

CURRENT ECONOMIC PERFORMANCE AND CHALLENGES FOR LITHUANIAN ECONOMY

ALGIRDAS MISKINIS
VILNIUS UNIVERSITY

Presentation prepared for the Conference:
Competitiveness Strategies for the EU Small States
Chambre de Commerce Luxembourg, Kirchberg
19-20 April 2018



LE GOUVERNEMENT
DU GRAND-DUCHÉ DE LUXEMBOURG
Ministère de l'Économie

Observatoire de la compétitivité



L-Università
ta' Malta

STATEC



UNIVERSITÉ DU
LUXEMBOURG

LU  **EMBOURG**
LET'S MAKE IT HAPPEN

Introduction

- Lithuania has one of the most liberal business environments in the world.
- However, Lithuania is behind most EU countries in FDI, in wages and salaries, in pensions etc.

Did Lithuania got stuck in the middle income trap?

- In order to catch up with other EU countries it is important to identify the reasons of drawbacks and main prospective challenges.
- An analysis of statistics and a comparison to other countries provides insights for the future.

Is Lithuania an advanced economy? (WB data)

- GDP per capita in 2016 – **14 900 USD** (16 604 in 2017) while in 1995 - only 2 169.
- GDP per capita is lower EU average of **23 821** but exceeds Hungary (11 903), Poland (12 309), Latvia (14 141) or Bulgaria (7 091). But Luxembourg (105 829).
- GDP per capita in PPP in 2016 was near 30 000.
- Lithuania ranks **37th** in HDI 2015 (“very high human development”). Behind are Slovakia, Portugal, Hungary, Latvia, Croatia). Lithuania is not higher because of a low life expectancy (only 73.5).

Indicator	2002	2004	2006	2008	2010	2012	2014	2017
GDP growth, %	6.9	7.4	7.8	2.9	1.6	3.7	3.0	3,9
Inflation, %	0.3	1.2	4.5	8.5	1.6	3.2	0.2	3,7
Unemployment, %	13.8	11.4	5.6	5.8	17.8	13.4	10.1	7,1
GDP per capita to EU average, %	43	50	56	63	60	69	75	75
Current account (% to GDP)	-5.3	-7.6	-10.6	-12.9	-0.3	-1.2	3.7	-1.6
Fiscal balance (% to GDP)	-1.9	-1.5	0.4	-3.3	-7.1	-3.2	-0.7	0.3
Government debt (% to GDP)	22.3	19.3	17.9	15.5	37.4	41.2	40.7	40.1
Export growth, %	10.5	16.2	15.8	28.5	32.7	14.4	-0.4	12.0
Net migration per 1000 population	-3.4	-9.5	-7.5	-5.2	-25.2	-7.1	-4.2	-6.1

Satisfaction and confidence across public services (2016)

