LATVIA

Highlights

- **Improving external demand and investment are set to drive GDP growth.** After collapsing last year, European Union (EU) co-financed investment has been slowly recovering. Amid robust private consumption and recovering exports GDP growth is expected to strengthen in 2017 and 2018.
- **Recently introduced reforms are designed to increase competitiveness and combat the "grey" economy.** A tax reform involves changes to the corporate, excise and labour taxes and also includes measures to reduce informality.
- **Work on healthcare reform has been launched.** The approval by the government of a healthcare conceptual reform plan is expected to bring more efficiency to the healthcare system, as well as to increase its funding.

Key priorities for 2018

- **The success of the recently approved tax reform will depend on its efficient implementation.** Any potential poor communication from the government may lead to only limited willingness to cooperate.
- **EU funds absorption needs to improve.** The current slow withdrawal of the EU funds is largely driven by the poor quality of project applications. Of all contracts signed by the end of 2016, almost 90 per cent of them required a resubmission.
- **Listing some of the state-owned enterprises (SOEs) at the stock exchange will improve corporate governance and increase transparency in those companies.** Currently, Latvian SOEs' stock in the free market amounts to merely 3 per cent of GDP, substantially below the global average of about 20 per cent.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.6	1.9	2.8	2.1	4.7
Inflation (average)	0.0	0.7	0.2	0.1	3.1
Government balance/GDP	-1.0	-1.2	-1.2	0.0	-0.6
Current account balance/GDP	-2.7	-2.0	-0.8	1.4	-0.2
Net FDI/GDP [neg. sign = inflows]	-1.6	-1.6	-2.3	0.0	-1.7
External debt/GDP	134.1	144.1	143.9	149.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	59.5	52.3	49.8	49.4	n.a.

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Macroeconomic performance

A sharp drop in investment in 2016 has held back GDP growth. In 2016, economic growth decelerated to 2.1 per cent, largely hampered by lower investment. In contrast, household consumption remained strongly supportive to growth, being underpinned by rising real wages and falling unemployment. During the first six months of 2017, the economy strengthened substantially, with growth reaching 4 per cent, backed by improving external demand and recovering investment.

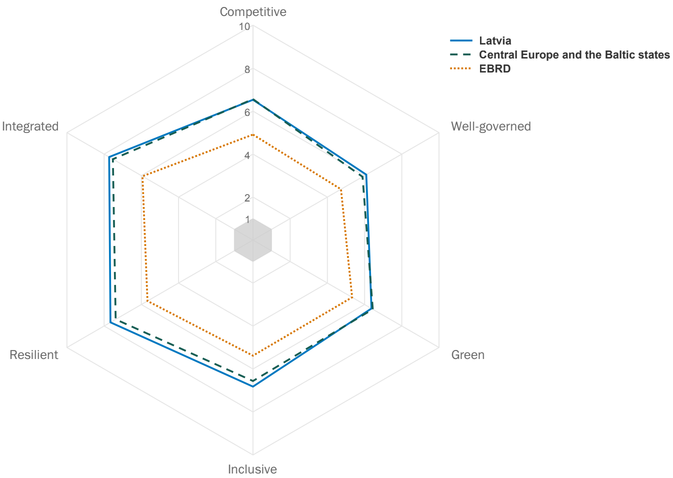
EU co-financed investment is rebounding slowly. Following a dramatic drop of 15.0 per cent in 2016, investment growth recovered to 17.5 per cent during the first half of 2017. Two factors are behind this improvement. First, the already substantially delayed investments co-financed by the EU funds have slowly started to materialise. Second, the recovering credit to non-financial corporates indicates that private investment is also picking up, supported by positive expectations regarding external demand.

Real wage growth exceeded productivity growth. In 2016, real wage growth decelerated somewhat to 4.9 per cent, from 6.6 per cent in the previous year, although it still exceeded real productivity growth by nearly three percentage points. Unit labour costs have been growing faster than those of Latvia's regional peers, and, if sustained, this trend could have a negative impact on the country's international competitiveness by eroding companies' profitability and deterring investment. Besides, the persistent net outward migration and low fertility rates are expected to further reduce the working-age population, which, as a result, will likely further weigh on potential growth in the medium term.

