

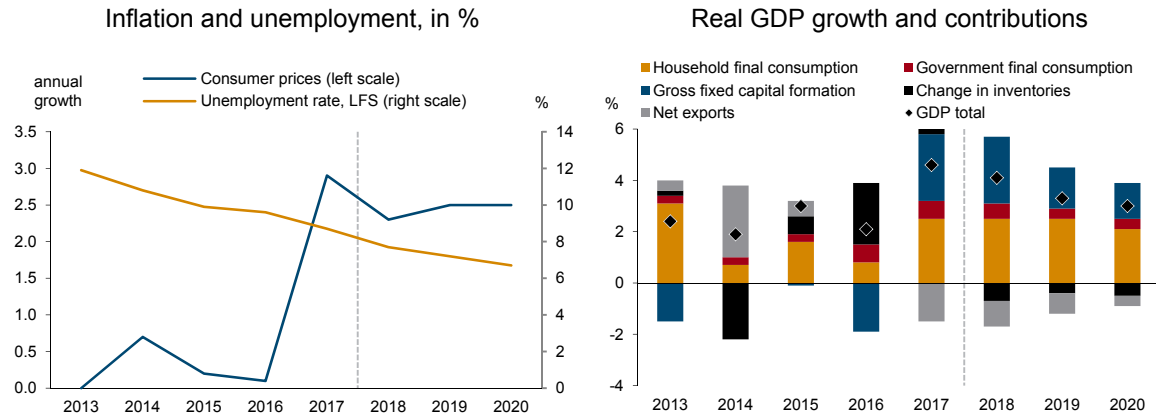


## LATVIA: Construction pushes growth but some slowdown ahead

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Both public and private investment have kept the economy growing at a high pace in 2018 and exports evolved more strongly than expected. Household consumption is also rising rapidly; a tightening labour market and the 2018 income tax reform will provide further stimulus. While public spending is likely to expand quickly, we assume external demand growth to abate gradually. In 2018 we expect another year with high GDP growth of 4.1%, followed by a slight slowdown to 3.3% in 2019 and 2.7% in 2020.

Figure 46 / Latvia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**After a strong upturn in external trade last year, export growth subsided only slightly in 2018.** Growth in exports to Western Europe abated in general, but remained high to Sweden and Russia. The most important export sectors, wood and food, as well as metals and machinery, have reported good growth figures. So far, Latvian producers have been able to maintain their shares in the world market. However, their external competitive position is under pressure, given sustained wage growth. Low growth rates in industry, despite increasing household consumption, show the mounting problem in the manufacturing sector. Although capital investment and household consumption are rising strongly, real growth in imports declined. As a result, the current account surplus will increase this year. However, in 2019-2020 we expect net exports to become more negative, in line with a cooling of external demand activity.

**Gross fixed capital investment continues to grow at a fast pace (+17.1% year on year in H1 2018).**

Fresh EU funds have started to become available on a larger scale and the government continues to invest – the Rail Baltica high-speed train project will result in higher public investment in 2019 and 2020. The current investment boom is largely confined to construction, while investment in machinery and equipment is almost stagnant. The number of building permits granted shows that a longer-term rise of construction activity is to be expected not only for infrastructure, but also for residential, office and other commercial buildings.

**Since Latvia's third largest bank, ABLV, was forced to initiate a shutdown of its operations due to allegations of institutionalised money laundering in February 2018, the Latvian banking sector has experienced a loss.** 11 banks were urged by the ECB to review their operations aimed at foreign customers. The turmoil resulted in a stronger decline of foreign deposits in the first quarter of 2018, but this then levelled off in the following months. The EU institutions pointed out that the Latvian government has to do more on anti-money laundering measures and the Latvian banks have to cut back their engagement in offshore banking services substantially.

