Economic Development Scenario 2022–2025

September 2022

The Economic Development Scenario (hereinafter – the scenario) has been updated considering the actual Lithuania’s economic development during the first half of 2022[1] and after the changes that took place following the scenario published in June 2022. The assumptions about the external environment are in line with the Economic Forecast published by the European Commission[2] in July this year.

The Summer Economic Forecast of the European Commission published in July 2022 projects that the European Union (hereinafter – the EU) gross domestic product (hereinafter – GDP) will grow by 2.7% in 2022, and 1.5% in 2023. According to the European Commission, Russia's war against Ukraine negatively affects the EU economy and slows down its growth. The EU's heavy dependence on Russian fossil fuels leaves the EU economy vulnerable to changes in energy markets, while weakening global economic growth reduces external demand.

In the near future, the Lithuanian economy will continue to face the negative indirect consequences of the war in Ukraine caused by Russia. It is expected that the momentum of economic recovery gained last year will run out due to the impact of geopolitical tensions, and after the end of the first half of the year (GDP grew by 3.2% during this period), economic activity will be quite sluggish for the rest of the year. Based on the assumptions of economic activity and the external environment according to the EC forecasts in July, this year Lithuania's GDP could grow by 1.6%, in 2023 – 1.4%, and in 2024-2025 – 3% per year. Increased energy tensions in the EU and increased likelihood of an energy crisis increase the negative risks of this scenario realisation.

The scenario projects the war in Ukraine will have a negative impact on economic activity in Lithuania, therefore the results of the second half of 2022 will not be as good as those of the first half. In 2022 the number of employed population is expected to grow by 1%, and the unemployment rate, calculated according to the Labour Force Survey methodology, will decrease to 6.3%. The worsening geopolitical situation will negatively affect the labour demand in exporting industrial and transport companies in the short term. In domestic market-oriented activities, high energy resource costs will encourage optimization of operations and revision of staff hiring plans, although labour demand in these activities is expected to remain. It is projected that in 2023 the number of employed population will remain stable, and the unemployment rate will increase to 6.8%. In the later years of the medium term, the number of the working-age population will decrease for demographic reasons and will have a negative impact on the labour supply and the development of employment. The unemployment rate will also decrease, but will remain above 6% due to the relatively high number of long-term unemployed.

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[1] The date of inclusion of statistical data and other information in the scenario is 31 August, inclusive.
[2] Summer 2022 Economic Forecast: Russia’s war worsens the outlook (europa.eu).

The development of the average wages is foreseen after taking into account the trends in the labour market, the war in Ukraine. This year, many factors will promote wage growth in the country. This is a strong demand for qualified workers and their lack, which both the private and public sectors face in at least half of the country's economic activities; decisions made by the Government regarding the payment of public sector employees (increased wages for education, health care, statutory employees, increased basic salary for civil servants and other employees of budgetary institutions); significantly increased MMW (13.7% to EUR 730); increased inflationary expectations, which may also affect wages. However, from the second quarter of the current year, as economic activity slows down, the acceleration of wage growth fades: it is expected that in 2022 the wage growth rate in the country will reach 12 %, in 2023 it may slow down to 8.1 %, and in the later years of the medium term to 5.0 %.

Russia's war against Ukraine continues to drive up energy prices, and annual inflation, measured by the Harmonized Index of Consumer Prices, in July 2022 increased to 20.9% and according to the preliminary estimates of Statistics Lithuania, it rose to 21.1% in August. Statistics show that food price growth is losing momentum. In July, the monthly growth of food prices (including non-alcoholic beverages) in Lithuania was the weakest in the last 8 months, and the global food price index calculated by the Food and Agriculture Organization of the United Nations decreased for the fourth month in a row. A significant decrease in the index was recorded in July after Ukraine and Russia reached an agreement on the export of grain from Ukrainian ports. A more favourable price development is also observed in the group of industrial non-energy goods, which makes up about a third of the consumer basket. As supply chain constraints eased and consumer purchasing power weakened due to higher inflation, prices of these commodities remained stable in July compared to the previous month for the first time in half a year. On the other hand, in the middle of 2022, as Russia began to limit gas supplies to Europe, and gas, biofuel and electricity prices on the stock exchanges began to grow rapidly, the period of rising energy commodity prices, especially electricity and heat energy, may be prolonged. The average annual inflation in 2022 is projected to make up 17.8%, and in 2023 the rate of inflation will slow down to 6%. In the structure of inflation, the largest part (about two-thirds) will be made up of high energy commodity prices, which are significantly increased by the war in Ukraine. In 2024-2025, assuming that the prices of energy raw materials will remain stable, the inflation rate should approach 2%.

