The Lithuanian Economy

Is the Lithuanian manufacturing sector losing steam?

- Some industries are winning, some are losing
- Export performance – a mixed picture
- Sustaining competitiveness is becoming challenging

Some industries are winning, some are losing
In the second quarter of this year, manufacturing growth numbers suddenly turned negative, raising questions of whether the Lithuanian manufacturing sector is losing steam. It is probably still too early to wave the red flag - the main reasons behind the decline were related to the difficulties facing some specific sectors, as well as some one-offs. However, recent trends indicate that a part of the manufacturing sector could actually be losing competitiveness.

Export performance – a mixed picture
Export performance in the first half of this year was negatively affected by competitiveness issues in some industries, as well as shrinking export prices. Although confidence indicators suggest that export growth should recover going forward, there is not much room for optimism. The dairy industry is having a hard time returning to the growth path, but the opening up of the Chinese market could deliver a much-needed boost. Exports of goods of Lithuanian origin were growing most rapidly to the UK, the Scandinavian countries, the US, Japan, the UAE, and Saudi Arabia, but exports to Germany and some other EU countries as well as the CIS countries were disappointing.

Sustaining competitiveness is becoming challenging
The Lithuanian companies’ assessment of their competitive position inside the EU and in non-EU markets declined in the second quarter of this year. Price competitiveness was negatively affected by an appreciation of the real effective exchange rate. Meanwhile, rapidly rising unit labour costs (ULCs) are starting to cause a headache to Lithuanian producers. Limiting ULC growth and maintaining the competitiveness of Lithuanian exports require actions from both sides – the manufacturers and the government.
Is the Lithuanian manufacturing sector losing steam?

Manufacturing and export performance deteriorated in the second quarter of this year, raising the question of whether the Lithuanian manufacturing sector is losing steam. However, it is still too early to wave the red flag, as the woes of some industries were largely responsible for the poor overall performance of the sector. Nevertheless, growth is becoming more uneven across different industries – some are struggling to grow, while others seem to be booming.

Some industries are winning, some are losing

In recent years, the Lithuanian manufacturing sector has been demonstrating surprising resilience in the face of the economic woes of its trading partners, as well as of the geopolitical tensions in some of its export markets. The recessions in Russia and Ukraine and the Russian ban on the imports of food products from the EU, combined with sluggish economic growth in the EU, have posed challenges to some industries, but manufacturing as a whole has been demonstrating steady growth since the end of 2014. However, in the second quarter of this year, manufacturing growth numbers suddenly turned negative. In annual terms, manufacturing output declined by 0.7%--the worst performance since the beginning of 2014. Meanwhile, in April – June, the seasonally adjusted industrial confidence indicator also dropped to the lowest level since August of last year. Could this recent decline be a sign that the Lithuanian manufacturing sector is losing steam?

Main drag came from refined oil products and some one-offs

It is probably still too early to wave the red flag - the main reasons behind the decline were related to the difficulties facing some sectors, as well as some one-offs. The contraction in manufacturing output in the second quarter was almost entirely caused by a 17% decline (in annual terms) in production of refined petroleum products. The decline was related to the temporary maintenance shutdown of part of the Orlen Lietuva production facility, as well as to renewed competitiveness issues resulting from squeezed downstream margins of refined petroleum products in the world market. The company produces around 20% of Lithuania’s total manufacturing output; thus, even minor changes in its production have a large impact on aggregate manufacturing results.

Production of tobacco products was affected by the new EU regulations

Manufacturing output, excluding the production of refined petroleum, continued to grow in the second quarter, albeit at a somewhat slower pace - growth decelerated marginally from 5% in the first quarter to 4.6% in the second quarter. This was mostly due to a decline of production in a few sectors, e.g., manufacturing of tobacco products, other transport equipment, and pharmaceutical products, as well as the repair and installation of machinery and equipment. The decline in production of tobacco products is most likely temporary and related to the new EU regulations regarding the packaging of tobacco products – as soon as...
the tobacco products in old packages leave the warehouses, production should recover. Meanwhile, the production of pharmaceutical products tends to be highly volatile; thus, the recent decline in output should not be seen as a sign of deeper underlying problems.

