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 identified and it is based on the available statistical data. The National Audit Office of Lithuania, implementing the functions of the budget policy monitoring institution (hereinafter - Fiscal Institution), endorses the Economic Development Scenario for 2020-2023, published by the Ministry of Finance on 14 December 2020. 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.
According to the provisions of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, the Ministry of Finance shall publicly announce, at least quarterly, the updated Economic Development Scenario (until exceptional circumstances are cancelled), while the Fiscal Institution shall submit its opinion on the endorsement of Economic Development Scenario to the Seimas.

In Q1-Q3 of 2020, the contraction of Lithuania's economy was lower than expected and reached 0.8%, however, uncertainty about the impact of the second wave of the pandemic remains in Q4. Domestic consumption deteriorated in Q1-Q3 and the change in investment remained negative, however, the decline in real gross domestic product (GDP) was mitigated by the recovery of the exports of goods in Q3. During this period, the decline of Lithuania's economy was not as significant as in many major European Union (EU) countries. The value-added generated by activities of agriculture, industry, information and communication, and real estate have had the most positive impact on Lithuania's economy.

Household consumption expenditure decreased by 2.2% in the first three quarters of 2020, as compared to the corresponding period of 2019. After the 9.3% contraction in Q2, private consumption in Q3 was higher than a year ago, as a result of the lifting of strict trade restrictions, which were in force in spring, the growth of disposable income of residents and the rapid recovery of expectations of consumers that remain cautious so far. The turnover of retail trade (excluding fuel) increased by 4.3% over the first ten months.

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

However, the restrictions introduced during the second quarantine are likely to lead to lower private consumption in Q4 of this year.

Despite double-digit growing average monthly gross earnings in Q3 of 2020, the situation in the labour market may deteriorate. This is illustrated by an increase in the unemployment rate and a decrease in the number of employed in the said quarter. Gross earnings grew by 9.4% in Q1–Q3 of 2020, while the number of employed persons decreased by 1.3% compared to the corresponding period a year ago. The unemployment rate increased by around 2 percentage points in Q3 and amounted to 9.3%. It is likely that the Government's economic stimulus measures, which intended for helping to protect jobs and the income of the population, have mitigated the situation in the labour market.

Although the fall in gross fixed capital formation (GFCF) in Q2 of 2020 improved in Q3, it remained negative (–1.7%). During Q1-Q3, GFCF decreased by 3.5% compared to the corresponding period a year ago. The industrial production capacity utilisation level is approaching pre-pandemic levels and reached 74.9% in November. However, according to the business tendency survey in services, industry, construction and trade, part of the enterprise leaders, who answered that their activity has not been restricted, has remained decreased since March.

In the first three quarters of 2020, real exports and imports of goods and services decreased by 1.5% and 6.1% respectively, compared to the corresponding period of 2019. During this period (excluding the impact of mineral products) the value of exports of goods of Lithuanian origin was 1.3% higher than a year ago, however, re-exports and exports of services decreased by 0.7% and 7.4% respectively. The positive annual change in the real exports of goods in Q3 was supported by the increase in the exports of cereal, which was driven by this year's abundant harvest and favourable grain purchase prices. This is likely to improve exports performance in Q4 as well. As domestic consumption and investment declined, the value of imports of goods (excluding mineral products) and services fell by 5.4% and 8.9% respectively in three quarters of this year.

In January–November of 2020, the average annual growth in the Harmonised Index of Consumer Prices (HICP) accounted for 1.2%. Inflation was reduced by a fall in gas, fuel, heat energy and fuel for personal transport equipment prices. HICP growth is almost twice as low as in 2019, however, there is a tendency of the service prices being the main driver of inflation. They grew by 4.4% during the first ten months of this year. GDP deflator growth in Q1-Q3 amounted to 0.8% and was four times lower than in the corresponding period in 2019, reflecting a slowdown in the overall price level in the country. It should be noted that the nominal GDP of three quarters amounted to EUR 36.0 billion, and was similar to the level of 2019 in the corresponding period.

The growing scale of the COVID-19 pandemic has a negative impact on global economies and the risk factors related to geopolitical context remain. Although governments in the EU Member States implement policies to stimulate economies, including measures to preserve businesses, employees' income and domestic consumption, the European Commission (EC) maintains a forecast of the fall of 7.4%[2] in the GDP of the EU in 2020. The renewed quarantine restrictions have a negative impact on international trade, tourism and the service sector and, as a consequence, prompts a review of existing economic recovery forecasts. The contraction of the services sector and declining industrial activity in Germany, France, Italy and Spain, which account for around 75% of the GDP in Euro Area, have a negative impact on their economies. Fiscal risks

[2] Autumn 2020 Economic Forecast published by European Commission. Internet access: https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en_2.pdf.

related to rising levels of general government debt in EU countries and other issues of public finances also contribute to the uncertainty. The small and open economy of Lithuania is affected accordingly, especially its international trade. It should be noted that after the adoption of the provisions of the Mobility Package in July 2020, some Lithuanian companies, providing road transport services, are expanding at least a part of their activities to other EU countries and this has a negative impact on the Lithuanian transport sector.

The growing probability of hard Brexit contributes to uncertainty in the geopolitical situation as the transition period approaches. The absence of a clear outcome of the EU Multiannual Financial Framework for the year 2021-2027, which includes the EU'S support package accounting to EUR 750 billion, has not facilitated the situation as well. Geopolitical tensions are being alleviated by the resumed negotiations between the USA and China on the implementation of the first phase of the trade deal in summer of 2020.Following the US Presidential elections, the EU is expected to reduce the risk of trade tensions between the EU and the USA.

