

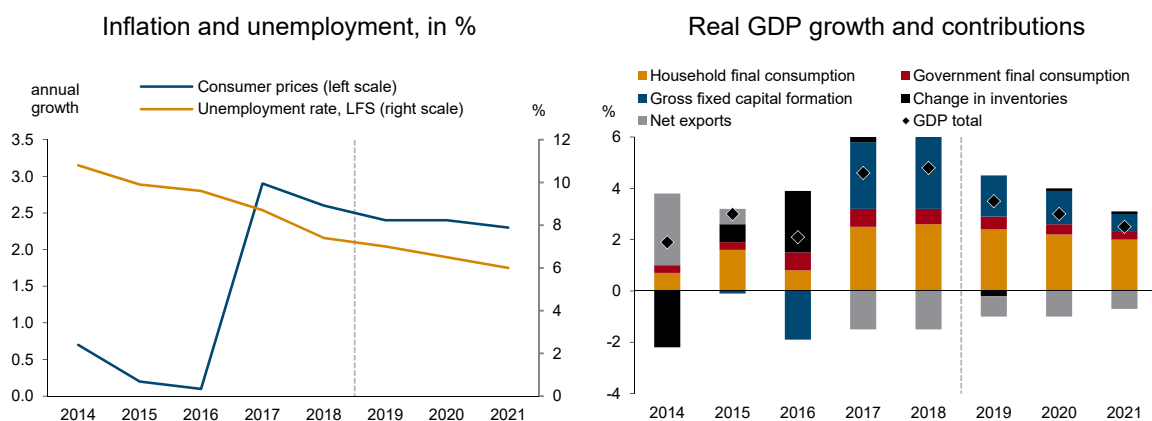


## LATVIA: Beyond peak, but growth further bolstered by investment

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Both public and private investment keep the economy growing at a high pace in 2019, whereas export activity is further abating this year. Household consumption will continue to rise rapidly in 2019. While employment increases, skill shortage results in strong wage growth. The incoming coalition government may pursue a more lax fiscal policy. In 2019 we expect GDP to grow still considerably, by 3.5% in real terms, followed by a further slowdown to 3% in 2020 and 2.5% in 2021.

Figure 6.11 / Latvia: Main macroeconomic indicators



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

**Surprisingly strong investment activity in the second half of last year helped Latvian GDP to grow remarkably, by 4.8% in real terms, in 2018.** Capital spending will continue to bolster economic activity in 2019 but to a minor degree. One of the major ongoing public investment projects co-financed by EU funds is Rail Baltica, the high-speed train connecting the Baltics with central Europe. At the moment the project is in the phase of detailed technical design, while the construction will be realised in 2020-2025. EU-financed road upgrading has already been accomplished to a great extent. The current investment boom is fostered by construction activity; however, investment in machinery revived in the second half of 2018 in manufacturing and service sectors. Historically high rates of capacity utilisation show the need for investment in production equipment. The latest figures for building permits granted indicate that the rise in construction activity related to dwellings, but also office, industrial and other commercial buildings is going to continue in 2019. Given strongly rising prices and wages in the construction sector from 2020 onwards an amelioration of demand is to be expected.

**Export growth fell more than expected in 2018, given the weaker developments in major trading partners.** Growth in exports to Western Europe, Estonia and Latvia abated, but remained high to Sweden and Finland. Positive contributions came from the important export sectors wood, articles of base metals, transport vehicles and prepared foodstuffs, while electrical and mechanical appliances fared rather badly. So far, Latvian producers have been able to maintain their shares in the world market. However, their external competitive position is under pressure, given sustained wage growth. Declining employment in manufacturing, despite increasing household consumption, shows the mounting problem of the industrial sectors. Although capital investment and household consumption are rising strongly, real growth in imports declines, given the high share of re-exported goods and transit trade in the Latvian economy. As a result, the current account deficit will widen only slightly this year. However, in 2020-2021 we expect net exports to become more negative, in line with a cooling of external demand.