Manufacturers of food products are having hard time returning to growth path

However, the shine of some other former manufacturing stars seems to be fading. Manufacturers of food products are having a hard time returning to the growth path they enjoyed before the highly profitable Russian market slammed its doors. In the first half of this year, the food industry increased its output by only 1%, compared with the same period a year ago. The capacity utilisation rate in the food industry, which declined to its lowest level in three years in July, also indicates the industry's struggles. However, given the highly positive export expectations in July by the manufacturers of food products, this industry may still surprise on the upside.

Normalisation of relationship with Russia could be a game changer

An important wild card is Russia – normalisation of the economic relationship between it and the EU could be a game changer for food manufacturers and some other sectors. The Russian economy is emerging from recession, but the two-way trade restrictions may be lifted only sometime next year at the earliest. Food manufacturers have been slow to replace the lost Russian market with less profitable yet more stable markets (see graph below).

Some other industries are also losing momentum

Manufacturing growth in some other industries has also lost momentum. Annual growth of furniture manufacturing decelerated from double digits in previous years to just 1.4% in the first half of this year. Similarly, annual growth of machinery and equipment manufacturing decelerated from double digits in previous quarters to 3.3% in the second quarter of this year. It is still too early to say whether this is just a temporary slowdown or not, but we cannot rule out that a part of the manufacturing sector is actually losing some competitiveness.

Some industries are shining bright

Nevertheless, some industries were shining bright and continued expanding at an accelerated pace. In the second quarter of this year, manufacturing of motor vehicles, trailers and semi-trailers was over one-third higher than a year ago, and that of textiles expanded by one-fourth; meanwhile, that of beverages as well as that of computer, electronic, and optical products expanded by one-fifth, in annual terms. Annual growth in the output of wood, of fabricated metal products, and of other non-metallic mineral products, as well as that of rubber and plastic products, accelerated to over 10% in the second quarter of this year. Thus, while some industries may be finding it harder to enter new markets and continue expanding at an accelerated pace, others, on the contrary, seem to be growing rapidly.

Export performance – a mixed picture

Exports of mineral fuels, fertilisers, and dairy products are declining

Second-quarter export numbers were in line with those of the manufacturing sector – in nominal terms, annual growth of exports of Lithuanian-origin goods contracted by 6.4%, which was the worst result since the start of 2014. As already outlined above, shrinking exports of mineral fuels were the most to blame for that. In addition, declining nominal exports of fertilisers, as well of dairy products, contributed negatively to growth. Exports, excluding mineral products and fertilisers, expanded by 6% in the second quarter, compared with the same period last year. However, it is worthwhile noting that the deterioration of the export growth numbers in the second quarter was largely caused by very poor export performance in June. However, confidence indicators suggest that this could have been just a temporary slowdown and export growth may pick up going forward.

Shrinking export prices is one of the culprits

Not only competitiveness issues are to blame for the woes of the aforementioned manufacturing sectors, but also shrinking export prices. For instance, during the first five months of this year, the prices of exported refined mineral fuels were almost one-third lower and those of chemicals and chemical products almost 9% lower than during the same period a year ago. Even the prices of food products were somewhat lower this year, compared with the previous year. In real terms, the decline in exports was most likely moderate or not even a decline at all, in the second quarter of this year.

1 Read more about the Tobacco Products Directive that became applicable on 20 May 2016: http://ec.europa.eu/health/tobacco/products/revision/index_en.htm
Agricultural production is the main driver of export growth

Nevertheless, so far there are not too many reasons to be extremely optimistic about the export performance of Lithuanian manufacturers. Although some manufacturers, such as those of optical and medical equipment, and machinery and equipment, as well as furniture, continued increasing their exports, it was not manufactured products that were the main driver of export growth in the first half of this year, but agricultural production, thanks to exports of grain almost 90% higher than last year. However, the grain effect might start fading towards the second half of this year, and, if the situation in the refined oil and fertiliser markets does not improve, or new drivers of export growth do not emerge, we might continue to see disappointing export trends.

The dairy industry is still bleeding, but there is a ray of hope

Moreover, the dairy industry still seems to be bleeding. Exports continue declining not only to CIS countries, but also to the EU countries - due to the Russian embargo of food products, there is an oversupply of dairy products in the European market. Nor is entering new markets an easy task – more is being exported to Saudi Arabia\(^2\) and the US, as well as to South Korea, but in insufficient amounts to compensate for the losses in the aforementioned markets. But there is a ray of hope – the opening up of the Chinese market, expected already this year, could give a much-needed boost to the exports of dairy products.

