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Outlook for Lithuania

Investment drives faster growth in Eurozone’s newest member

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Having risen by an estimated 2.9% in 2014, Lithuania’s GDP is forecast to grow by 3.4% this year. This means that the Eurozone’s newest member will also be one of its strongest, reflecting an upturn in investment, service exports and consumer spending sufficient to offset a continued slight decline in goods exports.

Growth is then set to pick up further to average 4.7% a year in 2016–19, as goods exports rebound and investment retains momentum even when monetary policy starts to tighten. Medium-term growth will be slightly ahead of potential, reflecting the re-emerging external deficit financed by rising capital inflows.

Annual inflation turned negative in December, and is now forecast to post a 0.3% fall this year as lower oil prices more than offset demand pressures. Inflation is then set to rise to 0.9% in 2016 and just over 2% a year in 2017–19 as stronger growth allows labor cost increases to be passed on.

The fiscal deficit, which has more than halved since 2012 to 0.9% of GDP in 2014, is forecast to fall more slowly in 2015–19, with public infrastructure investment and defense spending preventing any move into surplus. This presents a risk of excessive demand and above-forecast inflation in 2017–19. But the growth-supporting focus of public spending is consistent with stable and still relatively low public debt.

Slow merchandise export growth in 2015, despite entry to the Eurozone in January, mainly reflects the deep recession expected in Russia and slow recovery of larger markets outside the more dynamic Baltic-Nordic zone. Exports are set to rise more strongly from 2016 in line with faster Eurozone growth and Russia’s emergence from recession. But with import growth recovering even more sharply, the current account surplus is forecast to fall to close to zero in 2019, leaving growth more reliant upon stronger inward investment.
Investment drives faster growth in Eurozone’s newest member

Expansion to accelerate despite slow export recovery ...

After slowing to 2.9% in 2014 (on preliminary data), Lithuania’s growth is forecast to quicken to 3.4% this year, meaning that the Eurozone’s newest member, having joined the single currency on 1 January, will be among the fastest-growing. This is principally due to a strong recovery in domestic consumption, investment and exports of services, sufficient to offset another year of slightly declining goods exports. Industrial output has recovered, rising 2.7% on the year in December, lifting GDP back to its pre-crisis level during 2014, despite the stagnation of export growth after an initial rebound in 2012. This contrasts with other small countries on the Eurozone periphery, which continue to rely on external trade to pull them out of their post-2008 recessions.

Relatively buoyant domestic demand is expected to lift this year’s performance compared with that of more export-dependent neighbors, which will be held back by slow growth elsewhere in the Eurozone and recession in Russia. Although its exports have been hit by last year’s imposition of Russian trade barriers, centered on food, progress has already been made in redirecting trade toward the EU (where main markets have continued to grow) and to North America and Asia. As a stronger export recovery takes hold from 2016, GDP growth is forecast to pick up to about 4.7% a year, maintaining the significant differential over the Eurozone as a whole.

... as labor market improvements keep inflation pressure down

Labor productivity growth has slowed since strong post-recession gains in 2010 and 2011. But the 2.9% increase in 2013 was still well above the Eurozone average (of 0.7%), and further widening of this advantage underlies our strong GDP forecast. Wage pressures were substantially reduced in 2014, despite industrial expansion and recent loss of skilled labor through emigration. The annual increase in average hourly labor costs fell to 3% in Q3 2014 from 6.7% a year earlier. Although the average wage increase was still 3.3% in Q3 (while inflation fell to zero at the end of that quarter), real wage rises have, to date, been broadly matched by productivity growth in most trade-exposed sectors.

