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Lithuania:
Demand-side policies affect balanced growth

Lithuania's new centre-left coalition government seems to have put into effect an appropriate policy-mix combining demand-side measures and growth-enhancing supply-side instruments. Raising minimum wages has not increased consumer inflation; it has, however, bolstered household consumption, while investments in transport infrastructure have boosted prospects of growth in the medium term. At the same time, surprisingly high export growth has kept the current account deficit low. One of the dangers to economic growth and the current rebound in welfare after the bust is that the government might resort to austerity in order to aim at too early an accession to the euro area in 2015.

Growth of goods exports speeded up as expected also in the first quarter of 2013 contrary to the situation in the Baltic neighbours. However, one should keep in mind that two major effects drive the favourable nominal export increase. First, the abundant harvest of last year, which was 25% higher than a year earlier, and second, higher revenues of the Mazeiku Nafta refinery resulting inter alia from new export destinations for its refined petroleum such as Iran, Algeria and more intensive export activity towards Belarus, the United States, Poland and also Russia. Nevertheless, since the positive effect of crops and fuel exports will most likely recede throughout this year and external demand from the Baltic neighbours is likely to weaken, we expect Lithuania's growth in goods exports to decline somewhat compared to 2012. However, falling crude oil prices also reduce the nominal growth of imports and thus the contribution of net exports to overall GDP growth will still remain balanced and the deficit of the current account at a low level in 2013.

The new government led by the Social Democratic party is stepping up investments in the public infrastructure. Considerable investments in the energy and transport infrastructure started to be realised, such as the international container distribution centre in Klaipeda, the most important Lithuanian port, and the LNG terminal at the same site. In the future it will cover up to 25% of Lithuania's gas demand. Both projects shall be finalised in 2015 and will remain drivers of strong investment activity thereupon. At the same time however entrepreneurs are still reluctant to expand investments given the uncertain prospects for external demand for most manufactured goods in the euro area. Households and companies have started taking up more credits but are still deleveraging slightly. Investments are reported to be financed much more out of earnings or, in the case of household investment in dwellings, out of accumulated savings. Dwellings construction is increasing, while overall construction activities are still on the decline. As the Lithuanian refinery still reduced its stock of crude oil due to high prices, overall investment activity even declined. However, this year private but much more so public gross fixed capital investments shall develop at high pace.

After a substantial rise in employment in 2012, job increases slightly slowed down in the first quarter of 2013. However, growth in employment continues in manufacturing and high-skill service sectors. The unemployment rate fell in the first quarter of 2013. Although employment shall continue to grow in 2013, we also expect labour supply to increase more strongly this year. Although employment rates for the younger generation have increased considerably in the past few year, the unemployment rate for those aged 15-24 still amounts to 23%, double the figure before the economic bust. Emigration declined remarkably and immigration is increasing; net migration is still negative. The improving situation of the labour market has changed the situation for the better and attracts more migrant workers to return to their home country.

The necessary step to raise the minimum gross wage of employees to EUR 289 after the parliamentary election in late 2012 did not result in higher inflation but is a first step in recuperating the living conditions of low-income groups to a decent level, necessary to prevent further emigration of the much needed workforce. The increase in the purchasing power of low-income earners will further support the growth of domestic demand this year, while consumer sentiments are improving. The expert group established by the new government in order to deliver recommendations for changes in the personal income tax system has not presented final suggestions yet. It is still unclear if the envisaged redistribution of the tax burden shall be realised within the existing flat tax system or via introduction of progressive income taxation. A decision on the issue may be expected towards the end of the year. The anticipated changes shall serve two purposes. First, as the Finance Minister pointed out (and the EC and OECD have done for a long time already) the tax wedge of low-wage earners should be lowered to allow for higher employment growth for low-skilled workers. Second, it would give Lithuania the chance to take the necessary steps towards an increase of the meagre government share of below 36% in 2013, while at the same time reducing its debt burden, if required. Lithuania would need to increase its public expenditures in the social sphere in general but especially for health purposes. As in the other Baltic states the share of employees in the public social sectors in total employment is substantially below the EU-27 average and too small to deliver reasonable health outcomes.

Given the favourable economic developments, tax revenues will expand rather favourably. At the same time the share of public expenditures declined strongly also due to the still effective pay freezes for medium to high wage earning public servants. Since refinancing costs of public debt are likely to fall further, we expect a reduction of the budget deficit to 2.5% of GDP in 2013. Thereafter the Lithuanian government may opt for a slower pace in further reducing the budget deficit. The new centre-left government announced the aim of joining the euro area at the beginning of 2015, yet consumer inflation will most probably exceed the Maastricht criteria unless ‘unorthodox measures’ are to be introduced (the Latvian government e.g. lowered the value added tax by 1 percentage point). A danger to the momentarily positive economic developments in the country is that the Lithuanian government might aim at too early euro accession. As can be seen from the cases of Latvia and Estonia (but also other small open economies such as Ireland and Slovenia) the euro area neither is a safe haven nor does it deliver the right instruments and policies for economic and social cohesion. Early entry would in the case of Lithuania hamper economic growth and thus welfare developments, which alienates international investors much more than a reasonable delay of the entry date towards the euro area. Moreover, the government would risk to lose the support of the electorate that ousted austerity-driven ‘internal devaluation’ policies. As in Latvia, the project of euro accession is supported only by a minority of the population.

A still rather favourable development of external demand, the ongoing upswing in investments and robustly evolving household demand is expected to result in GDP growth by 3.5% in 2013. The scenario for the years to come is based on the assumptions of a slight weakening of external demand in the euro area, while domestic demand, including expenditures for the public wage bill and investments, will further speed up. Thus, we expect GDP growth to increase to 3.8% in 2014 and 4.2% in 2015.

