14. LATVIA

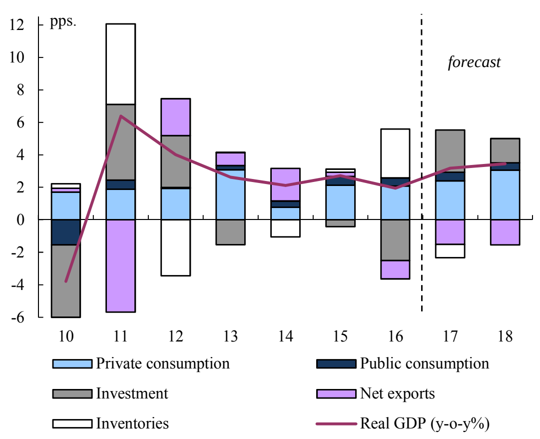
Growth rebound driven by domestic demand

Latvia's economic growth in 2016 (2.0%) suffered from a drop in investment but is expected to exceed 3% over the forecast horizon due to the upturn in the EU financing cycle and an increase in household purchasing power. Despite some tightening, the labour market should benefit from this pick-up and unemployment should inch down. Combined with energy price pressures, the surge in domestic demand is set to fuel inflation. Government borrowing is set to increase from a balanced position in 2016 to a deficit of 1.7% of GDP in 2018 through higher capital spending and tax cutting measures.

Growth is set to rebound

With the resumption of EU-funded projects and continued consumption growth, Latvia's GDP is expected to accelerate to 3.2% in 2017 and 3.5% in 2018 after 'just' 2.0% in 2016. Last year, the economy suffered from weak investment, primarily in construction, related to the trough in the EU-funds cycle. GDP growth, however, was supported by private consumption. Risks over the forecast horizon are somewhat tilted to the downside and related to both the timeliness of the investment upturn and external demand.

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



Investment is set to soar in 2017, consumption in 2018

In 2017, investment is expected to pick-up markedly, in line with the use of the EU-funds and the renewal of the Air Baltic fleet. The former is expected to support economic growth and the recovery of the construction sector. The latter is mirrored by imports and is neutral on domestic activity. In 2018, private consumption is expected to accelerate, supported by a marked increase in the national minimum wage (from EUR 380 to EUR 430 per month) and a planned decrease in personal income tax rates.

Temporary factors weigh on the external position

The acceleration of domestic demand in Latvia is expected to be reflected in imports and weigh on the trade balance. In addition, the renewal of the Air Baltic fleet will raise imports over the forecast horizon. Finally, with the rise in oil prices, price differentials between imports and exports are expected to further widen the trade deficit. These developments directly impact the current account, which is expected to turn to a deficit over the forecast horizon.

Gradual decline in unemployment

Unemployment is expected to decline to 8.7% by 2018, somewhat faster than in recent years but in line with economic activity. In 2016, the unemployment rate edged down from 9.9% to 9.6%. Net emigration is expected to fade out only gradually, which means that demographic trends will continue to weigh on the labour market.

Inflation rebound

As oil prices rise again on international markets and domestic demand strengthens, inflation in Latvia is expected to rebound to reach 2.3% in 2017 before levelling off at 2% in 2018. In 2016, inflation remained subdued at 0.1%, limited by the drop in energy prices.

Tax cuts drive fiscal expansion in 2018

The general government reached a balanced position in 2016. The tax rich composition of growth in terms of wages and consumption, together with revenue increasing measures, contributed to solid tax revenues. Positive revenue surprises from corporate income tax and excise on fuels was further supported by a one-off receipt of confiscated illicit funds (0.2% of GDP). Expenditure growth was limited by a 21%

contraction in capital spending and underspending on goods and services, while social and wage expenditure exceeded the plans.

A government deficit of 0.8% of GDP is projected in 2017, as the expenditure savings in 2016 are not expected to be repeated. Tax revenue is expected to benefit from both the better-than-expected outturn in 2016 and a more positive economic outlook for 2017. Moreover, revenue-increasing measures, in particular the increase in the micro enterprise tax rate (0.2% of GDP) should increase the tax revenue share of GDP. Expenditure growth is driven by the pick-up in capital spending and further growth in public sector wages and contribution-based benefits.

