VALSTYBĖS KONTROLĖ
BUDGET POLICY MONITORING

To the Seimas of the Republic of Lithuania

OPINION ON THE ENDORSEMENT OF THE ECONOMIC DEVELOPMENT SCENARIO

28 March 2023 No BPE–1

Vilnius

AS RISKS TO ENERGY PRICES DIMINISH AND THE GROWTH OF LITHUANIAN ECONOMY SLOWS DOWN, IT SHOULD BE SUPPORTED BY INVESTMENT RATHER THAN COMPENSATION

The National Audit Office, implementing the functions of the fiscal institution (hereinafter – Fiscal Institution in the NAO), submits to the Seimas its opinion on the Economic Development Scenario (EDS) for 2023–2026 published by the Ministry of Finance in March.

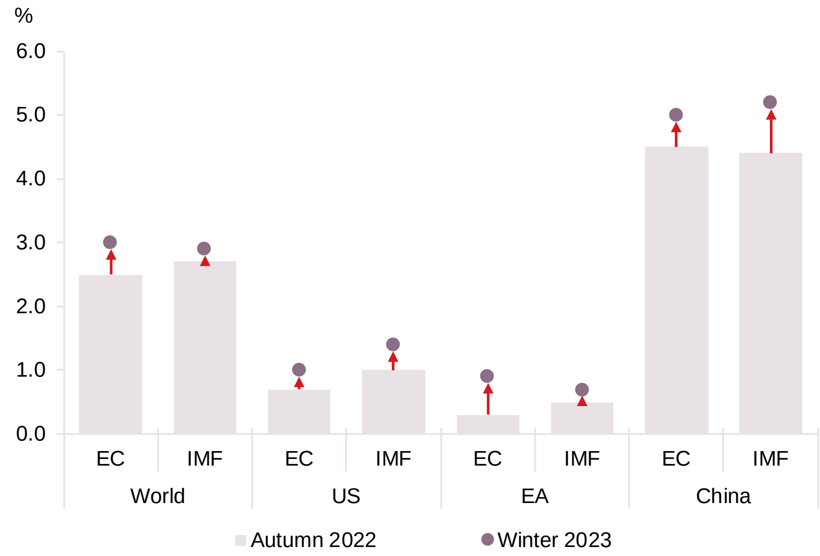
The war in Ukraine, which has been going on for more than a year now, is leading to persistent uncertainty about economic developments. Data on the gross domestic product in Q4 2022 showed a contraction in the economy, driven by a deterioration in domestic consumption and industry, and the outlook is therefore assessed with caution against the backdrop of lingering risks to the economy. A warm winter, the availability of alternative gas suppliers and the rapid development of the energy infrastructure have led to lower gas prices than expected in December. The economic health of the exporting sector and trading partners is crucial for Lithuania's highly open economy. The March EDS projects that slower growth in Lithuania's trading partners than in 2022 will prevent exports from expanding, while Lithuania's GDP growth will be supported by investment and household consumption. With the economy below its potential level, a general government deficit is possible, but with interest rates rising, the management of the sector's finances requires greater prudence. In this regard, a greater share of resources should be devoted to investments that build economic resilience rather than compensations.

1. **More favourable global economic development in 2022 improves the assumptions of the March 2023–2026 EDS.**
2. **Lithuania's growing economy in 2022 was caught up by a decrease in purchasing power, which contributed to a worse-than-expected Q4 2022 result.**
3. **In the absence of export growth, moderate Lithuanian real GDP growth in 2023 will be supported by household consumption and investment.**
4. **In the medium term, deficits are possible, but the focus should be on promoting growth through investment rather than compensation.**
5. **The National Audit Office of Lithuania, implementing the functions of the fiscal institution, endorses the Economic Development Scenario, however, the persisting geopolitical risks may affect the economic development.**

1. MORE FAVORABLE GLOBAL ECONOMIC DEVELOPMENT IN 2022 IMPROVES THE ASSUMPTIONS OF THE MARCH 2023–2026 EDS

International institutions predict a better outlook for global economic growth in 2023 than was projected in autumn 2022 (Figure 1). Stronger-than-expected domestic consumption in 2022 and stronger-than-expected investment growth in the US in the autumn have a positive impact on the outlook for the domestic economy in 2023. Growing consumption in the US has supported the EU's strong international trade performance, while inflation-targeting measures by national governments are contributing to improved domestic consumption and more favourable household and business expectations. China's opening up after the restrictions imposed during the COVID-19 pandemic contributes to easing the tensions in supply chains. Based on the data of February, Business activity indicators such as the Purchasing Managers' Index (PMI) point to the persistent contraction in the sectors of industry and services (Figure 1 of Annex 1). More favourable developments in the world's major economies are improving the outlook for global growth.

Figure 1. International institutions are improving GDP projections for the world's major economies in 2023



Source: European Commission, International Monetary Fund

- **The outlook for the US economy has been upgraded but is clouded by persistent risks.** In 2022 country's economy grew by 2.1% whereas international institutions [1] had projected an average growth of 1.7%. Household consumption had a positive impact on GDP growth in 2022, but due to a declining savings rate. Inflation remained high at 6.4% in January 2023 and the cost of living continued to rise. High job vacancies and a particularly low unemployment rate of 3.4% in January encourage the US central bank to continue raising interest rates. This could have a further negative impact on business activity, which, according to the industrial PMI, is showing contraction. Volatility in financial markets reflects continuing concerns about economic contraction.
- **Opening up consumption opportunities after the lifting of restrictions imposed during the COVID-19 pandemic improves China's economic outlook for 2023.** The lifting of pandemic-related restrictions is likely to lead to faster Chinese domestic consumption. Given the problems in the property market and the uncertainties of the geopolitical situation, achieving the 5.0% growth target, one of the lowest in a decade, may be

[1] The International Monetary Fund (IMF) projected US economic growth of 1.6% in autumn 2022, while the European Commission and the Organisation for Economic Co-operation and Development have projected growth of 1.8%.

challenging. Based on future contracts, the price of gas is projected to decline between 2023 and 2026, but a recovery in the country's industrial activity could increase global demand for raw materials, including metals, and gas. This would lead to an increase in their prices on the global market. This process would increase inflation rates in the world's major economies and adversely affect their economic development. This is particularly relevant for the EU, which is becoming more dependent on liquefied natural gas supplies as a result of the cut-off of Russian gas supplies.

- **The favourable results for 2022 have a positive impact on the EU outlook for 2023 but are weighed down by persistently high production costs and tightening financial conditions.** The EU economy contracted by 0.1% in Q4 2022 but avoided the projected annual contraction. The increase in liquefied natural gas flows, the relatively warm winter and the consequent lower demand for gas are leading to a decrease in gas prices. This is also driven by the high level of EU gas storage capacity, which exceeded 60.0% in March, compared to an average of 33.0% to the corresponding period of 2017–2019. Support measures by EU governments (around 1.2% of EU GDP) help to cushion households and businesses against higher prices. On the other hand, energy-intensive industries in the major EA countries, including Lithuania's main export partner Germany, are still affected by high production costs. The EU's international competitiveness is also undermined by US green energy subsidies to domestic manufacturing companies. Such support encourages EU-based companies to relocate some of their activities to the US and to rethink their expansion strategies within the community. In addition, the outlook for 2023 is challenged by the European Central Bank's (ECB) interest rate hikes on the back of high inflation in an environment of continued geopolitical tensions.

