14. LATVIA

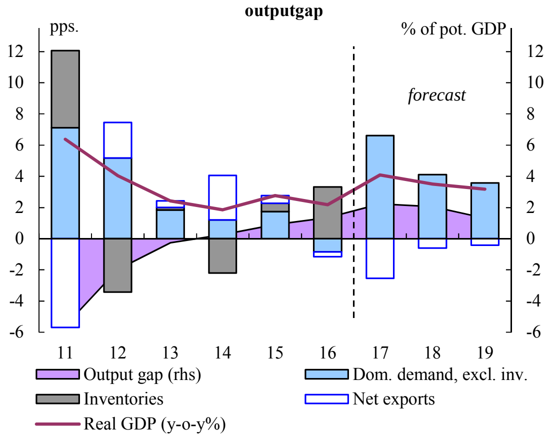
Investment recovers remarkably

The confluence of thriving consumption, greater foreign demand and a strong rebound in investment is set to push Latvia's GDP growth above 4% in 2017. Once the initial boost from the investment recovery wanes, growth should ease but remain over 3% in 2018 and 2019, due to strong consumption and improving external demand. The shrinking labour force will continue to drive down unemployment and stoke wage pressures. Inflation is likely to average around 3% in 2017 and stay thereabout in 2018 and 2019 on the back of rapid wage growth. The government deficit is expected to be contained at 1% of GDP in 2018 and 2019 despite the large costs of tax reforms.

Growth recovers remarkably in 2017

Economic growth exceeded 4% in the first half of 2017, up from 2.2% in 2016. Strong wage growth drove household consumption and inflation, to some extent. The dramatic decline in investment in 2016 looks set to be fully compensated by double-digit growth in 2017, while an improving external outlook has benefited exports. All demand components saw an improvement compared to 2016.

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



Growth set to remain strong in 2018 and 2019

The investment upswing is expected to extend into 2018 by which time EU structural fund disbursements should reach their normal levels. Household consumption is forecast to remain solid on the back of rapidly rising wages, which will at the same time increasingly translate into higher inflation, dampening real growth. Tax cuts are expected to add some more fuel to the domestic demand in 2018, but are unlikely to impact 2019 growth much.

Trade is on the up

Increasing demand from both the EU and Russia is set to lift goods export growth to some 4% in the coming years. Service exports, by contrast, are forecast to slow down as demand for transit services from Russia is falling. Import growth is set to spike in 2017 due to renewal of the AirBaltic fleet. It is projected to remain high in 2018 and 2019 in line with strong domestic demand. The current account balance is set to deteriorate, mainly as a result of higher imports.

Wage growth set to translate into prices

Despite virtually no employment growth, the unemployment rate is set to decline to 7.3% by 2019. The shrinking labour force therefore exerts strong pressure on wage growth, which will be further boosted by a substantial increase in the minimum wage. Wage growth is expected to jump to around 10% in 2017, also due in part to a reduction in undeclared wages. Over the forecast horizon, wage growth is set to slow to more sustainable levels.

The rebound in energy prices proved to be mild and short-lived, but a surprise spike in food prices pushed HICP inflation to almost 3% in the first half of 2017. While the impact of energy prices is expected to wane by the end of the year, high wage growth is expected to ensure that inflation stays close to 3% in both 2018 and 2019.

Fiscal position controlled despite reform costs

The government deficit is expected to be 0.9% of GDP in 2017. The forecast of government revenue forecast has been revised up by some 0.4 pps., compared to the spring forecast, but the government's decision to pre-pay support for electricity production carries previously unplanned costs of 0.5% of GDP. The better-than-expected performance of tax revenues is linked mainly to the pick-up in wages.

In 2018, the government deficit is projected at 1.0% of GDP, compared to a forecast of 1.8% in spring 2017. The bulk of the improvement is explained by revised tax reform plans. Notably, the revenue loss associated with the transition to a new corporate income taxation system is largely shifted out to 2019. Other measures were also adjusted with a deficit-improving effect. The overall effect of the tax reform measures is still revenue reducing -0.2% of GDP in 2018. The reduction of the standard rate of personal income tax from 23% to 20% costs 0.7% of GDP and the changes in corporate income tax reduce revenues by 0.3% of GDP. These are partly compensated by the increases in excise duties (+0.2% of GDP), tightening administration of VAT (+0.3%) and aligning taxes on both wage and capital income at 20% rate (+0.1%). Moreover, the social contributions rate is due to be increased by 1 pp. yielding 0.3% of GDP, which is ear-marked for financing a 0.7% of GDP increase in healthcare spending. Other spending increases amount to 0.5% of GDP, including for social benefits and road infrastructure. The spending measures are financed from revised revenue projections and through the expenditure review process (0.3% of GDP).

