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## **Latvia: economic dynamism with signs of overheating\*\***

In 2004 Latvia joined the EU as well as NATO. The decision to phase out Russian-language high schools in September 2004 resulted in strong protests by Russian speakers. Relations with Russia are not quite relaxed, also on the score of the still unsigned border agreement.

Latvia's GDP grew by 7.8% in real terms in 2004, after 7.5% in 2003. The sectors recording the fastest growth were construction (12% output growth), manufacturing and transport and communications.

Growth in gross fixed capital formation accelerated to 15% in 2004, after average annual growth rates of about 10% during the preceding five years. Private consumption has developed dynamically as well. Both investment and consumption have benefited from very low interest rates, which lately have even been slightly negative in real terms: borrowing has been expanding very rapidly.

At the turn of the century, Russia started to construct new harbour capacities on the shores of the Baltic Sea (in the Gulf of Finland, close to St. Petersburg). The declared aim of that project was to bypass Latvian territory, with its Soviet-era transit routes for oil and other exports. Recently however some transit traffic business via Latvia has been resuming. Russian oil products transport via the transit pipeline increased by 22% in 2004 and cargo transport by rail rose as well. Cargo routes via Latvia offer a rational alternative, as ports in Latvia are ice-free in winter, unlike in the Gulf of Finland.

In the early 2000s inflation had been under control. But in 2004 yearly consumer price inflation roughly doubled, from about 3% in 2003 to over 6%, resulting also from rising excise taxes prior to EU accession and increasing oil prices. The exchange rate of the Latvian lats (LVL) depreciated nominally by 4% against the euro during the year 2004.

Import growth was exceptionally strong in 2004, especially because of expectations of rising prices after EU membership. Compared to the previous year, imports of goods expanded by 20%. Machinery and equipment and raw materials (oil in particular) were the most important import items. Also export activities experienced robust annual growth of 17.5%, dominated by wood and wood products (making up a third of the country's

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exports). Metals benefited from the global market price rise, overtaking textiles as Latvia's second most important export item. Germany, the UK and Sweden remained the most important export destinations, accounting together for 40% of Latvian exports in 2004.

Even though exports experienced a strong growth acceleration, the current account deficit widened significantly to as much as 12.9% in 2004. The FDI inflow is not nearly able to cover that deficit. Foreign direct investment reached EUR 530 million, a third of which in the form of reinvested earnings. The amount of outward FDI increased as well, amounting to some EUR 85 million.

The pegging of the lats to the euro – the first most significant monetary adjustment following Latvia's accession to the EU – was effected on 1 January 2005; it will be followed by Latvia's participation in the Exchange Rate Mechanism II (ERM II). According to the current plans, the euro will be adopted on 1 January 2008.

Latvia has not been as prudent as Estonia in its fiscal policy. Nonetheless, in the past five years, budget deficits have been rather modest, never exceeding the Maastricht limit of 3% of GDP. The public sector debt is less than 15% of GDP. However, the potential risks of overheating and widening current account deficits represent a challenge to Latvia's fiscal policy. To counteract signs of overheating, the Latvian government is likely to tighten its fiscal policy in 2005. The Bank of Latvia is expected to raise its refinancing rate.

Despite high economic growth, the employment situation is improving only slowly. The overall unemployment rate was 10.4% in 2004, ranging from 4% (in the capital of Riga) to nearly 30% (in the eastern rural regions).

