NATIONAL AUDIT OFFICE OF LITHUANIA

To the Seimas of the Republic of Lithuania

OPINION ON THE ENDORSEMENT OF THE ECONOMIC DEVELOPMENT SCENARIO

21 September 2021 No. BPE-6

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 10 September 2021, as it is suitable for the preparation of the budgets attributable to the general government.

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 updated 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.

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

Driven by the low base effect, the development of Lithuania's economy was strong in the first half of 2021. Compared with the same period a year ago, the country's real GDP increased by 4.7% in the first half of 2021. The economic growth was mainly supported by investment and household consumption expenditure. Meanwhile, the impact of net exports was negative. Manufacturing, with the chemical industry making a significant contribution, and the results of the performance of wholesale and retail trade, transport, accommodation and food services were the main drivers of gross value added. It should be noted that the strong performance in the first half of 2021 was driven by the low base effect: in Q2 2021, the country's economy was no longer constrained by the tight quarantine restrictions that were in place during the same period a year ago. Correspondingly, this effect is also observed in many other macroeconomic indicators (Annex 1).

[1] On 26 March 2020, 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. Internet access: https://www.valstybeskontrole.lt/EN/Product/23910/opinion-on-the-compliance-of-the-unusual-event-with-the-definition-of-exceptional

The annual change in household consumption expenditure in the first half of 2021 reached 7.0%. Decreasing unemployment, rising average monthly gross earnings and stable consumer expectations have created favourable conditions for growth in consumer spending. The adaptation of both households and businesses to the challenges posed by the quarantine conditions has allowed domestic trade to grow. In the first seven months of 2021, compared to the same period in 2020, turnover of retail trade (excluding fuel) increased by 13.8%.

In the first half of 2021, the labour market situation was better than a year ago, but still remained affected by the pandemic. In Q2 2021, the unemployment rate decreased by 1.1 p.p. (to 7.4%) compared to Q2 2020, while the number of employed persons increased slightly (0.7%). Several activities have had a major impact on employment growth: manufacturing, information and communication, and construction. The largest negative impact was from wholesale and retail trade, repair of motor vehicles and motorcycles, and education activities.

In the first half of 2021, the average monthly gross earnings (excluding individual enterprises) rose to EUR 1,566.4 per year, i.e. by 10.9%.[2] Average monthly gross earnings increased in all economic activities. This was likely caused not only by higher lump-sum bonuses, allowances and cash payments but also to a shortage of labour force, as reflected in the record-high number of job vacancies in the country at the end of the first half of 2021 (24.8 thousand). The annual increase, compared to the first half of 2020, was around 41%. The highest number of job vacancies during this period was recorded in activities of manufacturing, transport, trade, and public administration.

Gross fixed capital formation (GFCF) grew by 14.8% in the first half of 2021 compared to the first half of 2020. The main contributors to this strong growth were investment spending on other machinery, equipment and weapon systems (7.4 p.p.) and transport equipment (4.2 p.p.). As companies returned to their investment plans, imports of capital goods increased by 33.9% in the first half of 2021 compared to the same period a year ago. Not only has industrial production capacity utilisation exceeded pre-pandemic level but also reached an all-time high of 79.2% in August. According to the data of the opinion survey of enterprise managers in areas of services, industry, construction and trade, although business confidence indicators remain positive, the share of companies stating that they are not constrained is still lower than before the COVID-19 pandemic. Before the pandemic, insufficient demand was limiting a larger number of companies, while more recently more companies have identified a shortage of labour force and raw materials as the most limiting factors for business development.

