



Lithuania's Economic Outlook for 2016–2019

September 2016

The Economic Development Scenario was updated on the basis of the statistical data published by 30 August and the information obtained, which, following Government of the Republic of Lithuania Resolution No 154 of 18 February 2016, was presented by the Ministries of the Republic of Lithuania (of Environment, Social Security and Labour, Transport and Communications, Economy, Foreign Affairs, Agriculture). Key assumptions of the external economic environment (oil prices, EUR / USD exchange rate, European Union (hereinafter - the EU) and the euro area economic perspectives) correspond to the estimates published in the European Commission (hereinafter – the Commission) Research “The Economic Outlook after the UK Referendum: A First Assessment for the Euro Area and the EU¹” of July 2016. Based on the information available while drafting the Economic Development Scenario an assumption was made that negotiations on withdrawal of the United Kingdom (hereinafter – the UK) from the EU (Brexit) will not start until the end of 2016. As long as Article 50 of the Lisbon Treaty is not triggered, the UK exit process has not started. In case of triggering Article 50, the process of negotiations on withdrawal takes no longer than 2 years; however, in case of the consent by the Member States, the European Council may extend the term for negotiations (in assessment of the complexity of the situation, it is likely that the negotiations may last for longer than 2 years). During the negotiations all UK and EU mutual obligations are valid. Therefore, we assume that there will be no essential changes (such as a change in trade regime or immigration policy) till 2019.

Having estimated the results of the first half of the year and having regard to foreign demand that will decrease (due to the increased uncertainty after the UK referendum *Brexit*) and domestic demand to be partially dented due to increased uncertainty, we project that in 2016 the country’s GDP growth will account for 2.3%, i.e. by 0.2 percentage point less than it was foreseen in spring. In the later period – in 2017–2019 – we also reduced the projected GDP growth rate – down to 2.7%, 2.5% and 2.5%.

Despite moderate growth, Lithuania’s GDP growth will be more accelerated than that of the EU and the euro area, and the situation of residents in the period covered by the Economic Development Scenario will further improve: unemployment rate will decline, and due to the wage increasing more rapidly than inflation the purchasing power of residents will remain strong. Wage increase will be predetermined by the lack of qualified staff.

However, the Lithuanian economic entities will perform under the circumstances of the increased external environment uncertainty and the higher competition. Although the investment process will be supported by the projects implemented under the EU 2014–2020 financial period and favourable credit condition, changes in the cost will stimulate business to look for productivity enhancing solutions.

In order to increase resilience of the country to external threats in the medium term it is necessary to pursue responsible fiscal policy, reduce the State debt level and increase financial resources of the State in the Reserve (Stabilisation) Fund. Enhancement of efficiency of public

¹ http://ec.europa.eu/economy_finance/publications/ceip/pdf/ip032_en.pdf

expenditure and tax incentives, optimisation of the accumulated public assets under the circumstances of the external environment uncertainty become one of the most important fiscal policy elements.

In order to establish a foundation for a an acceleration in GDP growth, enhancement of the national economy productivity, reduction of differences in the standard of living (social inequality) among the counties, ensuring compliance of the labour force with the needs of the labour market, immediate implementation of the properly adjusted structural reforms (financially and economically sound), and ensuring a favourable investment environment should be key economic policy objectives. Without the essential education reform, improving the quality of the health system, ensuring that the projects financed under the EU 2014-2020 financial period funds created high quality long-term jobs, it will be difficult to achieve these goals. It is important for business to make maximum efficient use of available production resources, increase their volumes and to modernise jobs. However, after *Brexit* in Europe and outside it economic uncertainty strengthened, which has a negative impact on business and consumer expectations. On the other hand, flexible Lithuanian economy and qualified, still relatively cheap labour force might be attractive factors for moving of the services that operated in the UK to Lithuania. Therefore, it is important that the relevant authorities and the Lithuanian business already now identify the areas of potential opportunities and take targeted action.

The indicators of the Lithuanian economy of the first half of 2016 were quite good – despite the decelerated investment process, Lithuania’s GDP growth was higher than the EU and the euro area average (2.2%), unemployment rate was falling, employment – increasing, and deflation was replaced by moderate inflation.

At the beginning of 2016 the investment process was sluggish – in the first quarter of 2016 investment into gross fixed capital formation dropped by 6.8% (5.8 percentage points of this drop were predetermined by falling investment expenditure on housing), and within half of the year it decreased by 3.4%. In the first half of 2016 investment followed a decreasing trend due to decreasing expenditure on housing and other buildings and structures (negative impact of this expenditure on the changes of the first half of the year represented –5 percentage points). Since the beginning of the year rebound transport sector has increased investment, and in the first half of 2016 it made a positive impact of 3.4 percentage points on the change in gross fixed capital formation.

