

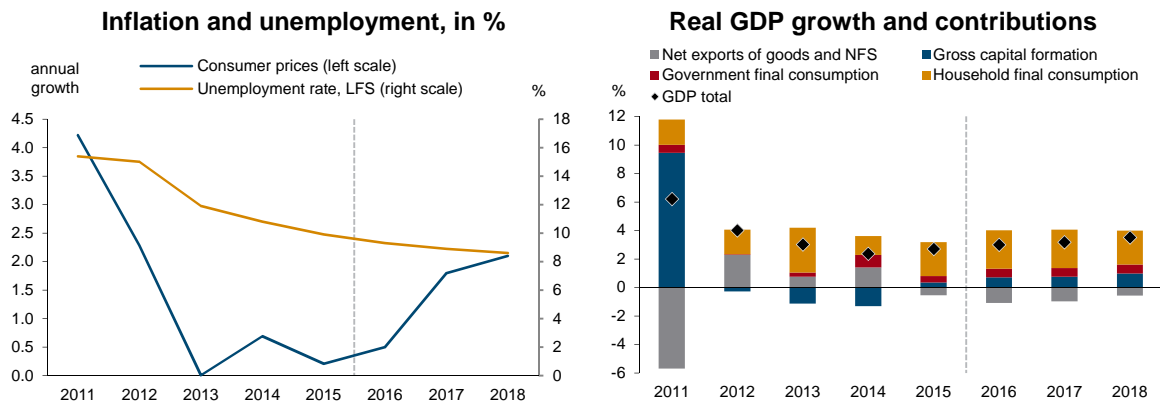


## LATVIA: Growing wages push domestic demand

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For 2016, we have slightly raised our GDP growth forecast for Latvia to 3%. As expected, the slump in Russian demand can be offset by growth in exports to the EU and Asian markets. Whereas household consumption will develop markedly and rapidly, investment growth will remain comparatively low. Improvements in the labour market and a rapid rise in real wages will keep households in a buoyant mood in terms of spending. We expect an upswing in GDP growth to 3.2% in 2017 and 3.5% in 2018, driven by stronger external demand and greater investment activity in both the public and private sectors.

Figure 46 / Latvia: main macroeconomic indicators



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

The ongoing recession in Russia drags on Latvia's trade balance. Exports to the Eastern neighbour fell by about 25% in 2015, year on year, in nominal terms. We expect the negative impact to decrease, however, a revival of trade with the CIS countries will not happen before 2017. External demand of the euro area countries and other EU Member States was obviously not too lively, but exports to the rest of the world acted as a counterbalancing force, expanding by 22% in nominal terms in 2015, year on year; however, only about 15% of the goods exports are destined for non-EU and non-CIS countries. Production and exports of foodstuffs are ailing due to the Russian downturn and embargo, and those of mineral products suffer from the low oil price. However, good news comes from the increasingly important machinery sector, reporting strong export growth figures. For 2016 we expect external demand to become more lively again.

In the steel industry, production at Liepajas metalurģs, the largest company in the sector, is still suffering from low prices driven down by Chinese producers flooding the world market. The company welcomes the European Commission's anti-dumping probes into steel imports from China and urges the government to subsidise its production – which is, however, very unlikely to happen. Thus temporary production halts are expected also in 2016 and gas and electricity utilities may again refrain from supplying energy.

Given the low growth of external demand, capacity utilisation remained almost stagnant in 2015. Thus we do not expect a strong upswing of private fixed capital investments this year; the same applies to public investments. The availability of fresh EU funds will not, according to the 2016 government budget, result in public investments growing swiftly but will be used only later, from 2017 onwards. The pessimistic sentiments of entrepreneurs in the construction sector are understandable if we look at the recently declining numbers of building permits for non-residential buildings, while households will keep on raising their credit-funded expenditures for the acquisition of dwellings. Overall, we expect total gross fixed investment to continue growing at a low rate both in 2016 and 2017.

