To the Seimas of the Republic of Lithuania

OPINION ON THE ENDORSEMENT OF THE ECONOMIC DEVELOPMENT SCENARIO

23 December 2021 No. BPE–8

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 is based on the available statistical data. Fiscal institution, whose functions are performed by the National Audit Office, endorses the Economic Development Scenario for 2021–2024, published by the Ministry of Finance on 22 December 2021.

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. Until exceptional circumstances are cancelled, the Ministry of Finance shall publicly announce, at least quarterly[2], 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 2021

In Q1–Q3 2021, the Lithuanian economy has maintained strong growth. During the first three quarters of 2021, real GDP increased by 4.9% compared to the corresponding period a year ago. Investment and household consumption expenditure had the greatest positive impact on economic growth, however with the strong increase in imports, impact of net exports was negative. Gross value added was mainly driven by the manufacturing industry and the performance of wholesale and retail trade, transport, accommodation, and food service activities. Results in the manufacturing sector, whose output in March–October grew at double-digit rates, were driven mainly by the chemical and furniture industries. Since strong demand for raw materials persisted, the wood and metal industries also made a significant contribution. It should be noted that strong performance in Q1–Q3 2021

[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.

[2] Republic of Lithuania Constitutional Law on the Implementation of the Fiscal Treaty, Article 7(3).

was driven by the low base effect which was most pronounced in Q2[3]. This effect was also observed in many other macroeconomic indicators (Annex 1).

In the first three quarters of 2021, household consumption expenditure increased by 6.9% compared to the corresponding period of 2020. Increasing average monthly earnings, declining unemployment rate, and favourable expectations of the financial position of consumers have facilitated the growth of the consumption expenditure of the population. The ability to adapt to the pandemic conditions by both households and business has boosted domestic trade. During the first ten months of 2021, retail turnover (excluding fuels) increased by 12.3% compared to the corresponding period of 2020.

In Q3 2021, the number of employed persons grew by 3.3% compared to the same period a year ago and exceeded the pre-pandemic level. Amendments to the job search allowances[4] that entered into force in September are likely to have contributed to the growth of this indicator, leading to higher participation of a part of former unemployed persons in the labour market. Despite the declining unemployment rate which was 6.7% in Q3 2021, the number of job vacancies grew and remained at a record high. In Q1-Q3 2021, the double-digit annual growth rate of average gross monthly earnings in the country was driven not only by its increase in the public sector, bonuses, or an increase in the minimum monthly wage but also by a persistent problem of labour shortage. It should be noted that earnings and their growth rates differ greatly in different sectors and municipalities; therefore, the majority of vacancies are concentrated in large cities and their inner-ring municipalities[5]. The problem of a shortage of skilled labour also contributes to these differences.

After the rapid growth of gross fixed capital formation (GFCF) during the first half of 2021, the rate in Q3 was slower because of lower investment in other buildings and structures[6]. Nevertheless, in Q1–Q3 2021, the growth of GFCF was double-digit and reached 10.2% compared to the corresponding period a year ago. This change was mainly due to productivity-oriented investments in other machinery, equipment and weapons systems (5.6 percentage points), and transport equipment (3.3 percentage points). The level of industrial production capacity utilization remained at a record high and accounted for 79.6% in November. According to the opinion survey of enterprise managers in areas of services, industry, construction, and trade, the share of companies claiming to be limited by labour shortages on average amounted to 29.2%. The last time the closest figure to this one was at the beginning of 2008.

Growth in real exports and imports of goods and services in Q1–Q3 2021 amounted to 14.5 and 17.4%, respectively. The strong growth of international trade indicators was mainly driven by the Q2 performance, which was influenced by the base effect. Excluding mineral products, the value of export of goods of Lithuanian origin in January–October of 2021, increased by 19.6% over the year. Exports of chemicals, furniture, wood products, and base metals mainly contributed to this growth. This year, the impact of crop exports was

[3] 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 earlier.

[4] Subsidies for compensation of wages and job search allowance were paid until 31 August.

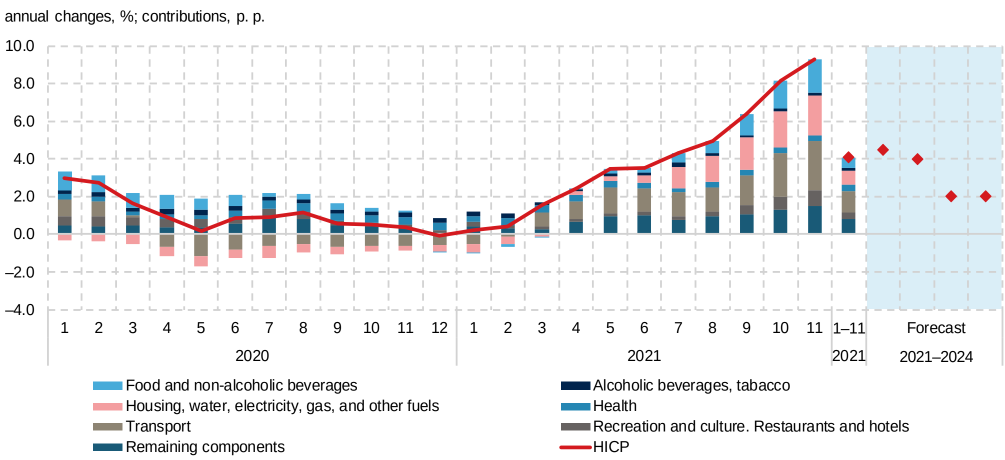
[5] In Q3, 74% of job vacancies were registered in six largest cities and their inner-ring municipalities.

