NATIONAL AUDIT
OFFICE OF LITHUANIA
• BRINGING BENEFITS •

To: the Seimas of the Republic of Lithuania

OPINION ON THE ENDORSEMENT OF THE ECONOMIC DEVELOPMENT SCENARIO

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Vilnius

Under the conditions of exceptional uncertainty[1], the Economic Development Scenario prepared by the Ministry of Finance of the Republic of Lithuania results from the assumptions chosen and identified, and it is based on the available statistical data. The Fiscal Institution hereby endorses the Economic Development Scenario for 2020–2023, published by the Ministry of Finance on 30 June 2020, confirming that it is suitable for the preparation of budgets attributed to the general government sector. However, the risk of the change of internal and external conditions, which might have a significant effect on the deterioration of the economic situation, remains and the scenario may not materialise. During the period of exceptional circumstances, the Ministry of Finance shall, at least quarterly, publicly announce the updated Economic Development Scenario, while the Fiscal Institution shall submit its opinion on the endorsement of the Economic Development Scenario to the Seimas.

The Lithuania's economic growth was higher than anticipated and reached 2.4% in Q1 2020; however, the impact of COVID-19 has emerged in Q2. This growth was mainly driven by domestic consumption and net exports. The impact of quarantine, declared due to COVID-19, on the economy of Lithuania was not as significant as in many major European Union (EU) countries. Contrary to western and southern EU countries, the growth of Lithuania's economy is determined more by activities in the industry, construction, trade and transport sectors, which account for about 60% of gross value added. Activities of hotels, restaurants, recreation, and entertainment likely had been negatively affected before the announcement of the quarantine, whereas growth in the majority of other activities was observed in Q1. The increasing average monthly gross earnings and positive expectations of consumers in Q1 2020 have underpinned the growth of household consumption expenditure. However, the decline of the turnover of the retail trade (except for fuel) by 14.8%, as compared with the same period of the previous year, was observed in April, which was caused by strict trade restrictions, dropped consumer expectations and increased registered unemployment. Meanwhile, the turnover of the retail trade (except for fuel) was 1.8% higher in May than a year ago. Compared to the respective period of the previous year the employment in the country grew by 0.9% in Q1.

[1] 26/03/2020 The Fiscal Institution published an opinion on the compliance of the unusual event with the definition of exceptional circumstances. Internet access: http://ifi.lt/opinion.aspx?id=10368.

During the first three months of the current year, the unemployment rate remained quite stable; nevertheless, according to the provisional data, it boosted by 2.0% in April.

The gross fixed capital formation (GFCF) increased by 1.6% in Q1 2020; this is the lowest growth since 2017. In June, the level of industrial capacity utilisation was one of the lowest since 2011 and was 70.3%. According to the data of a business tendency survey of company leaders in services, industry, construction, and trade, the key factors limiting their activities are financial constraints and insufficient demand. The growth of the real exports and imports of goods and services in Q1 has significantly slowed down; nevertheless, it remained positive and was 0.9% and 0.1%, respectively. Impacted by the seasonal exports of cereal, the growth of exports of goods of Lithuanian origin (excluding mineral products) was 3.1%. However, the effect of COVID-19 has emerged in April, when this indicator dropped by 16.1% as compared to the previous year. Accordingly, a double-digit fall in the re-exports (excluding mineral products) and the exports of services was recorded. Meanwhile, with the decrease in the domestic demand and the volume of industrial production, during the first four months of the current year, the imports of goods (excluding mineral products) and services declined by 4.5% and 7.4%, respectively.

The average annual harmonised index of consumer prices (HICP) growth rate was 2.9% at the beginning of 2020; however, the price level was significantly affected by the fall in the oil price in March-May. Moreover, inflation has been reduced by the impact of components of clothing and footwear as well as housing, water, electricity, and gas. It is worth mentioning that the growth of the GDP deflator reached 1.5% in Q1 and was two times lower than in the same period in 2019; this indicates the slowdown in general price level growth in the country. The nominal GDP increased by 3.9% during the same period. The highest contribution to the growth of the nominal value added by the change in the general price level was observed in the activities of public administration and defence, education, human health and social work, and construction.

