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The Lithuanian Economic Review analyses the developments of the real sector, prices, public finance and credit in Lithuania, as well as the projected development of the domestic economy. The material presented in this review is the result of statistical data analysis, modelling and expert assessment. The review is prepared by the Bank of Lithuania.

Chapter I "International Environment" and Chapter II "Monetary Policy of the Eurosystem" are based on the data published by 13 March 2020, while the remaining chapters – on information made available by 2 March 2020.

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CHARTS

ABBREVIATIONS

CIS	Commonwealth of Independent States
EC	European Commission
ECB	European Central Bank
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurostat	statistical office of the European Union
Eurosystem	European Central Bank and euro area national banks
GDP	gross domestic product
HICP	harmonised index of consumer prices
ICT	information and communications technology
IMF	International Monetary Fund
MFI	monetary financial institution
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	purchasing managers' index
RE	real estate
UK	United Kingdom
US	United States of Amerika
VAT	value-added tax

LITHUANIA'S ECONOMIC DEVELOPMENT AND OUTLOOK

The present Lithuanian Economic Review provides a comprehensive picture of Lithuania's economic performance in 2019, based on the data and information published by 13 March, i.e. prior to the nationwide lockdown imposed due to the coronavirus (COVID-19). Given the drastic changes brought by the quarantine measures introduced across the globe, the country's macroeconomic projections were updated on 27 March and published separately.[1]

The euro area's economic growth moderated at the end of 2019 – right before the coronavirus outbreak. The US-China trade war not only had a dampening impact on trade between the two countries but also negatively affected other economies trading with China and strongly integrated into the global value chain. For instance, Germany's GDP stalled in the last quarter of 2019, whereas France saw its GDP growth turn negative in the same quarter as a result of widespread labour strikes started at the end of the year. Italy's economy slowed down already before the pandemic, with its GDP shrinking by 0.3% quarter-on-quarter in the fourth quarter of 2019. Among other things, such developments might have been underpinned by high uncertainty over economic policy triggered by ongoing trade conflicts and Brexit.

Despite the global slowdown, Lithuania's economy maintained its rapid growth up until the end of the year and reached 3.9%. Economic growth was mostly driven by private consumption and investment. Robust wage growth and low inflation boosted household disposable income and consumption throughout 2019. Rapid investment growth (reaching 7.4%) was supported by the private sector's investment in machinery and equipment, as well as construction of non-residential buildings and structures that was co-financed from EU funds. Investment in ICT equipment, which had already been on an upward path for several years reflecting business digitalisation and modernisation in Lithuania, also showed a substantial increase. This type of investment is of the utmost importance in terms of its productivity-enhancing effect. Even though Lithuania's exports remained robust, the growth rates of many categories of Lithuanian-origin goods decreased at the end of 2019. The tightening of the labour market reached a plateau last year, as the unemployment rate stabilised at 6.3%. While wage growth in the private sector lost some steam, the general wage growth in the country remained buoyant and reached 9%. The easing of tensions was to some extent prompted by a positive migration balance observed for the first time since the restoration of Lithuania's independence, as immigration exceeded emigration by 10,000 persons. Inflation in the country remained low and stood at 2.2%. The key inflation drivers included prices of services which were significantly affected by growing wages, as well as global food prices pushed higher by a poor harvest.

[1] Macroeconomic projections (March 2020).

I. INTERNATIONAL ENVIRONMENT

(the cut-off date is 13 March 2020)

Even though some risks have subsided, global economic growth has been losing momentum under the pressure of the coronavirus outbreak. According to estimates as of end-2019, the global economy was expected to expand by approximately 3% in 2020. However, the coronavirus pandemic made this projection much more pessimistic. Having started in China and resulted in a downfall in the country's manufacturing and services sectors, the virus continued to spread across the entire globe. The initial fears of short-term supply disruptions, which could potentially be offset by inventories, later gave way to the realisation that the negative repercussions of the infection will reverberate throughout the global economy through various channels. This in turn led to a strong demand shock that was triggered both directly – through the services sector (particularly its travel segment) as well as consumers staying at home and cutting down their consumption of durable goods – and indirectly, i.e. through the weakening financial markets reducing the value of household assets and private consumption. Suspension of manufacturing operations, disruptions in supply chains and the imposed lockdown measures have induced a supply shock which manifested itself in a shortage of goods and order delays. Moreover, it might be further aggravated by mass layoffs in the near future. Early in the year, economic outlook was based on two assumptions: the coronavirus was expected to be contained within China's borders and its spread to be halted entirely. Yet surveys (e.g. Sentix) show that since February the global economy has been growing at a much slower pace or even declining. According to the IMF, the predicted pickup in global growth will not materialise this year due to the coronavirus impact, and its growth rate should fall below 2.9%. In March, the OECD cut its global growth forecast by 0.5 percentage point (to 2.4%) in the optimistic scenario, not ruling out a potential deceleration to 1.4% in case of a more adverse scenario.

The coronavirus pandemic, a new migrant crisis unfolding in Greece and the headwinds faced by the major economies give little hope that the euro area economic growth will gain traction in 2020. At the end of 2019, a favourable situation in the labour market, growing disposable income and low borrowing costs continued to fuel the growth of private consumption – one of the key driving forces of the euro area economic development. Moreover, they helped offset the decline in external demand. Even though the situation in the manufacturing sector stabilised at the beginning of the year (see Chart 1), the euro area economy reached growth of a meagre 1.2% in 2019. Having narrowly escaped a technical recession in the third quarter, Germany's economy stagnated in the fourth quarter. In the last quarter of 2019, France also saw its GDP shrink for the first time since 2016 (the quarter-on-quarter change was -0.1%) as a result of mass protests initiated in December by trade unions against the president's plans to reform the country's pension system. Italy, which has become the centre of the worst coronavirus outbreak in Europe and where a nationwide lockdown was imposed, is very likely to plunge into recession in 2020. Other countries of the bloc are already experiencing certain disruptions in their supply chains as well as a slowdown in the services sectors. Another source of concern for the EU is thousands of migrants from Syria stuck at the Turkey-Greece border. This situation may soon evolve into a new refugee crisis.

The UK's economy recovered in early 2020 on the back of fading political uncertainty. The strongest upward trends were observed in the services sector which accounts for approximately 80% of the country's GDP. The victory of Boris Johnson's Conservative party in the UK's snap general election gave a boost to consumer confidence, whereas the country's businesses recorded the fastest revenue growth since mid-2018. Private consumption, which remained on an upward path at the end of 2019, and corporate investment encouraged job creation, while the country's exports recorded another increase in January. The strongest impetus for economic recovery came from the subsiding risk of hard Brexit following the UK's exit from the EU on 31 January, which marked the beginning of a transitional period during which trade relations between the UK and the EU will remain broadly unchanged. The parties are expected to reach a free trade agreement by the end of the year. However, frictions in negotiations induce the risk of a narrow deal or no deal at all.