As the energy commodity prices increase, residents' costs for housing maintenance will increase, but the impact of rising prices will be partially amortized by compensating part of gas and electricity prices, expanding the range of heating compensation recipients, and other measures to support the purchasing power of the most vulnerable groups of society. Despite the fact that the purchasing power of households will be suppressed by rapidly rising prices, the income of the population will continue to grow. In 2022 wage growth is expected, expenditure and income policy measures will be applied from the middle of this year, namely higher non-taxable income amount, old-age pensions, benefits and state pensions. After evaluating these factors, the extremely good results of the first quarter (household consumption expenditure grew by 7.6% in the first quarter of

2022) and the reserve accumulated by the population enabling consumption, it is expected that household consumption expenditure in 2022 could grow by 2.5%. As price growth moderates and stabilizes in the medium term, and income keeps increasing, the purchasing power of the population will strengthen and household consumption expenditure will grow by an average of 3.2% per year in 2023-2025.

The geopolitical tensions caused by the war in Ukraine, still continuing disruptions in supply chains and extremely increased uncertainty complicate the planning and implementation of investment projects. The extremely volatile situation in the energy resource markets, soaring prices and rising operating costs will lead to more cautious business investment and abandonment of some projects, although the need to increase operational efficiency and invest in alternative energy sources is even stronger during this period. A lack of housing supply in the real estate market, rising interest rates, uncertainty about the future, high costs of construction work and materials, and still stagnant supply chains will lead to a dampening of investment in housing, other buildings and structures in the second half of 2022. Taking into account the development of investments in the first half of 2022 and the aforementioned factors, we project that the investment process in the country in 2022 will slow down, expenses for the gross fixed capital formation will grow more than twice as slowly (increased by 3%) as in the previous year (in 2021, the growth rate reached 7%). In the medium term, even after the subsidence of geopolitical tensions, the main factors determining the development of investments will be the continuing lack of suitably qualified employees, the need to maintain competitiveness and reduce dependence on fossil fuels, the investment policy carried out by the public sector, including EU funds and the funds of the Recovery and Resilience Plan. It is projected that expenses for the gross fixed capital formation could be higher by 5.1% per year in the period 2023-2025.

It is projected that due to geopolitical factors in 2022 the exports of goods and services at constant prices will grow by about 3.0 %, and with the improvement of conditions in foreign markets could increase by about 3.1% on average per year in 2023-2025.

The scenario was drawn up at the moment of an exceptional increase in the instability of the external environment, with ongoing active military actions in Ukraine. Increased economic uncertainty due to geopolitical tensions in Europe caused by Russia's war against Ukraine, increased risks of long-term inflation, tensions in financial markets and uncertainty about the outlook for the global economy are the main negative risk factors that could lead to changes in the estimates of key indicators in this scenario. The extent of the negative economic consequences for Lithuania will depend on how long the military actions in Ukraine will last and on how EU countries will manage to cope with the challenges arising in the field of energy. The challenges posed by new strains of the virus also remain among the downside risks.

According to the alternative scenario presented in the World Economic Outlook[3] published by the International Monetary Fund (hereinafter - IMF) in July, under the worst-case scenario, global

[3] World Economic Outlook Update, July 2022: Gloomy and More Uncertain

GDP in 2022 and 2023 would grow by 0.6 and 0.9 percentage points, respectively, slower than projected in the IMF base scenario, and EU GDP in 2023 – by 1.3 percentage points slower.

Therefore, there is a risk that in the event of unfavourable circumstances, the change in Lithuania's GDP compared to the estimates provided for in this scenario, can be at least two percentage points lower in 2023.

