14. LATVIA

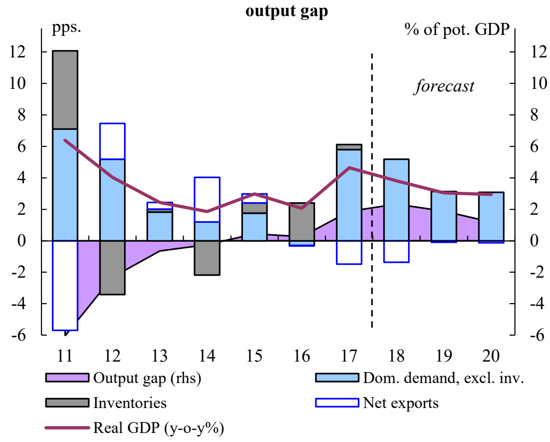
Balanced growth ahead

Economic growth in Latvia was stronger than expected in the first half of the year, but is set to cool in the second half and thereafter as investment growth slows. Inflation is set to remain elevated at around 3%, driven by energy prices. The labour market is expected to tighten further, as the labour force continues to shrink and employment rises. The government deficit is expected to increase to 1.0% of GDP in 2019, before declining in 2020.

2018 growth better than expected

Latvia's GDP grew by a stronger-than-expected rate of 4.6% (y-o-y) in the first half of the year, boosted by investment, which has grown at double-digit rates (y-o-y) for five consecutive quarters. Private consumption growth also improved compared with last year. Exports held up better than projected given the expected decline in financial services and transit services. In the second half of 2018, however, economic growth is expected to slow, as investment growth appears to have peaked and the impact from the winding down of the non-resident banking sector are expected to finally pass through to the economy. As a result, GDP growth in Latvia is expected to reach 4.1% in 2018.

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



Slower but more balanced growth forecast in 2019 and 2020

Latvia's growth momentum is expected to continue over the forecast horizon, albeit at a slower pace, with GDP growth projected at about 3% in both 2019 and 2020. Solid wage growth and continued consumer optimism are set to drive private consumption growth. Following the remarkable surge in 2017 and 2018, investment growth is forecast to slow down considerably but remain positive, as pent-up demand for office space and housing is forecast to drive construction investment over the coming years. Limited fiscal space is expected to weigh somewhat on public consumption growth in 2019. Weakening external demand is set to slow overall export growth over the projection horizon. In addition, the structural decline in financial and transit services are expected to further dent the outlook for export growth, slowing down the underlying positive growth momentum. The current account is set to remain balanced, as historically high and increasing savings easily cover current investment needs.

Investment growth supports employment

Employment is set to increase, thanks in particular to rapid growth in construction investment. The strong demand for labour in the economy has attracted previously inactive people into the labour force and led to a softening of the ageing-driven decline in labour supply. The unemployment rate is set to decline further. The tight labour market should continue to support wage growth over the coming years, although it is somewhat mitigated by slower demand growth and a stable minimum wage.

HICP inflation is set to hover just below 3% in both 2018 and 2019, driven mainly by energy and service prices, before moderating in 2020 as the pressure from energy prices fades out.

The risks to the forecast are balanced. On the positive side, credit growth recovery and increased labour supply could help sustain the investment boom beyond 2018 and therefore reinforce consumption and export growth. On the negative side, adverse developments in the external environment could dampen domestic optimism and undermine overall economic growth.

Fiscal deficit set to increase in 2019

The government deficit is forecast at 0.8% of GDP in 2018, better than expected in the spring.

Corporate income tax revenue exceeded expectations in the first half of the year, while revenues from the personal income taxes underperformed and VAT receipts were broadly in line with consumption growth.[70] Dividends received by the government also surprised on the upside. The government's capital spending is expected to be stronger than planned earlier while spending on goods, services and interest expenditure are set be somewhat below expectations.

For 2019, the government deficit is projected at 1.0% of GDP. This includes the effect of previously adopted tax reform measures as well as the pension expenditure increases adopted in summer of 2018. Social payments and public sector wages are expected to be the main drivers of the expenditure growth, while public investment expenditure is set to stabilise after a surge in the last two years.

