

# Economic Development Scenario 2021–2024

March 2021

The Economic Development Scenario (hereinafter – the scenario) was developed considering actual economic development of Lithuania in 2020<sup>1</sup>, statistical base for forecasting<sup>2</sup> which has been changed after publishing the scenario by the Ministry of Finance in December 2020, as well as developments in epidemiological situation and external environment. Assumptions about the external environment in the medium term are in line with the economic forecast published by the European Commission<sup>3</sup> in February this year.

According to the winter economic forecast of the European Commission published in February 2021, the economy of the main export market of Lithuania – the European Union (EU) – is projected to grow 3.7 % in 2021 and 3.9 % in 2022. The economic recovery of the EU is expected to start in the second quarter of 2021.

According to the information available during the preparation of the scenario, most countries of the world were still affected by the COVID-19 pandemic, while the epidemiological situation both in Lithuania and in most of Lithuania's main foreign trade partners was managed by measures restricting the mobility of residents and business functioning which negatively affected the economies. The second national quarantine imposed in Lithuania on 7 November 2020 has been tightened on 16 December. Lithuania lived under strict quarantine conditions till 14 February 2021. According to the plan for gradual modification of the quarantine regime published by the Government at the beginning of February, the restrictions of quarantine are lessened at both municipal and national levels considering the changed epidemiological situation in the country.

Although the first people were vaccinated against the COVID-19 disease at the end of 2020 both in Lithuania and other countries around the world, the vaccination process has not yet gained momentum. This is due to the insufficient amount of vaccines required to achieve collective immunity. It is likely that vaccines may be available to the general public in the EU Member States in the second quarter of 2021, and mass vaccination will accelerate by mid-2021. Taking into account the fact that at least two thirds of the population should be vaccinated in order to achieve collective immunity, it is likely that this target can be achieved in the EU Member States in 2021. In developing the scenario we assumed that for at least another year specific epidemiological control measures limiting economic activity and the mobility of the population will still be needed to contain and control the spread of the virus. It was also assumed that the State financial support to businesses and residents will maintain economic viability and that the majority of business will be able to resume its functioning immediately after the restrictions on activity are lifted.

After the recession caused by the pandemic in 2020, Lithuania's economy is expected to recover in 2021. As the epidemiological situation deteriorated markedly in the fourth quarter of 2020, the

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<sup>1</sup> The Economic Development Scenario has been developed based on the information published by 1 March, inclusive.

<sup>2</sup> On 1 March 2021 Statistics Lithuania published the data of National Accounts for 2020.

<sup>3</sup> Winter forecast of the European Commission [https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/winter-2021-economic-forecast-challenging-winter-light-end-tunnel\\_en](https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/winter-2021-economic-forecast-challenging-winter-light-end-tunnel_en)

negative impact of the COVID-19 virus on the economy was felt also in the first quarter of 2021, and acceleration of mass vaccination from the second quarter is likely to lead to an increase in economic activity. Over the entire year of 2021 Lithuania's economy could grow 2.6 %, while the economic recovery is expected to accelerate in the subsequent years of the medium term – GDP could grow 3.2 %, on average, per year.

In 2020 the COVID-19 pandemic significantly worsened the labour market situation in the country. The unemployment rate, calculated according to the methodology of the labour force survey, increased by 2.2 percentage points to 8.5 % in 2020, while the number of the employed population decreased by 1.5 %. The unemployment rate was mostly increased by the negative impact of the pandemic on economic activity of the country and business expectations, as well as strict measures to manage the epidemiological situation, which restricted the functioning of part of economic activities. The unemployment rate has been slightly raised also by the recorded highest positive net migration during the period of independence and continued economic activity of the working-age population, which increased the number of labour force in the country, as well as by a decrease in the number of the employed in agriculture. The situation in the labour market was defused by the Government subsidies to enterprises for downtime and support to self-employed, which reduced the risk of unemployment and mitigated the impact of the crisis on employees, as well as helped to avoid mass redundancies. A strong labour demand and employment growth in the public sector have also cushioned the situation in the labour market. However, the imposition of the second quarantine since November 2020 has increased the vulnerability of jobs, especially in the services sector directly affected by quarantine restrictions. In 2020 accommodation and food services suffered the biggest losses in employment as a result of the pandemic, where the number of employees fell 14.3 %. A slightly weaker, but a significant decrease in the number of the employed was observed in trade, construction, transport and storage and manufacturing activities. The most vulnerable categories of workers, such as young people with less professional skills and constituting a significant proportion of workers in the services sector, low-skilled workers have been particularly affected. If high unemployment persists over a longer period, this would pose a negative risk for both the labour market and economic potential perspectives.