In the second half of 2016 the economic development will be hindered by unfavourable external factors. In case the risk identified in the Scenario of March 2016² in respect of the results of the UK referendum of 23 June 2016 and extension of mutual Russian and EU sanctions materialises, in the second half of 2016 and the later period, which is covered by the Economic Development Scenario, the Lithuanian economic entities will operate under the circumstances of a greater external

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[http://finmin.lrv.lt/uploads/finmin/documents/files/LT_ver/Aktual%C5%ABs_valstyb%C4%97s_finans%C5%B3_duomenys/ERS_a_prasymas_2016-03-18_paskelbtas\(1\).pdf](http://finmin.lrv.lt/uploads/finmin/documents/files/LT_ver/Aktual%C5%ABs_valstyb%C4%97s_finans%C5%B3_duomenys/ERS_a_prasymas_2016-03-18_paskelbtas(1).pdf)

environment uncertainty and the increased competition, whereas recent tightening of the labour market will not decrease in the medium term. In this context, the most effective way to increase export volumes would be enhancing production capacities and efficiency of their utilisation. Enhancement of operational efficiency will be relevant not only for exporting enterprises – due to the increasing labour cost and the lack of skilled staff for the domestic market-oriented enterprises it would be also beneficial to modernise jobs. Although in the medium term the investment process will be supported by the projects implemented under the EU 2014–2020 financial period and favourable credit conditions, however, having evaluated the current trends and the increased economic uncertainty, the change in gross fixed capital formation is projected to be negative (–2.6%) in 2016. From 2017 due to acceleration in implementation of the projects financed by the EU Funds assistance, gross fixed capital formation will grow faster than it was projected in the Scenario of March 2016: in 2017 – 6.3%, 2018 – 6.5%, 2019 – 6.7%. In 2019 the share of gross fixed capital formation expenditure of GDP is likely to increase up to 22.1%, and it will be higher than the multiannual average of this indicator (21.1%). However, the funds invested will not be sufficient to ensure rapid economic convergence with the average of the euro area countries.

Our calculations show that unfavourable demographic trends and sharp decrease in investment during the crisis caused the slowdown in potential economic growth of the country from approximately 5% in the pre-crisis period to 2.5% in 2015, and the current investment level and labour resources might ensure potential GDP growth of just about 2%. In 2015 total factor productivity predetermined just 0.5 percentage point of potential GDP growth, and labour productivity (calculated on the basis of the gross value added generated by one employed person per year), as compared to the previous year, almost did not change – it increased only by 0.3%. Consequently, in the medium term enhancement of country's labour productivity and competitiveness – by automatization and optimisation of the activities of enterprises and institutions, installation of innovations and new technologies as well as modern staff management measures, enhancement of equipment use efficiency and upgrading labour force qualification – should be the economic policy priority.

For Lithuania – a small and open economy – investment into R&D and innovation is the most efficient way to increase economic competitiveness and to ensure sustainable economic growth. Although in the European Innovation Scoreboard published by the Commission in July 2016 Lithuania ranks among faster than the EU average growing countries by innovation in the period of 2008–2015 (increase of 2.4%, EU average – 0.7%), the innovation index calculated by the Commission in Lithuania in 2015 was by almost half lower than the EU average (about 0.3 and about 0.5, accordingly). According to the Eurostat data, expenditure on R&D is still below the EU average (in 2014 in Lithuania it accounted for 1.01% of GDP, i.e. half the EU average – 2.03% of GDP). Given that the essential infrastructure necessary for R&D, where more than EUR 1 billion were invested, was created by the 2007–2013 EU Funds assistance, in the medium term it is necessary to ensure efficient use of this infrastructure.

The period when the country's competitive advantage could be achieved entirely due to the gap between the labour cost of Lithuania and the more developed countries ended. In the first quarter of 2016, as compared to the corresponding period of the previous year, the average gross monthly earnings in the country (including individual enterprises) increased by 7.4% (in private sector – by

8.3%, public sector – 5.7%) – it has been the fastest growth of the average monthly gross earnings in the country since 2009. The earnings were increasing in enterprises of all types of economic activities, in particular, especially in those activities where the earnings are the lowest, and the type of activities is related to provision of services: accommodation and food service activities (14.1%), arts, entertainment and recreation activities (9.5%), administrative and support service activities (8.5%), and also real estate activities (9.7%). The slowest increase in the earnings was in public administration and defence activities (4.7%), electricity, gas, steam and air conditioning supply activities (4.6%).

The situation of the labour market favourable to employees and the strengthening negotiating power of staff stimulated growth in the earnings. A great impact was made by the accelerated growth of the minimum monthly salary (hereinafter referred to as the MMS) – since the beginning of 2015 it was raised each half of the year and since 1 July of the current year it is EUR 380. In 2016 the MMS will increase by 16.8%, and the impact of this increase on the growth rate of the average monthly gross earnings will account for about 2 percentage points. The impact increasing the growth rate of the earnings by about 0.5 percentage point will remain also in 2017 (as a result of the increase in the MMS in the middle of 2016).

