

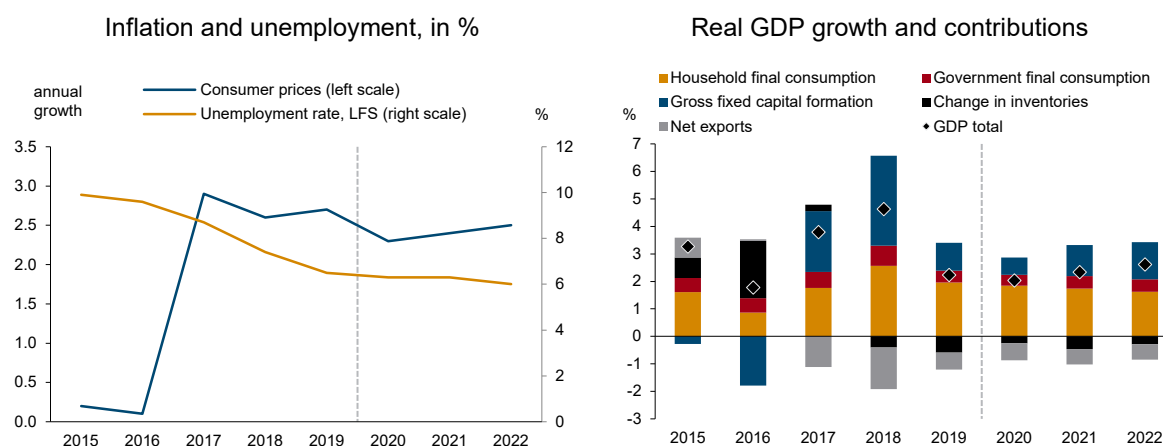


LATVIA: Weak investment and stuttering trade keep growth low

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The Latvian economy experienced a soft landing in 2019. Growth in gross fixed capital investment and foreign trade has declined substantially and will remain subdued in 2020-2021. A tight labour market will keep wages rising fairly swiftly, which will lead to lively household consumption over the next two years. Export activity is likely to revive slightly this year. Despite the economic slowdown, the labour market is tightening further, with the unemployment rate set to fall to 6.3% this year and in 2021. In 2020, we expect GDP growth to decline further to 2.0%, to be followed by a slight upswing (to 2.4%) in 2021 and on to 2.6% in 2022.

Figure 6.11 / Latvia: Main macroeconomic indicators



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

Weak economic activity in the fourth quarter of last year resulted in overall GDP growth for 2019 declining to 2.2% in real terms year on year. The slowdown in global economic activity resulted in Latvia's exports falling towards the end of last year and almost stagnating in 2019 as a whole, compared to 2018. Growth in exports to Western Europe abated, while a certain revival was reported in exports to Russia, Latvia's third most important trading partner. The slowdown in the Swedish economy – and particularly the low housing production there – led to declining Latvian exports by the important wood sector and other building materials sector. In general, substantially rising wages are putting pressure on the competitive position of the Latvian manufacturing sector. As a result, growth in industrial production was – at 1% in real terms year on year – rather anaemic in 2019, despite the still strongly increasing household consumption.

While goods exports are stagnating, the export of services is thriving. In particular, trade in business services is growing at a good pace, while the important transport sector has reached saturation point, due to the stagnation of transit traffic in the direction of Russia. For 2020, we expect some upswing in goods exports. Agricultural exports will also increase, following a particularly good harvest in 2019. Strongly growing wages will keep the import of consumer goods flourishing in 2020. However, we expect the current account deficit to remain below -1% of GDP in the period 2020-2021.

While the industrial sector and construction are experiencing continued low growth, the tertiary sector – particularly business and public services – is developing at a good pace. Only the banking sector is contracting further, following necessary changes to the business model of banks in terms of services offered to foreign clients. The ECB and national banking regulators requested the introduction of anti-money-laundering practices, following the closure of two large banks in 2018 and 2019. Payments by foreign clients channelled through the Latvian banking sector and foreign deposits have both declined substantially in recent years, but foreign deposits still amounted to 19% of total deposits in December 2019.