In the first half of 2021 the growth rate of real exports and imports of goods and services reached 14.6% and 16.1% respectively. The strong growth in international trade indicators was mainly driven by the Q2 performance, which was influenced by the base effect: in the corresponding period a year earlier, exports and imports were strongly affected by the uncertainty of COVID-19 and the measures taken to contain the pandemic. Excluding mineral products, the value of exports of goods of Lithuanian origin in January–July 2021, was mainly driven by the chemical and furniture industries, during the year increased by 22.3% and re-exports by 10.6%. Increasing investment and household consumption has

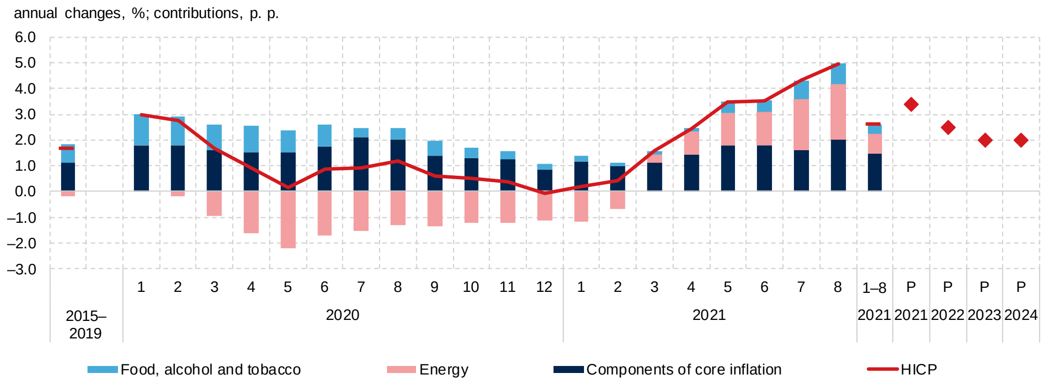
[2] Average monthly gross earnings grew by 11.9% in the public sector and by 10.7% in the private sector during the same period.

led to an increase in the value of imports of goods by 20.9%. During this period, international trade in services is growing at a slower pace than in goods.

The annual average Harmonised Index of Consumer Prices (HICP) for January–August 2021 grew by 2.6% compared to the same period a year ago. The transport component had the largest impact on the change in the HICP (0.8 p.p.), following the increase in oil prices in 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.).

Inflation dynamics between 2020 and 2021 was strongly influenced by the prices of energy resources. Core inflation is analysed to provide a clearer picture of price level development[3]. The impact of core inflation components on HICP growth averaged 1.5 p.p. in January-August 2021 (Figure 1). This rate is close to the 2015–2019 average (1.1 p.p.) and lower than 1.8 p.p. recorded in January–August 2020. These dynamics of core inflation suggest that the current rise in inflation, which is largely driven by recovering energy prices, will be temporary. A risk remains that prolonged supply chain disruptions and rising inflation expectations could lead to faster price increases than projected in the Scenario.

Figure 1. HICP and its contributions



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

In the first half of 2021, the growth of GDP deflator was 4.9%. The rise in the general price level was driven not only by the HICP but also by a strong increase in other price indices in Q2.[4] In the first half of this year, nominal GDP was 9.9% higher than in the same period a year earlier. The performance of manufacturing and wholesale and retail trade, transport, accommodation and food services was the main contributor to the growth in gross value added at current prices.

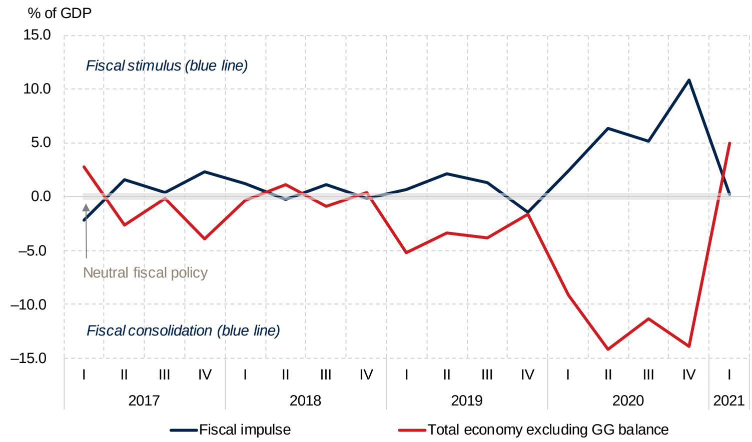
In 2021, domestic demand is driven by the private sector, fiscal stance is neutral. Fiscal stance was close to neutral in Q1 2021, however, domestic demand was boosted by a decline in the net lending/borrowing of private sector (Figure 2). In 2020, Government stimulated the economy by increasing debt, while in the private sector the loan portfolio of non-financial corporations contracted, savings grew, households' consumption

[3] Core inflation is calculated by subtracting the impact of highly volatile food, alcohol and tobacco and energy prices from overall inflation.