In 2018, the government deficit is projected to further increase to 1.8% of GDP as a result of the tax reform with an estimated deficit-increasing effect of 1.1% of GDP. The key measures include a personal income tax cut from 23% to 20%, an increase in the income-differentiated basic allowance, an introduction of 0% corporate income tax rate for reinvested profits and the alignment of capital tax rates at 20%. The deficit forecast accounts for the higher consumption and economic activity generated by the reform. Expenditure growth is supported by a further increase in capital spending, accelerating public wage growth and a further expansion in social benefits, also in view of the planned increase in the national minimum wage. The structural deficit is expected to widen from ¾% of GDP in 2016 to 2½% of GDP in 2018, following the nominal deficit path.

The government debt-to-GDP ratio stood at 40% of GDP in 2016 and is expected to fall to 36% by 2018 largely by decreasing the large cash reserves accumulated in 2016.

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	24368.3	100.0	4.5	2.6	2.1	2.7	**2.0**	**3.2**	**3.5**	
Private Consumption	14863.9	61.0	3.9	5.0	1.3	3.5	**3.4**	**3.9**	**4.9**	
Public Consumption	4394.5	18.0	1.7	1.6	2.1	3.1	**2.7**	**3.0**	**2.5**	
Gross fixed capital formation	5242.2	21.5	8.4	-6.0	0.1	-1.8	**-11.7**	**14.2**	**7.3**	
of which: equipment	1962.2	8.1	8.9	-5.4	-10.9	-0.6	**-1.1**	**18.0**	**9.0**	
Exports (goods and services)	14360.7	58.9	7.6	1.1	3.9	2.6	**2.8**	**3.4**	**3.6**	
Imports (goods and services)	14636.3	60.1	6.7	-0.2	0.5	2.1	**4.6**	**6.1**	**6.1**	
GNI (GDP deflator)	24310.0	99.8	4.4	3.1	2.2	2.6	**2.5**	**2.5**	**3.5**	
Contribution to GDP growth: Domestic demand			5.3	1.8	1.2	2.2	**0.1**	**5.5**	**5.0**	
Inventories			0.1	0.0	-1.1	0.2	**3.0**	**-0.8**	**0.0**	
Net exports			-0.7	0.8	2.0	0.3	**-1.1**	**-1.5**	**-1.5**	
Employment			-0.5	2.3	-1.4	1.3	**-0.1**	**0.3**	**0.5**	
Unemployment rate (a)			12.9	11.9	10.8	9.9	**9.6**	**9.2**	**8.7**	
Compensation of employees / head			9.6	5.5	8.6	6.9	**6.9**	**6.0**	**6.8**	
Unit labour costs whole economy			4.4	5.1	4.9	5.4	**4.8**	**3.1**	**3.7**	
Real unit labour cost			-0.9	3.6	3.3	5.0	**4.0**	**0.0**	**1.0**	
Saving rate of households (b)			1.6	-4.5	-3.5	-2.2	**0.6**	**0.2**	**0.1**	
GDP deflator			5.4	1.5	1.6	0.4	**0.7**	**3.1**	**2.7**	
Harmonised index of consumer prices			4.8	0.0	0.7	0.2	**0.1**	**2.2**	**2.0**	
Terms of trade of goods			-0.3	1.3	-0.9	2.4	**5.3**	**-0.9**	**-1.0**	
Trade balance (goods) (c)			-16.8	-11.1	-9.3	-8.4	**-7.0**	**-8.9**	**-10.5**	
Current-account balance (c)			-8.3	-2.1	-2.0	-0.8	**1.9**	**-0.9**	**-2.6**	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-7.2	0.4	1.2	2.0	**3.7**	**0.9**	**-0.7**	
General government balance (c)			-2.5	-1.0	-1.6	-1.3	**0.0**	**-0.8**	**-1.8**	
Cyclically-adjusted budget balance (d)			-2.4	-0.9	-1.8	-1.7	**-0.6**	**-1.4**	**-2.4**	
Structural budget balance (d)			-	-0.9	-1.4	-1.7	**-0.8**	**-1.4**	**-2.4**	
General government gross debt (c)			19.7	39.0	40.9	36.5	**40.1**	**38.5**	**36.0**	

(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.