Foreseeing more favourable development in the world's major economies in 2023 improves the assumptions of the March Economic Development Scenario (Figure 1). The European Commission (EC) updated the assumptions, used by the Ministry of Finance for the EDS when publishing economic development forecasts in February 2023. The EC estimates that the Euro will strengthen against the US dollar in 2022 on the back of better-than-expected macroeconomic indicators for the EA in the autumn and a faster-than-expected rise in the ECB base interest rates than in the US central bank. Futures point in a similar direction (Annex 1, Figure 1). This would lead to a cheaper import of raw materials, including energy resources, into the EU. The technical assumption of a high oil price in 2023 is driven by the projected stronger growth of the world's major economies in 2023 and the reopening of China's economy, which boosts oil demand. The oil price will remain at a similar level between 2024 and 2026. Brent's oil futures also indicate a similar trend. Following the European Commission's revision of the assumptions in a positive direction, the March EDS upgrades the global and EU growth assumptions for 2023. Accordingly, a slowdown in the growth of Lithuania's main export market is projected in 2023.

Table 1. The Ministry of Finance's assumptions for the Economic Development Scenario of March 2023

Indicator	2022	2023P	2024P	2025P	2026P
USD/EUR exchange rate*	1.04	1.08 (0.98) ▲	1.09 (0.98) ▲	1.09 (0.98) ▲	1.09
Global (excl. EU) GDP growth, %*	3.1	3.0 (2.9) ▲	3.3 (3.4) ▼	3.3 (3.4) ▼	3.3
European Union's GDP growth, %*	3.5	0.8 (0.3) ▲	1.6 (1.6)	1.6 (1.6)	1.6
Growth of the main Lithuanian export markets, %**	3.3	1.6	2.2	2.2	2.2
Oil prices (Brent, USD/barrel)*	100.7	84.8 (85.0) ▼	79.9 (78.0) ▲	79.9 (78.0) ▲	79.9

▼ – negative review ▲ – positive review

* Technical assumption made public by the EC on 13 February 2023.

** As of March 2023, the projection estimates are based on an updated calculation methodology and are not comparable with previously published estimates.

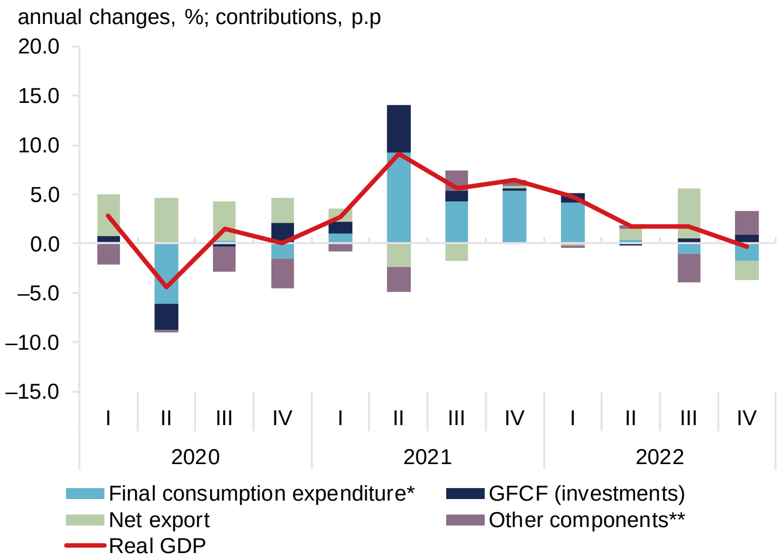
The EDS assumptions for December 2022 are presented in brackets.

Source: Ministry of Finance

2. LITHUANIA'S GROWING ECONOMY IN 2022 WAS CAUGHT UP BY A DECREASE IN PURCHASING POWER, WHICH CONTRIBUTED TO A WORSE-THAN-EXPECTED Q4 2022 RESULT

Lithuania's real GDP declined by 0.4% in Q4 2022 compared to the corresponding quarter a year ago. For comparison, during this period, Estonia's GDP contracted by 4.1% and Latvia's modestly increased (by 0.3%). The unfavourable results of the Lithuanian economy in Q4 were undermined by the negative impact of net exports (Figure 2). It was driven by imports, which grew by 3.6% during the year, outpacing exports of goods and services (1.3%). The import was driven by the continued growth in re-export and investments. The contraction in household consumption expenditure has contributed significantly to the economic contraction. Meanwhile, the impact of investment on real GDP change was positive.

Figure 2. The contraction of real GDP in Q4 2022 is driven by net export and household consumption expenditure

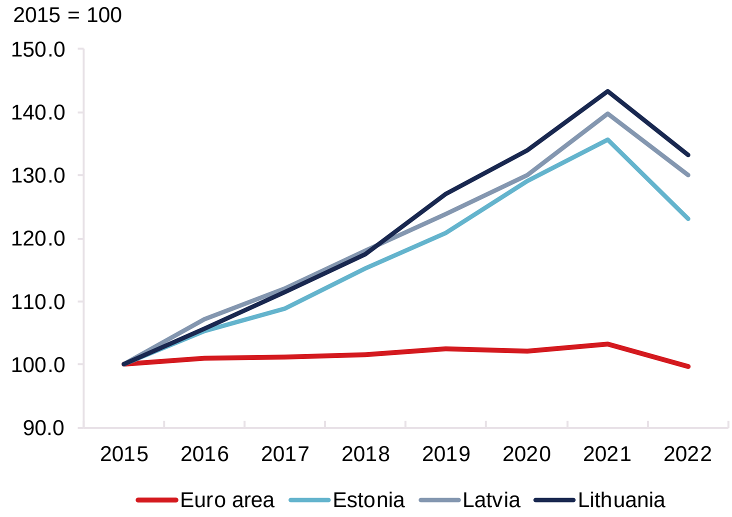


* excluding NPISH, ** NPISH, changes in inventories, acquisitions less disposals of valuables

Source: State Data Agency, calculations by the National Audit Office implementing the functions of the fiscal institution

In Q4 2022, the impact of a sharp increase in the cost of living on household consumption which contracted by 2.8%. Since 2015, the increase in real compensation per employee in Lithuania has been the highest among the Baltic countries, significantly outpacing the overall growth of the euro area (Figure 3). Wage growth has remained strong in the context of the war in Ukraine and the energy crisis, but inflation has outpaced it. In 2022 the real compensation per employee declined by 7.0%[2], and in Q4 2022, the contraction was even bigger and reached 8.0% compared to the corresponding period a year ago. The decline in real consumption is reflected in a contraction in retail sales excluding fuel, due to a decline in purchasing power. It contracted by 9.5% in December compared to the corresponding period a year ago, taking into account price effects. Nominally, trade grew, but the volumes purchased declined. Part of this contraction can be explained by a decline in the consumption of non-essential goods. With rising wages failing to catch up with rising prices, consumers may have decided to postpone some purchases. Improving, but still poor, public expectations may have contributed to such behaviour. However, the decline in grocery turnover may be a sign that low-income consumers are facing financial difficulties. Price increases for main consumer goods such as food and energy have a significant impact on the consumption possibilities of these households, as they represent a larger share of the consumption basket. For this reason, it is important to provide support in a targeted manner, taking into account fiscal sustainability, in order to help those households whose budgets are most constrained by the shock in the prices of essential goods.

Figure 3. The recent strong growth in real compensation per employee declined in 2022



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

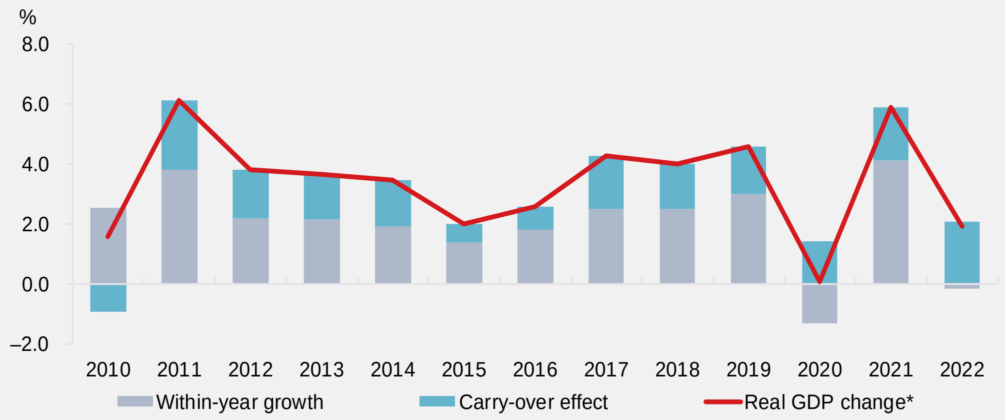
In 2022 Lithuania's real GDP increased by 1.9%. Taking into account the carry-over effect, GDP growth in these years was supported by the inertia of economic growth from 2021 (Insert A). Compared to the other Baltic countries, Latvia's real GDP growth in 2022 was 2.0% while Estonia recorded an economic contraction of 1.3%.

