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Latvia
Out of the crisis - into the euro?

For the whole year 2011, we expect the Latvian GDP to grow by 3.6% in real terms. Gross fixed investment, especially in industrial sectors, as well as the process of restocking are expected to act as the main growth drivers this year. The financial situation of indebted households and high unemployment will allow private consumption to increase only slightly, while the government's consolidation measures will further reduce public consumption. Although the current account will still remain positive in 2011, net trade will contribute negatively to overall economic activity. In the years 2012 and 2013, GDP growth is likely to pick up further to 3.8% and 4% respectively, mainly thanks to the ongoing revival of capital investments. A slight amelioration of the labour market situation and some revival of real incomes should allow households to expand consumption henceforward more swiftly again.

After gross fixed capital investment still declined substantially throughout 2010, the first quarter of 2011 witnessed a strong revival of investments (+28% year on year in real terms). This was particularly driven by expenditures on machinery and equipment of public utilities and the transport sector. However, the growth of capital investments is likely to be somewhat lower on average in 2011, as bank loans to the private sector are still on the decline. Household consumption continued to grow more strongly than expected in the first quarter of 2011, increasing by 3.6% year on year in real terms. But, due to rising consumer prices, real wages continue to be restrained and the share of non-performing loans still amounted to almost 20% in the first quarter of 2011.

Latvian exports also performed strongly in the first quarter of 2011, rising by more than 40% year on year in nominal terms. But the rise in domestic demand also triggered a renewed increase in imports of goods and services. Thus, net trade – after providing a positive stimulus to GDP growth during the past three years when domestic demand was deeply depressed – is contributing negatively to GDP growth in 2011 and thereafter. The still eminent weakness of Latvia's tradable goods sector can also be indentified when comparing trade figures and industry performance. Although exports developed quite strongly (in nominal terms), the real growth of industrial production, at only 11% year on year, remained relatively low in the first quarter.

As in other CESEEs, also in Latvia the rising prices of imported food and energy caused inflation to resurge to 3.8% in the first quarter of 2011. Due to the tax hikes adopted in order to accomplish fiscal consolidation, consumer prices are to increase further throughout 2011, although with 4.5% annually still quite moderately. In the following two years price increases should abate somewhat, since the government intends to refrain from further consolidation measures on the revenue side. Moreover, the tight situation on the labour market will keep wages restrained for a longer period. The economic recovery has not resulted in a significant revival of employment yet. Particularly jobs in industry still declined slightly. The unemployment rate fell only somewhat, to 16.6% in the first quarter of 2011. Given the strict consolidation path pursued by the Latvian government, the situation on the labour market will improve only gradually, and the unemployment rate will still exceed 12% on average in 2013.

In April 2011 the parliament approved amendments to the 2011 budget law in order to accelerate fiscal consolidation. The adopted austerity measures include further tax hikes on excises and natural gas for final consumers. The reduction of maternity leave and sickness benefits that were introduced as one-off measures in the course of the economic crisis will be extended until the end of 2014. With those measures introduced, the Latvian government expects to reduce the budget deficit to 4.2% of GDP in 2011 and further to 2.5% in 2012, which could enable the country to join the eurozone at the beginning of 2014 as intended. Nevertheless, inflationary developments may hamper the achievement of that goal. In May 2011 the IMF and the EU Commission approved the next tranche of their rescue package. The Latvian authorities however do not intend to draw on the amount but re-entered the international capital market by successfully placing a USD 500 million ten-year bond at a rate of 5.25%.

On 23 July the Latvian electorate are called to a referendum on the dissolution of the parliament which was initiated at the end of May by President Valdis Zatlers after lawmakers had blocked an anti-corruption investigation against Ainars Slesers, the head of the pro-business opposition party ‘For a Good Latvia’. In June the parliament refused Zatlers a second term as president of Latvia, but opted for Andris Berzins, a former banker, to become his successor. Nevertheless, in the upcoming referendum Latvians will most probably vote for early parliamentary elections in September. It is expected that Prime Minister Dombrovski will again be backed by the electorate as was the case in last year’s vote. Therefore no substantial changes are to be awaited concerning fiscal and economic policies in the medium term.

For the whole year 2011, we expect the Latvian GDP to grow by 3.6% in real terms, after three years of decline by more than 20% cumulatively. Gross fixed investment, especially in industrial sectors, as well as the process of restocking are expected to act as the main growth drivers this year. The financial situation of indebted households and high unemployment will allow private consumption to increase only slightly, while the government's consolidation measures will further reduce public consumption. Although the current account will still remain positive in 2011, net trade will contribute negatively to overall economic activity. In the years 2012 and 2013, GDP growth is likely to pick up further to 3.8% and 4% respectively in real terms, mainly thanks to the ongoing revival of capital investments. A slight amelioration of the labour market situation and some revival of real incomes should allow households to expand consumption more swiftly again.