[4] In Q2 2021, compared to the corresponding period in 2020, prices have risen due to low base effect: 11.2% for industrial products sold by producers, 7.7% and 13.0% for exported and imported goods, 5.6% for construction input, and 10.6% for purchase of agricultural products.

declined, and their loan portfolio grew at a slower pace than in 2019. The opposite trend is observed this year: private consumption and investment are growing, the loan portfolio of households is expanding at a faster pace, the loan portfolio of non-financial corporations in financial institutions is shrinking at a slower pace, and the fiscal policy is neutral. In the context of a strong private sector recovery and in order not to overheat the economy, at least a neutral fiscal policy should be maintained.

Figure 2. Fiscal impulse* and annual change in private sector net lending/borrowing**



* Change in the GG structural primary balance (SPB).

** Change in the net lending/borrowing of total economy excluding general government as % of GDP. For example, if the change is negative, the private sector surplus rises relative to a year ago, with a corresponding fall in domestic demand.

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

Macroeconomic environment and risk factors

External risks remain linked to the recovery of the global economy. The recovery remains uneven, nevertheless, international institutions are improving their growth forecasts for the major economies [5], and the European Commission expects that the activity of EU economies will return to pre-pandemic levels by the end of 2021[6]. The improvement in the forecasts is largely due to the maintenance of fiscal support measures and the vaccination against COVID-19. The recovery of the EU tourism sector with the introduction of the international EU digital COVID certificates is also contributing to the improved situation. The economic recovery will be stimulated by household savings accumulated during the period of restrictions, improving consumer and investor expectations and rising investment by private companies. Further economic development will also depend on the ability of consumers and businesses to adapt to market changes. Lithuania's international trade may also be affected by the geopolitical situation with China and Belarus. However, these countries account for a small share of Lithuania's international trade volume: in 2020, China's share of exports of goods was 1.1% and Belarus' was 3.6%.

[5] According to the IMF's July 2021 World Economic Outlook, the global economy for the period 2021-2022 is projected to grow as follows: for the euro area 4.6% and 4.3%, for the UK 7.0% and 4.8%, for the USA 7.0% and 4.9%, respectively. Internet access: https://www.imf.org/-/media/Files/Publications/WEO/2021/Update/July/English/text.ashx.

[6] The Summer 2021 Economic Forecasts by the European Commission. Internet access: https://ec.europa.eu/info/sites/default/files/economy-finance/ip156_en.pdf.

The challenge of balancing supply and demand in the global economy remains. The country's economic development will also depend on the growth rates and demand from international trading partners[7]. In addition, supply chains remain disrupted by shortages of goods and raw materials, production capacity, and transportation, leading to imbalances between supply and demand, and consequently to rising prices of raw material. As the global economic recovery improves and inflation accelerates, the world's central banks continue their monetary policy stimulus measures.

Internal risk factors remain related to inflation and labour market challenges. Strong domestic demand, declining savings rate and persistent supply-demand imbalances will drive the growth of domestic prices. Labour market challenges also remain: the number of job vacancies reached record levels, nevertheless, the unemployment rate and the number of employed persons have not returned to their pre-pandemic levels. This shows that the shortage of skilled workers[8] is a growing problem.

The main threat to economic recovery, both in Lithuania and worldwide, is the further development of the pandemic. Uncertainty remains about the future progress of vaccination[9], the spread of new COVID-19 mutations and the introduction of new restrictions.

The average Brent oil price for June–August 2021 was above the 2019 level and stood at USD 72.6 per barrel[10]. Uncertainty about the future dynamics of the COVID-19 pandemic[11], OPEC and Russia's decision to continue their plan to increase oil production[12] contributed to the price volatility. Based on Futures, the price of Brent crude oil is expected to remain higher than in 2019, reaching USD 72.2 and USD 68.8 per barrel in 2021 and 2022 respectively[13].

