10. LATVIA

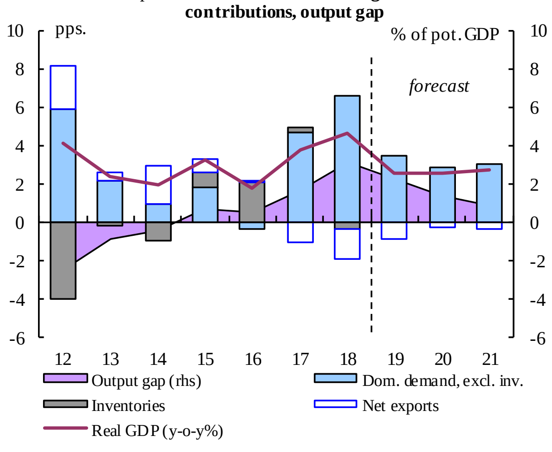
Growth slows amid weakening investment and exports

Latvia's economic growth is set to slow down to 2.5% in 2019. Private consumption is expected to remain the main growth driver over the forecast horizon as investments are expected to slow further in 2020 before picking up slightly in 2021. Export growth is set to remain modest due to weak external demand. Driven by increases in utility and food prices, inflation is forecast this year at 3.1% before cooling off in 2020 and 2021. The slowing investment is set to relieve labour demand somewhat, but the declining labour force is set to maintain a tight labour market. The government deficit is expected to remain at 0.6% of GDP through 2021.

Investment cycle cools off

Latvia's real GDP grew by 2.4% (y-o-y) in the first half of the year, supported mainly by private consumption and slowing, but still strong investment. Growth is set to improve slightly in the second half thanks to a good harvest and favourable calendar effects. Yet, compared to 2018, growth has slowed significantly, as the investment cycle is losing steam and exports face growing headwinds from main trading partners. While a strong labour market remains supportive of private consumption, public consumption is restrained because of tax cutting measures. On balance, GDP growth in Latvia is expected to reach 2.5% in 2019.

Graph II.10.1: **Latvia - Real GDP growth and contributions, output gap**



Private consumption set to maintain a healthy growth rate

In 2020, real GDP growth is set to increase slightly to 2.6%. Private consumption growth is expected to increase slightly due to slowing inflation and a tax cut boosting real disposable incomes, but slowing employment growth and somewhat lower wage growth are set to work in the opposite direction. Investment growth is set to fade in 2020 as EU fund inflows peak and private investment is likely to slow from the high output level attained in 2019. Despite bright prospects for agricultural products and services, export growth is expected to struggle in the face of weak demand in Latvia's main foreign markets. In 2021, real consumption should benefit from slowing inflation while investments are supported by the beginning of the construction of the Rail Baltica line, a major project integrating the Baltic States with the rest of the European rail network. Export growth is expected to recover slightly, but the scope for positive surprises remains limited. The current account is set to remain balanced throughout the forecast horizon.

Labour market set to remain tight

The slowdown of investment growth is set to relieve employment demand somewhat and therefore ease the pressure on the tight labour market in 2020 and 2021. However, as the labour force should continue to shrink, the unemployment rate is expected to decline further, albeit at a slower pace, falling to 6.4% by 2021. Consequently, wage growth is set to remain relatively high, but should slow somewhat in 2020 in the absence of a minimum wage increase and following a wage restraint in the public sector.

HICP inflation is set to reach around 3% in 2019, driven by rising food prices and growing cost of the utilities following energy price growth of the previous years. In 2020, inflation is set to slow to 2.5% and then to 2.3% in 2021 as energy and food price growth flattens.

The risks to the forecast are tilted to the downside as the slowdown in investment and exports may spill over to the labour market and therefore negatively affect private consumption. Moreover, the uncertainty related to the external environment could also impact export growth more sharply than currently forecast.

Budget deficit set to remain stable

The general government deficit is forecast at 0.6% of GDP in 2019, improving slightly from 0.7% in 2018. Overall, tax collection has slightly exceeded projections with the exception of corporate income tax, the collection of which has considerably underperformed. Fiscal costs of the transition to the new corporate taxation regime appear larger than initially assumed. On the positive side, labour tax collection has been better than expected. Government spending, by contrast, is expected to be in line with the Commission's earlier projections.