Table 1

<table>
<thead>
<tr>
<th>Lithuania (annual percentage changes unless specified)</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<tr>
<td>GDP</td>
<td>2.9</td>
<td>3.4</td>
<td>4.4</td>
<td>4.8</td>
<td>4.8</td>
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<td>Private consumption</td>
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<td>4.7</td>
<td>4.5</td>
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<td>5.0</td>
<td>6.0</td>
<td>5.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Stockbuilding (% of GDP)</td>
<td>-3.6</td>
<td>-4.4</td>
<td>-3.7</td>
<td>-3.3</td>
<td>-2.6</td>
<td>-1.8</td>
</tr>
<tr>
<td>Government consumption</td>
<td>1.2</td>
<td>2.3</td>
<td>2.0</td>
<td>3.1</td>
<td>3.7</td>
<td>3.8</td>
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<tr>
<td>Exports of goods and services</td>
<td>2.0</td>
<td>5.8</td>
<td>7.2</td>
<td>7.5</td>
<td>7.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>2.7</td>
<td>5.5</td>
<td>7.9</td>
<td>7.8</td>
<td>7.7</td>
<td>7.6</td>
</tr>
<tr>
<td>Consumer prices</td>
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<td>-0.3</td>
<td>0.9</td>
<td>2.2</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Unemployment rate (level)</td>
<td>10.6</td>
<td>10.5</td>
<td>9.5</td>
<td>8.5</td>
<td>7.5</td>
<td>6.5</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>1.3</td>
<td>1.2</td>
<td>0.6</td>
<td>0.5</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Government budget (% of GDP)</td>
<td>-0.9</td>
<td>-0.6</td>
<td>-0.6</td>
<td>-0.5</td>
<td>-0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>Government debt (% of GDP)</td>
<td>38.3</td>
<td>37.8</td>
<td>36.4</td>
<td>34.5</td>
<td>32.5</td>
<td>30.6</td>
</tr>
<tr>
<td>ECB main refinancing rate (%)</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Euro effective exchange rate (1995 = 100)</td>
<td>123.6</td>
<td>108.6</td>
<td>104.7</td>
<td>105.4</td>
<td>106.6</td>
<td>108.0</td>
</tr>
<tr>
<td>Exchange rate (US$ per €)</td>
<td>1.33</td>
<td>1.07</td>
<td>1.01</td>
<td>1.01</td>
<td>1.02</td>
<td>1.04</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
A relatively low participation rate (with around 72% of 15–64 year-olds in work in 2013, compared with typical Eurozone rates above 75%) gives scope to expand the effective supply of labor even without any expansion of the workforce.

In the short term, the fall in consumer prices (of 0.1%) at the end of 2014 is expected to continue into early 2015, as lower energy prices offset any impact of euro conversion and a Q1 drop in consumer confidence tempers retail demand. But indirect tax increases (including a rise in district heating VAT to 16% from 9%) and rising domestic demand will put upward pressure on headline inflation in the second half of this year. The move into deflation has not been deep enough to cause serious deferral of consumer spending, and retail sales growth continued through Q4 (up 3.3% on the year in January, despite a 0.5% fall on the month). Although inflation is now expected to show a fall of 0.3% in 2015, the impact of this modest decline on real incomes should promote expenditure recovery in the medium term. And producer prices have been falling even faster (down 3.1% on the month and 10.6% on the year in January), a differential that will help to rebuild internally-financed investment as more spare capacity is reabsorbed in 2015.

Inflation is forecast to rise to 0.9% in 2016 and over 2% in 2017. But it is then set to level out, even if Eurozone monetary policy continues to be more relaxed than would have been chosen for local conditions. The differential of domestic inflation over the Eurozone average will not cause a serious increase in relative costs over the forecast period if current favorable trends in productivity growth and quality improvement are maintained.

**Private investment picking up after initial public boost**

Public projects have so far played an important role in the investment upturn, in part because of the Government being first to benefit from lower borrowing costs. Private sector credit growth remained constrained in 2014, due to banks keeping lending criteria relatively tight as they expanded their capital base. This balance will start to shift during 2015, with stronger private investment growth expected from next year as confidence increases and financing costs stay low. Investment may also be encouraged in the medium term by steps to reduce traditionally high non-wage labor costs. These costs outgrew wages for most of 2013, but slowed sharply last year as the improving fiscal balance created scope to lighten the burden of payroll taxes.