[2] Remuneration for the employee – the total remuneration, in cash or in kind, paid by an employer to an employee for work performed by the employee during the accounting period. Remuneration for the employees consists of the wage and employer's social contribution. To estimate real remuneration per worker, data on nominal remuneration per worker, excluding seasonality and number of working days, are used, together with the harmonised consumer price index.

Box A. Carry-over effect on Lithuania's real GDP growth

In 2022, Lithuania's real GDP growth is driven by a carry-over effect from 2021. The annual change in GDP depends not only on the development of GDP in the current year but also on the dynamics of this indicator in the previous year. Carry-over effect shows how much GDP would grow in the current year if it remained at the same level as in Q4 of the previous year. This effect is calculated using seasonally and calendar adjusted data. The difference between the change in real GDP and the carry-over effect shows a growth development of the GDP within the current year. As EC stresses[3], the carry-over effect can be particularly strong during economic upturns and downturns. For Lithuania, this effect averaged 1.4 p.p. between 2010 and 2021 (Figure A.1). As the Lithuanian economy grows rapidly after the pandemic shock, the carry-over effect increases in 2021 and accelerates real GDP growth by 2.1 p.p. in 2022. Meanwhile, an unfavourable geopolitical environment, challenges in energy markets and slowing domestic and external demand are likely to lead to a negative within-year growth in 2022 (–0.2 p.p.). After a moderate contraction in GDP in Q4 2022, no significant carry-over effects are expected in 2023, which would make it difficult to expect strong economic growth in 2023. However, with risks to energy prices easing, within-year growth of GDP is expected to turn positive again this year.

Figure A.1 In 2022 real GDP growth is driven by a carry-over effect



* seasonally and calendar adjusted data

Source: State Data Agency, calculations by the National Audit Office implementing the functions of the fiscal institution

3. IN THE ABSENCE OF EXPORT GROWTH, MODERATE LITHUANIA'S REAL GDP GROWTH IN 2023 WILL BE SUPPORTED BY HOUSEHOLD CONSUMPTION AND INVESTMENT

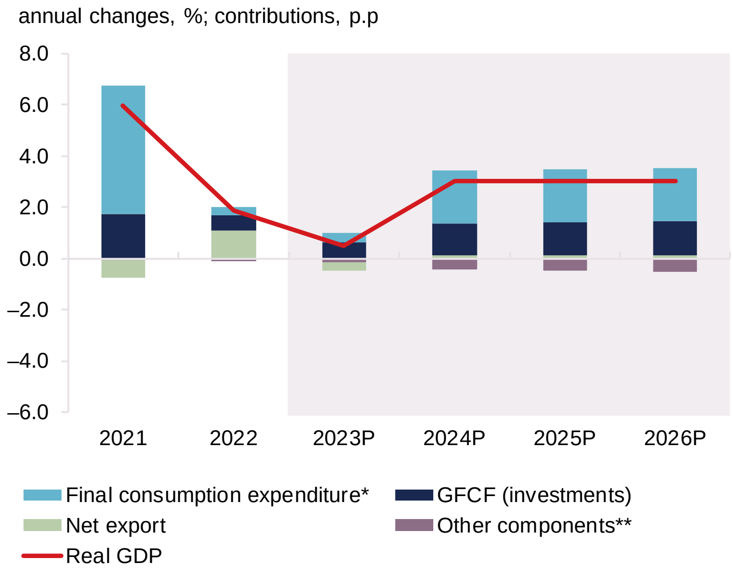
Weaker-than-expected domestic and external demand is leading to a more cautious outlook for Lithuania's real GDP growth in 2023. The EDS of March projections on this indicator are reduced to 0.5% in 2023. Economic development is likely to be supported by investment and household consumption expenditure (Figure 4). Net export is also projected to have a negative impact on GDP growth in 2023.

Challenges in industrial sectors sensitive to energy prices persist, but export performance in 2023 will be positively affected by the 2022 grain harvest, which was 7.0% better than in 2021. However, in the face of slowing external demand, the scenario projects real exports of goods and services to remain at 2022 levels. Meanwhile, imports will increase moderately, driven by domestic demand and re-exports (Annex 2). Stronger growth in

[3] 16/05/2022 European Commission economic forecasts for spring. Internet access: https://economy-finance.ec.europa.eu/system/files/2022-05/ip173_en.pdf.

international trade indicators and real GDP is expected between 2024 and 2026 as external and domestic demand recover (Figure 4).

Figure 4. In March 2023, EDS foresees that domestic consumption and investments will be the main drivers of real GDP growth in 2023–2026

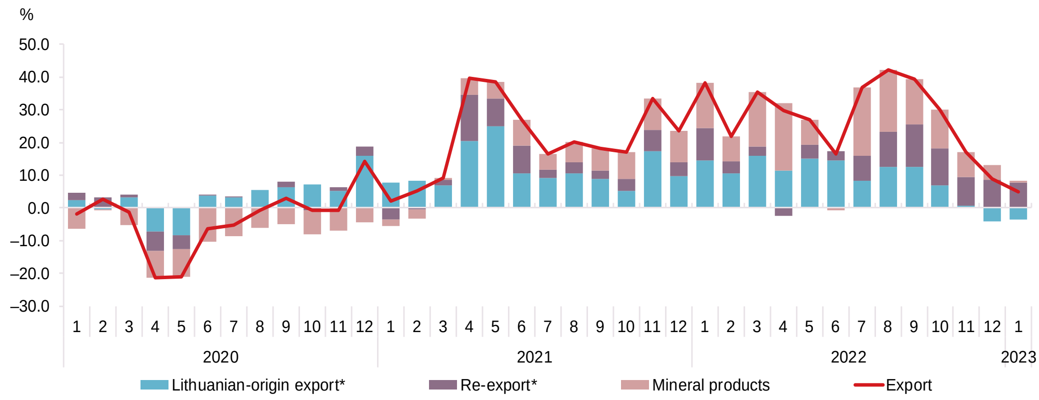


* excluding NPISH, ** NPISH, changes in inventories, acquisitions less disposals of valuables

Source: State Data Agency, Ministry of Finance, calculations by the National Audit Office implementing the functions of the fiscal institution

In 2022, the structure of re-exports has changed significantly: if current trends continue, re-exports are likely to have a positive impact on Lithuania's international trade performance in 2023. Rising interest rates and reduced purchasing power of the population in Lithuania's main export partners in 2022 led to slower growth in demand for the country's exported goods and services. As manufacturing output contracted in Q4 2022, the value of exports of Lithuanian-origin goods (excluding mineral products) grew at a significantly slower pace in October–November and fell by 8.1% year-on-year in December (Figure 5). A contraction is also observed in January 2023. This is mainly due to a contraction in chemical exports. However, the growth in the value of re-exports (excluding mineral products) accelerated from July 2022. The structure of exports in this category has changed: re-export flows to Russia have contracted significantly but have increased notably to other countries of the Commonwealth of Independent States (CIS), in particular Belarus, Kazakhstan and Kyrgyzstan. The main growth was in re-exports of land vehicles, their parts and other machinery and equipment. In January 2023, re-exports of goods supported growth in the value of goods exports. With continued opportunities for international trade with Eastern countries, re-exports are likely to have a positive impact on Lithuania's export performance in 2023.

