

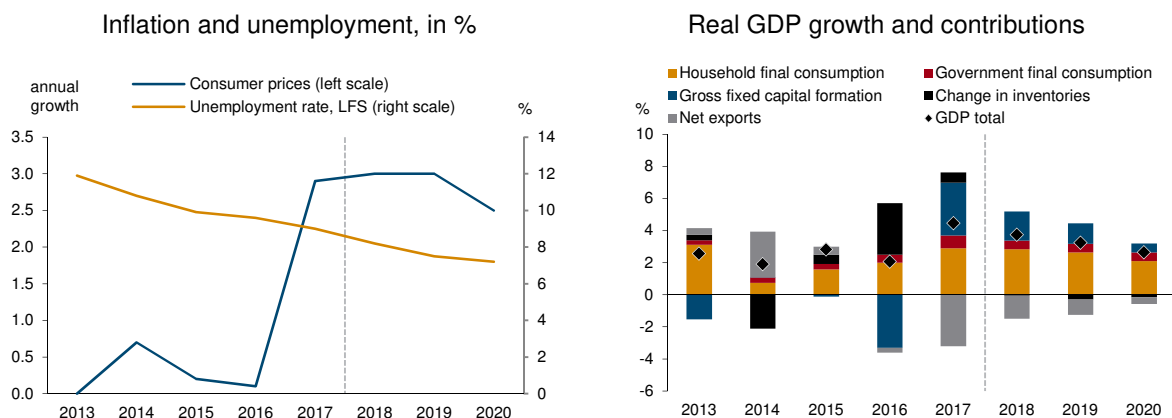


LATVIA: Riding high on the investment cycle

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Following a remarkable 2017, when GDP growth attained 4.5%, Latvia's economy will keep prospering at its potential in both 2018 and 2019. Public spending is continuing to expand rapidly, driven by the inflow of EU funds, while enterprises will also increase their investments. Growth in exports will remain lively. 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 3.3%, followed by a slight slowdown to 2.7% in 2020.

Figure 50 / Latvia: Main macroeconomic indicators



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

Gross fixed capital investment will continue to grow strongly in 2018. In 2017, fresh EU funds started to become available on a larger scale, thus allowing public investment in infrastructure to grow. However, the recent EBRD Transition report highlights the need for the Latvian government to raise the quality of project applications, in order to boost the absorption of EU funds. In the private sector, capital expenditure is expected to broaden in 2018, as capacity utilisation has reached relatively high levels in industry. In 2017, growth in enterprise investment was limited to the transport and trade sectors. Almost 40% of the increase in enterprise investment stemmed from the Latvian carrier airBaltic's replacement of part of its fleet. The airline was nationalised in the course of the economic crisis in 2011, but last year the government announced its re-privatisation; so far it has failed to find strategic investors, and given the high competition among low-cost carriers, the authorities will most probably be stuck with their 80%

share for some time to come. Private residential construction remained sluggish in 2017. The upward trend in the number of building permits, for residential and non-residential buildings alike, means that the prospects for the sector look rosier in 2018. Overall, we forecast total gross fixed investment to increase somewhat more slowly than in 2017, but still strongly – by another 10% in real terms in 2018 and 7% in 2019.

Following a year of stagnation, Latvian goods exports grew strongly in 2017 and will continue to do so throughout 2018. In 2017, exports to the CIS countries even increased by 25% in nominal year-on-year terms. But trade with Western Europe, the Scandinavian countries and the rest of the world also gradually gained momentum. Wood and food producers report an upswing in export growth figures, but the strongest increases are observed in the re-exporting wholesale sector. In general, we expect growth in both goods and services exports to slow slightly, but still to remain lively in 2018. With capital investment and household consumption increasing strongly, imports are expected to pick up again, and the goods trade balance is likely to turn more negative.

As expected, the rising level of prices for imported goods in 2017, compared to the previous year, resulted in an increase in consumer inflation to 2.9% p.a. Strong wage growth has started to raise core inflation. As the effect of increasing energy prices abates, we expect consumer inflation to remain at the level of about 3% this year and in 2019.

Still ample capacity in the construction sector led to a decline in employment in 2017 there, while job growth has been recorded in the service sectors. Overall employment will remain stagnant in the coming two years. In the medium term, demographic developments – including continuing net emigration – will result in a further decline in the working-age population and also in employment. Given the mounting demand for skilled employees, the Latvian government may reverse its restrictive stance on labour immigration. Employment rates are gradually increasing to the levels of the Scandinavian countries. Towards the end of 2017, the unemployment rate dipped below 9%. Up to the end of the forecast period in 2020, we expect it to decline gradually to about 7%.

Gross real wages will continue to rise, by another 4.5% in 2018 and about 3.5% in 2019. Inspired by the forthcoming parliamentary elections in October of this year, the government approved a substantial increase in the minimum wage, from EUR 380 to EUR 430 in January 2018. Thus, we expect household consumption to increase by about 4.5% in real terms this year and next, and by 3.5% in 2020.

As from January 2018, Latvia introduced a progressive component to its personal income tax scheme, having pursued a flat tax system for more than 20 years. The government reduced the rate of tax on annual income of below EUR 20,000 to 20%, kept it at 23% for higher earnings, and increased it to 31.4% for income above EUR 55,000. European Commission (EC) analysis has concluded that the government's stated aim of the reform, i.e. to reduce income inequality, will not be met. The bulk of the tax relief is received by middle and higher-income households, while the high tax wedge of low-income earners has not been reduced sufficiently. Moreover, among other measures, the tax reform includes the abolition of taxation on retained profits for enterprises, which is likely to reduce government revenues by 1% of GDP. The EC states that the reduction in the already low government revenue share in GDP will limit the financing of structural reforms, the redistributive function of the state and the additional resources required for the health and pension systems. The tax reform and election-biased expenditure

increases this year will result in a one-year increase in the budget deficit to 1% of GDP in 2018, followed by a decline to 0.5% in 2020.

