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Latvia:
Is this the path towards cohesion?

The revival of previously depressed domestic demand backs high GDP growth in Latvia. Moreover, strong growth in exports to Russia and the Baltic neighbours counterbalances the flagging demand of the euro area. Falling consumer inflation rates and a reduction of the budget deficit to 1.4% of GDP in 2012 allows Latvia to head towards euro area accession in 2014.

Experiencing a prolonged revival of economic growth also in 2012, Latvia is praised by international organizations and commentators as the 'success story' of applying harsh austerity measures in order to adjust external imbalances. Being a small open economy, the country could significantly improve its export performance via wage cuts and substantial layoffs resulting in productivity and unit labour costs improvements. However, the question remains whether Latvia will be able to continue its economic catching-up process towards Western Europe while preventing further boom-bust cycles in the future. The country's anticipated accession to the eurozone in 2014 will reduce the cost for refinancing the government and private debt burdens, but should not be expected to serve as a shelter against future economic backslides.

Latvian exporters continued to improve their competitive position in 2012 and increased their shares not only in the markets of their main trading partners but found also new niches for their products. Growth in exports abated compared to 2011, as it did throughout the European Union, but remained at a remarkably high pace. Slower growth in investments and a reduced pace of restocking resulted in imports evolving less swiftly. For 2013 we expect a further slowdown of export growth although the Baltic neighbours and Russia will back external demand growth. Thus the contribution of net exports to GDP growth will once again become negative.

Growth in gross fixed capital formation, which was particularly volatile last year, is expected to slow down in the first half of 2013. Exporters will be reluctant to expand their investments unless they see external demand speeding up again. Nevertheless, entrepreneurs report to have reached high levels of capacity utilization in 2012, for the first time after the onset of the crisis. Most likely the government will take advantage of the good progress of revenues and increase somewhat investments in the public infrastructure. The upcoming elections at the municipal level in June 2013 and at the national level in 2014, as well as Riga becoming European Capital of Culture in 2014, will be drivers of additional expenditures.

Employment continued to grow throughout 2012, most prominently in the non-tradable sectors, but also in manufacturing. In total, the increase amounted to about 3% year on year. However, due to the massive layoffs during the crisis and substantial emigration total employment is still about 15% below the level five years ago. Job creation will slow down this year but will still reach roughly 2% per annum. The unemployment rate dropped to about 13.5% of the active population towards the end of 2012. However, we expect economic growth in 2013 to be too low to bring about fast improvements on the Latvian labour market.

Latvian employees also experienced a slight speed-up of the increase in net wages last year, by 1.5% in real terms. This trend is most likely to strengthen, given the fall in the unemployment rate and still low consumer price inflation. Thus consumption of private households will become the main driver of economic growth in 2013.

The lively economic activity of 2012 resulted in increased tax revenues of the government. At the same time public expenditures were kept almost unchanged compared to 2011 in real terms. Thus the finance ministry could present a budget deficit of 1.4% of GDP for 2012. The budget for 2013, approved already in mid-November last year, foresees a deficit of 1.4% of GDP this year as well. The flat rate of the income tax was reduced from 25% to 24% from January 2013 onwards, while the untaxed income was left unchanged and the monthly guaranteed minimum income benefit was cut from EUR 65 to EUR 50. Child care benefits for parents with children up the age of 1½ years were substantially raised again as of January 2013 after having been cut back during the crisis. The medium-term budget plan foresees an increase of investments in the public transport and energy infrastructure.

Although the country has succeeded in overcoming the worst of the economic crisis, the deep scars in Latvian society remain apparent. Apart from the still high unemployment rate – which would be even higher by more than 2 percentage points if including discouraged workers who have abandoned their search for work – Latvia suffers from widespread poverty and high income inequality.. The changes to the income tax law, approved together with the 2013 budget, foresee a further reduction of the personal income tax rate to 22% in 2014 and 20% in 2015. This will not only reduce the income base of the government required to perform the necessary upgrading of public infrastructure, e.g. in health and education, but will moreover further increase the high levels of income inequality in the country.

The reduction of the VAT rate in 2012 will continue to hold down consumer inflation in the first half of the year. Thus the Maastricht criteria will most certainly be met at the time of assessment by the European Commission in late spring this year. The Latvian government started to campaign broadly for its aim to join the eurozone in 2014, which in December 2012 was supported by only one third of the Latvian population.

The upswing of economic growth has made Latvia a trustable debtor again to international lenders. Thus in December 2012 the Latvian government could place 7-year government bonds at the international markets, with a volume of about 10% of the public debt at an interest rate below 3% per annum. The money was inter alia used to make an early repayment of all outstanding obligations to the IMF that had accrued from the rescue package granted in 2008.

Given the stagnant economic development in the eurozone, GDP growth will decline also in Latvia, from 5.4% last year to 3.8% in 2013. The further outlook is based on the assumption of a general improvement of economic activity in Europe in 2014, which should allow Latvian producers to further exploit their export possibilities and increase entrepreneurs' appetite in general to expand their capacities. Thus we expect GDP growth to revive to 4.3% in 2014 and 4.5% in 2015.

