

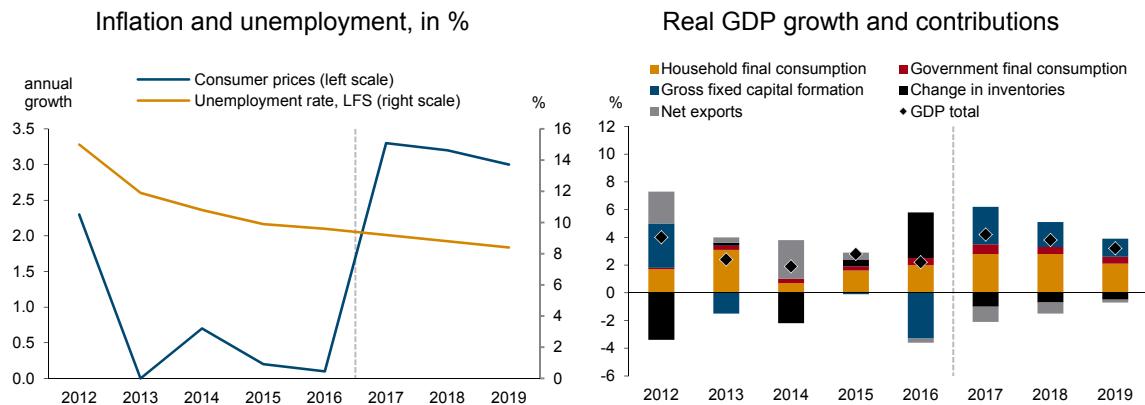


## LATVIA: Public investment and minimum wages to lift growth

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Our GDP growth forecast for 2017 has been increased to 4.2%. Private and (particularly) public investment activity is expanding faster than expected. The inflow of EU funds is likely to amount to 2.6% of GDP this year. As anticipated, exports to Russia have revived following the upswing in that country. Household consumption is developing rapidly, and this will continue in the coming years thanks to rising minimum wages and the 2018 income tax reform. In both 2018 and 2019, we expect continuously robust GDP growth of 3.8% and 3.2%, respectively.

Figure 40 / Latvia: Main macroeconomic indicators



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

**After a slump in 2016, gross fixed capital investment is growing strongly.** Following an interim year that caused a halt in public capital expenditure, fresh EU funds have become available again in 2017. Thus, public investment in infrastructure rallies again; the inflow from Brussels is expected to amount to 2.6% of GDP in 2017. Apart from the public sector, the increase in capital expenditure however has so far occurred only in transport and trade, but is expected to broaden next year as capacity utilisation has reached relatively high levels in industry. Private residential construction output, however, has remained rather anaemic this year. The development of the number of building permits, for residential and non-residential buildings alike, does not show a stronger upwind for prospects in the sector for 2018. Overall, we forecast total gross fixed investment to increase more strongly than expected previously, by 15% in 2017 and another 10% in real terms in 2018.

**The rather difficult years for the export sector are over, the development of foreign demand in 2017 and 2018 is positive.** In the past years direct exports and transit trade to Russia were under

pressure due to Russian sanctions and the downturn of economic activity in the Eastern neighbourhood. In 2017 Latvian goods exports have started to grow again more strongly, to Russia by even about 35% in the first half of 2017 in nominal year-on-year terms. But also trade with Western Europe, the Scandinavian countries and the rest of the world has gradually gained momentum. Wood and food producers report an upswing of export growth figures, but the strongest increases are observed in the re-exporting wholesale sector. In general, we expect both goods and services exports to revive again this year, and to remain lively in the years to come. With strongly increasing capital investments but also household consumption, however, imports are expected to grow faster and the goods trade balance is likely to become more negative again.

**As expected, the rising level of prices for imported goods in 2017, compared to the previous year, resulted in an increase in consumer inflation.** Strong wage growth has started to raise core inflation. As the effect of slightly reviving energy prices abates, rising prices in the services sector and an upswing in those of imported goods will raise consumer inflation to about 3.3% this year and 3.2% in 2018.

