



## LATVIA: Consumers in excellent mood

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**In the first year of Latvia's accession to the euro area we expect a slight upswing of economic growth to 4.2% driven by improving conditions in the main trading partners and rising investment in machinery and equipment. The government reshuffle at the beginning of this year will not result in a change of economic policies pursued so far. Also in 2015 and 2016 GDP growth will amount to about 4% since household consumption will be supported by strongly rising wages.**

Latvia's economy continued to grow at a surprisingly high pace of 4% in 2013. The strong increase of household consumption counterbalanced the weaknesses of external demand and investment activities. The decline in overall industrial production last year was strongly influenced by the insolvency of Liepajas metalurģs, the only metallurgical plant in the Baltics. Production was halted and the majority of employees laid off. Moreover, the avoidance of bankruptcy burdened the government deficit by 0.3% of GDP last year. A purchase agreement with a bidder is not to be expected before the summer term 2014.

Accordingly, trade developments were driven by the slump in the production of iron and steel and a decrease of the cereal harvest in 2013. By contrast, in other commodity groups, particularly in machinery and wood being the most important traded products, exports increased rather swiftly. However, trade developments were also negatively influenced by the abating demand developments in neighbouring Estonia and Russia. The decrease in industrial production, low investment and the decline in commodity prices, in particular of crude oil, resulted in a stagnation of nominal goods imports and thus still a positive contribution of net exports to GDP growth. In the first half of 2014 the negative impact of the halt in the production of Liepajas metalurģs will still influence overall export growth. Thereafter, we expect an upswing in goods trade driven by stronger demand developments in Estonia and West and North European trading partners.

Investments in machinery and equipment declined by almost 30% in the total economy and by even 40% in the manufacturing sector in the first three quarters of 2013. Apart from that, low overall export growth resulted in producers reducing their inventories. Construction activity continued to develop at a good pace driven by investment in new residential buildings and repair works. This is also due to the Latvian system of allocation of temporary residence permits to third-country citizens in exchange for real estate investments, which was introduced in 2010. At the same time Latvian households and non-financial enterprises are continuing to deleverage. While this process is expected to come to an end for the companies towards the end of this year, in the case of the households the amount of new loans is likely to surpass repayments and write-offs of non-performing loans not before 2016.

In November 2013 Valdis Dombrovskis, who had been Prime Minister from 2009 onwards, resigned. He took political responsibility after the collapse of a supermarket in Riga, which killed 54 people. The austerity measures enacted under Valdis Damobrovskis in 2009 had comprised the abolishment of the national building inspectorate which led to a more lax oversight of construction projects.

In January 2014 a new government led by Laimdota Straujuma, the former minister of agriculture, was enacted. The centre-right wing coalition government comprises the former three partners 'Unity', 'Reform Party' and 'National Alliance' and the newly joined 'Union of Greens and Farmers'. Thus the left-wing 'Harmony Centre' remains the only opposition party until the regular parliamentary elections in October this year.

The coalition partners agreed to refrain from amending the 2014 state budget. The budget plan, being the first enacted under the fiscal discipline law, foresees a reduction of the government deficit to 0.9% this year. On the revenue side, social security contributions were reduced by 1.5 percentage points and the non-taxable threshold in income taxation increased somewhat, while taxation of natural resources has been broadened and raised. An increase of expenditures is stipulated by the indexation of small pensions from September 2013 onwards and a rise in the public wage bill by 9% in 2014. The latter is a result of an increase in the minimum wage by about 10% to EUR 320 and an unfreezing of wages of public employees, who experienced substantial cuts during the economic crisis.

The medium-term budget plan comprises a reduction of the flat personal income tax rate by 1 percentage point both in 2015 and 2016. The installed debt brake will lead to a gradual decline of the structural deficit towards 0.5% by the end of the decade.

