15. LITHUANIA

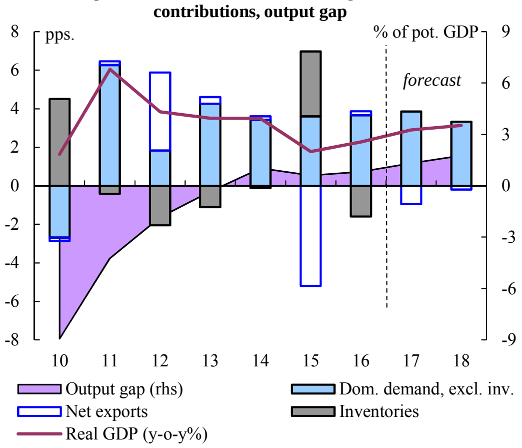
Improving growth outlook for both domestic and external demand

A recovery in EU funds-driven investment and exports are set to power GDP growth up to 2.9% in 2017 and 3.1% in 2018. At the same time, rising inflation is expected to take a toll on private consumption by dampening real disposable income growth. Employment is expected to continue growing but should slow as the labour supply approaches its limit. The general government surplus is set to swing into deficit in 2017and 2018 due to the short-term costs of structural reforms.

2016 ended on a positive note

GDP growth reached 2.3% in 2016 on the back of an especially strong fourth quarter. Overall, private consumption carried growth in 2016, driven by strong wage and employment growth and subdued inflation. Investment declined slightly as the economy weathered a temporary decline in EU-funded projects, although investment dynamics turned around in the fourth quarter. As expected, export growth in 2016 recovered to a solid 2.9% thanks to particularly strong growth in service exports. Meanwhile, import growth was subdued, mainly reflecting weak investment. Inflation increased somewhat on the back of rising food and service prices.

Graph II.15.1: **Lithuania - Real GDP growth and contributions, output gap**



Recovering investment and exports set to boost growth over the forecast horizon

GDP growth is forecast to rise to 2.9% in 2017 and 3.1% in 2018, as solid investment and export growth are set to complement strong private consumption growth. Rising inflation will lower real disposable income growth and hence weigh on household consumption. Strong wage growth and expanding employment are nevertheless expected to ensure that private consumption continues to grow at a solid pace. A gradual roll-out of EU funded projects should ensure strong investment growth in both 2017 and 2018. Solid growth in mortgage credit suggests that investment should gain further momentum.

Export growth is expected to pick up over the forecast horizon, as the improving economic outlook in both the EU and Russia are set to boost demand in Lithuania's main export markets. In addition, the positive momentum gained by service exports in 2016 is expected to continue in 2017 and 2018. Rapidly rising unit labour costs, however, may make it more difficult to gain market share. Import growth is expected to recover in step with investment and exports in 2017. Overall, net exports are expected to subtract from growth in 2017 but should turn broadly neutral in 2018.

Risks to the forecast are balanced, as potential downsides from political uncertainty are countered by cautious optimism of a stronger-than-expected recovery of the EU economy.

The labour market finds some slack as older workers delay retirement

In 2016, employment grew by 2%, up from what was already a strong growth of 1.3% in 2015. In response to the strong demand for labour, the labour force expanded, as a rapidly increasing number of older workers chose to remain in the labour market past retirement age. As a result, the unemployment rate decreased to 7.9% - low by historical standards, but with some room left to decrease further still. In 2017, both employment and the labour force are expected to continue to grow, albeit at a slower pace than in recent years. The unemployment rate is forecast to decline in line with employment growth, falling to 7.6% in 2017 and 7.2% in 2018.

Inflation set to spike in 2017 and to remain strong thereafter

HICP inflation is set to reach 2.8% in 2017 before slowing down again in 2018. A substantial but short-lived surge in energy prices combined with excise and VAT increases are set to drive inflation up in 2017 before slowing down in 2018. Core inflation, however, is expected to remain elevated due to solid wage growth and the economy nearing its full capacity.

Tax-rich growth drives fiscal improvement

Lithuania's 0.2% of GDP general government deficit in 2015 changed to a surplus of 0.3% in 2016, as the buoyant labour market led to a strong collection of payroll taxes and overall expenditures were lower than planned. These developments offset the loss of revenues due to an increase in non-taxable incomes, as well as higher spending on pensions and public wages.

