NATIONAL AUDIT
OFFICE OF LITHUANIA
• BRINGING BENEFITS •

To the Seimas of the Republic of Lithuania

OPINION ON THE ENDORSEMENT OF THE ECONOMIC DEVELOPMENT SCENARIO

22 June 2021 No. BPE-5

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 fiscal institution, endorses the Economic Development Scenario for 2021–2024, published by the Ministry of Finance on 11 June 2021, as it is suitable for the preparation of the budgets attributable to the general government.

It should be noted that estimates of the potential gross domestic product and the output gap was published on the same day as Economic Development Scenario was announced[2]. These estimates are not included in the list of indicators approved by the National Audit Office, implementing the functions of the fiscal institution. On a usual basis, they have been published only after the adoption of the Economic Development Scenario. The assessment of the cyclical position of the economy is inseparable from the macroeconomic projections, and therefore it would be appropriate to continue publishing the estimates of potential GDP and the Economic Development Scenario jointly in the future.

The risk remains that the Scenario may not materialise due to changes in internal and external conditions leading to a significant change in the economic situation. During the period of exceptional circumstances, the Ministry of Finance, at least quarterly, shall publish the Economic Development Scenario, while the National Audit Office of Lithuania, implementing the functions of the fiscal institution, shall submit its opinion on the endorsement of the Economic Development Scenario to the Seimas.

[1]The National Audit Office, implementing the functions of the fiscal institution, issued an opinion on the compliance of the unusual event with the definition of exceptional circumstances on 26 March 2020. Internet access: https://old.ifi.lt/opinion.aspx?id=10368.

[2]11/06/2021 Communication by the Ministry of Finance "On the Potential Gross Domestic Product and Output Gap During 2020–2024". Internet access: https://finmin.lrv.lt/lt/aktualus-valstybes-finansu-duomenys/ekonomines-raidos-scenarijus/pranesimai-apie-potencialaus-bvp-rodiklius.

The development of Lithuania's economy in the first half of 2021

Despite the quarantine regime in place in Q1 2021, the development of Lithuania's economy has been more favourable than expected. Stronger economic growth is expected in Q2 2021, driven by the base effect. In Q1 2021, compared to the same period a year ago, Lithuania's real GDP grew by 1.2%, compared to a decline of 1.3% in the euro area. The country's economic growth was mainly supported by investment and household consumption expenditure. Manufacturing was the main driver of gross value added, with the chemical industry making a significant contribution. Taking into account the favourable results of industrial production (excluding refined petroleum products) in Q1, its annual growth accelerated and reached 30.3% in April due to the base effect[3].

Compared to Q1 2020, household consumption expenditure increased by 0.6% in Q1 2021. This was due to higher disposable income than a year ago and stable but still cautious consumers' expectations. In April 2021, compared to the corresponding period in 2020, an increase of 35.2% was recorded in turnover of retail trade (excluding fuel). This change of such magnitude can be attributed to a significant (64.0%) increase in retail sale of non-food products, as uncertainty has decreased and consumers have adapted to the circumstances.

Although some business activities were restricted in Q1 2021, the unemployment rate was the lowest (7.5 %) since the beginning of pandemic[4]. However, the number of the employed persons remains 2.5% lower compared to a year ago, most notably in transport, trade, construction, and education activities. The largest decline in the number of employed persons was recorded in the 15–29 age group (7.8%) and the 65+ age group (11.6%).

Gross fixed capital formation (GFCF) grew by 6.3% in Q1 2021 compared to Q1 2020. Industrial production capacity utilisation has returned to its pre-pandemic level and stood at 77.1% in May. While business confidence indicators are improving according to the data of the opinion survey of enterprise managers in areas of services, industry, construction and trade, rising raw material prices, disruptions in supply chains, and shortages of labour force are becoming a challenge.

Real exports and imports of goods and services grew by 3.6% and 4.0% respectively in Q1. The growth in exports was driven by a 13.7% increase in exports of goods of Lithuanian origin (excluding mineral products). The chemical industry has made a significant contribution to this result. The value of imports of goods increased by 5.5% on the back of rising investment and household consumption. Meanwhile, international trade recovered even faster in April. Compared to the same period in 2020, when exports and imports were strongly affected by COVID-19, excluding mineral products, exports of goods of Lithuanian origin grew by 36.2%, while re-exports and imports grew at an accelerating pace[5].

