

## Economic Development Scenario 2022–2025

March 2022

The Economic Development Scenario (hereinafter – the scenario) has been updated considering the actual Lithuania's economic development in 2021<sup>1</sup>, the Government decisions affecting economic activity as planned in the Republic of Lithuania Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets for 2022, and changes in epidemiological situation and external environment.

Geopolitical crisis in Europe caused by the Russian military invasion into Ukraine, which started in February 2022, has greatly exacerbated economic uncertainty and instability in the external environment. The scenario assumes that the war in Ukraine will directly and significantly affect the volumes of Lithuania's foreign trade with Ukraine, Belarus and Russia. Higher energy and other raw material prices as a result of the hostilities will dampen the economic activity of the European Union (hereinafter – the EU)<sup>2</sup> – the main trading partner of Lithuania, and therefore the demand of this market will also be worse than projected in the scenario drawn up in December 2021.

At the time of drafting the scenario, most countries of the world were still affected by the COVID-19 virus pandemic, while new strains of the virus increased the risk of a faster spread of infection. However, after vaccination of the majority of the population and growing number of people who have gained immunity in the EU countries (also in Lithuania), the impact of the pandemic on economic activity has weakened. When drafting the scenario, there were no reliable evidence that the COVID-19 disease is becoming endemic in Europe, and therefore the assumption that for at least one more year the containment and control of the spread of the virus in Lithuania will require more or less epidemiological control measures have not been changed.

Despite the challenges posed by the pandemic and unfavourable geopolitical environment, Lithuania's economic growth is expected to continue in the medium term. Due to the impact of geopolitical crisis, Lithuania's GDP growth is expected to grow slower – 1.6 % in 2022. In the following years, the growth prospects of the main export partner – the EU – are expected to remain favourable, and business, earlier maintaining stable commercial ties with the countries participating in the war, will shift its activities towards more reliable and stable markets, therefore the Lithuanian economy will grow at more accelerated pace: 2.5 % in 2023, and 3 % per year in 2024-2025.

The labour market situation improved in 2021. After lifting the quarantine in the country and softening the restrictions on contact activities in the second half, a larger number of people entered the labour market, therefore labour activity and employment driven by strong demand for labour increased, and labour market sluggishness and unemployment decreased. The number of employed

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<sup>1</sup> The date of inclusion of statistical data in the Economic Development Scenario – 1 March, inclusive, of other information – 10 March, inclusive.

<sup>2</sup> Based on presumption of the EC study ([European Economic Forecast. Autumn 2021 | European Commission \(europa.eu\)](#)) that in 2022, due to the energy price shock, the EU GDP will grow 1 percentage point less than foreseen in the EC Forecast published on 10 February 2022.

population grew 2.5 % in the second half of 2021, as compared to a corresponding period in 2020, and was slightly higher than the number before the pandemic in the second half of 2019. The number of population employed in accommodation and catering activities, as well as activities of organising entertainment and recreation considerably affected by the pandemic has also reached the pre-pandemic level in the fourth quarter. Manufacturing together with the information and communication activity were the sectors most conducive to employment growth in 2021.

The increase in employment brought the unemployment rate close to the pre-pandemic level. According to the data of the Labour Force Survey published by Statistics Lithuania, in 2021 the unemployment rate in the country was 7.1 % and over the year decreased by 1.4 percentage point. In the second half of 2021, the unemployment was by 2.3 percentage points lower than in the corresponding period last year. While unemployment declined sharply at national level, regional disparities remained high, and long-term unemployment rate increased up to 3 % in the fourth quarter, reaching on average 2.7 % in 2021.

Job vacancy indicators show a strong increase in labour demand in the country in 2021, and in the second half remained at historic heights. According to the data by Statistics Lithuania, the number of vacancies in the country amounted to 24.2 thousand in 2021 and over the year increased by 46 %, while the vacancy rate, reflecting the ratio between the number of vacancies and the total number of jobs, reached on average 1.8 %. Both the private and the public sector have faced the problem of staff shortage. The number and rate of vacancies at national level also in certain activities (wholesale and retail trade, transport and storage, information and communication, administrative and service, human health activities) have been the highest since the first quarter of 2008.