With the decrease of restrictions on economic activities, the rise of the expectations of business and consumers is observed in May-June. However, the small and open economy of Lithuania depends not only on domestic conditions but also on changes in the international environment.

Geopolitical tensions are rising in Q2 2020, which were overshadowed by the COVID-19 spread throughout the world in Q1. Despite the fact that the US and China have signed the first phase of a trade deal In January 2020 the tension between these countries is not declining: the mutual intentions of both the US and China to introduce additional tariffs on some groups of goods remain. During the COVID-19 pandemic, the relations of the US and China had worsened, while there were also disagreements on the funding of the World Health Organisation. Meanwhile, seeking to maintain good cooperation, the EU has to manoeuvre between the US and China because both of them are significant EU trade partners. EU plans to tighten the competition rules for companies coming from third countries that have been benefiting from large government subsidies did not ease the situation. A negative impact is also made by the stalled negotiations on trade between the US and EU due to the following reasons: intentions of EU to introduce digital services taxes, unequal aviation subsidies, and different standards for food products.

The European Commission (EC) foresees[2] a significant decline of 7.4% in the GDP of the EU in 2020. In light of using the proposed EUR 750 billion rescue fund, EC seeks to revive EU economies. The increasing household saving rate in Germany, France, Italy, and Spain

[2] Spring 2020 economic forecast of the European Commission. Internet access: https://ec.europa.eu/info/sites/info/files/economy-finance/ip125_en.pdf.

(these countries create approximately 75 % of the GDP in the Euro Area) is negatively impacting the domestic consumption of these countries. Due to the impact of the COVID-19 on the labour market, domestic consumption, and international trade, the Government of Germany has agreed on the EUR 130 billion fiscal economic stimulus package. This agreement should have a positive impact on the demand for goods and services exported from Lithuania. The international trade of Lithuania will be negatively affected by the possible adoption of the Mobility Package in the medium term. If the EU and the United Kingdom do not reach an agreement, the risk remains that the Hard Brexit will occur – this would also have a negative effect on the international trade of Lithuania.

World central banks supplement the list of measures stimulating economic growth. In view of the impact of COVID-19 on the economy of the Euro Area and lower inflation, and in order to support the funding terms of the real economy, especially companies and households, the European Central Bank increases the envelope for the pandemic emergency purchase programme up to EUR 1,350 billion. Seeking to stabilise the unemployment rate and to sustain the inflation, the Federal Reserve System has already lowered the base interest rate to 0.0% and additionally plans to purchase individual corporate bonds. The Bank of England supplements monetary policy by adding GBP 100 billion in bond purchase programme.

A slow recovery of the Brent oil price that has significantly dropped at the beginning of the COVID-19 pandemic is observed in Q2 2020. The rising unrest in the Middle East from the end of 2019 and the spread of COVID-19 throughout the world has impacted the oil price: the overfilled oil storages determined the drop of the oil price below the USD 30.0 a barrel limit at the end of Q1 2020. However, the deal on the reduction of oil extraction between OPEC and Russia signed in April, country borders opening after the quarantine, and improving stock market sentiments had a positive effect on the oil demand. The positive impact on the oil price is also made by the possibility to extend the deal between OPEC and Russia on the reduction of oil extraction until the end of 2020.

The remaining high uncertainty due to risk factors relating to the domestic demand may determine a slower recovery of the economy. The economic downturn caused by COVID-19 and reduced expectations of consumers influenced a greater households' propensity to save. If negative sentiments persist, the household saving will grow even more, leading to further decline in domestic demand in 2020. High uncertainty also remains due to the possibility of the second wave of the pandemic, which could lead to the insolvency of companies and a consequent rise in unemployment rate. This could contribute to a greater economic contraction than projected and would increase income inequality. Besides these risks, the challenges raised by the ageing society on the labour market and public finances remain.

