15. LITHUANIA

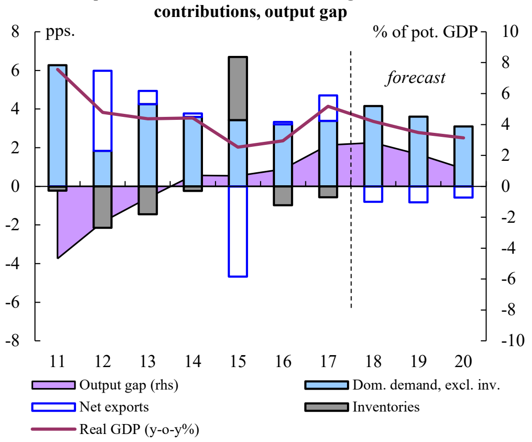
Domestic demand to drive GDP growth

Consumption and investment were strong in the first half of the year and are expected to continue supporting GDP growth over the forecast horizon. After peaking in 2017, inflation is expected to slow, as upward pressures from indirect taxes dissipate. The labour market is tightening and will continue to put pressure on wages. Lithuania is expected to maintain a general government surplus over the forecast horizon and a debt level well below 60% of GDP.

Growth momentum maintained

The strong momentum which propelled GDP growth in Lithuania to 4.1% in 2017 continued in the first half of 2018. The main drivers were private consumption and a robust increase in investment that was also supported by greater use of EU funding. Export growth slowed down to average levels due to a strong base effect (in 2017, exports grew by 13.6%, the highest in the EU) and weakening foreign demand. Contrary to 2017, re-exports, mainly to non-EU partners, almost came to a halt.

Graph II.15.1: **Lithuania - Real GDP growth and contributions, output gap**



Private consumption remains supported by high employment and rising real wages, which increases disposable income. After gaining momentum in 2017, investment continues to flourish, with productive investments, like machinery and intellectual property, growing at a faster pace than non-productive investments. From the beginning of 2018, inflation started slowing as the effect of last year's excise duty hikes and a one-off increase in air passenger transport prices in 2017 waned. Overall, the economy should remain strong in 2018 and grow at a rate of 3.4%.

Domestic factors expected to support growth

In 2019 and 2020, economic growth is expected to moderate to 2.8% and 2.5% respectively, driven by private consumption and, to a lesser extent, by investment. While wage growth is set to be somewhat slower than in 2018, private consumption should get an additional boost from the tax and social security reforms that were adopted this summer. At the same time, investment growth is expected to remain buoyant, boosted by a greater use of EU funds and spurred by capacity constraints in the context of increasing labour shortages.

After an exceptional trade performance in 2017, both imports and exports are expected to grow more slowly over the forecast horizon due to base effects and cooling economic activity in important trading partners. Domestic demand for capital goods as well as strong private consumption are expected to continue driving import growth. Service exports, especially in transport, ICT and manufacturing services are set to remain an important determinant of export growth resulting in a trade surplus in services. However, as this is unlikely to offset the trade deficit in goods, the overall net export contribution to GDP growth is expected to be slightly negative in the coming years.

Persistent tightness in the labour market

In the first half of 2018, the unemployment rate fell to 6.6%, which is approximately 1 pp. lower compared to the same period in 2017. The record high employment rate signals a shrinking labour force and strong labour demand. Due to increases in minimum wages and labour shortages, salaries grew by approximately 10% in the first six months of this year.

On the labour supply side, contrary to previous years, preliminary data points to an improving migration balance. However, more immigrants and the increasing temporary employment of workers from neighbouring non-EU countries cannot fully offset labour shortages. As labour demand is expected to remain strong, the unemployment rate is set to decline to 6.3% by 2019. Tightness in the labour market is also expected to continue exerting upward pressure on wages over the forecast horizon.

Inflation slowing down

After peaking at 3.7% in 2017, HICP inflation is expected to drop to 2.6% in 2018, 2.2% in 2019 and 2.1% in 2020. A significant slowdown in the inflation rate in 2018 reflects the fading away of excise duties hikes and other one-off effects. These factors are expected to offset the upward pressures stemming from higher oil prices and strong wage growth in 2018. In 2019 and 2020, inflation is forecast to further moderate in line with the expected stabilisation of oil prices.