As the geopolitical crisis in Europe will negatively affect economic activity in Lithuania, the labour market situation is expected to deteriorate in 2022: the number of employed population will decrease by 0.2 %, and the unemployment rate, calculated according to the Labour Force Survey methodology, will increase up to 7.3 %. The deterioration of geopolitical situation in the short term may have a negative impact on labour demand in the exporting and transport sectors. Labour demand is expected to remain strong in activities geared to the internal market and, therefore, a rapid increase in unemployment is not currently expected. The number of population employed is projected to grow 0.1 % in 2023 and the unemployment rate will fall down to 6.9 %. In the following medium-term years, the number of working age population will decline due to demographic reasons and will negatively affect labour supply and employment development. A relatively high number of unemployed who do not meet the rapidly changing needs of the labour market will slow down the unemployment rate at less accelerated pace and will be close to 6 % at the end of the medium term. The implementation of the Recovery and Resilience Facility will have a positive impact on employment throughout the medium term.

A favourable economic situation and strong labour demand have stimulated wage growth in 2021. Average gross wages in the country increased 9.8 %. Wages grew at the same pace in both the private (9.9 %) and the public sector (9.8 %). Real wage growth, which slowed down sharply in the second half due to increased inflation, reached 4 % last year. The annual wage growth was recorded in all economic activities, including accommodation and catering, recreation organisation, retail trade activities most affected by the pandemic, where wages have been growing at double-digit

rates. Wage growth has been driven by a number of factors: favourable economic developments; ability of business to adapt activities to pandemic and quarantine conditions in a short period of time; a strong increase in the supply of job vacancies and a shortage of skilled workers matching the needs of the labour market; the Government's support measures to stimulate the domestic demand; a low comparative base; minimum monthly wages (hereinafter – MMW) increased by 5.8 %; increased basic salary for civil servants; higher wages for education and health workers, including wage supplements for health workers due to the pandemic situation and additional workload and other reasons.

Despite the ongoing geopolitical crisis this year, many positive factors will stimulate a strong wage growth in the country. This is a strong demand for and a shortage of skilled workers, faced at least in a half of the economic activities of the country by both the private and the public sector; the Government's decisions on remuneration of the public sector employees (increased wages for education, health workers, statutory staff, increased basic salary for civil servants and other employees of budgetary institutions); significantly increased MMW (13.7 %, up to EUR 730). The wage growth rate in the country is expected to reach 8.8 % in 2022. In the following medium-term years, in the absence of decisions on MMW developments and wages in the public sector, the wage growth rate will slow down to 5.0-5.2 %.

Average annual inflation (reflecting the average rate of annual inflation over 12 months), measured on the basis of the Harmonised Index of Consumer Prices, reached 4.6 % in 2021 and, as compared to 2020, increased by 3.5 percentage points. This increase in inflation reflected a strong low base effect, global increase in energy prices and disruptions in the supply of other raw materials and industrial goods, imbalances in global demand and supply of goods. Most of the inflation – about two thirds – was driven by external factors: boosted prices of imported energy raw materials and other industrial goods and commodities, higher prices of food raw materials on international markets, increased vegetable prices in the region. Domestic factors, mainly related to the prices of services and processed food, account for about one third of inflation.

Since April 2021, the main driver of inflation has been a sharp rise in prices of energy raw materials, which have been reflected in the consumer basket by higher prices of transport fuels, heating energy, gas, electricity and other fuels. Higher price increases since October have been observed wider and in more diverse range of goods and services, as more companies started to pass on higher production costs (energy and other raw materials, wages) to consumers, and consumers' expectations towards inflation have increased. In February 2022, price increases were visible in all major groups of goods and services, with annual inflation reaching 14 %. In February, high energy commodity prices, which amounted to about 5.9 percentage points of the inflation rate, remained a key factor for inflation. Changes in the prices of food, services and industrial non-energy goods added to inflation, accordingly, about 3.2, 2.4 and 2.5 percentage points. In February, annual inflation was also accelerated by changes in other (than heating energy) administered prices caused by higher excise duty rates on alcohol and tobacco products, increased electricity and gas prices for household consumers. The increase in MMW at the beginning of the year and higher energy prices were likely to have the multiplier effect on prices of services, which increased by 9.7 % in February as compared to the corresponding period last year.

