

Macroeconomic Developments and Outlook for the Lithuanian economy

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In the beginning of 2008, external economic conditions became more complex. With the expansion and persistence of the financial crisis, the probability of recession in the United States has increased and economic growth prospects in many other countries, including the neighbouring Baltic countries, have deteriorated. Meanwhile, following the increase in commodity prices (mainly food and oil), the inflation started to grow in many countries at the end of 2007, and it is likely that the trend will continue this year. Uncertainty regarding the further global economic development has increased, both due to the impact of shocks in financial markets on growth and due to the evolution of the prices of commodities. At this stage, the impact of global financial shocks on the financial system of Lithuania is not significant; however, it is likely that the global recession of the real estate market will have an indirect impact (through economic sentiments).

Although the latest available GDP data show that the economy of Lithuania was still growing at the end of 2007, the evidence, that the development of the national economy reached the cyclical turning-point, has emerged. The real estate market dynamics, which significantly contributed to the recent economic upturn reversed from the fourth quarter of 2007. Housing prices stopped increasing, and the number of real estate contracts went down by 20 per cent, compared to the third quarter. Due to higher uncertainty in the real estate market and the tightening of bank lending conditions, lending for house purchase and to enterprises related to the housing market declined significantly since the fourth quarter of 2007. Investment growth decelerated. It has to be noted however that a favourable household and corporate income growth dynamics in recent years may still be able to ensure inertness of the economic activity in the nearest quarters, since the household consumption growth remains robust.

A rapid economic development is still supported by relatively efficient adaptation of the labour market to dynamically changing needs of the economy. However, the rate of unemployment that reached the historically lowest level and has not declined for several consecutive quarters and still rapidly growing wages show that the labour reserves are almost exhausted. It is likely that limited resources have also partially determined a significant deceleration in the growth of manufacturing.

Compared to the January forecasts, the economic growth prospects of Lithuania in 2008–2009 are considered to be less favourable. In 2009, the GDP growth should slow down to the level lower than the long-term average, while the recovery should start in 2010. The GDP growth forecasts for 2008–2009 were reduced, taking into consideration the fact that in the beginning of this year the key factors determining the slowdown of economic growth were more intensive than expected, uncertainty in the global financial markets increased and the growth prospects of most economies of the world deteriorated. Moreover, the data for the beginning of the year show that inertness of the real estate and construction sectors is weaker than previously thought. This fact should determine a decline in investment related to the construction sector in 2008–2009, while unfavourable development of this sector should spill over to other sectors that focus on domestic demand and determine an overall deceleration in the growth of income of the economy and thus an overall slowdown of the growth of private sector investment and consumption. Together with the deceleration in the nominal income growth, the private consumption growth will be additionally subdued by more moderate expectations regarding the future income growth and higher inflation, however consumption will remain the main contributor to the GDP growth over the whole period of the forecast.

The slowdown of economic growth should result in a higher rate of unemployment. Labour demand still exceeds supply in many economic sectors, therefore, it is likely that a part of free labour resources will be utilised. However, the rate of unemployment should increase at least temporarily, since the decline in labour demand is expected in most economic sectors that

focus on domestic demand due to the overall economic growth slowdown. These conclusions are based on the assumption that there are weaker possibilities for the population to emigrate to other countries. In many countries, which were the main host countries accepting Lithuanian emigrants up to now, economic growth is slowing down, therefore, labour demand weakens. With the narrowing of the gap between labour demand and labour supply, wage growth should approach the level of productivity growth.

Although growth forecasts for many major export partners of Lithuania and the world in 2008–2009 were reduced significantly in the beginning of the year, the export of Lithuania should remain sufficiently resilient to these demand fluctuations. A significant share of Lithuania's export consists of products, which are expected to be largely unaffected by the global economic slowdown. Due to these peculiarities of the Lithuanian export structure, its development is much more significantly affected by factors related to the prospects of individual sectors than the overall trends of external demand. In the short term, the export growth will be very significantly affected by the recovery of the oil-refining capacity. It is forecasted that in 2008 it will account for almost a half of the overall export growth. The growth of exports of other sectors (agriculture and food, fertilisers and plastics) should decelerate temporarily, mostly due to the influence of supply factors. It is forecasted that in the medium term the demand for the production of these sectors should remain strong, the capability of competing in foreign markets by the Lithuanian exporters should not decline and the real export growth should be close to its long-term average.

In the first months of 2008, the overall annual inflation increased. In March, the annual HICP inflation made up 11.4 per cent, while the annual average inflation was 7.4 per cent. The overall inflation was pushed up significantly by a more rapid increase in the prices of all main goods and services (food, administered prices, liquid fuel, industrial goods and services). Consumer price growth was mostly determined by the impact of external shocks and administrative decisions, however, the domestic price pressures were also significant.

