



## LATVIA: Headwind from the east

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**Prospects for the Latvian economy in 2015 have gradually deteriorated over the past few months. The major devaluation of the Russian rouble and the Russian economic slump will drag down the volume of Latvian exports. Entrepreneurs will thus be reluctant to expand their investment activities – at least not before 2016. It is expected, however, that household consumption will keep the Latvian economy buoyant, increasing by 2.1% in 2015 before a revival in external demand sets in and revitalises economic activity overall.**

Throughout 2014 the growth of export volumes declined not least due to the Russian embargo on food products. Although trade with western markets is developing at a good pace, in 2015 the setback of Russian demand will result at best in stagnation of overall Latvian exports. The expected decline in transit trade will also hit the transport and wholesale trade sectors.

In line with exports also industrial production decreased for the second year in a row in 2014. A substantial upswing is not to be expected in 2015 either, although positive growth might be accomplished. Liepajas metalurģs, the largest producer in the Latvian steel sector, which became insolvent and was taken over by the Ukrainian KVV group last year, resumed production in mid-February 2015. In total the plans envisage the reinstatement of about 1,300 employees.

In the light of unsatisfying business prospects, confidence indicators in the industrial and construction sectors are on the decline. Accordingly, in the second half of last year growth in fixed capital investments declined and will remain almost stagnant in 2015. The same applies to public investments, which are planned to be reduced slightly as a share in GDP, from about 3.8% of GDP last year to 3.6% in 2015. The availability of fresh EU funds will result in public as well as private investments growing more swiftly in 2016 and thereafter.

The budget deficit is scheduled to be reduced slightly and is likely to amount to 1.3% of GDP in 2015. From January 2015 onwards the flat income tax rate was cut from 24% to 23%, while the minimum wage was increased by 12.5% to EUR 360. A further cut of the income tax rate of one percentage point and an increase in tax allowances for low-income earners and families are envisaged for 2016.

The significant decrease of energy prices resulted in consumer prices remaining stagnant in 2014 and even declining in January 2015. However, with prices in services rising by about 4% and oil prices unlikely to fall further, we expect consumer price inflation to increase slightly in 2015.

Households benefited from low inflation and strongly rising wage incomes in 2014. As a result, net incomes expanded remarkably, by 7.6%. For this year we expect wage growth to slow down slightly to 6.5% and continue to grow at a high pace, by some 6%, in 2016 as well.

Already in 2014 the number of employed declined by 1% although the unemployment figures were decreasing gradually. Towards the end of 2015 we expect the unemployment rate to fall below 10% for the first time after the outbreak of the economic crisis in 2008. Demographic developments, reinforced by negative net migration, will however result in a decline in the labour force by more than 1% annually in the years ahead.

Considering the strong increase in net wages, the growth in household consumption, at slightly below 3% in real terms, remained relatively restrained last year. The economic and political instability in Russia results in precautionary savings of Latvian households. Also in the coming two years they will prefer to lower their debt burden, although household consumption will remain the most important driver of growth of the Latvian economy.

In the light of the severity of the Russian economic downturn we had to lower the growth forecast for 2015 from 2.7% to 2.1%. Expecting exports and thus also industrial production to revive on account of increased external demand both from eastern and western neighbours, we forecast an upswing in overall economic activity to 2.8% both in 2016 and 2017.