The significant decrease in oil prices will keep consumer inflation almost stagnant also in 2016. The wage growth increased core inflation. However, only in 2017 and thereafter will rising prices in the services sector and an upswing of external demand result in consumer inflation rising to about 2%.

Employment growth attained 1.2% in 2015 and will continue at the same rate also this year. The declining activity in the transport sector and partly also in construction will result in lower employment there, while particularly services sectors will provide for ongoing job creation. However, demographic developments – including net emigration – result in a further decline in the working-age population, thus growth in employment will decrease as well. Towards the end of 2015 the unemployment rate returned to single digits for the first time since the outbreak of the global financial crisis in 2008. This year and in 2017 we expect a more gradual reduction to 9.3% and 8.9%, respectively.

The improvement of the labour market situation and the increase in the minimum wage from EUR 320 to EUR 360 resulted in real net wages growing by more than 7% in 2015. In January 2016 minimum wages have again been raised, but only slightly, to EUR 370 per month. We therefore expect that household incomes will grow at a somewhat slower pace this year. Consumer confidence indicators increased slightly towards the end of 2015 and households plan to invest more in consumer durables. Benefiting from still low inflation, households will increase their consumption in 2016 even slightly more than last year. Thus domestic demand will keep the Latvian economy developing at a good pace.

In February this year a new government led by Prime Minister Māris Kučinskis, a member of the agrarian 'Union of Greens and Farmers', was appointed; the coalition remained unchanged, comprising also the centre to right wing conservative parties 'Unity' and 'National Alliance'. Former Prime Minister Laimdota Straujuma had stumbled over teacher strikes and disagreements in the coalition on hikes in defence expenditures, ongoing immigration issues and state assistance to the ailing national airline Air Baltic. However, no change in economic and fiscal policies is to be expected. The government budget for 2016 foresees an increase in the defence budget of 45% to 1.4% of GDP with a medium-term target of 2% for 2018. The introduced changes in income taxation (a solidarity tax for the upper 0.6% of income earners and the change from the non-taxable personal allowance to an income-dependent declining amount) turns the flat tax system slightly more progressive. Public wage growth will, as in recent years,

remain below the one of the private sector. The budget deficit of 1.3% of GDP in 2015 was slightly above the planned 1% but is expected to move towards the target this year and the next.

Despite the persisting Russian economic downturn, we forecast the GDP to rise by 3% in 2016. 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 slightly increased our forecast for the upswing in overall economic activity to 3.2% for 2017 and 3.5% for 2018.