The annual average Harmonised Index of Consumer Prices (HICP) for January–May 2021 grew by 1.6% compared to the same period a year ago (Figure 1). The transport component had the largest impact on the change in the HICP (0.5% p.p.), following the increase in oil

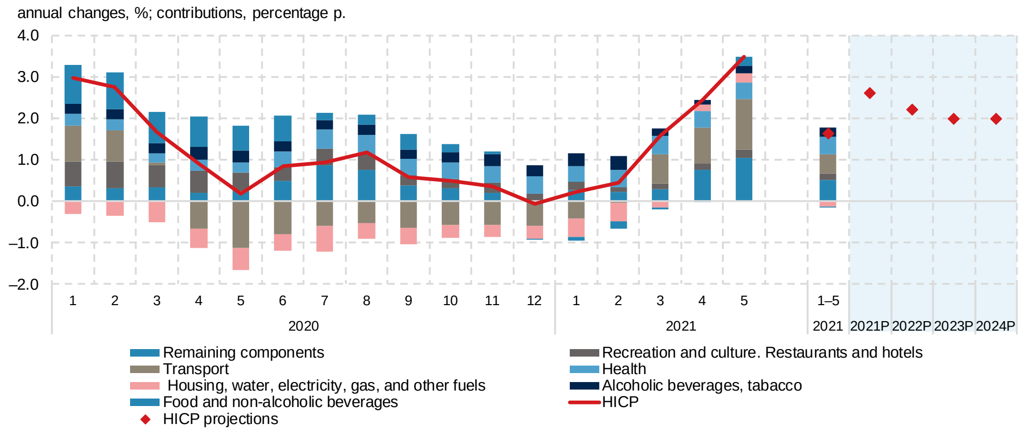
[3] For comparison: in Q1 2021, the annual increase of this indicator was 11.5%.

[4] Compared to Q1 2020, the unemployment rate has increased by 0.4 p.p.

[5] In April 2021, excluding the impact of mineral products, the annual growth rate of re-exports was 36.6% and that of imports of goods was 46.3%.

prices on the global market. Part of the increase in the index was also driven by an increase in prices of health goods and services (0.4% p.p.). The high inflation estimate for May (3.5%) was also influenced by the base effect.

Firgure 1. HICP and its contributions



Source – Statistics Lithuania, forecasts of Ministry of Finance, calculations by the National Audit Office, implementing the functions of the fiscal institution

The increase in the general price level in the country accelerated: the growth of GDP deflator reached 2.1% in Q1, up from 1.3% a year earlier. Nominal GDP increased by 3.3% during the same period. Public administration and defence; education; human health and social work; and manufacturing were the main contributors to gross value added at current prices.

Macroeconomic environment and risk factors

External risks remain linked to the global economic recovery. Even though the recovery of the world's major economies has been uneven, international organizations have been improving its' forecasts[6], while the European Commision expects activity in the EU and other major economies to return to pre-pandemic levels by the end of 2022[7]. Economic growth will be driven by a recovery in private consumption, investment, and growth in the demand of exports. A more favourable situation is also expected in the EU tourism sector with the introduction of the international EU Digital COVID-19 Certificates. During the pandemic, the country's economic development will also depend on the growth rates and demand from international trading partners[8]. Domestic consumption will be influenced by factors related to the dynamics of the COVID-19 pandemic, such as the spread of new virus mutations, the vaccination process, and possible restrictions.

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[6] According to the OECD Survey projections, published in May 2021, the acceleration of global economic growth over the period of 2021–2022 is foreseen: respectively 4.3% and 4.4% in the euro area, 7.2% and 5.5% in the UK and 6.9% and 3.6% in the US. According to the IMF's Economic Survey projections, published in April 2021, the following growth are foreseen: 4.4% and 3.8% in the euro area, 5.3% and 5.1% in the UK, and 6.4% and 3.5% in the US.

[7] The Spring 2021 Economic Forecasts by the European Commission. Internet access: https://ec.europa.eu/info/sites/default /files/economy-finance/ip149_en.pdf.

