14. LATVIA

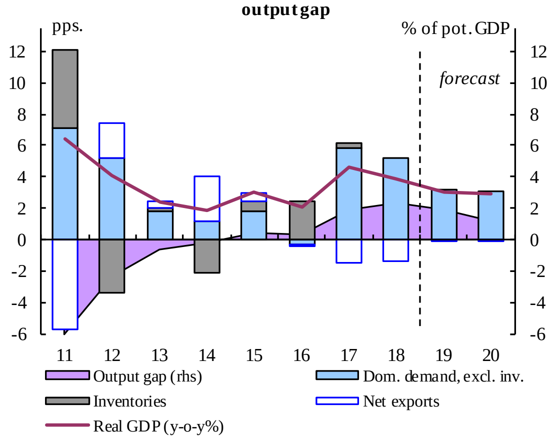
Growth to moderate as investment slows down

In 2018, GDP growth reached 4.8%, marking the peak of the current investment cycle. Strong employment and wage growth fuelled private consumption, while investment grew at double-digit rates for the second year. Growth is set to slow this year as investment moderates and employment growth halts. Exports are expected to pick up slightly despite the slower external demand growth. Inflation is forecast to rise to 2.8% in 2019 before declining to 2.4% in 2020. The government deficit is set to fall from 1.0% of GDP in 2018 to 0.6% in 2019 and 2020.

Investment boom continued in 2018

GDP growth reached 4.8% in 2018 – the highest rate since 2011. Economic growth was driven by private consumption and double digit growth in investment. Investment growth was broad-based across asset types and was fast in both the public and private sector. The construction boom helped increase employment significantly for the first time since 2015 and, together with solid wage growth, supported an acceleration of private consumption. Exports, on the other hand, performed modestly, as financial and transport services struggled, and a poor harvest weighed on food exports.

Graph II.14.1: **Latvia - Real GDP growth and contributions, output gap**



Growth to slow in 2019 and 2020

In 2019, GDP growth is expected to slow to 3.1% as investment growth comes down from the exceptionally high growth of the previous two years. The disbursement of EU funds will increase only slightly in 2019, leaving investment growth largely in the hands of the private sector. At the same time, private consumption is set to remain strong due to solid wage growth and enduring consumer optimism. With most of the decline in financial services exports now in the past, export growth is set to increase slightly in 2019. However, slowing global trade and lower European growth make it unlikely that external demand will outperform domestic growth, leading to an overall negative contribution of net exports.

In 2020, GDP growth is expected to slow further to 2.8%. Private consumption growth is forecast to slow mildly as employment is expected to stall by 2020 due to supply constraints. Also, EU fund disbursements for investment will be past their peak, providing a much lower impulse to investment. On the other hand, export growth is set to strengthen slightly on the back of recovering growth in Europe.

Employment growth set to stall

Strong economic growth and higher activity among people close to the retirement age temporarily increased employment by a staggering 1.6% in 2018. However, employment growth is set to slow considerably over the forecast horizon as working age population continues falling and untapped labour supply becomes increasingly thin. At 6.9% in 2019 and 6.7% in 2020, the unemployment rate remains close to its record low of 6.1%, achieved in the previous boom in 2007. Wage growth is expected to maintain a steady pace due to the tight labour market, but might relent somewhat as labour intensive construction activity abates. If wages continue to grow faster than productivity Latvia's exports could underperform.

HICP inflation is forecast to increase slightly in 2019 to 2.8% due to higher-than-last-year excise tax increases and a rise in heating tariffs. The rapid wage growth is causing a steady rise in services prices, which continues driving core inflation. Assuming no changes in tax policy, inflation in 2020 should moderate to 2.4% - the lowest level in recent years. Energy inflation is set to recede and the calming investment cycle is expected to relieve the pressure on wages.

Fiscal deficit set to fall to 0.6% of GDP

The government deficit stood at 1.0% of GDP in 2018, exceeding the 0.7% estimate of the 2019 budgetary plan, as the adjustments from cash to accrual estimates turned out deficit-increasing. Overall, 2018 showed strong expenditure growth for investment, public sector wages and for goods and services, while revenues were supported by solid wage and consumption growth, mitigating the effect of tax cutting measures.

