Sebastian Leitner

Latvia:
Aiming for euozone accession

The downturn of the European trade cycle leads to lowered growth prospects also for Latvia in 2012. The corporate and the household sector will continue to deleverage quite strongly, thus the growth in investments and household consumption will decline as well. Eager to join the eurozone in 2014, the Latvian government will most probably manage to reduce the budget deficit to below 3% in 2012. The greatest obstacle will however be to lower the consumer inflation rate to the Maastricht criterion. From 2013 onwards we expect external demand to trigger a revival in output growth.

The revival of the Latvian GDP growth rate to 5.3% year on year that could be observed in 2011 was triggered largely by an upswing in domestic demand. Exports increased substantially in the first half of 2011, but growth rates declined markedly throughout the rest of the year. After gross fixed capital investment had declined for three years to below half of the level of 2007, outlays especially for machinery and equipment started rising again in 2011, by about 20% in real terms. Also households started to spend again, increasing consumption by 4.4% in real terms. The current account, which still had a surplus of 3% in 2010, once again moved into the red although the deficit, at about -1%, is still small.

The growth rates of external demand, being vibrant in the first half of 2011, dwindled towards the end of the year. Looking at the export structure, it can be observed that the core of the production structure of the country is still the wood industry and, to a minor extent, crude and semi-processed iron and steel, while the further processing sectors (i.e. pulp, paper, furniture and machinery) remain underdeveloped. In 2012 the growth in external demand especially of Western European countries is expected to decline even further. The same is likely to be the case for exports to Latvia's main trade partners Estonia and Lithuania. Only the growth of eastward exports is expected to remain somewhat more stable this year.

With growth of exports and industrial production slowing down, the investment activity, which recovered in 2011, is likely to fall off again in 2012. The same development is expected for foreign direct investment. In 2011 inflows particularly to the real estate sector recuperated, while inflows to the manufacturing sectors remained small. The corporate and the household sector are deleveraging quite strongly; in the course of 2011 the stock of bank loans to the private sector declined by almost 8%. The share of non-performing loans (overdue more than 90 days) decreased only gradually, to 18% in September 2011, the highest figure among the new EU member states.

Consumption will not develop as vibrantly in 2012 compared to last year because of the slowdown of general economic activity and a low employment growth rate. However, average gross and real wages are likely to increase somewhat in the private sector. Moreover, due to the outward migration the inflow of remittances has increased in the past three years, financing households' consumption outlays. With domestic demand remaining strong, the growth rate of imports will once again surpass that of exports. Thus we expect the current account deficit to grow to 2% of GDP and net exports to have a negative impact on GDP growth in 2012.

The outstanding target of the Latvian government for 2012 is to fulfil the Maastricht criteria in order to be accepted to join the eurozone in 2014. Thus, the key indicator to be observed is the development of consumer prices, which increased by not less than 4.2% in 2011. Obviously, last year's inflation was driven by rising prices for imported food and energy as well as by increases in VAT and excise tax rates. The government will thus refrain from increasing the tax wedge on consumption in 2012 and the year after, at least until the decision of the ECOFIN in mid-2013. However, there is still the danger that the average inflation rate of the three 'best performing' countries in the eurozone falls below 0.8% in 2012 due to recessionary developments. Then the case of Latvia would become a play for the political stage in Brussels despite a low inflation rate, which we expect to be 2.3% for the whole year of 2012 on average.

Furthermore, the Latvian government is obviously eager to reduce the budget deficit below the Maastricht criterion of 3% in 2012. The rise in economic activity and consumption, together with the increases in indirect taxation, resulted in budget revenues growing by one percentage point to 37% of GDP in 2011. In parallel, the cuts in public wages and reduction of spending in the fields of defence, health and education reduced the ratio of public expenditures to GDP from more than 44% in 2010 to about 41% in 2011. The budget for 2012 foresees further nominal restraint on the public wage bill, as well as a cut of public investments and various subsidies to the corporate sector, but also of social transfers. Even the IMF points to the fact that the tax structure and the austerity measures are highly unfavourable towards low-income earners.

We expect the budget deficit to decline to 2.8% in 2012. At the end of 2011 the IMF-EU rescue programme to Latvia came to an end, thus from this year onwards the repayment of borrowed funds has to be arranged. Since in total the Latvian government had to draw on only USD 4.1 billion of the USD 7.5 billion rescue package and its long-term government bond yields are comparable to those of Poland, Lithuania and the Slovak Republic, it should not have problems meeting its refinancing needs.

The situation on the labour market remains strained, with an unemployment rate of more than 15% on average in 2011. Notably, no employment recovery took place in industry; only in the service sectors can some revival be observed. Half of the 4% growth in employment in 2011 can be traced back to an increase in (formal or informal) jobs in agriculture. In the coming two years we expect employment growth to be even more sluggish, increasing by not more than 1% per year.

The 2011 census figures show that the population living in Latvia declined dramatically, by about 13% compared to 2000; this was an even stronger decline than in the period of the transitional crisis from 1989 to 2000 (-11%). While in the past decade the natural decrease of the population resulted in a reduction by about 120 thousand persons, net emigration caused another decline in the population figure by about 190 thousand people. In the past three years in particular more than 100 thousand persons are estimated to have left the country to make a living abroad. These developments are a threat to the future growth potential of the Latvian economy. Even more critical appears the situation if we look at the development of the demographic structure highlighted in the 2011 census; the number of people aged 0 to 14 years declined by 32% from 2000 to 2011, which is likely to pose a problem for long-term economic growth for Latvia.