Considering the labour market trends, increased quarantine duration and assumptions about population vaccination, we expect that the number of employed people will increase by 0.7 % in 2021, while the unemployment rate, calculated according to the labour force survey methodology, will remain at the same level as last year, i.e. 8.5 %. Until the pandemic is contained, the Government subsidies to enterprises for downtime and support to self-employed as well as the ability of enterprises to adapt to perform activities under unusual conditions of the pandemic will have a mitigating effect on jobs and employment in the country. Still persisting the second wave of the virus will have a negative impact on employment in the first half of 2021, and the subsequent recovery of economic activity and the rise in labour demand in the services sector will lead to a faster fall in unemployment. In 2022 accelerating economic activity will increase the number of the employed population by 0.9 %, and the unemployment rate will decrease down to 7.5 %. In the following medium-term years, due to ageing population, the number of the employed population will gradually start to decline, while the unemployment rate, due to the persistence of significant structural unemployment, will decline at a slower pace and constitute 6.5 % at the end of the medium term.

The impact of the pandemic on the domestic economy will dampen the rate of wage growth. We expect that in the context of increased unemployment rate and high uncertainty about economic development of Lithuania and export partners in 2021, as compared to 2020, wages will grow at a slower pace in both public and private sectors although the wage growth will be slightly supported by a 5.8 % higher minimum monthly wage (MMW). Enterprises affected by the pandemic will be more cautious in reviewing wage levels for employees in the private sector as a result of rising unemployment and the supply of workers. Wages will grow faster in enterprises that have not felt direct effects of the pandemic, are engaged in the development of high value-added products and will continue to face shortages of highly skilled workers. Wage growth will be slightly supported by the planned implementation of the reform of remuneration of professional military servicemen, increase in salary of employees of statutory institutions, teachers and educators, basic salary of civil servants.

We expect the average gross monthly wage to grow 5.2 % in the country in 2021. In 2022 the wage growth rate will slow down to 4.5 % due to the projected slower wage growth in the public sector. As the unemployment rate declines in the subsequent medium-term years, the rate of wage growth in the country will accelerate mainly driven by the growth of labour productivity in the private sector and will be close to 5.5 % at the end of the period. In the medium term, we expect the wage growth to exceed inflation, thus the purchasing power of employees will keep increasing.

Inflationary pressures in Lithuania declined in the second half of 2020 due to more favourable prices of imported goods caused by the global economic downturn triggered by the pandemic and weakened demand for energy and food raw materials in international markets, as well as the negative impact of the pandemic on the Lithuanian economy, especially on the services sector, which led to lower demand and prices for part of consumer services. The inflation rate is expected to accelerate in 2021. From the second quarter of this year, it is likely that the annual inflation rate will be increased by oil prices boosted to pre-crisis level, which will increase the prices of energy goods, especially vehicle fuel. As a result of the acceleration of population vaccination and the recovery of economic activity in the services sector, the prices of services are expected to gradually recover. Though currently the pressure on food prices remains subdued, the rise in the food price index of the Food and Agriculture Organisation of the United Nations (FAO) warns against the rise in global prices of certain food raw materials such as cereals, thus we can expect a rise in prices of food products in the near future.

Taking into account the development trends in consumer prices and changing technical assumptions about oil prices, we expect annual average inflation to reach 1.8 % in 2021 and 2022, while at the end of the medium term it will remain within a sustainable range and will represent 2 %. In the medium term, the development of prices of imported goods, especially energy, foodstuffs and services, the situation in the domestic labour market and decisions on administered prices will have a significant impact on price developments in the medium term.