[6] The decline of this investment component had an impact of -2.7 percentage points to the annual change in GFCF of Q3 2021 and reached 3.5%.

negative due to the lower yield[7] in September–October and it may remain so in Q4. In January-October, the value of re-exports (excluding mineral products) increased by 9.9% and exports of services increased by 13.3%. With investment and household consumption growth, the value of imports of goods increased by 20.8% and that of services by 21.2%. It should be noted that the rise in export and import prices also contributed to the growth of these indicators.

In January–November of 2021, the growth of the annual average Harmonized Index of Consumer Prices (HICP) was 4.1% compared to the corresponding period a year ago (Figure 1). With the rise in crude oil prices on the global market, the transport component had the largest impact on the change in the HICP (1.2 percentage points). In the second half of the year, there was a significant price increase in the gas and electricity markets; therefore, part of the growth of the index was determined by the component of housing, water, electricity, gas, and other fuels (0.7 percentage points). Rising prices for food and non-alcoholic beverages (0.5 percentage points) also contributed to the rise in prices. High inflation estimates at the end of the year are also affected by the base effect.

Figure 1. HICP and its contributions



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

The growth of the GDP deflator in Q1–Q3 2021 amounted to 5.8% and was one of the largest in the EU[8]. The rise in the general price level was driven not only by the HICP but also by the growth of other price indices[9]. In Q1–Q3, nominal GDP was higher by 11.0% compared to the same period a year ago. 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.

[7] Based on the preliminary assessment of the Institute of Economics and Rural Development of Lithuania, in 2021, the crop yield will be 8.6% lower than in 2020.

[8] As of 13 December, in Q1–Q3 2021, the GDP deflator growth per year was faster in the Czech Republic (6.9%), Sweden (6.6%), and Luxembourg (6.3%) compared to Lithuania.

[9] Compared to the corresponding period of 2020, in January-October 2021, prices for industrial products sold by producers grew by 8.0%, for exported and imported goods – by 5.4 and 11.4%, respectively, for construction input – by 5.4% and for purchase of agricultural products – by 11.7%.

Macroeconomic environment and risk factors

Disruptions in supply chains are expected to remain in the short term. The continuing spread of COVID-19, the lack of goods and raw materials, production and transport capacity, especially in the industrial sector, pose supply challenges – price growth is accelerating both in the major world economies and in Lithuania[10]. Increased demand for goods contributes to this as well.

The balance of external risk factors is negative. Growing geopolitical tensions over the measures to manage the migrant crisis at the Belarus border and their further flows may have a negative impact on the Lithuanian economy. Moreover, sanctions against Belarus[11] and possible countermeasures, as well as disruptions to trade with China[12], may have a negative impact on international trade, investment, and the country's medium-term economic development.

Internal risk factors remain related to the labour market and inflation. The labour shortage and faster growth of wages than productivity may in the long run pose challenges related to the growth of prices of Lithuanian-origin goods and services which could reduce the country's competitiveness in international markets. Rapidly rising inflation, which is driven more by external factors and is mainly affected by growing energy prices, brings challenges to domestic consumption. There are risks to the management of expectations and the wage-price spiral: expectations of rising inflation could push workers to negotiate higher wages, which would lead to further price increases. Also, with high level of production capacity utilization and lack of raw materials, there are still risks regarding the use of European Union funds, both regionally and countrywide.

It is likely that in 2022 oil prices will remain higher than in 2019. Oil shortage due to insufficient crude oil production[13] and rapid economic recovery allowed the average Brent crude oil price to reach USD 79.5 per barrel in September–November[14]. Although the rise in oil prices has been observed in recent months, it has been slowed down by new pandemic restrictions in some countries as well as by decisions regarding the strategic use of oil reserves[15], and uncertainty about a new variant of coronavirus (Figure 2). Based on Futures, the price of Brent crude oil is expected to remain higher in 2022 than in 2019, reaching an average price of USD 67.4 per barrel[16].

[10] According to the Business Trends Survey, in January-October of 2021, the shortage of raw materials as a factor limiting industrial production increased by 12.7% percentage points and in the construction sector – by 7.4 percentage points, compared to the same period in 2020.