In view of an additional impact of the MMS increased on 1 July 2016 and the results of the first quarter of 2016, we envisage that in 2016 the average monthly gross wages in the country will grow faster than it was projected in spring 2016, – 7.4% (in March, without evaluation of the second increase in the MMS from 1 July 2016, a 5.8% growth was envisaged). In 2017–2019 the changes in the average monthly gross wages will depend on the development of economic factors – labour supply and demand, labour productivity, inflation, profitability of enterprises. The fastest growth of the wages will be in private sector – of the activities that are characterised by high labour demand and the earnings of which remain the lowest one. The average monthly gross wages in the country should increase by 6.2% in 2017, 6.1% – in 2018, and 6.3% – in 2019.

The wages projected to increase faster than labour productivity reflects strengthening negotiating powers of staff and convergence of the wages towards the rate of the wages on the single EU labour market. Given that the gap between labour productivity and the growth rates of the wages will narrow in the medium term, and inflation will accelerate, such development of the wages should not make damage to macroeconomic sustainability of the country in the medium term; however, it will limit the possibilities for increasing the MMS.

Over the last five years the MMS increased by 64% (from EUR 231.7 in the first half of 2012 to EUR 380 in the second half of 2016), i.e. the MMS was increasing almost three times faster than the average monthly gross wages of the country (a 24.7% change comparing the projection in 2016 with the actual data in 2012).

After the increase of the MMS up to EUR 350 in the first quarter of 2016, the ratio between it and the average monthly gross wages increased from 43.8% in 2015 to 47.5% in the first quarter of 2016. In Vilnius County this ratio was below the national average – it accounted for 42.6%. In the Counties of Alytus, Marijampolė, Panevėžys, Šiauliai, Tauragė, Telšiai, Utena the ratio between the MMS and the average monthly gross wages exceeded 50%, and it warns about the MMS increase impact subduing economic development in these Counties. Further increase in the MMS may result

in a rise in prices for goods and services by a part of small and medium-sized enterprises (in particular, in the Counties where the ratio between the MMS and the earnings exceeds 50%) due to the increased labour cost, hinder creation of new jobs and employment of new staff.

Improvement of the financial situation of households predetermined accelerated growth of household consumption (5.4%) in the first half of 2016. In the first quarter of 2016 household expenditure increased by 5.3% and predetermined 3.5 percentage points of GDP growth in the first quarter. In the second quarter such expenditure increased even faster – by 5.6%, and the impact on GDP growth was the greatest one over several recent years and predetermined 3.7 percentage points of GDP growth. The consumption amount was increased not only by the increased labour income but also by consumer credits and the purchasing power of residents that strengthened due to faster than prices increasing wages as well as the decreasing oil prices. In the medium term the increasing prices and economic uncertainty that enhanced due to *Brexit* should dampen household consumption growth. In the medium term changes in consumption (deceleration) will be predetermined also by demographic changes – the increasing number of residents aged 65 and over. According to the data by Statistics Lithuania, in 2015 the at-risk-of-poverty rate for persons aged 65 and over stood at 25%, the at-risk-of-poverty rate for households with children also stood at 25%, and for households with one adult and dependent children – even 47.6%. On a country-wide basis 640 thousand residents of the country lived below the risk of poverty bound, and the at-risk-of-poverty rate accounted for 22.2% in the country. This means that a large part of the population has very limited possibilities to enhance consumption. According to the Survey of the Financial Behaviour of Households carried out by the Bank of Lithuania at the beginning of 2016, only four of ten households would be willing to save a major share of the increased income, and every third would put away half of the funds of the increased income. Average-income earners would be willing to save additional income, and low-income earners would spend all additional income. Given the propensity of households to consume, in the medium term household consumption expenditure growth will be still quite fast – on the average, about 4.4% per year.

Fast increase in real wages and supply of job vacancies, which in the first half of 2016 grew in every type of economic activities, encouraged the residents who so far have been passive to gain access to the labour market and to become active labour market participants – in the first half of 2016 the labour force participation rate in the age group 15–74 represented 67.9% and was by 1.5 percentage point higher than in the corresponding period a year ago. The participation rate that has risen to record levels predetermined that over the same period the labour force increased by 11.3 thousand persons in the country, or by 0.8% and compensated the labour force lost due to the negative impact of demographic factors.

The participation rate was increasing in all age groups; the highest increase was in the age group 55 and over and the age group 15–24. In the age group 25–54 (labour force in this group represents 70% of labour force of the country) labour participation was increasing moderately. In the age group 55–64 the participation rate as compared to the corresponding period a year ago increased by 4.3 percentage points (up to 69.7 %), in the group of residents aged 65 and over – by 1.7 percentage points, and the labour force in the common group of residents aged 55 and over increased by 31.2 thousand and compensated the decrease in the labour force (by 20 thousand persons) in the age group 15–54.