In 2020 the COVID-19 virus pandemic was alarming in society, limited access to certain services by its containment measures, temporary disruption of part of trade processes led to lower consumption expenditure of the population last year. Household consumption expenditure declined by 1.5 % in 2020. The decline in consumption was mainly due to limited supply. Whereas the

demand side – the disposable income of the population – grew at national level last year. Income from paid employment, which accounts for the largest share of disposable income in the country, grew by almost one tenth, social benefit levels also increased. The restricted access to goods and services has contributed to accelerating growth in savings which lasted until the end of 2020. The increase in accumulated funds and more cautious behaviour of the population is reflected by the data on deposits<sup>4</sup> and loans<sup>4</sup> granted to households – in December 2020 household deposits were by one fifth higher (19.8 %), as compared to December 2019, where at the beginning of 2020 the annual change constituted 11.4 % (January 2020). The consumption in the country was also dampened by a slower growth in spring 2020 and the decline of lending to households for consumption purposes at the end of the year (annual change reached -6.5 % in December 2020).

Quarantine continuing in 2021 and its unknown duration give rise to uncertainty and dampen the domestic demand. However, in line with improved epidemiological situation and eased restrictions, further continuing income support measures by the Government, vaccination process progresses and diminishing anxiety about the development of the pandemic, the mood of the population should improve, expenditure on consumption could be planned more courageously, and part of the funds accumulated last year could be used in 2021. We project that household consumption expenditure could grow 2.6 % in 2021.

In the medium term household consumption expenditure developments will mainly be determined by the situation in the labour market, social policy implemented by the Government and demographic processes. In 2022-2024 household consumption expenditure in Lithuania could grow 3.3 %, on average, per year.

A very high uncertainty caused by the pandemic has led to lower expenditure for investment projects. As a result of the COVID-19 virus, most enterprises postponed their investment plans. In Lithuania, expenditure on gross fixed capital formation decreased by 0.2 % in 2020. The change in fixed capital investment was negatively affected by a 39.7 % decrease in investment in transport equipment (a -5.3 percentage point impact) and 1.6 % lower investment in other buildings and structures (a -0.7 percentage point impact).

Investment in tangible fixed assets data shows that the private sector was extremely cautious in 2020 and cut the investments by one tenth (-9.9 % at current prices). Whereas the public sector increased investment expenditure and supported the investment process in the country (grew 19.7 % at current prices). The public sector will continue to contribute to the development of investments and intends to allocate EUR 1.1 billion each year, on average, to the implementation of investment projects provided for in the State Investment Programme.

Despite the unfavourable economic situation and difficulties faced by certain sectors, not all investments in the country have declined. Productive investment crucial to a stronger economic basis grew in 2020. This could be due to both an increased need to look for new tools to increase operational efficiency and a one-off factor to have more equipment due to increased need to ensure remote activities (both for work and education purposes). In 2020 investments in information and

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<sup>4</sup> Balance at the end of the period.

communication technologies grew 21.4 %, other equipment, machinery and weapon systems – 14.5 % and intellectual property products – 11.8 %.

Quarantine continuing in Lithuania in 2021 and strict virus containment measures pose big challenges for business, therefore increasing labour productivity will continue to be particularly relevant and productive investments should remain a priority area. As the vaccination process progresses, the epidemiological situation improves and foreign demand recovers, the private sector should be more courageous in implementing the investment projects. We project that expenditure for gross fixed capital formation could grow 4.6 % in 2021.

As economic activity in Lithuania and abroad grows, more and more available production capacities is utilized, the EU assistance is used efficiently, the investment growth in the country could accelerate in the medium term and grow, on average, 5.6 % per year in 2022-2024.

Based on assumptions about the recovery of foreign demand in 2021, export of goods and services is expected to grow 4.8 %. In subsequent medium-term years, export of goods and services could grow, on average, about 6.2 % per annum.