Taking into account the consumer price development trends and updated technical assumptions about oil price developments, the scenario projects the average annual inflation to be 9.8 % in 2022. The rise in prices of imported energy raw materials, which will be significantly affected by the war in Ukraine, will remain the key factor for inflation this year. Further increases in prices of food, services and industrial non-energy goods will have a slightly lower but significant impact on inflation. Food prices will be affected by higher energy prices, the likely shortage of grain supply (Ukraine and Russia are significant global exporters of grains, and imports from these countries may suffer as a result of hostilities) and higher fertiliser prices (Belarus is a significant exporter of fertilisers, their imports into the EU are currently prohibited, besides, more expensive gas is used to produce fertilisers). Higher price increases for services will be driven by higher energy prices, strong wage growth, including the strong impact of the MMW increase, travel disruptions due to the closure of the Russian airspace for the EU aircrafts and a low comparative base. Still persistent disruption of global supply chains which emerged during the pandemic exacerbated by the war in Ukraine and the consequent additional difficulties in transporting goods, high energy prices, a ban on imports of part of raw materials from Belarus and more complex imports from Russia, high global demand for metals and semiconductors will have the multiplier effect on prices of industrial non-energy goods (household appliances, construction articles, furniture, etc.), the major part of which Lithuania is importing. In 2023, energy prices are expected to decrease (oil prices fall approximately 9 %, gas prices – approximately 31 %), prices of other raw materials and food will grow at less accelerated pace or stabilise, and the average wage growth will slow down, therefore inflationary pressure will be subdued, and the inflation rate in the country will slow down to 3 %. In 2024-2025, assuming that energy commodity prices will stabilise, the inflation rate should be close to 2 %.

In 2021 one of the main drivers of the economic recovery was the rapid increase in household consumption expenditure (grew 7.3 % and contributed 4.4 percentage points to the GDP change). Such an increase in this expenditure was the result of a low comparative base, softened restrictions on contact activities and a good financial situation of the population. The improvement in the financial situation has led not only to increased spending on consumption needs, but also to accumulation of savings. The outstanding amounts of household deposits in banks kept growing, although the growth rate has been slowing down since July 2021, and was still above the pre-pandemic rate (about 11 %). At least part of the accumulated reserve could be used in the coming years, this would help to maintain consumption in the country in a context of markedly increased prices when rising prices of housing, food and services hamper higher consumption possibilities.

Despite price increases, in January 2022 the turnover in retail trade grew rapidly (18.1 %) and it was driven by good results in non-food sales (grew 43.8 %). There was an active purchase of non-essential goods: the turnover in textiles, clothing and footwear increased threefold (grew 209.4 %), while the turnover in audio-visual equipment, furniture and lighting equipment increased 77.7 %. Moreover, the turnover of enterprises offering food or drink was more than 2.5 times higher (grew 163 %). Despite a strong growth of the turnover in retail trade, sentiment of the population in the country has deteriorated. In January–February 2022, the consumer confidence indicator fell 4 and 2 percentage points over the year (down to -5 % and -4 %), respectively. Russia's hostilities in Ukraine, which began at the end of February, are likely to negatively affect consumer expectations. Increased uncertainty about the future and high prices of raw materials caused by the geopolitical

crisis, as well as increased costs of housing and food have a negative impact on the sentiment of the population, and are likely to result in more cautious spending on non-essential goods and services. However, the expected wage growth, higher social benefits and pensions will support households' income, while the heating cost compensation mechanism will at least partially absorb the burden of increased housing costs.

Taking into account the increased uncertainty due to geopolitical tensions, subdued purchasing power of the population caused by increased prices and deteriorating sentiment of the population, we expect the household consumption expenditure to grow at a slower pace in 2022 than last year – 2.1 %.

It is not clear how long the uncertainty caused by the geopolitical crisis and concerns in the society because of it will last, but if the impact of prices diminishes, the change in the household consumption expenditure could stabilise at 3.4 % in the medium term.

The investment process recovered last year — expenditure for gross fixed capital formation (hereinafter – GFCF) increased by 7 % in Lithuania. Productive investments were actively developed in 2021. After the historically high share of available capacities in the industry have been used, investments in other machinery and equipment were actively carried out in order to meet the increased demand and to enhance labour productivity in 2021. Investments in other machinery, equipment and weapon systems were one of the fastest-growing GFCF components in 2021 (grew 20.2 %) and the most important GFCF growth factor (contributed 3.6 percentage points to GFCF growth). Investments in transport equipment driven by the recovery in demand were growing at the most accelerated pace (29.3 %) of all GFCF components. The increase in the number of job vacancies in transport and storage economic activities shows that without changes in the situation, investments in transport equipment may be limited by staff shortages.