The development of Lithuania's economy in medium term

The growth rate of Lithuania's real GDP is projected to reach 4.3% in 2021 due to strong domestic demand, while the growth rate will slow to 4.0% in 2022. The more favourable than expected economic development results in Q2 2021 contributed to the upward revision of the projections for 2021. According to the Economic Development Scenario, published in September, household consumption and accelerating investment will be the main drivers of GDP growth. Imports of goods and services growing faster than exports will lead to a negative impact of net exports on economic development over the medium term.

[7] In the first half of 2021, the main export partners of goods of Lithuanian origin: Germany (10.2%), USA (10.1%), Poland (6.8%), Sweden (6.5%), Latvia (6.4%), and the Netherlands (6.4%).

[8] According to the Business Trends Survey, in the first eight months of this year, the shortage of labour force as a limiting factor increased by 7.6 p.p. in the industrial sector and by 5.8 p.p. in the construction sector, compared to the same period in 2020.

[9] The proportion of the population vaccinated with at least one dose of vaccine is 62.6% in Lithuania and 65.3% in the EU, while the proportion of the population fully vaccinated is 57.5% in Lithuania and 59.3% in the EU. Data source: http//www.ourworldindata.org (07/09/2021).

[10] Based on 31/08/2021 data. Internet access: www.barchart.com.

[11] The increase in COVID-19 cases globally between July and August 2021 has prompted major oil consumers such as China and the USA to review their pandemic containment measures.

[12] Increase oil production by 400,000 barrels per day every month until the end of 2022.

[13] Based on www.barchart.com (09/09/2021), oil price in 2021–2022 respectively will reach USD 72.2 and 68.8 per barrel.

In 2021, household consumption expenditure is projected to grow by 5.4%. Private consumption is expected to remain an important driver of economic growth both in the second half of 2021 and in 2022. Expenditure on goods and services is expected to increase as the COVID-19 vaccination process continues and the financial situation of the population improves. Private consumption will be boosted by projected above-inflation growth in average monthly gross earnings and rising number of employed persons. Consumption expenditure may also be positively affected by the likely decline in the household saving rate and the Government's decisions on economic and social policies.

The number of employed persons is projected to grow by 0.4%, 0.9% and 0.2% in 2021–2023 respectively. With this increase, the country's unemployment rate is likely to continue to decline in 2022 (to 6.7%). The growth of employment will be driven by the tensions in labour market, reflected in the rising number of job vacancies, and by Government's decisions on changes to employment benefits from 1 September[14]. On the other hand, faster growth of employment will be constrained by the shortage of skilled workers[15] and the uncertainty surrounding the development of the pandemic and measures to contain its spread. Other factors holding back the growth of employment in the medium term are declining resident population, ageing population and emigration[16].

Given the strong growth of average monthly gross earnings in the first half of 2021, this indicator is projected to rise by 9% over 2021 and 8% in 2022. This will be influenced by a shortage of labour force, which is still identified as one of the main factors constraining the business activity, the increase in the minimum monthly wage in 2022 and Government's decisions on public sector pay rises or bonuses.

Record high production capacity utilisation, challenges in the supply chains and in the labour market raise not only potential threats but also the need for businesses to invest. A faster-than-expected recovery in private sector investment in delayed and new projects could lead to a faster growth in gross fixed capital formation in 2021, than over the medium term. Favourable assessment of production demand and shortages of resources such as raw materials, equipment and labour force in certain sectors can stimulate an increase in investment to expand production and improve performance efficiency. Investments will also benefit from expenditure on other machinery, equipment and weapon systems, information and communication technology, and transport equipment which is likely to continue in the second half of 2021 as well. The growth of public investment will benefit from EU funds, the Recovery and Resilience Facility and government expenditure on defence They are also likely to stimulate private sector investment. The GFCF is projected to grow by 13.4% in 2021 and 7.5% in 2022. However, there are risks to the 2021 estimate for this indicator, not only due to the uncertainty of the COVID-19 pandemic but also due to the lower base effect in the second half of 2021 (in the second half of 2020, investment growth was 3.5%).

