

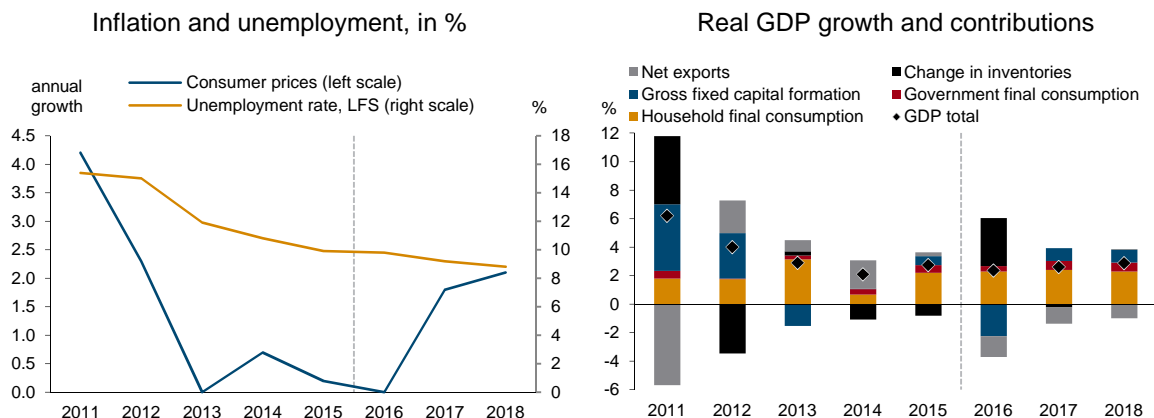


## LATVIA: EU funds to rekindle investment ahead

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We have slightly reduced our GDP growth forecast for Latvia for 2016: down to 2.4%. Private investment activity has become increasingly sluggish, whereas the current year's major cuts in public capital expenditure by a third were not unexpected. It proved possible to offset by and large the slump in Russian demand by securing growth via exports to the EU and Asian markets. Household consumption has developed at a smart pace, while the rapidly rising real wages will continue to buoy the spendthrift mood among consumers. In both 2017 and 2018 we expect an upswing in GDP growth to 2.6% and 2.9%, respectively, the main driver being stronger external demand and greater investment activity in both the public and private sectors.

**Figure 33 / Latvia: Main macroeconomic indicators**



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

In the second quarter of this year Latvian goods exports stabilised in nominal terms and increased already in value added terms year on year. While demand from Russia is still declining, trade with Western Europe, the Scandinavian countries and the rest of the world has expanded again more rapidly. Exports of fish and products thereof are still ailing due to the Russian embargo and those of mineral products due to the low level of the oil price. Good news comes from the wood sector reporting strong export growth figures. In general, we have to revise our forecast for export growth in 2016 downwards, while a stronger revival will take place only in 2017.

As expected, in mid-September 2016 Liepajas Metalurgs, the only steel mill in the Baltic states, was declared insolvent by a local court. The government had lately refrained from subsidising the heavily indebted company. After running into insolvency already two years ago, the plant was sold to Ukrainian investors, the KVV Group. Shortly thereafter, the worldwide decline in steel prices, resulting inter alia from Chinese producers flooding the market, rendered production at the Latvian site cost inefficient. The KVV Group announced to sue Latvia in the EC's Anti-Monopoly and Corruption Prevention Committee, claiming to have been treated detrimentally by the government.

Gross fixed capital investment dropped by more than 20% in real terms in the first half of 2016. This resulted particularly from a reduction of capital expenditure by about a third both by the central state and local governments. Nevertheless, given the modest expansion of industrial production, also private fixed capital investments are going to decline this year. Private residential construction output fell as well, particularly in the second quarter of 2016, and declining numbers of building permits both for non-residential and residential buildings are reinforcing the negative prospects in the sector. For 2017, however, public investment in infrastructure will revive with fresh EU funds becoming available. Overall, we expect total gross fixed investment to decline by at least 10% in 2016 and to grow at a rate of 4% in real terms in 2017.

As expected, the significantly lower level of prices for imported goods in the first three quarters of 2016 compared to the previous year kept consumer inflation stagnant. Strong wage growth has raised core inflation slightly. However, only in 2017 and thereafter will rising prices in the services sector and an upswing in import prices result in consumer inflation increasing to about 1.8%.

The declining activity in construction leads to lower employment there, while job growth is recorded in the industrial sectors. Overall employment is almost stagnating in Latvia in 2016. Demographic developments – including continuing net emigration – result in a further decline in the working-age population; thus growth in employment is likely to remain below 1% in the coming years. Towards the end of 2015, the unemployment rate had receded to single digits for the first time since the outbreak of the global financial crisis in 2008. However, for this year we expect it to remain almost unchanged and in the years to come to decline more gradually. Gross real wages will keep on growing by about 5% not only in 2016 but also in the years ahead. The government plans to increase the minimum wage in 2017, most likely by more than 5%. Thus, growth of household consumption will continue to increase next year after having accelerated already in 2016. Higher than expected government revenues will result in a lower than envisaged budget deficit amounting to about 0.8% of GDP this year.

Due to the delayed expansion of external demand and the stronger than anticipated investment decline, we have slightly reduced our GDP growth forecast for 2016, down to 2.4%. However, because of the expected speed-up in demand in the EU and a rise in domestic investment activity driven by the inflow of EU funds, we expect GDP growth to accelerate somewhat in 2017 and 2018, to 2.6% and 2.9%, respectively.