In 2021, the private sector invested actively – investments in tangible fixed assets in this sector grew 22 % at current prices (sector-by-sector data at constant prices is not published by Statistics Lithuania). The enterprises in the economic activities of transport and storage and manufacturing are among the enterprises providing the largest amounts for investments in tangible fixed assets. In 2021, the expenditure for investments in tangible fixed assets by enterprises in these economic activities grew 39.8 % and 6.7 %, respectively. The growth was also recorded in real estate activities (7.2 %). However, the market balance has changed, and already in 2021 the alteration has been observed in the main housing market of the country — in Vilnius — i.e. a decline in the supply of new apartments, taxation of infrastructure development, disruptions in supply chains, rising costs and increased uncertainty will dampen the results in 2022.

Since the scenario announced in December 2021, geopolitical situation has changed substantially. The escalation of tensions in early 2022 increased uncertainty, and hostilities in Ukraine, which started on 24 February, brought further uncertainty and concerns about the prospects for the external environment. Considering the increasing prices of raw materials due to this situation, uncertain further development of geopolitical situation, it is likely that business will slow down the development and the implementation of investment projects. In view of increased uncertainty, the investment process is likely to slow down — expenditure for GFCF will grow 2.7 % in 2022.

Looking at the ongoing uncertainty about the future and uncertain evolution of the geopolitical situation, it is projected that in 2023 the investment process will remain subdued, and at the end of the medium term, due to tensions on the labour market and the need to increase productivity and to reduce operating costs in order to operate successfully, business investments are expected to accelerate. Projects implemented by the public sector, including those implemented with the EU funds, should support the investment process in the country throughout the medium term. We expect GFCF to grow 4.8 % in 2023, 5.4 % per annum in the remaining medium-term years (2024-2025).

The year 2021 was favourable to the Lithuanian exporters, exports of goods (at current prices) grew 20.5 %. This development was influenced by the rapid recovery in foreign demand after softening the restrictions of the pandemic and the low comparative statistical base. Chemical industry production had the largest impact on the growth of exports of goods in 2021, which accounted for 15 % of total Lithuanian exports of goods, grew 32.6 % per year, and increased the overall growth of exports of goods by 4.5 percentage points. The increase in Lithuanian exports in 2021 was also influenced by rocketing global oil prices and recovering demand for petroleum products, which led to rapid growth in exports of mineral products. In 2021, exports of mineral products, representing 10.4 % of total exports, grew by 73.4 %, and increased the overall growth of Lithuanian exports of goods by 5.3 percentage points.

In 2021, a strong recovery in foreign trade in services was observed. According to the preliminary data of the Bank of Lithuania, exports of services grew 13.3 % in 2021. The recovery of exports of services has been significantly influenced by relieving travel services after the pandemic restrictions were lifted. A strong growth was also obvious in exports of business and financial services. Due to the increased demand for goods, a significant increase has also been observed in the transport sector.

The geopolitical crisis in Europe and the sanctions against Russia and Belarus imposed by the EU, the USA and other countries will negatively affect Lithuania's foreign trade. Disrupting logistics chains, rising raw material prices, and lower foreign demand due to the high uncertainty and impact of sanctions are challenges that Lithuanian exporters will face. The scenario foresees that exports of goods and services will decrease by 6.0 % in 2022, and on average could grow by about 3.5 % per year in 2023-2025.

Increased economic uncertainty due to the geopolitical crisis in Europe caused by the Russian military invasion of Ukraine, increased risks of long-term inflation, tensions on financial markets and uncertainty about global economic growth are key negative risk factors that may lead to changes in estimates of key indicators in this scenario. Although the impact of the pandemic on economic development has recently been significantly weakened, the challenges posed by new strains of the virus also remain among key adverse risks.

Due to the geopolitical crisis in Europe and a sharp increase in uncertainty about the evolution of energy prices in 2022-2023, technical assumptions for energy prices were based on the average of 10 observations made public by 1 March on market prices of Brent oil and natural gas futures prices (90 USD/bar and 85.2 EUR/MWh, respectively, in 2022, 81.6 USD/bar and 58.7 EUR/MWh,

respectively, in 2023). The technical assumption is that prices for these energy raw materials will remain stable in 2024-2025. If these technical assumptions change, the outlook for inflation would change. If unbridled global growth of prices of energy and other raw materials and commodities and supply disruptions persist, the inflation may be higher in the medium term than projected in the scenario. Protracted high inflation could lead to macroeconomic imbalances in prices, labour market, real estate sectors and constrain economic development.