[11] Imports from Belarus account for about 3% of all Lithuanian imports.

[12] Exports of Lithuanian-origin goods to China account for up to 2%. However, in Q1–Q3 2021, the exports of these goods halved compared to the corresponding period of 2020. China is among Lithuania's six main import partners; imports from it account for 4.4% of all Lithuanian imports.

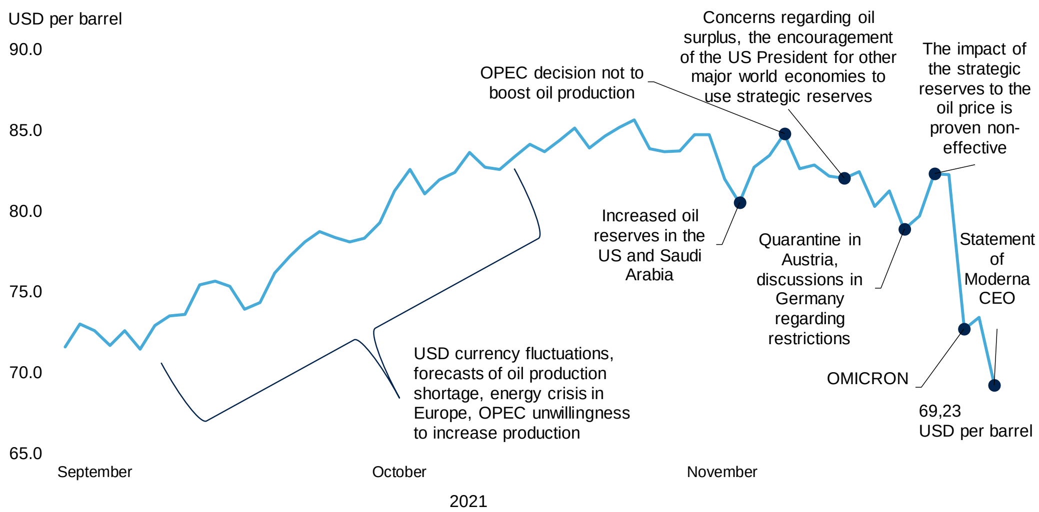
[13] The resolution of July between OPEC and Russia to boost oil production by 400 thousand barrels a day has not been adjusted. In the meeting of the organisation in December, it was assured that the decision could be reviewed shortly in order to respond appropriately to the changed circumstances.

[14] Based on 01/12/2021 data. Internet access: www.barchart.com.

[15] The US President's order to release 50 million barrels of oil from the strategic reserve and the encouragement for other major world economies such as the United Kingdom or Japan to follow this example.

[16] Based on 01/12/2021 data. Internet access: www.barchart.com.

Figure 2. Oil price fluctuations in September–November of 2021



Source: www.barchart.com. The chart uses the data of 1 December 2021.

Opinions of the world's central banks differ on the management of inflation growth. Given the favourable economic growth and seeing the risk of high inflation, at the meeting in November, the US Federal Reserve decided to reduce the asset purchase programmes but maintained the previously established low-interest rates of 0.01–0.25%. Based on the renewed restrictions[17] in some Member States, the European Central Bank is planning to maintain an expansionary monetary policy[18] longer than the US Federal Reserve. On the other hand, central banks of the United Kingdom, Norway, Poland, New Zealand, and several other central banks, identifying the risks stemming from inflation, have raised interest rates: the increase ranges from 0.25% to 2.5%.

The development of Lithuania's economy in the medium term

The Economic Development Scenario for 2021–2024 published by the Ministry of Finance on 22 December 2021, is endorsed because the projections of changes in GDP at constant and current prices, household consumption expenditure, average earnings and employment fall into the endorsable range of the relevant indicator[19] (Annex 3) and do not contradict the expert assessment of the National Audit Office.

The Economic Development Scenario prepared by the Ministry of Finance projects that due to strong domestic demand, in 2021 the growth of Lithuania's real GDP will reach 4.8%, and in 2022–2023 it will slow down to 3.7% and 3.5%, respectively. The published statistical information of Q3 shows that the country's economy continues to grow rapidly. This encourages the review of projections in 2021 in a positive direction. The Economic Development Scenario, published in December, foresees that household consumption and accelerating investment will be the main drivers of GDP growth. Imports of goods and services will grow faster than exports due to strong domestic demand. This

[17] Quarantine in Austria. Restrictions on unvaccinated people in Germany.

[18] In March 2022, ECB is planning to dismiss the purchase of a financial asset programme amounting to EUR 1.85 trillion; however, it is considered to extend parallel longer-term asset purchase measures for several months.

[19] The assessment and approval methods are further specified in the Description of the Assessment and Approval of the Economic Development Scenario. Internet access: https://www.valstybeskontrole.lt/TVS/Content/Biudzeto_stebesena/ERS_vertinimo_ir_tvirtinimo_aprasas.pdf.

will lead to a negative impact of net exports on economic development in the medium term.