The tendencies of the labour force participation rate and limited possibilities to compensate the loss in the labour force due to emigration and other negative demographic factors do not inspire great optimism. In the last 6 years the participation rate in the age group 25–54 stood at 89–90% and since the second half of 2010 it has not increased. Moreover, in 2015 this Lithuania's indicator was the fifth highest among the EU countries having exceeded the EU average by 3.8 percentage points. In this age group there are no possibilities for significant increase of the participation. In the age group 55–64 the participation rate in Lithuania in 2015 was also one of the highest in the EU (66.2%), however, the examples of the Scandinavian countries show that there is room for increasing to the level of 74–76%, still, in the light of the lower health status of this age group in Lithuania, it is unlikely. Furthermore, even if the participation rate in this age group approximated the 75% threshold in the medium term, it would increase the labour force just by about 20 thousand persons, i.e. by approximately as much as the negative net migration of the working age population in 2015. Therefore, high labour force participation of the older working age population will only temporarily and partially compensate the losses of labour force incurred due to unfavourable demographic trends (in particular, emigration), mitigate imbalances between labour demand and supply, however, it will not stop decrease in labour force. Moreover, there are no grounds for expecting fast increase in labour force participation during the entire medium term. The latest projections on Lithuania's working age population prepared by the Commission show that the number of the population aged 15-74 will gradually decline in Lithuania in the medium term (on the average, by 1.6% each year). The unemployment rate in the country has already approached the structural unemployment rate, thus, labour force resources predetermined by the structural unemployment rate have also already been exhausted. Consequently, in the medium term the employment growth rates will decelerate (with risks of decrease in employment), and the unemployment rate will decrease not at the same accelerated pace as in recent years.

As the number of job vacancies rose by a quarter and the labour force increased, the number of the employed persons increased in many economic activities in the first half of 2016, and in total it increased by 2.4% in the national economy. In public sector the number of the employed persons went up by 3.2%, 2.6 percentage points of this increase were predetermined by the increase in the number of the employed persons in the educational activities (input into total increase in the employed persons in the national economy – 0.9 percentage point). In private sector the number of the employed persons increased by 2.1%, and this increase was mostly predetermined by the increase in the number of the employed persons both in the activities oriented towards export and domestic market: administrative and support service activities, manufacturing and wholesale and retail trade. In private sector this pace was strongly depressed by the decreased employment in agricultural activities.

The changes in the number of the employed persons in educational activities predetermined almost 2/5 of the growth rate of the employed persons in the national economy in the first half of 2016. In view of demographic indicator trends such high increase of the employed persons in educational activities is difficult to explain. According to the data by Statistics Lithuania, at the beginning of 2016 in the country the number of pre-school children (0–6 years old) was by 1,702 persons or 0.8% higher than in the previous year (of which the number of 6-year old children increased by 1,350 persons or 4.7%), and the number of children of school age (7–18 years old) and persons of

student age (19–23 years old) decreased by 2.8% and 6.7%, accordingly. Despite that, the number of the employed in educational activities in the first half of 2016, as compared to the corresponding period a year ago, increased by 9.3% or 14.9 thousand persons. In 2016 employment in educational activities had to be stimulated by the valid mandatory pre-school education for children who turn six years old in the corresponding calendar year. However, based on the assessment by the Ministry of Science and Education, the implementation of the valid pre-school education curriculum would require additional employment of about 200 teachers. Therefore, there is reasonable doubt as to reliability of statistical data (the sample of statistical survey on population employment is sufficient for assessing only general employment and unemployment indicators but it is insufficient for preparing detailed statistical information) or estimate of an additional need for teachers.

Labour demand promoting labour force participation and employment further strengthened in the first half of 2016. The annual growth rate of job vacancies stood at 24.7%. For the first time since 2007 the number of job vacancies did not decrease (i.e. it increased or was stable) in all types of economic activities, what warns that improvement in the labour market situation is approaching the peak. The greatest impact on the growth of job vacancies in the country was made by the increase of job vacancies in transport and storage activities, public management and defence activities, wholesale and retail trade, therefore, in these activities the increase in the employed is the most likely in the nearest future in case of sufficient labour supply.

The increase of job vacancies that has lasted for the last seven years warns about further increasing labour demand and strengthening mismatch between labour supply and demand. According to the data by the Labour Exchange, the lack of staff of certain professions in the country is becoming more and more apparent. In Lithuania there is a lack of HGV drivers, tailors, bricklayers, concrete placers, floor layers and tile setters, roofers, constructors, electricians, welders. Thus, it is likely that the enterprises engaged in transport, storage and construction activities will be most affected by the lack of skilled staff in the nearest future. The accelerated increase in job vacancies (a 39.5% increase), but relatively low increase in the employed persons (a 3.2% increase) in public management and defence activities in the first half of 2016 show that civil service also starts to face the lack of skilled staff. It is likely that in the medium term due to more attractive wages in private sector the number of the employed persons in civil service will increase slowly with a risk of moderate decrease.