The inflation projection could also be affected by new decisions related to changes in administered prices, changes in monetary and fiscal policy measures. The impact of the liberalisation of the electricity market on the average electricity price was also not known at the time of drafting the scenario. In the event of protracted growth of energy prices, a greater share of corporate costs may be passed on to retail commodity prices and increase the inflation rates. There is a risk related to the shortage of skilled workers in the country, which, according to the job vacancy data, remained high in the second half of 2021, contributing to the wage growth rate, although the geopolitical crisis in Ukraine has mitigated this risk. If strong wage growth continues over the medium term, part of the costs of production of goods and services, linked to increased wages, may to a greater extent be shifted to the final output prices and have a greater impact on the inflation rate over the medium term.

The increased shortage of skilled labour force in Lithuania also poses a negative risk to economic development. A strong shortage of skilled workers, if persisting despite the geopolitical crisis, can increase wage pressures and contribute to the factors limiting production expansion. In the medium term, the scenario projects the labour supply and employment to be affected by demographic developments such as ageing society, international migration and changes in labour force participation. Demographic development assumptions in the scenario were based on publicly available Eurostat demographic projections (the “no migration” scenario for these projections). Changing assumptions about international migration and labour force participation would change the outlook for the development of labour market indicators. The outlook for the development of labour market indicators may also be affected by statistical revisions, if any, taking into account the results of the 2021 population and housing census.

As a result of hostilities, a large number of the Ukrainian war refugees may arrive in Lithuania. If a significant part of them were integrated into the Lithuanian labour market in the medium term, this would have a double impact on the labour market. An increase in the number of employees would increase the growth potential of the economy, but could also increase the number of the unemployed and jobseekers, subdue the rate of wage growth.

At the time of drafting the scenario, no decision was taken on the increase of wages in the public sector in 2023-2024, therefore the wage projection for this period was based on cautious assumptions about wage developments in the public sector. The wage projection for the period 2023-2024 does not include the impact of an increase in the MMW that was not the subject of the Government’s decisions at the time of this scenario.

Uncertainty about the magnitude of the economic and social consequences of the pandemic lasting more than two years and geopolitical crisis in Europe poses additional negative risks to the

realisation of this scenario. Income disparities of the population, uneven pace of recovery in individual economic sectors may become the long-term phenomena and hamper the economic development.

Further escalation of the geopolitical crisis, an increase in society anxiety and a decline in expectations, faster than expected price increases, adverse labour market developments would lead to worse results in changes of household consumption expenditure than projected in this scenario. A change in the geopolitical situation would also lead to a different development of gross fixed capital formation from that envisaged in this scenario. Changes in business expectations and behaviour, faster increases in raw material prices, problems related to financing of the investment projects, deterioration of the situation in the external environment would also lead to changes in the GFCF developments. However, increased energy independence strengthening needs as a result of the unfavourable geopolitical situation and the increased implementation of the European Green Deal projects would contribute positively to investment developments.

A more efficient use of the EU Structural Funds and other resources in the medium term may increase Lithuania's GDP more than projected in this scenario. The increased impact of the unprecedented application of the EU recovery measures in other EU countries — Lithuania's foreign trading partners — and its impact on the Lithuanian economy in the medium term may also boost the growth of Lithuania's economy more than projected in this scenario.

### Key indicators of the economic development scenario

Title of the indicator	2021	2022 <sup>P</sup>	2023 <sup>P</sup>	2024 <sup>P</sup>	2025 <sup>P</sup>
GDP (at current prices), MEUR	55,326	60,224	63,582	66,769	70,124
GDP (at constant prices) change, %	4.9	1.6 (3.7)	2.5 (3.5)	3.0 (3.5)	3.0
Harmonised consumer price index (average annual) change, %	4.6	9.8 (4.0)	3.0 (2.0)	2.0 (2.0)	2.0
Investment (at constant prices) change, %	7.0	2.7 (7.5)	4.8 (8.0)	5.4 (8.0)	5.4
Change of the exports of goods and services (at constant prices), %	14.1	-6.0 (5.3)	3.3 (5.1)	3.7 (5.1)	3.7
Unemployment rate (based on definition of the Labour Force Survey), %	7.1	7.3 (6.4)	6.9 (6.0)	6.6 (5.8)	6.3
Average monthly gross wage change, %	9.8	8.8 (9.3)	5.2 (5.8)	5.0 (5.7)	5.0
Change of the number of employed persons, %	0.8	-0.2 (0.6)	0.1 (0.0)	-0.3 (-0.4)	-0.4

Sources: Ministry of Finance, Statistics Lithuania.

<sup>P</sup> – projection. An estimate of a relevant indicator of the economic development scenario published in December 2021 is presented in brackets.