Figure 5. Annual growth in the value of goods exports in January 2023 was supported by re-exports

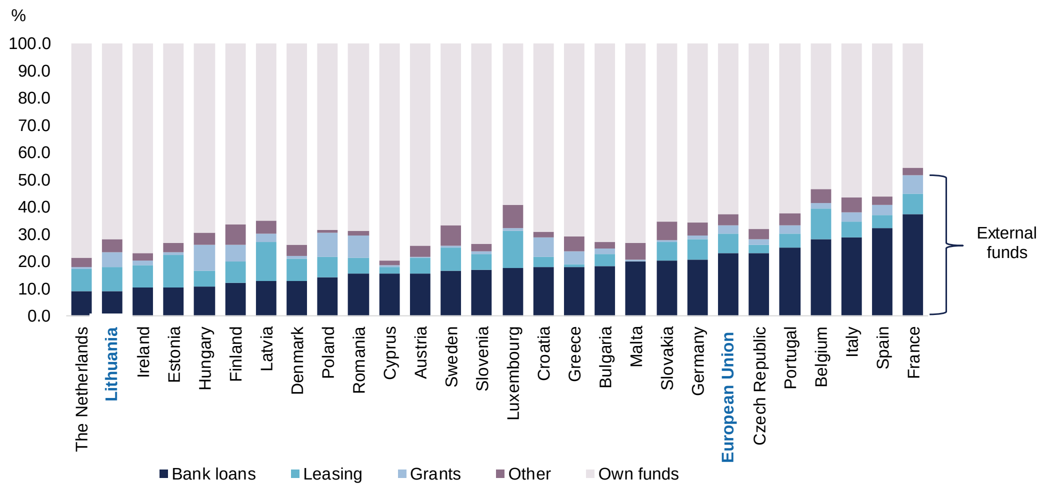


* excluding mineral products

Source: State Data Agency, calculations by the National Audit Office implementing the functions of the fiscal institution

Supposing that private companies will be cautious about investing in 2023, a positive impact on investment can come from the effective implementation of EU programmes. The data regarding opinions of business managers in February 2023 showed persistent business concerns. The industrial confidence indicator remains below its multi-year average, with a weaker assessment of demand for manufactured goods and an increase in inventory levels. With the industrial capacity utilisation rate reaching 66.9% in February 2023 (down 9.2 p.p. on a year earlier), new investment decisions may be more cautious, negatively impacting the dynamics of gross fixed capital formation (investment). Rising interest rates may have a smaller direct negative impact on the investment plans of Lithuanian companies than in other EU countries (Figure 6). In 2021, only 9.2% of investments in Lithuania were financed by bank loans.

Figure 6. The structure of business investment shows that Lithuania's dependence on bank loans in 2021 is among the lowest in the EU



Source: European Investment Bank, calculations by the National Audit Office implementing the functions of the fiscal institution

Growth in gross fixed capital formation should be supported by public investment. They will be positively influenced by the flow of European Union financial support. As 2023 is the last year of implementation of the EU's 2014–2020 Multiannual Financial Framework, there is a good chance that the remaining EUR 1 billion will be utilised. In the medium term, the envisaged Economic Recovery and Resilience Measures and the implementation of the EU Funds Investment Programme 2021–2027 are expected to contribute in particular to investment. Using these financial flows to drive not only digital but also green transformation, investing in energy efficiency and renewable energy, while at the same time increasing the country's economic resilience and potential growth. This objective is also linked to the future investment needs of Lithuanian companies: 70% of Lithuanian companies plan to invest in green energy in the next three years, higher than the EU average (51%)[4]. The EDS projects that growth in gross fixed capital formation could remain at a similar level in 2023 as in 2022 and accelerate in the medium term (Annex 2).

The downward revision of the 2023 HICP growth is driven by lower energy prices. Growth in the Harmonised Index of Consumer Prices (HICP) is projected to slow to 8.5% in 2023. This estimate is 0.9 p.p. lower than the one published in the December EDS. This review is driven by the fall in natural gas prices, where its futures price has fallen by a factor of almost 2.5 in 2023[5]. A significant increase in price levels[6] in the second half of 2022 will have a carry-over effect on the 2023 projections. The downward trend in inflation will be influenced by the improving situation in energy markets, a high comparative base, slowing economic growth and easing tensions in supply chains. In 2022, the higher prices of food and energy commodities increase the share of these commodity groups in the consumption basket and the weight of the HICP in 2023[7]. This implies that price changes in these commodity groups will have a larger impact on the index than in 2022. Despite the lower projected growth of the HICP in 2023, the projection for the GDP deflator has been raised to 9.8%. This is due to the higher general government consumption deflator and the fact that the export deflator is expected to grow faster than the import deflator.

With inflation projected to decline, private consumption is expected to grow moderately in 2023. In 2022, rapidly increasing prices reduced the purchasing power of the population, but a significant increase in the number of employed persons, a likely decline in the savings rate and financial support from the state kept household consumption on an upward path. However, annual changes in household consumption expenditure in 2022 Q3 and Q4 were negative, at –1.7% and –2.8%. The projection for 2023 has been revised downwards to reflect the development of the indicator (Annex 2). It should be noted that 16.6%[8] of the Lithuanian population were owners, with mortgage or loan, compared to 28.7% in the EA. Higher EURIBOR interest rates will have a negative impact on their consumption (Figure 7). The consumer confidence indicator returned in February 2023 to its pre-Ukraine war level (Annex 3), when households were positive about their future financial situation. With continued positive trends in the labour market and projected above-inflation wage growth, household consumption expenditure is projected to grow by 0.5% in 2023 and by 3.4% annually in the medium term.

[4] European Investment Bank study, 2022. Internet access: https://www.eib.org/attachments/lucalli/20220266_econ_eibis_2022_lithuania_en.pdf.

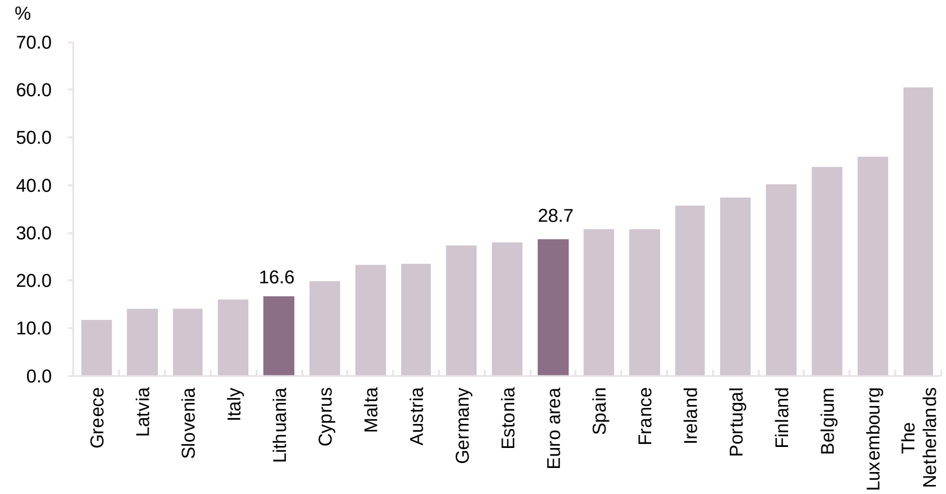
[5] The average price of TTF gas futures for the day of 28/11/2022 was EUR 131.71/MWh in 2023 and EUR 53.15/MWh on 23/02/2023.

[6] If the price level would remain the same as in December 2022, the growth of HICP would reach 6.7% in 2023.