We project that in 2016 the number of the employed persons will increase by 2.1%, in 2017 – 0.8%, 2018 – 0.2%, 2019 – 0.0%. At the end of the period covered by the Economic Development Scenario the unemployment rate will represent 6.3%.

A favourable situation for employees on the labour market predetermining rapid increase in the wages has influence also on the changes in prices, especially in service sector. The increased MMS results in the increase in the labour cost in service sector, thus, the price for the services provided by these employees is also rising. Over the recent 1.5 years the development of the prices for services has remained stable and accounted on the average 3.4% each year. Taking into consideration the

projected stable growth pace of the wages, in the medium term the upward trend in the prices should not considerably vary.

Next year the prices for transport fuel, which currently are close to their level in 2008–2009, will go up as a result of gradually increasing oil prices. However, the prices for gas and electricity that fell down again in the middle of this year will reduce the costs of household expenditure on energy products both in 2016 and in 2017.

In recent years successfully implemented projects enhancing energy security, global decrease in oil prices and consistently rising consumer income significantly reduced the share of consumer expenditure on energy products. In 2016, as compared to 2013, the share of consumer expenditure on energy products (excluding transport fuel) was halved – from 9.9% to 5.4%. The share of expenditure on electricity decreased from 3.2% to 1.7%, gas – from 1.6% to 0.7%, thermal energy – from 4.2% to 1.7%. A decrease in the share of expenditure on energy products (that are mostly imported) created a possibility for consumers to assign a share of income for acquiring local goods and services, and it improved the current account balance of the country.

Stable increase in excise duties on alcoholic beverages for all types of alcoholic beverages (by 8% each) and ethyl alcohol (by 2.5% each) established by the Republic of Lithuania Law on Excise Duties will have a 0.1 percentage point accelerating impact on inflation each year in the period of 2016–2018. The impact of the same size on the inflation will be made also by the foreseen increase of excise duties on tobacco products in 2016–2018.

The core inflation (calculated based on the HICP excluding energy products and unprocessed food), in recent two years was featured by stability and in 2014–2015 on the average represented 1.2%. Real wages and household expenditure that were rapidly increasing in the first half of the current year accelerated the annual core inflation rate up to 2%. In the medium term as the earnings were increasing faster than labour productivity and domestic demand was growing, the core inflation rate will gradually accelerate and approach the multiannual average (2.4%).

The projection of the average annual inflation remains unchanged. It is foreseen that the average annual inflation calculated based on the HICP will stand at 0.7% in 2016, 2.2% – in 2017, 2.5% – in 2018, and 2.5% – in 2019.

In the medium term the external environment will remain unfavourable to the Lithuanian exporters due to economic uncertainty resulting from *Brexit*. Extended restrictions on trade with Russia and the decreased demand both in the UK and throughout the EU will sharpen international competition.

In the nearest future the possibilities for reorientation to other markets will be more complex. Although in 2017 in CIS countries the economic recovery is projected, after the crisis the purchasing power of the countries of this trading bloc has decreased, in many of the countries of this bloc economic insecurity has increased. The demand in the main Lithuanian trading partners in the EU and the European Free Trade Association (EFTA) countries will be restrained due to the negative impact of *Brexit*, moreover, in the majority of not euro area countries the factor reducing competitiveness of the Lithuanian exporters – depreciation of the currencies – will intensify. The

possibilities for competition on export markets will be reduced also by the labour cost increasing faster than labour productivity.

In the medium term exporters will have to adjust to the changed economic circumstances, invest in order to enhance competitiveness and to manage the currency risk, take decisions reducing production costs, increasing operational efficiency and production amounts. Reorientation of the Lithuanian export markets that took place in 2015 is a cause of modest optimism for export prospects – it creates conditions for consolidation and development of export volumes in already discovered third countries, especially where settlement of payments is made in dollar.

The results of 2015 show that even in case of unfavourable conditions the Lithuanian enterprises are able to adjust and to increase amounts of the exported production. The export value of goods of Lithuanian origin (excluding mineral products, the value of which was adversely affected by the decreased oil prices) went up by 3.2% in 2015. The greatest impact on the growth rate was made by the increase in the exports of plant products, furniture, machinery and mechanical appliances, chemical industry products of Lithuanian origin.

However, in view of the external environment that changed due to *Brexit* and the changes in labour productivity, in the medium we foresee more modest perspectives of the exports of the Lithuanian goods and services than it was projected in spring 2016. We foresee that in 2016 real exports of goods and services will increase by 4.9%, in 2017 – 2.8%, in 2018 – 3.1%, in 2019 – 3.3%.