In January of this year the Latvian treasury successfully sold a seven-year bond amounting to one billion euros with a fixed interest rate of 2.625% p.a. Thus the second instalment of the EC's rescue loan can easily be repaid in March 2014, lowering the total interest burden of the government debt at the same time. A second emission of about the same amount is planned for the second half of 2014 in order to arrange for repayment of the third instalment of the EC loan due in 2015. Thereafter the treasury plans to reduce its cash buffers which are still held in order to guarantee timely repayment of loans irrespective of market conditions. The effect will be a substantial decline of the public debt burden.

Employment growth continued in 2013 even at a higher pace compared to the year before. New jobs were created particularly in manufacturing, trade and due to a revival in the construction sector. The level of unemployment fell considerably by a fifth to 11.7% last year. Nevertheless, the unemployment rate of youngsters (15-24) remains well above 20% and also much above the country average in the eastern parts of Latvia. For 2014 we expect annual job growth to attain still about 2%. Since the employment rate will have reached almost the pre-crisis level of 70% of the working-age population, job growth will decelerate thereafter. Although emigration slowed down considerably from its peak in the three years after the start of the economic crisis, the resident population of Latvia still fell by 1% in 2013, driven also by a strong natural decrease.

After five years of declining or stagnating remuneration, average real wage growth increased considerably in 2013 by about 5% per annum. For 2014 an even stronger upswing will be driven by the increase of the minimum wage by more than 10%, the unfreezing of the public wage bill and in general by the amelioration of the labour market situation.

Employment and wage developments pushed household consumption, which was the main driver of growth in 2013. This was also influenced by high inflows of personal remittances attaining 2.5% of GDP from 2010 onwards. Euro area accession seems to have improved consumer sentiments further. For 2014 and 2015 we expect that the spending mood of households will continue to enhance and banks shall be ready to provide more new loans for consumer durables.

During 2013 the consumer price index fell to zero. Deflationary developments during the year were particularly caused by the price decline of imported oil products. In 2014 overall price developments will be influenced by the liberalisation of the electricity market, which is expected to cause on average a 10% increase in the bill of the households. Stronger wage growth will also cause the core inflation to rise.

For the years 2014 to 2016 we expect GDP to continue growing at a high pace of about 4% annually. Internal demand will be pushed by rising employment levels, growing inventories and a revival of investments of private enterprises in machinery and equipment. The latter will be driven by a rebound in external demand in Northern Europe and neighbouring Estonia. However, growth in the most important trading partner Russia will remain subdued. From 2015 onwards also EU funds will become available for an increase of public investments in infrastructure. The rise in household consumption will also increase import activity, thus net exports will start to contribute negatively to GDP growth from 2014 onwards. A peril to a medium-term balanced growth path may be continuing wage growth above productivity growth which could lead to another boom-bust cycle. However, given the experience of past years, the banking sector will refrain from moving to laxer lending standards in the coming years.

