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## Lithuania: Above-average growth

***Last years' revival after the economic disaster of 2007 to 2010 allows Lithuanian households to gradually recuperate their consumption levels, thereby acting as the main growth driver in 2012. The parliamentary elections in October shall bring about a change in the government from centre-right to centre-left. However, the orientation of economic policies – austerity and the target to join the Eurozone in about 2015 – will remain the same.***

Export growth declined gradually in the few first months of 2012. Surprisingly, however, exports to Lithuania's trading partners in the EU remained quite nimble, whereas external demand in Russia, its most important trading partner, even declined in nominal terms at the beginning of 2012. A mix of higher oil prices and vigorous domestic demand saw import growth rates consistently exceeding export growth rates. Thus, in the first quarter 2012 the current account deficit leapt once again to 8% of GDP. For 2012 as a whole, we expect import growth to weaken somewhat. That notwithstanding, current account deficits are back on the books since over the medium term Lithuania as its Baltic neighbours will continue to enjoy more rapid growth than their trading partners.

The country's economy continues to be driven by domestic demand. Although credit growth remains stagnant in both the household and corporate sectors, mitigation of conditions in the labour market has brought about a marked increase in household consumption (after a fall of more than 25% in 2008 – 2010), which should remain resilient throughout the year. Owing to rising real wages, we expect the propensity to consume to remain high throughout 2013 and 2014 as well.

In particular, investment in machinery and equipment continued to rise in the manufacturing sector. However, given the downturn in external demand, producer confidence dropped. Entrepreneurs started to reduce stocks in the last quarter 2011 and in the first quarter 2012, thus gross capital formation continued declining year-on-year in real terms.

The economic revival of 2011 brought about an increase in employment, particularly in industry. In the first quarter 2012, the rate of unemployment dropped to 14.5%: a figure still far above the EU-27 average. The likely flattening of the business cycle over the next six months will generate only a meagre number of jobs. We thus expect the average unemployment rate to decline only slightly to 13.8% in 2012. The still strained situation in the labour market has caused average real wages to drop still further in Lithuania. However, towards the end of the current year the effect of lower import prices on domestic inflation shall bring about a rise in real wages for the first time since the onset of the economic crisis. Moreover, in May the government suggested raising the Lithuanian minimum wage to €260 to enter into effect in January 2013: a measure that the opposition parties also support. Thus, the resultant stronger wage growth should also bolster consumption dynamics in 2013.

On account of the lower import prices and their impact on inflation, the increase in the prices of consumer goods dropped gradually over the first few months of 2012. Given the likelihood of a drop in oil prices, a resource on which Lithuania is now more dependent than ever following the closure of the Ignalina nuclear power plant, we expect the CPI-rate to drop to 3% on average in 2012.

The revival of external demand over the past two years allowed the Lithuanian government to pursue its severe austerity policy and to cut the budget deficit. The current year's fiscal deficit will be reduced to slightly above 3% of GDP. Although the government has maintained a strict policy of restraint where public wages, pensions and public expenditures are concerned, it is discussing various forms of tax cuts for households in order to secure public support for the upcoming parliamentary elections.

Scheduled to be held in October 2012, the elections will most probably bring about a change in government with the ruling centre-right coalition ceding to a centre-left coalition. The strongest opposition parties, the Labour Party led by Viktor Uspaskich, the Social Democratic Party and the Order and Justice Party headed by Rolandas Paksas are front-runners in the opinion polls, while the Homeland Union chaired by Prime Minister Kubilius is the only right-wing party that, were elections to be held today, would clear the 5 per cent barrier regulating representation in parliament. The opposition parties mentioned above recently reached an agreement on joining forces after the elections in order to form a coalition government. The Social Democrats held the post of the prime minister in the penultimate parliamentary term (2004 – 2008). No radical changes are to be expected from the parties most likely to coalesce, since they lean more to the centre as well as being more inclined towards the business sector than the left wing. One issue that the opposition

parties are mooted is a switch from the present flat-tax system to a progressive income tax scheme. Not only has the flat-tax system had detrimental distributional consequences, but Lithuania is also currently the country with the lowest government revenue-to-GDP ratio. Slovakia has also very recently decided to abandon the flat-tax system that it introduced in 2004 in order to alleviate the budget's chronic revenue shortage. In an era when sovereign debt crises abound, progressive taxation seems to be enjoying a revival.

Driven by a decline in external demand, but displaying stable household consumption, 2012 will see a slowdown in GDP growth to 3% in real terms. In 2013 and 2014, with the exports of goods gradually recovering, a slight increase in corporate investments will re-emerge. The probable increase in both minimum and average real wages should provide for stable household consumption. We thus expect GDP to grow at a swifter pace: 3.6% in 2013 and 4.2% in 2014.