In 2021, the projected growth of household consumption expenditure may reach 6.6% and 4.0% in 2022. Strong domestic demand is expected to remain an important driver of economic growth. Growing average gross monthly earnings exceeding projected inflation growth and rising employment will have a positive impact on private consumption. The decline in the household saving rate and the discretionary fiscal policy measures adopted by the Government, such as the increase in the minimum monthly wage, the amount of non-taxable income and social benefits, are also likely to contribute to the increase in household expenditure.

With regard to the faster recovery of the labour market in Q3 of this year, it is projected that in 2022, the employment growth will slow down to 0.6% and the unemployment rate will decrease to 6.4%. The increase in the minimum monthly and public sector earnings and the remaining pressures in the labour market due to the expected labour shortage will contribute to the growth of the average monthly earnings (9.3%) in 2022.

Strong foreign demand, favourable business expectations, access to credit, and challenges in the labour market have a positive effect on private sector investment in production capacity development and enhanced productivity. By ignoring the need to increase operational efficiency, companies may face difficulties in fulfilling their production orders and lose competitiveness in export markets. Active private business investment is expected to remain an important factor contributing to the growth of gross fixed capital formation not only in 2022 but also in the medium term. The growth of public sector investment will be positively supported by the funds of the European Union's Multiannual Financial Framework and the Economic Recovery and Resilience Facility. However, to channel financial flows to green transition and digital transformation projects, their implementation may face challenges[20] due to their compliance with the European Green Deal. There are potential negative risks to public sector investment, including rising prices in the construction sector and protracted procurement procedures. In the Economic Development Scenario, it is projected that, in 2021, GFCF could grow by 9.1%, in 2022 – by 7.5% and in 2023–2024 – by 8.0% each year.

With the recovery of the economies of Lithuania's main trading partners, in 2021–2023, real exports of goods and services are estimated to increase by 11.3%, 5.3%, and 5.1%, respectively. Domestic demand is projected to remain strong over the medium–term, leading to faster growth in imports than in exports: in 2021–2023 it will reach 14.7%, 6.3%, and 6.5%, respectively.

The Ministry of Finance forecasts that, in 2021, the HICP will rise to 4.5% and in 2022, the growth rate will slow down to 4.0%. Such dynamics may be determined by the base effect, the easing situation in the energy markets, and supply chains. The rise in inflation is expected to be temporary, stabilising at 2% over the medium term.

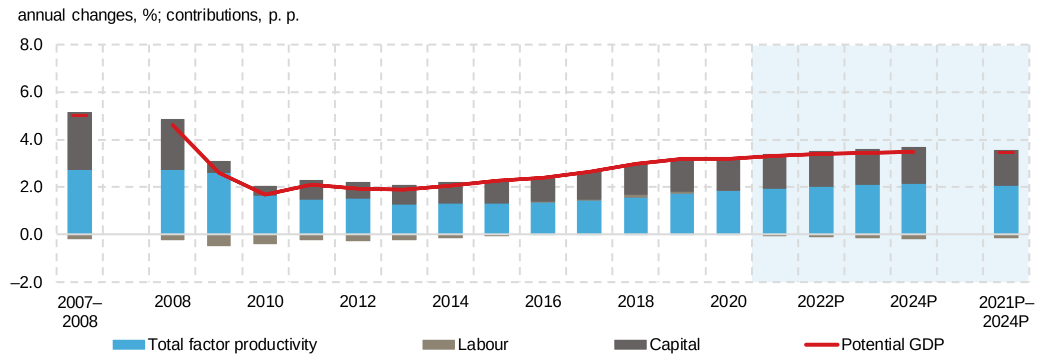
Foreseeing a faster HICP growth in 2021–2022 than expected, the projections of the rise in the general price level are revised upwards. In the Economic Development Scenario,

[20] According to a study carried out by the European Investment Bank (EIB) in 2021, more than 40% of the surveyed Lithuanian companies assess the future transition to stricter climate standards and regulations as a risk to their business. This is the largest share of companies among the analysed countries (EU countries and the USA). Internet access: https://www.eib.org/attachments/publications/eibis_2021_european_union_en.pdf.

published in December, it is projected that, in 2021, the growth of the GDP deflator will reach 6.1% and, in 2022–2023, 4.0% and 2.0%, respectively.

Lithuania's real GDP is expected to exceed the potential level in 2021-2024. The National Audit Office, implementing the functions of the fiscal institution, projects potential GDP[19] to increase on average by around 3.4%[21] annually between 2021 and 2024 (Figure 3). The output gap is likely to be 1.6%, 1.9%, 1.8%, and 1.8% of potential GDP for the mentioned period.