**Declining activity in construction has led to lower employment there, while job growth has been recorded in the services sectors.** Overall employment will again decline slightly in 2017 as in the year before. Demographic developments – including continuing net emigration – will result in a further decline in the working-age population and also in employment in the coming years. However, employment rates are likely to increase gradually at the same time. In the first half of 2017, the unemployment rate receded to 9.2%. Up to the end of the forecast period in 2019, we expect it to decline gradually to 8.4%.

**Gross real wages will continue to rise, by 4.5% in 2017 and by about 3.5% in the two years ahead.** Inspired by the forthcoming parliamentary elections in October next year, the government approved a strong increase in the minimum wage from EUR 380 to EUR 430 in January 2018. Thus, we expect growth in household consumption to increase by more than 4.5% in real terms this and the next year and still by 3.5% in 2019.

**Starting with January 2018, Latvia will introduce a progressive personal income tax rate, after having pursued a flat tax system for more than 20 years.** The aim is to reduce income inequality, which is one of the highest in the EU, while providing additional resources for the health and pension system. The government lowered the rate for annual income up to EUR 20,000 to 20%, kept it at 23% for higher earnings, but increased it to 31.4% for income above EUR 55,000. Moreover, apart from other measures, the tax reform foresees an increase in the payroll tax of 1 percentage point and the abolition of the taxation of retained profits for enterprises. The government budget for 2018 foresees expenditure growth – particularly in the field of health and defence, but also in education and EU-funded infrastructure. The budget deficit is expected to amount to 0.8% of GDP in 2017. The effect of the tax reform and election-biased expenditure increases will be a one-year increase in the budget deficit to 1.2% of GDP in 2018.

**Broader-based stable economic growth is expected in the years to come.** In 2017, external demand has started to grow again at a vivid pace, not only in nominal but also in real terms. After a sharper than anticipated investment hike in 2017, we expect a further – also election-induced – upswing in 2018. Also household demand is continuing to evolve at a remarkable pace, thus our GDP growth forecast for 2017 has been raised to 4.2%. Due to the anticipated speed-up in demand in the EU, and domestic investment activity driven by the inflow of EU funds, we expect GDP growth to remain high at 3.8% in 2018 before declining slightly to 3.2% in 2019.