Overall, broader-based economic activity is expected to grow at potential in both 2018 and 2019.

External demand will continue to grow at a lively pace, not only in nominal but also in real terms. After a stronger than anticipated investment hike in 2017, we expect a continued – also election-induced – free-spending mood in 2018. Household demand is continuing to evolve at a remarkable pace, and will be underpinned by high wage increases and income tax reductions. Due to further lively import demand from 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 and 3.3% in 2019 – before declining slightly to 2.7% in 2020.

Table 20 / Latvia: Selected economic indicators

	2013	2014	2015	2016	2017 ¹⁾	2018 Forecast	2019 Forecast	2020
Population, th pers., average	2,013	1,994	1,978	1,960	1,950	1,930	1,920	1,915
Gross domestic product, EUR mn, nom.	22,832	23,682	24,353	24,927	26,900	28,600	30,400	32,000
annual change in % (real)	2.6	1.9	2.8	2.1	4.5	3.8	3.3	2.7
GDP/capita (EUR at PPP)	16,700	17,600	18,500	18,800	19,800	.	.	.
Consumption of households, EUR mn, nom.	13,780	14,178	14,393	15,040	16,300	.	.	.
annual change in % (real)	5.3	1.2	2.7	3.4	4.7	4.7	4.4	3.5
Gross fixed capital form., EUR mn, nom.	5,291	5,337	5,385	4,538	3,743	.	.	.
annual change in % (real)	-6.0	0.1	-0.5	-15.0	16.0	10.0	7.0	3.0
Gross industrial production ²⁾								
annual change in % (real)	-0.9	-1.0	3.6	5.4	8.4	7.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	2.3	4.5	14.0	-7.3	-1.5	.	.	.
Construction industry								
annual change in % (real)	8.1	7.9	-1.2	-17.9	19.5	.	.	.
Employed persons, LFS, th, average	893.9	884.6	896.1	893.3	890.0	893	893	890
annual change in %	2.1	-1.0	1.3	-0.3	-0.4	0.3	0.0	-0.3
Unemployed persons, LFS, th, average	120.4	107.6	98.2	95.3	90.0	80	70	70
Unemployment rate, LFS, in %, average	11.9	10.8	9.9	9.6	9.0	8.2	7.5	7.2
Reg. unemployment rate, in %, eop ³⁾	9.5	8.5	8.7	8.4	6.8	.	.	.
Average monthly gross wages, EUR	715.7	765.0	818.0	859.0	930.0	1,000	1,070	1,130
annual change in % (real, gross)	4.6	6.2	6.7	3.8	4.5	4.5	3.5	3.0
Average monthly net wages, EUR	515.4	560.0	603.0	631.0	680.0	730	770	810
annual change in % (real, net)	5.6	8.0	7.4	4.3	3.8	3.8	3.0	2.8
Consumer prices (HICP), % p.a.	0.0	0.7	0.2	0.1	2.9	3.0	3.0	2.5
Producer prices in industry, % p.a.	1.6	0.4	-1.0	-3.0	2.2	2.5	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	36.7	37.0	37.2	37.4	37.0	36.0	35.7	35.6
Expenditures	37.7	38.2	38.4	37.3	37.8	37.0	36.4	36.1
Net lending (+) / net borrowing (-)	-1.0	-1.2	-1.2	0.0	-0.8	-1.0	-0.7	-0.5
General gov.gross debt, EU def., % of GDP	38.9	40.8	36.8	40.5	38.0	36.0	34.5	34.0
Stock of loans of non-fin.private sector, % p.a.	-7.0	-3.3	-2.8	0.1	-4.7	.	.	.
Non-performing loans (NPL), in %, eop	8.3	6.9	6.0	4.4	4.2	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.25	0.05	0.05	0.00	0.00	.	.	.
Current account, EUR mn	-621	-411	-116	342	-185	-411	-711	-821
Current account, % of GDP	-2.7	-1.7	-0.5	1.4	-0.7	-1.4	-2.3	-2.6
Exports of goods, BOP, EUR mn	9,810	10,242	10,336	10,391	11,349	12,100	12,700	13,300
annual change in %	1.7	4.4	0.9	0.5	9.2	6.6	5.0	4.7
Imports of goods, BOP, EUR mn	12,431	12,621	12,538	12,310	13,953	15,200	16,200	17,010
annual change in %	1.2	1.5	-0.7	-1.8	13.3	8.9	6.6	5.0
Exports of services, BOP, EUR mn	3,900	4,105	4,355	4,575	4,822	5,200	5,500	5,750
annual change in %	3.5	5.3	6.1	5.1	5.4	7.8	5.8	4.5
Imports of services, BOP, EUR mn	2,127	2,066	2,276	2,433	2,589	2,800	3,000	3,150
annual change in %	-0.8	-2.9	10.2	6.9	6.4	8.1	7.1	5.0
FDI liabilities, EUR mn	743	704	752	222	1,169	.	.	.
FDI assets, EUR mn	373	409	126	217	467	.	.	.
Gross reserves of NB excl. gold, EUR mn ⁵⁾	5,565	2,448	2,957	3,100	3,617	.	.	.
Gross external debt, EUR mn	30,501	34,035	34,921	37,079	37,660	37,800	39,500	40,000
Gross external debt, % of GDP	133.3	143.7	143.4	148.8	140.0	132.0	130.0	125.0
Average exchange rate EUR-LVL/EUR	0.9981	1.0000	1.0000	1.0000	1.0000	1	1	1

1) Preliminary and wiiw estimates. - 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.