With the recovery of the economies of Lithuania's main trading partners and rising domestic consumption and investment, real exports of goods and services are projected to grow by 11.1% and 6.2% respectively in 2021 and 2022, while imports are expected to

[14] Wage subsidies and jobseeker's allowance amounting to EUR 212 will be paid till 31 August. Internet access: https://socmin.lrv.lt/lt/naujienos/socialine-apsauga-kas-keiciasi-nuo-liepos-1-dienos.

[15] According to the Employment Service, 57.1% of registered job offers were for skilled workers and machinery and equipment operators. The number of job offers for managers and professionals is also growing. Internet access: https://uzt.lt/wp-content/uploads/2021/08/LIETUVOS-DARBO-RINKA-2021-07.pdf.

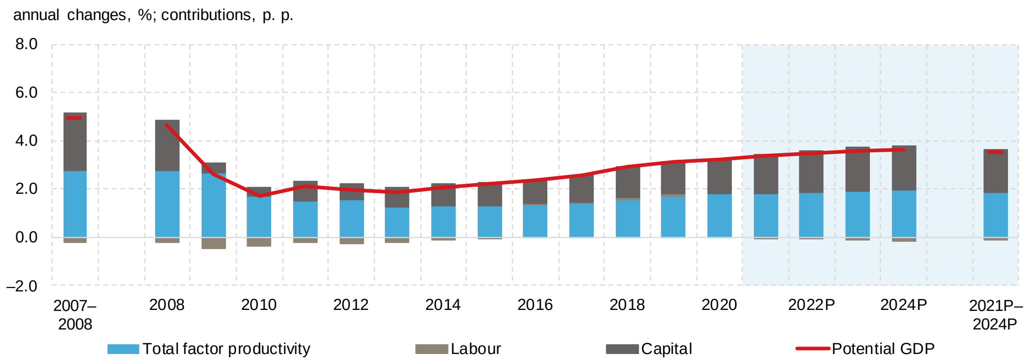
[16] According to Statistics Lithuania, net migration of Lithuanian citizens has turned positive since May 2021.

increase by 14.2% and 7.4%. Imports are also projected to grow faster than exports over the rest of the medium term.

The HICP is projected to rise to 3.4% in 2021 and decline to 2.5% in 2022. These dynamics can be driven by the base effect, higher oil prices and disruptions of supply chains. Inflation is expected to stabilise at 2% in the medium term. The growth of GDP deflator is projected to reach 5.2% in 2021, slowing to 2.5% in 2022.

In 2021, Lithuania's real GDP is likely to be close to its potential and the output gap is expected to be 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 3.5% annually between 2021 and 2024[17] (Figure 3). The output gap is likely to reach 0.3%, 0.7%, 0.5% and 0.4% of potential GDP in 2021–2024 respectively.

Figure 3. Potential GDP growth and its contributions



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

The positive cyclical position of the Lithuanian economy is also reflected in other macroeconomic indicators that are actually observed. In August 2021, the share of industrial, trade, service and construction companies constrained by the shortage of labour force is above the 2019 level. During this period, industry's production capacity utilisation is at a record high and the number of job vacancies remains one of the highest since 2008, according to the Employment Service. The updated Heatmap of Lithuania's Economy shows that economic temperature continues to rise in Q3 2021 (Annex 2).

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 assessment on the Economic Development Scenario for 2021–2024 prepared by the Ministry of Finance of the Republic of Lithuania and published on 10 September 2021, and prepared its opinion. Pursuant to provisions of Paragraph 7 (3) of Article 8 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.

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

[17] 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 driver is negative and stands at –0.1 p.p.

