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Latvia:
Eurozone within reach

Latvia is heading towards Eurozone accession and shall fulfil the Maastricht inflation and deficit criteria this year. However, the unemployment rate still amounts to more than 15% and the competitiveness of the industrial sector will remain a sore point of the Latvian economy. With sluggish export developments domestic demand is the trigger of GDP growth this year and 2013.

In the first quarter of 2012, Latvia recorded the highest GDP growth rate in the EU-27 (6.9% year-on-year), although external demand had slowed down to a remarkable degree. The level of capital investments, which had dropped in 2009 to half of the pre-crisis level, has continued to rebound strongly. Furthermore, the gradual upswing in employment has triggered growth in domestic consumption.

Growth in the export of goods continued to decline over the first few months of 2012. In particular, external demand among Latvia’s trading partners in Western European slowed down perceptibly. However, in the course of the past two years Latvian exporters were able to improve their competitive position and, in turn, their market shares in their main export markets as well. Moreover, on looking at detailed trade figures, we can see that the range of export products has broadened over the past two years. The relative importance of wood products has declined, while metal products and machinery have assumed greater importance. Moreover, Latvian producers, in particular in the food industry, have managed to increase substantially the volume of exports to Russia.

Subsequent to the slump in export growth rates, imports of intermediary goods also lost momentum. However, imports of goods continue to record nominal growth rates surpassing those of exports on account of strong domestic demand. The current account deficit will thus record gradual growth in 2012 and the two years thereafter.

In contrast to the second half of 2011, the volume of retail trade in the first months of 2012 experienced rapid growth again, reflecting rising consumer confidence in the wake of improvements in the labour market situation. Subsequently, private household consumption increased by 5.6% in real terms year-on-year in the first quarter 2012. Owing to the modest rise in real wages and the inflow of remittances, household consumption will continue to drive GDP growth throughout the year. Nevertheless, private households and the corporate sector keep on deleveraging.

The growth rate of gross fixed capital investment strongly increased in the first quarter of 2012, the main driver being public expenditures on the construction of roads and other transport infrastructure. Owing to the cloudy outlook in terms of exports and industrial production in the months to come, investment in machinery will also be restrained during the rest of 2012.

Compared to the previous year, employment in the service sector continued to grow slightly in the first quarter 2012. The recalculation of population figures in line with the findings of 2011 census yielded an upward revision of unemployment rates by 1 percentage point. Throughout 2012, the deceleration of external demand will allow for only a slight reduction in unemployment, while employment in manufacturing will even go into decline. A persistent problem in the Latvian labour market is the pronounced divergence between urban and rural regions, as well as between the western and eastern regions of the country. Whereas in the Riga area the registered unemployment rate has dropped to less than 10%, it stands at almost 25% in the Latgale region in the south-east part of the country.

Although gross wages have continued to rise (by 3.7% in the first quarter of 2012), average real net wages have remained stagnant. Whereas consumer inflation will drop over the rest of the current year, households will experience a slight increase in their purchasing power towards the end of 2012.

The most important goal in Latvian economic policy remains the attainment of the Maastricht criteria so that country can join the Eurozone in 2014. During the first months of 2012, consumer inflation rates declined constantly. However, the previously forecast CPI-rate of 2.8% for 2012 gave rise to concern over the possibility of the country not meeting the inflation criterion, should the euro-crisis lead to still more recession and hence to a decline of inflation rates in Southern Europe. Aware of the situation, the Latvian government decided in May 2012 to lower VAT from 22% to 21% from 1 July 2012 onwards. That move should lower the annual inflation rate for 2012 by about 0.5 percentage points.

The severe austerity measures introduced during the economic crisis had already led to a drop in the general government deficit to 3.5% of GDP in 2011. Since many of the spending cuts are more of a permanent nature extending over the medium term, such as staff cutbacks in the public sector as well as cuts in both public wages levels and social transfers, the government deficit will continue to fall given every expectation of tax revenues increasing as mentioned above. The resolve to reduce the rate of VAT will prevent the budget deficit from dropping close to 2%; however the deficit will hold at about 2.6% of GDP in 2012. Assuming a gradual upswing in economic activities, the budget deficit will decline further over the next two years.

Assuming a recovery of external demand dynamics across Western Europe, we expect GDP growth in 2013 and 2014 to pick up speed once again: rising to 3.3% in 2013 and 3.8% in 2014. Public investment is likely to remain at a high level in the current year and the year thereafter, since a large portion of EU-funds for the period 2007-2013 remained unspent up to now. Moreover, assuming that the slowdown in GDP growth to 2.7% in 2012 will still allow for a slight reduction in unemployment, we also expect real wages to start rising somewhat more rapidly in the two years to come. Accordingly, household demand is also likely to increase over the next two years. Weighing in at about 3% in real terms year-on-year, it will thus remain an important driver of GDP growth.

