14. LATVIA

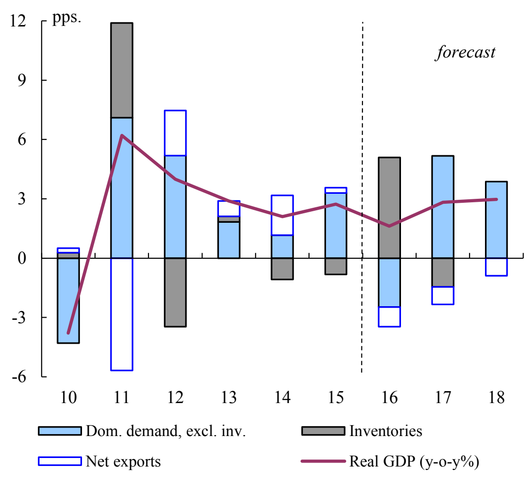
Investment temporarily weighs on growth

Latvia's economy is expected to have showed a subdued growth of 1.6% in 2016 due to a drop in investment, linked to delays in the use of EU investment funds. However, investment is expected to bounce back and push growth to around 3% over the forecast horizon. The government position improved to a balance in 2016, but is projected to record a deficit of 1% of GDP in 2017 and 2018.

Growth in 2016 remained below expectations

In 2016 GDP growth was supported by private consumption and exports but investment plummeted. In particular, delays in the implementation of EU-funded projects, related to the changeover to a new programming period, had a marked impact in the construction sector. Investment is expected to pick up over the next two years as these delays come to an end. Overall, economic growth is expected to improve from 1.6% in 2016 to 2.8% in 2017 and 3.0% in 2018, returning to the trend of a catching-up economy. The balance of risks is tilted somewhat to the downside in view of possible further delays in the absorption of EU funds and the uncertain external environment.

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



Construction is set to resume after a sharp fall

In the first three quarters of 2016, investment in construction dropped dramatically. This downturn affected investment in civil engineering the most. It contracted by more than one third in the first three quarters compared with the year before. Residential and non-residential buildings were also affected (-8% and -5% y-o-y respectively). This decrease in construction is for a large part linked to the slower use of EU funds. Yet, investment in equipment goods also dropped in 2016. The pick-up in EU-funded investment and low interest rates should support the resumption of investment growth in the coming quarters.

The external position to turn to a deficit

The trade deficit has been increasing in volume terms as domestic demand outpaced external demand. As a consequence, trade weighed on growth in 2016 and its contribution to GDP growth is expected to remain negative over the forecast horizon. In nominal terms, low energy prices on the import side brought the current-account close to balance in 2016. In 2017 and 2018, higher energy prices are expected to lead to a current-account deficit of -3.3% by 2018.

Both unemployment and employment declined in 2016

In 2016, the unemployment rate gradually declined to 9.5%. However, employment also slightly declined, as Latvia suffers from adverse demographic dynamics negatively affecting both its overall population and its working age population. Tightening labour supply combined with regained economic growth should support a further decline in the unemployment rate, down to 9.0% by 2018. It should also support the continuation of wage increases over the forecast horizon. The accumulated wage gains in turn should support private consumption as the main driver of economic growth.

Inflation to return to normal

In 2016, inflation remained subdued at 0.1%. This low rate was driven by falling energy prices while non-energy prices hovered closer to 2%. With energy prices projected to rise again, the inflation is forecast to reach 1.9% in 2017 and 2.0% in 2018.

Fiscal deficit is projected to increase

The general government is estimated to have reached a balanced position in 2016, significantly outperforming the 0.8% of GDP deficit estimated in the autumn 2016 forecast. Revenue from excise duties and corporate income tax exceeded expectations. VAT revenue growth was stronger than suggested by its tax base, showing signs of a better tax collection. Moreover, non-tax revenue was stronger than planned, including a one-off receipt from confiscated illicit money (0.2% of GDP). Notable savings were on purchases of goods and services and on EU budget contributions, while social expenditure surpassed the budgetary plans. Public capital spending is estimated to have temporarily dropped by almost 30%, linked to the transition to the new programming period for EU investment financing.

In 2017, the government deficit is projected to increase to 1.0% of GDP as significant expenditure growth is expected to only be partly offset by revenue increases. Expenditure growth is driven by the resumption in capital spending, the decision to increase expenditure for health, internal security and education, as well as a further increase in social expenditure. The latter is driven by both a higher number of recipients and an increase in the level of contribution-based benefits. Tax-revenue-to-GDP ratio is projected to rise on the back of the strong growth in wages and private consumption and due to revenue-increasing measures. An increase in the micro enterprise tax rate should yield 0.2% of GDP. Moreover, improvements in tax collection and indirect tax increases are expected to more than offset lower revenue collected from state-owned enterprises.