Table LV

Latvia: Selected Economic Indicators

	2008	2009	2010	2011	2012 [1]	2013	2014 Forecast	2015
Population, th pers., average [2]	2266.1	2254.8	2239.0	2058.2	2034.9	2023	2013	2003
Gross domestic product, LVL mn, nom.	16085	13070	12784	14275	15470	16500	17800	19300
annual change in % (real)	-3.3	-17.7	-0.9	5.5	5.4	3.8	4.3	4.5
GDP/capita (EUR at exchange rate)	10500	8600	8600	9800	10900	.	.	.
GDP/capita (EUR at PPP)	14600	12700	13200	14700	15900	.	.	.
Consumption of households, LVL mn, nom.	9904	7889	7947	8725	9400	.	.	.
annual change in % (real)	-5.8	-22.8	2.5	4.7	5.5	4.4	4.7	4.8
Gross fixed capital form., LVL mn, nom.	4770	2820	2330	3045	3600	.	.	.
annual change in % (real)	-13.7	-37.4	-18.1	27.9	15.0	9.0	11.0	13.0
Gross industrial production [3]								
annual change in % (real)	-3.2	-18.1	14.9	9.0	6.1	5.0	9.0	11.0
Gross agricultural production (EAA)								
annual change in % (real)	0.2	-0.7	-2.4	2.8	9.4	.	.	.
Construction industry								
annual change in % (real)	-3.1	-34.9	-23.4	12.4	14.5	.	.	.
Employed persons, LFS, th, average [4]	1124.5	983.1	940.9	970.5	885.6	905	915	925
annual change in % [4]	0.6	-12.6	-4.3	3.1	2.8	2.2	1.1	1.1
Unemployed persons, LFS, th, average [4]	90.5	203.2	216.1	176.4	155.5	140	130	120
Unemployment rate, LFS, in %, average [4]	7.5	17.1	18.7	15.4	14.9	13.5	12.5	11.5
Reg. unemployment rate, in %, end of period [4]	7.0	16.0	14.3	11.5	10.5	.	.	.
Average gross monthly wages, LVL	479	461	445	464	482	.	.	.
annual change in % (real, net)	6.2	-5.6	-6.5	0.3	1.5	.	.	.
Consumer prices (HICP), % p.a.	15.2	3.3	-1.2	4.2	2.3	2.8	3.5	3.5
Producer prices in industry, % p.a.	11.4	-4.6	2.8	7.4	3.3	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	34.9	34.0	35.3	35.0	37.1	37.0	36.5	36.0
Expenditures	39.1	43.7	43.4	38.4	38.5	38.4	37.3	36.0
Net lending (+) / net borrowing (-)	-4.2	-9.7	-8.1	-3.4	-1.4	-1.4	-0.8	0.0
Public debt, EU-def., % of GDP	19.8	36.7	44.5	42.2	41.0	38.0	36.0	34.0
Central bank policy rate, % p.a., end of period [5]	6.0	4.0	3.5	3.5	2.5	.	.	.
Current account, EUR mn	-3014	1598	532	-434	-400	-650	-900	-1000
Current account, % of GDP	-13.2	8.6	2.9	-2.1	-1.8	-2.8	-3.6	-3.7
Exports of goods, BOP, EUR mn	6531	5253	6813	8578	9700	10600	11800	13200
annual growth rate in %	8.5	-19.6	29.7	25.9	13.1	9.3	11.3	11.9
Imports of goods, BOP, EUR mn	10603	6575	8084	10765	12100	13400	15300	17700
annual growth rate in %	-4.3	-38.0	23.0	33.2	12.4	10.7	14.2	15.7
Exports of services, BOP, EUR mn	3088	2747	2754	3181	3550	3900	4400	4950
annual growth rate in %	14.1	-11.0	0.3	15.5	11.6	9.9	12.8	12.5
Imports of services, BOP, EUR mn	2169	1625	1647	1868	2050	2230	2500	2800
annual growth rate in %	9.9	-25.1	1.4	13.4	9.7	8.8	12.1	12.0
FDI inflow, EUR mn	869	68	284	1039	800	1000	.	.
FDI outflow, EUR mn	169	-44	14	44	170	200	.	.
Gross reserves of NB excl. gold, EUR mn	3514	4572	5472	4666	5373	.	.	.
Gross external debt, EUR mn	29763	29097	29978	29459	30100	.	.	.
Gross external debt, % of GDP	130.0	157.1	166.2	145.8	135.7	.	.	.
Average exchange rate LVL/EUR	0.7027	0.7057	0.7087	0.7063	0.6973	0.71	0.71	0.71
Purchasing power parity LVL/EUR	0.5051	0.4812	0.4632	0.4726	0.4783	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) From 2011 according to census March 2011. - 3) Enterprises with 20 and more employees. - 4) From 2012 according to census March 2011. - 5) Refinancing rate of National Bank.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.