In the presence of the before-mentioned internal and external risks, the contraction of Lithuania's real GDP by 7.0% is foreseen in 2020; however, the economic recovery is expected in the medium term. The economic downturn can be driven by the decreased domestic consumption and investments as well as reduced exports. It is likely that growth of the temporarily contracted Lithuanian economy will reach 5.9% in 2021 and will exceed 2% each year in the medium term. For the last few years, the growth of average monthly gross earnings in the country has surpassed 8.0%. Nevertheless, with the increase of unemployment rate, the employers are gaining an advantage in terms of negotiations. The forecast indicates that if the number of employed persons decreases by 2.8% in 2020, the growth of earnings will also decline by 1.8%. The growth of these indicators is forecasted with economic recovery in 2021. The fall by 3.7% is projected in household consumption expenditure in 2020 which is associated to the predicted shrinkage of the funding for wages and salaries. This is expected to recover the following year. It is plausible that private consumption will be positively affected by the means of the economic stimulus plan[3], increasing the disposable income of the households as well as one-off and other social benefits and the increase of the tax-exempt amount of income. According to the assessment of the Fiscal Institution, the drop in the household consumption expenditure, projected by the Ministry of Finance, can be above 3.7% in 2020. These projections might be affected by a greater than expected decline in household expectations and increase savings.

The growth of the government consumption expenditure in 2020 that is projected in the Economic Development Scenario can be lower than 7.6%. According to the assessment of the Fiscal Institution, not all measures of the economic stimulus plan will increase government consumption expenditure, for example, the 50% payment of the rent tax to companies, additional funds to the Public Investment Programme or wage subsidies to the employers. Private investments will decrease because of liquidity issues and remaining uncertainty; however, the public investments and financial contributions of EU will positively impact the GFCF. It is projected that the GFCF will decrease by 6.0% in 2020, while it may grow by 3.8% in 2021. Due to the expected contraction of Lithuania's trading partners' economies, the negative impact of the spread of COVID-19 on foreign and domestic demand and the implemented measures to mitigate the spread of the virus, it is expected that the country's real exports of goods and services will experience a double-digit drop in 2020.

The evolution of the harmonised index of consumer prices, which is projected by the Ministry of Finance, can be affected by the lowered expectations of consumers, labour market situation and fallen oil prices. The projections of changes in prices for 2020 and 2021, counted under the HICP, constitute 0.7% and 1.7%, respectively. When analysing price indices, it is noticed that the change in GDP deflator is likely to be impacted not only by the dynamics of the HICP. For the first 4–5 months of the current year, producer price index, export price index, import price index, and purchase price indices of agricultural products, as compared with the corresponding period of the previous year, have decreased. This will contribute to decline of the GDP deflator in 2020, the change of which likely can be slightly positive or even step into negative territory.

In the Economic Development Scenario, the economic recovery is projected in the medium term; however, during the period of exceptional circumstances, it is especially important to assess the internal and external risks. When fiscal discipline rules are temporally not applicable during the preparation of budgets attributable to the general government sector, responsible and transparent budget planning remains relevant.

The National Audit Office of the Republic of Lithuania, implementing its functions of budget policy monitoring institution (hereinafter referred to as the Fiscal Institution) set out in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, has carried out an assessment and issued an opinion on the Economic Development Scenario for 2020–2023 prepared by the Ministry of Finance of the Republic of Lithuania and published on 30 June 2020. Pursuant to provisions of Paragraph 6 (3) of Article 9 of the Law on National Audit Office of the Republic of Lithuania, the Fiscal Institution hereby submits its opinion to the Seimas of the Republic of Lithuania.

[3] In the Stability Programme of Lithuania for 2020, discretionary COVID-19 plan measures are presented. Internet access: https://finmin.lrv.lt/uploads/finmin/documents/files/LT_SP2020_04_30.pdf.

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