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 observable macroeconomic indicators. In November 2021, the share of industrial, trade, service, and construction companies constrained by the labour shortage exceeded the 2019 level. Since February of 2021, the level of industrial capacity utilisation is constantly increasing and reached a record high in November. During this period, the number of job vacancies remains among the highest since 2008, according to the Employment Service. The updated Heatmap of Lithuania's Economy shows that economic temperature continues to rise in Q4 2021 (Annex 2).

Exceptional circumstances during favourable economic development

In the European Semester Spring Package 2021[22], published by the European Commission on 02/06/2021, it is noted that the general escape clause of the Stability and Growth Pact should remain in force in 2022. The main criterion for deactivating the escape clause is the return of the level of economic activity of the EU Members to pre-pandemic levels[23]. Based on the EC autumn forecasts[24], at the end of 2022, the GDP of all EU countries except for Spain will reach or exceed the level of Q4 2019.

In the wake of the COVID-19 pandemic at the beginning of 2020, all EU countries suffered a downturn. Although the recovery remains uneven, based on the 2020–2021 GDP growth of EU countries, it can be stated that Lithuania's economy was among those that quickly

[21] Decomposing into contributions of factors, total factor productivity contributes around 2.1 percentage points to potential GDP growth. The contribution of capital, which is closely linked to the overall development of investment, is 1.5 percentage points. However, the contribution of the labour factor is negative at –0.1 percentage points.

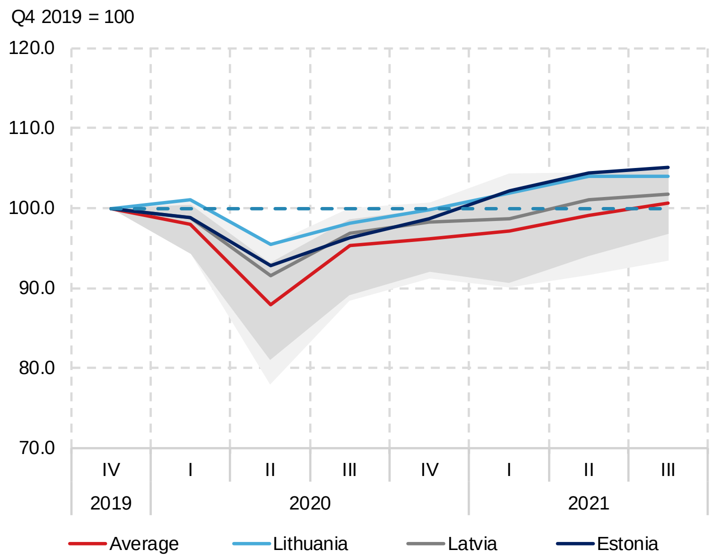
[22] 02/06/2021 European Semester Spring Package 2021. Internet access: https://ec.europa.eu/info/publications/european-semester-spring-package-2021-economic-coordination_en.

[23] 03/03/2021 Communication from the Commission to the Council. Internet access: https://eur-lex.europa.eu/legal-content/LT/TXT/PDF/?uri=CELEX:52021DC0105&from=EN.

[24] Commission Economic Forecast, Autumn 2021. Internet access: https://ec.europa.eu/info/sites/default/files/economy-finance/ip160_en_0.pdf.

recovered from the COVID-19 shock. Lithuania's economy has already returned to the pre-pandemic level in Q1 2021. (Figure 4).

Figure 4. GDP* growth of Lithuania and other EU countries



*Excluding Ireland[25], seasonally and calendar adjusted

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

Lithuania's macroeconomic development reveals an improvement in the situation; however, with the growth of long–term expenditure, fiscal sustainability faces a risk. When assessing the draft budget of 2022, the National Audit Office of Lithuania, implementing the functions of the fiscal institution, noted that with the decreasing further management costs of the COVID-19 pandemic, long–term expenditure is growing faster than revenues. In addition, having assessed the draft budget of 2022, EC gave Lithuania a recommendation to control the growth of national spending[26]. According to EC, the accommodative policy in Lithuania is mostly supported by the growth of current expenditure. Such expenditure stimulates the economy; however, it is not as significant to the increase of potential as investment, that is used by Latvia, Slovenia, Greece, and Ireland. Without the shortage of aggregate demand [27], sustainable long-term income is necessary for funding current expenditure. The application of fiscal discipline rules would allow fiscal space to be restored and prevent spending cyclical or one-off revenues to fund long–term expenditure.

The continuity of exceptional circumstances has to be considered before starting the preparation cycle of budgets attributable to the general government sector of 2023. Considering that in 2023 uncertainty regarding COVID-19 will probably decrease, the management costs of the pandemic should have a lesser impact on public finances. In comparison with other EU countries, Lithuania's tax revenues of 2020 survived the wave of the pandemic with the lowest budget losses (Figure 5). Despite this lowest impact on revenues in 2020, in 2021, they increased the most, when compared with other EU countries. Favourable macroeconomic development is also projected. For these reasons, according to the opinion of the National Audit Office, implementing the functions of the fiscal institution, it needs to be considered whether it is appropriate to maintain exceptional circumstances.