World central banks have been continuing their monetary policy stimulus measures. Taking into account the spread of the second wave of COVID-19, the European Central Bank during its meeting in December 2020 decided to maintain interest rates at a record low and, after some adjustments, to continue other measures promoting liquidity in the system and credit to businesses and households. Meanwhile, the US Central Bank keeps an interest rate range of 0.01–0.25%, which was reduced in March, continues lending and market stimulus measures.

Even though "Brent" oil price has been the highest since the spread of COVID-19 worldwide, it has remained below the pre-pandemic level. In the view of the continuation of the fall in the demand for oil, the renewal of quarantine restrictions and taking into account the return of Libya to the market, the average oil price in October-November 2020 was around USD 43.0 per barrel[3]. However, the agreement reached between OPEC and Russia on a lower-than-previously planned increase in the oil extraction quota and positive expectations for the COVID-19 vaccine allowed the oil price to reach USD 50.0 per barrel at the beginning of December.

Internal risk factors remain related to domestic demand, consumer expectations and the labour market. The restrictions imposed due to the spread of COVID-19 reduce domestic consumption and increase uncertainty in labour income. Taking this into account, consumer expectations may deteriorate and the level of savings may grow. The medium-term challenge of reducing unemployment, which is largely dependent on economic recovery, remains. The measures taken by the Government during the first wave of COVID-19 could have helped companies to withstand financial losses, however, with the beginning of the second wave of the pandemic, support of the Government becomes even more important.

Given the above-mentioned internal and external risk factors, Lithuania's real GDP is projected to contract by 1.5% in 2020, however, the recovery is expected in the medium term. Compared to the Economic Development Scenario (the scenario), published in September, the projections of exports of goods and services for 2020 were improved the most, leading to a positive impact of net exports on GDP. This effect on economic development is outweighed by the decline of domestic consumption and investment. The growth of temporary contracted economy is expected to reach 2.8% in

[3] Based on 09/12/2020 data. Internet access: www.barchart.com.

2021 and to exceed 3% annually in the medium term. It is projected that the increase of household consumption and the acceleration of investments will have a positive effect on GDP.

In the scenario, published in December, the growth of 3.0% of household consumption expenditure is projected in 2021. It will be supplemented by the projected increase in the number of employed and the growth of average gross monthly earnings at a slower pace, which will exceed inflation. It is projected that the number of employed will grow moderately by 0.7% in 2021, the unemployment rate will decrease to 8.2%. Discretionary decisions made by the Government[4] will also contribute to earnings growth (4.1%). Disposable income of residents will be increased by the indexation of pensions and the growth of other social benefits as well. Competition in the labour market is likely to be stimulated by the remaining positive trends of net migration and the Government's focus to facilitate the transformation of the structure of the economy. With limited opportunities to participate in the labour market for different social groups, the problem of income inequality remains relevant. This will also require greater flexibility in the labour market to adapt to new challenges.

The growth of general government final consumption expenditure in 2020–2021 could be lower than 6.2% and 2.5% respectively, which is projected in the December scenario. According to the assessment of the Fiscal Institution, the projection for 2020 deviates from the Q1-Q3 statistical information[5]. Over the first three quarters, general government consumption expenditure increased by 0.2%.

The use of EU support funds and additional measures adopted by the Government to stimulate the economy will contribute to the growth in investment in the medium term. The plan for the DNA of the Future Economy aims to invest in sustainable economic development. If these funds were used efficiently, this would contribute to faster growth in investment. It is particularly important to make targeted use of support funds aimed at the continuation of enterprise activities, as this would contribute to a more stable situation in the labour market. GFCF is projected to decrease by 5.2% in 2020 and to grow by 4.7% in 2021. Anticipating the growth of Lithuania's trade partners' economies in 2021, it is projected that both the country's real exports and imports of goods and services will grow by more than 6%. This is likely to be supported by faster growth in the exports and imports of services.

The projected development of the Harmonised Index of Consumer Prices over the medium term may be determined by the growth of domestic demand and oil price fluctuations. Inflation, measured by HICP, will reach 1.4% in 2021 and will rise steadily to 2.0% in 2023. It is expected that prices of services will continue to grow in Lithuania since they are still lower as compared to the prices of services in Euro Area. The analysis of price indices shows that the growth of the GDP deflator is likely to be influenced not only by the dynamics of HICP in 2021–2023. In the first nine to ten months of this year, the prices of industrial products sold by producers, exported and imported goods and purchase prices of agricultural products decreased compared to the corresponding period last year. As the economy recovers, rising oil prices may lead to higher labour costs in industrial, construction and service enterprises, which will affect the overall price level growth over the medium term.

[4] Increase of minimum monthly wage, increase of wages for persons employed in budgetary institutions, education sector, public health care professionals, etc.

[5] Based on the data published on 01/12/2020 for the second estimate of gross domestic product in Q3 of 2020.

The approval of COVID-19 vaccine provides moderate optimism regarding the containment of the pandemic, however, this in itself does not guarantee a quick recovery of Lithuania's economy in 2021. Uncertainty is not diminished by the possibility of uneven recovery of EU economies, given their ability to manage the spread of COVID-19 and the vaccination process. The United Kingdom became the first country in Western Europe to allow the use of a COVID-19 vaccine for mass vaccination in early December. A growing number of countries will follow this example, and the future breakthrough in the containment of the pandemic is being considered. This allows for at least a partial recovery of the economies of EU, including Lithuania, in 2021. In order to achieve this, the challenges of the vaccination process and its duration must be overcome its production, transportation, distribution and vaccination activity of the population. The recovery of the country's economy will depend not only on the success of overcoming these challenges but also on the fulfilment of internal and external risk factors and the ability of businesses and residents to adapt to rapidly changing environment.

The National Audit Office of the Republic of Lithuania, implementing its functions of budget policy monitoring institution (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 14 December 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.

Auditor General Mindaugas Macijauskas