Table LV

## Latvia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005 forecast	2006 forecast
Population, th pers., mid-year <sup>2)</sup>	2410.0	2390.5	2373.0	2355.0	2338.6	2325.3	2313.6	.	.
Gross domestic product, LVL mn, nom.	3902.9	4224.2	4685.7	5168.3	5691.1	6322.5	7270	7920	8600
annual change in % (real)	4.7	3.3	6.9	8.0	6.4	7.5	7.8	6	6.5
GDP/capita (EUR at exchange rate)	2449	2833	3526	3900	4177	4216	4680	.	.
GDP/capita (EUR at PPP - wiiw)	5960	6340	7010	7660	8250	8760	9670	.	.
Gross industrial production <sup>2)</sup>									
annual change in % (real)	3.1	-5.4	4.7	9.2	5.8	6.5	6.0	6	5.5
Gross agricultural production									
annual change in % (real)	-7.9	-10.6	4.1	6.7	4.0	0.5	.	.	.
Construction industry <sup>2)</sup>									
annual change in % (real)	.	7.8	8.0	6.0	10.8	13.7	12	.	.
Consumption of households, LVL mn, nom.		2683.8	2953.5	3251.4	3566.7	3985.5	.	.	.
annual change in % (real)		4.3	6.3	7.3	7.4	8.6	9.0	.	.
Gross fixed capital form., LVL mn, nom.	979.4	980.0	1151.5	1297.4	1370.6	1527.8	.	.	.
annual change in % (real)	61.4	-6.8	10.2	11.4	13.0	10.9	15.0	9	8
LFS - employed persons, th, avg. <sup>3)</sup>	986.1	968.5	941.1	962.1	989.0	1006.9	1020	.	.
annual change in % <sup>3)</sup>	-0.4	-1.8	-2.8	2.2	2.8	1.8	1.3	.	.
LFS - employed pers. in industry, th, avg. <sup>3)</sup>	208.2	193.1	193.0	186.3	193.1	197.6	194	.	.
annual change in % <sup>3)</sup>	1.9	-7.3	-0.1	-3.5	3.7	2.3	-1.9	.	.
LFS - unemployed, th pers., average <sup>3)</sup>	162.0	161.0	159.0	145.0	134.5	119.2	118	.	.
LFS - unemployment rate in %, average <sup>3)</sup>	14.2	14.2	14.5	13.1	12.0	10.6	10.4	9.8	9.5
Reg. unemployment rate in %, end of period	9.2	9.1	7.8	7.7	8.5	8.6	8.5	8	7.5
Average gross monthly wages, LVL	133	141	150	159	173	192	210	.	.
annual change in % (real, gross)	5.3	2.9	3.0	3.5	6.0	7.8	2.4	.	.
Consumer prices, % p.a.	4.7	2.4	2.6	2.5	1.9	2.9	6.2	5.5	4.5
Producer prices in industry, % p.a.	1.9	-4.0	0.6	1.7	1.0	3.2	8.6	6	5
General government budget, EU-def., % GDP <sup>4)</sup>									
Revenues	40.6	37.3964	35.1	34.4	33.1	34.5	34.0	35.3	34.8
Expenditures	41.2	42.2	37.8	36.5	35.7	36.0	36.0	38.1	37.7
Deficit (-) / surplus (+)	-0.6	-4.9	-2.7	-2.1	-2.7	-1.5	-2.0	-2.8	-2.9
Public debt in % of GDP <sup>4)</sup>	.	.	12.9	14.9	14.1	14.4	14.6	15.4	16.6
Discount rate, % p.a., end of period	.	4.0	3.5	3.5	3.0	3.0	4.0	.	.
Current account, EUR mn	-575	-609	-388	-700	-653	-807	-1356	-1430	-1380
Current account in % of GDP	-9.7	-9.0	-4.6	-7.6	-6.7	-8.2	-12.5	-12.7	-11.3
Total reserves minus gold, EUR mn	619	832	915	1307	1209	1150	2601	.	.
Gross external debt, EUR mn	2635	3791	5011	6345	6865	7505	9950	.	.
FDI inflow, EUR mn	317	326	447	147	269	266	530	.	.
FDI outflow, EUR mn	49	16	13	21	4	32	85	.	.
Exports of goods, BOP, EUR mn	1795	1772	2252	2502	2700	2809	3322	3800	4250
annual growth rate in %	.	-1.3	27.1	11.1	7.9	4.1	18.2	15	12
Imports of goods, BOP, EUR mn	2800	2735	3382	3992	4269	4584	5540	6050	6530
annual growth rate in %	.	-2.3	23.7	18.0	6.9	7.4	20.9	10	8
Exports of services, BOP, EUR mn	989	961	1270	1318	1319	1342	1432	.	.
annual growth rate in %	.	-2.9	32.2	3.8	0.1	1.7	6.7	.	.
Imports of services, BOP, EUR mn	718	646	754	750	749	831	976	.	.
annual growth rate in %	.	-10.1	16.7	-0.5	-0.1	10.9	17.5	.	.
Average exchange rate LVL/USD	0.59	0.58	0.61	0.63	0.62	0.57	0.54	.	.
Average exchange rate LVL/EUR (ECU)	0.66	0.62	0.56	0.56	0.58	0.64	0.67	0.70	0.70
Purchasing power parity LVL/USD, wiiw	0.24	0.24	0.25	0.25	0.26	0.27	0.29	.	.
Purchasing power parity LVL/EUR, wiiw	0.27	0.28	0.28	0.29	0.29	0.31	0.32	.	.

Notes: 1) Preliminary. - 2) Enterprises with 50 employees and more. - 3) From 2002 persons aged 15-74, up to 2002 persons aged 15 and over. - 4) According to ESA 95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; AMECO Database; forecasts by wiiw and European Commission.