Ongoing shifts in the export markets

The first half of this year also revealed ongoing shifts in the export markets for Lithuanian goods (see graph above). Surprisingly, exports of goods to Germany, excluding the highly volatile exports of refined oil products and fertilisers, contracted. The main categories that contributed most to the decline were fish and dairy products, plastic and rubber products, vehicles, and tobacco products.

Exports to UK have been growing rapidly, but uncertainty after Brexit vote looms

Regarding the European market, growth of exports was most rapid to the UK, where an annual growth of over 20% was reached, as well as to the Scandinavian countries - Finland, Sweden, and Norway. However, the period of double-digit export growth rates in the UK market enjoyed by the Lithuanian manufacturers of wood, machinery and equipment, optical

---

2 Saudi Arabia has become one of the largest export markets for Lithuanian dairy products. In the second quarter of 2016, almost 9.5% of such exports went to that country. Other large markets include Italy, Poland, and Latvia.
and medical instruments, furniture, and plastic and rubber products, as well as fish products, might as well already be over. Given the depreciation of the UK pound and the UK’s worsening economic growth prospects for this year and the next following the Brexit vote, Lithuanian exporters might have to face lower profitability in, and less rapid export growth to, the British market.

![Chart: Contribution to annual growth of exports of goods* in 1H 2016, pp]

**Non-EU and non-CIS markets contributed most to growth**

Interestingly, the largest positive contribution to export growth came not from European or CIS markets, but from other markets, such as Japan, the US, the UAE, and Saudi Arabia. Higher exports of grain are to a large extent responsible for the last two. Meanwhile, in the first half of this year, exports to Japan tripled. This was almost entirely due to higher exports of tobacco products - however, not because a new export market was attained, but most likely due to a shift in production of Philip Morris cigarettes from other parts of the world to the plant in Lithuania.

Meanwhile, the US was one of the few markets where Lithuanian producers of refined mineral fuels and fertilisers expanded their nominal exports in the second quarter, in annual terms. The US was also a friendly market for Lithuanian exports of nonorganic chemicals, pharmaceuticals, wood and wood products, machinery and mechanical equipment, and electric machinery and equipment. Given the accelerating economic growth in the US next year and possible strengthening of the US dollar due to diverging monetary policies, this market could still have a lot of potential for Lithuanian exporters. The signing of the Transatlantic Trade and Investment Partnership between the US and the EU would highly benefit Lithuanian producers. However, given the general dissatisfaction with such trade agreements among voters, this is unlikely to be confirmed anytime soon.

**Broad-based export growth to the US - potentially still an underexploited market**

**Assessment of competitive position by Lithuanian manufacturers deteriorated in second quarter**

**Price competitiveness has worsened**

Sustaining competitiveness is becoming challenging

The Lithuanian companies’ assessment of their competitive position inside the EU and non-EU markets, as well as their export expectations (see graph on the next page), declined in the second quarter of this year, in line with the rather weak production and export numbers. However, companies’ expectations regarding exports, as well as the evaluation of their competitive position, improved at the start of the third quarter, indicating that export growth may pick up in the second half of the year.

One of the reasons for the worsened assessment of the competitive position outside the EU could have been related to the deterioration of the price competitiveness of Lithuanian producers. The real effective exchange rate (REER) has appreciated by 4.5% since its low in April 2015, meaning that Lithuanian goods have become more expensive than its competitors’. However, the situation has improved somewhat since the beginning of this year.
In addition to deteriorating price competitiveness, maintaining cost competitiveness is becoming a headache, too. The lack of labour identified by manufacturers as a factor limiting production has been picking up: in July the indicator reached the highest level since 2008 (see graph below). Due to the lack of a qualified labour force and increasing competition for it as well as increases in the minimum monthly wage, wage growth has been already exceeding that of productivity - this has led to rising unit labour costs (ULCs).

Over the last two years, the increases in the ULCs in the manufacturing sector have been extremely steep (see graph above). In the first quarter of this year, ULCs in manufacturing were 18% higher than those in 2010 and only 3.7% behind those in 2008. In order to limit ULC growth and maintain the competitiveness of Lithuanian exports, companies need to increase productivity through innovation and investment, as well as move up the value chain.\(^3\) Meanwhile, the government should keep the rise of labour costs under control by loosening labour market regulations and abstaining from unsustainable increases in the minimum monthly wage.