Table LV

Latvia: Selected Economic Indicators

	2007	2008	2009	2010 [1]	2010	2011	2011	2012	2013
					1st quarter			Forecast	
Population, th pers., average	2276.1	2266.1	2254.8	2235.0	.	.	2220	2210	2200
Gross domestic product, LVL mn, nom.	14779.8	16188.2	13082.8	12735.9	2852.8	3070.9	13800	14800	16000
annual change in % (real)	10.0	-4.2	-18.0	-0.3	-6.1	3.5	3.6	3.8	4
GDP/capita (EUR at exchange rate)	9300	10200	8200	8000	.	.	.	.	.
GDP/capita (EUR at PPP)	13900	14100	12200	12600	.	.	.	.	.
Consumption of households, LVL mn, nom.	9087.1	10052.4	7941.2	7908.0	1870.0	2019.3	.	.	.
annual change in % (real)	14.9	-5.3	-24.1	-0.1	-6.2	3.6	2.2	2.2	2.5
Gross fixed capital form., LVL mn, nom.	4975.1	4748.5	2806.8	2286.3	339.5	449.4	.	.	.
annual change in % (real)	7.5	-13.5	-37.3	-19.5	-44.4	28.4	14	11	11.5
Gross industrial production [2]									
annual change in % (real)	1.1	-3.2	-18.1	14.9	5.5	10.7	13	10	8
Gross agricultural production									
annual change in % (real)	10.8	0.2	-0.7	-3.6	.	.	.	.	.
Construction industry									
annual change in % (real)	13.6	-3.1	-34.9	-23.4	-43.4	-15.1	.	.	.
Employed persons - LFS, th, average	1118.0	1124.5	983.1	945.0	916.1	944.3	970	1010	1040
annual change in %	2.8	0.6	-12.6	-3.9	-12.5	3.1	3	4	3
Unemployed persons - LFS, th, average	71.3	90.5	203.2	215.0	235.8	188.3	.	.	.
Unemployment rate - LFS, in %, average	6.0	7.5	17.1	18.7	20.5	16.6	15.5	14	12.5
Reg. unemployment rate, in %, end of period	4.9	7.0	16.0	14.3	17.3	14.4	.	.	.
Average gross monthly wages, LVL	398	479	461	445	432	452	.	.	.
annual change in % (real, net)	19.9	6.2	-5.6	-6.5	-9.0	0.2	.	.	.
Consumer prices (HICP), % p.a.	10.1	15.2	3.3	-1.2	-3.9	3.8	4.5	3.5	4
Producer prices in industry, % p.a.	16.1	11.4	-4.6	2.8	-4.8	8.2	.	.	.
General government budget, EU-def., % GDP									
Revenues	35.4	34.6	34.6	35.2	.	.	36.7	36.5	37.0
Expenditures	35.8	38.8	44.2	42.9	.	.	41.5	40.4	39.0
Net lending (+) / net borrowing (-)	-0.3	-4.2	-9.6	-7.6	.	.	-4.8	-3.5	-2.0
Public debt, EU-def., in % of GDP	9.0	19.7	36.7	44.7	.	.	48.5	49.5	49.0
Central bank policy rate, % p.a., end of period [3]	6.0	6.0	4.0	3.5	3.5	3.5	.	.	.
Current account, EUR mn	-4710	-3014	1598	643	351	52	100	-300	-600
Current account in % of GDP	-22.3	-13.1	8.6	3.6	8.7	1.2	0.5	-1.4	-2.7
Exports of goods, BOP, EUR mn	6020	6531	5253	6728	1374	1924	8700	10400	12600
annual growth rate in %	22.1	8.5	-19.6	28.1	15.1	40.1	29	20	21
Imports of goods, BOP, EUR mn	11074	10603	6575	7884	1647	2227	9900	11900	14500
annual growth rate in %	22.6	-4.3	-38.0	19.9	-2.1	35.2	26	20	22
Exports of services, BOP, EUR mn	2707	3088	2747	2773	615	648	2900	3200	3600
annual growth rate in %	27.6	14.1	-11.0	0.9	-9.7	5.5	5	10	13
Imports of services, BOP, EUR mn	1974	2169	1625	1660	356	390	1800	2000	2300
annual growth rate in %	24.5	9.9	-25.1	2.2	-8.6	9.5	8	11	15
FDI inflow, EUR mn	1705	869	68	260	-104	238	500	.	.
FDI outflow, EUR mn	270	169	-44	12	45	-25	.	.	.
Gross reserves of NB excl. gold, EUR mn	3860	3514	4572	5472	5321	4997	.	.	.
Gross external debt, EUR mn	26835	29763	29097	29940	29175	29243	.	.	.
Gross external debt in % of GDP	127.1	129.2	157.0	166.6	162.3	150.2	.	.	.
Average exchange rate LVL/EUR	0.7001	0.7027	0.7057	0.7087	0.7083	0.7048	0.71	0.71	0.71
Purchasing power parity LVL/EUR	0.4663	0.5057	0.4764	0.4513	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.
1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) Refinancing rate of National Bank.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.