Auditor General Mindaugas Macijauskas

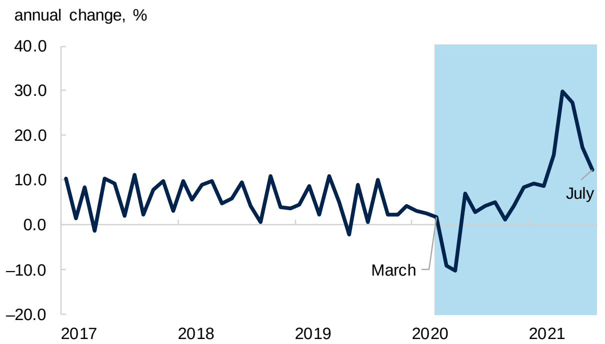
ANNEXES

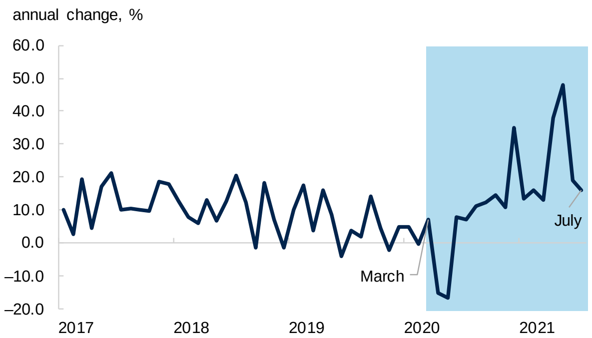
Opinion
On the Endorsement of the
Economic Development Scenario
Annex 1

The changes in the Lithuanian economy during a period of exceptional circumstances

1 Chemical and wood industries were the main contributors to the July **industrial production**[1] ....

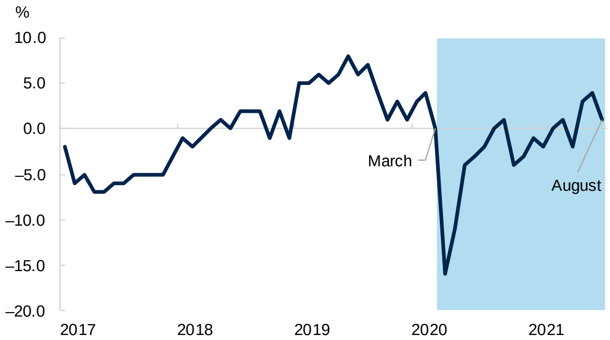
2 ...and **exports of goods of Lithuanian origin**[2], which grew at double-digit rates.

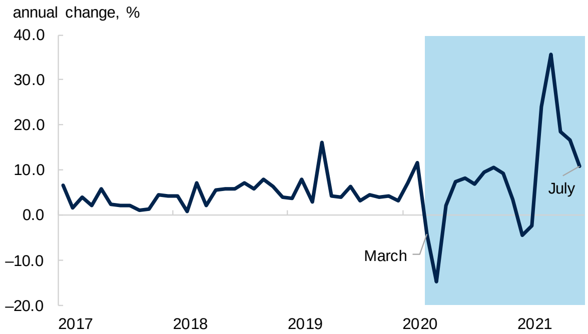




3 **Consumers' expectations** remain positive.

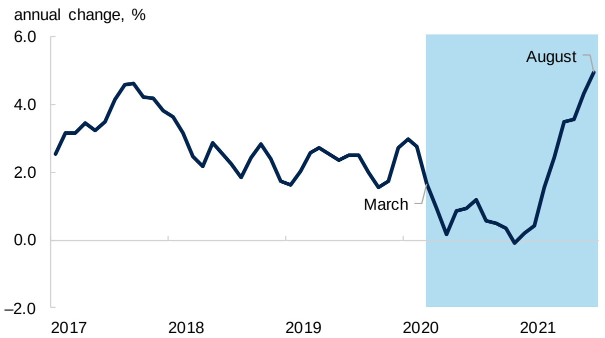
4 The non-food trade was the main driver to the increase in **retail trade turnover**[3] in July.