In 2019, the government deficit is projected to decrease to 0.6% of GDP, as a result of the budgeted expenditure restraint. Notably, purchases of goods and services are planned to be contained. While public sector wages is set to remain dynamic, in particular for medical personnel, public investment should level out after the rush in 2017 and 2018.

An increase in social transfers is linked to wage growth in the economy and several benefit-increasing measures. Revenue growth will be supported by dynamic domestic growth drivers, while coping with the tax cuts of 2017.

In 2020, the government deficit is projected at 0.6% of GDP under a no policy change assumption. In particular, public sector wage growth should moderate, but purchases of goods and services should pick-up. The net effect of revenue measures is expected to turn positive in 2020, as a period of implementation of the 2017 tax reform ends. The structural deficit peaked at 2% of potential GDP in 2018.

The government debt-to-GDP ratio is expected to fall from 40% in 2017 to 33.5% in 2020. This reflects a drop in liabilities of public companies in 2018 and the government's net borrowing being lower than nominal GDP growth.

Table II.14.1:

Main features of country forecast - LATVIA

		2017			Annual percentage change						
	mio EUR	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		27033.1	100.0	3.8	3.0	2.1	4.6	**4.8**	**3.1**	**2.8**
Private Consumption		16151.6	59.7	3.9	2.5	1.4	4.1	**4.5**	**3.7**	**3.6**
Public Consumption		4853.3	18.0	0.9	1.9	3.9	4.1	**4.0**	**1.5**	**1.3**
Gross fixed capital formation		5650.7	20.9	5.4	-0.5	-8.4	13.1	**16.4**	**2.8**	**1.7**
of which: equipment		2277.1	8.4	3.5	-1.3	11.1	8.2	**10.9**	**3.5**	**1.5**
Exports (goods and services)		16515.7	61.1	6.9	3.1	4.4	6.2	**1.8**	**2.2**	**2.4**
Imports (goods and services)		16491.2	61.0	5.4	2.1	4.4	8.9	**5.1**	**2.0**	**2.3**
GNI (GDP deflator)		26846.0	99.3	3.7	2.8	2.4	4.2	**4.6**	**3.2**	**2.9**
Contribution to GDP growth:	Domestic demand			4.5	1.8	-0.3	5.8	**6.8**	**3.1**	**2.8**
	Inventories			-0.2	0.7	2.4	0.3	**-0.1**	**0.0**	**0.0**
	Net exports			-0.2	0.6	0.0	-1.5	**-2.0**	**0.1**	**0.1**
Employment				-0.7	1.4	-0.3	0.0	**1.6**	**0.3**	**0.0**
Unemployment rate (a)				12.5	9.9	9.6	8.7	**7.4**	**6.9**	**6.7**
Compensation of employees / head				9.5	7.7	7.3	8.0	**7.8**	**6.2**	**5.0**
Unit labour costs whole economy				4.9	6.1	4.8	3.1	**4.6**	**3.3**	**2.1**
Real unit labour cost				-0.1	6.1	3.9	0.0	**0.3**	**0.6**	**0.1**
Saving rate of households (b)				1.3	1.7	5.2	3.3	**5.0**	**6.3**	**7.3**
GDP deflator				5.0	0.0	0.9	3.2	**4.2**	**2.7**	**2.0**
Harmonised index of consumer prices				4.1	0.2	0.1	2.9	**2.6**	**2.8**	**2.4**
Terms of trade of goods				0.1	2.4	3.5	0.9	**1.6**	**-0.1**	**-0.2**
Trade balance (goods) (c)				-16.1	-9.0	-7.5	-8.5	**-8.7**	**-8.6**	**-8.6**
Current-account balance (c)				-7.5	-0.5	1.6	0.7	**-0.5**	**-0.2**	**-0.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.1	2.3	2.6	1.5	**1.3**	**1.7**	**1.9**
General government balance (c)				-2.8	-1.4	0.1	-0.6	**-1.0**	**-0.6**	**-0.6**
Cyclically-adjusted budget balance (d)				-2.6	-1.5	0.0	-1.2	**-2.1**	**-1.4**	**-1.1**
Structural budget balance (d)				-	-1.5	-0.2	-1.2	**-2.1**	**-1.6**	**-1.1**
General government gross debt (c)				23.4	36.8	40.3	40.0	**35.9**	**34.5**	**33.5**

(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.