# LATVIA

## Highlights

- **Economic expansion has decelerated.** In the first half of 2016, GDP growth of 2.1 per cent continued to be mostly driven by private consumption, whereas growth of investment and net exports turned negative. Private consumption is expected to remain the key driver for growth in the short term.
- **The gas market is being liberalised.** The parliament has approved amendments to the energy law, which stipulates gas market liberalisation, including unbundling of services provided by the single national gas utility, Latvijas Gaze.
- **Latvia is now a fully fledged member of the OECD.** Latvia has been subjected to a number of technical reviews, which, among others, assessed the quality of public governance and competition policies. During the accession process, Latvia further strengthened corporate governance standards, also by re-establishing boards of directors in key state-owned enterprises (SoEs).

## Key priorities for 2017

- **Sustainable energy projects should be further developed.** This is especially important in the small and medium-sized enterprise (SME) and residential sectors, as, for example, only 2 per cent of multi-apartment residential housing stock has been renovated. Energy projects in these sectors are being held back by institutional barriers, which need to be removed.
- **Latvia will need to further enhance the export orientation of its economy and facilitate engagement of foreign direct investors.** Greater openness is a prerequisite for the transmission into Latvia and subsequent broader adoption of new technologies and production processes. Given the minimal local innovation, this is the most promising path to a more innovative economy.
- **The funding environment for innovative enterprises needs to be expanded to include new financial instruments.** At present, private equity and venture capital funds remain underdeveloped and fragmented between relatively small local markets, as local stock exchanges in the Baltic states continue to lose liquidity.

Main macroeconomic indicators %

| | 2012 | 2013 | 2014 | 2015 | 2016 proj. |
|---|---|---|---|---|---|
| GDP growth | 4.0 | 2.9 | 2.1 | 2.7 | 2.2 |
| Inflation (average) | 2.3 | 0.0 | 0.7 | 0.2 | -0.1 |
| Government balance/GDP | -0.8 | -0.9 | -1.6 | -1.3 | -1.0 |
| Current account balance/GDP | -3.6 | -2.7 | -2.0 | -0.8 | -1.0 |
| Net FDI/GDP [neg. sign = inflows] | -3.2 | -1.6 | -1.6 | -2.3 | -0.5 |
| External debt/GDP | 138.6 | 134.1 | 142.4 | 138.2 | n.a. |
| Gross reserves/GDP | n.a. | n.a. | n.a. | n.a. | n.a. |
| Credit to private sector/GDP | 66.3 | 59.6 | 52.4 | 49.9 | n.a. |

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## Macroeconomic performance

**Private consumption supports GDP growth.** During the first half of 2016, GDP grew by 2.1 per cent year-on-year, which reflects a marginal slow-down from the previous year. In 2015, economic growth in Latvia, at 2.7 per cent, was driven mainly by strong private consumption, underpinned by real wage growth above 7.0 per cent. The contribution from net exports turned negative, as the recession in Russia continued to weigh on exports, particularly in the dairy sector, and somewhat recovered investment boosted import demand. Export volumes grew only marginally at 2.1 per cent in 2015, and remained flat in the first half of 2016. Exports to Russia continue to decline amid a further depreciation of the rouble in relation to the euro in the year to mid-2016.

**Investment growth sharply decreased.** The end of the previous budget of EU structural funds is evident in the substantial shrinkage in investment growth from 2.7 per cent in 2015 to -20 per cent in the first six months of 2016. The stock of bank credit to the private sector continues to contract, albeit at a lower rate.

**The labour market continues to tighten.** The unemployment rate has been fluctuating around 10 per cent since the end of 2014. This persistency reflects the structural nature of unemployment, which to a large extent is driven by skills mismatches and a lack of regional labour mobility. Strong real wage growth and a decline in the working-age population create serious challenges for the authorities, particularly as nominal labour productivity per person remains the lowest in the central Europe and the Baltic states (CEB) region, at only 65 per cent of the EU average in 2015.