Under a no-policy-change assumption, the government deficit is projected to decrease to 0.7% of GDP in 2020. This is linked to an expected resumption of tax revenue growth in line with economic developments, as the effect of the adopted tax-cutting measures is estimated to be lower than in 2018-2019. 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 1¾% of GDP in 2018 to 1¼% by 2020.

Government debt, which was an estimated at 40% of GDP in 2017, should decline to 36% of GDP by 2020, as nominal GDP growth outpaces the government's net borrowing. In 2018-2019, a reduction in the cash reserves should lower the gross debt ratio, but increase it in 2020 ahead of a large debt redemption in early 2021.

[70] For the time being, the forecast includes revenue collected under the VAT reverse charge mechanism for domestic supplies of consumer electronics and electrical household appliances (0.1% of GDP). However, the European Commission has objections concerning this measure because it violates EU VAT rules. Without prejudice to the final decision on this measure, it is assumed as part of the forecast as a technical assumption.

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	**4.1**	**3.2**	**2.9**
Private Consumption		16151.6	59.7	3.9	2.5	1.4	4.1	**4.5**	**4.0**	**4.0**
Public Consumption		4836.5	17.9	0.9	1.9	3.9	4.1	**4.0**	**1.8**	**1.8**
Gross fixed capital formation		5650.7	20.9	5.4	-0.5	-8.4	13.1	**11.2**	**2.8**	**2.2**
of which: equipment		2277.1	8.4	3.5	-1.3	11.1	8.2	**5.0**	**3.0**	**3.0**
Exports (goods and services)		16515.7	61.1	6.9	3.1	4.4	6.2	**3.6**	**3.3**	**3.0**
Imports (goods and services)		16491.2	61.0	5.4	2.1	4.4	8.9	**6.3**	**3.4**	**3.3**
GNI (GDP deflator)		26846.0	99.3	3.7	2.8	2.4	4.2	**4.1**	**3.6**	**3.0**
Contribution to GDP growth:	Domestic demand			4.5	1.8	-0.3	5.8	**5.7**	**3.3**	**3.2**
	Inventories			-0.2	0.7	2.4	0.3	**0.0**	**0.0**	**0.0**
	Net exports			-0.2	0.6	0.0	-1.5	**-1.7**	**-0.1**	**-0.2**
Employment				-0.7	1.4	-0.3	0.0	**1.5**	**0.3**	**0.1**
Unemployment rate (a)				12.5	9.9	9.6	8.7	**7.3**	**6.7**	**6.5**
Compensation of employees / head				9.5	7.7	7.3	8.0	**7.1**	**5.8**	**5.8**
Unit labour costs whole economy				4.9	6.1	4.8	3.1	**4.4**	**2.8**	**2.9**
Real unit labour cost				-0.1	6.1	3.9	0.0	**0.7**	**0.7**	**0.2**
Saving rate of households (b)				1.3	1.8	2.7	3.2	**5.4**	**6.0**	**6.8**
GDP deflator				5.0	0.0	0.9	3.2	**3.7**	**2.1**	**2.7**
Harmonised index of consumer prices				4.1	0.2	0.1	2.9	**2.7**	**2.7**	**2.4**
Terms of trade of goods				0.1	2.4	3.5	0.9	**1.2**	**-1.3**	**0.2**
Trade balance (goods) (c)				-16.1	-9.0	-7.5	-8.5	**-8.7**	**-9.3**	**-9.3**
Current-account balance (c)				-7.6	-0.5	1.4	0.7	**0.0**	**-0.4**	**-0.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.1	2.3	2.4	1.5	**1.8**	**1.7**	**1.9**
General government balance (c)				-2.8	-1.4	0.1	-0.6	**-0.8**	**-1.0**	**-0.7**
Cyclically-adjusted budget balance (d)				-2.6	-1.5	0.0	-1.2	**-1.8**	**-1.7**	**-1.2**
Structural budget balance (d)				-	-1.5	0.0	-1.2	**-1.8**	**-1.7**	**-1.2**
General government gross debt (c)				23.3	36.8	40.3	40.0	**37.1**	**35.5**	**35.7**

(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.