

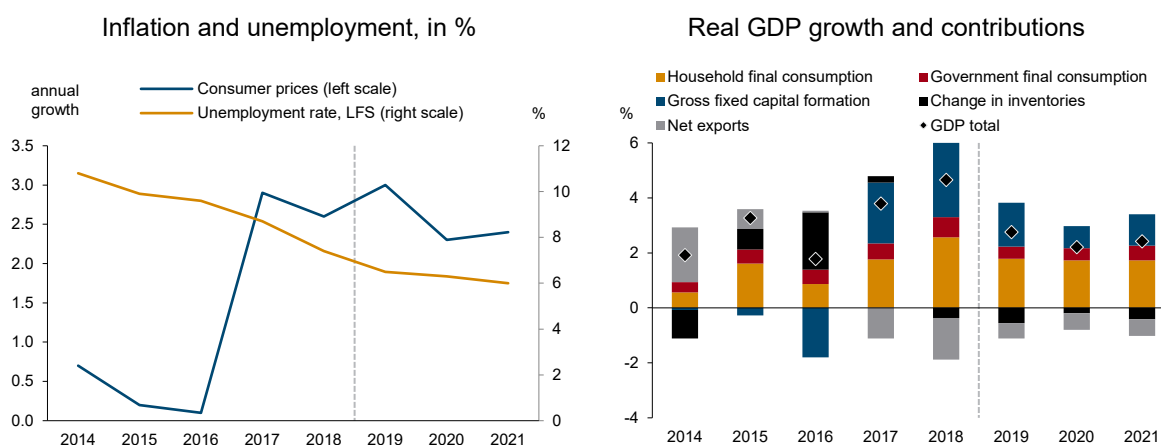


LATVIA: In the midst of a soft landing

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Economic growth has almost halved in comparison to the last two boom years. Investment growth has slowed, although household consumption remains robust. Although abating slightly, exports have grown more strongly than expected so far in 2019. Despite the economic slowdown, the labour market is tightening further with the unemployment rate falling towards 6.5% in 2019. This year, we expect GDP growth to decline to 2.7%, followed by a further slowdown to 2.2% in 2020 and amelioration to 2.4% in 2021.

Figure 5.11 / Latvia: Main macroeconomic indicators



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

Overall, GDP growth declined to 2.4% in the first half of 2019 in real terms year on year. The slowdown in global economic activity resulted in Latvia's exports stagnating nominally in the same period compared to last year. Export growth however only abated with Western Europe whereas an absolute decline was reported with the main trading partner Russia. Swiftly rising wages are putting the competitive position and thus the world export share of the Latvian manufacturing sector under pressure. Generally, stagnation in industrial production despite increasing household consumption shows the mounting problem in the manufacturing sector. However, the most important export items, wood and articles thereof and electrical machinery, are still reporting good growth figures. Besides, the export of services is rising at a higher pace. In particular, trade in transport and business services is flourishing. Since the growth of imports is also declining, the negative contribution of net exports to overall GDP growth is expected to decrease for this year. We may even see the current account deficit decreasing further and remaining below -1% of GDP in the period 2020-2021.

Gross fixed capital investment growth has slowed compared with 2018, but was still robust at 5.9% year on year in H1 2019. Fresh EU funds were used on a larger scale last year, while public investment for this year and 2020-2021 is expected to remain at the same level in relation to GDP. The government continues to invest in the Rail Baltica high speed train project. This year contracts were signed for the design of all main tracks and related infrastructure such as bridges and stations. The construction of the tracks will start in 2021 and the project is scheduled to be finished in 2026. In total, Latvia had spent 38% of the planned EU funds from the 2014-2020 budget by July 2019. Along with Estonia and Lithuania, Latvia is a frontrunner in the group of new EU Member States in this respect. Only a few EU countries (e.g. Finland, Ireland and Sweden) have already spent 50% or more. Last year's construction boom levels off this year, however, the number of building permits granted shows that the growth of building activity will continue next year too and not only in the field of dwellings, but also in industrial and other commercial buildings. Investment in machinery and equipment has also grown quickly so far in 2019.

