Economic development and prospects in Lithuania

25 July 2008

Compared to April, the Bank of Lithuania's assessment concerning the key mechanism underlying the deceleration of the GDP growth over the projection horizon has remained broadly unchanged. Notwithstanding the gradual deceleration of the GDP growth, it has remained sufficiently high. Domestic economic developments underlying the slowdown of the economy seems to be consistent with the previous assessments. A decrease in the real estate market turnover and tightening of lending standards have led to a decrease in lending both to enterprises and households, and in the nearest months are expected to lead to a loss of momentum in the construction and related sectors.

Trends in external environment, both income growth and inflation, are less favourable than expected. Despite an ongoing decline in the overall concerns regarding the systemic risk in banking sectors of most advanced economies, normal functioning of the financial sector has not been restored yet. The turmoil in the global financial markets actually had negligible impact on the Lithuanian financial system, but an economic slowdown in many of the Lithuania's main trading partners have led to a rise in risks to export development. The economic growth in the neighbouring Baltic countries has lost its momentum faster than expected. In Q1, annual GDP growth in Estonia was 0.1 percent, the lowest during an eight-year period, whereas Latvia's GDP growth decreased to 3.3 percent. However, the GDP growth in Russia has remained strong. In the context of rising oil and other energy prices, the continued and strong increase in inflation has become a challenge both for advanced and developing economies.

During the forecast horizon, the GDP growth is projected to slow down reflecting a more moderate growth of domestic demand and particular of investment. In 2009, the real GDP growth will be around half of what it was over the recent years, but will remain sufficiently strong and in line with the labour productivity growth. As the credit and construction boom recedes, the activity of the domestic demand-oriented sectors will gradually weaken and current macroeconomic imbalances will diminish. Residential investment should slow down significantly already this year. Exceptionally good results for the construction activity in Q1 accompanied by worsening expectations over the prospects of this sector and decreasing volumes of the planned construction work indicate a likely contraction of construction-related investment in the second half of the year. Against the background of strong profit growth in 2007, a fall in the expected return on real estate investment, a rise in labour costs and shortage of labour, rising energy prices, and inflows from EU structural funds, the productive investment growth is likely to be sustained over the nearest future. The downside risks to investment growth are linked to lower profitability expectations in both domestic and external markets.

Decelerating wage growth, a gradual increase of unemployment rate and inflation are expected to contribute to a significant slowdown of private consumption growth in the second half of the year. Consumer behaviour recently showed that the propensity to consume is pro-cyclical as households tend to spend increasingly larger share of their income during economic boom periods. Declining saving rate in 2006 suggested that consumers interpret the observed income increase as permanent. However, the currently observed rapid consumption growth in the context of negative consumer expectations suggests that households do not tend to smooth consumption over the business cycle; as a result, there is limited room to use saving as a consumption buffer when income growth decelerates. During the projection horizon the consumption growth will, therefore, largely mimic income growth, and the adjustment will be more pronounced than previously expected. The purchasing power will diminish significantly also because of a marked increase in energy prices throughout the entire forecasting period.

In Q1 2008,the Lithuanian labour market remained tight; however, the first signs of the moderation in labour market pressures could be observed. The vacancy rate has changed insignificantly, which shows a still high tension in the labour market; but in some sectors, the number of job vacancies is going down. In contrast, the wage growth in private sector was faster than expected. An average wage in the private sector went up by 24.3 percent year on year compared to 22.2 percent in previous quarter. Over the projection horizon the labour market is expected to be flexible and adjust to unfavourable economic conditions. Following a deceleration in domestic demand, the gap between wage and labour productivity growth will close. The labour market flexibility is a necessary condition in order to ensure a robust long-term growth of the Lithuanian economy. However, a legal implementation of wage indexation will impair the self-adjustment mechanism of the labour market, and will increase the risk of higher inflation expectations, wage and price persistence, and therefore will increase the likelihood of a weaker long-term economic growth.

During the forecasting period, the export growth will be supported by favourable economic developments in Russia and some other CIS countries as well as Lithuania's export orientation towards the products that are more resistant to business cycle fluctuations. The downside risks to export stem from a slower GDP growth in some EU countries, in particular in Latvia and Estonia. Meanwhile, the development of business investment is a key requirement for a strong long-term export and GDP growth. Notwithstanding economic factors that stimulate formation of a productive capital, negative trends of investing into machinery and equipment in recent quarters show a significant risk for their development in future.

In recent months, gross annual inflation continued to rise. In June, average HICP inflation stood at an annual rate of 9.3 percent. Due to demand and cost pressures, headline inflation was markedly pushed up by an increase in core inflation, as well as a continued rapid growth of food prices, an increase in cigarette excise taxes, and rising energy prices.

In 2008–2009, inflation will mainly be rising due to the dynamics of commodity prices; however, the domestic pressure on consumption prices is seen to ease gradually. The upside risks to inflation, indicated in the April projection, have materialized. The prices for food have been rising faster than expected, and the growth of world oil prices in litas stood at around 60 percent in May–June, year on year. With all these factors taken into account, average annual inflation in 2008 is expected to be just below 12 percent. Although a slowdown of domestic demand is forecasted for the second half of the year, the domestic inflation is hardly to start decreasing by the end of the year due to inflation inertia. Inflation is expected to start moving down gradually in 2009. Global factors of long-term nature stand behind the growth of food prices; therefore it is expected that the overall food price level will remain elevated. Compared to 2007, the growth of prices for agricultural products however is expected to moderate over the projection horizon, and the domestic pressures to food prices should also recede. The growth of energy prices will remain high during the projection horizon. A rapid rise in oil prices is expected to lead to an increase in prices for imported gas and, eventually, heating energy. Energy prices are also one of the main upside risks to inflation.

ECONOMIC DEVELOPMENT FORECAST FOR LITHUANIA IN 2008–2009

	July 2008 projection			Compared to April 2008		
	2007	2008*	2009*	2007	2008*	2009*
Price and Cost Developments (annual percentage changes)						
Average annual inflation (based on HICP)	5.8	11.8	7.8	0.0	2.0	1.5
GDP deflator	8.6	12.2	6.6	0.0	1.5	0.2
Wages (compensation per employee)	16.2	18.0	5.7	0.0	2.6	-0.5
Import deflator	4.1	12.3	7.3	0.0	1.1	1.5
Export deflator	4.6	17.2	8.2	0.0	5.5	2.4
Economic Activity (constant prices; annual percentage change s)						
Gross Domestic Product	8.8	6.0	4.2	0.0	-0.6	0.3
Private consumption expenditure	11.6	7.3	2.7	0.0	0.0	-0.1
General government consumption expenditure	3.8	6.1	3.0	0.0	-1.0	0.1
Gross fixed capital formation	15.8	4.0	1.9	0.7	-0.2	-1.1
Exports of goods and services	4.7	10.4	8.7	0.0	-2.7	-0.5
Imports of goods and services	9.1	14.4	4.9	0.0	4.7	-1.7
Labour Market						
Unemployment rate (as a percentage of labour force)	4.3	5.5	6.0	0.0	0.3	0.6
Employment (annual percentage changes)	2.3	-1.2	-0.6	0.0	-0.4	-0.4
External sector (as a percentage of GDP)						
Balance of goods and services	-12.0	-12.5	-9.9	0.0	-2.1	-0.7
Current account balance	-13.2	-13.5	-10.8	0.0	-1.6	-0.2
Current and capital account balance	-11.2	-11.3	-8.6	0.0	-1.7	-0.2

*projection