**In the parliamentary elections that took place on 6 October, the centre-left 'Harmony Centre', which has a stronghold in the Russian-speaking minority, came first again (as in 2011 and 2014) with 23 of the 100 Saeima seats.** The liberal-conservative block of parties was completely rearranged, a phenomena that has happened quite often in Latvia in times of political scandals and turbulences. Only one of the three parties forming the previous coalition government, the populist right-wing 'National Alliance' was able to hold their relative position, while 'Union of Farmers and Greens' of Prime Minister Kučinskis was halved and 'Unity', having been the main centre-right party for about 10 years, has almost completely lost its previous electorate to newcomers due to internal fights. These are the populist anti-establishment party 'Who owns the state?' – KPV (16 seats), the 'New Conservative Party' – JKP (16 seats) and the liberal 'Development/For!' (13 seats). Although KPV and JKP have not ruled out cooperation with 'Harmony' before the elections, the most probable outcome of the coalition talks is a centre-right government. We expect only minor changes in economic and fiscal policy from the incoming government. The medium-term budget strategy foresees substantial increases in family benefits and public health expenditure for the coming years. In the latter, they are currently the second lowest spender in the EU as a share of GDP after Cyprus. At the same time, however, the fiscal strategy foresees a reduction of the overall share of the government in GDP via gradual tax reductions.

**Job growth strongly gained momentum (+1.9% year on year in H1 2018), not only given the upswing in construction, but also in the trade and ICT sectors.** Employment rates are increasing strongly and are approaching the levels of Scandinavian countries, which are the frontrunners in the EU in this respect. We expect the unemployment rate to fall to 7.7% in 2018 on average and to further decline to about 7% by the end of the forecast period in 2020. However, regional disparities are strong: while in Riga full-employment is evident, in the old industrial regions bordering Russia the unemployment rate is 15%. In the longer term Latvia is likely to experience a major decline of the working-age population – Eurostat projections indicate that, without policy changes, the age group 15-64 could shrink by 20% compared to 2015 up to 2030. Thus, the effective pension age is likely to increase in the coming years. Moreover, depending on the composition of the new coalition, the incoming government may allow higher immigration to solve the problem of a shortage of skilled labour.

**Further tightening of the labour market resulted in strong growth of net wages, by 7.6% in the first half of 2018 year on year in real terms.** This is also an outcome of the strong increase in the minimum wage (+13%) that, inspired by the parliamentary elections, came into force in January 2018. In the coming years we expect slower but still substantial increases in household incomes. This will further

fuel household consumption which is projected to increase by about 4.2% in real terms this year. In the period 2019-2020 we expect some slowdown but consumption to still grow by 3.5% in 2020.

**Strong wage growth has not fed through into rising inflation yet.** On the contrary, low import prices have resulted in a decline in consumer price growth during 2018 so far. We expect the level of CPI inflation to remain at about 2.5% in 2019 and 2020.

**All in all, compared to our Summer Forecast we have become more optimistic, increasing our real GDP growth rate for this year to 4.1%.** Private investment activity and external demand have picked up more strongly than expected. The strong upswing in public investment, not only this year but also in 2019 and 2020, will be facilitated by increasing inflows of EU funds. Rising household incomes will help private consumption to keep on growing steadily. However, we see some cooling off in 2019 and 2020, particularly in external demand, thus we have revised our GDP growth forecasts slightly to 3.3% and 3% respectively.