**Following the parliamentary elections in October 2018, it took until the end of January 2019 to form a new government, and the stability of the government is questionable.** The rather heterogeneous coalition comprises the liberal 'Unity' and the populist right-wing 'National Alliance', both already partners in the former government. In addition, three newly founded parties that together attained almost half of the seats in the parliament were incorporated: the populist anti-establishment party 'Who owns the state?' – KPV (16 seats), the 'New Conservative Party' – JKP (16 seats) and the liberal 'Development/For!' (13 seats). The centre-left 'Harmony Centre', which came first in the elections (as in 2011 and 2014) with 20% of the votes and has a stronghold in the Russian-speaking minority, was again excluded from coalition talks. Up to now all Latvian parties from the liberal-nationalistic block reject collaboration with 'Harmony Centre', stressing the at least former strong ties with the party 'United Russia' of President Putin. Given the multitude of claims announced before the elections by the five coalition partners and the anti-EU stance of the populist KPV party, the stability of the government is in question. Over the medium term we might observe more strongly rising minimum wages and swifter rising government consumption, i.e. somewhat laxer fiscal policy, in order to meet the demands of all coalition parties. In the absence of a government, 2019 started with a temporary budget. The incoming Finance Minister announced that no tax changes will be introduced this year or next. The medium-term budget strategy foresees substantial increases in family benefits and public health expenditure for the coming years. At the same time, however, the fiscal strategy foresees a reduction of the overall share of the government in GDP via gradual tax reductions.

**Employment grew swiftly in 2018 (+1.7% year on year), driven particularly by the upswing in construction.** Strongly rising wages in the sector attracted employees from other industries and foreign workers. However, jobs also increased considerably in trade, the ICT sector and hotels and restaurants. Tourism in general is flourishing, the number of foreigners visiting the country increased by 9% last year compared to 2017. Employment rates are increasing strongly and are approaching the levels of Scandinavian countries, which are the frontrunners in the EU in this respect. The unemployment rate fell to 7.5% in 2018 on average and is expected to decline to about 6% by the end of the forecast period in 2021. In the longer term, Latvia is going to experience a substantial decline of the working-age population. In the past 15 years the age group 15-64 already shrank by 20% – without policy changes a reduction of the same extent is likely up to 2030 given ongoing negative net migration and the natural population decline. Even the strong wage rises experienced at the moment are not likely to increase return migration sufficiently to reverse the trend.

**The rather tight situation in the labour market resulted in strong growth of gross wages, by 6% in 2018 year on year in real terms.** This was also an outcome of the strong increase in the minimum wage (+13%) in January last year. Given the political standstill following the parliamentary elections, no further increase was arranged for 2019. Thus, this year we expect a slower but still substantial increase in household incomes, which will continue also in 2020-2021. This will further fuel household consumption which is projected to increase by about 4.1% in real terms in 2019. In the period 2020-2021 we expect some slowdown but consumption to still grow by 3.5% on average. The above-mentioned strong rise in household incomes is, however, unequally distributed; a considerable part of the Latvian population is left behind. Overall, 23% of the Latvian population was at risk of poverty (according to EU definition) in 2017, substantially more than in most other EU countries. 49% of pensioners and 60% of the unemployed fall below the poverty line, showing that support provided by social transfers is rather low in Latvia.

**Strong wage growth has not fed through into rising inflation in 2018.** On the contrary, although high oil prices contributed substantially to consumer inflation, the CPI declined to 2.6% last year. This can be explained by slowly rising prices for imported goods and rather high productivity growth in the economy. With falling prices for imported energy and low increases of excises, we expect the level of consumer inflation to decrease further to about 2.4% in 2019 and 2020.

**Surprised by strong investment activity in the second half of last year, we have also become slightly more optimistic for this year. Thus, we have increased the forecast for the GDP growth rate to 3.5% in 2019.** Private investment activity and also public investment will remain buoyant, not only this year but also in 2020, the latter facilitated by ongoing inflows of EU funds. An increase in employment and rising wages help private consumption to keep on growing steadily. Although export activity is losing momentum, the net contribution of trade is expected to improve this year. Thereafter, we see some cooling off, given the deterioration of the external economic environment and a downward trend in the investment cycle towards the end of the forecast period. However, we forecast the Latvian GDP to grow still by 3% in 2020 and 2.5% in 2021.