Table 15 / Latvia: Selected economic indicators

	2013	2014	2015	2016 <sup>1)</sup>	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	2,013	1,994	1,978	1,960	1,964	1,944	1,950	1,945	1,940
Gross domestic product, EUR mn, nom.	22,787	23,618	24,271	24,866	11,675	12,472	26,800	28,700	30,500
annual change in % (real)	2.4	1.9	2.8	2.2	2.6	4.0	4.2	3.8	3.2
GDP/capita (EUR at PPP)	16,700	17,500	18,500	18,900	.	.	.	.	.
Consumption of households, EUR mn, nom.	13,780	14,178	14,393	15,040	7,250	7,848	.	.	.
annual change in % (real)	5.3	1.2	2.7	3.4	3.4	4.5	4.6	4.7	3.5
Gross fixed capital form., EUR mn, nom.	5,291	5,337	5,385	4,538	1,837	2,180	.	.	.
annual change in % (real)	-6.0	0.1	-0.5	-15.0	-17.8	17.5	15.0	10.0	7.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	-0.9	-1.0	3.6	5.4	4.7	9.6	9.5	7.0	5.0
Gross agricultural production									
annual change in % (real)	2.3	4.5	14.2	-1.9	.	.	.	.	.
Construction industry									
annual change in % (real)	8.1	7.9	-1.2	-17.9	-19.0	13.1	.	.	.
Employed persons, LFS, th, average	893.9	884.6	896.1	893.3	893.9	887.1	890	888	885
annual change in %	2.1	-1.0	1.3	-0.3	0.3	-0.8	-0.4	-0.2	-0.3
Unemployed persons, LFS, th, average	120.4	107.6	98.2	95.3	98.1	89.0	90	90	80
Unemployment rate, LFS, in %, average	11.9	10.8	9.9	9.6	9.9	9.2	9.2	8.8	8.4
Reg. unemployment rate, in %, eop <sup>3)</sup>	9.5	8.5	8.7	8.4	8.3	7.2	.	.	.
Average monthly gross wages, EUR	715.7	765.0	818.0	859.0	839.7	905.8	930	1,000	1,070
annual change in % (real, gross)	4.6	6.2	6.7	3.8	5.8	4.6	4.5	4.0	4.0
Average monthly net wages, EUR	515.4	560.0	603.0	631.0	618.8	662.5	680	730	780
annual change in % (real, net)	5.6	8.0	7.4	4.3	5.5	3.8	3.8	3.5	3.5
Consumer prices (HICP), % p.a.	0.0	0.7	0.2	0.1	-0.6	3.1	3.3	3.2	3.0
Producer prices in industry, % p.a.	1.6	0.4	-1.0	-3.0	-3.5	1.4	2.0	2.5	2.0
General governm.budget, EU-def., % of GDP									
Revenues	35.9	35.9	35.9	36.6	.	.	36.0	35.3	35.7
Expenditures	36.9	37.5	37.2	36.6	.	.	36.8	36.5	36.4
Net lending (+) / net borrowing (-)	-1.0	-1.6	-1.3	0.0	.	.	-0.8	-1.2	-0.7
Public debt, EU-def., % of GDP	39.0	40.9	36.7	40.4	.	.	38.0	37.0	35.0
Stock of loans of non-fin.private sector, % p.a	-7.0	-8.8	-3.4	0.5	-0.3	1.0	.	.	.
Non-performing loans (NPL), in %, eop	8.3	6.9	6.0	4.4	5.1	4.4	.	.	.
Central bank policy rate, % p.a., eop <sup>4)</sup>	0.25	0.05	0.05	0.00	0.00	0.00	.	.	.
Current account, EUR mn	-621	-411	-116	342	202	-17	-100	-500	-700
Current account, % of GDP	-2.7	-1.7	-0.5	1.4	1.7	-0.1	-0.4	-1.7	-2.3
Exports of goods, BOP, EUR mn	9,810	10,242	10,336	10,391	4,888	5,366	11,300	11,900	12,400
annual change in %	1.7	4.4	0.9	0.5	-1.6	9.8	8.5	5.5	4.5
Imports of goods, BOP, EUR mn	12,431	12,621	12,538	12,310	5,848	6,631	14,100	15,300	16,200
annual change in %	1.2	1.5	-0.7	-1.8	-4.4	13.4	14.5	8.5	6.0
Exports of services, BOP, EUR mn	3,900	4,105	4,355	4,575	2,222	2,335	4,900	5,200	5,500
annual change in %	3.5	5.3	6.1	5.1	7.6	5.1	6.5	6.0	5.0
Imports of services, BOP, EUR mn	2,127	2,066	2,276	2,433	1,151	1,233	2,600	2,800	3,000
annual change in %	-0.8	-2.9	10.2	6.9	9.6	7.1	7.3	6.5	5.5
FDI liabilities, EUR mn	743	704	752	222	-129	361	500	.	.
FDI assets, EUR mn	373	409	126	217	149	170	300	.	.
Gross reserves of NB excl. gold, EUR mn <sup>5)</sup>	5,565	2,448	2,957	3,100	2,912	3,113	.	.	.
Gross external debt, EUR mn	30,501	34,035	34,921	37,079	37,923	37,424	37,500	38,700	39,700
Gross external debt, % of GDP	133.6	144.1	143.9	149.1	152.5	139.6	140.0	135.0	130.0
Average exchange rate EUR-LVL/EUR	0.9981	1.0000	1.0000	1.0000	1.0000	1.0000	1	1	1

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.