

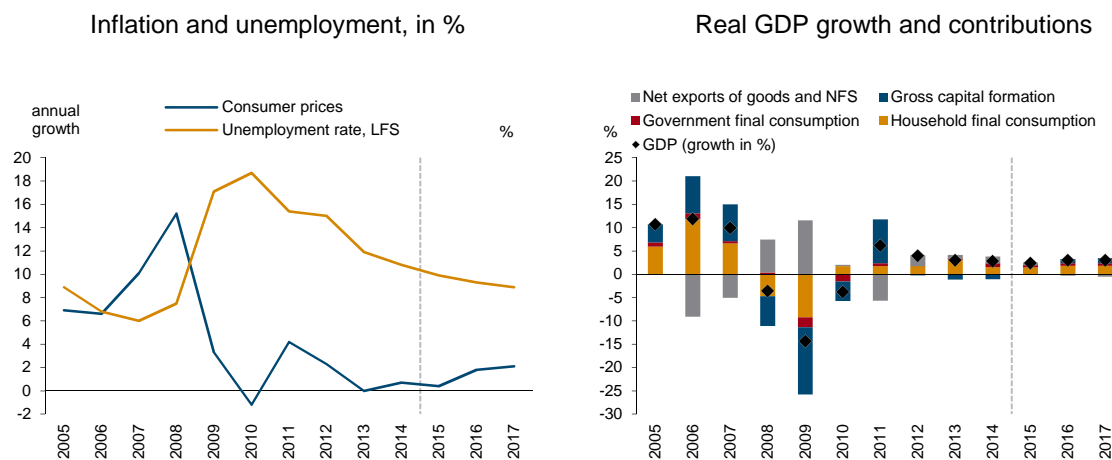


LATVIA: Growing below potential

SEBASTIAN LEITNER

For 2015, our GDP growth forecast for Latvia remains almost unchanged at 2.4%. As expected, the slump in Russian demand has been offset by growth in exports to the EU and Asian markets. While household consumption is developing at a good pace, investment activity remains stagnant. In both 2016 and 2017 we expect an upswing in GDP growth to 3%, driven by stronger external demand and investment activity in both the public and private sectors.

Figure 49 / Latvia: Main macroeconomic indicators



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

Latvian goods exports to the CIS countries fell by 15% year-on-year in nominal terms in the first seven months of 2015, due in particular to the recession in Russia. However, monthly figures show that the negative impact is decreasing and exports to the CIS will gradually stabilise. While external demand from the euro area countries (including the Baltic neighbours Estonia and Lithuania) is stagnant, the one of the other EU Member States is developing at a good pace. Exports to the rest of the world even expanded by 18% in nominal terms year-on-year; however, only about 15% of the goods are destined for non-EU and non-CIS countries. Concerning commodities, wood and machinery, the two most important export sectors, are reporting satisfactory growth figures.

In the steel industry, the high hopes concerning full resumption of production and re-employment of employees at Liepajas metalurģis, the largest company in the sector, have been disappointed and

exports are not taking off. Worldwide prices for steel are on the downturn, particularly since Chinese producers suffer from low domestic demand and thus flood the world market. The Ukrainian KVV group, which took over insolvent Liepajas metalurģs last year, has sorted out its latest problems with suppliers of scrap metal and the gas and electricity utilities. However, its complaints about too high costs at the Latvian factory and the claims for subsidies from the government show a bumpy road ahead for steel production in Latvia. For manufacturing in total, we see an upward development driven not only by exports to non-CIS destinations, but also by domestic demand in particular. Since prices of imports are on decline also this year, the nominal growth rate of imported goods is even lower than that of exports. The contribution of net trade to GDP will however be once again negative in 2015.

Although throughout 2015 consumer confidence indicators declined slightly compared to last year, household consumption and retail figures are on the upward trend. Households benefit from still low inflation, strongly rising wage incomes and a cut of the flat income tax rate from 24% to 23% as of the beginning of 2015. Thus, the expected growth in household consumption of about 2.5% in 2015 will keep the Latvian economy developing at a good pace. However, precautionary savings and deleveraging keep household investments in real estate anaemic.