The general government's position has balanced for the first time since 1998. Thanks to a much smaller deficit at the central government level, Latvia's government fiscal position improved substantially in 2016, after it saw a deficit of 1.3 per cent of GDP in the previous year. However, the expected pick-up in capital spending, higher public sector wages and a new 2018 tax package, which is forecast to cost about 1.5 per cent of GDP during the first three years of its implementation, will likely result in fiscal deficits over the coming years. According to the European Commission autumn report, the government deficit should reach 1.0 per cent of GDP in 2018 and 1.1 per cent in 2019.

A further recovery in GDP growth will depend on higher investment. Private consumption will likely remain strong, underpinned by improving labour markets and recovering domestic credit. Together with rising EU co-financed investment, GDP growth is expected to reach 4.7 per cent this year and 4.1 per cent in 2018. However, downside risks come from lower-than-expected EU funds absorption and/or weak external demand.

Assessment of transition qualities (1-10)



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Major structural reform developments

A package of tax reform has been introduced. The reforms are designed to increase competitiveness and combat the “grey” economy. In July 2017, a package of 12 tax reform bills was adopted by the parliament and will enter into force from January 2018. The reform involves changes to the corporate, excise and labour taxes and also includes measures to reduce informality. A greater rate of progression in personal income taxation is expected to have a positive impact on consumer spending, although the reduction in the tax wedge will likely boost Latvia’s competitiveness only marginally. The reform of corporate taxation, which envisages a tax deferral until actual distribution, is expected to improve transparency and boost investment. Expansion of the reverse VAT payment in some problematic sectors, the reduction of VAT thresholds and the introduction of an online trade transactions register should help in combating the informal economy, which is estimated by the Stockholm School of Economics in Riga at greater than 20 per cent of GDP in 2016.

Healthcare reform has been initiated. The government approved a healthcare conceptual reform plan in July 2017. It is expected to bring more efficiency to the healthcare system, as well as to increase its funding. At the moment, public spending on health in Latvia is among the lowest in the EU (3.7 per cent of GDP against the EU average of 7.2 per cent in 2014). Some additional funding will come from higher social security contributions, which will be increased as part of the broad tax reform from January 2018.

The government aims at privatisation of some state-owned enterprises. Following a sale of 20 per cent of the shares in Latvia’s national carrier airBaltic to a German investor in 2016 and subsequent acquisition of this shareholding by a Danish aviation investor, the government plans to further reduce its stake in the company to below 50 per cent by the end of 2017. A potential buyer would be required to keep the existing network of the company as well as to maintain Riga Airport as the airline’s home base. Listing of the company at the stock exchange has not been considered. Nevertheless, the government’s intention is to increase the amount of Latvian SOEs on the stock exchange, with some initial proposals being announced by the end of the year. Currently, Latvian SOEs’ stock in the free market amounts to merely 3 per cent of GDP, substantially below the global average of about 20 per cent.

A reform plan to enhance the efficiency of public administration has been announced. According to a reform proposal announced in July 2017 by the State Chancellery, the current number of employees in public administration is expected to be cut by 6 per cent by 2020, while the creation of new vacancies would be frozen. Besides, the proposed reform also details increasing the salaries of remaining employees to up to 80 per cent of wages paid in the private sector. Further improvements in public governance should be explored during the revision of functions of small state institutions, including options for their centralisation.

EU funds absorption remains low. By mid-2017, about half of the total EU funding available to Latvia of €5.6 billion in 2014-20 had been approved by the Ministry of Finance. However, only about 8 per cent of the financing has been disbursed so far, mainly in the spheres of transportation, employment and education. Similar to the other EU new member states, Latvia also experiences difficulties in withdrawing EU funds from the current EU budget. During the first half of 2017, the amount of EU transfers to the country represented only 0.5 per cent of what had previously been the annual average since 2010. In contrast, EU funds for the state roads’ construction are expected to be fully utilised already in 2019.

Getting electricity and resolving insolvency remain key business obstacles in Latvia. In the World Bank *Doing Business 2018* report, Latvia slipped by five places to number 19 globally, still remaining behind its two Baltic peers, Estonia (12th) and Lithuania (16th). Latvia ranked best in getting credit and paying taxes categories, whereas getting electricity and resolving insolvency were scored the lowest. The number of days to obtain a permanent electricity connection is 28 days longer than the OECD average of 79 days.