% of citizens expressing confidence/satisfaction



Lithuania



National government

28% 42%

Police
70% 77%

Health care
52% 70%

Judicial system
34% 55%

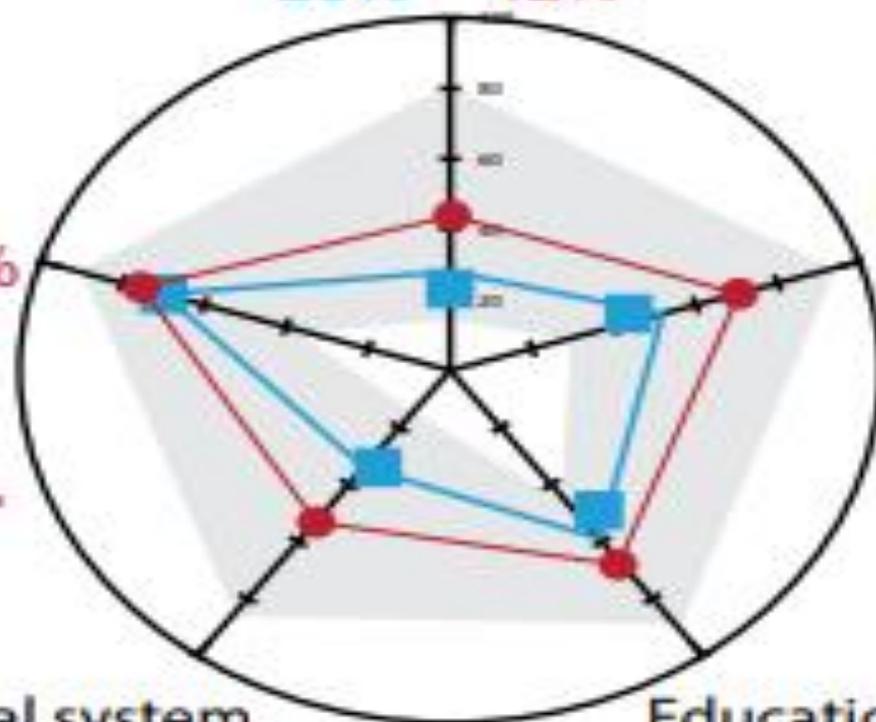
Education system
59% 67%



Average



Range



Crisis

- 2002- 8 - stable economic growth (7% per year), however, during economic crisis in 2009 GDP dropped by **14.8%**.
- During pre-crisis period in 2008 was high inflation - **8.5 %**, current account deficit - **12.9 %**, high capital inflows).
- Three reasons for **overheating**:
 - Growth in real estate but not in export sectors,
 - Investments from foreign loans but not domestic savings,
 - No regulation of foreign money inflows and exchange rate.
- Remedy through **cruel austerity** measures (pensions, salaries, social expenditures) at the expense of people wellbeing
- Long term consequences of such cuts – **unemployment, emigration, inequality.**
- Refusal to borrow from IMF increased foreign **public debt** from 15.6% to GDP in 2008 to 42.6% in 2015. **Fiscal deficit** in 2010 reached 7.1% to GDP.

After crisis

- Growth engine - **export growth** (30% per year) until crisis with Russia;
- Exports of Lithuanian origin – 60% while **40% - re-export**. Goods of Lithuanian origin are exported mostly to EU while re-exports goes to CIS countries.
- Recent growth engines – **export (16.9% growth in 2017), local demand, investments** (actual individual consumption in 2016 reached 85% of EU level); Lithuania excels in export of transportation services.
- **8.8%** growth of industrial output in 2017.
- In 2017, average salary reached **€848** per month (in 2000 was €300). Three consequences of increase in wages and salaries: jobs in Lithuania became more attractive, boost of local demand, but has a negative impact on export competitiveness.

Excellent business environment

Good business environment is an important factor for local businesses and FDI.

- In 2017 IMD World Competitiveness rankings ranked Lithuania 33rd (30th in 2016) - above Latvia (40th), Slovenia (43rd).
- In GCI Lithuania was 41st in 2017-18 while 35th in 2016-17 (behind only Estonia and Malta). Lithuania is low in market size, labour market efficiency, financial market development
- Major drawbacks of business environment are in tax rates and administration, government bureaucracy, restrictive labour regulations
- In 2018, Lithuania was 16th (behind Estonia) in Ease of Doing Business Index (in 2017 21st).
- In Heritage Foundation's IEF in 2018 Lithuania ranked the 19th freest country in the world (before was even higher).

Labour costs and education

- Labour costs are growing , but wages still remain low. In 2016, hourly labour cost was €7.3 (lower was only in Bulgaria and Romania) while EU average was €25,4. During 2004 - 16 cost increased 2.3 times, when in the EU – 1.3 times.
- Low wages make labour intensive sectors more competitive, but: creates emigration, reduces motivation for innovations;
- Labour is well educated: in 2016 more than half of the population aged 30-34 had tertiary education (58,7%) when EU average was 39,1. Effective rate of people with tertiary education exceeds EU target for 2020 (40%). But:
- education not always is relevant to the labour market needs and is leading to a shortage of workers for blue-collar jobs and lower FDI;
- 2005-2015 numbers of students decreased by 36%, this leads to the inefficiency of resources. Teaching at university is't attractive.

Challenge – low income redistribution and high inequality

- General government revenue in 2016 (% to GDP) - **34.5%** (45% before crisis) when EU average - **44.9%**. As a result - low public financial resources for the implementation of economic and social policies. Lower percentage was only in Ireland (27.5%) and Romania (31.7%) when in Finland it was 54.2%. Redistribution is low due to high tax evasion, low tax base, flat income tax (one of least progressive system in the EU) .
- Environmental taxes on vehicles and property taxes are almost non-existent.
- In 2016, the richest 20 % had incomes more than 7 times higher than the incomes of the poorest 20 % (EU average 5.2).
- When public revenues are low such are **wages in the public sector, pensions and social benefits**. This also has a domino effect on wages in private sector as well. Low public revenues and expenditures demonstrate limited possibilities of the government stimulate economic growth. Pensions are low and can decrease further. Social transfers are not able to reduce poverty.

