



## LATVIA: Economic activity is losing steam

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**The slowdown of external demand in the Baltic region will have a negative impact on the pace of the Latvian economy, whereas the large rises in wages will keep the spending mood alive and well among households. Although the prospects for entrepreneurs are subdued, private investment has revived compared to last year; it will permit the GDP to grow by 2.5% over the current year.**

Export developments remained sluggish in the first half of 2014. While external demand of the EU trading partners still increased by almost 5% nominally, trade with Russia declined already considerably before August this year. In the second half of the year the Russian ban on agricultural products will hit dairy and meat production as well as export volumes of fish. The transport and wholesale sectors will also face losses due to reduced direct and transit trade. Overall the value added is expected to be about 0.5% lower due to the current sanctions.

Although the deleveraging process of the households has not yet come to an end, household investment in dwellings has increased and has positively affected construction production, which is on the upswing. Enterprise investments particularly in the manufacturing sector remained lively, while public investments slowed down, except in the railway sector.

The decrease in industrial production is predominantly driven by the losses of Liepajas Metalurģis, the only metallurgical plant in the Baltics. At the beginning of October 2013 the company, which had become insolvent, had to be supported by the government; in spring 2014 production was halted. The company was sold to the Ukrainian metal producer KVV for EUR 107 million. Thus the government will be able to recover all the funds it invested in the enterprise in the past two years. The KVV group intends to invest another EUR 30 million into the metallurgic plant, which in 2012 was still the largest Latvian company in heavy industry, employing close to 2,500 workers. Production is expected to resume at the end of 2014, which should induce a substantial increase in total industrial production.

Consumer prices remained almost stable in the course of the year driven by low prices of imported energy and food. The Russian sanctions will foster competition within the EU, resulting in falling prices of agro-food products.

In the parliamentary elections that took place on 4 October 2014 all three ruling coalition parties – ‘Unity’, ‘Union of Farmers and Greens’ and ‘National Alliance’ – won additional seats. Prime Minister Laimdota Straujuma announced to renew the collaboration with her partners. As in the past elections of

2011, the leftist 'Harmony Centre', which is supported particularly by the Russian-speaking minority, came in first with 24 of the 100 Saeima seats. Due to its passive position on the Russian aggression in Ukraine the party however lost support in the Latvian-speaking community and thus 7 seats. It will again not be able to find a coalition partner.

Overall employment is stagnating, but increasing in the sectors of construction, transport and health services. A decline in the number of jobs is to be observed in wholesale and retail trade. Although the employment rate is continuing to rise, employment figures will decline in the coming years. The demographic development and the ongoing net outward migration will result in a gradual decrease of the working-age population. Given the skills mismatch on the labour market, the unemployment rate will however decline less swiftly in the coming quarters and fall below 10% during 2015.

An increase in the minimum wage and the shortage of high-skilled labour induced a rise in net wages by more than 8% in real terms in the first half of 2014. Next year household incomes are due to increase further on, given the plan to lift the minimum wage by another 5% and reduce the flat personal income tax rate by 1 percentage point to 23% from January 2015. A further reduction by 1 percentage point is planned for the beginning of 2016.

In spite of incomes increasing more swiftly, the growth rate of household consumption slowed down in the past quarters. Nevertheless, the development of confidence indicators drives expectations that the spending mood of consumers will rise again towards the end of 2014 and next year.

The slowdown of external demand expansion in the Baltic region will cause the Latvian economy to lose steam in 2014 and in the two years ahead, respectively. Thus overall GDP growth will decline to 2.5% this year. In 2015 and 2016 household consumption will remain the most important driver of growth, while exports will recover only gradually. GDP growth will thus remain lower as compared to the more recent period of recovery, at 2.7% next year and 3% in 2016.

