

# Bank of Lithuania Macroeconomic Projections for 2007-2008

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## *Main economic developments following the latest release of macroeconomic projections in October 2006*

In 2006, the Lithuanian economy continued to grow at impressively high rates, notwithstanding some mostly one-off factors<sup>1</sup> that had a negative effect on growth figures in the second half of the year. The ongoing economic upturn was further driven mainly by strong domestic demand, underpinned by buoyant household income growth and strong corporate earnings, historically low real interest rates, procyclical fiscal policy, financial injections from EU structural funds, and very strong confidence indicators and optimistic expectations. Against the background of the increase in labour demand on the one hand, and the ongoing intensive emigration of labour force on the other, the unemployment rate was historically low<sup>2</sup> and wage growth outpaced productivity growth. As the national saving rate followed a downward trend, growing investment expenditure was financed mostly by resorting to financing from abroad, which was reflected by the deteriorating current account. In 2006, the inflation rate increased notably. This increase was driven to a large extent by a strong rise in food prices (unfavourable weather conditions and the ongoing food price convergence are mainly responsible for this); also, demand-related inflationary pressures started to emerge. On the other hand, favourable oil price developments in the last quarter of 2006 cushioned some inflationary pressures.

Real GDP growth was 0.5 p.p. weaker than projected in October,<sup>3</sup> and the trends of expenditure component dynamics diverged. Private consumption and imports were considerably stronger than projected earlier – mostly due to stronger income growth, additional stimuli coming from crediting and quite significant statistical revisions of the historical GDP data.<sup>4</sup> Public consumption expenditure also increased strongly, mostly reflecting wage rises in the public sector. Export growth slowed down considerably, and it was mostly linked to one-off factors, such as a decline in the operating capacity of the oil refining industry owing to exogenous shocks. Inflation was more benign than predicted, as oil prices fell at the end of 2006.

## *Economic Outlook for the Lithuanian Economy for 2007-2008*

Economic trends recorded at the end of 2006 together with the latest available data for 2007 confirm unabated economic upturn and very strong household and business confidence regarding domestic economic conditions. At the same time, the fiscal policy stance and monetary conditions remain strongly accommodative. This implies that the economic upturn is likely to continue throughout 2007 and will be reflected by strong domestic demand, high current account deficit, decreasing unemployment rate, wage rises outpacing productivity growth and rising demand-pulled

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<sup>1</sup> Stronger capacity constraints in the oil refining industry due to a major fire in the oil refinery, unfavourable weather conditions for the agriculture, and production disruptions at the Ignalina nuclear power plant due to scheduled repairs and accidental failures.

<sup>2</sup> Available data on unemployment cover the period starting from the first quarter of 1995.

<sup>3</sup> Statistical error in the preliminary release of the GDP data for 2006 is exceptionally large, therefore, significant revisions of the published statistical data are quite likely.

<sup>4</sup> October 2006 projections were compiled using GDP at constant prices data. Since the Lithuanian Statistics Office recently changed the GDP statistics compilation methodology by switching to chain-linking, April 2007 projections are based on chain-linked volumes of GDP and its constituents. The change in methodology had a sizeable effect on short-run projections of private consumption and investment expenditure.

inflation. In addition to cyclical factors, inflation will be also driven by energy (gas and heat energy) price shocks, though due to still unchanged gas prices for regulated consumers (contrary to earlier expectations of an increase in January 2006) their projected impact on consumer price inflation should be more moderate than estimated earlier. Export growth will be significantly negatively affected by temporary disruptions in the oil refining activity.

At the end of 2007 or in the beginning of 2008 the strong cyclical upturn of the Lithuanian economy may come to an end. GDP growth is projected to slow down to 5.5%. The slowdown is mainly related to lower growth of consumption and investment expenditure. It is likely that as the indebtedness of the economy and real interest rates rise, the credit growth and thus its stimulating impact on consumption and investment may decrease. Slower economic growth will lead to easing imbalances in the labour market (a smaller gap between labour demand and supply), slower growth of unit labour costs and easing inflationary pressures. In 2008, the unemployment rate is still projected to decrease marginally in the face of the ongoing labour force emigration. Export developments, projected for 2008, are quite positive. Once oil refining capacity is expectedly restored in the second half of 2007, further export growth will be mostly determined by strong, though gradually subsiding, external demand.

Uncertainties surrounding the baseline scenario for further economic developments are clearly on the rise. In principle, there are two scenarios that are almost equally likely: a further deepening of imbalances may be observed, which might then result later in a sharper economic slowdown, or the economic slowdown may start sooner than projected in the baseline. Materialisation of each of the alternative scenarios depends to a large extent on country risk perceptions by foreign investors (investor sentiment may be tightly linked to economic developments in the neighbouring Baltic economies as well) and domestic expectations about the future prospects of the economy.

During the projection period of 2007-2008, financial transfers from the EU funds will be an important growth-fuelling factor via their stimulating impact on disposable income and real investment. Nevertheless, until the beginning of 2007 the absorption of the EU support was rather subdued. In the baseline projection, the absorption rate is largely in line with that observed in 2005-2006. It is likely, however, that in order to utilise funds intended for 2004-2006 programming period more efficiently, the actual utilisation of the EU structural support may be more intensive than projected. This would constitute a significant additional stimulus for the economic development in 2007-2008.

## Macroeconomic projections for 2007-2008

	April 2007 projections (annual percentage changes)			Compared to October 2006 projections (percentage points)		
	2006	2007	2008	2006	2007	2008
<b>Prices and costs</b> (annual percentage changes)						
Average annual inflation (measured by the Harmonised Index of Consumer Prices)	3.8	4.7	4.3	-0.2	0.8	-
GDP deflator	7.1	4.6	4.3	1.4	2.4	-
Wages (compensation per employee)	15.2	19.8	10.1	1.8	9.1	-
Import deflator (goods and services)	6.2	2.9	3.7	-2.3	0.8	-
Export deflator (goods and services)	1.2	0.3	3.5	-3.8	-4.4	-
<b>Economic activity</b> (constant prices, annual percentage changes)						
Gross domestic product	7.5	7.9	5.5	-0.5	1.2	-
Private consumption expenditure	13.3	11.8	6.5	2.5	4.2	-
Government consumption expenditure	7.3	4.9	2.5	3.2	2.5	-
Gross fixed capital formation	11.9	11.3	6.2	0.0	3.0	-
Export (goods and services)	15.4	9.1	12.6	-1.6	0.5	-
Import (goods and services)	15.4	12.1	11.0	0.3	5.4	-
<b>Labour market</b>						
Unemployment rate (percent of labour force)	5.6	4.5	4.0	-0.1	-0.4	-
Employment (annual percentage changes)	1.7	0.7	0.1	0.3	0.1	-
<b>External sector</b> (as a percentage of GDP)						
Trade balance (goods and services)	-10.5	-13.8	-13.6	-1.7	-7.8	-
Current account balance	-11.0	-13.7	-14.0	-2.0	-6.8	-
Combined current and capital account balance	-9.7	-12.1	-12.3	-2.6	-7.5	-

Source: Bank of Lithuania estimations.