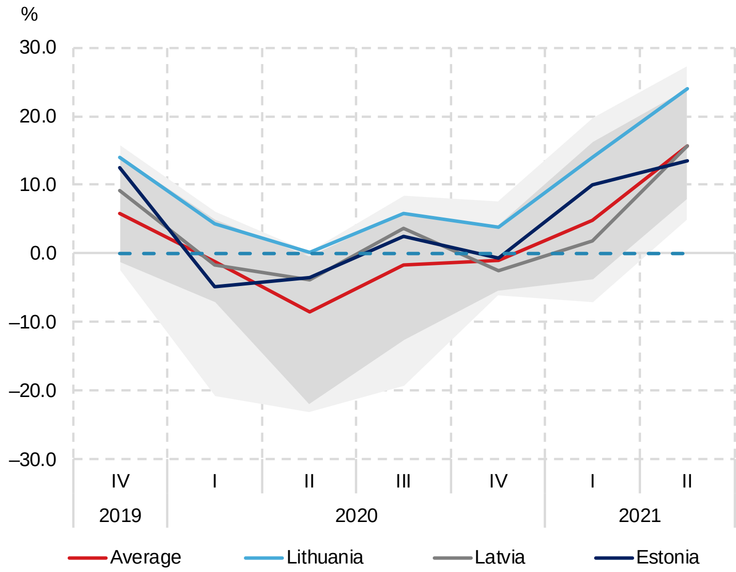
[25] Ireland's data was not included due to the impact of international companies to the GDP results of this country.

[26] 24/11/2021 2022 Draft Budgetary Plans – Overall assessment of the European Commission. Internet access: https://ec.europa.eu/info/sites/default/files/economy-finance/draft_budgetary_plans_2022_-_overall_assessment.pdf.

[27] With strong domestic demand, when the household consumption level is projected as one of the greatest factors driving GDP growth of the country. In Q3 2020, household final consumption expenditure returned to the pre-pandemic level.

The decision to withdraw the exceptional circumstances should be made in Q1 2022 because then the preparation of the draft budget of 2023 begins.

Figure 5. Growth of tax revenues of Lithuania and other EU countries



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

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 and issued an opinion on the Economic Development Scenario for 2021–2024 prepared by the Ministry of Finance of the Republic of Lithuania and published on 22 December 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.

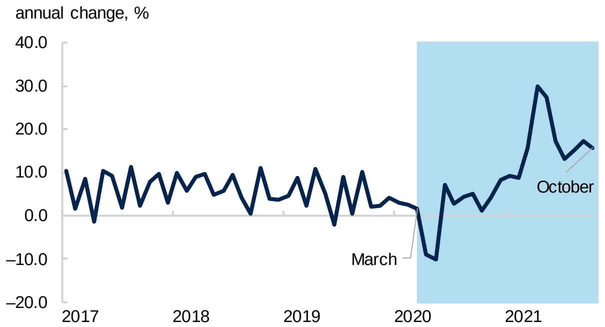
Auditor General — Mindaugas Macijauskas

ANNEXES

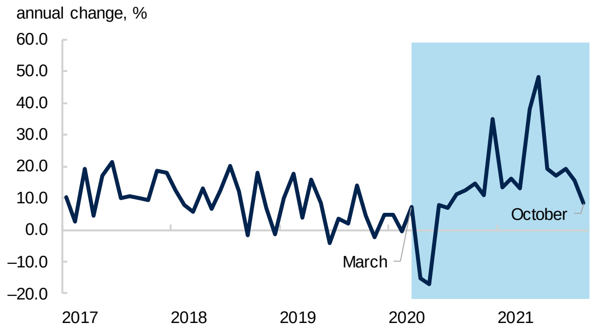
Opinion
On the Endorsement of the
Economic Development Scenario
Annex 1

Developments in the Lithuanian economy during the period of exceptional circumstances

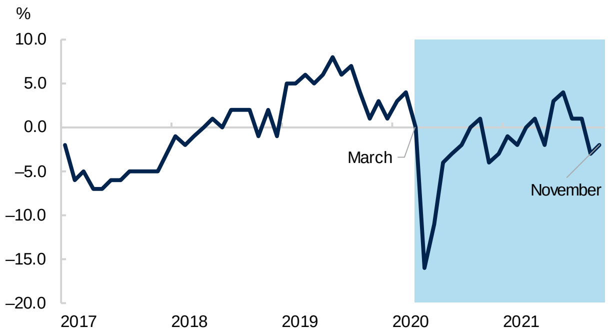
① The Chemical and furniture industries were the main contributors to **industrial production**[1] in October.