In August 2019 the ECB assessed that PNB banka, Latvia's sixth largest institute, was failing or likely to fail in accordance with the Single Resolution Mechanism Regulation and had to be shut down. The ECB concluded after inspection, that PNB banka, formerly known as Norvik, failed to provide evidence that it would be able to replenish its capital in order to meet its liabilities. This is another blow to the country's financial sector, following the shutdown of the operations of Latvia's third largest bank, ABLV, due to institutionalised money laundering in 2018. The turmoil resulted in a stronger decline of foreign deposits in the first quarter of 2018, levelling off in the following months. However, in the second quarter of 2019, a decline of more than 10% was experienced again.

Job growth cooled off in the first half of 2019 to 1% year on year. However, given the continuous decrease in the working age population, another strong decline of the unemployment rate to 6.5% is expected on average this year. Also rising vacancy rates highlight the tight situation in the labour market. Employers are increasingly in need of technicians and trade workers and plant and machine operators. Given the likely economic slowdown in the coming two years, we however expect the unemployment rate to remain at the current level in the forecasting period till 2021.

The further tightening of the labour market also resulted in net wages rising at a fast pace, by 7.5% in the first half of 2019 year on year in real terms. Following the last increase in the minimum wage of 13% in January 2018 to EUR 430, the government announced that the next hike would not take place before 2021. However, it plans to lift it to not less than EUR 500 then. The budget proposal foresees increasing the non-taxable minimum to EUR 300 on 1 January 2020, while the coalition also agreed to lift it to EUR 400 in 2021 and EUR 500 in 2022. Thus, household incomes will increase slower but still substantially in the coming years. This will further fuel household consumption which is projected to increase by about 3.2% in real terms this year. In the period 2020-2021, we expect some slowdown but consumption still to grow by 3.0% per annum.

Despite strong wage growth, consumer price inflation is likely to remain below 3% in 2019. Low growth of import prices and a slight decline of oil prices are expected to result in the growth of consumer prices to fall below 2.5% in 2020 and 2021.

All in all, compared to our Summer Forecast we have become less optimistic, lowering the forecast GDP growth rate for this year from 3.3% to 2.8%. Private investment activity has slowed down more strongly than expected, while external demand still grew stronger than recently forecasted. Rising household incomes will help private consumption to keep on growing steadily. The continuing investment in public transport infrastructure, not only in this year but also in 2020 and 2021, is facilitated by ongoing inflows of EU funds. For 2020, we see more cooling off particularly in external demand, thus we have revised our growth forecast slightly to 2.2%, while in 2021 a stabilisation will result in GDP increasing to 2.4%.