[8] In Q1 2021, the main export partners of Lithuanian origin: Germany (10.4%), USA (10.0%), Poland (6.9%), the Netherlands (6.8%), Sweden (6.5%) and Latvia (6.2%). In 2021, comparing to 2019–2020, the share of exports of these goods to the US increased (5.6% and 6.0% respectively in 2019–2020).

As economic sentiment in the international environment improves[9], risks from disruptions to supply chains are also observed. As the world's industrial sector recovers, demand for raw materials in the world's major economies is growing faster than expected. Material shortages are also being felt in Lithuania: according to the business trends survey, the shortage of raw materials and equipment for manufacturing as a factor constraining production has increased by 8 p.p. in the first five months of this year, compared to the corresponding period in 2020. The shortage of materials supply will affect economic development of Lithuania's main trading partners.

In June 2021, the growth of "Brent" oil price was robust and for the first time in two years approached the price level in May 2019. The increasingly strong recovery of the major economies in recent months, the resulting increase in market demand for oil and the continuing restrictions on oil production have led to an average "Brent" oil price of USD 67.4 per barrel between March and June 2021[10]. In June, OPEC members and Russia decided to keep to their plans to increase oil production in the light of the recovery in oil consumption and optimistic forecasts for oil demand growth and to release more crude into the market from July[11]. Despite this decision, the price of "Brent" oil continued to rise by reaching USD 70.3 per barrel on 1 June.

The world's central banks have been continuing their monetary stimulus measures. Although the European Central Bank has improved its growth forecasts for the euro area in 2021 and 2022, it decided in June to maintain unusually low interest rates and to continue other programmes that will contribute to liquidity provision and to easining of lending to businesses and households. In April, the US central bank decided to maintain an interest rate range of 0.1%–0.25% and to continue lending and market stimulus measures.

Internal risk factors remain related to inflation and labour market challenges. As quarantine restrictions loosen, improving consumer expectations will boost domestic consumption and the saving rate will fall. The restrictions imposed on the service sector during the quarantine period and the resulting supply-demand imbalances will lead to an increase in prices of services. The rapid growth in global production will push up commodity prices due to shortages of raw material supplies and rising oil prices. Accelerating growth of prices may raise the risk of an increase in consumer inflation expectations. In addition to these factors, challenges in the labour market remain: as the COVID-19 vaccination continues and restrictions loosen, the number of employed persons will increase and people and businesses will need to adapt to changes in the market.

Active labour market policy measures must be introduced in order to reduce structural unemployment. Labour market dynamics point to structural unemployment, where labour costs in the industry, construction and services, excluding public administration and defence; compulsory social security, are rising at the fastest pace in the context of the highest unemployment rate in the region (Figure 2). Structural unemployment reflects that the structure of labour supply does not meet the structure of labour demand. The unemployed persons are unable to fill in vacancies as they do not have the required profession or qualifications, or because they live in live too far from

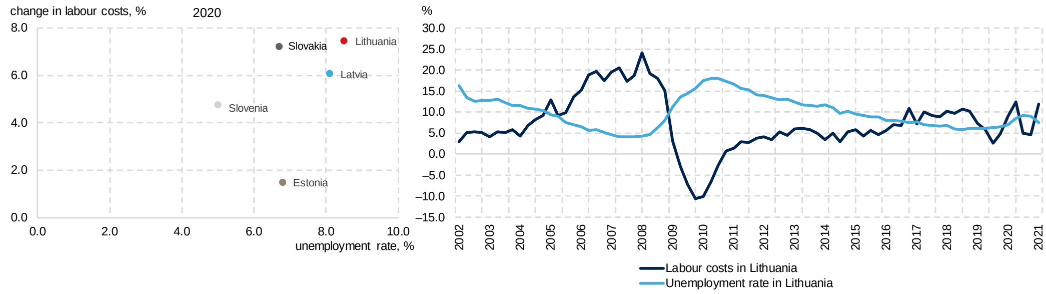
[9] The value of Global Economic Policy Uncertainty Index (GEPU) has been declining moderately since January 2021, reaching 76.3 in April (110.1 in January). Internet access: https://www.policyuncertainty.com/all_country_data.html.