Risk for the Economic Development Scenario Fulfilment

Although the risk identified in March 2016 in respect of the results of the UK referendum of 23 June 2016 and extension of mutual Russian and EU sanctions has materialised, the list of negative risk factors did not shorten.

After *Brexit* economic uncertainty has strengthened in Europe and outside it, which negatively affects business and consumer expectations, and simultaneously, the development of business investment and household consumption both in Lithuania and other global economies. Furthermore, currently, it is not clear how long *Brexit* negotiations will last (potentially they may take longer than 2 years) and what their results will be.

Geopolitical tension still persists, global economic growth has slowed down, mutual Russian and EU sanctions extended till 2017 may be not lifted for a longer period. The difficulties encountered by the EU – a problem of debts of some countries, issue of refugees invading Europe, tension in EU bank sector, threat of terrorism – have not diminished. There is a risk of political tension in the EU. This increases vulnerability of both global and euro area as well as Lithuanian economies.

Positive *Brexit* consequences should not be rejected either. At the end of the medium term due to *Brexit* some persons in Lithuania may refuse plans to emigrate, and the ones who have already emigrated to the UK might decide to come back to Lithuania – it would improve demographic trends and create conditions for even faster increase in the number of the employed persons.

Flexible Lithuanian economy and qualified, relatively cheap labour force might be attractive factors for moving the services that operated in the UK to Lithuania. Therefore, it is very important that relevant institutions and the Lithuanian business already now identify the areas of potential possibilities and take targeted action.

Development of Key Economic Activities and Perspectives in the Medium Term

Type of Economic Activities (Proportion of the Value Added in the First Half of 2016)	Development and Perspectives
Wholesale and retail trade (18.6%*)	<p>As domestic demand accelerates and household income increases, the retail trade indicators improve – in the first half of 2016 retail trade growth rates in Lithuania were among the fastest in the EU (about 2.5 times higher than the average in the EU countries). At the beginning of 2016 retail trade turnover was increasing each month, as compared to the corresponding month of 2015, and over the first half of the year it increased by 7.0% – such growth of retail trade is one of the fastest over recent years. The trade in transport fuel increased by 13.7%, and it predetermined almost half of retail trade growth; trade in foodstuffs, alcoholic beverages and tobacco products – 4.8%, trade in non-food goods – 5.8% (the greatest influence was made by the increase in trade in pharmaceutical, medical and cosmetic goods, information and communication equipment, cultural and recreational goods, watches, jewellery).</p> <p>According to the business survey data by Statistics Lithuania, in the first half of 2016 the trade confidence indicator was significantly higher than in the corresponding period in 2015, however, at the beginning of the second half of the year optimism of the enterprises engaged in trade started to flag, and in August by 4 percentage points lower trade confidence indicator than a year ago was fixed. In the medium term the development of trading volumes will be stimulated by the decreasing unemployment rate and rapidly increasing earnings and it will be hindered by the increasing transport fuel prices and possible changes in consumer behaviour resulting from uncertainty over the future – postponed acquisition of non-basic goods. Therefore, the development of the enterprises engaged in wholesale and retail trade will be more moderate in 2017–2019 than in 2016.</p>
Transportation and storage (12.3%*)	<p>In 2016 transportation and storage activities recovered after downturn experienced in 2015. In the first half of 2016 revenue from sales of enterprises providing transportation and storage services went up by 3.6% – such results were predetermined by an 11.2% increase in the income of road freight transport enterprises. Good results of the first half of 2016 were predetermined by the diversified export market of transportation services (exports of road transport services to Germany, France,</p>

Type of Economic Activities (Proportion of the Value Added in the First Half of 2016)	Development and Perspectives
	<p>Denmark, Austria, and the Netherlands were increasing) and relatively low fuel prices.</p> <p>According to the business survey data published by Statistics Lithuania for 2007–2016, in January-August 2016 a very large part of road transportation enterprises estimated their business situation as good or satisfactory, and since February-August 2016, as compared to the corresponding period in 2015, the number of enterprises projecting growth of demand for the services they provided in the nearest months.</p> <p>However, in the medium term as oil prices increase, the development of transportation and storage service enterprises may be constrained due to the increase in fuel prices, therefore, it is very important for the enterprises engaged in this type of activities to reduce fuel costs by modernising and strengthening car fleets. Economic uncertainty and indefiniteness in respect of future trade conditions that occurred after <i>Brexit</i> could negatively affect volumes of exports of transportation services to the UK. Possible negative impact of export of transport services to the UK, which makes up about 5% of total exports of transportation services, might compensate the development on the current markets and consolidation on the new ones. According to the data of the Lithuanian Carriers Union, the Lithuanian carriers have great potential to work on Eastern – Iran, Azerbaijan, and China – markets.</p>
Accommodation and food services (1.4%*)	<p>In the first half of 2016 the Lithuanian accommodation establishments received 1.2 million tourists, it is by 11.0% more than over the same period last year: the number of both foreign and local tourists, comprising about half of the tourist flow, was increasing. After a long break tourist flows from one of the main incoming tourism markets – Belarus – were increasing. There was a significant increase in the number of accommodated tourists not only from Europe (Poland, Latvia, Belarus, Germany, Ukraine, etc.) but, due to attractive image formation of common travel destination of the three Baltic countries, also from Asian countries where residents are willing to visit all the three Baltic countries in a single trip.</p> <p>According to the data by the State Department of Tourism, in the accommodation establishments of the cities for tourists it is pretty hard to find places for overnight accommodation, there is a lack of guides, it can therefore be concluded that the demand for tourism</p>