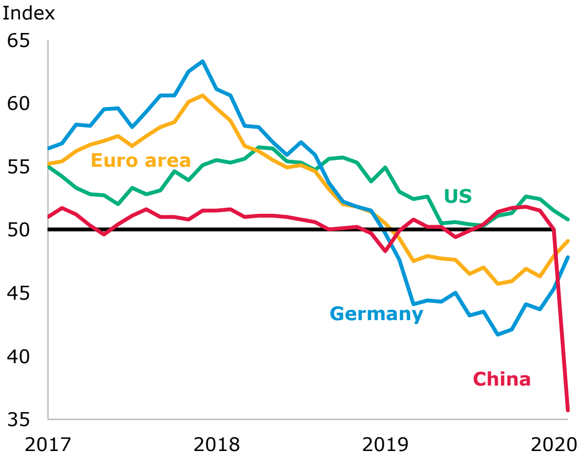
The spillover effects of the coronavirus outbreak hit the US economy at the beginning of 2020. In 2019, the US economy continued its record-breaking expansion, reaching an increase of 2.3%. Despite the

US-China trade conflict, rising net exports driven by a decline in imports emerged as the biggest contributor to the country's output growth. Moreover, strong performance of the labour market (unemployment rate in January stood at 3.6%), rising wages and high levels of consumer confidence supported the growth of private consumption expenditure. However, a potential escalation of trade conflicts, in particular between the US and the EU, heightening geopolitical tensions and the challenges brought on by the coronavirus are set to dampen economic growth in 2020. In fact, the novel virus has already affected the country's economy. For instance, in February, economic activity in the US suffered its first decline since the partial government shutdown in 2013, whereas the services PMI recorded a decrease, largely reflecting the weakening demand in the tourism and services sectors. In response to the growing economic risks, the US Federal Reserve System has decided to cut its benchmark interest rate by 0.5 percentage point to 1.0–1.25% in early March 2020.

In 2019, China's economy grew at its slowest pace in 30 years and its performance is set to worsen further in 2020. China's PMI plummeted to its all-time lows (27.5) in February on the back of a fall in consumption and a decline in economic activity. Given that China, dubbed the 'world's factory', accounts for one-third of the total manufacturing output and is the top exporter at a global scale, it is hardly surprising that a decline in its economic activity caused by the coronavirus and its prevention measures has negative economic repercussions both on a national and global levels. China's sales of durable goods (with car sales plunging by 92% in the first two weeks of February) and the services sector (with international flights from China falling by 55.9% year-on-year) were hit the hardest by the coronavirus shock. Even if China puts its production facilities back to work in the upcoming months, the risks that disruptions in supply chains in South Korea, Japan and Europe will keep curbing export orders remain very high. The IMF has revised its 2020 China growth forecast down by more than 0.4 percentage point to below 5.6%.

Having recovered at the beginning of the year, the manufacturing sector is now set to be dampened by the coronavirus outbreak.

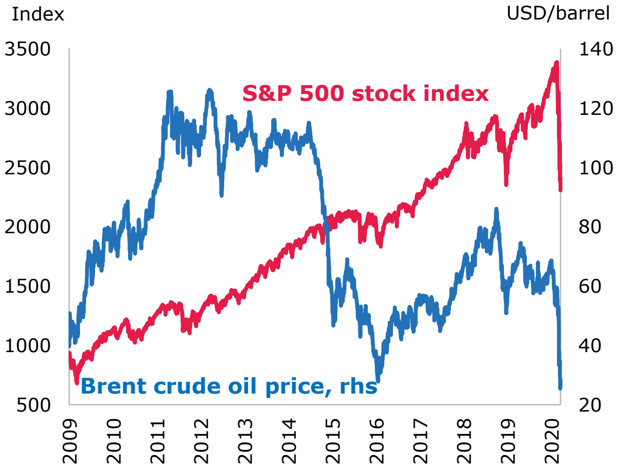
Chart 1. Manufacturing PMI for the euro area, Germany, the US and China



Source: Markit.

Following a collapse in crude oil prices caused by the coronavirus and disagreements within OPEC, stock prices suffered the steepest fall since the global financial crisis.

Chart 2. Dynamics of the S&P 500 stock index and Brent crude oil prices



Source: Macrobond.

Weaker global economy will weigh on economic growth in Lithuania's neighbouring countries. Private consumption in Estonia, Latvia and Poland continued its rapid growth in 2019, underpinned by rising wages and strong consumer confidence. As estimated by the EC in February 2020, even though domestic demand will support economic growth in Estonia and Poland, it will prove insufficient to prevent a slowdown in 2020, largely due to the deteriorated external environment. Meanwhile, Latvia's economic growth should accelerate marginally on the back of increasing consumption in the private and public sectors.

In 2020, the coronavirus outbreak and disagreements between OPEC members have dampened optimism in financial and commodities markets. Fears over the impact of the novel virus started causing jitters in financial markets already in late February and peaked on 12 March, dubbed the Black Thursday, when stocks suffered their worst one-day fall since the crash of 1987. Such panic in the markets was triggered not only by the announcement of the coronavirus pandemic early that week but also by the 30-day suspension of all travel from the Schengen area to the US put in place by the US president's administration, as well as by the ECB's decision to keep its key policy rates unchanged. As a result, lower-rated undertakings saw their interest rates increase substantially, which means that the tightening of financial conditions may produce an adverse effect on financial stability. The currencies of economies with strong links to China's supply chains have weakened, as the shutdown of production facilities has slammed stocks of the country's manufacturers. Even though the coronavirus pandemic caused a drop in global crude demand, OPEC members failed to agree on further cuts to their production levels, which led to the scrapping of all restrictions. Consequently, on 9 March, the price of crude oil plunged to USD 30 per barrel – its lowest level since 1991 (see Chart 2). The drastic fall in crude oil prices added yet another layer of uncertainty in the financial markets. Investors' retreat to safety resulted in spiking gold prices that reached their seven-year highs (USD 1,700 per troy ounce), whereas the yield of 30-year US Treasuries sank below 1% for the first time in history. Central banks responded to these developments by cutting their policy rates, some governments pledged to take fiscal stimulus measures, while the IMF set up an emergency programme to help countries fight the virus.

The balance of risks to the global outlook is strongly tilted to the downside. The coronavirus, which has emerged in China and spread globally, is likely to inflict more pain to the global economy than the 2002–2003 SARS outbreak – according to some estimates, the latter cost approximately USD 40 billion.[2] There are still certain risks that a failure to contain the virus might induce particularly severe losses to the global economy through both the demand-side and supply-side factors. China, which accounts for 16.3% of the world's GDP (up from a meagre 4.2% in 2003), now plays a much more important role in global value chains, hence a slowdown in this country should have serious repercussions on the global economy. Other risks include a failure to secure a UK-EU trade deal, the growing US corporate debt and its deteriorating quality, rising levels of indebtedness (particularly in foreign currencies) in the emerging markets, an increasing risk appetite in the current low interest rate environment, which in turn poses a threat to the global financial stability, disputes within OPEC over the levels of crude oil production as well as escalating tensions and the risk of armed conflicts in the Middle East that might trigger another migrant crisis in the EU.

[2] Globalization and Disease: The Case of SARS.

II. MONETARY POLICY OF THE EUROSYSTEM

(the cut-off date is 13 March 2020)

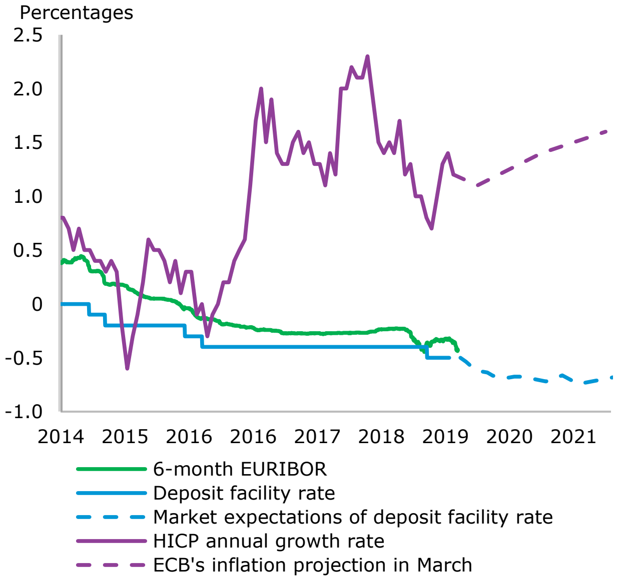
Over the past six months, the Eurosystem has further been strengthening its accommodative monetary policy stance, aiming to ensure the sustained convergence of inflation towards levels that are below, but close to, 2%. The high level of the accommodative monetary policy is ensured by the exceptionally low ECB key interest rates and their projected development, the increasing stock of acquired bonds as well as new long-term lending operations. The ECB's Governing Council has also decided to launch a review of its monetary policy strategy.