Low income redistribution and high inequality

- The major outcome of low income redistribution is **income inequality**. In 2016 the inequality of disposal income in Lithuania was the highest in the EU with Gini reaching **37.0** after Bulgaria (EU average - **30.8**, while lowest level in Slovakia - 24.3, Slovenia – 24.4).
- Social exclusion is also high. In 2016, people at risk of poverty in Lithuania accounted for **30.1%** to population. The lowest social exclusion was in Czech Republic (**13.3%**), when the highest rate in Bulgaria (**40.4%**). EU average exclusion rate was **23.4%** of total population.
- Household final consumption expenditure in 2016 still accounted for large share to GDP – **64.3%** (in Sweden – 43.1%, Slovenia – 53.4). EU average – 54.6%. Lithuanians spend for food 22.2% when Britons -8.1%.
- General tax burden to GDP is very small. In 2016 it was 29% (EU – 40%). The problem is not only in collection but also in tax base - low direct income taxes, low capital and property taxes, no ecological taxes. IMF requires to increase tax progressivity by one step (now maximum 15+9%). Now lowest tax burden is for highest incomes.

Challenge – low innovation and labour productivity

- In EU expenditure on R&D to GDP in 2016 - **2.0%** and a target for 2020 is 3%, in Lithuania - **0.74% (in 2006- 0.79)** (in Sweden – 3.25, Austria – 3,09, but Latvia – 0.44, Romania – 0,48);
- Low expenditure – an obstacle for development of new products and technologies; no up in value chain;
- According to WB data high-tech export from Lithuania - **12.0%** of total exports (average in the world -**19.2%**, Ireland – 30%, Malta -21%).
- Lithuania is 40th in Global Innovation Index 2017. In EU Innovation Scoreboard Lithuania is moderate innovator but during last few years improved position. Now performance is above EU average but lag in sales, employment, intellectual assets.
- Low share of R&D in business sector – **36%** (lower only in Cyprus – 33%, when in the large number of countries – more than 70% (Slovenia is best with 76%).

Challenge – low innovation and labour productivity

- Since 2013 productivity growth is slow and *has stopped catching up with more advanced countries*
- Obstacle – low investment. In 2016, gross fixed capital formation to GDP in Lithuania- **18.8%**, significantly below Estonia - 23.7%, Czech Republic - 25.2%, EU average – 20.1%.
- Labour productivity (Gross value added) per hour worked in 2016 was **€13.6**, increasing at constant prices in comparison to 2013 – **€13.3**. The highest in real estate **€35**, ITT **€24**, the lowest in agriculture – **€5.6**.
- In 2016 productivity was 62.4% to EU28, similar to Estonia, Hungary but higher than Latvia and Romania or especially to Bulgaria (44.7%).
- This demonstrates that the Lithuanian industries are producing predominantly **low value added products** and services and can compete only with similar products produced in China etc.

Challenge – backward economic structure

- Productivity is low as share of low value added production is high. Here is an urgent need to modernise economic structures.
- Economy is based on traditional **low or medium value added industries** – furniture, food, textile, chemical etc. The competitiveness was secured mainly by low labour costs.
- In the future companies will not secure growth with low salaries. To pay higher wages the companies are forced to **produce higher value-added products**, so as to ensure that unit labour costs do not increase.
- **Technological modernisation** is the only way for companies to compete in export markets. Low wage rates do not offer a sustainable future. It is necessary to shift production to high value added products.
- In 2018, 21% of state budget revenues - EU support. What will be after 2020 if this support will be substantially reduced?

Challenge – emigration

- During 2005-16 annual decrease of population was around 30.000, population is declining about 1% annually . Since independence Lithuania **lost ¼ of its population** .
- Emigration results in a decrease of labour supply and has a negative impact on **production output**. Decreasing labour supply discourages **FDI**.
- In some countries in Eastern Europe emigration shaved 0.6-0.9 percentage points from annual GDP growth in 1999-2014 (IMF).
- Emigration, coupled with an aging population will negatively affect the **sustainability of the pension system, health care and education**.
- In result of emigration numbers of **students** are decreasing. This calls for the merging of educational institutions in order to optimise the number of students per school.
- Two options: Higher productivity or attraction of labour from abroad. But import of foreign workers creates severe social problems.

Conclusions

- CEE countries which launched reforms earlier achieved better results.
- Lithuania got stuck in the **middle income trap**.
- Increase in wages and salaries boosts local demand but reduces export competitiveness. **Cheap labour** creates problems with emigration and labour motivation.
- When **government revenues** are low so are wages in the public sector, pensions and social benefits. In result – high inequality and poverty.
- Low level of **expenditure on R&D** restrains the development of new products and technologies and does not allow to move value chain up. Hopefully, a strategy to make Lithuania a Fintech and blockchain hub will be successful.
- The **labour productivity** per hour worked is low because companies are producing low value added products. More investments in new products and technologies are required.
- **Emigration**, coupled with aging population, negatively affects pension system, health care and education.
- The shortage of labour requires more attention to the **sustainability of public finance and economic growth**.

Thank You