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	<p>services exceeds the supply and good results for 2016 may be expected.</p> <p>The increased visibility and attractiveness of Lithuania due to the euro adoption and new flight destinations opened in the medium term will lead to the development of accommodation sector. As compared to the year 2009, when approximately 30 destinations were available, in 2016 from Lithuania it is possible to reach twice more airports of other countries, and by 2020 it is planned to open still 30 new routes, and intensity of approximately fifteen already existent flights should increase.</p> <p>In the first half of 2016 the increasing foreign tourist flows and rising income of the Lithuanian residents stimulated the activities of the enterprises providing food services – their turnover increased by 6.6%. The increasing spending of foreign tourists contributed to the improving results of food service activities – about one fifth of the spending of foreign tourists includes the costs for food and drinks. According to the business survey data by Statistics Lithuania, in January-August 2016 almost all enterprises providing food services estimated their business situation as good or satisfactory, the majority of the enterprises did not project the decrease in the demand. It is likely that similar trends should remain also in the medium term.</p>
Manufacturing (19.7%)	<p>In the first half of 2016 the manufacturing growth rates were increasing at a more accelerated pace than in the previous year and they were an important engine of GDP growth – predetermined one third of the change in the GDP for the first half of 2016. The value added increased by 3.3%: in the first quarter by 3.5%, in the second quarter – by 3.0%. Slower growth of the value added in manufacturing in the second quarter was predetermined by the decreased manufacture of refined oil products – in the structure of manufacturing the manufacture of these products represents about one fifth, therefore, total result of this activities is especially sensitive to fluctuations in manufacture of refined oil products. The production of the majority of other manufacturing sectors was increasing; it is therefore likely that so far manufacturers have not faced the problems of decrease in the demand.</p> <p>The index of expectations for the third quarter of 2016 published by the Lithuanian Confederation of Industrialists shows that the enterprises are cautious about</p>

Type of Economic Activities (Proportion of the Value Added in the First Half of 2016)	Development and Perspectives
	<p>the future; however, they expect development (manufacturing enterprises are positive about domestic demand and export perspectives). Due to fluctuation in the industrial confidence indicator calculated by Statistics Lithuania and its components it is difficult to assess their impact on the results of manufacturing. However, in May-August 2016, as compared to the corresponding months of 2015, the number of enterprises projecting growth in exports increased.</p> <p>Manufacturing is one of the most external oriented activities – about two thirds of production are sold outside the Lithuanian market, therefore, the results of manufacturing are strongly influenced by the situation on foreign markets.</p> <p>The changes in the demand for exports and competition on export markets will be key factors that affect the development of manufacturing and the whole industry in the medium term. Due to the projected slower growth of the main foreign partner – EU economy – and the decreasing demand in the medium term the Lithuanian manufacturers will have to reconsider the structures of their export markets and business development trends. A better access to the markets of the third countries will be created by the changes in the trade regime between the EU and other countries already achieved and under coordination.</p>
Construction (6.1%)	<p>In the first half of 2016 the value added generated in construction activities decreased by 13.4%, however, the recession of construction activities that lasted for a year should end in the second half of 2016. The results of construction enterprises are greatly dependent on public investment, the major share of which is financed by EU assistance; therefore, traps occurred when one EU Structural Funds assistance period (for 2007-2013) ended and the EU Funds assistance of the new period (for 2015–2020) have not reached the market yet. This resulted in a 25.6% decrease in engineering structure construction works and a 15% decrease in non-residential building construction works. Construction of residential buildings remained the only segment that increased (by 19%) at the beginning of 2016, however, these works represented less than 20% of construction works carried out in the country.</p> <p>The results of construction activities of the second half of the year will be positively influenced by the use of EU Structural Funds assistance that gained momentum (in the first half of 2016 only one fourth of the funds</p>