**Table 21 / Latvia: Selected economic indicators**

	2014	2015	2016	2017 <sup>1)</sup>	2017 January-June	2018	2018 Forecast	2019 Forecast	2020
Population, th pers., average	1,994	1,978	1,960	1,950	1,942	1,926	1,930	1,920	1,915
Gross domestic product, EUR mn, nom.	23,618	24,320	25,038	27,033	12,666	13,755	28,800	30,500	32,200
annual change in % (real)	1.9	3.0	2.1	4.6	4.4	4.7	4.1	3.3	3.0
GDP/capita (EUR at PPP)	17,500	18,500	18,900	20,200	.	.	.	.	.
Consumption of households, EUR mn, nom.	14,178	14,393	14,751	15,842	7,597	8,141	.	.	.
annual change in % (real)	1.2	2.7	1.4	4.2	2.7	4.6	4.2	4.1	3.5
Gross fixed capital form., EUR mn, nom.	5,337	5,385	4,915	5,651	2,295	2,760	.	.	.
annual change in % (real)	0.1	-0.5	-8.4	13.1	13.9	17.1	13.0	8.0	7.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	-1.1	3.6	5.4	8.3	9.6	2.1	2.5	3.0	2.0
Gross agricultural production									
annual change in % (real)	4.5	14.0	-7.3	0.0	.	.	.	.	.
Construction industry									
annual change in % (real)	10.5	-0.6	-16.6	18.7	11.0	33.3	.	.	.
Employed persons, LFS, th, average	884.6	896.1	893.3	894.8	887.1	903.8	908	917	925
annual change in %	-1.0	1.3	-0.3	0.2	-0.8	1.9	1.5	1.0	0.9
Unemployed persons, LFS, th, average	107.6	98.2	95.3	85.4	89.0	77.7	76	71	66
Unemployment rate, LFS, in %, average	10.8	9.9	9.6	8.7	9.2	8.0	7.7	7.2	6.7
Reg. unemployment rate, in %, eop <sup>3)</sup>	8.5	8.7	8.4	6.8	7.2	6.4	.	.	.
Average monthly gross wages, EUR	765.0	818.0	859.0	926.0	905.3	982.5	1,000	1,070	1,140
annual change in % (real, gross)	6.2	6.7	4.9	4.5	4.6	6.2	6.0	4.5	4.0
Average monthly net wages, EUR	560.0	603.0	631.0	676.0	662.7	729.0	730	780	830
annual change in % (real, net)	8.0	7.4	4.3	3.8	3.8	7.6	6.0	4.5	4.0
Consumer prices (HICP), % p.a.	0.7	0.2	0.1	2.9	3.1	2.2	2.3	2.5	2.5
Producer prices in industry, % p.a.	0.4	-1.0	-2.5	2.5	1.7	3.5	3.5	2.8	2.5
General governm.budget, EU-def., % of GDP									
Revenues	36.6	36.9	37.0	37.3	.	.	36.0	35.7	35.6
Expenditures	38.1	38.2	37.0	37.8	.	.	36.8	36.4	36.1
Net lending (+) / net borrowing (-)	-1.5	-1.4	0.1	-0.5	.	.	-0.8	-0.7	-0.5
General gov.gross debt, EU def., % of GDP	40.9	36.8	40.3	39.9	.	.	36.0	34.5	34.0
Stock of loans of non-fin.private sector, % p.a.	-3.3	-2.8	0.1	-4.7	-0.1	-5.3	.	.	.
Non-performing loans (NPL), in %, eop	6.9	6.0	4.4	4.1	4.4	4.2	.	.	.
Central bank policy rate, % p.a., eop <sup>4)</sup>	0.05	0.05	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	-411	-113	403	191	87	236	529	299	169
Current account, % of GDP	-1.7	-0.5	1.6	0.7	0.7	1.7	1.8	1.0	0.5
Exports of goods, BOP, EUR mn	10,242	10,340	10,411	11,543	5,447	5,892	12,470	13,090	13,710
annual change in %	4.4	1.0	0.7	10.9	11.2	8.2	8.0	5.0	4.7
Imports of goods, BOP, EUR mn	12,621	12,538	12,296	13,851	6,623	6,959	14,540	15,500	16,360
annual change in %	1.5	-0.7	-1.9	12.6	13.3	5.1	5.0	6.6	5.5
Exports of services, BOP, EUR mn	4,105	4,356	4,606	4,973	2,375	2,519	5,300	5,610	5,870
annual change in %	5.3	6.1	5.7	8.0	6.2	6.1	6.6	5.8	4.6
Imports of services, BOP, EUR mn	2,066	2,279	2,432	2,641	1,233	1,338	2,860	3,060	3,210
annual change in %	-2.9	10.3	6.7	8.6	7.2	8.5	8.3	7.0	4.9
FDI liabilities, EUR mn	704	712	222	1,024	330	-42	0	.	.
FDI assets, EUR mn	409	134	199	499	214	-116	0	.	.
Gross reserves of NB excl. gold, EUR mn	2,448	2,957	3,100	3,620	3,113	3,629	.	.	.
Gross external debt, EUR mn	34,035	34,947	37,289	37,984	37,621	35,568	36,000	36,600	38,600
Gross external debt, % of GDP	144.1	143.7	148.9	140.5	139.2	123.5	125.0	120.0	120.0

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) Official refinancing operation rates for euro area (ECB).

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