Due to the war in Ukraine, the uncertainty of the price development of energy raw materials remains extremely high. In the scenario for 2022-2023, technical assumptions for the prices of energy raw materials were made based on the European Commission's Brent oil price assumptions published in July 2022 and published future market prices of natural gas (in 2022 USD 108.2/bar and EUR 128.4/MWh, respectively, and in 2023 USD 95.6/bar and EUR 160.0/MWh, respectively). In 2024-2025 a technical assumption is made that the prices of these energy raw materials will remain stable. Changes in these technical assumptions would change the outlook for inflation. In the IMF's risk scenario, global oil prices could increase by 30% compared to the base scenario, and gas prices could rise by about 200%.

The inflation projection could also be affected by new decisions made regarding changes in administered prices, changes in monetary and fiscal policy measures. A prolonged period of high energy commodity prices may increase the share of corporate costs passed on to retail prices and prolong the period of high inflation, while prolonged high inflation expectations will further affect the rate of wage growth and increase the risk of a wage-price spiral.

Lack of skilled staff, which is likely to persist despite the geopolitical crisis, can further increase pressure on wages and contribute to the factors limiting manufacturing expansion. The scenario predicts that in the medium term, labour supply and employment will be affected by demographic developments, namely, population ageing, international migration, and changes in labour force activity. In the preparation of the scenario demographic development assumptions were based on the publicly available demographic projections of Eurostat (scenario on international balanced migration for these projections). If the assumptions of international migration and labour force activity change, the prospects for the development of labour market indicators would change.

Further escalation of geopolitical tensions, increasing public anxiety and deterioration of expectations, faster-than-expected price growth, and unfavourable changes in the labour market would lead to worse household consumption expenditure estimates than projected in this scenario. The changes in migration trends could also affect the development of consumption expenditure. There is a positive risk that additional measures adopted by the Government of the Republic of Lithuania, aimed at increasing the income and/or reducing costs of the population, would encourage higher household consumption expenditure in the country.

Changes in the mood and behaviour of business representatives, faster growing prices of raw materials, problems related to financing of investment projects, deterioration of the situation in the external environment can disrupt the progress of ongoing investment projects and slow down the implementation of new projects. However, due to the unfavourable geopolitical situation, increased needs for strengthening energy independence, faster implementation of the European Green Deal projects would positively contribute to investment developments.

The estimates of the indicators presented in the scenario are determined to a large extent by the relevant actual statistical data available at the time of the scenario compilation, which lately has been changing significantly after reviews and/or revisions by Statistics Lithuania.

In case the main assumptions on the basis of which this scenario has been developed are not fulfilled, the estimations of many indicators provided for in this scenario would change.

Key indicators of the economic development scenario

Title of the indicator	2021	2022[P]	2023[P]	2024[P]	2025[P]
GDP (at current prices), MEUR	55,383	65,373	70,279	73,838	77,624
GDP (at constant prices) change, %	5.0	1.6 (1.6)	1.4 (2.1)	3.0 (3.0)	3.0 (3.0)
Harmonised consumer price index (average annual) change, %	4.6	17.8 (15.8)	6.0 (6.0)	2.0 (2.0)	2.0 (2.0)
Investment (at constant prices) change, %	7.0	3.0 (3.2)	4.5 (4.8)	5.4 (5.4)	5.4 (5.4)
Export of goods and services (at constant prices), change %	15.9	3.0 (–2.5)	2.0 (2.8)	3.7 (3.7)	3.7 (3.7)
Unemployment rate (based on definition of the Labour Force Survey), %	7.1	6.3 (7.0)	6.8 (7.0)	6.7 (6.7)	6.4 (6.4)
Average monthly gross wage change, %	10.6	12.0 (13.2)	8.1 (8.4)	5.0 (5.0)	5.0 (5.0)
Employed persons, change %	0.8	1.0 (0.7)	0.0 (0.0)	–0.2 (–0.2)	–0.4 (–0.4)

Sources: Ministry of Finance, Statistics Lithuania.

[P] – projection. An estimate of a relevant indicator of the economic development scenario published in June 2022 is presented in brackets.