LATVIA

Highlights

- **Investment has recovered strongly.** Following a sharp contraction in 2016, investment recorded double-digit growth in 2017 and the first half of 2018, boosted in part by higher EU funds absorption and contributing to a GDP expansion of above 4.5 per cent.
- **The reputation of the banking sector has been dented.** The ABLV Bank, the third-largest bank in Latvia, is being voluntary liquidated after accusations of money laundering linked to aiding North Korea's nuclear programme and some illegal activities in eastern Europe.
- **Tax reform has brought positive results.** A more progressive income tax system was introduced from January 2018, which reduces the high tax wedge on low-income earners and improves tax compliance.

Key priorities for 2019

- **The reputation of the financial sector should be restored.** Following recent scandals in the banking sector in Latvia, ambitious self-cleaning measures should be implemented in order to better address potential risks associated with money laundering, corruption and combating the financing of terrorism.
- **Labour market constraints should be further reduced.** Taking advantage of the currently strong GDP growth, the government should focus on measures that encourage greater employment of targeted groups, such as in rural areas, as well as reduce structural unemployment.
- **Efforts to make Latvia's economy more innovative should be continued.** The ongoing working group meetings among the various state-owned companies on how to increase the innovativeness of Latvia's economy are a step in the right direction. However, a greater and early involvement of the private sector is needed in order to successfully achieve the desired results.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.9	3.0	2.1	4.6	3.9
Inflation (average)	0.7	0.2	0.1	2.9	2.4
Government balance/GDP	-1.5	-1.4	0.1	-0.5	-0.8
Current account balance/GDP	-2.0	-0.8	1.4	0.7	-0.5
Net FDI/GDP [neg. sign = inflows]	-1.6	-2.3	0.0	-2.0	-2.2
External debt/GDP	143.7	143.7	149.6	141.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	52.4	49.9	49.2	43.4	n.a.

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Macroeconomic performance

A solid recovery in investment has accelerated GDP growth. In 2017, GDP growth reached 4.5 per cent, and 4.7 per cent in the first half of 2018, underpinned by a rebound in investment and still-solid household consumption. Following two consecutive years of contraction, investment growth turned positive and registered double-digit growth in 2017 and in the first half of 2018. The surge in investment coincides with improved EU funds utilisation, as well as a hike in private sector investment. The latter is mainly financed by companies' own funds, rather than credit growth, which remains subdued, partly because of the government's ambition to decrease the foreign share of deposits in Latvia's banking sector, a move recently reinforced by new legislation (see below).

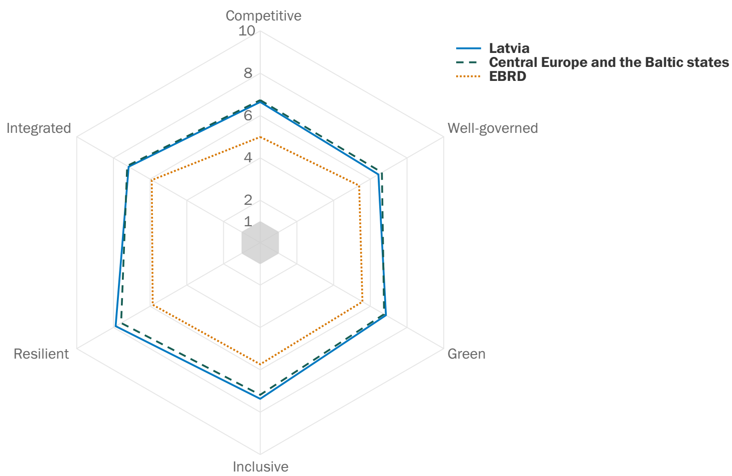
Robust household consumption, at 5.1 per cent growth in 2017, continued to be supported by a tightening labour market, which saw average real wage growth of 4.8 per cent. Only strong investment-driven imports weighed somewhat on the robust recovery of GDP growth.

A shortage of qualified labour remains a challenge for Latvia's competitiveness and long-term growth potential. Due to the current strong GDP figures, Latvia's labour market is flourishing, with falling unemployment (7.4 per cent in June 2018) and rising employment rates (76.6 per cent in the first quarter of 2018). The gap between employment of men and women dropped to only 3.8 percentage points, which is substantially below the EU average of 11.7 percentage points. At the same time, the ongoing emigration remains a challenge. Between 2009 and 2016, the outflow of people with higher education accounted for 40 per cent of net outward migration, according to a study by the European Centre of Expertise. That loss constitutes more than 17 per cent of the highly educated working-age population in Latvia.

Fiscal policy has been pro-cyclical. According to the Fiscal Discipline Council, the government is failing to take advantage of the current favourable economic situation and pro-cyclical trends to further reduce the fiscal deficit. While the government debt is expected to drop to 37 per cent of GDP in 2018, the European Fiscal Board calculations, based on the European Commission's forecasts, project a 0.7 per cent fiscal expansion in 2018 and 0.2 per cent in 2019, despite clear signs of overheating.

GDP growth is estimated to moderate. Economic expansion in the short term is expected to be further driven by investment and household consumption, but these two should be more balanced in their contribution to growth. GDP growth is expected to slow down to 3.9 per cent and 3.5 per cent, this and next year, respectively. In the short term, household consumption is forecast to remain solid, backed by higher wages and lower unemployment.

Assessment of transition qualities (1-10)



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Major structural reform developments

A scandal has damaged the reputation of the banking sector. The Latvian financial regulator, the Finance and Capital Market Commission (FCMC), started an investigation of ABLV Bank in February 2018, after the US Financial Crimes Enforcement Network (FinCEN) proposed sanctions against the bank's money-laundering allegations linked to aiding North Korea's nuclear programme and illegal activities in Azerbaijan, Russia and Ukraine. As a result, the FCMC requested ABLV to stop all payment orders and transactions. A voluntary liquidation plan was proposed in March 2018, which was approved by the financial regulator in June 2018. It is likely to begin by the end of 2018. The ABLV Bank was the third-largest in the country and its liquidation will affect about 25,000 customers, to whom €1.5 billion-worth deposits are expected to be returned.

Financial operations by high-risk customers have been limited. A bill aimed at reducing transactions between Latvian banks and shell companies was approved in April 2018. The bill also improves information exchange in the financial sector. Consequently, the share of foreign deposits is expected to drop from the current 30 to 20 per cent, while the aim of the government is to cut it to only 5 per cent of all deposits. While the law will likely have a negative impact on GDP growth in the short term, it is aimed at strengthening the banking sector, which was severely hit by the ABLV crisis.

Tax reforms are addressing the shadow economy and promoting inclusion. Starting from January 2018, a more progressive income tax system was introduced, which reduces the high tax wedge on low-income earners and improves tax compliance. According to an early estimate of the finance ministry, the reform has already brought positive results, in particular to unreported wages. Latvia's shadow economy is estimated at 22 per cent of GDP in 2017, according to the Shadow Economy Index for the Baltic Countries by the Stockholm School of Economics in Riga, which is higher than in neighbouring Baltic states.

EU cohesion policy funds will be reduced in the new budget. According to the early proposal for the 2021-27 EU budget, announced by the European Commission in May 2018, Latvia's cohesion funding is expected to shrink by 13 per cent, relative to the current budget. Overall, the implementation of all EU funds available to Latvia for 2014-20 (€5.6 billion) stood at 60 per cent by mid-2018. The EU cohesion funds are expected to be reduced for those countries and regions, where income per capita approaches the level of 75 per cent of the EU average. In 2016, Latvia's purchasing power-adjusted GDP per capita reached 65 per cent.