The scenario was developed under conditions of high uncertainty. At the beginning of 2021 the epidemiological situation in Lithuania and other EU and world countries was still very unstable, requiring strict epidemiological control measures. New strains of the virus, which may cause the more rapid spread of the COVID-19 disease and engender higher mortality, increase the risk that in order to control outbreaks of the virus and to protect health care systems from overheating, the need to apply measures having a negative impact on the economy in Lithuania and the EU countries may take longer than in the first quarter of this year. As a result, labour market tensions caused by the pandemic, disruptions in supply chains and changes in business and consumer behaviour may be more affected than foreseen in the scenario. Due to constantly changing volumes of the supply of vaccines and the timetable for delivery, reliable data on the end date of mass vaccination for the general public are not yet available. Also, the effect of mass vaccination on individual society groups is not known, it is not clear for how long the resistance to COVID-19 virus persists after vaccination, and it is not known whether the infection will require annual re-vaccination of the public.

High uncertainty about the timing of pandemic containment, uncertainty about the time and scale of recovery of the global economy, geopolitical tensions and possible tensions in financial markets, irresponsible behaviour of the society tired of long-term constraints are essential negative risk factors that may lead to changes in the estimates of key indicators in this scenario.

In the event that the pessimistic scenario published by the European Commission in February is materialized, the estimates of the indicators envisaged in the scenario would also change due to the failure of the assumption regarding the prospects of the main Lithuanian export market used when developing this scenario. In the pessimistic scenario, the European Commission foresees that a stronger and longer-lasting outbreak of the COVID-19 disease and the associated need to prolong the application of more stringent virus containment measures or the implementation of delayed vaccination programmes may lead to economic growth in the euro area by about 2 percentage

points slower in 2021 than expected in the European Commission Baseline Scenario published in February.

There is also a risk that premature withdrawal of public financial support to business and population may lead to an increase in corporate bankruptcies, a slowdown in job creation and an increase in long-term unemployment and the number of socially vulnerable people. All of this would slow down the economic recovery and create tensions in public finance.

There is also a positive risk that the effective implementation of mass population vaccination plans in Lithuania and other EU countries will provide the basis for economic growth still this year at a faster rate than foreseen in this scenario. Accelerating EU and global economic recovery, the use of the EU Funds' assistance and the application of unprecedented EU economic recovery measures<sup>5</sup> through reforms and investments in the medium term may boost economic growth in Lithuania more than expected in this scenario.

### Key indicators of the economic development scenario

| Title of the indicator  | 2020   | 2021P  | 2022P  | 2023P  | 2024P  |
|---|--------|--------|--------|--------|--------|
| GDP (at current prices), MEUR   | 48,794 | 50,966 | 53,564 | 56,312 | 59,251 |
| GDP (at constant prices), rate of change, %                           | -0.8   | 2.6    | 3.2    | 3.2    | 3.2    |
| Harmonised consumer price index (average annual), rate of change, %   | 1.1    | 1.8    | 1.8    | 1.9    | 2.0    |
| Investment (at constant prices), rate of change, %                    | -0.2   | 4.6    | 5.3    | 5.7    | 5.7    |
| Export of goods and services (at constant prices), rate of change, %  | -1.3   | 4.8    | 6.7    | 6.0    | 6.0    |
| Unemployment rate (based on definition of the labour force survey), % | 8.5    | 8.5    | 7.5    | 6.9    | 6.5    |
| Average monthly gross wage, rate of change, %                         | 9.6    | 5.2    | 4.5    | 5.0    | 5.4    |
| Employed persons, rate of change, %                                   | -1.5   | 0.7    | 0.9    | -0.1   | -0.5   |

Sources: Ministry of Finance, Statistics Lithuania

<sup>5</sup> EU economic recovery instrument "Next Generation EU" has not been included into the scenario. Approx. EUR 2 billion of grants are foreseen for Lithuania in the EU Recovery and Resilience Facility which is established as a response to economic, health, social and other sector crisis caused by the pandemic. To make use of funds under the Recovery and Resilience Facility, the Member States develop their economic recovery and resilience plans. The plan of Lithuania will have to be submitted to the European Commission by 30 April 2021.