Driven by a decline of external demand growth, 2012 will bring about an end to last year's swift GDP revival. We expect economic output to increase by only 2% in real terms. In 2013 and 2014 a gradual recovery of goods exports shall bring forth again an increase of corporations' investments. This should also trigger a swifter rise in wages. Thus household demand is likely to recover as well. Accordingly, we expect GDP to grow at a higher rate, by 3.3% in 2013 and 4% in 2014.

Table LV

Latvia: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 [1)]	2012	2013 Forecast	2014
Population, th pers., average [2)]	2287.9	2276.1	2266.1	2254.8	2239.0	2067.4	2047	2037	2027
Gross domestic product, LVL mn, nom.	11126.6	14720.7	16084.7	13070.4	12738.7	14000	14600	15500	16500
annual change in % (real)	11.1	9.6	-3.3	-17.8	-0.3	5.3	2	3.3	3.5
GDP/capita (EUR at exchange rate)	7000	9200	10100	8200	8000	9600	.	.	.
GDP/capita (EUR at PPP)	12200	13900	14100	12000	12500	14500	.	.	.
Consumption of households, LVL mn, nom.	7166.1	9049.0	9903.6	7889.3	7908.0	8690	.	.	.
annual change in % (real)	21.6	14.6	-5.8	-22.8	0.6	4.4	2.5	3	3.5
Gross fixed capital form., LVL mn, nom.	3665.9	5013.3	4769.6	2820.3	2487.2	3180	.	.	.
annual change in % (real)	16.3	7.9	-13.7	-37.4	-12.2	21	6	8	8
Gross industrial production [3)]									
annual change in % (real)	6.5	1.1	-3.2	-18.1	14.9	9.0	4	8	10
Gross agricultural production (EAA)									
annual change in % (real)	-1.9	10.8	0.2	-0.7	-2.4	1.7	.	.	.
Construction industry									
annual change in % (real)	13.3	13.6	-3.1	-34.9	-23.4	12.4	.	.	.
Employed persons - LFS, th, average	1087.1	1118.0	1124.5	983.1	940.9	970.5	980	990	1010
annual change in %	5.2	2.8	0.6	-12.6	-4.3	3.1	1	1	2
Unemployed persons - LFS, th, average	79.5	71.3	90.5	203.2	216.1	176.5	.	.	.
Unemployment rate - LFS, in %, average	6.8	6.0	7.5	17.1	18.7	15.3	14	13	12
Reg. unemployment rate, in %, end of period	6.5	4.9	7.0	16.0	14.3	11.5	.	.	.
Average gross monthly wages, LVL	302	398	479	461	445	465	.	.	.
annual change in % (real, net)	15.6	19.9	6.2	-5.6	-6.5	0.3	.	.	.
Consumer prices (HICP), % p.a.	6.6	10.1	15.2	3.3	-1.2	4.2	2.3	2.5	3.0
Producer prices in industry, % p.a.	10.3	16.1	11.4	-4.6	2.8	7.4	.	.	.
General government budget, EU-def., % GDP									
Revenues	37.8	35.6	34.9	34.6	36.1	37	36.5	37.0	37.5
Expenditures	38.3	35.9	39.1	44.2	44.4	41	39.3	39.5	39.5
Net lending (+) / net borrowing (-)	-0.5	-0.4	-4.2	-9.6	-8.2	-4	-2.8	-2.5	-2.0
Public debt, EU-def., in % of GDP	10.7	9.0	19.8	36.7	44.7	43	42.4	41.2	39.5
Central bank policy rate, % p.a., end of period [4)]	5.0	6.0	6.0	4.0	3.5	3.5	.	.	.
Current account, EUR mn	-3603	-4710	-3014	1598	535	-160	-400	-550	-700
Current account in % of GDP	-22.5	-22.4	-13.2	8.6	3.0	-0.8	-1.9	-2.5	-3.0
Exports of goods, BOP, EUR mn	4929	6020	6531	5253	6813	8600	9200	10300	11800
annual growth rate in %	14.3	22.1	8.5	-19.6	29.7	26	7	12	15
Imports of goods, BOP, EUR mn	9032	11074	10603	6575	8084	10300	11200	12500	14400
annual growth rate in %	33.7	22.6	-4.3	-38.0	23.0	27	9	12	15
Exports of services, BOP, EUR mn	2121	2707	3088	2747	2763	3100	3300	3600	4000
annual growth rate in %	21.7	27.6	14.1	-11.0	0.6	12	6	9	11
Imports of services, BOP, EUR mn	1586	1974	2169	1625	1666	1850	2000	2200	2450
annual growth rate in %	26.3	24.5	9.9	-25.1	2.5	11	8	10	11
FDI inflow, EUR mn	1339	1705	869	68	284	1150	.	.	.
FDI outflow, EUR mn	136	270	169	-44	16	50	.	.	.
Gross reserves of NB excl. gold, EUR mn	3346	3860	3514	4572	5472	4643	.	.	.
Gross external debt, EUR mn	18128	26835	29763	29097	29978	29600	.	.	.
Gross external debt in % of GDP	113.4	127.6	130.0	157.1	166.8	149.3	.	.	.
Average exchange rate LVL/EUR	0.6962	0.7001	0.7027	0.7057	0.7087	0.7063	0.71	0.71	0.71
Purchasing power parity LVL/EUR	0.4000	0.4664	0.5051	0.4814	0.4543	0.4669	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) From 2011 according to census March 2011. - 3) Enterprises with 20 and more employees. - 4) Refinancing rate of National Bank.

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