Table LT

Lithuania: Selected Economic Indicators

	2009	2010	2011	2012 1)	2012	2013	2013	2014	2015
					1st quarter			Forecast	
Population, th pers., average 2)	3339.5	3286.8	3029.3	2993.5	2998.5	2970.4	2979	2964	2949
Gross domestic product, LTL mn, nom.	92032	95323	106370	113472	25250	26223	119800	127500	137600
annual change in % (real)	-14.8	1.5	5.9	3.7	3.9	3.5	3.5	3.8	4.2
GDP/capita (EUR at exchange rate)	8000	8400	10200	11000	.	.	.	.	.
GDP/capita (EUR at PPP)	12900	14100	16600	18000	.	.	.	.	.
Consumption of households, LTL mn, nom.	62807	60586	67431	72605	16919	17769	.	.	.
annual change in % (real)	-17.8	-4.8	6.8	4.3	7.4	2.9	3.0	4.0	4.5
Gross fixed capital form., LTL mn, nom.	15807	15589	18901	18925	3597	3948	.	.	.
annual change in % (real)	-39.5	1.9	18.4	-2.4	6.1	6.4	7.0	10.0	12.0
Gross industrial production (sales)									
annual change in % (real)	-13.8	6.4	6.4	3.7	2.8	6.3	6.0	8.0	8.0
Gross agricultural production (EAA)									
annual change in % (real)	1.0	-7.2	10.3	14.5	.	.	.	.	.
Construction industry									
annual change in % (real)	-48.3	-7.3	22.1	-7.3	7.9	-4.6	.	.	.
Employed persons, LFS, th, average 3)	1415.9	1343.7	1370.9	1278.5	1252.2	1267.2	1295	1315	1330
annual change in % 3)	-6.8	-5.1	2.0	1.8	1.3	1.2	1.3	1.5	1.1
Unemployed persons, LFS, th, average 3)	225.1	291.1	248.8	195.2	211.6	191.2	177	163	148
Unemployment rate, LFS, in %, average 3)	13.7	17.8	15.4	13.3	14.5	13.1	12.0	11.0	10.0
Reg. unemployment rate, in %, end of period 4)	12.5	14.4	11.0	11.4	11.8	12.4	.	.	.
Average gross monthly wages, LTL 5)	2056.0	1988.1	2045.9	2123.8	2138.1	2239.9	.	.	.
annual change in % (real, net)	-7.2	-4.3	-1.4	0.5	-0.5	2.0	.	.	.
Consumer prices (HICP), % p.a.	4.2	1.2	4.1	3.2	3.6	2.2	2.0	2.5	3.6
Producer prices in industry, % p.a.	-13.5	10.3	13.9	5.0	8.5	-0.1	.	.	.
General goverm.budget, EU-def., % of GDP									
Revenues	35.5	35.2	33.3	32.9	33.3	.	33.0	33.3	34.0
Expenditures	44.9	42.4	38.9	36.2	38.9	.	35.5	35.5	36.0
Net lending (+) / net borrowing (-)	-9.4	-7.2	-5.5	-3.3	-5.5	.	-2.5	-2.2	-2.0
Public debt, EU-def., % of GDP	29.3	37.9	38.5	40.7	42.7	.	40.2	39.0	37.0
Central bank policy rate, % p.a., end of period 6)	1.57	1.07	1.24	0.52	0.79	0.34	.	.	.
Current account, EUR mn	996	20	-1151	-167	-782	-386	-1000	-1100	-1200
Current account, % of GDP	3.7	0.1	-3.7	-0.5	-10.7	-5.1	-2.9	-3.0	-3.0
Exports of goods, BOP, EUR mn	11797	15651	20151	23071	5125	5988	26000	29000	32000
annual change in %	-26.6	32.7	28.8	14.5	12.0	16.8	12.7	11.5	10.3
Imports of goods, BOP, EUR mn	12688	16990	21958	24131	5759	6132	26100	29500	33500
annual change in %	-37.4	33.9	29.2	9.9	13.6	6.5	8.2	13.0	13.6
Exports of services, BOP, EUR mn	2629	3088	3738	4587	909	1013	5300	6350	7800
annual change in %	-18.9	17.5	21.0	22.7	19.1	11.5	15.5	19.8	22.8
Imports of services, BOP, EUR mn	2192	2274	2742	3340	739	895	4000	4700	5500
annual change in %	-22.7	3.7	20.6	21.8	21.9	21.1	19.8	17.5	17.0
FDI inflow, EUR mn	-9	604	1040	650	280	478	1400	.	.
FDI outflow, EUR mn	143	-4	40	312	59	44	250	.	.
Gross reserves of NB excl. gold, EUR mn	4472	4788	6120	6203	5755	5401	.	.	.
Gross external debt, EUR mn	22363	22976	23976	24784	25302	.	.	.	.
Gross external debt, % of GDP	83.9	83.2	77.8	75.4	77.0	.	.	.	.
Average exchange rate LTL/EUR	3.4528	3.4528	3.4528	3.4528	3.45	3.45	3.45	3.45	3.45
Purchasing power parity LTL/EUR	2.1363	2.0627	2.1198	2.1108	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 according to census March 2011. - 3) From 2012 according to census March 2011. - 4) In % of working age population. - 5) Annual data include earnings of sole proprietors. - 6) VILIBOR one-month interbank offered rate (Lithuania has a currency board).

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.