[7] The share of food and alcoholic beverages increased by 1.1 p.p., while the share of energy increased by 1.6 p.p.

[8] Based on European Union Statistics on Income and Living Conditions 2021 (EU-SILC).

Figure 7. In 2021, the share of the Lithuanian population with an outstanding mortgage was one of the lowest in the EA*

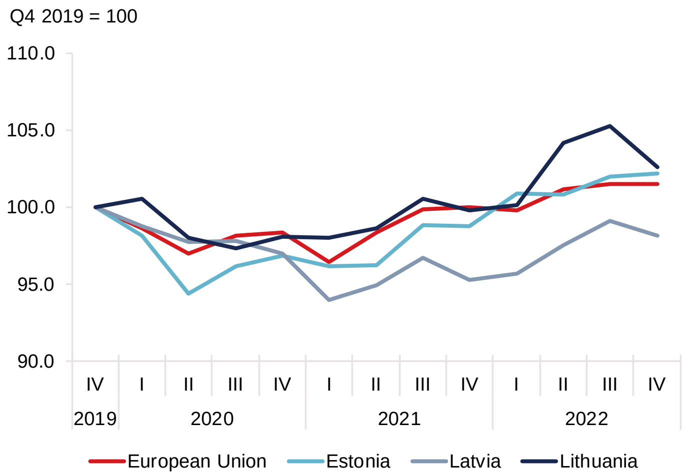


* Slovakia excluded due to a lack of data

Source: Eurostat

The labour market situation is expected to remain favourable in the context of the economic downturn forecast for 2023. The labour market in 2022 hit record rates: at 5.9%, the unemployment rate was at its lowest level since 2008, while the increase in the labour force allowed the number of employed persons to grow by almost 4% compared to a year earlier (Figure 8). Nevertheless, the number of job vacancies remained high, allowing average monthly gross earnings to grow by 13% against a background of high inflation. However, some signals of a labour market downturn have emerged in Q4 2022: the number of job vacancies has started to fall, the share of firms saying they are most constrained by insufficient demand and less constrained by a shortage of labour force has increased[9]. This trend is also reflected in the Employment Service's survey of employers: a shortage of labour force is less of a constraint on expansion in 2023 than rising energy costs and the price of raw materials.

Figure 8. The number of employed persons in Lithuania grew faster than in the Baltic States and the EU and is higher than in Q4 2019



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

[9] According to the Statistical Business Trends Survey on constraints for services, industry and trade.

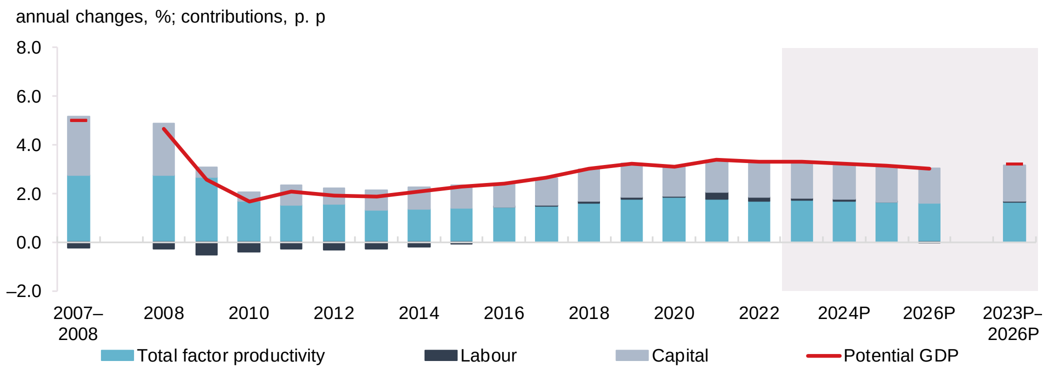
The average monthly gross earnings growth in 2023 is projected to be close to double-digit rates (as in the past 7 years), but slower than in 2022. A faster increase in average earnings will be constrained by the potential difficulties faced by companies due to the slowing economy, the continuing uncertainty about possible high energy and raw material prices, and more expensive borrowing. In the medium term, earnings growth will be influenced by possible decisions on the minimum monthly wage and public sector earnings increases.

The willingness of Lithuanian employers to retain workers[10] and the persistently low unemployment rate in the EU[11] point to a moderate decline in the number of employed persons in 2023 (0.7%). Accordingly, the March EDS projects the unemployment rate to rise from 5.9% in 2022 to 7.0% in 2023. The unemployment rate is projected to decline over the period 2024–2026, reflecting the country's stronger economic growth. In the medium term, the number of people in employment is projected to decline due to the impact of demographics.

4. IN THE MEDIUM TERM, DEFICITS ARE POSSIBLE, BUT THE FOCUS SHOULD BE ON PROMOTING GROWTH THROUGH INVESTMENT RATHER THAN COMPENSATION

The National Audit Office, implementing the functions of the fiscal institution, projects potential GDP[12] to increase on average by around 3.2% annually between 2023 and 2026 (Figure 9). By highlighting the factors of change, the total factor productivity increases potential GDP growth by around 1.7 p.p. The contribution of capital, which is closely linked to the overall development of investment, contributes 1.5 p.p. The impact of the labour factor is positive and amounts to 0.04 p.p. According to the Fiscal Institution in the NAO, the output gap from potential in 2023 is likely to reach –1.5 p.p. of GDP and in 2024 will reach –1.8 p.p. of GDP. The updated Heatmap of the Lithuanian Economy shows that the temperature of the economy continues to slow in Q1 2023 (Annex 4).

Figure 9. Total factor productivity and capital will be the main drivers of Lithuania's potential GDP growth in 2023–2026



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

[10] "Trends and future projections for the employment situation in Lithuania in 2022". Internet access: https://uzt.lt/darbo-rinka/darbo-rinkos-tendencijos/89.

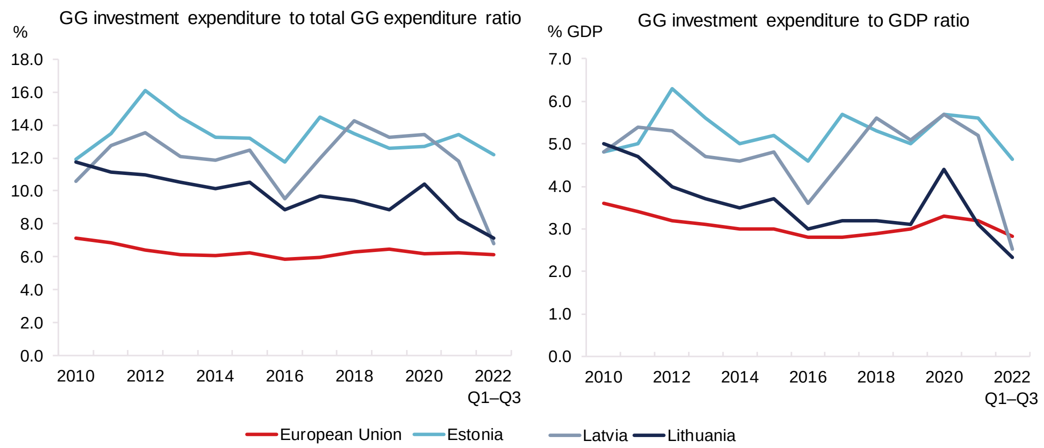
[11] The EU unemployment rate stood at 6.1% in January 2023, and has remained the same since May 2022.

[12] The assessment methods are further detailed 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.

A moderate fiscal stimulus is possible given the prospects for slowing growth and the negative output gap. This means that the general government can face a deficit. The analysis of the Fiscal Institution in the NAO[13] shows that when the output gap is negative, the fiscal impulse can have an additional impact on GDP. Thus, Lithuania's fiscal multiplicator could exceed 1 during a recession. However, more fiscal stimulus should be avoided, as domestic demand can accelerate inflation.