**Rising disposable income will further underpin growth.** Private consumption is expected to remain the key driver for growth in the short term, particularly supported by the hikes in the minimum wage in 2016 and the planned indexation of pensions in 2017. Due to the persistently weak external environment, growth expectations for this year have been revised slightly down, to 2.2 per cent, while an accelerated utilisation of EU funds, as well as improvements in external demand, may result in further improvement in the growth rate next year.

## Major structural reform developments

**Latvia has become a fully fledged member of the OECD.** The agreement of accession to the Organisation for Economic Co-operation and Development (OECD) was signed and ratified by the Latvian parliament in June 2016. Following the start of negotiations in May 2013, Latvia has been subject to a number of technical reviews, which, among others, assessed the quality of public governance and competition policies. During the accession process, Latvia further strengthened corporate governance standards, also by re-establishing boards of directors in key SOEs. Also, the OECD's anti-money laundering regulations were implemented. Latvia's continued compliance in this area is essential, given ongoing capital flight from Russia and Latvia's traditional role as an offshore banking centre for former Commonwealth of Independent States (CIS) economies.

**Gas market liberalisation has advanced.** The amendments to the energy law, approved by the parliament and signed into law in February 2016, stipulate full gas market liberalisation from April 2017, including the unbundling of services provided by the Latvijas Gaze natural gas utility. The entry of private players is expected to create a more competitive gas market, and gas prices may drop to levels closer to those in western Europe. A diversified gas supply will ultimately strengthen energy security, which will be underpinned by the Baltic common gas market, which is expected to be set up by 2020.

**Changes to business taxation were put on hold.** In November 2015, the parliament decided to delay until 2017 the implementation of the initially scheduled changes to micro enterprise tax and minimum mandatory social security contributions. The proposed amendments stipulate a further reduction in tax rates for micro companies with turnover below a particular threshold. This has been already criticised in the tax system review prepared by the World Bank, as the depressed tax rates shift economic activity away from larger companies, and thus effectively constrain innovation and expansion. The World Bank's findings and recommendations are expected to provide tax policy guidelines for 2017-20 and the drafting of next year's budget.

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**Latvia's least-developed region will benefit from status as a special economic zone.** In May 2016, parliament approved a bill creating a special economic zone (SEZ) in the Latgale region in eastern Latvia. The zone is expected to cover public and private properties, with the share of the latter being no higher than 30 per cent. Businesses operating in the SEZ will be able to benefit from tax discounts of up to 55 per cent of the value of the invested capital. The law will be effective from 2017 until the end of 2035 and is expected to stimulate investment and job creation in the region, where GDP per capita is just 34 per cent of the EU average (in purchasing power standards).

**Previous EU structural funds have been fully absorbed.** Latvia managed to utilise the entire allocation of €4.5 billion of EU structural funds under the 2007-13 budget framework. This was evident in a sharp increase in public investment in 2015, the final year for funds disbursement from the expiring budget period. According to the Ministry of Finance, the structural funds account for more than 70 per cent of total public investment in Latvia. Through three national and regional programmes Latvia is expected to utilise €5.6 billion of EU structural funds over the course of the next budgetary period, covering the years 2014-20. The key targeted areas are innovation, environmental protection and social inclusion.

**Innovation performance has improved.** According to the 2016 European Innovation Scoreboard, Latvia advanced to the group of "moderate" innovators. The greatest improvement was observed in terms of graduation of doctorate students, whereas the amount of public-private scientific co-publications appeared to have deteriorated relative to the previous year. Over the entire lifespan of this measure since 2007 research and development (R&D) intensity increased only marginally. Almost half of these expenditures are financed by funds from abroad, which is the highest such share in the European Union.

**The Latvian government approved an action plan on economic growth in April 2016.** The plan provides a detailed description of government measures required to attain those goals. It includes further improvements in the business environment, national security and greater international cooperation, particularly with the Nordic states and international financial institutions.