Table 16 / Latvia: Selected economic indicators

	2012	2013	2014	2015 <sup>1)</sup>	2015 January-June	2016	2016 Forecast	2017 Forecast	2018
Population, th pers., average	2,034	2,013	1,994	1,978	1,982	1,965	1,965	1,950	1,945
Gross domestic product, EUR mn, nom.	21,849	22,774	23,608	24,349	11,487	11,778	24,900	26,000	27,300
annual change in % (real)	4.0	2.9	2.1	2.7	2.4	2.1	2.4	2.6	2.9
GDP/capita (EUR at exchange rate)	10,800	11,300	11,800	12,300	.	.	12,700	13,300	14,000
GDP/capita (EUR at PPP)	16,000	16,700	17,500	18,500	.	.	.	.	.
Consumption of households, EUR mn, nom.	13,065	13,780	14,166	14,584	7,088	7,357	.	.	.
annual change in % (real)	2.9	5.2	1.1	3.7	3.7	3.7	3.8	4.0	3.8
Gross fixed capital form., EUR mn, nom.	5,551	5,291	5,337	5,497	2,222	1,712	.	.	.
annual change in % (real)	14.4	-6.0	0.1	2.8	2.3	-21.8	-10.0	4.0	4.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	6.2	-0.9	-1.0	3.6	3.5	4.7	5.0	4.0	5.0
Gross agricultural production									
annual change in % (real)	17.3	3.4	3.1	8.7	.	.	.	.	.
Construction industry									
annual change in % (real)	13.7	8.1	7.9	-1.2	-2.2	-19.0	.	.	.
Employed persons, LFS, th, average	875.6	893.9	884.6	896.1	891.2	893.9	900	905	910
annual change in %	1.6	2.1	-1.0	1.3	0.6	0.3	0.4	0.6	0.6
Unemployed persons, LFS, th, average	155.1	120.4	107.6	98.2	98.9	98.1	100	90	90
Unemployment rate, LFS, in %, average	15.0	11.9	10.8	9.9	10.0	9.9	9.8	9.2	8.8
Reg. unemployment rate, in %, end of period <sup>3)</sup>	10.5	9.5	8.5	8.7	8.6	8.3	.	.	.
Average monthly gross wages, EUR	684.4	715.7	765.0	818.0	798.5	835.2	860	920	980
annual change in % (real, gross)	1.4	4.6	6.2	6.7	5.9	5.2	5.2	5.0	4.5
Average monthly net wages, EUR	488.0	515.4	560.0	603.0	589.8	615.2	630	660	690
annual change in % (real, net)	1.6	5.6	8.0	7.4	6.6	5.0	5.0	3.5	2.5
Consumer prices (HICP), % p.a.	2.3	0.0	0.7	0.2	0.4	-0.6	0.0	1.8	2.1
Producer prices in industry, % p.a.	4.2	1.6	0.4	-1.0	-0.4	-3.5	-3.0	1.0	1.5
General governm. budget, EU-def., % of GDP									
Revenues	36.3	36.1	35.9	36.0	.	.	36.3	36.2	36.0
Expenditures	37.1	37.0	37.4	37.2	.	.	37.1	37.0	36.5
Net lending (+) / net borrowing (-)	-0.8	-0.9	-1.6	-1.3	.	.	-0.8	-0.8	-0.5
Public debt, EU-def., % of GDP	41.3	39.0	40.7	36.4	.	.	36.0	35.0	34.0
Central bank policy rate, % p.a., end of period <sup>4)</sup>	2.50	0.25	0.05	0.05	0.05	0.00	.	.	.
Current account, EUR mn	-794	-621	-463	-189	-135	115	-100	-500	-600
Current account, % of GDP	-3.6	-2.7	-2.0	-0.8	-1.2	1.0	-0.4	-1.9	-2.2
Exports of goods, BOP, EUR mn	9,645	9,810	10,214	10,322	4,962	4,808	10,100	10,500	11,000
annual change in %	16.2	1.7	4.1	1.1	2.5	-3.1	-2.2	4.0	4.8
Imports of goods, BOP, EUR mn	12,282	12,431	12,414	12,364	6,033	5,726	12,200	13,000	14,000
annual change in %	13.6	1.2	-0.1	-0.4	1.3	-5.1	-1.3	6.6	7.7
Exports of services, BOP, EUR mn	3,768	3,900	3,853	4,038	1,915	1,993	4,120	4,470	4,800
annual change in %	8.6	3.5	-1.2	4.8	4.5	4.1	2.0	8.5	7.4
Imports of services, BOP, EUR mn	2,145	2,127	2,101	2,273	1,053	1,117	2,350	2,450	2,600
annual change in %	7.7	-0.8	-1.2	8.2	7.7	6.1	3.4	4.3	6.1
FDI liabilities (inflow), EUR mn	840	743	813	684	389	-178	200	.	.
FDI assets (outflow), EUR mn	127	373	441	112	64	166	100	.	.
Gross reserves of NB excl. gold, EUR mn <sup>5)</sup>	5,373	5,565	2,448	2,957	2,783	2,912	.	.	.
Gross external debt, EUR mn	30,254	30,501	33,794	34,505	34,963	37,810	37,400	40,300	43,700
Gross external debt, % of GDP	137.4	133.7	143.1	141.7	143.6	151.8	150.0	155.0	160.0
Average exchange rate EUR-LVL/EUR	0.9922	0.9981	1.0000	1.0000	1.0000	1.0000	1	1	1
Purchasing power parity EUR-LVL/EUR	0.6711	0.6793	0.6750	0.6657	.	.	.	.	.

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of National Bank before. - 5) 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.