

# Macro focus

Macro analysis – September 1, 2014

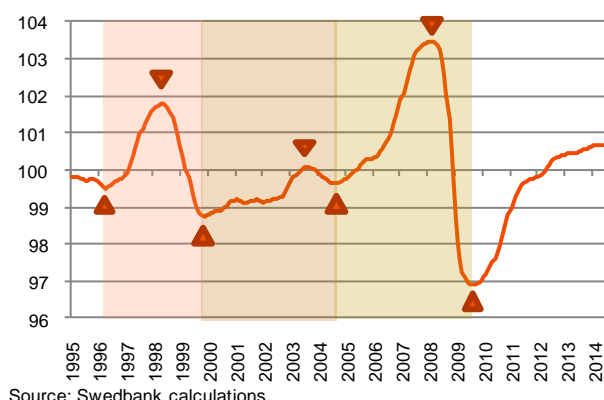
## Leading indicators are warning of a reversal in the business cycle in Lithuania

- The economy is still growing faster than normal
- CLI is signalling a turning point in the business cycle
- Somewhat slower growth is likely

### Lithuania's economy is still growing faster than normal

Every economy experiences fluctuations in economic activity over time. These fluctuations in economic activity around its long-run growth path are called business cycles. A business cycle has four components. First, the economy goes through a period of **recovery and expansion**, which is marked by a significant increase in total output, income, employment, and trade, as well as by a widespread expansion in many sectors of the economy. Next, the economic activity reaches its maximum level, or, in other words, its **peak**. After the peak follows the third component, a downtrend period, called a **contraction or a recession**. This period can be marked by either a significant decline in output, income, employment, and trade (a hard landing), or just recurring slow growth in these variables (a soft landing). Finally, the economic activity reaches its minimum level – a **trough**. After this point is reached, the story starts to repeat itself from the beginning, and the economy returns to a period of recovery and expansion.

Lithuania's business cycle  
(de-trended and smoothed GDP)



In our analysis, the business cycle is defined as the difference between smoothed GDP data and its long-term trend<sup>1</sup>. The movements in the de-trended and smoothed GDP series indicate that the Lithuanian economy went through three business cycles

<sup>1</sup> Trend estimation is based on the Hodrick-Prescott filter

over the period 1995-2014, as measured from trough to trough (see graph on the left).

Two of the business cycles were marked by recessions. In 1999, following the Russian crisis, the Lithuanian GDP contracted by 1.1%, and, in 2009, the economy declined by almost 15% as a result of the global financial crisis, large structural imbalances in the economy, and the bursting of the real estate bubble. Another business cycle between these two went largely unnoticed, because it was not marked by a recession, but just by somewhat slower economic growth.

At the end of 2009, the lowest turning point (trough) of the most recent business cycle was reached; this marked the beginning of a new business cycle and the start of the recovery. Currently, the Lithuanian economy is in the expansion phase (the GDP series is increasing and above 100), and output is growing faster than normal, as indicated by the upward-sloping curve of the business cycle. However, some changes to this trend are likely in the near future.

### Economic growth might soon fall below its long-term potential

We have constructed a new tool, called the composite leading indicator (CLI), for the Lithuanian economy. The CLI can provide early signals of the turning points (peaks and troughs) in the country's economic activity. It is composed of economic indicators, whose movements are similar to those of the business cycle, but which anticipate turning points months before they happen.

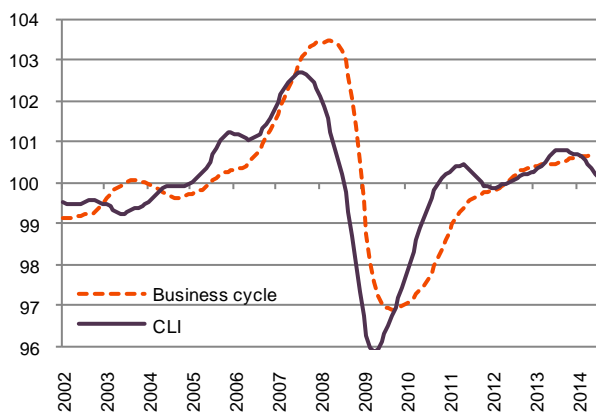
The CLI contains 11 monthly component series:

- Share prices -- OMX Vilnius,
- Registered job vacancies, seasonally adjusted (sa),
- Imports of durables, sa,
- Retail sale of computers, software, etc., sa,
- Apartment sales (number of deals),
- HICP, all items (inverted),
- Share of fixed-term deposits in M2 money supply (inverted),
- Industry - production expectations, sa,
- Industry - production capacity utilisation,
- Services - demand expectations, sa, and
- Consumer confidence indicator.

The CLI series starts only in 2002 since not all the component series are available prior to that year; thus, it is impossible to check the performance of the CLI in predicting the turning points of the 1996-1999 business cycle. However, if we had the

CLI in 2007 it would have warned us about the peak of the business cycle, which was followed by a recession, nine months before the actual change in economic activity started. Similarly, the CLI would have provided an early indication that the first signs of recovery were arriving five months before the recovery became apparent in the business cycle indicator.

**Business cycle and the CLI**



Source: Swedbank calculations

The CLI series is again signalling a turning point in the business cycle. The CLI peaked one year ago and has been sloping downwards ever since. The main factors behind this downturn have been worsening consumer confidence and business expectations, and downward slopes in sales of apartments and registered job vacancies (all de-trended and smoothed). Much of this downturn in the CLI is caused by increased uncertainty and likelihood of an external shock – an escalation in the Russia-Ukraine crisis.

Although the business cycle is still moving upwards, it is possible that it will soon follow the path indicated earlier by the CLI. A downward-trending business cycle indicator would mark slower growth or – in more serious cases – a recession. However, in the absence of an external shock a recession in Lithuania is still very unlikely, as the economy is much healthier than it was in 2008 – there is neither a trade nor a current account deficit, the structural budget deficit is smaller, and the private sector is enjoying record savings, has deleveraged significantly, and has one of the lowest debt ratios in the EU. Also, the banking sector is well capitalised.

We do not expect that the reversal in the business cycle will lead to a recession (a hard landing) this time. Instead, given current geopolitical tensions, the food product embargo imposed by Russia, and other possible future sanctions, as well as the slower-than-expected growth of the main trading partners, somewhat slower economic growth is likely, at least until the middle of 2015 (a soft landing).

Swedbank has recently lowered its GDP growth forecasts for Lithuania for this year and the next. We expect that output will increase by 3% this year, before accelerating to 3.5% in 2015 and to 3.8% in 2016. Despite this somewhat slower growth, Lithuania will remain one of the fastest-growing economies in the EU.

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