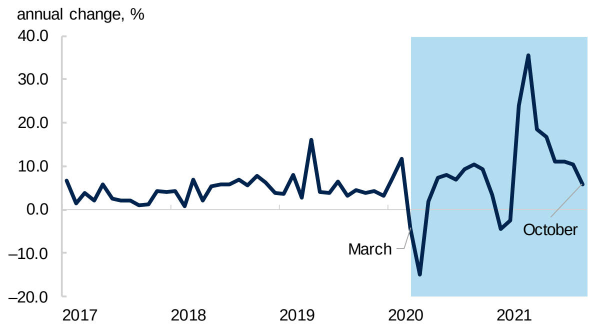
② The lower crop yield of this year was one of the factors **contributing to the slower growth of export of goods of Lithuanian origin**[2] in October.



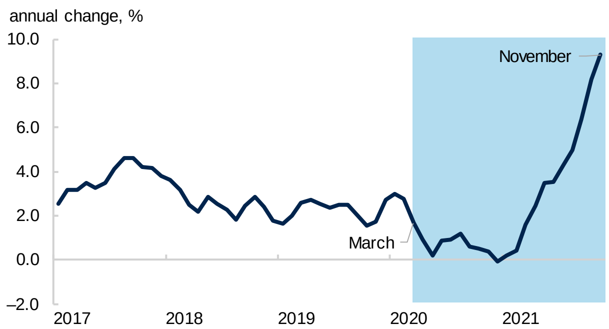
③ During October-November, **consumer expectations** were negative.



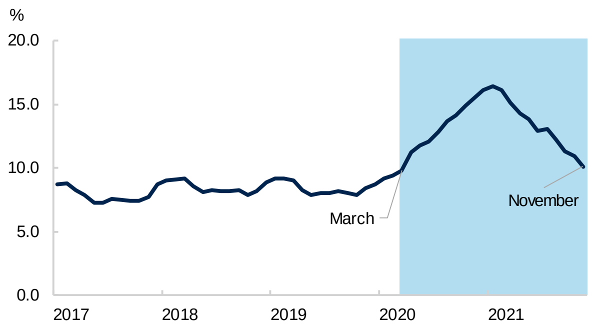
④ The main contributor to the increase in **retail turnover**[3] in October was non-food trade.



⑤ The growth of costs of electricity, gas, fuel, heat, and motor fuel continues to accelerate **inflation.**



⑥ With the labour shortage in the country, **registered unemployment** continues to fall.



[1] except refined petroleum products / [2] except mineral products / [3] except the sale of automotive fuels

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

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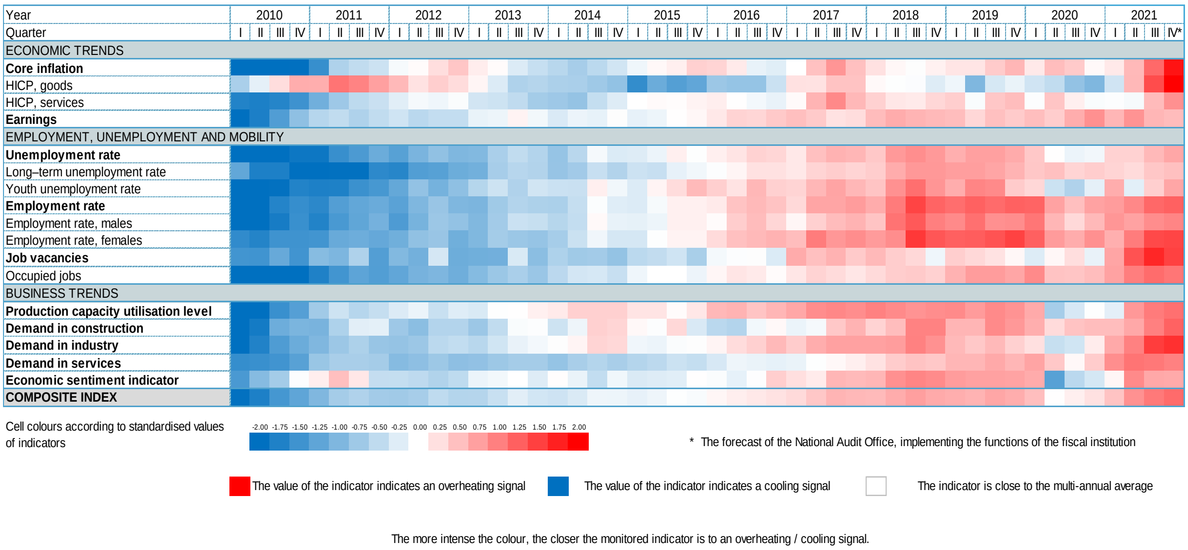
Annex 2

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[28] indicates that the temperature of Lithuania's economy in 2021 keeps on rising and exceeds the pre-pandemic level. This is reflected in most of the indicators analysed[29]. Considering that registered unemployment, which in November was 10.1%, is decreasing four months in a row[30], it might be expected that in Q4 2021 the unemployment rate will decrease, and employment rate (20-64-age group) will increase. According to the data of SODRA, average monthly income in October increased by 8.9% over the year compared to the same period in 2020. The level of production capacity utilisation keeps on rising in Q4. Increasing costs of services contribute to the growth of core inflation, which, at the end of 2021, might exceed the multi–annual average.

