



Economic outlook for Lithuania

23 October 2008

Compared to July, economic outlook for Lithuania in 2008–2009 is less favourable: the adjustment will be more pronounced than expected. The GDP growth projections were revised downwards, as the downside risks materialised. This is mainly related to a negative shift in expectations in the context of global financial crisis. Projection revisions are also driven by less favourable external environment. The confidence crisis in financial markets, as financial leverage declines, has increased the borrowing costs, however, liquidity constraints to the Lithuanian banking sector have not been observed so far. In addition, economic growth projections of Lithuania's foreign trade partners have also been revised downwards, in some countries (for example, Latvia and Estonia) – significantly.

In Q2 2008 the real GDP growth declined somewhat and stood at 5.2 percent. The observed persistence of economic growth has been supported by the household consumption. However, its contribution to growth is fading away, and deceleration in consumption growth should gain momentum in the coming quarters. Despite robust nominal income growth, consumer purchasing power has been eroded by increasing inflation. Moreover, in recent years the consumption growth exceeded real income growth due to the positive net flow of loans to households. The latter started to decelerate, reflecting unfavourable expectations with respect to the real estate prices and weaker growth outlook. In addition to declining real income growth, a fall in the volume of new loans to households and elevated debt servicing costs will put further pressure on consumption growth.

Investment growth reached negative territory earlier than expected. In the context of the less favourable growth outlook and weaker expectations of corporate profitability, the investment volume is expected to fall throughout the projection horizon. The decline of investment volumes linked to residential and non-residential construction should be observed at the end of this year. The adjustment of transportation investment should be profound due to difficulties in transport sector and tightening credit conditions. Machinery investment is expected to start recovering as the structure of the economy adapts to changing environment. However, these positive trends will most probably not be observed before second half of 2009. Next year a decline in the general government investment will amplify negative investment growth. As stated in the State Investment Programme of 2009-2011, a part of the general government investment will be postponed until 2010.

Negative foreign demand trends reduce export growth projections. This year the increase of export has been mostly stimulated by recovered exports of mineral products, however, this impact will subside in 2009 due to the base effect. The medium-term outlook for exports (excluding fuels) is less favourable due to a substantially lower growth of external demand. In 2007 positive trends were observed in sectors that are more resistant to business cycle fluctuations (agriculture, food manufacturing and chemical industry) but their outlook has also deteriorated. Good global crops, which substantially increased the supply of agricultural products, and falling agricultural commodity prices in global markets should slow down the export growth of agricultural and food products.

Sizeable external imbalances will contract – the current account deficit that widened last year will narrow down to less than half of the 2008 level. The recent demand growth has largely been driven by the consumption of imported goods. Decreasing domestic demand will imply a fall in import volumes.

Decelerating economic growth reduces tension in the labour market. Although the unemployment rate rose only marginally in the first half of 2008, a fall of the total vacancy rate has been observed. The wage growth has lost momentum, especially in construction and financial intermediation sectors, where the wage growth over recent years has been the most

pronounced. It is anticipated that during the projection horizon labour resources will be reallocated via the reduction of wages, meanwhile the level of unemployment will grow rather moderately. An unsustainable wage growth, exceeding the labour productivity growth by about three times, will slow down markedly and in 2009 will stand at moderately positive figures but below the labour productivity growth. Nominal wages in some sectors will decrease. These assumptions are made on the basis of the results of enterprise survey conducted by the Bank of Lithuania in April. These results revealed that about a quarter of company wage bill is performance dependent. In addition, the labour force emigration is expected to decline and alleviate the pressure on wages. Negative growth outlook in the countries, which are the main host markets for Lithuanian emigration, allow for a labour supply increase in Lithuania's labour market.

The main downside risks to the baseline projection scenario are associated with the financial sector. Due to the global financial crisis the cost of borrowing is rising and loan affordability becomes more limited. If tension in global financial markets remains for a longer period private sector crediting possibilities may be constrained more than the level of this sector borrowing demand. On the other hand, losses of Lithuanian parent banks due to bank bankruptcy in other countries are insignificant, financial system has encountered no lack of liquidity and the quality of loan portfolio remains sound.

Having reached the peak of the last several years, gross annual inflation started to decline since the middle of the year. The growth of prices was markedly pushed down by a recent fall in fuel prices and a slower increase of food prices. The level of core annual inflation remained almost unchanged since July, while headline inflation is pushed up by rising administered prices, especially prices of heating energy.

The 2008-2009 inflation forecasts are broadly in line with earlier assessments. However, external and domestic pressures on prices are anticipated to be somewhat weaker. It is projected that a higher inflation in 2008 will be followed by lower consumer prices growth in 2009. Suppressed domestic demand and labour costs pressures will be one of a lower inflation factors next year. The impact of commodity prices is also gradually fading when global economic trends are changing. Recent drop in prices of the main agricultural products in global markets should contribute to a slower growth of prices in Lithuania, while strong global oil price movements change market expectations related to oil price perspectives during the projection horizon. It has been observed that a probability of abrupt fluctuations of commodity prices remains large, therefore, uncertainty of the inflation prospects associated with the rise of global prices is persisting. In 2009 the upside risks to inflation projection are linked to gas prices, and therefore, heating energy prices.

ECONOMIC OUTLOOK FOR LITHUANIA IN 2008–2009

	October 2008 projection			Compared to July 2008		
	2007	2008*	2009*	2007	2008*	2009*
Price and Cost Developments (annual percentage changes)						
Average annual inflation (based on HICP)	5,8	11,6	6,9	0,0	-0,2	-0,9
GDP deflator	8,8	11,9	2,7	0,2	-0,3	-3,9
Wages (compensation per employee)	16,2	21,6	3,5	0,0	3,6	-2,2
Import deflator	4,0	8,8	1,0	-0,1	-3,5	-6,3
Export deflator	4,6	12,6	1,4	0,0	-4,6	-6,8
Economic Activity (constant prices; annual percentage changes)						
Gross Domestic Product	8,9	4,2	1,2	0,1	-1,8	-3,0
Private consumption expenditure	11,6	4,8	-4,7	0,0	-2,5	-7,4
General government consumption expenditure	3,3	5,7	2,2	-0,5	-0,4	-0,8
Gross fixed capital formation	20,8	-3,7	-6,7	5,0	-7,7	-8,6
Exports of goods and services	4,3	12,3	3,8	-0,4	1,9	-4,9
Imports of goods and services	11,6	12,0	-4,5	2,5	-2,4	-9,4
Labour Market						
Unemployment rate (as a percentage of labour force)	4,3	5,4	7,9	0,0	-0,1	1,9
Employment (annual percentage changes)	2,3	-1,9	-2,9	0,0	-0,7	-2,3
External sector (as a percentage of GDP)						
Balance of goods and services	-13,4	-11,8	-6,0	-1,4	0,7	3,9
Current account balance	-14,6	-13,0	-6,2	-1,4	0,5	4,6
Current and capital account balance	-12,6	-10,6	-4,1	-1,4	0,7	4,5

*projection