[10] Based on 10/06/2021 data. Internet access: www.barchart.com.

[11] This decision will allow an increase in oil production to 2 million barrels per day by the end of July.

regions where jobs are available. Active labour market policy measures should be used to increase the potential of labour force.

Firgure 2. Labour costs in the industry, construction and services, excluding public administration and defence; compulsory social security, and the unemployment rate



Source: Eurostat, calculations by the National Audit Office implementing the functions of the fiscal institution

The development of Lithuania's economy in medium-term

The growth rate of Lithuania's real GDP is projected to reach 4.1% in 2021, with the acceleration to 4.4% in 2022 and moderate growth rates in 2023–2024. More favourable than expected economic development results in Q1 2021, the inclusion of the funds of the Recovery and Resilience Facility (RRF)[12] and improved assumptions on the growth of the main export markets have contributed to the upward revision of projections. According to the Economic Development Scenario, published in June, GDP growth is expected to be driven mainly by household consumption and accelerating investment. Imports of goods and services growing faster than exports will lead to a negative impact of net exports on economic growth in the end of the medium term.

Household consumption expenditure is projected to grow by 4.0% in 2021. The easing of restrictions and the increase in the number of people vaccinated against COVID-19 are expected to improve consumers' perception of the economic situation and increase spending on goods and especially services. Private consumption will be boosted by projected above-inflation growth in average monthly gross earnings and an increase in the number of the employed persons. Household consumption expenditure may also be affected by improving consumption opportunities, as well as by the funds accumulated during quarantine.

The number of employed persons is projected to grow by 0.4% and 1.2% for 2021 and 2022, respectively, while the unemployment rate is expected to reach 6.8% in 2022. This will be mainly due to the easing of restrictions on the activities of companies, in particular those in the service sector. On the other hand, the faster growth of this indicator is likely to be influenced by the changes in the models of business enterprises brought about by the pandemic, as well as by the ability of workers and employers to adapt flexibly to changing conditions. The growth of the employed persons in the medium term will also be constrained by Lithuania's worsening demographic situation: a declining resident population, emigration, and an ageing population.

[12] On 14 May, following the Government's approval, the national draft of Recovery and Resilience Facility (RRF) "New Generation Lithuania" was submitted to the European Commission. Internet access: https://finmin.lrv.lt/lt/es-ir-kitos-investicijos/naujos-kartos-lietuva.

Comparing Q1 2021 with Q1 2020, with a 9.9% increase in average monthly gross earnings, the average monthly gross earnings are likely to continue to increase in 2021–2022, influenced by the shortage of labour in the country, identified by employers as one of the main factors constraining activity. This is confirmed by the increasing number of job vacancies in the country in recent months, especially for skilled workers. The growth of average monthly gross earnings is projected to increase by 7.9% in 2021 and slow to 5.2% in 2022.

The implementation of the European Union's Multiannual Financial Framework and the Recovery and Resilience Facility will have a positive impact on the development of country's investment in the medium term. RRF funds are expected to start to be used in the second half of 2021, with an accelerated absorbtion in 2022, with the transition to the green economy and digital transformation are identified as priority funding areas. The increase in public sector investment during the pandemic is expected to continue to make a significant contribution to GFCF growth. They will also benefit from the efficient and consistent use of international support funds. Improving business expectations, the vaccination process gaining momentum, a recovery in foreign demand and production capacity utilisation will have a positive impact on accelerated investment by companies in projects postponed before the pandemic as well as in new ones. However, faster growth in labour costs than in labour productivity is signalling about factors that are constraining development of investment. It is estimated that the GFCF could grow by 6.4% in 2021 and by an average of 8.0% annually in 2022–2024, in line with increasing international support flows.