**Table 15 / Latvia: selected economic indicators**

	2011	2012	2013	2014	2015 <sup>1)</sup>	2016	2017	2018
						Forecast		
Population, th pers., average	2,060	2,034	2,013	1,994	1,979	1,965	1,950	1,945
Gross domestic product, EUR mn, nom.	20,244	21,811	22,763	23,581	24,300	25,200	26,500	28,000
annual change in % (real)	6.2	4.0	3.0	2.4	2.7	3.0	3.2	3.5
GDP/capita (EUR at exchange rate)	9,800	10,800	11,300	11,800	12,300	12,800	13,600	14,400
GDP/capita (EUR at PPP)	14,700	16,000	16,600	17,500	18,600	.	.	.
Consumption of households, EUR mn, nom.	12,246	13,020	13,733	14,148	14,700	.	.	.
annual change in % (real)	2.9	2.9	5.3	2.2	4.0	4.5	4.5	4.0
Gross fixed capital form., EUR mn, nom.	4,501	5,551	5,291	5,394	5,600	.	.	.
annual change in % (real)	24.1	14.4	-6.0	0.4	3.5	4.0	4.5	4.0
Gross industrial production <sup>2)</sup>								
annual change in % (real)	9.0	6.2	-0.9	-1.1	3.6	5.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	2.8	17.3	3.4	3.1	8.7	.	.	.
Construction industry								
annual change in % (real)	12.4	13.7	8.1	7.9	-1.2	.	.	.
Employed persons, LFS, th, average <sup>3)</sup>	970.5	875.6	893.9	884.6	895.0	905	912	918
annual change in %	3.1	1.6	2.1	-1.0	1.2	1.1	0.8	0.7
Unemployed persons, LFS, th, average <sup>3)</sup>	176.4	155.1	120.4	107.6	100.0	90	90	90
Unemployment rate, LFS, in %, average <sup>3)</sup>	15.4	15.0	11.9	10.8	9.9	9.3	8.9	8.6
Reg. unemployment rate, in %, end of period <sup>3)4)</sup>	11.5	10.5	9.5	8.5	8.7	.	.	.
Average monthly gross wages, EUR	660.2	684.4	715.7	765.0	815.0	870	930	1,000
annual change in % (real, gross)	-0.1	1.4	4.6	6.2	6.3	6.0	5.5	5.2
Average monthly net wages, EUR	469.5	488.0	515.4	560.0	600.0	640	680	730
annual change in % (real, net)	0.1	1.6	5.6	8.0	7.0	5.5	5.0	5.0
Consumer prices (HICP), % p.a.	4.2	2.3	0.0	0.7	0.2	0.5	1.8	2.1
Producer prices in industry, % p.a.	7.7	4.1	1.7	0.4	-1.1	-1.0	1.0	1.5
General government budget, EU-def., % of GDP								
Revenues	35.6	36.2	36.0	35.8	36.0	36.0	36.0	36.0
Expenditures	39.0	37.0	36.9	37.3	37.3	37.1	37.0	36.5
Net lending (+) / net borrowing (-)	-3.4	-0.8	-0.9	-1.6	-1.3	-1.1	-1.0	-0.5
Public debt, EU-def., % of GDP	42.8	41.4	39.1	40.8	37.0	36.0	35.0	34.0
Central bank policy rate, % p.a., end of period <sup>5)</sup>	3.50	2.50	0.25	0.05	0.05	.	.	.
Current account, EUR mn	-573	-719	-544	-467	-291	-900	-1,000	-1,000
Current account, % of GDP	-2.8	-3.3	-2.4	-2.0	-1.2	-3.6	-3.8	-3.6
Exports of goods, BOP, EUR mn	8,300	9,645	9,810	10,180	10,281	10,860	11,510	12,200
annual change in %	24.7	16.2	1.7	3.8	1.0	5.6	6.0	6.0
Imports of goods, BOP, EUR mn	10,743	12,208	12,351	12,454	12,394	13,200	13,860	14,600
annual change in %	31.9	13.6	1.2	0.8	-0.5	6.5	5.0	5.3
Exports of services, BOP, EUR mn	3,471	3,768	3,900	3,853	3,985	4,320	4,670	5,000
annual change in %	13.8	8.6	3.5	-1.2	3.4	8.4	8.1	7.1
Imports of services, BOP, EUR mn	1,991	2,145	2,127	2,107	2,251	2,470	2,690	2,900
annual change in %	13.8	7.7	-0.8	-0.9	6.8	9.7	8.9	7.8
FDI liabilities (inflow), EUR mn	1,075	840	743	661	700	.	.	.
FDI assets (outflow), EUR mn	75	127	373	428	0	.	.	.
Gross reserves of NB excl. gold, EUR mn <sup>6)</sup>	4,666	5,373	5,565	2,448	2,957	.	.	.
Gross external debt, EUR mn	29,603	30,254	30,501	33,542	34,600	35,300	36,600	39,200
Gross external debt, % of GDP	147.0	137.6	133.7	142.2	142.4	140.0	138.0	140.0
Average exchange rate EUR-LVL/EUR <sup>7)</sup>	1.0050	0.9922	0.9981	1.0000	1.0000	1	1	1
Purchasing power parity EUR-LVL/EUR	0.6698	0.6711	0.6793	0.6750	0.6587	.	.	.

- 1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) From 2012 according to census March 2011. - 4) In % of labour force (LFS). - 5) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of National Bank before. - 6) From January 2014 (Euro introduction) only foreign currency reserves denominated in non-euro currencies. - 7) Euro fixed series.

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