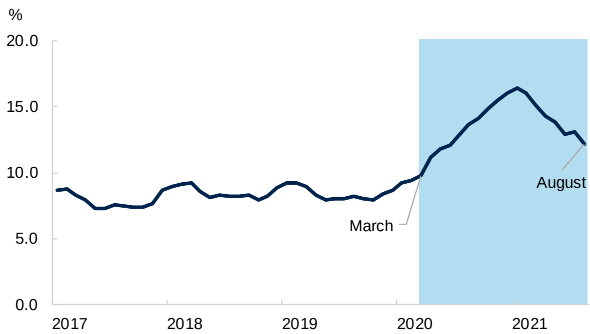




5 The increase of **consumer prices** is driven by the cost of electricity, gas, heat and fuel.

6 **Registered unemployment** has continued to fall since the beginning of the year, as the number of job vacancies has increased.

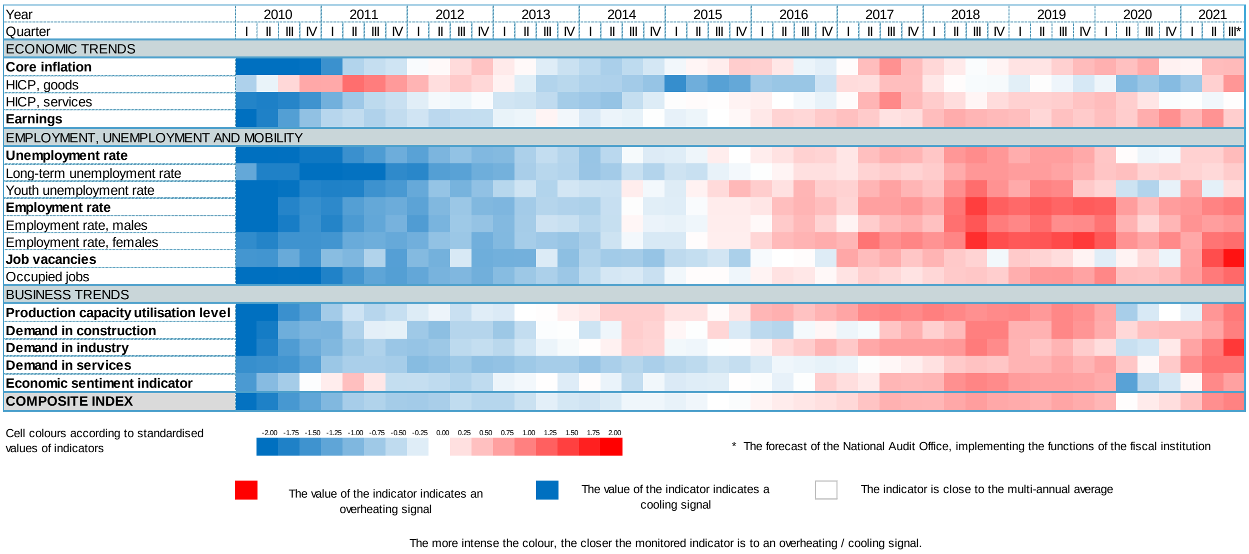




[1] except refined petroleum products / [2] except mineral products / [3] except the sale of automotive fuels
Note: in Figures 1, 2, 4, 5 the strong growth in March–May 2021 is due to the base effect.
Source: Statistics Lithuania, Employment Service, calculations by the National Audit Office implementing the functions of the fiscal institution

Opinion
On the Endorsement of the
Economic Development Scenario
Annex 2

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[18] indicates that the temperature of the Lithuanian economy is likely to continue to rise in Q3 2021. This is reflected in most of the indicators analysed[19]. According to the Employment Service, registered unemployment in the country reached 12.2% in August[20]. In Q3 2021, the employment rate of the country is projected to increase and the unemployment rate to decrease. According to the SODRA data, the average monthly income in July increased by 9.1% over the year compared to the same period in 2020. Production capacity utilisation rates continue to rise in Q3, with fewer companies reporting that they are constrained by insufficient demand. The rise in oil prices in recent months has led to an increase in the prices of goods. Core inflation in Q3 is expected to be slightly above the multi-annual average.

[18] 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.

[19] Some of the statistical indicators used in the heatmap for Q3 2021 are provisional. Core inflation, the July change in the HICP of goods and services compared to the corresponding period of the previous year and equated to Q3. 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).

[20] The rate reached 13.7% in August 2020 and 13.1% in July 2021.