14. LATVIA

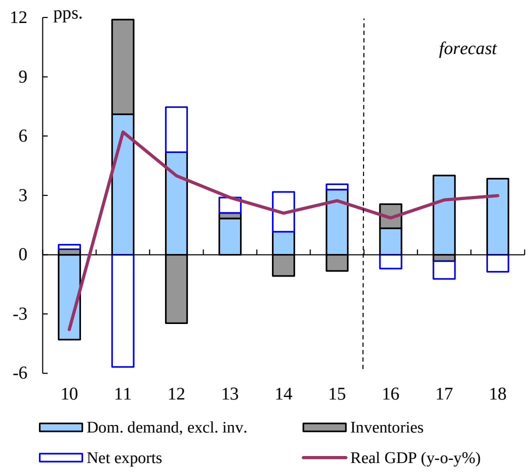
Growth drops below expectations but outlook remains favourable

Economic growth is projected to ease to 1.9% in 2016 as the use of EU funding for investment has dropped substantially below projections. However, the expected rebound in the investment cycle is set to lift growth to around 3% over the forecast horizon, supported by an improving labour market. Public finances appear to be slowly deteriorating, with a reliance on one-off revenue.

Weak investment curbs economic growth

Economic growth slowed considerably in the first half of 2016 as the use of EU funding for investment was much less than expected. Under the revised government plan for the use of EU funds, investment is expected to pick up strongly over the next two years, contributing to the projected economic rebound, which is also supported by robust household consumption. Overall, economic growth is expected to improve from 1.9% in 2016 to 2.8% in 2017 and 3.0% in 2018. 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 set to rebound after sharp fall

The downturn in the investment cycle severely hit the construction sector, which contracted by nearly 20% y-o-y in the first half of 2016. This decrease was directly linked to the slower use of EU funds, while the level of residential construction remained broadly stable amid some increase in new mortgage loans. Investment in road infrastructure picked up in July 2016 and the whole construction sector is expected to gain some momentum in the second half of the year, as prompted from the latest economic sentiment indicator and the government's investment plans. Increasing bank lending to companies should also have a positive impact on investment and growth.

External balance benefits from price effects

Import volumes increased faster than exports in the first half of 2016 in line with expectations, but the balance of trade improved due to positive terms of trade effects related to energy prices. As prices of energy commodities are assumed to gradually increase, the trade deficit is set to widen in 2017 and 2018. The outflow of primary income had previously been expected to reflect a one-off negative impact from profit repatriation in the banking sector, but this is now set to affect only foreign investment. As a result, the current account in 2016 should improve much more than expected in the spring. Accordingly, the current account is estimated to be broadly balanced in 2016 and to move back to a deficit afterwards.

Unemployment drops in line with expectations

Despite weaker-than-expected economic growth, the labour market performed in line with expectations in the first half of 2016. Unemployment declined somewhat and job creation picked up marginally while wage growth slowed. The downturn in construction was concentrated in less labour-intensive activities and the job losses there were more than offset by other sectors. The positive trend in the labour market is set to continue at a slow pace, as job creation remains restrained by the shrinking population.

Energy, service prices to push up inflation

Consumer prices picked up in the third quarter of 2016, but the full-year average is projected to remain very low, reflecting the earlier strong downward effect from energy prices. In 2017, inflation is forecast to rebound to 1.8% under the assumption of higher oil prices, including their lagged effect on natural gas and heating prices.

Further acceleration in service prices, helped by wage growth, and a fading impact from energy prices are set to keep inflation around 2% in 2018.

Fiscal position benefits from one-off revenue

The headline government deficit is expected to reach 0.8% of GDP in 2016. The relatively solid growth of consumption and wages should support tax revenue. VAT revenue suffers from weak investment but this is more than offset by strong performance in excise and corporate income taxes. Expenditure overruns on sick leaves and unemployment benefits stem from the increased generosity over the past years and the behavioural response to this. However, the overruns are balanced by capital and interest savings. Moreover, a one-off receipt from anti-money laundering investigations should improve the government balance by 0.2% of GDP in 2016.