Fiscal loosening ahead

Tax collection, helped by tax-rich economic growth and contained government spending, enabled Lithuania to achieve a general government surplus in 2016 and 2017. As these developments continue in 2018, the general government balance is expected to stand at 0.6% of GDP in 2018. However, the surplus is expected to narrow over the forecast horizon with the implementation of the reform package adopted in 2018. Adjustments to the tax and social security systems are set to result in lower tax revenues and increased spending. Subsequently, the general government balance is expected to stand at 0.4% in 2019 and fall to 0.1% of GDP in 2020.

The structural deficit is expected to fall from ¾% in 2018 to ½% of GDP in 2020, due to a decreasing output gap.

Following the downward trend since 2015, Lithuania's debt-to-GDP ratio is set to decline further in 2018. It should reach 34.8% thanks to a bond redemption at the beginning of the year. As the government will have to secure the pre-financing of 2020 bond redemptions in 2019, the general government debt is set to increase to 37.9% of GDP in 2019 before settling to 37.6% in 2020.

Table II.15.1:

Main features of country forecast - LITHUANIA

		2017		Annual percentage change						
	bn EUR	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		42.2	100.0	3.9	2.0	2.4	4.1	**3.4**	**2.8**	**2.5**
Private Consumption		26.6	63.0	4.5	4.0	5.0	3.3	**4.2**	**3.9**	**3.3**
Public Consumption		6.9	16.4	0.7	0.2	-0.1	-0.4	**0.7**	**0.7**	**0.6**
Gross fixed capital formation		8.1	19.2	4.1	4.9	0.3	6.8	**7.3**	**5.3**	**4.4**
of which: equipment		2.9	6.9	5.5	13.4	8.9	8.6	**9.5**	**6.7**	**5.5**
Exports (goods and services)		34.1	80.9	8.7	0.9	4.0	13.6	**5.2**	**4.1**	**3.7**
Imports (goods and services)		33.0	78.1	7.8	6.8	3.8	12.0	**6.5**	**5.2**	**4.4**
GNI (GDP deflator)		40.5	96.0	4.0	-0.8	2.4	4.2	**3.6**	**3.0**	**2.7**
Contribution to GDP growth:	Domestic demand			4.2	3.4	3.2	3.4	**4.2**	**3.6**	**3.1**
	Inventories			-0.2	3.3	-1.0	-0.6	**0.0**	**0.0**	**0.0**
	Net exports			0.1	-4.7	0.1	1.3	**-0.8**	**-0.8**	**-0.6**
Employment				-0.8	1.3	2.0	-0.5	**-0.4**	**-0.5**	**-0.5**
Unemployment rate (a)				12.0	9.1	7.9	7.1	**6.5**	**6.3**	**6.3**
Compensation of employees / head				6.6	5.9	6.7	8.7	**8.2**	**7.7**	**6.0**
Unit labour costs whole economy				1.8	5.1	6.4	3.8	**4.2**	**4.2**	**2.9**
Real unit labour cost				-0.8	4.7	4.9	-0.5	**1.6**	**0.6**	**-0.7**
Saving rate of households (b)				3.4	0.4	0.2	-1.5	**-2.9**	**-1.9**	**-2.3**
GDP deflator				2.6	0.3	1.4	4.3	**2.6**	**3.7**	**3.6**
Harmonised index of consumer prices				2.6	-0.7	0.7	3.7	**2.6**	**2.2**	**2.1**
Terms of trade goods				1.1	2.5	2.4	0.5	**-0.5**	**0.2**	**0.9**
Trade balance (goods) (c)				-9.0	-5.3	-4.6	-4.6	**-5.9**	**-6.5**	**-6.3**
Current-account balance (c)				-5.2	-2.0	-0.7	0.9	**-0.8**	**-0.8**	**-0.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.5	1.0	0.7	2.1	**0.6**	**0.6**	**0.7**
General government balance (c)				-3.1	-0.3	0.3	0.5	**0.6**	**0.4**	**0.1**
Cyclically-adjusted budget balance (d)				-2.7	-0.5	-0.2	-0.6	**-0.6**	**-0.5**	**-0.4**
Structural budget balance (d)				-	-0.7	-0.4	-0.7	**-0.6**	**-0.5**	**-0.4**
General government gross debt (c)				26.0	42.6	39.9	39.4	**34.8**	**37.9**	**37.6**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.