In 2019, the government deficit is projected at 1.1% of GDP under a no-policy-change assumption. While the costs of the tax reform are expected to weigh on tax revenues (-0.8% of GDP), economic growth dynamics should support revenue growth. Expenditure growth is projected to be based on a further increase in social spending, while the increase in the public sector wage bill should be contained by reforms that reduce the number of public sector employees. Moreover, investment expenditure is set to stabilise after a surge in new EU financed projects in 2017 and 2018. Latvia's structural deficit is expected to increase to 1¾% of GDP in 2017 and 2018 before declining to 1½% of GDP in 2019.

The government debt is expected to fall to 39% of GDP in 2017 and should decline further to about 36% of GDP in 2018 and 2019. The debt dynamics reflect fluctuations in expected cash balances, while the underlying debt ratio is on a downward path, as nominal GDP growth outpaces the government's net borrowing.

Table II.14.1:

Main features of country forecast - LATVIA

	2016			Annual percentage change						
	mio EUR Curr. prices	**% GDP**	**98-13**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP	24926.7	100.0	4.1	1.9	2.8	2.1	**4.2**	**3.5**	**3.2**
Private Consumption	15319.5	61.5	3.8	1.4	2.5	3.3	**4.3**	**4.0**	**3.9**
Public Consumption	4492.7	18.0	1.6	1.9	1.9	2.7	**4.0**	**2.5**	**2.0**
Gross fixed capital formation	4537.8	18.2	7.7	0.1	-0.5	-15.0	**17.8**	**5.5**	**4.0**
of which: equipment	1761.4	7.1	7.2	-10.9	-1.3	-6.5	**18.0**	**5.0**	**4.0**
Exports (goods and services)	14965.8	60.0	6.8	6.0	3.0	4.1	**3.8**	**4.2**	**4.0**
Imports (goods and services)	14742.4	59.1	6.4	1.2	2.1	4.5	**7.9**	**5.1**	**4.5**
GNI (GDP deflator)	24866.5	99.8	4.0	2.0	2.7	2.1	**4.2**	**3.4**	**3.4**
Contribution to GDP growth: Domestic demand			5.1	1.2	1.7	-0.8	**6.6**	**4.1**	**3.6**
Inventories			0.0	-2.1	0.6	3.2	**0.0**	**0.0**	**0.0**
Net exports			-0.8	2.8	0.5	-0.3	**-2.4**	**-0.6**	**-0.4**
Employment			-0.6	-1.4	1.4	-0.3	**0.2**	**-0.2**	**-0.2**
Unemployment rate (a)			12.7	10.8	9.9	9.6	**8.4**	**7.9**	**7.3**
Compensation of employees / head			9.6	8.6	7.7	6.8	**9.5**	**8.8**	**8.1**
Unit labour costs whole economy			4.7	5.1	6.2	4.3	**5.3**	**4.9**	**4.6**
Real unit labour cost			-0.4	3.3	6.2	4.0	**3.0**	**1.5**	**1.4**
Saving rate of households (b)			1.2	-3.5	-2.2	2.7	**3.7**	**5.9**	**6.4**
GDP deflator			5.2	1.8	0.0	0.3	**2.2**	**3.4**	**3.2**
Harmonised index of consumer prices			4.3	0.7	0.2	0.1	**2.9**	**2.8**	**2.9**
Terms of trade of goods			0.3	-0.9	2.4	3.5	**-0.5**	**0.5**	**0.5**
Trade balance (goods) (c)			-16.5	-10.0	-9.0	-7.7	**-10.3**	**-10.4**	**-10.4**
Current-account balance (c)			-8.0	-1.5	-0.2	1.4	**-1.4**	**-1.6**	**-1.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-6.7	1.7	2.7	2.4	**-0.1**	**0.0**	**0.4**
General government balance (c)			-2.7	-1.2	-1.2	0.0	**-0.9**	**-1.0**	**-1.1**
Cyclically-adjusted budget balance (d)			-2.6	-1.3	-1.6	-0.5	**-1.8**	**-1.8**	**-1.6**
Structural budget balance (d)			-	-1.0	-1.6	-0.6	**-1.8**	**-1.8**	**-1.6**
General government gross debt (c)			21.3	40.9	36.9	40.6	**39.1**	**35.6**	**35.8**

(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.