Net purchases have been restarted under the Governing Council's asset purchase programme (APP) at a monthly pace of €20 billion as from 1 November 2019. In the period from March 2015 to the end-January 2020, the Eurosystem purchased assets totalling €2.7 trillion, whereas the Bank of Lithuania's purchases amounted to €10.7 billion (€0.2 billion since November 2019). The net purchases are expected to end shortly before the Governing Council starts raising the key ECB interest rates. According to expectations of market participants, the deposit facility rate, which was decreased in September 2019, will not increase for at least a couple of years (see Chart 3).

In March 2020, the ECB's Governing Council decided on an additional comprehensive package of monetary policy measures in response to the coronavirus threat to economic growth and inflation rates in the euro area. First, in order to provide immediate liquidity support to the euro area financial system, it was decided to temporarily (until June 2020) conduct additional longer-term refinancing operations (LTROs) on particularly favourable terms, i.e. by applying an average deposit facility rate which stands at -50 basis points since September 2019 (see Chart 3). Second, in order to support bank lending to enterprises that have been most affected by the pandemic, more favourable conditions will be provided in terms of targeted longer-term refinancing operations (TLTROs). For example, the interest rate applied in these operations for banks that maintain their usual levels of credit provision may be 25 basis points below the average deposit facility interest rate. Third, the Governing Council decided to add a temporary envelope of additional net asset purchases of €120 billion until the end of the year. This will support favourable financing conditions for the real economy amid continued heightened uncertainty.

The ECB interest rates remain at very low levels.

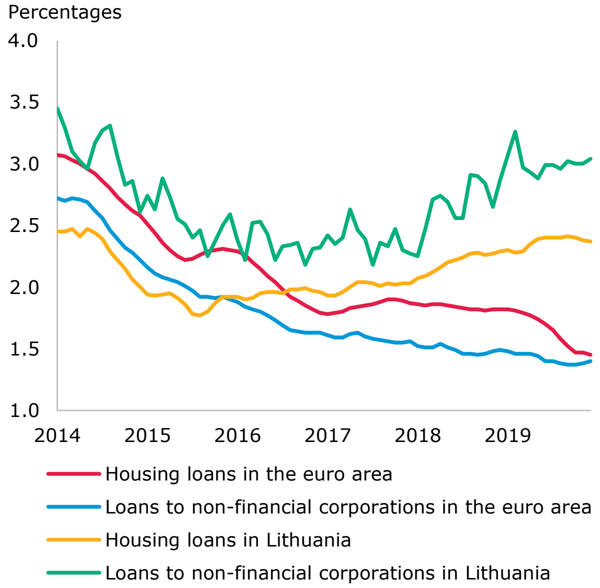
Chart 3. Actual ECB interest rates, inflation and market expectations



Sources: ECB and Refinitiv.
Note: Data as of 13 March.

Funding conditions remain favourable.

Chart 4. Average interest rates on new MFI housing loans and loans to non-financial corporations



Sources: ECB and Bank of Lithuania calculations.
Note: 3-month moving average.

The Eurosystem's accommodative monetary policy measures contribute to exceptionally low loan interest rates. During the past year, interest rates in the euro area (especially in the housing loan market) have plunged to historic lows. After several years of growth, the average interest rates on new loans in Lithuania have stabilised and remain higher than the euro area average (especially those to non-financial corporations) (see Chart 4). Elevated interest rates in the Lithuanian market may be determined by the deteriorating competitive environment in the context of recently increased concentration in the banking sector, as well as a potentially higher risk of new loans. Yet it should be noted that if the Eurosystem had not implemented its accommodative monetary policy, loan interest rates in the country would most probably have been even higher.

In January, the ECB's Governing Council launched a review of its monetary policy strategy. The Eurosystem's monetary policy strategy was adopted in 1998 and some of its elements were clarified in 2003. However, since then, the euro area and the world economy have been undergoing profound structural changes: globalisation, rapid digitalisation, evolving financial structures and the threat to environmental sustainability. Furthermore, the slowing productivity growth, ageing population, as well as the legacy of the financial crisis have driven interest rates down. Therefore, the ECB and other central banks have less room to reduce interest rates when needed. While reviewing its strategy, the ECB Governing Council will focus on the quantitative formulation of price stability (which currently is to maintain inflation at a level sufficiently close to, but below, 2%) as well as on the analysis of the effectiveness and potential side effects of the monetary policy toolkit aimed at ensuring price stability. The review will also take into account how financial stability, employment and environmental sustainability can be relevant in implementing the ECB's monetary policy. Finally, the Governing Council will review its communication practices. The process is expected to be concluded by the end of the year.[3]

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[3] During the strategy review, euro area residents are welcome to share their views at the events organised by central banks or to submit their proposals on this website.

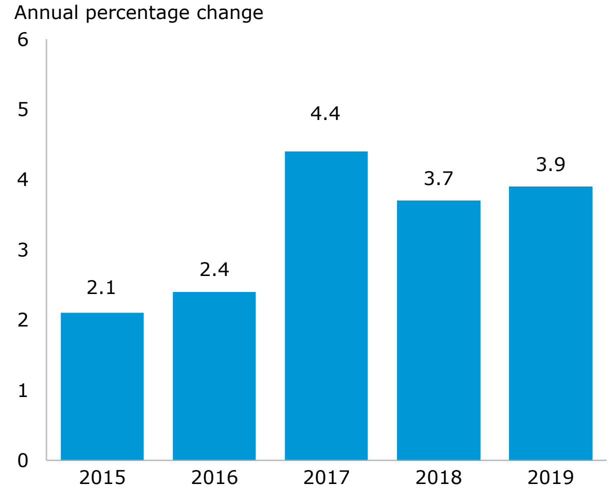
III. REAL SECTOR

(the cut-off date is 2 March 2020)

Last year, Lithuania's economy managed to resist negative downside factors. Faltering external trade affected by ongoing trade wars, the EU industry struggling for recovery and challenges faced by the transport sector did not have a substantial negative impact on Lithuania's economic growth in 2019. Having increased by 4.2% in the first quarter, the country's real GDP grew at a stable pace of 3.8% in the second to fourth quarters of 2019. As a result, last year Lithuania's economy recorded an increase of 3.9% (see Chart 5). Rapid economic growth was underpinned by domestic demand, with both household consumption and investment maintaining their momentum (see Chart 6). Meanwhile, after robust gains observed in the first half of the year, exports of goods and services decelerated in the second half of 2019, while in the fourth quarter their growth rate nearly halved as compared to the first six months of the year. Until now, such developments have not given any grounds for changing estimates of the cyclical position of the economy (relatively rapid economic growth has for some time been fuelling the widening output gap, which shows the extent to which the current economic development has deviated from its sustainable path (see Chart 7)) and, in turn, have led to imbalances. However, the economy is not expected to maintain such buoyant growth in the upcoming years – the coronavirus outbreak should undermine both exports and domestic demand. Moreover, economic growth will be held back by the projected slowdown in EU funding as well as uncertainty related to the transport sector. It should be noted that a stronger-than-expected impact of the pandemic on the global economy and its spread in Lithuania are increasing the risk of less favourable economic developments.

Lithuania's economy maintained its momentum in 2019.