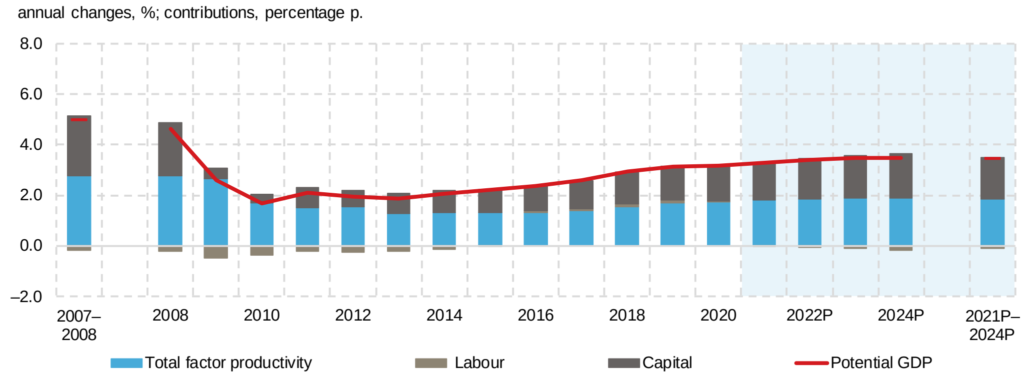
With the recovery of the economies of Lithuania's main trading partners and rising domestic consumption and investment, the growth rate of both real exports and imports of goods and services is projected to exceed 8% in 2021, while the growth rate of 6% is expected in 2022.

Inflation is projected to reach 2.6% in 2021 (Figure 1). This could be due to low base effects, fluctuations in oil prices and disruptions of supply chains. Inflation is expected to stabilise around 2% over the medium term. The economic recovery and rising oil prices may lead to higher labour costs in the industrial, construction and service sectors, which will have an impact on the overall price level in the medium term. The growth of GDP deflator is projected at 2.6% and 2.2% for 2021 and 2022.

Lithuania's real GDP is likely to be close to its potential in 2021 and the output gap is expected to turn positive in the medium term. The National Audit Office, implementing the functions of the fiscal institution, projects potential GDP to increase on average by around 3.4% annually between 2021 and 2024[13] (Figure 3).

[13] Excluding the change factors, total factor productivity contributes around 1.9% p.p. to potential GDP growth. The contribution of capital, which is closely linked to the overall development of investment, is 1.7% p.p. However, the contribution of the labour is negative and stands at -0.1% p.p.

Firgure 3. Potential GDP growth and its contributions



Source: Eurostat, calculations by the National Audit Office, implementing the functions of the fiscal institution

According to Economic Development Scenario, published in June, these dynamics reflect a more favourable cyclical position of the country's economy than previously expected. The output gap is projected to reach 0.2% of potential GDP in 2021 and around 1% of potential GDP in the medium term. The most recent IMF mission's findings point in the same direction[14], with projections of this indicator of 0.3%, 0.9% and 0.6% of potential GDP for 2021–2023 respectively.

The more favourable cyclical position of the Lithuanian economy is also reflected in other macroeconomic indicators that are actually monitored. In May 2021, the industry's production capacity utilisation reached its 2019 level. Correspondingly, in this sector, the share of companies constrained by shortages of labour force is also at 2019 levels. The shares of trade and construction companies constrained by shortages of labour force are close to the multi-year averages. In services companies, other factors, including quarantine measures, are the most restrictive. According to the data of the Employment Service, the number of job vacancies in May 2021 is the highest since 2008 and is equal to 20.8 thousand. The updated Heatmap of Lithuania's Economy shows that economic temperature continues to rise in Q2 2021.

Although the cyclical position this year is expected to be better than it was expected in the spring, the situation in the country's various economic activities is not even. According to data of Q1 2021, industrial, information, and communication activities were among the contributors to the growth of gross value added at constant prices. However, activities of food service and accommodation, arts, entertainment and recreation are subject to quarantine restrictions. The need of more targeted stimulus measures with the focus on economic activities, that are the most affected by the pandemic, remains relevant.

The National Audit Office of the Republic of Lithuania, implementing its functions of budget policy monitoring institution, set out in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, has carried out an

[14] 14/06/2021 Concluding Statement of the International Monetary Fund (IMF) following a mission to Lithuania under Article IV of of the IMF's Articles of Agreement, Internet access: https://www.imf.org/en/News/Articles/2021/06/14/mcs061421-lithuania-staff-concluding-statement-of-the-2021-virtual-article-iv-mission.

assessment on the Economic Development Scenario for 2021–2024 prepared by the Ministry of Finance of the Republic of Lithuania and published on 11 June 2021, and prepared its opinion. Pursuant to provisions of Paragraph 6 (3) of Article 9 of the Law on National Audit Office of the Republic of Lithuania, the National Audit Office hereby submits its opinion to the Seimas of the Republic of Lithuania.

