Lithuania

Country note, January 2019

FISCAL INSTITUTION

Key messages:

- **Rapid wage growth outpaces the growth of labour productivity**
- **Weakening external demand will slowdown Lithuania's exports**
- **The stance of economy signals the need to increase the rainy-day fund**
- **The fiscal policy maintains its pro-cyclical stance**
- **Gross debt will stabilize at around 38.0 per cent of GDP in the medium-term because of negative automatic debt**

Macroeconomic outlook

Lithuania's economic growth was balanced in the first half of 2018, as it was positively contributed by domestic demand and net exports. As in the rest of the Baltic States, the value-added in the construction sector grew at the fastest pace. Industry, trade, transport, information and communication services were also actively developing. Private consumption was driven by a sharp increase in wages and decreased inflation.

Weakening external demand will slowdown Lithuania's exports in 2019. Unlike external demand, domestic macroeconomic indicators are forecast to retain momentum. Having started to show clear signs of an upward trend this year, investment will continue to grow.

Higher immigration rates have eased tensions in the labour market only marginally, therefore a rapid wage growth outpaces the growth of labour productivity. In Q3 of 2018, against Q3 of 2017, average gross monthly earnings in the whole economy increased by 10 per cent.

On the back of further weakening demand in external trade partners, economic expansion in 2019 should moderate and reach 2.8 per cent. Positive output gap brings cyclical revenue to the general government (Chart 1) and signals the need to increase the rainy-day fund.

Short-term fiscal outlook

Given the reduction in the GG primary structural balance in 2018 and 2019, the fiscal policy of Lithuania will maintain its pro-cyclical stance. The fiscal space has not been created during good times to ensure at least neutral fiscal policy during a downturn in the business cycle (Chart 2).

Medium-term fiscal outlook

The package of six structural reforms covering the areas of taxation, pensions, the informal economy, education, health and innovations was adopted in 2018. Reform of taxation is related to consolidating the employers and employees base for social security contributions. Labour taxes were consolidated on the employee's side, but the gross salary will be recalculated by increasing it 1.289 fold. The employer's rate of social security contributions was cut from 31.18 to 1.47 per cent, and the employee's contributions rate was raised from 9 per cent to 19.5 per cent. A cap on social security contributions for income exceeding a sum of 120 average wages per year (8,900 euros per month) has been introduced and provided for a gradual reduction in the "capped" level of employment income (from 6,200 Eur in 2020 to 4,400 Eur in 2021). These changes will reduce the revenue of GG in the medium-term. As a result, deterioration in GG balance is projected. Nevertheless the increase in GG deficit, gross debt will stabilize at around 38.0 per cent of GDP in the medium-term because of negative automatic debt dynamics (Chart 3).

Fiscal framework and national fiscal rules

The fiscal framework of Lithuania requires to pursue a neutral fiscal policy in 2019 since one of the escape clauses is activated: the average of GG balances for 2014-2018 is positive. Therefore, domestic expenditure benchmark was not applicable for the draft budget 2019, but structural deficit rule was in force. The structural deficit must be decreased by at least 0.1 p. p. of GDP. The MoF estimates that the rule of structural balance is obeyed, however, IFI's assessment shows that fiscal policy will maintain its pro-cyclical stance in 2019.

Chart 1: Structural Balance

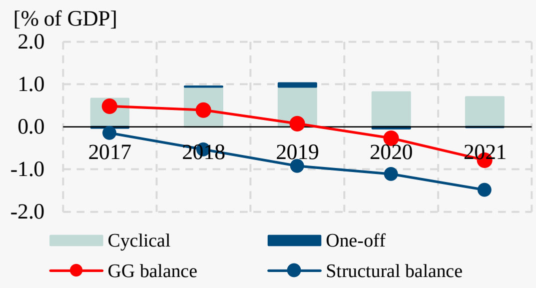


Chart 2: Fiscal Stance

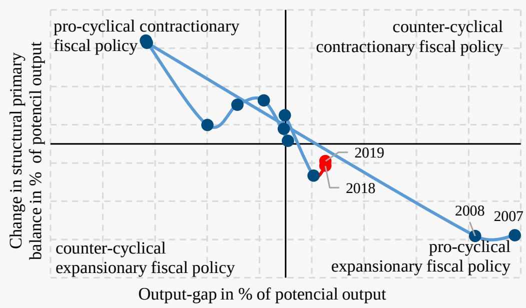
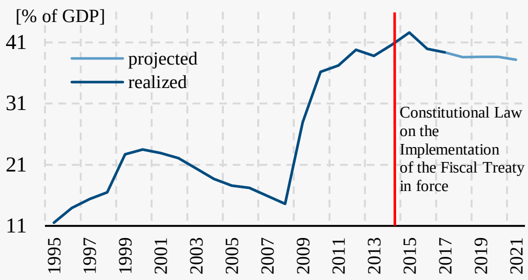


Chart 3: Debt-to-GDP ratio



Key indicator forecast

		2016	2017	2018 f	2019 f	2020 f	2021 f
Real GDP growth rate	[% y-to-y]	2.4	4.1	3.4	2.8	2.5	2.5
Output Gap MoF est.	[%]	1.1	2.4	2.4	1.5	0.7	0.2
Output Gap IFI est.	[%]	-0.1	1.6	2.3	2.3	2.0	1.7
GG balance – targets	[% of GDP]	0.3	0.5	0.6	0.4	0.2	0.1
GG balance - IFI est.	[% of GDP]	0.3	0.5	0.4	0.1	-0.3	-0.8
GG debt - MoF est.	[% of GDP]	39.9	36.2*	34.8*	35.0*	34.8*	34.3*
GG debt - IFI est.	[% of GDP]	39.9	39.4	38.6	38.6	38.6	38.2
GG structural balance -MoF est.	[% of GDP]	0.0	-0.5	-0.4	-0.3	-0.1	0.0
GG structural balance - IFI est.	[% of GDP]	0.5	-0.1	-0.5	-0.9	-1.1	-1.5

* without accumulation for debt refinancing

Sources:

MoF: Draft Budget 2019, 17.10.2018

IFI: The Report on financial indicators of general government 2019, 8.11.2018

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