Table LT

## Lithuania: Selected Economic Indicators

	2008	2009	2010	2011 <sup>1)</sup>	2011 1st quarter	2012	2012 Forecast	2013	2014
Population, th pers., average <sup>2)</sup>	3358.1	3339.5	3286.8	3053.8	.	.	3023	3008	2993
Gross domestic product, LTL mn, nom.	112084	91914	95074	106019	23234	25249	112500	120000	129400
annual change in % (real)	2.9	-14.8	1.4	5.9	5.9	3.9	3	3.6	4
GDP/capita (EUR at exchange rate)	9700	8000	8400	9500	.	.	.	.	.
GDP/capita (EUR at PPP)	15400	12800	14000	16200	.	.	.	.	.
Consumption of households, LTL mn, nom.	73406	63309	60994	67378	15147	16761	.	.	.
annual change in % (real)	4.2	-17.4	-5.0	6.1	5.5	6.8	4	3.5	4
Gross fixed capital form., LTL mn, nom.	28370	15808	15489	18651	3202	3589	.	.	.
annual change in % (real)	-5.2	-39.5	1.0	17.0	45.7	8.4	7	9	10
Gross industrial production (sales)									
annual change in % (real)	5.5	-14.6	6.7	7.4	14.5	3.9	4.5	6	7
Gross agricultural production (EAA)									
annual change in % (real)	8.8	1.0	-7.2	6.5	.	.	.	.	.
Construction industry									
annual change in % (real)	4.0	-48.5	-7.7	22.2	15.9	11.7	.	.	.
Employed persons - LFS, th, average	1520.0	1415.9	1343.7	1370.9	1340.4	1365.9	1390	1405	1420
annual change in %	-0.9	-6.8	-5.1	2.0	0.9	1.9	1.4	1.1	1.1
Unemployed persons - LFS, th, average	94.3	225.1	291.1	248.8	277.6	230.9	.	.	.
Unemployment rate - LFS, in %, average	5.8	13.7	17.8	15.4	17.2	14.5	13.8	12.5	11.5
Reg. unemployment rate, in %, end of period <sup>3)</sup>	4.4	12.5	14.4	11.0	13.6	11.8	.	.	.
Average gross monthly wages, LTL	2151.7	2056.0	1988.1	2042.0	2071.6	2138.1	.	.	.
annual change in % (real, net)	10.1	-7.2	-4.3	-1.5	-1.4	-0.5	.	.	.
Consumer prices (HICP), % p.a.	11.1	4.2	1.2	4.1	3.2	3.6	3	3	3.5
Producer prices in industry, % p.a.	18.2	-13.5	10.3	13.9	15.4	8.5	.	.	.
General govern.budget, EU-def., % GDP									
Revenues	33.9	34.3	33.7	32.0	31.6	.	33.5	33.2	34.0
Expenditures	37.2	43.8	40.9	37.5	39.2	.	36.8	36.0	36.5
Net lending (+) / net borrowing (-)	-3.3	-9.4	-7.3	-5.5	-7.6	.	-3.3	-2.8	-2.5
Public debt, EU-def., in % of GDP	15.5	29.4	38.0	38.5	39.2	.	40.5	41.0	40.0
Central bank policy rate, % p.a., end of period <sup>4)</sup>	7.84	1.57	1.07	1.24	1.10	.	.	.	.
Current account, EUR mn	-4194	1182	410	-481	-74	-586	-1500	-1500	-1500
Current account in % of GDP	-12.9	4.4	1.5	-1.6	-1.1	-8.0	-4.6	-4.3	-4.0
Exports of goods, BOP, EUR mn	16077	11797	15651	20169	4571	5112	22300	25500	29000
annual growth rate in %	28.5	-26.6	32.7	28.9	50.0	11.8	11	14	14
Imports of goods, BOP, EUR mn	20280	12648	16921	21678	4999	5652	24000	28000	33000
annual growth rate in %	20.8	-37.6	33.8	28.1	49.5	13.1	11	17	18
Exports of services, BOP, EUR mn	3240	2657	3115	3761	777	748	3800	4200	4700
annual growth rate in %	10.5	-18.0	17.2	20.7	24.1	-3.7	1.0	11	12
Imports of services, BOP, EUR mn	2835	2140	2141	2650	537	619	2900	3200	3600
annual growth rate in %	14.7	-24.5	0.0	23.8	23.4	15.3	9	10	13
FDI inflow, EUR mn	1341	47	568	875	150	300	.	.	.
FDI outflow, EUR mn	229	157	60	118	-7	52	.	.	.
Gross reserves of NB excl. gold, EUR mn	4458	4472	4788	6120	4738	5755	.	.	.
Gross external debt, EUR mn	23009	23163	24071	24813	23976	.	.	.	.
Gross external debt in % of GDP	70.9	87.0	87.4	80.8	78.1	.	.	.	.
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	2.1710	2.1498	2.0621	2.1405	.	.	.	.	.

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) In % of working age population. - 4) VILIBOR one-month interbank offered rate (Lithuania has a currency board).

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