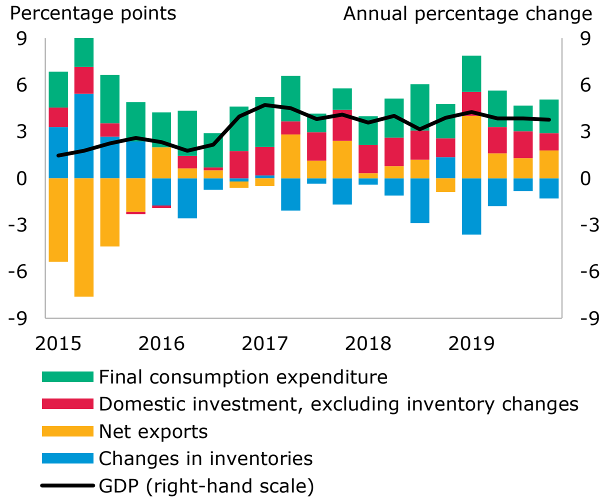
Chart 5. GDP dynamics and projections (adjusted for seasonal and workday effects)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The rapid growth of Lithuania's economy was supported by domestic demand factors.

Chart 6. Contributions to real GDP growth

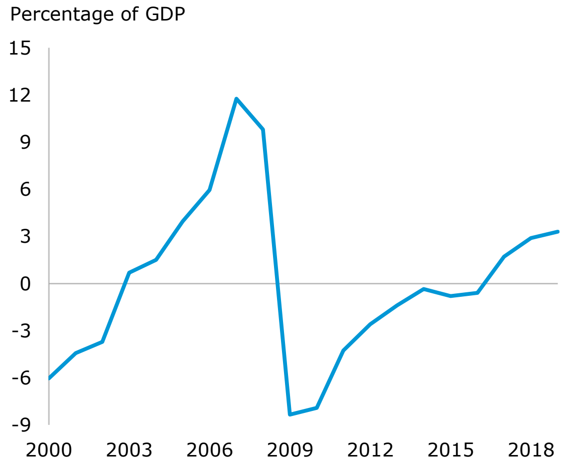


Sources: Statistics Lithuania and Bank of Lithuania calculations.

Household consumption continued to be mainly driven by favourable developments in the labour market. Growing employment and rising wages (for more details, see Chapter IV "Labour Market") remained one of the key drivers of household income during the period under review, whereas a slower rise in prices for goods and services provided a further boost to household purchasing power. It should be noted, however, that households were reluctant to spend the entire increase in their income, which might partly be attributed to their willingness to save more. A consumer survey conducted by the EC provided further evidence for this tendency – last year, households rated both their potential to save at the current moment and in the next twelve months as the highest since the first data release. Household consumption trends will become even less positive in the years to come, which will mainly reflect unfavourable demographic and labour market dynamics as well as potential decisions of the national authorities aimed at countering the coronavirus spread in Lithuania. The latter factor, coupled with persistent uncertainty surrounding the pandemic and its consequences, will contain household spending on entertainment and similar services, and may also lead to postponed purchases of more expensive goods or services.

In 2019, the output gap hit its highest level since the global financial crisis.

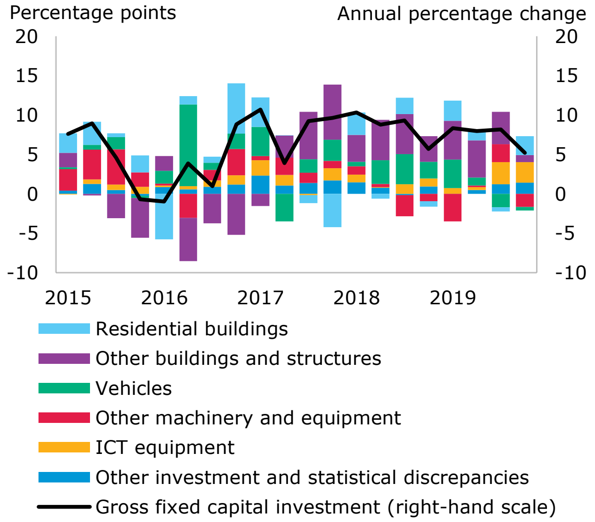
Chart 7. Output gap



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Investment growth remained rapid despite the deteriorating international environment.

Chart 8. Contributions to investment



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Despite the unfavourable international environment, investment growth in 2019 stood at 7.4%, remaining rather similar to the rates observed in 2017–2018. Last year, tangible investments were mainly boosted by entities engaged in manufacturing, RE operations or activities attributable to the general government sector, as well as by energy and transport companies. Such businesses increased their investment in both machinery and equipment as well as in buildings and structures (see Chart 8). Rates of investment in non-residential buildings and structures, which have been following an upward path over the past few years, are driven by increased EU funding for investment projects. In 2019, the amount of EU funding rose by nearly a fourth. Meanwhile, having surged in the second quarter of the year, investment in ICT equipment reached its highest level in seven years. Growing investment in ICT equipment, which has been playing an increasingly prominent role, reflects the willingness of businesses to keep up with global digitalisation trends as well as the country's focus on the development of higher value-added services. The importance of the latter type of investment, as well as of that in other machinery (excluding vehicles), is further supported by their inherent potential to make the greatest contribution to the country's technological progress and productivity – the factors that contribute substantially to the sustainable growth in wages and living standards.

It is worth noting that in the second half of 2019 investment in vehicles shrank partly due the EC's plans to launch the Mobility Package as well as the government's decisions on the taxation of daily allowances, which prompted Lithuania's freight transport undertakings to revise their future business strategies. Currently, re-registration or establishment of subsidiaries in the neighbouring countries have been distinguished as the most attractive alternatives for companies seeking to maintain their existing profit margins. This may put a downward pressure on economic growth in the short term. In the longer term, however, the decisions regarding the taxation of daily allowances made by the national authorities should contribute to improvements in social security coverage for truckers staying in Lithuania. At the same time, it would also help slightly reduce the existing inequality of income taxation, when individuals with identical income are subjected to different income tax rates, and ensure increased funding for certain public services and social spending. In the near future, the investment environment will become less conducive, mainly due to uncertainty surrounding international developments (including the impact of the coronavirus outbreak), weakening the growth of EU funding flows, the planned launch of the Mobility Package as well as manufacturing capacity utilisation trending down from historically high levels.

IV. LABOUR MARKET

(the cut-off date is 2 March 2020)

Positive migration trends have helped stabilise tensions in the labour market. In 2019, immigration exceeded emigration by 10,000 persons (see Chart 9). The balance of migration of Lithuanian citizens showed particularly marked improvements: at the end of the year, the number of Lithuanian emigrants returning home essentially caught up with the number of those leaving the country. Such developments were primarily driven by the healthy state of Lithuania's labour market. Despite a slight increase in the unemployment rate, employment prospects remained positive, whereas real wages soared by 56% compared to the beginning of the post-crisis period in 2011. The wage gap[4] between Lithuania and the top emigration destinations in seven years has narrowed from approximately a three-fold to two-fold difference. Improvements in the migration balance of Lithuanian citizens might also have been driven by Brexit, as a result of which the UK's labour market has become less attractive to Lithuanians, as well as a slowdown in other EU economies. Meanwhile, the migration balance of foreign citizens continued to improve on the back of the softening immigration policy, expansion of the country's transportation sector in the EU market and positive developments in the construction industry. Last year, thanks to a substantially positive migration balance, Lithuania's population stopped declining for the first time since 1992 and remained broadly stable. It should be noted, however, that the working age[5] population continued to diminish, albeit the pace of its decline was the slowest since 2004. The slowdown in the decrease of potential labour supply has contributed to the stabilisation of tensions in the labour market.