**Table 1 / Latvia: Selected Economic Indicators**

	2010	2011	2012	2013 <sup>1)</sup>	2013 January-June	2014	2014 Forecast	2015 Forecast	2016 Forecast
Population, th pers., average <sup>2)</sup>	2,098	2,060	2,034	2,013	.	.	2,005	1,995	1,987
Gross domestic product, EUR-LVL mn, nom. <sup>3)</sup>	18,166	20,297	22,043	23,222	10,892	11,305	23,900	24,900	26,200
annual change in % (real) <sup>3)</sup>	-2.9	5.0	4.8	4.2	3.9	2.5	2.5	2.7	3.0
GDP/capita (EUR at exchange rate)	8,600	9,800	10,900	11,600	.	.	11,900	12,500	13,200
GDP/capita (EUR at PPP)	13,400	15,000	16,300	17,700	.	.	.	.	.
Consumption of households, EUR-LVL mn, nom. <sup>3)</sup>	11,421	12,457	13,226	14,092	6,969	7,170	.	.	.
annual change in % (real) <sup>3)</sup>	3.3	2.8	2.7	6.1	7.1	2.5	2.8	3.2	3.2
Gross fixed capital form., EUR-LVL mn, nom. <sup>3)</sup>	3,469	4,494	5,548	5,401	2,166	2,298	.	.	.
annual change in % (real) <sup>3)</sup>	-20.0	24.2	14.5	-5.2	-8.6	5.0	3.0	3.5	4.0
Gross industrial production <sup>4)</sup>									
annual change in % (real)	14.9	9.0	6.1	-0.8	-2.0	-1.8	-1.5	5.0	6.0
Gross agricultural production									
annual change in % (real)	-2.4	2.8	17.4	-3.7	.	.	.	.	.
Construction industry									
annual change in % (real)	-23.4	12.5	13.5	8.3	8.8	18.9	.	.	.
Employed persons, LFS, th, average <sup>5)</sup>	940.9	970.5	875.6	893.9	884.6	885.4	895	898	900
annual change in %	-4.3	3.1	1.6	2.1	3.2	0.1	0.1	0.3	0.2
Unemployed persons, LFS, th, average <sup>5)</sup>	216.1	176.4	155.1	120.4	123.1	112.5	110	100	90
Unemployment rate, LFS, in %, average <sup>5)</sup>	18.7	15.4	15.0	11.9	12.2	11.3	10.7	10.0	9.5
Reg. unemployment rate, in %, end of period <sup>5)</sup>	14.3	11.5	10.5	9.5	9.6	8.9	.	.	.
Average monthly gross wages, EUR-LVL	633.2	660.2	684.4	715.7	702.0	751.0	.	.	.
annual change in % (real, gross)	-2.4	-0.1	1.4	4.6	4.1	6.4	.	.	.
Average monthly net wages, EUR-LVL	449.6	469.5	488.0	515.4	505.8	550.5	.	.	.
annual change in % (real, net)	-6.5	0.1	1.6	5.6	4.9	8.3	.	.	.
Consumer prices (HICP), % p.a.	-1.2	4.2	2.3	0.0	0.1	0.6	0.6	1.6	2.2
Producer prices in industry, % p.a.	2.4	7.7	4.1	1.7	2.1	0.7	.	.	.
General governm.budget, EU-def., % of GDP									
Revenues	35.3	34.9	35.1	35.3	.	.	34.5	33.9	33.5
Expenditures	43.5	38.4	36.5	36.2	.	.	35.6	35.1	34.7
Net lending (+) / net borrowing (-)	-8.1	-3.5	-1.4	-0.9	.	.	-1.1	-1.2	-1.2
Public debt, EU-def., % of GDP	44.6	42.0	40.9	38.2	.	.	38.8	35.5	33.0
Central bank policy rate, % p.a., end of period <sup>6)</sup>	3.50	3.50	2.50	0.25	2.5	0.2	.	.	.
Current account, EUR mn <sup>7)</sup>	421	-572	-719	-543	-239	-411	-700	-800	-900
Current account, % of GDP	2.3	-2.8	-3.2	-2.3	-2.2	-3.6	-2.9	-3.2	-3.4
Exports of goods, BOP, EUR mn <sup>7)</sup>	6,657	8,300	9,645	9,810	4,660	4,803	10,010	10,450	10,980
annual change in %	32.8	24.7	16.2	1.7	6.7	3.1	2.0	4.4	5.1
Imports of goods, BOP, EUR mn <sup>7)</sup>	8,145	10,743	12,208	12,351	5,928	-6,034	12,560	13,260	14,170
annual change in %	24.6	31.9	13.6	1.2	2.7	1.8	1.7	5.6	6.9
Exports of services, BOP, EUR mn <sup>7)</sup>	3,050	3,471	3,767	3,900	1,836	1,828	3,900	4,110	4,370
annual change in %	-3.3	13.8	8.5	3.5	2.3	-0.5	0.0	5.4	6.3
Imports of services, BOP, EUR mn <sup>7)</sup>	1,749	1,991	2,145	2,127	991	979	2,130	2,240	2,350
annual change in %	1.5	13.8	7.8	-0.8	-1.5	-1.1	0.1	5.2	4.9
FDI inflow (liabilities), EUR mn <sup>7)</sup>	286	1,045	863	680	294	82	.	.	.
FDI outflow (assets), EUR mn <sup>7)</sup>	14	44	150	310	153	55	.	.	.
Gross reserves of NB excl. gold, EUR mn <sup>8)</sup>	5,472	4,666	5,412	5,565	5,551	2,383	.	.	.
Gross external debt, EUR mn <sup>7)</sup>	30,119	29,603	30,254	30,501	31,391	32,483	.	.	.
Gross external debt, % of GDP	167.2	146.6	136.2	131.1	135.2	135.9	.	.	.
Average exchange rate EUR-LVL/EUR	1.0084	1.0050	0.9922	0.9981	0.9964	1.0000	1.0000	1.0000	1.0000
Purchasing power parity EUR-LVL/EUR	0.6441	0.6566	0.6629	0.6692	.	.	.	.	.

Note: Latvia has introduced 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. - 2) According to census March 2011. - 3) According to ESA 2010. - 4) Enterprises with 20 and more employees. -

5) From 2012 according to census March 2011. - 6) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of the National Bank before. - 7) BOP 6th edition. - 8) From January 2014 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

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