After two years of strong investment growth, outlays for gross fixed capital increased at a much slower pace in 2019. Investment co-financed by EU funds has peaked and no longer provides an additional boost to investment growth. The 2020 government budget shows a reduction in public investment – from 5.5% of GDP in 2019 to 4.9% this year. However, in 2021 the start of the construction of the main tracks and infrastructure (such as bridges and stations) for Rail Baltica, the high-speed rail project, will lead to a revival of public investment growth. In 2019, construction activity generally slowed, increasing by only 2.9% in real terms year on year. For 2020, we do not anticipate much of a revival; however, the number of building permits issued shows that some upswing is likely in the housing sector, with stronger growth in the non-residential building sector. This is substantiated by the fact that, after long years of deleveraging, the stock of mortgage debt for private households started to increase again in 2019, on the back of substantial income growth and negative real interest rates. Given the limited expectations for overall GDP growth in 2020 and next year, enterprises will be reluctant to invest in machinery and equipment in the near future.

Following two years of job growth, employment started to stagnate in 2019. With the steady decrease in the working-age population, the unemployment rate again fell last year – to 6.5% on average. Also, rising vacancy rates highlight the tight situation in the labour market. Employers are increasingly in need of a skilled workforce. Given the likely economic slowdown in the coming two years, however, we expect employment to continue to stagnate this year and in 2021, while the unemployment rate is likely to remain at around 6.3%.

The dwindling supply of skilled labour has also meant that gross wages have been rising rapidly – in 2019, by 5% in real terms year on year. The minimum wage has not been increased for 2020; however, a sharp rise from EUR 430 to EUR 500 is expected from 2021. From January 2020, the non-taxable minimum was increased to EUR 300, and the governing coalition also agreed to raise this to EUR 400 in 2021 and to EUR 500 in 2022, in order to boost the budgets of low-income households. A further proposal for changes to the tax structure would see a reduction in the VAT rates on medicines, foodstuffs, restaurant meals and newspapers from 2021. Thus, in the coming years wage earners will experience a steady rise in their real incomes. This will further fuel household consumption, which is

projected to increase by about 3.2% in real terms this year. In the period 2021-2022, we expect private consumption to continue to provide stable support for GDP growth.

Consumer price inflation is likely to decline further, to 2.3% in 2020. Despite the ongoing strong wage growth, inflation is being damped down by meagre increases in import prices, declining prices for food and lower tariffs for utilities. However, the January 2020 increase in fuel excise duty provides a counterbalance. In general, we expect consumer price inflation to be relatively low not only this year, but also in 2021 (when it is likely to reach 2.4%).

All in all, since last year's Autumn Forecast we have become slightly less optimistic, and have reduced the forecast GDP growth rate for 2020 from 2.2% to 2.0%. Private investment activity is likely to slow down more than previously expected, while external demand will grow slightly more strongly than in 2019. Rising household incomes will help private consumption to keep on growing steadily. Public investment activity will decrease in 2020; however, activity is likely to pick up in 2021-2022, when the construction of rail and road infrastructure increases, facilitated by ongoing inflows of EU funds. For 2021, international forecasters (EC, IMF) predict a more rapid rise in external demand in the advanced economies, which should also support Latvian exporters. Thus, we have revised our growth forecast for 2021 to 2.4%; in 2022, further stabilisation will result in GDP increasing by 2.6% in real terms.

