

# Bank of Lithuania Macroeconomic Projections for 2007-2008<sup>1</sup>

25 October 2007

## Conjectural Developments

Macroeconomic data for the first half of 2007 confirms that the deceleration of economic growth observed in 2006 was of temporary nature and reflected the impact of specific factors that are not related to business cycle. The latest data does not show a deceleration in economic growth, with domestic demand, supported by credit, low (close to zero) real interest rates and a lack of fiscal tightening, remaining the main driver behind GDP growth. As a result of robust final consumption and investment growth, an increase in the current account deficit is expected, however the observed widening of external imbalances is partly related to the one-off factors – approximately a third of an increase in the current account deficit in the first half of the year was associated with the temporary negative impact of the oil refining sector. Moreover, despite rising production costs, export developments are favourable and the observed deterioration of the trade balance does not reflect a loss in external competitiveness.

Due to active utilisation of the labour resources and the increasing participation rate, the labour force and employment increased markedly in the first half of the year, while the rate of unemployment was low by historical standards. These developments supported the supply side of the economy, although robust employment growth did not reduce tensions in the labour market. Reflecting labour market tightness and institutional factors (increase of public sector wages), the overall wage level continued to rise rapidly.

In the course of 2007 the average annual inflation has been rising steadily. These developments were mainly driven by a continued rise of processed food prices, which is largely determined by increases in prices of agricultural products and increasing labour costs. The contribution of industrial goods to the headline inflation remains neutral. However, the impact of services is on an upward trend, albeit still relatively moderate, reflecting domestic demand-related inflationary pressures.

## Outlook for 2007-2008

### Real sector

In the short-term, the current cyclical upturn, indicated by robust domestic demand, high current account deficit, wage growth outpacing labour productivity growth and rising inflation, is projected to continue. In 2007 real GDP growth is projected to accelerate to 8.5 per cent, which will be partially related to the restoration of oil refining capacity in the fourth quarter, and a subsequent recovery in export growth. The downturn of the business cycle is likely to start in the second half of 2008, leading to a light deceleration of the real GDP growth rate in 2008 (7.4%). The turning point is projected to originate from the decline in credit flow and resource constraints in the labour market. The positive impact of EU structural funds will remain significant throughout the projection horizon.

In view of strong credit flows observed at this stage and persistence in the real economy, the direct effect of external financing on private consumption as well as the impact through household income is expected to remain sizeable in the first half of 2008. In addition, other business cycle related factors (in particular, labour market tightness and employment growth) as well as expansionary and socially oriented fiscal policy manifesting through public sector wage rises, increase in minimum wage and transfers to households, income tax cuts, are projected to support the private sector nominal income growth. In the short term, the incentives for corporations to expand private sector investment will be strengthened by elevated return on investment, offsetting the negative impact of the ECB monetary policy tightening.

In the medium term, the credit flow to the non-financial private sector is expected to converge to the levels consistent with income growth. With the rise of uncertainty regarding the development of the real estate prices, more moderate activity of the real estate market is likely, which will determine a weaker demand for housing and housing-related loans and construction related investment

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<sup>1</sup> October 1, 2007 is the cut-off date for data used in these projections.

growth. Meanwhile, the possibilities to stimulate credit growth from the supply side are also almost exhausted. Against this background, the deceleration of credit flows, nominal income and, thus, domestic demand is warranted in the medium term. The resource utilisation in the labour market is assessed to be broadly at the level of full employment, preventing further decline of the unemployment rate. Therefore, employment growth during the projection horizon will be limited to the population growth and changes in the participation rate. As the participation rate is assumed to remain constant and the prevailing international migration trends to continue, the supply side constraints are likely, resulting in decelerating economic growth.

Due to a rapid growth of domestic demand, the current account deficit will continue to increase in 2008. It is projected that the fundamental developments of exports will be in line with the change of foreign demand, though the export growth will accelerate at the end of this year after the oil refining capacity is restored. This should have a mitigating effect on the increase of the trade deficit in the fourth quarter of this year.

### **Price developments**

With the acceleration of the rise in prices of food, strengthening of the domestic demand-related inflationary pressures and the impact of administrative decisions, average annual inflation is expected to reach 5,7 per cent in 2008. The trend of increase in prices of food products related to the global trends of agricultural product prices, price convergence and the environment of strong demand, is projected to continue in the nearest quarters. The expectations of higher future inflation are expected to create further inflationary pressures.

The rise of core inflation has an increasingly larger impact on the changes of headline inflation, and this impact should even strengthen in the course of the year due to growing domestic demand pressures. Nonetheless, the increase in unit labour costs projected in 2008 is partially related to the rise in the public sector wages and will not be fully passed on to producer and consumer prices.