The unemployment rate has slightly increased. In the second half of the year, it stood at 6.3% – a year-on-year increase of 0.5 percentage point (see Chart 10). This might have been influenced by a more cautious approach to expansion taken by the country's companies, more positive migration trends among Lithuania's citizens and certain economic policy changes related to social benefits. Employees who left their jobs for personal or family reasons accounted for approximately half of the new unemployed. This trend may be partly related to unemployment benefits and other allowances that have been increased in recent years. Some employees might have already considered leaving the labour market, hence even a minor rise in benefits might have prompted them to take the final decision to quit. The remaining part of the new unemployed may have resulted from layoffs, which, in the period under review, were probably driven by a slightly more cautious corporate approach to the economic environment. For instance, an increasing number of industrial companies currently suffer from insufficient demand (see Chart 11). Overall, the upward unemployment trends might have also been driven by a substantial decrease in net emigration of Lithuanian citizens as, for example, they might have become increasingly inclined to look for a job in the country instead of abroad, given the fading attractiveness of emigration opportunities – in this case, they also qualified as unemployed. Moreover, the rise in unemployment might reflect a larger number of returning emigrants who had not yet found any job in Lithuania.

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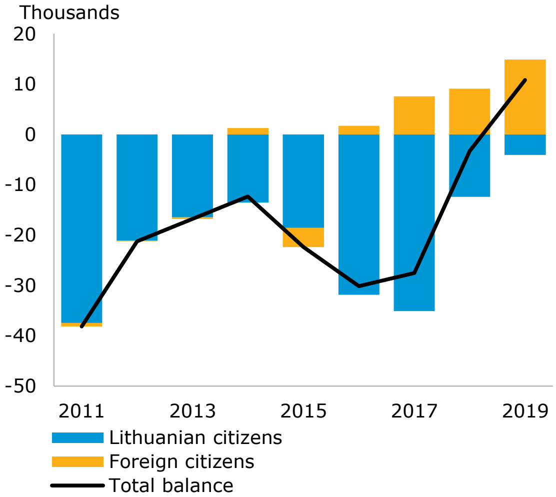
[4] Regarding the purchasing power.

[5] Aged 15–64.

The migration balance was positive.

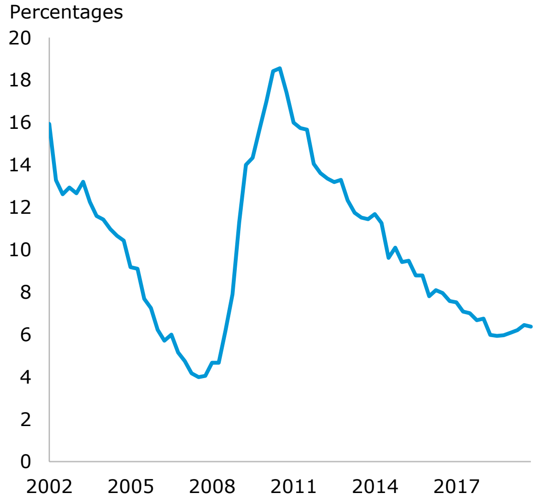
Chart 9. Contributions to the migration balance



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The unemployment rate slightly increased.

Chart 10. Unemployment rate

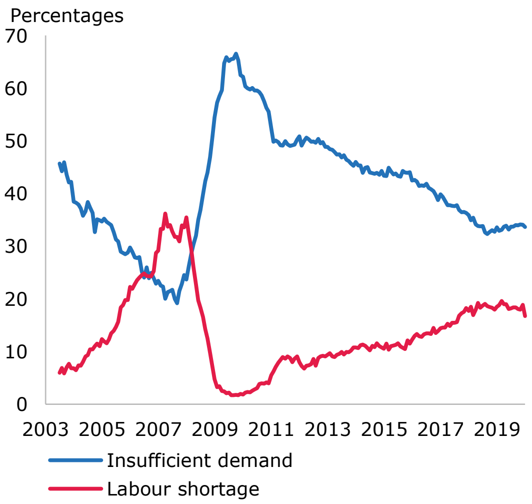


Sources: Statistics Lithuania and Bank of Lithuania calculations.

Employment growth has substantially accelerated. After several sluggish years, employment growth gained momentum in 2019, which was largely due to the vigorous expansion of the country's transportation sector in the EU and the easing of Lithuania's immigration policy, which has in turn facilitated hiring for transport, construction and industrial companies. However, it should be noted that employment growth in the transport sector moderated at the end of 2019 and the sector's future development is currently clouded by uncertainty, mainly due to the EC's plans to adopt the Mobility Package. Some other sectors, such the furniture industry, IT, administration and support services, also saw an increase in job creation, whereas the trade sector recorded a slowdown in job losses. Nonetheless, tensions in the labour market, which are particularly evident in major cities as well as in construction and trade sectors, have been stifling employers' ability to hire new staff in most economic activities.

Less optimistic business sentiment has been contributing to the stabilisation of tensions in the labour market.

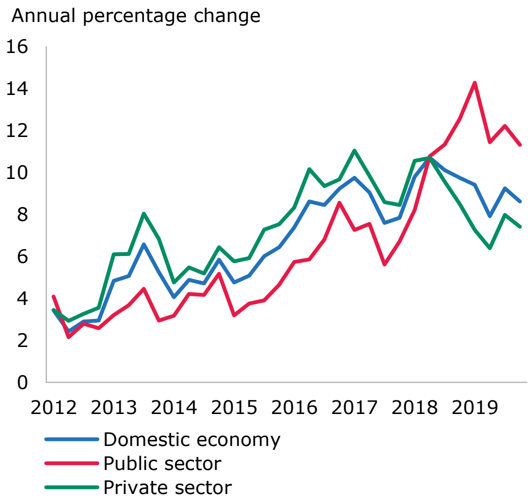
Chart 11. The share of companies facing constraints due to labour shortages and insufficient demand



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Trends of wage growth in the private and public sectors have diverged.

Chart 12. Wage dynamics



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Heightened uncertainty in the international environment, stabilised tensions in the labour market and certain technical factors have put downward pressure on wage growth. In the second half of 2019, wages in the country increased by 9.0%, with a 8.0% rise in the private sector alone (down by roughly 1.6 percentage points from the average growth observed in 2017–2018) (see Chart 12). The slowdown was partly triggered by increased uncertainty in the international environment, which made companies more cautious in terms of their future expansion, as well as by subsiding tensions in the labour market as a result of more positive migration trends and, finally, by the 'floor' of contributions to the State Social Insurance Fund (Sodra) introduced a couple of years ago, which substantially accelerated wage growth in 2018. However, this factor no longer had an effect on wage growth in 2019, which has consequently led to its deceleration. Meanwhile, wage growth in the public sector was particularly rapid (11.5%), with strong increases recorded in the public administration, education and healthcare sectors.

V. EXTERNAL SECTOR

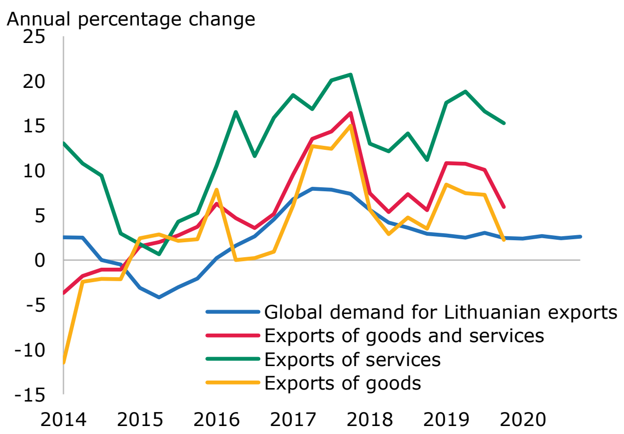
(the cut-off date is 2 March 2020)

Having gained momentum in the first half of 2019, growth of Lithuanian exports of goods and services slowed down in the second half of the year - a trend set to further continue in 2020. Such developments reflect difficulties faced by some euro area countries, uncertainty fuelled by trade wars, the coronavirus outbreak and its impact to the economy, as well as the implementation of the Mobility Package. National accounts have shown that the real annual growth of exports of goods and services in the country amounted to 10.6% in the first half and 8.2% in the second half of 2019 (see Chart 16). While exports of services grew more rapidly compared to 2018, export growth of Lithuanian-origin goods was the slowest in the past two years due to unfavourable international climate. Yet it should be noted that exports of goods have been waning on a broad scale, including the majority of main product groups. The key contributors to this decline are exports of mineral and oil products. The volumes of refined oil output and the production capacity of ORLEN Lietuva have diminished due to a fall in oil prices and cheaper petroleum products in global markets, which in turn led to a reduction in Lithuanian exports of mineral products. In 2019, real exports of coke and refined petroleum products shrunk by 5.4%.