Compared to January, the overall assessment of the factors that will determine inflation during the period of the forecast remains unchanged, however, it is forecasted that the consumer price development will be more dynamic. In the first half of the year, inflation should reach its peak and later decline gradually due to the weakening impact of external shocks and domestic demand pressures. The average annual inflation (on the basis of the harmonised index of consumer prices) is forecasted to be 9.8 per cent in 2008, 6.3 per cent in 2009 and 3.8 per cent in 2010. It is unlikely that the current pressure on the prices of agricultural products will diminish over the two-year period, therefore, it is forecasted that the price dynamics of agricultural products in global markets will have a significant impact on the inflation in Lithuania over the whole period of the forecast.

Similarly to earlier forecasts, the demand pressure on inflation should disappear with the turning of the economic cycle towards deceleration. Relatively decentralised labour market ensures favourable conditions for a flexible response of wage growth to the changing economic environment and for reaching market equilibrium. It also has to be noted that labour market flexibility and the absence of legal establishment of the private sector wage indexation are the key prerequisites that will ensure the reduction of inflation, smooth reorientation of resources towards export sectors, competitiveness of these sectors in foreign markets, and thus a sound long-term macroeconomic foundation of the Lithuania's economy.

Expectations regarding the return on investment in the real estate, the scope of the impact of the global financial crisis on the economy of Lithuania and the change in the prices of commodities and its impact on inflation are considered to be the main factors that may determine different dynamics of the economic development than projected in the main scenario. Uncertainty regarding the further economic development remains elevated, and the risks are tilted towards the downside. Stable, or based on some assessments, declining housing prices anchor expectations regarding their decrease in the future, and this in its own turn may determine a further drop in the demand for housing and thus a larger deceleration of overall economic growth. The forecastability of the processes strongly related to market sentiments is limited. They may be determined not only by market

conditions in Lithuania, but also by the changes in the neighbouring countries and global markets. Uncertainty related to these factors has increased significantly and thus may indirectly affect the prospects of the Lithuania's economy. It is expected that due to events in the global financial markets and the changes of expectations the financing conditions will become tighter, particularly with respect to housing loans. Nonetheless, the investments that are viable and increase long-term economic productivity should not face financing constraints.

Uncertainty regarding the inflation forecast is largely related to the change in the prices of commodities, particularly oil and agricultural products. In addition to the rapid income growth in emerging economies, the demand for agricultural products is also pushed up by the rising volume of production of biofuels. With an increase in oil prices, the production of fuel from alternative materials becomes has more economic ground, therefore, the prices of agricultural products may become more dependent on oil prices in the long run, and their short term volatility may increase.

After closing Ignalina nuclear plant in 2009 and transferring electricity production to other, less efficient power-plants, the price of electricity should increase significantly, although the scope of this change is not yet known.

BANK OF LITHUANIA MEDIUM-TERM MACROECONOMIC PROJECTIONS FOR 2008–2009

	Forecast of April 2008			Compared to January 2008		
	2007	2008*	2009*	2007	2008*	2009*
Price and Cost Developments (annual percentage changes)						
Average annual inflation (based on HICP)	5.8	9.8	6.3	0.0	1.9	1.4
GDP deflator	8.6	10.7	6.4	-0.1	3.1	2.0
Wages (compensation per employee)	16.2	15.4	6.2	1.3	-2.9	-0.2
Import deflator	4.1	11.2	5.8	0.8	8.0	4.4
Export deflator	4.6	11.7	5.8	-0.1	6.7	4.3
Economic Activity (constant prices; annual percentage change s)						
Gross Domestic Product	8.8	6.6	3.9	0.3	-1.5	-1.8
Private consumption expenditure	11.6	7.3	2.8	-0.4	-3.7	-3.4
General government consumption expenditure	3.8	7.1	2.9	-1.2	-1.4	0.3
Gross fixed capital formation	15.1	4.2	3.0	0.4	-4.4	-4.6
Exports of goods and services	4.7	13.1	9.2	-2.3	-1.3	-0.6
Imports of goods and services	9.1	9.7	6.6	-3.4	-6.0	-2.8
Labour Market						
Unemployment rate (as a percentage of labour force)	4.3	5.2	5.4	0.1	1.3	1.6
Employment (annual percentage changes)	2.3	-0.8	-0.2	-0.2	-1.1	-0.3
External sector (as a percentage of GDP)						
Balance of goods and services	-12.0	-10.4	-9.2	0.4	2.0	2.9
Current account balance	-13.7	-11.9	-10.6	0.1	1.8	2.8
Current and capital account balance	-11.9	-9.6	-8.4	-0.1	2.1	3.1

*projection