**Table 1 / Latvia: Selected Economic Indicators**

	2010	2011	2012	2013	2014 <sup>1)</sup>	2015 Forecast	2016 Forecast	2017
Population, th pers., average <sup>2)</sup>	2,098	2,060	2,034	2,013	2,005	1,995	1,987	1,979
Gross domestic product, EUR-LVL mn, nom. <sup>3)</sup>	18,166	20,297	22,043	23,222	24,000	24,700	26,000	27,500
annual change in % (real) <sup>3)</sup>	-2.9	5.0	4.8	4.2	2.5	2.1	2.8	2.8
GDP/capita (EUR at exchange rate)	8,600	9,800	10,900	11,600	12,000	12,400	13,100	13,900
GDP/capita (EUR at PPP)	13,400	15,000	16,300	17,200	17,800	.	.	.
Consumption of households, EUR-LVL mn, nom. <sup>3)</sup>	11,421	12,457	13,226	14,119	14,620	.	.	.
annual change in % (real) <sup>3)</sup>	3.3	2.8	2.7	6.1	2.8	2.9	3.2	3.4
Gross fixed capital form., EUR-LVL mn, nom. <sup>3)</sup>	3,469	4,494	5,548	5,401	5,770	.	.	.
annual change in % (real) <sup>3)</sup>	-20.0	24.2	14.5	-5.2	2.7	1.9	3.0	4.0
Gross industrial production <sup>4)</sup>								
annual change in % (real)	14.9	9.0	6.1	-0.8	-1.1	1.0	3.0	4.0
Gross agricultural production								
annual change in % (real)	-2.4	2.8	17.3	1.5	-1.0	.	.	.
Construction industry								
annual change in % (real)	-23.4	12.5	13.5	8.3	7.8	.	.	.
Employed persons, LFS, th, average <sup>5)</sup>	940.9	970.5	875.6	893.9	885.0	885	880	875
annual change in %	-4.3	3.1	1.6	2.1	-1.0	0.0	-0.6	-0.6
Unemployed persons, LFS, th, average <sup>5)</sup>	216.1	176.4	155.1	120.4	108.3	100	90	90
Unemployment rate, LFS, in %, average <sup>5)</sup>	18.7	15.4	15.0	11.9	10.9	10.2	9.6	9.2
Reg. unemployment rate, in %, end of period <sup>5)</sup>	14.3	11.5	10.5	9.5	8.5	.	.	.
Average monthly gross wages, EUR-LVL	633.2	660.2	684.4	715.7	766.0	.	.	.
annual change in % (real, gross)	-2.4	-0.1	1.4	4.6	6.4	.	.	.
Average monthly net wages, EUR-LVL	449.6	469.5	488.0	515.4	558.0	.	.	.
annual change in % (real, net)	-6.5	0.1	1.6	5.6	7.6	.	.	.
Consumer prices (HICP), % p.a.	-1.2	4.2	2.3	0.0	0.7	0.8	2.2	2.8
Producer prices in industry, % p.a.	2.4	7.7	4.1	1.7	0.4	.	.	.
General government budget, EU-def., % of GDP								
Revenues	36.0	35.5	35.8	34.8	34.5	33.9	33.5	33.1
Expenditures	44.2	38.9	36.6	35.7	36.1	35.2	34.7	34.0
Net lending (+) / net borrowing (-)	-8.2	-3.4	-0.8	-0.9	-1.6	-1.3	-1.2	-0.9
Public debt, EU-def., % of GDP	46.8	42.7	40.9	38.2	40.2	36.1	35.0	34.0
Central bank policy rate, % p.a., end of period <sup>6)</sup>	3.50	3.50	2.50	0.25	0.05	.	.	.
Current account, EUR mn <sup>7)</sup>	420	-572	-718	-543	-711	-800	-900	-900
Current account, % of GDP	2.3	-2.8	-3.2	-2.3	-3.0	-3.2	-3.5	-3.3
Exports of goods, BOP, EUR mn <sup>7)</sup>	6,657	8,300	9,645	9,810	10,115	10,200	10,500	10,900
annual change in %	32.8	24.7	16.2	1.7	3.1	0.8	2.9	3.8
Imports of goods, BOP, EUR mn <sup>7)</sup>	8,145	10,743	12,208	12,351	12,551	12,600	13,100	13,700
annual change in %	24.6	31.9	13.6	1.2	1.6	0.4	4.0	4.6
Exports of services, BOP, EUR mn <sup>7)</sup>	3,050	3,471	3,768	3,900	3,807	3,770	3,960	4,110
annual change in %	-3.3	13.8	8.6	3.5	-2.4	-1.0	5.0	3.8
Imports of services, BOP, EUR mn <sup>7)</sup>	1,749	1,991	2,145	2,127	2,082	2,060	2,130	2,210
annual change in %	1.5	13.8	7.7	-0.8	-2.1	-1.1	3.4	3.8
FDI inflow (liabilities), EUR mn <sup>7)</sup>	331	1,075	840	743	340	.	.	.
FDI outflow (assets), EUR mn <sup>7)</sup>	57	75	127	373	100	.	.	.
Gross reserves of NB excl. gold, EUR mn <sup>8)</sup>	5,472	4,666	5,412	5,565	2,446	.	.	.
Gross external debt, EUR mn <sup>7)</sup>	30,119	29,603	30,254	30,501	34,200	.	.	.
Gross external debt, % of GDP	167.2	146.6	136.2	131.1	142.5	.	.	.
Average exchange rate EUR-LVL/EUR	1.0084	1.0050	0.9922	0.9981	1.0000	1.0000	1.0000	1.0000
Purchasing power parity EUR-LVL/EUR	0.6441	0.6566	0.6629	0.6692	0.6707	.	.	.

Note: Latvia has introduced the Euro from 1 January 2014. Up to and including 2013 all time series in LVL as well as the exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 0.702804 (LVL per EUR) to achieve euro-fixed series (EUR-LVL).

1) Preliminary and wiiw estimates. - 2) According to census March 2011. - 3) According to ESA 2010. - 4) Enterprises with 20 and more employees. - 5) From 2012 according to census March 2011. - 6) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of National Bank before. - 7) BOP 6th edition. - 8) From January 2014 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

Source: wiiw Databases incorporating Eurostat and national statistics.