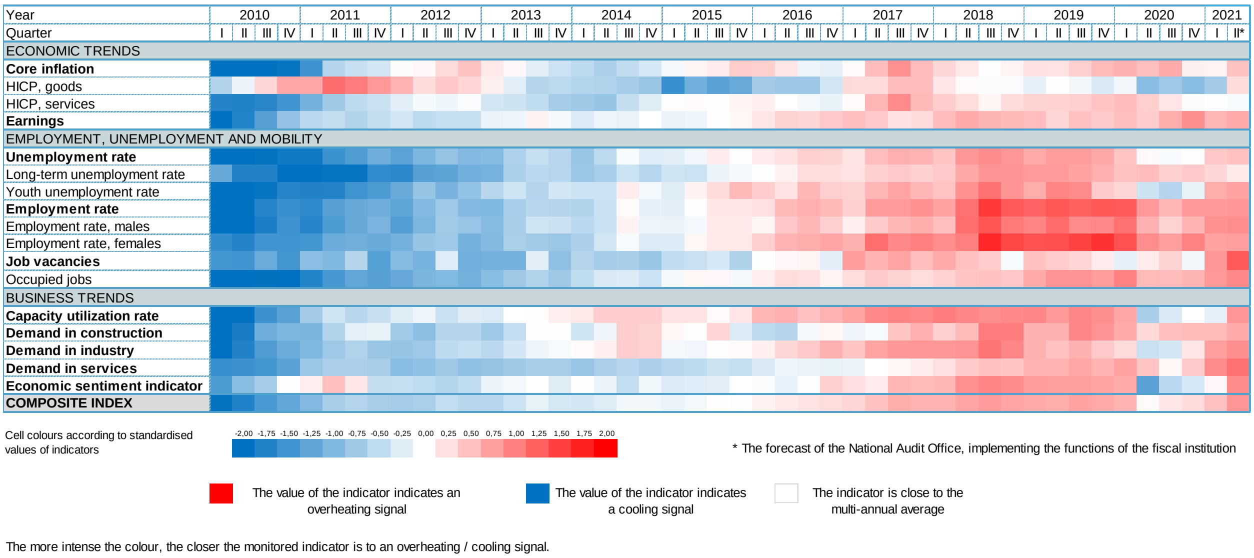
The opinion is accompanied by the Heatmap of Lithuania's Economy.

Auditor General Mindaugas Macijauskas

ANNEXES

The Heatmap of Lithuania's economy

The Heatmap of Lithuania's economy



Source: Eurostat, Statistics Lithuania, calculations by the National Audit Office, implementing the functions of the fiscal institution

The monitoring of macroeconomic imbalances[15] suggests that the temperature of the Lithuania's economy will rise in Q2 2021 and is likely to reach the 2017–2019 average level. This trend is reflected in most of the indicators analysed[16]. According to the data of the Employment Service, the number of job vacancies in May is the highest since 2008. The level of production capacity utilisation has been rising in Q2, reaching the pre-pandemic level. Employment rate is also expected to increase in April–May, in line with declining registered unemployment. Improved business sentiment is boosting demand for services and industry. The rise of oil prices in recent months has had an impact on commodity prices. Core inflation in Q2 is expected to be slightly above the multi-annual average.

[15] The methodology for drawing up the heatmap and the description of the indicators are set out in the National Audit Office's Opinion No BP- 5 "On the Endorsement of the Economic Development Scenario" of 20 September 2018. The heatmap shows the deviations from the long-term average.

[16] Some of the statistical indicators used in the heatmap for Q2 2021 are provisional. Core inflation, the April-May change in the HICP of goods and services compared to the corresponding period of the previous year and equated to Q2. Unemployment and employment rates, job vacancies and jobs occupied in Q2 are estimated using econometric models, taking into account data available from the Statistics Lithuania, the Employment Service and SODRA (State Social Insurance Fund).