a rise of gas prices. In contrast to the previous projections, the electricity price in January 2008 was not increased.

Assessment of Risks to Projections

As the first signs of economic slowdown are observed, there are less uncertainties about the and the main factors of the slowdown in the GDP growth. However, the uncertainty about domestic demand and investment growth, remains at the same level as in October projection and is considered to be very significant. The risks to the current account deficit are on the downside, reflecting the cyclical changes in the elasticity of imports with respect to income growth.

Imbalances between demand and supply in the labour market are expected to narrow partly because of an increase in the participation rate.

The uncertainty about the inflation rate is mainly due to energy and food prices and the impact of inflation expectations. In case of changes in the regulation mechanism of heating energy prices (allowing heating services' providers change prices for final consumers more than once per year), a stronger positive effect of heating prices on the overall inflation would be expected in 2008. In addition to the mentioned inflation factors, there is a high probability that adaptive expectations will strengthen and have a positive effect on the inflation rate.

Macroeconomic projections for 2007-2009

	January 2008 projections				Compared with October 2007			
	2006	2007*	2008*	2009*	2006	2007*	2008*	2009*
Price and cost developments (year-on-year percentage changes)								
Average annual inflation (based on HICP)	3.8	5.8	7.9	4.9	0.0	0.5	2.2	-
GDP deflator	6.6	8.7	7.6	4.4	0.0	0.5	0.1	-
Compensation per employee	16.9	14.9	18.3	6.4	0.0	0.8	-0.4	-
Import deflator (goods and services)	8.0	3.3	3.2	1.4	0.0	0.2	-1.0	-
Export deflator (goods and services)	5.2	4.7	5.0	1.5	0.0	-0.2	0.8	-
Economic Activity (constant prices; percentage change over previous period)								
Real GDP	7.7	8.5	8.1	5.7	0.0	0.0	0.7	-
Private consumption	11.8	12.0	11.0	6.2	-0.1	-0.1	0.1	-
Government consumption	5.5	5.0	8.5	2.6	0.0	0.1	5.0	-
Gross fixed capital formation	17.4	14.7	8.6	7.6	0.0	-2.4	-2.7	-
Exports (goods and services)	12.2	7.0	14.4	9.8	0.0	-1.6	1.6	-
Imports (goods and services)	13.8	12.5	15.7	9.4	0.0	-3.5	0.2	-
Labour Market								
Unemployment rate (% of labour force)	5.6	4.2	3.9	3.8	0.0	-0.1	-0.3	-
Total employment (change over previous period)	1.7	2.5	0.3	0.1	0.0	0.2	0.5	-
External sector (percent, compared to GDP)								
Trade balance	-10.4	-12.4	-12.4	-12.1	0.0	1.0	3.0	-
Current account balance	-10.7	-13.8	-13.7	-13.4	0.0	0.1	1.8	-
Current and capital account balance	-9.1	-11.8	-11.7	-11.5	0.4	0.6	2.2	-

* projection