The economic stimulus should focus on investment expenditures rather than on compensation targeted at the general population. Based on the assessment of the Fiscal Institution in the NAO[14], only one-third of the draft budget temporary energy price mitigation measures in 2023 are targeted. Given the current uncertainty, there may still be a need for support measures for individuals and businesses in the future. The European Commission's Communication on the fiscal policy guidelines 2024[15] notes that, if the need arise, measures must be targeted, focusing on the most vulnerable households and businesses, avoiding the broad measures adopted in the past. The EC stresses that the long-term solution to the energy crisis is to reduce dependence on imported fossil fuels, which requires a focus on accelerating reforms and investment. Measures should focus on reducing energy consumption, contributing to the goal of diversifying energy sources. The share of investment expenditure from the total general government expenditure and the ratio to GDP remain among the lowest among Baltic states (Figure 10). A study by Mineshima et al. (2014)[16] found that government investment multiplicators are higher than those of consumer spending. The investments would contribute to the economic growth potential and resilience of Lithuania's economy.

Figure 10. The share of expenditure of the gross fixed capital formation (investment) from the total general government expenditure and the ratio to GDP remains among the lowest in the Baltic countries



Source: Eurostat

In addition to new taxes, changes to existing taxes can be used to finance growth in public spending, contributing to the efficiency and equity of the tax system. The World Bank

[13] 10/11/2020 Fiscal Institution in the NAO opinion on the structural adjustment target. Internet access: https://www.valstybeskontrole.lt/EN/Product/23960/opinion-on-the-structural-adjustment-target-set-by-the-draft-law-on-the-approval.

[14] 28/10/2022 Fiscal Institution in the NAO opinion on the structural adjustment target. Internet access: https://www.valstybeskontrole.lt/EN/Product/24133/opinion-on-the-structural-adjustment-target.

[15] The European Commission's Communication on the fiscal policy guidelines 2024. Internet access: https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/fiscal-policy-guidance_en.

[16] Mineshima, A., M. Poplawski-Ribeiro, and A. Weber, 2014, "Fiscal Multipliers in Post-Crisis Fiscal Policy", ed. by C. Cottarelli, P. Gerson, and A. Senhadji (Cambridge: MIT Press, forthcoming).

report[17] points to the need to change the structure of corporate tax rates and the PIT system, as current regulation creates distortionary incentives and is not conducive to higher economic growth. Higher general government revenue would provide fiscal policy with the flexibility to respond to emerging shocks and contribute to achieving fiscal sustainability.

There is a need to revisit the debate on the continued need for exceptional circumstances in Lithuania, in light of the exemption from the general clause from 2024. As noted in the Communication, the general clause of the Stability and Growth Pact, which allowed the general government to temporarily derogate from the rules on fiscal discipline from 2020 onwards, should no longer apply from 2024. In this context, it is also necessary to return to the consideration of the continued application of exceptional circumstances in Lithuania. If the exceptional circumstances no longer apply in 2024, the national fiscal discipline rules, as defined by the Constitutional Law Implementing the Fiscal Treaty, should apply in full.

5. THE NATIONAL AUDIT OFFICE OF LITHUANIA, IMPLEMENTING THE FUNCTIONS OF THE FISCAL INSTITUTION, ENDORSES THE ECONOMIC DEVELOPMENT SCENARIO, HOWEVER, THE PERSISTING GEOPOLITICAL RISKS MAY AFFECT THE ECONOMIC DEVELOPMENT

The Fiscal Institution in the NAO endorses[18] the Economic Development Scenario for 2023–2026 published by the Ministry of Finance on 20/03/2023. It complies with identified assumptions, is based on the available statistical data, and the submitted projections do not contradict the expert evaluation of the National Audit Office implementing the functions of the fiscal institution.

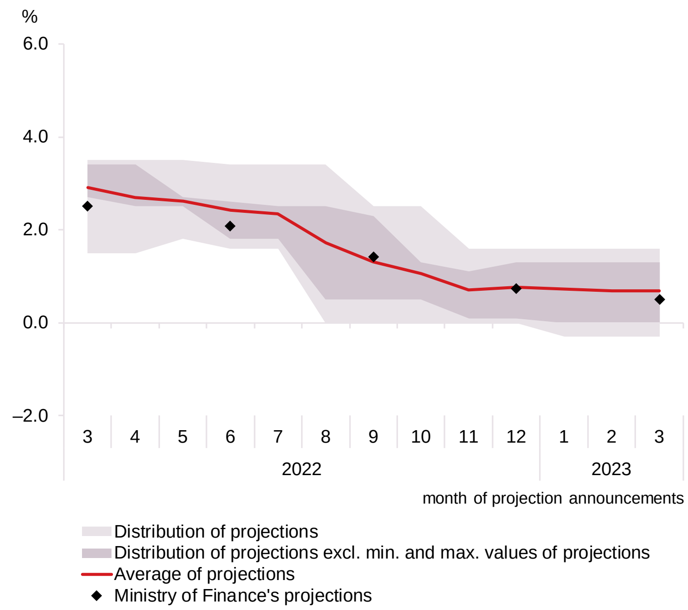
The Economic Development Scenario for 2023–2026 of the Ministry of Finance is prepared and published in accordance with the legal framework under the identified exceptional circumstances. The Ministry submitted the draft EDS to the Fiscal Institution in the NAO on 6/03/2023 for initial alignment. The assessments of the Fiscal Institution in the NAO and the Ministry of economic development did not differ significantly. At the meeting on 10 March, the questions raised by the Fiscal Institution in the NAO were answered, the main technical assumptions and risk factors were presented. The Ministry of Finance published the Economic Development Scenario for 2023–2026 on its website on 20/03/2023.

The March 2023 EDS projections for real GDP in 2023 are close to the average of other institutions' projections (Figure 11). The distribution of other institutions' projections for real GDP in 2023 shows that the economic outlook remains extremely difficult to predict. This will depend on the future situation in a dynamic energy market and geopolitical context. A number of other institutions have not updated their projections for 2023 (Annex 5).

[17] The World Bank. A microsimulation analysis of the scale and impact of tax optimisation and corporate "gorges". Report and recommendations. December 2022.

[18] Decision on the endorsement is based on the data that was available until 01/03/2023. The Ministry of Finance is obliged to publish an updated EDS at least once a quarter until the exceptional circumstances are lifted.

Figure 11. The March 2023 EDS projections for real GDP in 2023 are close to the average of other institutions' projections



The following institutions have been included in the projection distribution: European Commission, International Monetary Fund, Organisation for Economic Cooperation and Development (OECD), Bank of Lithuania, AB Swedbank, AB SEB.

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

According to the assessment of the Fiscal Institution in the NAO, risk factors, contributing to Lithuania's economic development, remain mainly related to the geopolitical situation and energy prices:

- ECB interest rates increment may have a stronger-than-expected impact on consumption and investments in the Euro area. Lithuania has one of the lowest private sector debt-to-GDP ratios in the EU, but a contraction in external demand could negatively affect the exporting sector. At the same time, the increased cost of financing government debt is undermining the ability of the public sector to respond to emerging challenges and stimulate economies.
- China's increased demand for energy resources could lead to higher-than-forecast prices. In this case, firms may be forced to limit production and consumer purchasing power would be reduced. This would have a negative impact on exports and domestic consumption, both in Lithuania and in other EU countries.
- Higher prices, reduced fertiliser consumption in 2022, weather uncertainties and agricultural exports from Russia and Ukraine could lead to higher-than-expected food prices in 2023.
- Lower growth in public sector consumption and investment may be the result of the slower implementation of measures funded by EU assistance.
- A faster transition to green energy, EC decisions such as changes in the electricity market mechanism, the joint purchase of gas by Member States, the introduction of price ceilings, requirements for filling gas storage facilities, etc., may have a positive impact on the economic development of both Lithuania and the EU.