Table 1 / Latvia: Selected Economic Indicators

	2009	2010	2011	2012	2013 <sup>1)</sup>	2014	2015	2016
						Forecast		
Population, th pers., average <sup>2)</sup>	2141.7	2097.6	2059.7	2034.3	2015.0	2005	1995	1987
Gross domestic product, EUR-LVL mn, nom.	18598	18190	20312	22083	23000	24400	26000	27700
annual change in % (real)	-17.7	-1.3	5.3	5.2	4.0	4.2	4.1	3.9
GDP/capita (EUR at exchange rate)	8600	8600	9800	10900	11400	12200	13000	13900
GDP/capita (EUR at PPP)	12700	13500	15000	16400	17500	.	.	.
Consumption of households, EUR-LVL mn, nom.	11225	11308	12415	13511	14300	.	.	.
annual change in % (real)	-22.8	2.5	4.7	5.5	6.0	5.5	5.2	4.6
Gross fixed capital form., EUR-LVL mn, nom.	4013	3315	4332	5033	5000	.	.	.
annual change in % (real)	-37.4	-18.1	27.9	8.7	-1.3	3.0	8.0	9.0
Gross industrial production <sup>3)</sup>								
annual change in % (real)	-18.1	14.9	9.0	6.1	-0.8	4.0	6.0	7.0
Gross agricultural production								
annual change in % (real)	-0.7	-2.4	2.8	17.4	-3.0	.	.	.
Construction industry								
annual change in % (real)	-34.9	-23.4	12.5	13.5	6.9	.	.	.
Employed persons, LFS, th, average <sup>4)</sup>	983.1	940.9	970.5	875.6	900.0	918	930	940
annual change in % <sup>4)</sup>	-12.6	-4.3	3.1	1.6	2.8	2.0	1.3	1.1
Unemployed persons, LFS, th, average <sup>4)</sup>	203.2	216.1	176.4	155.1	120.0	100	90	80
Unemployment rate, LFS, in %, average <sup>4)</sup>	17.1	18.7	15.4	15.0	11.7	10.2	9.0	8.0
Reg. unemployment rate, in %, end of period <sup>4)</sup>	16.0	14.3	11.5	10.5	9.5	.	.	.
Average monthly gross wages, EUR-LVL	656	633	660	684	719	.	.	.
annual change in % (real, gross)	-7.0	-2.4	-0.1	1.4	5.0	.	.	.
Average monthly net wages, EUR-LVL	487	450	470	488	516	.	.	.
annual change in % (real, net)	-5.6	-6.5	0.1	1.6	5.0	.	.	.
Consumer prices (HICP), % p.a.	3.3	-1.2	4.2	2.3	0.0	1.8	2.2	2.6
Producer prices in industry, % p.a.	-3.1	2.4	7.7	4.1	1.7	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	34.0	35.3	34.9	35.1	35.2	34.7	34.4	34.0
Expenditures	43.7	43.4	38.4	36.5	36.5	35.6	35.3	34.8
Net lending (+) / net borrowing (-)	-9.7	-8.1	-3.6	-1.4	-1.3	-0.9	-0.9	-0.8
Public debt, EU-def., % of GDP	36.9	44.4	41.9	40.6	41.0	38.0	35.5	33.0
Central bank policy rate, % p.a., end of period <sup>5)</sup>	4.00	3.50	3.50	2.50	0.25	.	.	.
Current account, EUR mn	1598	532	-434	-552	-210	-350	-600	-900
Current account, % of GDP	8.6	2.9	-2.1	-2.5	-0.9	-1.4	-2.3	-3.2
Exports of goods, BOP, EUR mn	5253	6813	8578	10017	10080	11000	12100	13300
annual change in %	-19.6	29.7	25.9	16.8	0.6	9.1	10.0	9.9
Imports of goods, BOP, EUR mn	6575	8084	10765	12322	12172	13250	14700	16400
annual change in %	-38.0	23.0	33.2	14.5	-1.2	8.9	10.9	11.6
Exports of services, BOP, EUR mn	2747	2754	3181	3554	3668	4000	4200	4500
annual change in %	-11.0	0.3	15.5	11.7	3.2	9.1	5.0	7.1
Imports of services, BOP, EUR mn	1625	1647	1868	2048	2034	2100	2200	2400
annual change in %	-25.1	1.4	13.4	9.6	-0.7	3.2	4.8	9.1
FDI inflow, EUR mn	68	284	1039	871	632	.	.	.
FDI outflow, EUR mn	-44	14	44	150	233	.	.	.
Gross reserves of NB excl. gold, EUR mn	4572	5472	4666	5412	5565	.	.	.
Gross external debt, EUR mn	29097	29978	29459	30113	31000	.	.	.
Gross external debt, % of GDP	157.1	166.2	145.8	135.3	134.5	.	.	.
Average exchange rate EUR-LVL/EUR	1.0041	1.0084	1.0050	0.9922	0.9981	1.0000	1.0000	1.0000
Purchasing power parity EUR-LVL/EUR	0.6858	0.6441	0.6565	0.6628	0.6529	.	.	.

Note: Latvia has introduced the euro from 1 January 2014. Up to and including 2013 all time series in LVL as well as the exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 0.702804 (LVL per EUR) to achieve euro-fixed series (EUR-LVL).

1) Preliminary and wiiw estimates. - 2) According to census March 2011. - 3) Enterprises with 20 and more employees. -

4) From 2012 according to census March 2011. - 5) Refinancing rate of National Bank.

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