Given the low level of external demand, capacity utilisation also declined this year. Thus private fixed capital investments will remain almost stagnant in 2015; the same applies to public investments. The availability of fresh EU funds will result in public as well as private investments growing more swiftly from 2016 onwards. The significant decrease in oil prices resulted in consumer prices remaining almost stagnant so far this year. However, with prices rising particularly in the service sector (owing to high wage increases) and an upswing in external as well as domestic demand, we will see a stronger upward movement of harmonised consumer prices in 2016 and 2017.

Latvia is currently growing below potential as are its Baltic neighbours, primarily on account of the economic slump in Russia. Thus growth in employment is meagre. However, demographic developments result in a further decline in the working-age population and thus also unemployment figures. Towards the end of 2015 the unemployment rate is expected to have fallen below 10% for the first time since the outbreak of the economic crisis in 2008. In the two years to come we expect a more gradual reduction.

At the end of September 2015 the Latvian government finalised its budget proposal for 2016. Due to government revenues increasing below potential, the planned reduction of the flat income tax rate from 23% to 22% has to be suspended. Minor changes on the revenue side include higher excise taxes, an increase in the non-taxable minimum income and, in addition, a wage-dependent non-taxable income bracket, making the effective tax rate on personal income more progressive. The strongest hikes in government expenditures are to be found in the defence budget, which is increased to 1.4% of GDP (up from 1% in 2015). The medium-term target is set at 2% for 2018. Minor increases of expenditures in real terms are foreseen for the ministries of health and internal affairs.

Despite the Russian economic downturn and bans on Latvian products, we forecast the GDP to rise by 2.4% in 2015. Given the expected speed-up in demand in the EU and a rise in domestic investment activity driven by the inflow of EU funds, we have revised our forecast for the upswing in overall economic activity slightly upwards, to 3% both for 2016 and 2017.