Table LV

Latvia: Selected Economic Indicators

	2008	2009	2010	2011 1)	2011	2012	2012	2013	2014
					1st quarter			Forecast	
Population, th pers., average 2)	2266.1	2254.8	2239.0	2064.1	.	.	2047	2037	2027
Gross domestic product, LVL mn, nom.	16085	13070	12739	14161	3046	3385	14900	15800	17000
annual change in % (real)	-3.3	-17.7	-0.3	5.4	3.5	6.9	2.7	3.3	3.8
GDP/capita (EUR at exchange rate) 2)	10100	8200	8000	9700	.	.	.	.	.
GDP/capita (EUR at PPP) 2)	14100	12000	12500	14500	.	.	.	.	.
Consumption of households, LVL mn, nom.	9904	7889	7908	8682	1991	2188	.	.	.
annual change in % (real)	-5.8	-22.8	0.7	4.6	3.5	5.6	3.5	3	3.5
Gross fixed capital form., LVL mn, nom.	4770	2820	2330	3045	471	692	.	.	.
annual change in % (real)	-13.7	-37.4	-18.1	27.9	31.4	39.0	15	8	10
Gross industrial production 3)									
annual change in % (real)	-3.2	-18.1	14.9	9.0	10.7	9.8	7	8	10
Gross agricultural production (EAA)									
annual change in % (real)	0.2	-0.7	-2.4	1.3	.	.	.	.	.
Construction industry									
annual change in % (real)	-3.1	-34.9	-23.4	12.4	-15.1	28.5	.	.	.
Employed persons - LFS, th, average 4)	1124.5	983.1	940.9	970.5	835.9	857.6	880	890	900
annual change in %	0.6	-12.6	-4.3	3.1	3.1	2.6	2	1	1
Unemployed persons - LFS, th, average 4)	90.5	203.2	216.1	176.4	178.9	166.7	.	.	.
Unemployment rate - LFS, in %, average 4)	7.5	17.1	18.7	15.4	17.6	16.3	15.5	14.5	14
Reg. unemployment rate, in %, end of period	7.0	16.0	14.3	11.5	14.4	11.7	.	.	.
Average gross monthly wages, LVL	479	461	445	464	450	466	.	.	.
annual change in % (real, net)	6.2	-5.6	-6.5	0.3	0.1	0.2	.	.	.
Consumer prices (HICP), % p.a.	15.2	3.3	-1.2	4.2	3.8	3.3	2.4	2.8	3.5
Producer prices in industry, % p.a.	11.4	-4.6	2.8	7.4	8.2	5.9	.	.	.
General government budget, EU-def., % GDP									
Revenues	34.9	34.7	35.7	35.6	36.6	.	35.9	37.0	37.5
Expenditures	39.1	44.4	43.9	39.1	38.8	.	38.5	39.5	39.5
Net lending (+) / net borrowing (-)	-4.2	-9.7	-8.1	-3.5	-2.3	.	-2.6	-2.5	-2.0
Public debt, EU-def., in % of GDP	19.8	36.7	44.7	42.6	43.9	.	43.5	44.5	45.5
Central bank policy rate, % p.a., end of period 5)	6.0	4.0	3.5	3.5	3.5	.	.	.	.
Current account, EUR mn	-3014	1598	535	-241	28	-143	-500	-600	-700
Current account in % of GDP	-13.2	8.6	3.0	-1.2	0.6	-3	-2.4	-2.7	-2.9
Exports of goods, BOP, EUR mn	6531	5253	6813	8598	1924	2146	9500	10600	12100
annual growth rate in %	8.5	-19.6	29.7	26.2	41.8	11.5	10	12	14
Imports of goods, BOP, EUR mn	10603	6575	8084	10586	2295	2713	12200	13600	15700
annual growth rate in %	-4.3	-38.0	23.0	31.0	40.4	18.2	15	11	15
Exports of services, BOP, EUR mn	3088	2747	2763	3176	663	772	3700	4100	4500
annual growth rate in %	14.1	-11.0	0.6	14.9	8.5	16.4	16	11	10
Imports of services, BOP, EUR mn	2169	1625	1666	1856	383	418	2000	2200	2450
annual growth rate in %	9.9	-25.1	2.5	11.4	8.2	9.1	8	10	11
FDI inflow, EUR mn	869	68	284	1108	270	101	.	.	.
FDI outflow, EUR mn	169	-44	16	64	21	-10	.	.	.
Gross reserves of NB excl. gold, EUR mn	3514	4572	5472	4665	4997	5067	.	.	.
Gross external debt, EUR mn	29763	29097	29978	29405	29082	29983	.	.	.
Gross external debt in % of GDP	130.0	157.1	166.8	146.7	145.1	142.6	.	.	.
Average exchange rate LVL/EUR	0.7027	0.7057	0.7087	0.7063	0.7048	0.7048	0.71	0.71	0.71
Purchasing power parity LVL/EUR	0.5051	0.4814	0.4543	0.4720	.	.	.	.	.

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. - 2) From 2011 according to census March 2011. - 3) Enterprises with 20 and more employees. - 4) Quarterly data according to census March 2011. - 5) Refinancing rate of National Bank.

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