[28] 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.

[29] Some of the statistical indicators used in the heatmap for Q4 2021 are provisional. Core inflation, the October–November change in the HICP indices of goods and services is compared with the corresponding period of the previous year and equated to Q4. Unemployment and employment rates, job vacancies, and jobs occupied in Q4 are estimated using econometric models, taking into account data available from Statistics Lithuania, the Employment Service and *SODRA* (State Social Insurance Fund).

[30] Based on data of the Employment service, in July of 2021, the registered unemployment was 13.1%; the indicator of November of 2021 is lower by 5.4 percentage points in comparison with the corresponding period a year ago.

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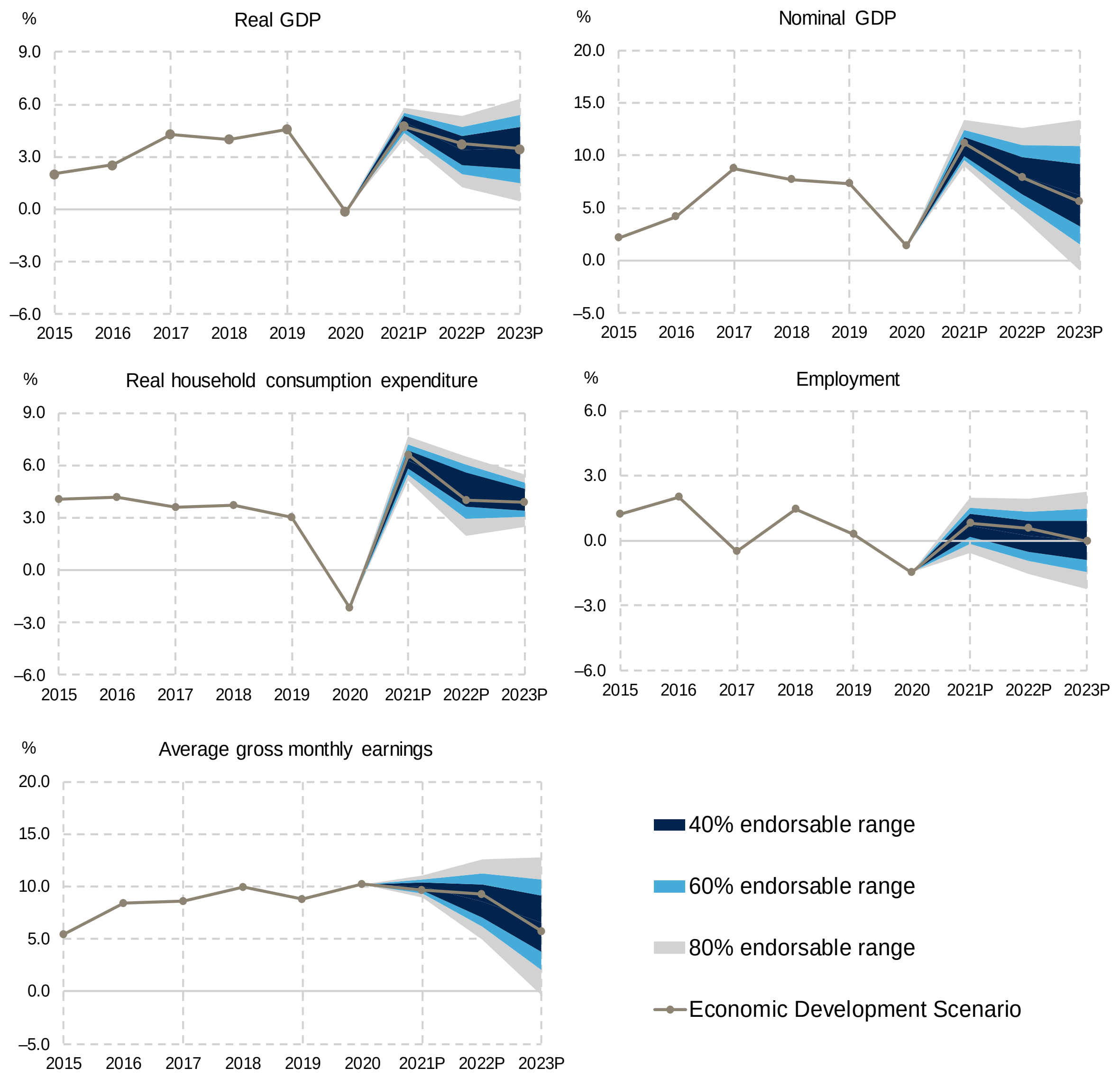
Endorsable ranges



Source: Statistics Lithuania, projections of the Ministry of Finance and the Bank of Lithuania, calculations by the National Audit Office implementing the functions of the fiscal institution