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**Table 2**

Forecast for Lithuania by sector (annual percentage changes in gross added value)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>2.9</td>
<td>3.4</td>
<td>4.4</td>
<td>4.8</td>
<td>4.8</td>
</tr>
<tr>
<td>Mfg.</td>
<td>3.5</td>
<td>4.8</td>
<td>4.7</td>
<td>4.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Agc.</td>
<td>-3.8</td>
<td>-2.3</td>
<td>1.0</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Cns.</td>
<td>16.1</td>
<td>7.6</td>
<td>5.3</td>
<td>5.0</td>
<td>4.8</td>
</tr>
<tr>
<td>Utls.</td>
<td>-5.4</td>
<td>0.5</td>
<td>2.0</td>
<td>2.5</td>
<td>2.6</td>
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<tr>
<td>Trd.</td>
<td>3.2</td>
<td>4.2</td>
<td>6.0</td>
<td>6.2</td>
<td>6.2</td>
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<tr>
<td>F &amp; B</td>
<td>1.6</td>
<td>3.6</td>
<td>4.9</td>
<td>5.0</td>
<td>5.1</td>
</tr>
<tr>
<td>Comm.</td>
<td>1.2</td>
<td>1.4</td>
<td>3.9</td>
<td>4.3</td>
<td>4.6</td>
</tr>
<tr>
<td>N-Mkts.</td>
<td>1.1</td>
<td>1.4</td>
<td>2.2</td>
<td>3.0</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
The falling budget deficit will enable the Government to continue its support for major infrastructure projects. This will, in turn, maintain the inflow of EU co-financing (which could rise as a result of the Commission-backed investment program promoted during Latvia’s current EU presidency) and multilateral development loans. Lithuania is already emerging as a regional re-exporter of gas, and is on track for completion this year of two new interconnections (with Poland and Sweden) that will reduce the price of imported electricity, which is now around 60% of the total consumed.

**Exports and cheaper energy keep current account close to balance**

Investment-led growth drawing in imports will gradually eliminate the current account surplus, which peaked in 2013–14 at around 1.5% of GDP. However, our forecast shows only a slow decline, supported by rising service sector exports. The external account remains in small surplus over the forecast period, in contrast to the wide deficits that accompanied rapid growth before 2008. Although imports are set to outgrow exports, efficiency improvements in the use of raw materials and rising value-added of processed exports will slow the deterioration in the visible trade balance.

The costs and risks of imported energy will also diminish as sources of gas are diversified through a new Baltic terminal, which took its first liquefied natural gas deliveries (from Norway) in December 2014. Large onshore wind developments, new interconnectors and a deepening regional electricity pool will help to keep power costs down, despite the lack of progress toward a replacement Baltic nuclear plant.

Containment of the external deficit will lessen the reliance on inward investment to finance growth, reducing risks around the medium-term forecast. Foreign direct investment (FDI) rose 5.1% in 2013 but dipped in the first half of 2014, reflecting slow Eurozone growth and geopolitical tensions in the region. It is expected to pick up in 2016–18, encouraged by Eurozone entry and increased scope for integration into EU supply chains. Lithuania is expected to retain some advantages in FDI attraction within the Baltic region, arising from population and market size, the level of workforce education, port facilities and other transport links, and the scope for manufacturing and service projects to be spread outside the capital city region.

**Budget deficit declines despite extra defense commitment**

The pace of GDP expansion in 2015–18 is sufficient to maintain the gradual closure of the fiscal deficit, without further spending cuts on a scale that would hold back the recovery of incomes and investment. Our forecast now shows this year’s deficit target (1.2% of GDP) being beaten. The ruling Social Democrats are committed to a substantial rise in defense spending, to the NATO target of 2% of GDP by 2020 from 1.1% in 2015. But with revenue now growing cyclically, the governing coalition will be reluctant to offset this with further spending cuts in other departments. Despite this, the deficit is on course to drop to 0.6% of GDP in 2016, and then continue falling as revenues rise while higher real wages and a falling unemployment rate (expected to be below 10% in 2016) reduce the social support bill.

The retention of a small budget deficit from 2017, when private investment, consumption and export demand are expected to be growing strongly, poses an upside risk to the medium-term inflation forecast. However, these risks are attenuated by the scope for financing additional imports (through inward investment) as domestic demand picks up, and by the relatively favorable labor market.
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