The general government surplus is set to revert to a deficit of 0.4% of GDP in 2017. This deficit is mostly explained by the costs of structural reforms related to labour market and pensions (0.5% of GDP). Furthermore, some new discretionary fiscal measures, in particular an increase in public wages and pensions, are set to increase expenditure, while a further increase in the non-taxable income threshold is set to add to tax revenue losses. On the positive side, a set of tax increases and efforts to improve tax compliance are expected to offset part of the revenues losses. In addition, the boost in revenues from tax-rich economic growth is expected to cover the higher spending on public wages and pensions.

Assuming continued expenditure restraint, the general government deficit is forecast to fall to 0.2% of GDP in 2018.

Risks to the public finance forecast are tilted to the upside, due to expectations of robust growth in the tax base, but only if expenditure growth is contained.

Lithuania's structural deficit is estimated to have fallen to around ¼% of GDP in 2016 but is expected to get closer to 1% of GDP in 2017 due to the costs of structural reforms. It is expected to edge above 1% of GDP in 2018.

General government debt fell from 42.7% of GDP in 2015 to 40.2% in 2016. In 2017, the debt ratio is forecast to increase to 42.4% of GDP due to the end-of-year pre-financing of forthcoming bond redemptions, but should fall back to 38.9% in 2018.

Table II.15.1:

Main features of country forecast - LITHUANIA

		2015			Annual percentage change					
	bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		37.3	100.0	4.5	3.5	3.5	1.8	**2.3**	**2.9**	**3.1**
Private Consumption		23.6	63.2	4.7	4.3	4.3	4.1	**5.6**	**3.8**	**3.4**
Public Consumption		6.6	17.6	1.3	0.7	0.3	0.9	**1.3**	**1.4**	**1.3**
Gross fixed capital formation		7.2	19.3	6.0	8.3	3.7	4.7	**-0.5**	**6.0**	**4.5**
of which: equipment		2.3	6.2	7.9	12.5	0.5	6.0	**6.8**	**6.1**	**4.0**
Exports (goods and services)		28.3	75.9	9.5	9.6	3.5	-0.4	**2.9**	**3.5**	**3.7**
Imports (goods and services)		28.6	76.5	9.1	9.3	3.3	6.2	**2.6**	**4.9**	**4.0**
GNI (GDP deflator)		35.8	96.0	4.3	4.0	4.9	-1.0	**2.1**	**3.1**	**3.3**
Contribution to GDP growth:	Domestic demand			4.9	4.3	3.4	3.6	**3.7**	**3.8**	**3.3**
	Inventories			0.2	-1.1	-0.1	3.4	**-1.6**	**0.0**	**0.0**
	Net exports			-0.4	0.3	0.2	-5.2	**0.2**	**-1.0**	**-0.2**
Employment				-1.0	1.3	2.0	1.3	**2.0**	**0.6**	**0.5**
Unemployment rate (a)				11.9	11.8	10.7	9.1	**7.9**	**7.6**	**7.2**
Compensation of employees / head				8.3	5.4	4.7	5.3	**5.0**	**5.1**	**5.6**
Unit labour costs whole economy				2.6	3.1	3.2	4.8	**4.7**	**2.8**	**2.9**
Real unit labour cost				-0.7	1.7	2.2	4.6	**3.5**	**-0.1**	**0.4**
Saving rate of households (b)				3.9	2.1	-0.6	-1.9	**-4.1**	**-4.8**	**-4.7**
GDP deflator				3.4	1.4	1.0	0.2	**1.2**	**2.9**	**2.5**
Harmonised index of consumer prices				3.5	1.2	0.2	-0.7	**0.7**	**2.8**	**2.0**
Terms of trade goods				1.0	0.0	0.6	3.2	**2.4**	**0.0**	**0.0**
Trade balance (goods) (c)				-10.4	-2.6	-2.6	-5.3	**-4.3**	**-5.6**	**-5.9**
Current-account balance (c)				-6.9	1.4	3.8	-2.2	**-1.1**	**-2.0**	**-1.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-5.5	4.5	6.5	0.8	**-0.1**	**-1.4**	**-1.0**
General government balance (c)				-3.8	-2.6	-0.7	-0.2	**0.3**	**-0.4**	**-0.2**
Cyclically-adjusted budget balance (d)				-3.7	-2.5	-1.1	-0.5	**-0.1**	**-0.9**	**-0.9**
Structural budget balance (d)				-	-2.1	-1.5	-0.6	**-0.2**	**-0.9**	**-1.1**
General government gross debt (c)				23.0	38.7	40.5	42.7	**40.2**	**42.4**	**38.9**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.