Exports of Lithuanian-origin goods excluding mineral products have been growing at the slowest pace since 2017. With the worst EU economic performance since 2013, Lithuania's exporting companies have recently faced the problem of weaker external demand (see Chart 13). In terms of export markets, slower growth in 2019 was observed in almost all country groups (see Chart 14). Japan and Sweden exert the most significant negative impact on exports of Lithuanian-origin goods excluding mineral products. The main reason behind decreasing exports to Japan is exports of tobacco that shrunk by more than half in 2019. With a rapid increase in Japan's tobacco imports, Lithuania has been outrivalled by Italy and South Korea, both of which saw an upsurge in exports of goods. Meanwhile, a decrease in exports to Sweden was driven by its moderating economic growth and investments – the country imported less furniture and wood as well as other products and investment goods, such as machinery and equipment. Despite shrinking demand and slower growth in the EU economies, Lithuania's export share in terms of trade with the EU was growing throughout 2019 (see Chart 15). In 2020, the demand for the Lithuanian exports is expected to rise at a more moderate pace compared to 2019. This year, the growth of exports will also be hampered by the coronavirus outbreak in China, the US and Europe, which, through global value chains and weakening business activity, is exerting an adverse impact on the Lithuanian external sector.

Growth in Lithuania's export demand is expected to moderate, yet remain stable in 2020.

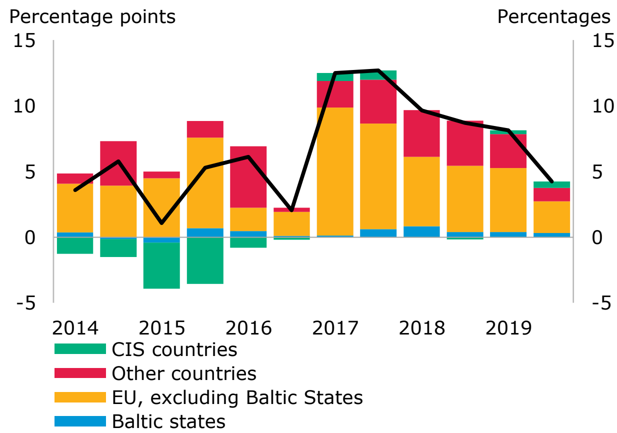
Chart 13. Annual growth of external demand and real exports of Lithuanian goods and services



Sources: Statistics Lithuania, ECB and Bank of Lithuania calculations.

In the second half of 2019, exports of Lithuanian goods grew at a slower pace across almost all markets.

Chart 14. Growth in exports of Lithuanian-origin goods excluding mineral products, by country group

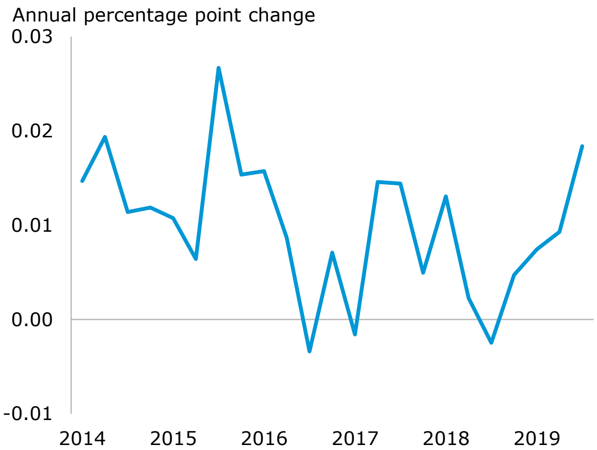


Sources: Statistics Lithuania and Bank of Lithuania calculations.

Exports to CIS countries recovered in the second half of 2019. Exports of Lithuanian-origin goods to CIS countries grew by 12.5% in the second half of the year (compared to a 4% increase during the same period in 2018). Such trends largely reflected the recovering exports to Russia – in terms of this particular market, export rates of Lithuanian-origin plastics and articles thereof, alcoholic and non-alcoholic beverages, as well as furniture have increased. Another important type of exports to Eastern markets is re-exports that saw a higher year-on-year growth in terms of CIS countries. However, this might be considered the result of a base effect due to an exceptionally rapid growth observed in 2017. The recovery of re-exports was mainly boosted by growth in exports to the Russian market, with vehicle re-exports remaining the most important product category. Yet it should be noted that the importance of re-exports of chemical products and plastics has also increased over the past year.

Lithuania's share in the EU export market doubled in the third quarter of 2019.

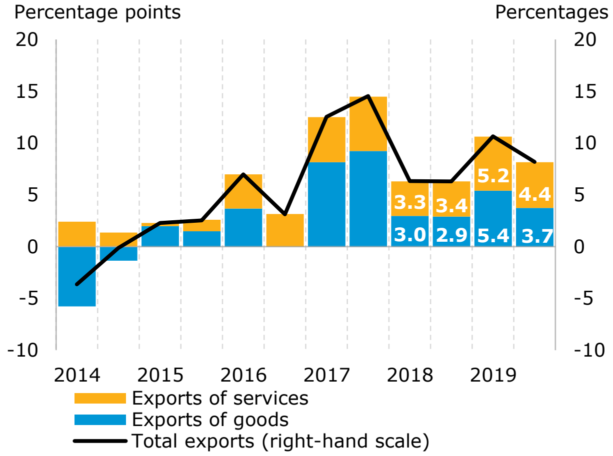
Chart 15. Developments of Lithuania's share in the EU export market



Sources: Eurostat, IMF and Bank of Lithuania calculations.

Growth in exports of goods shrunk by almost three times in the second half of the year.

Chart 16. Impact of real exports of Lithuanian-origin goods and services on the total export growth



Sources: Statistics Lithuania and Bank of Lithuania calculations.

2019 proved to be a successful year for Lithuania's agriculture – exports of its production supported the total export growth in the second half of the year, while almost all other groups of goods showed poorer results. According to preliminary data, the total agricultural output increased by 11%. This has in turn contributed to export growth, particularly in terms of exports of cereal and other grains to such markets as Saudi Arabia and China. With almost a five-fold increase in the value of cereal exported to Saudi Arabia and further expansion to China's market, export growth, particularly to the latter country, is expected to continue its upward trend (in 2019, a protocol on Lithuania's wheat exports to China was signed and a list of authorised companies was published). Even though trade agreements help in facilitating foreign trade and boosting export growth, the positive impact brought by the latter agreement will be outweighed by the external demand shock caused by the coronavirus which, in fact, has already taken its toll on the country's imports and exports.

The current account balance in 2019 was positive. While the trade deficit in goods has been narrowing, growing exports of services have helped maintain a positive current account balance[6], which accounted for 2.5% of GDP in the third quarter of 2019. Since 2017, the balance of almost all groups of services in Lithuania has been positive, while transport services still account for its largest share. In the second half of 2020, weaker growth in imports of investment and intermediate goods should aid in maintaining the current account balance surplus. However, the main threat to exports of services and, consequently, to the transport sector is still posed by the Mobility Package proposed by the EC. The requirement to return trucks to their country of

[6] The current account balance is calculated using four-quarter moving sums.

registration along with a rise in taxes on daily allowances may negatively affect the export volumes of transport services as well as a number of operations carried out from Lithuania, thus bringing the current account surplus down.