Table 6.11 / Latvia: Selected economic indicators

	2015	2016	2017	2018	2019 ¹⁾	2020	2021	2022
						Forecast		
Population, th pers., average	1,978	1,960	1,942	1,927	1,920	1,910	1,900	1,890
Gross domestic product, EUR mn, nom.	24,426	25,073	26,798	29,151	30,600	31,900	33,400	35,100
annual change in % (real)	3.3	1.8	3.8	4.6	2.2	2.0	2.3	2.6
GDP/capita (EUR at PPP)	18,700	18,900	19,900	21,300	22,200	.	.	.
Consumption of households, EUR mn, nom.	14,424	14,791	15,698	16,840	17,900	.	.	.
annual change in % (real)	2.7	1.5	3.0	4.4	3.4	3.2	3.0	2.8
Gross fixed capital form., EUR mn, nom.	5,368	4,899	5,554	6,554	7,000	.	.	.
annual change in % (real)	-1.2	-8.2	11.3	15.8	4.5	2.8	5.0	6.0
Gross industrial production ²⁾								
annual change in % (real)	3.6	5.4	8.3	1.5	0.9	1.0	2.0	2.0
Gross agricultural production								
annual change in % (real)	14.0	-7.3	1.5	-10.0	21.9	.	.	.
Construction industry								
annual change in % (real)	-0.6	-16.6	18.7	21.8	2.9	.	.	.
Employed persons, LFS, th, average	896.1	893.3	894.8	909.4	910.0	910	910	912
annual change in %	1.3	-0.3	0.2	1.6	0.1	0.0	0.0	0.2
Unemployed persons, LFS, th, average	98.2	95.3	85.4	72.8	63.0	61	61	58
Unemployment rate, LFS, in %, average	9.9	9.6	8.7	7.4	6.5	6.3	6.3	6.0
Reg. unemployment rate, in %, eop ³⁾	8.7	8.4	6.8	6.4	6.2	.	.	.
Average monthly gross wages, EUR	818.0	859.0	926.0	1,004.0	1,080.0	1,150	1,230	1,320
annual change in % (real, gross)	6.7	4.9	4.5	6.0	5.0	4.5	4.8	4.5
Average monthly net wages, EUR	603.0	631.0	676.0	742.0	800.0	860	920	990
annual change in % (real, net)	7.4	4.3	3.8	7.0	5.0	4.5	4.5	4.8
Consumer prices (HICP), % p.a.	0.2	0.1	2.9	2.6	2.7	2.3	2.4	2.5
Producer prices in industry, % p.a.	-1.0	-2.5	2.5	4.3	1.8	1.3	1.5	2.0
General governm.budget, EU-def., % of GDP								
Revenues	36.6	36.9	37.5	37.8	36.8	36.4	36.3	36.5
Expenditures	38.0	36.9	38.0	38.5	37.6	37.1	36.9	37.1
Net lending (+) / net borrowing (-)	-1.4	0.1	-0.5	-0.7	-0.8	-0.7	-0.6	-0.6
General gov.gross debt, EU def., % of GDP	36.7	40.2	38.6	36.4	36.0	35.0	34.0	33.0
Stock of loans of non-fin.private sector, % p.a.	-2.8	0.1	-4.7	-5.2	0.6	.	.	.
Non-performing loans (NPL), in %, eop ⁴⁾	6.0	4.4	4.1	5.3	5.8	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	0.05	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	-216	360	273	-198	-105	-235	-235	-135
Current account, % of GDP	-0.9	1.4	1.0	-0.7	-0.3	-0.7	-0.7	-0.4
Exports of goods, BOP, EUR mn	10,480	10,543	11,683	12,603	12,629	12,950	13,500	14,200
annual change in %	1.0	0.6	10.8	7.9	0.2	2.5	4.2	5.2
Imports of goods, BOP, EUR mn	12,721	12,430	13,905	14,953	15,112	15,700	16,400	17,200
annual change in %	-1.0	-2.3	11.9	7.5	1.1	3.9	4.5	4.9
Exports of services, BOP, EUR mn	4,351	4,601	4,964	5,268	5,628	5,800	6,100	6,500
annual change in %	6.1	5.7	7.9	6.1	6.8	3.1	5.2	6.6
Imports of services, BOP, EUR mn	2,334	2,468	2,702	2,972	3,120	3,250	3,400	3,600
annual change in %	10.4	5.7	9.5	10.0	5.0	4.2	4.6	5.9
FDI liabilities, EUR mn	729	302	991	390	1,008	500	.	.
FDI assets, EUR mn	128	202	516	-290	-52	100	.	.
Gross reserves of NB excl. gold, EUR mn	2,957	3,100	3,620	3,578	3,700	.	.	.
Gross external debt, EUR mn	34,861	37,217	37,922	35,697	36,100	36,700	36,700	38,600
Gross external debt, % of GDP	142.7	148.4	141.5	122.5	118.0	115.0	110.0	110.0

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) Loans more than 90 days overdue, and from 2018 also including loans unlikely to be paid. - 5) Official refinancing operation rates for euro area (ECB).

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