In 2017, the government deficit is projected at 1.1% of GDP. The draft budget envisages net revenue-increasing measures of 0.4% of GDP and net expenditure-increasing measures of 0.6% of GDP, including an allocation to the health sector reform (0.1% of GDP). Half of the revenue measures consist of a postponed change in the tax payment date for vehicles and a one-off receipt of confiscated illicit money, with the rest comprising small tax increases and collection improvements. The expenditure measures target health, internal security and education, and half of them are linked to pay increases. Expenditure growth is projected to be largely driven by a pick-up in public wages and capital spending, as implementation of EU-funded projects picks up, and a further expansion of social expenditure.

Under a no-policy change assumption, the government deficit is projected to worsen to 1.2% of GDP in 2018, as the expenditure trends are expected to continue and the effect of the previous one-off revenue will cease. Latvia's structural deficit is estimated to increase from 1½% of GDP in 2016 to around 1¾% in 2017 and 2018.

The government debt is estimated at 40% of GDP in 2016 and should decline to 36% of GDP by 2018, as the temporary accumulation of cash balances in 2016 is reduced and nominal GDP growth outpaces the government's net borrowing.

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	**1.9**	**2.8**	**3.0**
Private Consumption		14863.9	61.0	3.9	5.0	1.3	3.5	**3.8**	**3.9**	**4.0**
Public Consumption		4395.2	18.1	1.7	1.6	2.1	3.0	**2.7**	**2.5**	**2.5**
Gross fixed capital formation		5496.8	22.6	8.4	-6.0	0.1	2.8	**-6.5**	**5.5**	**4.2**
of which: equipment		2168.8	8.9	8.9	-5.4	-10.9	9.8	**-**	**-**	**-**
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	**3.1**	**4.1**	**4.5**
GNI (GDP deflator)		24290.5	99.8	4.4	3.4	2.2	2.6	**1.8**	**2.8**	**3.0**
Contribution to GDP growth:	Domestic demand			5.3	1.8	1.2	3.3	**1.3**	**4.0**	**3.9**
	Inventories			0.1	0.3	-1.1	-0.8	**1.2**	**-0.3**	**0.0**
	Net exports			-0.7	0.8	2.0	0.3	**-0.7**	**-0.9**	**-0.9**
Employment				-0.5	2.3	-1.4	1.4	**0.3**	**0.5**	**0.5**
Unemployment rate (a)				12.9	11.9	10.8	9.9	**9.6**	**9.2**	**8.8**
Compensation of employees / head				9.6	5.5	8.6	6.9	**5.1**	**5.5**	**5.5**
Unit labour costs whole economy				4.5	4.9	4.9	5.5	**3.6**	**3.1**	**2.9**
Real unit labour cost				-0.9	3.5	3.3	5.1	**2.7**	**1.3**	**0.7**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				5.4	1.3	1.5	0.4	**0.8**	**1.8**	**2.2**
Harmonised index of consumer prices				4.8	0.0	0.7	0.2	**-0.1**	**1.8**	**2.0**
Terms of trade of goods				-0.3	1.3	-0.9	2.4	**2.8**	**-0.7**	**0.0**
Trade balance (goods) (c)				-16.8	-11.2	-9.3	-8.4	**-7.5**	**-8.6**	**-9.3**
Current-account balance (c)				-8.3	-2.1	-2.0	-0.8	**0.0**	**-1.2**	**-1.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-7.2	0.4	1.2	2.0	**2.0**	**1.0**	**0.2**
General government balance (c)				-2.5	-0.9	-1.6	-1.3	**-0.8**	**-1.1**	**-1.2**
Cyclically-adjusted budget balance (d)				-2.4	-1.0	-2.0	-1.8	**-1.3**	**-1.6**	**-1.6**
Structural budget balance (d)				-	-1.0	-1.6	-1.8	**-1.5**	**-1.7**	**-1.6**
General government gross debt (c)				19.7	39.0	40.7	36.3	**40.0**	**37.2**	**36.0**

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