- The easing of tension in supply chains may lead to lower price increases and faster economic expansion, but risks remain from the imposition of new sanctions that would affect international trade.
- Declining inflation and a continued good labour market situation could lead to higher-than-expected household consumption in Lithuania. Declining energy prices would also have a positive impact on consumption in other EU countries, allowing Lithuanian exports to grow faster.
- The continued integration of war refugees from Ukraine into the labour market may have a positive impact on employment.

The National Audit Office of the Republic of Lithuania, implementing its functions as a 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 2023–2026 prepared by the Ministry of Finance of the Republic of Lithuania and published on 20/03/2023. Pursuant to Article 7(3) of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania and Article 8(7)(3) of the Law on National Audit Office, the National Audit Office submits its opinion to the Seimas of the Republic of Lithuania.

Head of Budget Monitoring Department Jurga Rukšėnaitė

ANNEXES

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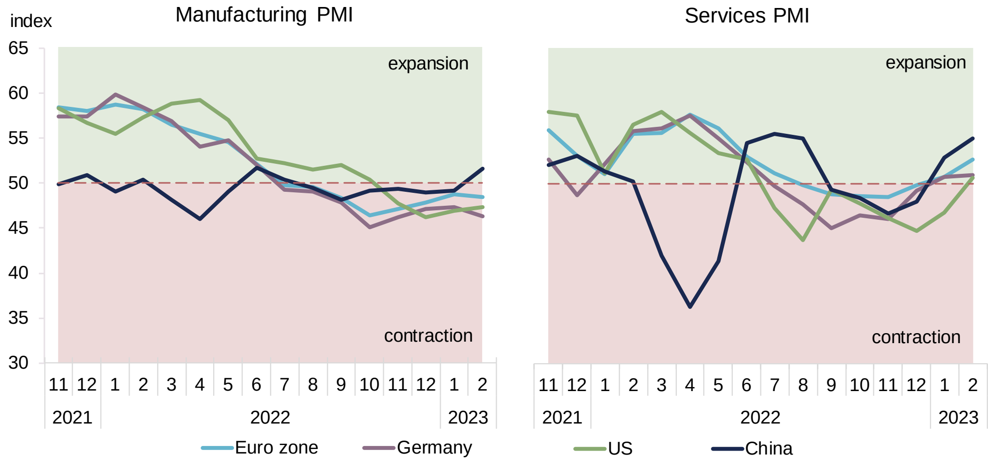
Annex 1

BUSINESS ACTIVITY IN GLOBAL ECONOMY AND COMPARISON OF ASSUMPTIONS OF INTERNATIONAL INSTITUTIONS

Figure 1. In 2023, the manufacturing Purchasing Managers' Index remains in contraction in the world's major economies, excluding China, with strong demand for services driving expansion



Source: https://www.pmi.spglobal.com

Table 1. Comparison of international institutions' oil prices and the exchange rate projections

Period	EC (13/02/2023)		ECB (16/03/2023)		World Bank (11/01/2023)		Futures (01/03/2023)	
	Oil price	USD/EUR	Oil price	USD/EUR	Oil price	USD/EUR	Oil price	USD/EUR
2022	100.7	1.04	103.7	1.05	100.0	–	101.0	1.03
2023P	84.8	1.08	82.6	1.08	88.0	–	81.9	1.06
2024P	79.9	1.09	77.8	1.08	80.0	–	77.3	1.08
2025P	79.9	1.09	73.9	1.08	80.0	–	73.0	1.09
2026P	79.9	1.09	73.9	1.08	80.0	–	69.8	1.10

The date of data publication is presented in brackets.

Source: European Commission, ECB, World Bank, www.barchart.com

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THE MINISTRY OF FINANCE'S MARCH 2023 PROJECTIONS FOR THE ECONOMIC DEVELOPMENT SCENARIO

Indicator, %	2022	2023P	2024P	2025P	2026P
Key macroeconomic indicators, rate of change					
GDP at constant prices	1.9	0.5 (0.7) ▼	3.0 (3.0)	3.0 (3.0)	3.0
Household consumption expenditure	0.5	0.5 (0.8) ▼	3.4 (3.4)	3.4 (3.4)	3.4
General government consumption expenditure	0.3	0.5 (0.8) ▼	0.0 (0.0)	0.0 (0.0)	0.0
Gross fixed capital formation	2.6	2.7 (3.0) ▼	5.4 (5.4)	5.4 (5.4)	5.4
Exports of goods and services	11.3	0.0 (0.7) ▼	4.9 (3.7) ▲	4.9 (3.7) ▲	4.9
Imports of goods and services	11.1	0.3 (0.8) ▼	5.2 (4.1) ▲	5.2 (4.1) ▲	5.2
GDP at current prices	19.1	10.3 (10.2) ▲	5.3 (5.3) ▲	5.1 (5.1)	5.1
Price indicators, rate of change					
GDP deflator	16.9	9.8 (9.4) ▲	2.3 (2.3)	2.0 (2.0)	2.0
Harmonised index of consumer prices (average annual)	18.9	8.5 (9.4) ▼	2.3 (2.3)	2.0 (2.0)	2.0
Labour market indicators					
Change in average gross monthly earnings	13.0	9.1 (9.1)	5.0 (5.0)	5.0 (5.0)	5.0
Unemployment rate (according to the Labour Force Survey methodology)	5.9	7.0 (7.0)	6.8 (6.8)	6.5 (6.5)	6.3
Change in the number of employed persons (according to the Labour Force Survey methodology)	3.8	−0.7 (−0.7)	0.0 (0.0)	−0.1 (−0.1)	−0.2

Projections of December 2022 for the Economic Development Scenario are presented in brackets.
According to the EDS assessment and endorsement description, the EDS indicators for approval by the Fiscal Institution in the NAO are marked on a purple background.

Source: Ministry of Finance

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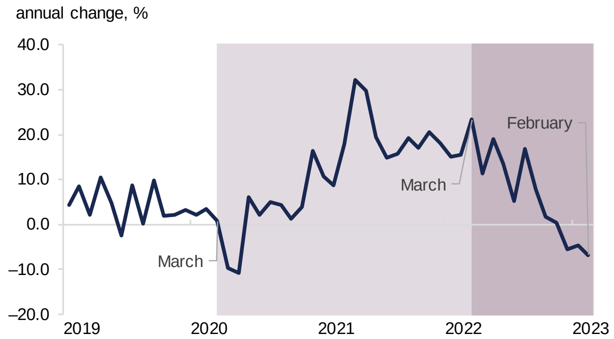
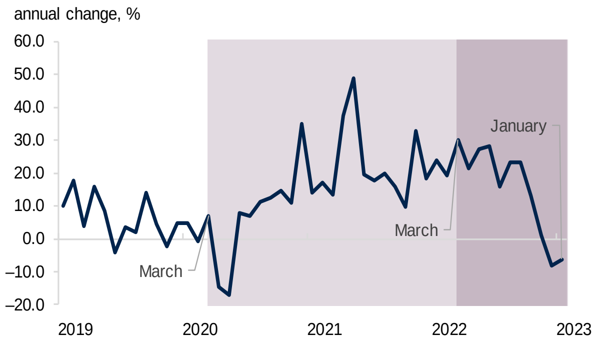
DEVELOPMENTS IN THE LITHUANIAN ECONOMY DURING A PERIOD OF EXCEPTIONAL CIRCUMSTANCES

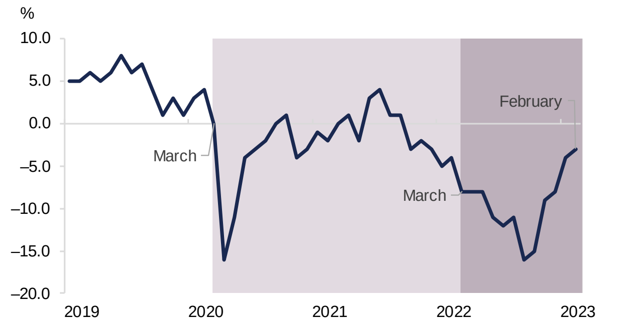
① The contraction in the chemicals industry and furniture and wood products was the main contributor to the fall in **industrial output**[1] in January–February.