Table 16 / Latvia: Selected economic indicators

	2011	2012	2013	2014 ¹⁾	2014 January-June	2015	2015 Forecast	2016 Forecast	2017
Population, th pers., average ²⁾	2,060	2,034	2,013	1,994	.	.	1,995	1,987	1,979
Gross domestic product, EUR-LVL mn, nom. ³⁾	20,244	21,811	22,763	23,694	11,312	11,699	24,400	25,600	26,900
annual change in % (real)	6.2	4.0	3.0	2.8	2.5	2.3	2.4	3.0	3.0
GDP/capita (EUR at exchange rate) ³⁾	9,800	10,800	11,300	11,900	.	.	12,200	12,900	13,600
GDP/capita (EUR at PPP) ³⁾	14,700	15,800	16,600	17,300	.	.	.	.	.
Consumption of households, EUR-LVL mn, nom. ³⁾	12,246	13,020	13,733	14,148	7,051	7,300	.	.	.
annual change in % (real)	2.9	2.9	5.3	2.5	2.5	2.5	2.5	3.0	3.0
Gross fixed capital form., EUR-LVL mn, nom. ³⁾	4,501	5,551	5,291	5,372	2,300	2,355	.	.	.
annual change in % (real)	24.1	14.4	-6.0	0.3	5.0	1.3	1.3	3.0	4.0
Gross industrial production ⁴⁾									
annual change in % (real)	9.0	6.2	-0.9	-1.1	-1.5	3.8	4.2	5.0	4.0
Gross agricultural production									
annual change in % (real)	2.8	17.3	1.5	2.8	.	.	.	.	.
Construction industry									
annual change in % (real)	12.4	13.7	8.1	7.9	18.9	-2.2	.	.	.
Employed persons, LFS, th, average ⁵⁾	970.5	875.6	893.9	884.6	885.4	891.2	890	895	900
annual change in %	3.1	1.6	2.1	-1.0	0.1	0.6	0.6	0.6	0.6
Unemployed persons, LFS, th, average ⁵⁾	176.4	155.1	120.4	107.6	112.5	98.9	100	90	90
Unemployment rate, LFS, in %, average ⁵⁾	15.4	15.0	11.9	10.8	11.3	10.0	9.9	9.3	8.9
Reg. unemployment rate, in %, end of period ⁵⁾⁽⁶⁾	11.5	10.5	9.5	8.5	8.9	8.6	.	.	.
Average monthly gross wages, EUR-LVL	660.2	684.4	715.7	765.0	751.0	800.3	820	880	950
annual change in % (real, gross)	-0.1	1.4	4.6	6.2	6.4	6.2	6.3	6.0	5.5
Average monthly net wages, EUR-LVL	469.5	488.0	515.4	560.0	551.0	590.7	600	640	680
annual change in % (real, net)	0.1	1.6	5.6	8.0	8.3	6.8	7.0	5.5	4.0
Consumer prices (HICP), % p.a.	4.2	2.3	0.0	0.7	0.6	0.4	0.4	1.8	2.1
Producer prices in industry, % p.a.	7.7	4.1	1.7	0.4	0.7	-0.4	-0.5	1.0	1.5
General government budget, EU-def., % of GDP									
Revenues	35.6	36.1	36.0	36.0	.	.	33.9	33.5	33.1
Expenditures	38.9	36.9	36.8	37.5	.	.	35.4	34.8	34.1
Net lending (+) / net borrowing (-)	-3.4	-0.8	-0.8	-1.5	.	.	-1.5	-1.3	-1.0
Public debt, EU-def., % of GDP	42.8	41.3	39.0	40.7	.	.	37.0	36.0	35.0
Central bank policy rate, % p.a., end of period ⁷⁾	3.50	2.50	0.25	0.05	0.15	0.05	0.05	0.05	0.20
Current account, EUR mn ⁸⁾	-573	-719	-544	-467	-262	-200	-500	-900	-1,000
Current account, % of GDP ⁸⁾	-2.8	-3.3	-2.4	-2.0	-2.3	-1.7	-2.0	-3.5	-3.7
Exports of goods, BOP, EUR mn ⁸⁾	8,300	9,645	9,810	10,180	4,825	4,959	10,440	10,860	11,510
annual change in %	24.7	16.2	1.7	3.8	3.5	2.8	2.6	4.0	6.0
Imports of goods, BOP, EUR mn ⁸⁾	10,743	12,208	12,351	12,454	5,977	6,075	12,700	13,200	13,860
annual change in %	31.9	13.6	1.2	0.8	0.8	1.6	2.0	3.9	5.0
Exports of services, BOP, EUR mn ⁸⁾	3,471	3,768	3,900	3,853	1,831	1,915	4,040	4,320	4,670
annual change in %	13.8	8.6	3.5	-1.2	-0.2	4.6	4.9	6.9	8.1
Imports of services, BOP, EUR mn ⁸⁾	1,991	2,145	2,127	2,107	981	1,057	2,280	2,470	2,690
annual change in %	13.8	7.7	-0.8	-0.9	-1.0	7.8	8.2	8.3	8.9
FDI liabilities (inflow), EUR mn ⁸⁾	1,075	840	743	661	307	380	700	.	.
FDI assets (outflow), EUR mn ⁸⁾	75	127	373	428	247	54	250	.	.
Gross reserves of NB excl. gold, EUR mn ⁹⁾	4,666	5,373	5,565	2,448	2,383	2,783	.	.	.
Gross external debt, EUR mn ⁸⁾	29,603	30,254	30,501	33,542	32,615	34,582	34,900	35,800	37,100
Gross external debt, % of GDP ⁸⁾	147.0	137.6	133.7	141.6	137.7	141.7	143.0	140.0	138.0
Average exchange rate EUR-LVL/EUR	1.0050	0.9922	0.9981	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000
Purchasing power parity EUR-LVL/EUR	0.6697	0.6783	0.6793	0.6858	.	.	.	.	.

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. - 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) In % of labour force (LFS). - 7) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of National Bank before. - 8) BOP 6th edition. - 9) 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.