For 2020, the government deficit is projected to remain at 0.6% of GDP. The budget plan includes 0.6% of GDP worth of new policy measures, including wage increases for teachers and medical personnel, and an increase in non-taxable allowance for personal income tax. These measures are mostly financed by reallocating resources from the existing budgetary envelopes. The budget also includes minor revenue-increasing measures. Social payments and public sector wages are expected to drive expenditure growth, while public investment expenditure is set to fall somewhat after having surged over the last three years.

Under a no-policy change assumption, the government deficit is projected to remain at 0.6% of GDP in 2021. This is linked to an expected tax revenue growth in line with economic developments. Few policy changes are stipulated for 2021. Public expenditure growth is expected to remain strong, particularly for social spending and public sector wages. Latvia's structural deficit is forecast to decrease from nearly 2% of GDP in 2018 to 1% by 2021.

The ratio of government debt to GDP, estimated at 36.4% in 2018, is forecast to decline to 32.9% by 2021, as nominal GDP growth outpaces the government's net borrowing.

Table II.10.1:

Main features of country forecast - LATVIA

	2018			Annual percentage change						
mio EUR	Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	29151.0	100.0	3.8	1.8	3.8	4.6	**2.5**	**2.6**	**2.7**
Private Consumption	17169.5	58.9	3.8	1.5	3.1	4.2	**3.2**	**3.6**	**3.5**
Public Consumption	5185.0	17.8	1.0	2.9	3.2	4.0	**2.8**	**2.3**	**3.0**
Gross fixed capital formation	6553.8	22.5	4.8	-8.2	11.3	15.8	**4.5**	**1.3**	**1.9**
of which: equipment	2565.0	8.8	3.5	11.2	9.3	13.1	**6.0**	**1.5**	**1.8**
Exports (goods and services)	17870.8	61.3	7.6	4.0	6.4	4.0	**2.7**	**1.8**	**2.3**
Imports (goods and services)	17924.7	61.5	6.0	3.8	8.4	6.4	**4.2**	**2.2**	**2.8**
GNI (GDP deflator)	28649.5	98.3	3.8	2.1	3.6	3.3	**3.1**	**2.5**	**2.6**
Contribution to GDP growth:	Domestic demand		4.3	-0.4	4.7	6.5	**3.4**	**2.8**	**3.0**
	Inventories		0.0	2.1	0.2	-0.4	**0.0**	**0.0**	**0.0**
	Net exports		-0.3	0.1	-1.1	-1.5	**-0.9**	**-0.3**	**-0.3**
Employment			-0.5	-0.3	0.0	1.6	**-0.4**	**0.0**	**0.2**
Unemployment rate (a)			12.2	9.6	8.7	7.4	**6.6**	**6.4**	**6.4**
Compensation of employees / head			9.5	7.3	7.6	8.5	**6.1**	**5.0**	**4.8**
Unit labour costs whole economy			5.0	5.1	3.7	5.3	**3.1**	**2.3**	**2.2**
Real unit labour cost			0.1	4.2	0.7	1.3	**0.0**	**0.0**	**0.0**
Saving rate of households (b)			1.2	4.5	4.4	6.3	**6.6**	**7.2**	**7.2**
GDP deflator			4.9	0.9	3.0	4.0	**3.1**	**2.3**	**2.2**
Harmonised index of consumer prices			4.0	0.1	2.9	2.6	**3.1**	**2.5**	**2.3**
Terms of trade of goods			0.2	3.5	0.9	1.6	**0.4**	**0.2**	**0.0**
Trade balance (goods) (c)			-15.7	-7.5	-8.3	-8.1	**-8.6**	**-8.5**	**-8.8**
Current-account balance (c)			-7.1	1.4	1.0	-0.7	**-0.8**	**-1.4**	**-1.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-5.4	2.5	1.7	1.1	**1.3**	**0.7**	**0.3**
General government balance (c)			-2.7	0.1	-0.5	-0.7	**-0.6**	**-0.6**	**-0.6**
Cyclically-adjusted budget balance (d)			-2.5	-0.1	-1.1	-1.9	**-1.5**	**-1.1**	**-0.9**
Structural budget balance (d)			-	-0.3	-1.1	-1.9	**-1.6**	**-1.1**	**-0.9**
General government gross debt (c)			24.9	40.2	38.6	36.4	**36.0**	**35.2**	**32.9**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.