VI. PRICES

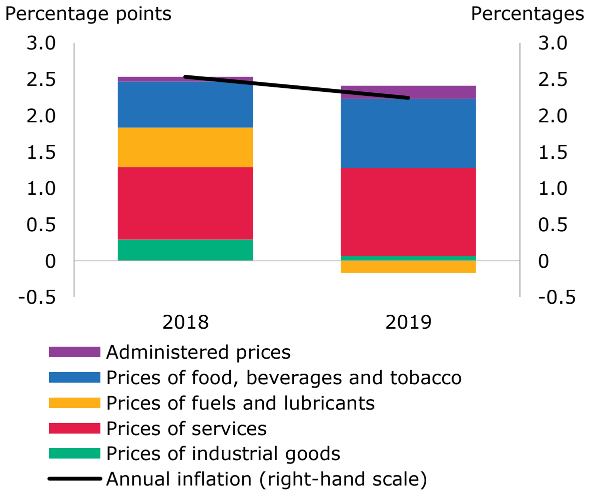
(the cut-off date is 2 March 2020)

In 2019, the average annual inflation stood at 2.2% and was lower than in 2018. Inflation was mostly driven by a stable growth in prices of services, reaching an average pace of 5%. Although reduced prices of fuels and lubricants had a dampening effect on inflation, food prices grew at a more robust rate and were less consumer friendly.

Both adverse weather conditions and changing food commodity prices in the global market had a significant impact on the last year's food price developments. The rapid growth of vegetable and meat prices was the main contributor to the recent developments in food prices. While vegetable prices last year went up by almost one-sixth due to adverse weather conditions, meat prices in the second half of the year were substantially altered by the African swine fever outbreak in China. With pork demand rising in Asia, its prices in Lithuania, as well as in the rest of the world, also increased – in the second half of 2019, pork prices in the country grew at an average rate of 13%, whereas in January 2020 they reached an annual increase of 17%.

Prices of services accounted for the largest share of inflation in Lithuania.

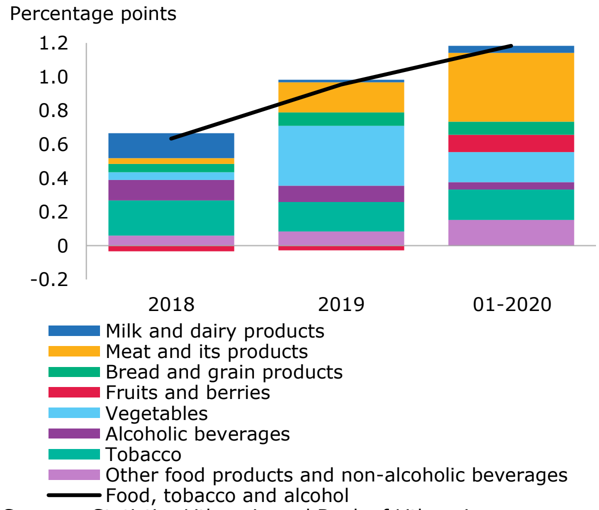
Chart 17. Contributions to HICP inflation



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Last year, growth in food prices was mainly driven by rising vegetable prices.

Chart 18. Impact of food, tobacco and alcoholic beverages to annual inflation



Sources: Statistics Lithuania and Bank of Lithuania calculations.

In 2019, lower oil and heat energy prices put downward pressure on energy prices. Last year, petrol and diesel prices went down by an average of 2%. However, in January 2020, diesel prices increased by 6%, while petrol prices – by 12%. Fuel prices were driven by excise duty rates for petrol and diesel that were increased as of 1 January. Moreover, such trends were also influenced by higher oil prices recorded in the same month. Although oil prices in 2019 fell on average by 10%, in January, amid heightened tension between the US and Iran, they surged by nearly 6% in just a few days and reached 70 US dollars per barrel. There is a number of factors contributing to the development of the latter prices, including tensions in international trade, escalation of conflicts in the East and further spread of the coronavirus – therefore, it means that oil prices are surrounded by high uncertainty. While talking about heat energy prices, it must be noted that in 2019 they slumped by almost 4%, mainly due to the significant fall in prices of biofuels that account for the largest share of fuels used in heat production. In the second half of 2019, prices of solid fuels declined by almost one-fifth due to various reasons, including a reduced VAT rate to firewood as well as other aspects related to firewood supply and demand.

Rapid wage growth observed in 2019 was one of the main reasons behind rising prices of services, since wages in the services sector account for a larger part of costs compared to the industry sector. Moreover, risings wages put additional upward pressure on prices of services through the growing demand. An average consumer in Lithuania tends to allot more than a quarter of their total expenditures to services and this share increases alongside the growth of their income. Last year, prices of services rose at an average pace of 5%, yet in certain segments they grew at a more robust rate. For instance, prices of fast food and takeaway services rose by more than 9%, while those of paid household services, including home cleaning services, increased by more than 20%. Nevertheless, an average consumer tends to spend less than 1% of their income on such services that become increasingly more expensive. Although these services comprise only a minor part of the consumer basket, they are likely to contribute to the fact that consumer inflation perceptions in Lithuania, which have reached 15% in 2019, significantly exceed the actual data.[7]

[7] Consumer survey data, Statistics Lithuania.

VII. FINANCING OF THE ECONOMY

(the cut-off date is 2 March 2020)

Savings rates in Lithuania exceed investments[8], while net lending has further increased over the past six months. National disposable income has for some time been growing at a more rapid pace compared to consumption expenditure, which has led to an increase in savings which, coupled with capital transfers from abroad, exceed the country's investment rates, thus allowing the economy's net lending to foreign countries (see Chart 19). According to financial accounts, net lending has in recent years been common to both the private and public sectors. With financial assets outpacing liabilities, net financial liabilities (difference between financial liabilities and assets) in the country have continued on a downward path. The declining indebtedness is boosting economic resilience to various shocks. In recent years, the public sector has successfully been reducing its net financial liabilities, whereas non-financial corporations have continued to maintain a rather stable ratio between net financial liabilities and GDP for the past five years. Financial assets of Lithuania's households substantially exceed their financial liabilities. In the third quarter of 2019, households' net financial assets accounted for 70.5% of the country's GDP and this ratio remained among the highest since it was first recorded in 2004.

The MFI corporate loan portfolio continued to shrink. In 2019, the MFI corporate loan portfolio decreased by 1.4% year-on-year, while in the fourth quarter it dropped by 2.7% on a quarter-on-quarter basis. The main reasons behind this decline are likely to include the tightening of lending standards by certain banks and the effects of higher concentration in the banking sector. Interest rates on new corporate loans stabilised in the second half of 2019: the average interest rates on such loans grew by 0.24 percentage point year-on-year to 3% and remained virtually unchanged in the last quarter of the year. The data for the third quarter of 2019 revealed varying trends pertaining to the financing of different business sectors. Portfolios related to specific corporate segments (RE operations, trade and manufacturing), which comprise the largest share of the total value of loans granted by banks, have decreased over the year. This, however, was accompanied by an increase in the volume of loans issued by credit institutions to undertakings engaged in professional, scientific and technical activities as well as transport, accommodation and catering. On the other hand, even though the MFI corporate loan portfolio trended down, corporate financial leverage remained elevated, as undertakings continued to tap alternative funding sources. Financial accounts indicate that the total amount of corporate liabilities increased by an annual rate of 2.1% in the third quarter of 2019.