Laura Galdikienė

---

\(^3\) Read more on innovation: [http://www.swedbank-research.com/english/lithuanian_economy/2016/june20/newsletter_innovation_most_room_for_progress.pdf](http://www.swedbank-research.com/english/lithuanian_economy/2016/june20/newsletter_innovation_most_room_for_progress.pdf)
Macro Research - The Lithuanian Economy

General disclaimer

This research report has been prepared by analysts of Swedbank Large Corporates & Institutions’ Macro Research department. The Macro Research department consists of research units in Estonia, Latvia, Lithuania, Norway and Sweden, and is responsible for preparing reports on global and home market economic developments.

Analyst’s certification

The analyst(s) responsible for the content of this report hereby confirm that notwithstanding the existence of any such potential conflicts of interest referred to herein, the views expressed in this report accurately reflect their personal and professional views.

Research reports are independent and based solely on publicly available information.

Issuer, distribution & recipients

This report by Swedbank Large Corporates & Institutions Macro Research department is issued by the Swedbank Large Corporates & Institutions business area within Swedbank AB (publ) (“Swedbank”). Swedbank is under the supervision of the Swedish Financial Supervisory Authority (Finansinspektionen).

In no instance is this report altered by the distributor before distribution.

In Finland this report is distributed by Swedbank’s branch in Helsinki, which is under the supervision of the Finnish Financial Supervisory Authority (Finanstilsynet).

In Norway this report is distributed by Swedbank’s branch in Oslo, which is under the supervision of the Financial Supervisory Authority of Norway (Finanstilsynet).

In Estonia this report is distributed by Swedbank AS, which is under the supervision of the Estonian Financial Supervisory Authority (Finantseisije).

In Lithuania this report is distributed by “Swedbank” AB, which is under the supervision of the Central Bank of the Republic of Lithuania (Lietuvos bankas).

In Latvia this report is distributed by Swedbank AS, which is under the supervision of The Financial and Capital Market Commission (Finanšu un kapitala tīrīgus komisija).

In the United States this report is distributed by Swedbank First Securities LLC (“Swedbank First”), which accepts responsibility for its contents. This report is for distribution only to institutional investors. Any United States institutional investor receiving the report, who wishes to effect a transaction in any security based on the view in this document, should do so only through Swedbank First. Swedbank First is a U.S. brer-dealer, registered with the Securities and Exchange Commission, and is a member of the Financial Industry Regulatory Authority. Swedbank First is part of Swedbank Group.

For important U.S. disclosures, please reference: http://www.swedbankfks.com/disclaimer/index.htm

In the United Kingdom this communication is for distribution only to and directed only at “relevant persons”. This communication must not be acted on – or relied on – by persons who are not “relevant persons”. Any investment or investment activity to which this document relates is available only to “relevant persons” and will be engaged in only with “relevant persons”. By “relevant persons” we mean persons who:

- Have professional experience in matters relating to investments falling within Article 19(5) of the Financial Promotions Order.

- Are persons falling within Article 49(2)(a) to (d) of the Financial Promotion Order (“high net worth companies, unincorporated associations etc”).

- Are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) – in connection with the issue or sale of any securities – may otherwise lawfully be communicated or caused to be communicated.

Limitation of liability

All information, including statements of fact, contained in this research report has been obtained and compiled in good faith from sources believed to be reliable. However, no representation or warranty, express or implied, is made by Swedbank with respect to the completeness or accuracy of its contents, and it is not to be relied upon as authoritative and should not be taken in substitution for the exercise of reasoned, independent judgment by you.

Opinions contained in the report represent the analyst's present opinion only and may be subject to change. In the event that the analyst's opinion should change or a new analyst with a different opinion becomes responsible for our coverage, we shall endeavour (but do not undertake) to disseminate any such change, within the constraints of any regulations, applicable laws, internal procedures within Swedbank, or other circumstances.

Swedbank is not advising nor soliciting any action based upon this report. This report is not, and should not be construed as, an offer to sell or as a solicitation of an offer to buy any securities.

To the extent permitted by applicable law, no liability whatsoever is accepted by Swedbank for any direct or consequential loss arising from the use of this report.

Reproduction & dissemination

This material may not be reproduced without permission from Swedbank Large Corporates & Institutions. This report is not intended for physical or legal persons who are citizens of, or have domicile in, a country in which dissemination is not permitted according to applicable legislation or other decisions.

Produced by Swedbank Large Corporates & Institutions.

Address
Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Landsvägen 42, Sundbyberg