Lithuania

Country note, January 2018

FISCAL INSTITUTION

Key messages:

- **Investment will emerge as a major supply-side contributor of economic growth in 2018**
- **Labour market continues to heat up, yet at a slower pace**
- **For the first time since 1990 adopted budgets of the general government for 2018 with nominal surplus amounting to 0.6% of GDP, however, projected fiscal stance is pro-cyclical**
- **Gross debt will remain on slowly decreasing path**

Macroeconomic outlook

Lithuania's economic growth has picked up notably in 2017 on the back of improvements in the international economic environment. A slower projected increase in demand for the imports of goods and services in the markets of Lithuania's key trade partners will translate into a slower growth of Lithuania's exports in 2018. However, investments will emerge as a major supply-side contributor of economic growth. Inflows from EU funds, which slumped in 2016 and failed to pick up in 2017, are assumed to increase next year, which is expected to contribute to the further growth of investment that will bolster economic activity in the short and long terms. Employment is expected to shrink as the labour supply approaches its limit. Due to the shortage of labour force, the wage bill is projected to grow at a robust pace, but slower than in recent years. Inflation in the country will remain elevated, though, lower than in 2017. Inflation is expected to reach 3.7% in 2017 before going down in 2018. As the growth of global commodity prices will moderate next year and upward pressure of increases in excise duties will be weaker in 2018 as compared to 2017, inflation is projected to be 2.6% in 2018 according to Bank of Lithuania's projections, published on 19 December of 2017.

Short-term fiscal outlook

The general government balance was set to swing into deficit in 2017 due to the short-term costs of structural reforms. However, revenue windfall and lower expenditure on co-financing of EU funds show that annual result might be close to a surplus of 0.4 % GDP. For the first time since 1990 Parliament adopted budgets of the general government for 2018 with nominal surplus amounting to 0.6% of GDP, yet the projected fiscal stance is pro-cyclical (Chart 2). Analysis of the fiscal institution of Lithuania shows that there is a positive risk that this year's nominal balance might be better than Ministry's of Finance estimate and negative risk of 0.1% of GDP that nominal surplus for 2018 will be smaller. This means that according to *ex-ante* assessment, structural balance is deteriorating (Chart 1) and there is a risk of non-compliance with the national fiscal rule.

Medium-term fiscal outlook

The medium-term objective (structural deficit of 1.0% of GDP) was achieved in 2014, and there was no deviation from it since then. This medium-term objective is set till 2018. Government projects that gross debt should decrease to 35.4% of GDP in 2020 (Chart 3).

Fiscal framework and national fiscal rules

The national fiscal rules enshrined in the Constitutional Law on the Implementation of the Fiscal Treaty has two functions: macroeconomic stabilisation and fiscal sustainability. When the economy is operating above its potential output and even if current and projected structural balance of general government is better than the medium-term objective, the fiscal rule requires that structural adjustment would be positive: the difference between next year's projected and current year's estimated structural balances is at least 0.1% of GDP. When the economy is below its potential output, fiscal rule suggests the implementation of fiscal stimulus. The national fiscal rule is stricter than EU fiscal rules in good times and looser in bad times. Rules are structured this way in order to build enough margin of manoeuvre during the boom to be able to use fiscal stabilisation in the downturn.

Chart 1: Development of the Structural Balance 2016-2020

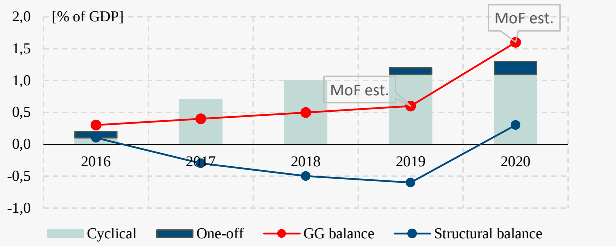


Chart 2: Fiscal Stance

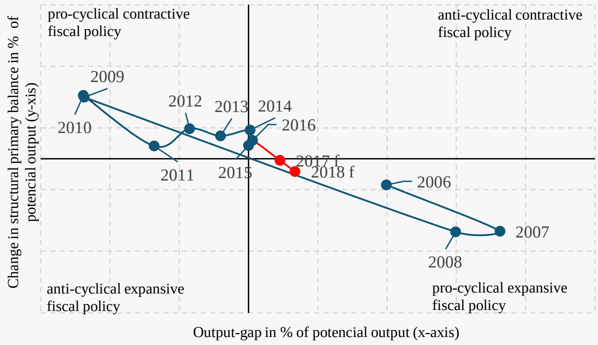
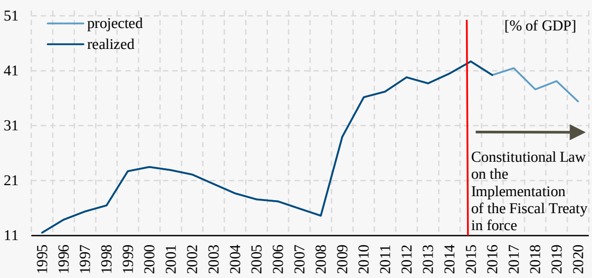


Chart 3: Debt-to-GDP ratio (% of GDP)



Key indicator forecast

		2016	2017 f	2018 f	2019 f	2020 f
Real GDP growth rate	[% y-to-y]	2.3	3.6	2.9	2.5	2.4
Output Gap - MoF est.	[%]	0.7	1.7	1.6	1.1	0.5
Output Gap - IFI est.	[%]	0.2	1.6	2.4	2.6	2.6
GG balance - MoF est.	[% of GDP]	0.3	0.1	0.6	0.6	1.6
GG balance - IFI est.	[% of GDP]	0.3	0.4	0.5	-0.4*	0.0*
GG debt - MoF est.	[% of GDP]	40.2	41.5	37.6	39.1	35.4
GG debt - IFI est.	[% of GDP]	40.2	38.5*	37.1*	35.9*	34.5*
GG structural balance - MoF est.	[% of GDP]	-0.1	-0.7	-0.1	0	1.1

Sources:

MoF: The explanatory note of Draft Budget for 2018, 17.10.2017

IFI: The 2017 Report on General Government Financial Indicators for 2018, 15.11.2017

**IFI projections from the 2017 Report on General Government Fiscal Sustainability, 20.6.2017*

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