**Table 6.11 / Latvia: Selected economic indicators**

	2014	2015	2016	2017	2018 <sup>1)</sup>	2019	2020	2021
						Forecast		
Population, th pers., average	1,994	1,978	1,960	1,942	1,930	1,920	1,910	1,900
Gross domestic product, EUR mn, nom.	23,618	24,320	25,038	27,033	29,000	31,300	33,000	34,600
annual change in % (real)	1.9	3.0	2.1	4.6	4.8	3.5	3.0	2.5
GDP/capita (EUR at PPP)	17,500	18,600	18,800	20,000	21,300	.	.	.
Consumption of households, EUR mn, nom.	14,178	14,393	14,751	15,842	17,000	.	.	.
annual change in % (real)	1.2	2.7	1.4	4.2	4.5	4.1	3.7	3.4
Gross fixed capital form., EUR mn, nom.	5,337	5,385	4,915	5,651	6,600	.	.	.
annual change in % (real)	0.1	-0.5	-8.4	13.1	13.5	7.5	6.0	3.5
Gross industrial production <sup>2)</sup>								
annual change in % (real)	-1.1	3.6	5.4	8.3	1.5	3.2	2.5	2.0
Gross agricultural production								
annual change in % (real)	4.5	14.0	-7.3	0.1	-8.1	.	.	.
Construction industry								
annual change in % (real)	10.5	-0.6	-16.6	18.7	21.8	.	.	.
Employed persons, LFS, th, average	884.6	896.1	893.3	894.8	910.0	920	925	930
annual change in %	-1.0	1.3	-0.3	0.2	1.7	1.1	0.5	0.5
Unemployed persons, LFS, th, average	107.6	98.2	95.3	85.4	72.8	69	64	59
Unemployment rate, LFS, in %, average	10.8	9.9	9.6	8.7	7.4	7.0	6.5	6.0
Reg. unemployment rate, in %, eop <sup>3)</sup>	8.5	8.7	8.4	6.8	6.4	.	.	.
Average monthly gross wages, EUR	765.0	818.0	859.0	926.0	1,010.0	1,080	1,150	1,220
annual change in % (real, gross)	6.2	6.7	4.9	4.5	6.0	4.5	4.0	3.8
Average monthly net wages, EUR	560.0	603.0	631.0	676.0	740.0	790	840	890
annual change in % (real, net)	8.0	7.4	4.3	3.8	7.0	4.3	3.8	3.6
Consumer prices (HICP), % p.a.	0.7	0.2	0.1	2.9	2.6	2.4	2.4	2.3
Producer prices in industry, % p.a.	0.4	-1.0	-2.5	2.5	4.3	2.0	2.5	2.5
General governm.budget, EU-def., % of GDP								
Revenues	36.6	36.9	37.0	37.2	36.5	36.4	36.3	36.5
Expenditures	38.1	38.2	37.0	37.8	37.3	37.4	37.6	38.0
Net lending (+) / net borrowing (-)	-1.5	-1.4	0.1	-0.6	-0.8	-1.0	-1.3	-1.5
General gov.gross debt, EU def., % of GDP	40.9	36.8	40.3	40.0	37.0	36.0	35.5	35.0
Stock of loans of non-fin.private sector, % p.a.	-3.3	-2.8	0.1	-4.7	-5.2	.	.	.
Non-performing loans (NPL), in %, eop	6.9	6.0	4.4	4.1	4.2	.	.	.
Central bank policy rate, % p.a., eop <sup>4)</sup>	0.05	0.05	0.00	0.00	0.00	.	.	.
Current account, EUR mn	-411	-113	403	191	-141	-214	-314	-364
Current account, % of GDP	-1.7	-0.5	1.6	0.7	-0.5	-0.7	-1.0	-1.1
Exports of goods, BOP, EUR mn	10,242	10,340	10,411	11,543	12,103	12,700	13,200	13,750
annual change in %	4.4	1.0	0.7	10.9	4.9	4.9	3.9	4.2
Imports of goods, BOP, EUR mn	12,621	12,538	12,296	13,851	14,665	15,400	16,100	16,850
annual change in %	1.5	-0.7	-1.9	12.6	5.9	5.0	4.5	4.7
Exports of services, BOP, EUR mn	4,105	4,356	4,606	4,973	5,212	5,400	5,700	6,000
annual change in %	5.3	6.1	5.7	8.0	4.8	3.6	5.6	5.3
Imports of services, BOP, EUR mn	2,066	2,279	2,432	2,641	2,831	3,000	3,200	3,350
annual change in %	-2.9	10.3	6.7	8.6	7.2	6.0	6.7	4.7
FDI liabilities, EUR mn	704	712	222	1,024	305	.	.	.
FDI assets, EUR mn	409	134	199	499	-248	.	.	.
Gross reserves of NB excl. gold, EUR mn	2,448	2,957	3,100	3,620	3,578	37,600	38,000	39,800
Gross external debt, EUR mn	34,035	34,947	37,289	37,984	36,300	37,600	38,000	39,800
Gross external debt, % of GDP	144.1	143.7	148.9	140.5	125.2	120.0	115.0	115.0

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) Official refinancing operation rates for euro area (ECB).

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