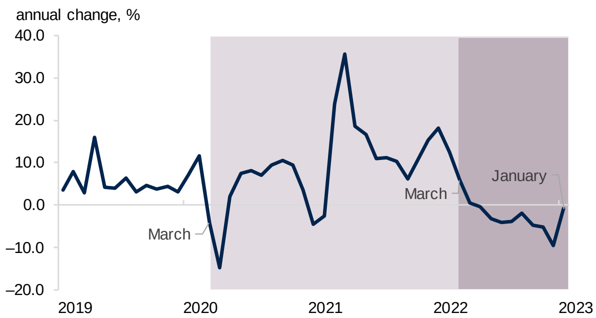
② In January, the value of **exports of Lithuanian origin goods**[2] continued to decline in line with the contraction in manufacturing production.



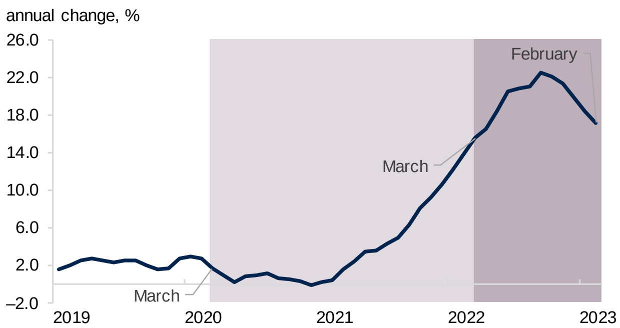
③ With households’ assessment of their financial situation for the year ahead favourable, **consumer expectations** in February are better than they were before the war in Ukraine.



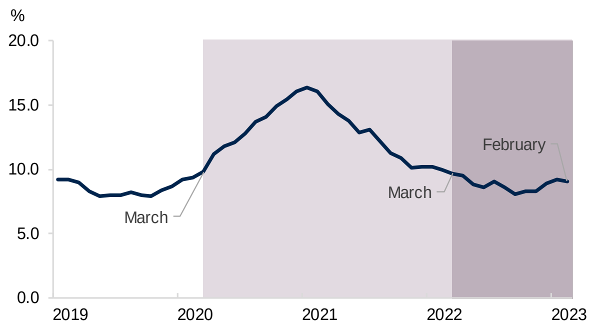
④ The increase in non-food trade in January led to an annual decrease in **retail turnover**[3] of only 0.9%.



⑤ Lower energy prices and a high comparative base are leading to a slowdown in **inflation**.



⑥ **Unemployment** recorded in February is close to the average level of 2022.



[1] Except refined petroleum products.

[2] Except mineral products.

[3] Except the sale of automotive fuels.

*Purple background highlights the period of exceptional circumstances. Russia’s war in Ukraine is marked separately by the darker colour.

Source: State Data Agency, Employment Service, calculations by the National Audit Office implementing the functions of the fiscal institution

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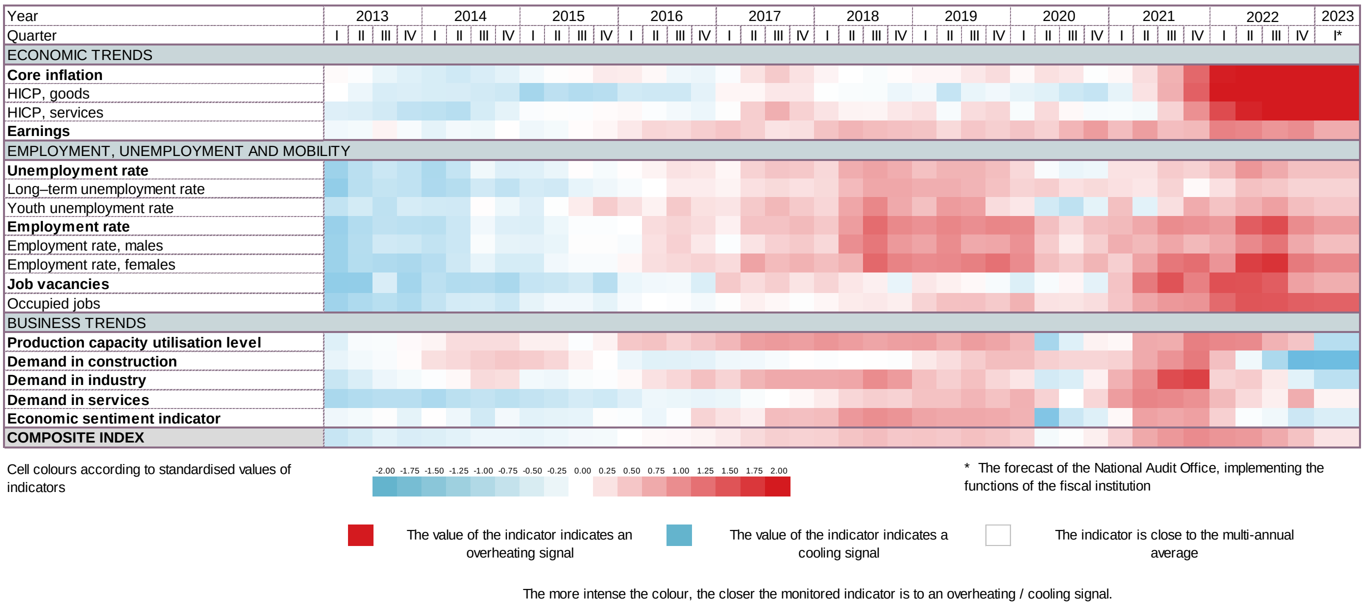
THE HEATMAP OF LITHUANIA'S ECONOMY

The monitoring of macroeconomic imbalances[19] shows that deteriorating business trends are leading to a cooling economic temperature, supported by high inflation and a favourable labour market situation[20].



Detailed Heatmap data may be found on the web page www.valstybeskontrole.lt/LT/BiudzetoStebesena under Makroekonominiai duomenys tab (En. *Macroeconomic data*).

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

[19] The methodology for drawing up the map and the description of the indicators are set out in the Fiscal Institution's Opinion No BP–5 "On the Endorsement of the Economic Development Scenario" of 20/09/2018. The map shows the deviations from the long-term average. The 05/04/2022 Opinion "On the Endorsement of the Economic Development Scenario" contains a description of the calculation of the construction demand indicator.

[20] Some of the statistical indicators used in the map for Q1 2023 are provisional. Net inflation, the January–February change in the HICP indexes of goods and services compared to the corresponding period of the previous year and equated to Q1. Unemployment and employment rates, job vacancies, and jobs occupied in Q1 are estimated using econometric models, taking into account data available from a State Data Agency, the Employment Service and Sodra (State Social Insurance Fund).

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REAL GDP PROJECTIONS OF OTHER INSTITUTIONS

Institution	Date of publication	2023P
The Bank of Lithuania	27/03/2023	1.3
European Commission	13/02/2023	0.3
OECD	22/11/2022	1.6
IMF	11/10/2022	1.1
AB SEB	24/01/2023	0.1
AB Swedbank	24/01/2023	−0.3
Average of institutions		0.7
The Ministry of Finance	20/03/2023	0.5

Source: the following institutions are included in the projections - EC, IMF, OECD, Bank of Lithuania, AB Swedbank, AB SEB; calculations by the National Audit Office implementing the functions of the fiscal institution