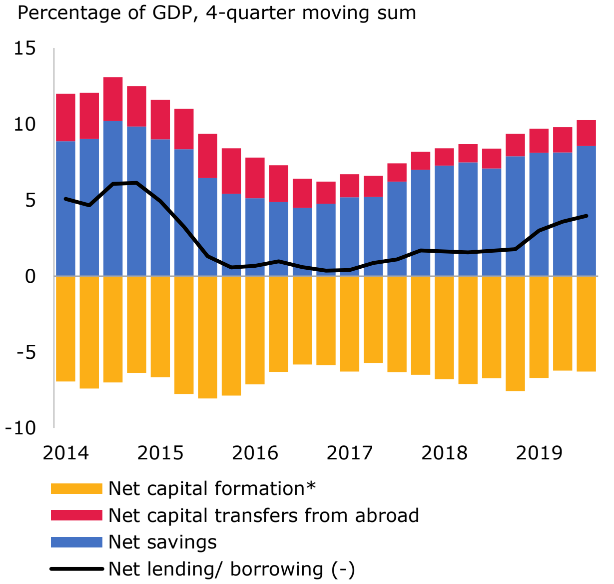
While expansion of the household loan portfolio decelerated, the housing loan portfolio maintained its rapid growth. In the second half of 2019, the household loan portfolio grew by an average annual rate of 8%, which represented a slowdown of more than 0.5 percentage point compared to the pace observed in the first half of the year. The rapid growth of the total household loan portfolio was driven by the largest housing loan portfolio, which expanded by approximately 9% in 2019. The portfolio of consumer and other loans showed no significant year-on-year change (inched up by approximately 1%), even though in mid-2019 its growth rate slightly exceeded 6%. In the period under review, new household loans for consumption and other purposes recorded a year-on-year decrease (see Chart 20). Such changes in lending dampened the growth of household consumption expenditure. These trends reflected the recent decline in the portfolio of loans for other purposes (mostly to one-person companies). Growth in lending to households continued to be underpinned by relatively low unemployment and rapidly increasing wages. The latter tendencies had a positive effect on household expectations, thus the consumer confidence index remained at a relatively high level at the end of the year, albeit household sentiment has been waning since September 2019. Growth in interest rates on new housing loans has been stalling from September – they edged down by 0.07 percentage point from the levels observed in June 2019 and reached 2.37% in December, although their annual average exceeded the end-of-2018 level by 0.14 percentage point. Interest rates on consumer loans continued their downward slide during the period under review and reached an average of 8.29% in

[8] Investment is measured by gross capital formation consisting of gross fixed capital formation and changes in inventories.

December 2019, while their annual average shrank by 0.79 percentage point year-on-year and by 0.43 percentage point compared to June 2019.

The country's investment rate lags behind its savings rate; net lending to foreign countries prevails.

Chart 19. Drivers of net lending

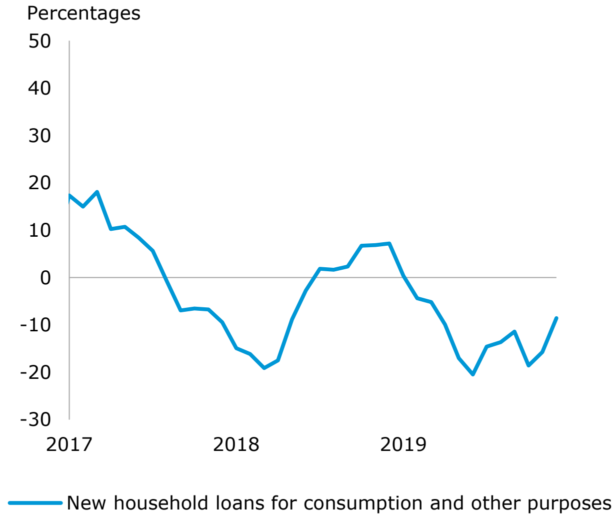


Sources: Statistics Lithuania and Bank of Lithuania calculations.

* Gross capital formation reduced by fixed capital consumption; a negative value indicates capital formation exceeding its consumption.

The volume of new household loans for consumption and other purposes has reduced.

Chart 20. Annual change in new household loans for consumption and other purposes granted over a 3-month period



Source: Bank of Lithuania.

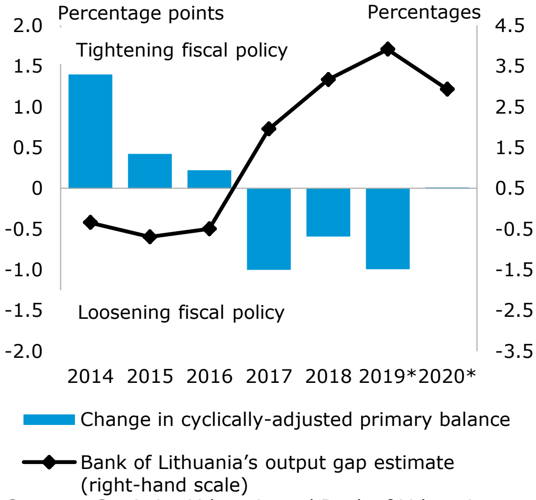
VIII. GENERAL GOVERNMENT FINANCE

(the cut-off date is 2 March 2020)

The general government balance deteriorated in 2019. Such trends were observed in spite of faster economic growth, which pointed to the expansionary character and pro-cyclicality of fiscal policy (see Chart 21). The fiscal loosening[9] during the period under review was driven by a number of revenue-reducing and expenditure-increasing measures adopted in 2019, including the higher tax-exempt income threshold, reduced personal income tax and decreased rates of social security contributions, along with the rising public wages and social benefits. As a result, the growth of general government expenditure recorded during the first three quarters of 2019 was broadly similar to that of 2018 (10.1%), whereas the revenue growth slowed down (to 6%).

Expansionary (loosening) fiscal policy implemented during the economic upswing points to the pro-cyclicality of fiscal policy.

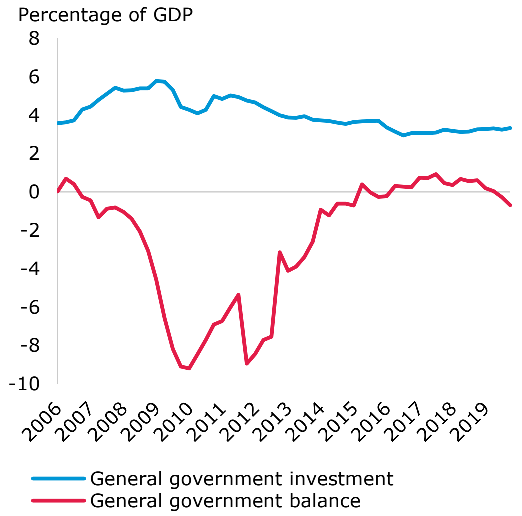
Chart 21. Dynamics and projections of Lithuania's fiscal policy stance and output gap



Sources: Statistics Lithuania and Bank of Lithuania calculations.
* Bank of Lithuania projections.

The lower general government investment to GDP ratio had a positive effect on the general government balance.

Chart 22. Dynamics of general government investment and balance



Source: Statistics Lithuania.

A decline in the general government investment to GDP ratio has in recent years contributed to the improving general government balance (see Chart 22). General government investment in Lithuania has been mainly financed from EU funds (according to the public investment programme, EU and other international support funds usually comprise more than half of public investment), which makes its development partly dependent on the EU's Financial Perspective. Given the currently lower level of EU co-funding as a percentage of GDP, the general government would have to increase the necessary contribution of own funds in order to maintain a similar level of investment, which would be complicated due to the necessity to stick to fiscal rules. Recently, the bulk of general government investment has been directed towards improving the transport infrastructure (nearly one-third of total investment), defence (roughly 15%) and education (about one-tenth). Lithuania, compared to the euro area, has been investing relatively less in research and development as well as fundamental research (around 18% in the euro area compared to nearly 9% in Lithuania). Although decreasing, the ratio of general government investment to GDP in Lithuania continued to move closer to the euro area average (standing at roughly 3.2% of GDP in Lithuania and 2.8% in the euro area) during the period under review and, therefore, was broadly in line with the general trends.

[9] Fiscal loosening is reflected by the deteriorating cyclically adjusted primary balance.