Type of Economic Activities (Proportion of the Value Added in the First Half of 2016)	Development and Perspectives
	<p>earmarked for implementation of the projects on modernisation of buildings for 2016 and one third of the funds for transport infrastructure were used). Moreover, according to the data by the Lithuanian Real Estate Development Association, in the second half the market of business centres will be supplemented with the largest since 2009 business centre areas (about 70 thou. sq. m.). This data allows expecting the expansion of construction activities in the second half 2016.</p> <p>A part of the enterprises engaged in construction activities diversified risk and, after decrease in construction work orders in Lithuania, develops business abroad. In the first half of 2016 the value of construction works carried out abroad increased by 26.1%. The Lithuanian construction enterprises executed the majority of the orders in Sweden, Norway, Estonia, Germany and Denmark. Withdrawal of the UK from the EU should not have significant influence over the increase in growth of exports of construction services that have gained momentum in recent years as exports of construction services to this country constitute only 1% of total exports of construction services.</p> <p>In the medium term the development of construction services will be stimulated by the works of transport infrastructure, housing modernisation and renovation, environmental projects funded by the EU Funds assistance envisaged for the 2014–2020 financial period, and projects not related to the EU Funds assistance under implementation, development of hotel and business centres.</p>
Agriculture (2.0%)	<p>In the first half of 2016 the value added generated in agricultural activities was increasing at quite accelerated pace – 2.4%, however, in the second half of the year such increase is unlikely. The greatest impact on the changes in the value added generated in agricultural activities is made by cereal crops, which in 2015 went up by 22.5% and were record crops in the whole history of the country. Given that in 2016 it will not be possible to repeat such an increase in cereal crops (according to the data by the Lithuanian Institute of Agrarian Economics, although crop areas were increasing, however, due to lower yields envisaged, by 10.4% lower crop cereals are projected in Lithuania), and the result of the third quarter (in the third quarter of 2015 the value added generated in agricultural activities increased even by 5.9%) is the most important one for a yearly change in agricultural activities, in the</p>

Type of Economic Activities (Proportion of the Value Added in the First Half of 2016)	Development and Perspectives
	<p>second half of the year the increase in agricultural activities should slow down.</p> <p>Like in recent years, in the medium term agricultural development due to buoyant supply (based on the data by the Food and Agriculture Organisation of the United Nations (FAO), a 0.6% in global crops and a 2.3% increase in the EU are projected for 2016) will be suppressed by low buying-in and export prices for agricultural products. In the medium term the Ministry of Agriculture foresees a moderate, on the average up to 1% per year, increase in the value added of this type of activities.</p>

Source: Statistics Lithuania, Ministry of Foreign Affairs, Ministry of Economy, Ministry of Energy, Ministry of Transport and Communications, Ministry of Agriculture, Bank of Lithuania, Lithuanian Confederation of Industrialists, Lithuanian Builders Association, Lithuanian Real Estate Development Association, State Department of Tourism, Lithuanian Institute of Agrarian Economics, Lithuanian Carriers Union, Lithuanian Association of Grain Growers, Food and Agriculture Organisation of the United Nations.

* Data of 2014

Comparison of Estimates of Key Macroeconomic Indicators for 2016–2017

Indicator	Year	Ministry of Finance September 2016	Commission May 2016	Difference in p.p. (Projections by the Ministry of Finance – Projections by the Commission)
Change in GDP, per cent	2016	2.3	2.8	–0.5
	2017	2.7	3.1	–0.4
Change in GDP deflator, per cent	2016	0.7	1.7	–1.0
	2017	2.2	1.9	0.3
Change in gross fixed capital formation (GFCF), per cent	2016	–2.6	2.5	–5.1
	2017	6.3	4.6	1.7
Change in household expenditure, per cent	2016	5.5	4.3*	1.2
	2017	4.2	3.9*	0.3
Harmonised index of consumer prices, per cent	2016	0.7	0.6	0.1
	2017	2.2	1.8	0.4
Unemployment rate, per cent	2016	8.0	7.8	0.2
	2017	7.2	6.4	0.8
Change in the average gross monthly earnings, per cent	2016	7.4	4.6**	2.8
	2017	6.2	5.1**	1.1

*Private consumption (change, per cent), consisting of household expenditure and non-profit institutions serving households

**Compensation of employees

The projections of a part of the indicators presented in the Economic Development Scenario for September 2016 prepared by the Ministry of Finance differ from the last available Commission forecasts. The differences were predetermined by the Lithuanian economic development trends that changed since May (when the Commission prepared the forecasts), economic uncertainty that strengthened due to *Brexit* and different external environment assumptions. The Ministry of Finance in preparation of the Economic Development Scenario for September 2016 used the estimates of oil prices, EUR / USD exchange rate, economic prospects of the EU and the euro area countries published in the Commission Assessment of July 2016 and the estimate of economic development of Russia and CIS countries published by the International Monetary Fund in July.