The impact of administrative decisions (mostly due to the increase of energy prices, such as electricity and heat energy, and harmonisation of excise duties) on inflation will remain significant in 2007 (0.7 percentage points) and will rise in 2008 to 1.3 percentage points. Compared to previous forecasts, a slightly smaller impact of administrative decisions (0.1 percentage points) on inflation is projected this year due to a lagging impact of the increase of the excise on cigarettes in March 2007<sup>2</sup>. In addition to the earlier planned increase of heat energy prices, the increase of electricity prices from January 2008 will also contribute to the impact of energy prices in 2008.

### **Assessment of risks to projections**

**GDP.** On the basis of information available in October 2007, the Bank of Lithuania considers these projections to be the most likely scenario of macroeconomic developments in Lithuania for 2007-2008. However, the uncertainty regarding the timing, extent, and the precise combination of factors resulting in the deceleration of growth, is elevated. Both upward and downward risks to growth projections are considerable. The balance of risks is assessed to be moderately on the downside.

The likelihood of a gradual deceleration of economic growth is largely associated with a number of inter-related factors: the risk assessment by foreign investors, macroeconomic stability in the other Baltic states, developments in the real estate market, private sector expectations regarding future income growth. In case of an adverse shock to one of these indicators, the negative developments in the others are likely to follow, resulting in the downward pressure on GDP growth.

On the other hand, the factors that will have a potentially favourable effect on the GDP growth are related to changes in the labour market. First, a continued increase in the participation rate cannot be excluded (compared to other EU states, the participation rate in Lithuania is relatively low). Second, there is some evidence of increasing inflow of employees from non-EU countries, meanwhile, as it is apparent from the public discussions, the Government is encouraged to simplify the requirements and procedures for the issue of employment permits. Finally, a continued shift of employment structure towards more productive sectors would ensure sustained higher labour productivity growth in the overall economy. Against this background, the labour market trends are likely to be more favourable compared to the baseline scenario, resulting in stronger aggregate supply growth and moderating internal and external economic imbalances.

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<sup>2</sup> The impact of an increase in the excise tax for cigarettes on the consumer prices was not immediate due to accumulated stocks prior to an increase in the tax rate.

**Inflation.** The risks to inflation projections are mainly on the upside, and are related to the increase in energy prices and the impact of inflation expectations. The higher than planned increase of electricity prices to final consumers, the increase of gas prices and the related increase of heat energy prices would have a significant upward impact on inflation in 2008. Moreover, as inflation rate has reached 5-6 per cent, the likelihood of higher inflation expectations and therefore an upward pressure on the inflation rate is considerable.

## Macroeconomic projections for 2007-2008

	October 2007 projections			Compared with April 2007		
	2006	2007*	2008*	2006	2007*	2008*
<b>Price and cost developments (year-on-year percentage changes)</b>						
Average annual inflation (based on HICP)	3,8	5,3	5,7	0,0	0,5	1,4
GDP deflator	6,6	8,2	7,5	-0,5	3,6	3,3
Compensation per employee	16,9	14,1	18,7	1,7	-5,7	8,6
Import deflator (goods and services)	8,0	3,1	4,2	1,8	0,2	0,5
Export deflator (goods and services)	5,2	4,9	4,2	4,0	4,7	0,7
<b>Economic Activity (constant prices; percentage change over previous period)</b>						
Real GDP	7,7	8,5	7,4	0,2	0,6	1,9
Private consumption	11,9	12,1	10,9	-1,5	0,4	4,3
Government consumption	5,5	4,9	3,5	-1,8	0,1	1,0
Gross fixed capital formation	17,4	17,1	11,3	5,5	5,7	5,0
Exports (goods and services)	12,2	8,6	12,8	-3,2	-0,5	0,2
Imports (goods and services)	13,8	16,0	15,5	-1,5	3,9	4,5
<b>Labour Market</b>						
Unemployment rate (% of labour force)	5,6	4,3	4,2	0,0	-0,2	0,2
Total employment (change over previous period)	1,7	2,3	-0,2	0,0	1,6	-0,3
<b>External sector (percent, compared to GDP)</b>						
Trade balance (4-q moving sum % of GDP)	-10,4	-13,4	-15,4	0,1	0,4	-1,8
Current account (4-q moving sum % of GDP)	-10,7	-13,9	-15,5	0,3	-0,2	-1,5
Current and capital account balance	-9,5	-12,4	-13,9	0,2	-0,3	-1,6

Note: The revisions in October 2007 projections are partly explained by considerable revisions in historical data for 2004-2007.

\* projection