Under a no-policy-change assumption, the government deficit is projected to remain unchanged at 1.0% of GDP in 2018. The structural deficit is expected at 1½% of GDP in 2017 and 2018, after an improvement to ¾% of GDP in 2016. Risks to the budgetary projections are related to the statistical accounting of public capital injections. [50] Moreover, the election cycle and a possible upsurge in construction costs along with the pick-up in investment demand could still bring negative surprises for public finances.

The government debt-to-GDP ratio is forecast to decline from 39.4% of GDP in 2016 to around 35% of GDP in 2018, as accumulated cash balances are used for debt repayment and as nominal GDP growth exceeds the government's net borrowing.

(50) The forecast excludes any possible deficit-increasing effects of the 2016 capital injections in the national airline Air Baltic and the wind-down of the bad-bank Reverta in 2017.

Table II.14.1:

Main features of country forecast - LATVIA

	2015		Annual percentage change						
mio EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	24348.5	100.0	4.5	2.9	2.1	2.7	**1.6**	**2.8**	**3.0**
Private Consumption	14863.9	61.0	3.9	5.0	1.3	3.5	**3.6**	**3.9**	**3.9**
Public Consumption	4395.2	18.1	1.7	1.6	2.1	3.0	**1.7**	**3.0**	**2.5**
Gross fixed capital formation	5496.8	22.6	8.4	-6.0	0.1	2.8	**-22.0**	**13.0**	**4.9**
of which: equipment	2168.8	8.9	8.9	-5.4	-10.9	9.8	**-11.7**	**7.1**	**3.4**
Exports (goods and services)	14360.7	59.0	7.6	1.1	3.9	2.6	**2.0**	**2.6**	**3.1**
Imports (goods and services)	14636.3	60.1	6.7	-0.2	0.5	2.1	**3.6**	**4.1**	**4.5**
GNI (GDP deflator)	24290.1	99.8	4.4	3.4	2.2	2.6	**1.5**	**2.8**	**3.0**
Contribution to GDP growth: Domestic demand			5.3	1.8	1.2	3.3	**-2.5**	**5.2**	**3.9**
Inventories			0.1	0.3	-1.1	-0.8	**5.1**	**-1.5**	**0.0**
Net exports			-0.7	0.8	2.0	0.3	**-1.0**	**-0.9**	**-0.9**
Employment			-0.5	2.3	-1.4	1.3	**-0.2**	**0.3**	**0.5**
Unemployment rate (a)			12.9	11.9	10.8	9.9	**9.7**	**9.5**	**9.0**
Compensation of employees / head			9.6	5.5	8.6	6.9	**4.8**	**5.3**	**5.5**
Unit labour costs whole economy			4.5	4.9	4.9	5.4	**2.9**	**2.7**	**2.9**
Real unit labour cost			-0.9	3.5	3.3	5.0	**2.3**	**1.2**	**0.3**
Saving rate of households (b)			1.6	-4.5	-3.5	-2.2	**-1.5**	**-1.5**	**-1.6**
GDP deflator			5.4	1.3	1.5	0.4	**0.6**	**1.5**	**2.6**
Harmonised index of consumer prices			4.8	0.0	0.7	0.2	**0.1**	**1.9**	**2.0**
Terms of trade of goods			-0.3	1.3	-0.9	2.4	**3.3**	**-2.1**	**-0.3**
Trade balance (goods) (c)			-16.8	-11.2	-9.3	-8.4	**-7.4**	**-9.3**	**-10.2**
Current-account balance (c)			-8.3	-2.1	-2.0	-0.8	**-0.1**	**-2.5**	**-3.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-7.2	0.4	1.2	2.0	**1.8**	**-0.3**	**-0.8**
General government balance (c)			-2.5	-0.9	-1.6	-1.3	**0.0**	**-1.0**	**-1.0**
Cyclically-adjusted budget balance (d)			-2.4	-0.9	-1.9	-1.6	**-0.5**	**-1.6**	**-1.6**
Structural budget balance (d)			-	-0.9	-1.5	-1.6	**-0.7**	**-1.6**	**-1.6**
General government gross debt (c)			19.7	39.0	40.7	36.3	**39.4**	**36.5**	**35.0**

(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.