Table 5.11 / Latvia: Selected economic indicators

	2015	2016	2017	2018 ¹⁾	2018 January-June	2019	2019 Forecast	2020 Forecast	2021
Population, th pers., average	1,978	1,960	1,942	1,927	1,934	1,919	1,920	1,910	1,900
Gross domestic product, EUR mn, nom. ²⁾	24,426	25,073	26,798	29,155	13,776	14,567	30,900	32,300	33,900
annual change in % (real)	3.3	1.8	3.8	4.6	4.7	2.4	2.8	2.2	2.4
GDP/capita (EUR at PPP) ²⁾	18,700	18,800	19,900	21,500	.	.	.	.	.
Consumption of households, EUR mn, nom. ²⁾	14,424	14,791	15,698	16,840	8,163	8,691	.	.	.
annual change in % (real)	2.7	1.5	3.0	4.4	4.9	3.2	3.1	3.0	3.0
Gross fixed capital form., EUR mn, nom. ²⁾	5,368	4,899	5,554	6,554	2,760	2,979	.	.	.
annual change in % (real)	-1.2	-8.2	11.3	15.8	17.1	5.9	7.0	3.5	5.0
Gross industrial production ³⁾									
annual change in % (real)	3.6	5.4	8.3	1.5	2.1	-0.4	1.0	2.0	2.0
Gross agricultural production									
annual change in % (real)	14.0	-7.3	0.1	-11.5	.	.	.	.	.
Construction industry									
annual change in % (real)	-0.6	-16.6	18.7	21.8	33.3	3.4	.	.	.
Employed persons, LFS, th, average	896.1	893.3	894.8	909.4	903.8	904.6	915	920	925
annual change in %	1.3	-0.3	0.2	1.6	1.9	0.1	0.6	0.5	0.5
Unemployed persons, LFS, th, average	98.2	95.3	85.4	72.8	77.7	64.2	64	62	59
Unemployment rate, LFS, in %, average	9.9	9.6	8.7	7.4	8.0	6.7	6.5	6.3	6.0
Reg. unemployment rate, in %, eop ⁴⁾	8.7	8.4	6.8	6.4	6.4	6.0	.	.	.
Average monthly gross wages, EUR	818.0	859.0	926.0	1,010.0	983.2	1,059.5	1,090	1,160	1,230
annual change in % (real, gross)	6.7	4.9	4.5	6.0	6.3	4.5	4.5	4.0	3.8
Average monthly net wages, EUR	603.0	631.0	676.0	740.0	729.5	784.2	790	840	890
annual change in % (real, net)	7.4	4.3	3.8	7.0	7.7	4.3	4.3	3.8	3.6
Consumer prices (HICP), % p.a.	0.2	0.1	2.9	2.6	2.2	3.1	3.0	2.3	2.4
Producer prices in industry, % p.a.	-1.0	-2.5	2.5	4.3	3.5	3.6	2.7	1.3	1.5
General governm. budget, EU-def., % of GDP									
Revenues	36.7	37.0	37.6	38.0	.	.	36.4	36.3	36.5
Expenditures	38.1	36.9	38.1	39.0	.	.	37.4	37.6	38.0
Net lending (+) / net borrowing (-)	-1.4	0.1	-0.6	-1.0	.	.	-1.0	-1.3	-1.5
General gov. gross debt, EU def., % of GDP	36.7	40.2	40.3	36.4	.	.	36.0	35.5	35.0
Stock of loans of non-fin. private sector, % p.a.	-2.8	0.1	-4.7	-5.2	-5.3	-3.5	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	6.0	4.4	4.1	5.3	5.9	5.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.05	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	-216	360	273	-198	330	161	-60	-160	-210
Current account, % of GDP	-0.9	1.4	1.0	-0.7	2.4	1.1	-0.2	-0.5	-0.6
Exports of goods, BOP, EUR mn	10,480	10,543	11,683	12,603	6,176	6,174	12,800	13,200	13,800
annual change in %	1.0	0.6	10.8	7.9	11.5	0.0	1.6	3.1	4.5
Imports of goods, BOP, EUR mn	12,721	12,430	13,905	14,953	7,048	7,343	15,400	16,000	16,800
annual change in %	-1.0	-2.3	11.9	7.5	6.1	4.2	3.0	3.9	5.0
Exports of services, BOP, EUR mn	4,351	4,601	4,964	5,268	2,498	2,675	5,600	5,800	6,200
annual change in %	6.1	5.7	7.9	6.1	5.4	7.1	6.3	3.6	6.9
Imports of services, BOP, EUR mn	2,334	2,468	2,702	2,972	1,373	1,485	3,150	3,250	3,500
annual change in %	10.4	5.7	9.5	10.0	8.8	8.2	6.0	3.2	7.7
FDI liabilities, EUR mn	729	302	991	390	-94	189	500	.	.
FDI assets, EUR mn	128	202	516	-290	-145	39	100	.	.
Gross reserves of NB excl. gold, EUR mn	2,957	3,100	3,620	3,578	3,629	3,665	.	.	.
Gross external debt, EUR mn	34,861	37,217	37,922	35,697	35,657	35,152	34,000	32,300	32,200
Gross external debt, % of GDP	142.7	148.4	141.5	122.4	122.3	113.8	110.0	100.0	95.0

1) Preliminary. - 2) Half-year data unrevised. - 3) Enterprises with 20 and more employees. - 4) In % of labour force (LFS). - 5) From 2018 loans more than 90 days overdue plus those unlikely to pay, loans more than 90 days overdue before. - 6) Official refinancing operation rates for euro area (ECB).

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