LATVIA

Highlights

- **Economic growth is moderating.** In 2018, the improved absorption of European Union (EU) funds and positive economic sentiment resulted in strong investment and gross domestic product (GDP) growth, but both investment and household consumption have been subdued in the first half of 2019.
- **Supervision of the banking sector has improved.** Following the accusations of money laundering in 2018 at ABLV Bank, the government has introduced several measures to reduce exposure to risky banking operations.
- **The government is encouraging small and medium-sized enterprise (SME) presence on the stock exchange.** The goal is to increase the international competitiveness of SMEs and to develop local capital markets.

Key priorities for 2020

- **Further efforts to strengthen banking supervision are needed.** In order to restore the reputation of Latvia's financial sector, extra reforms are required in order to prove the effectiveness of the regimes of anti-money laundering (AML) and combating the financing of terrorism (CFT).
- **Poor health outcomes should be addressed.** Life expectancy remains among the lowest in the European Union (EU), while amenable mortality is high. The long-awaited healthcare reform should be continued and more public funds should be devoted to improving patient access to treatment.
- **Productivity and GDP growth require greater investment in innovation.** Amid a shrinking population, a greater focus needs to be placed on knowledge-intensive activities. The recent efforts by the largest state-owned enterprises to boost innovation were welcome, but more private-sector involvement is needed early on.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.3	1.8	3.8	4.6	2.6
Inflation (average)	0.2	0.1	2.9	2.6	2.8
Government balance/GDP	-1.4	0.1	-0.5	-0.7	-0.8
Current account balance/GDP	-0.8	1.4	0.7	-0.7	-1.5
Net FDI/GDP [neg. sign = inflows]	-2.3	0.0	-2.0	-2.3	-2.5
External debt/GDP	143.7	148.6	140.3	120.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	49.7	49.2	43.8	38.0	n.a.

CONTINUES

Macroeconomic performance

Economic growth is moderating. After reaching 4.8 per cent in 2018, GDP growth slowed to 2.4 per cent in the first half of 2019. Domestic demand continued to be strong in 2018, fuelled by strong household and government consumption and a double-digit hike in investment. Net exports weighed on GDP performance in 2018 (by negative 2.2 percentage points), as investment-driven imports robustly outperformed weak exports. In the first half of 2019, almost all GDP components (except exports) saw some deceleration.

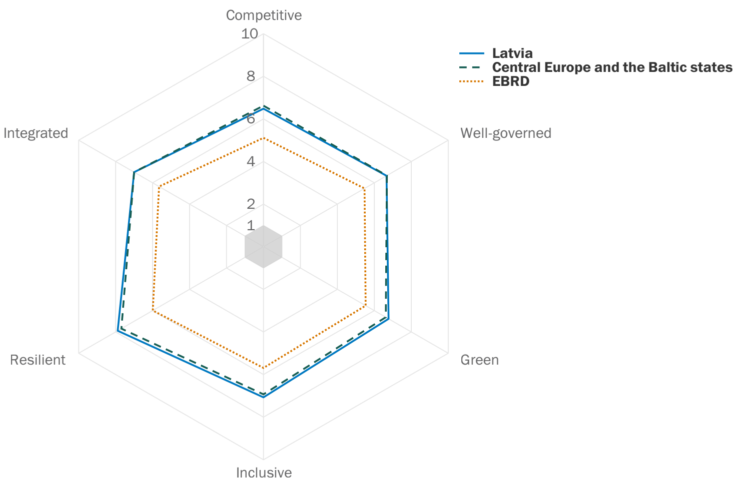
Investment remains strong despite a credit decline. Investment growth of 16.4 per cent in 2018 was mainly caused by improved EU funds absorption. As of mid-2019, 77.0 per cent of EU funding available in 2014-20 (€5.63 billion) was already invested in various projects. On the other hand, restructuring of the banking sector has continued to reduce banks' balance sheets. In the first half of 2019, the decline in lending activity to the private sector decelerated somewhat from -5.8 per cent in 2018 to -3.3 per cent year-on-year. Overall, the stock of credit to the private sector shrank to about 36.8 per cent of GDP by mid-2019, compared with almost 50.0 per cent at the beginning of 2016.

Growth of labour costs have been among the highest in the EU. Since 2010, unit labour costs increased by more than 35.0 per cent, the third-highest rate in the EU. Over the same period, real labour productivity improved by almost 28.0 per cent. Wage growth was 8.4 per cent in 2018, driven by labour shortages and an increase in the minimum wage. Wages are expected to increase further in the short term, albeit at a slower rate.

General government budget deficit widens. Following a small surplus in 2016, the general government balance turned negative in 2017 and dropped to a deficit of 0.7 per cent of GDP in 2018 as a result of increased public investment and higher public-sector wages. The government deficit is expected at 0.8 per cent of GDP in 2019. Government debt will likely decrease further, from 36.4 per cent of GDP in 2018 to below 35.0 per cent of GDP in 2020.

Labour shortages and restrained financing will weigh on growth. GDP growth is projected to decelerate to 2.6 per cent in 2019 and further to 2.2 per cent in 2020. The slowdown is due to a combination of factors, including decelerating economic growth in advanced European countries, adverse demographics and the reduced availability of sources of finance, such as EU funds and bank credit. However, additional rises in wages will drive further consumption growth.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Supervision of the banking sector continues to tighten. Following the completion of the financial system assessment by the Council of Europe's Moneyval committee (Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism), the prime minister signed three decrees on a further reform of the financial sector's supervisory system in February 2019. These measures are designed to address concerns raised in the Council of Europe's report about Latvia's AML/CFT regime. The new measures strengthen the Financial and Capital Market Commission, enable the government to expel banks involved in money laundering and enable more focus of the courts and prosecutors on more serious financial crimes.

T**he government is attracting more local companies to the stock exchange**. In May 2019, the Finance Ministry proposed regulations to encourage more SMEs to be listed on the Riga Stock Exchange. The goal is to increase the international competitiveness of the companies and to develop local capital markets. A support scheme is expected to promote and support financing availability for SMEs. Stock capitalisation in Latvia remains relatively small (4.6 per cent of GDP), compared with neighbouring Baltic states, and way below the EU average of 78.0 per cent. So far, reasons given by SMEs for not listing their shares include: high costs, low market liquidity, and insufficient awareness of the potential benefits.

Regional development has been enhanced. In April 2019, the parliament adopted a draft resolution on launching an administrative-territorial reform. According to the reform, the number of local governments would be reduced from 119 to 35. The economically weaker regions would be merged with stronger ones, with the goal of enhancing regional development and ensuring equal services to all residents The reform constitutes a continuation of the territorial reform started in 1998 and is expected to be completed by 2021.

The business environment is improving. In May 2019, the government endorsed a finance ministry plan to enhance the business environment in 2019-20. The key principles of the 40 measures in the plan include a consumer-friendly public administration, the expansion of e-governance, a competitive tax system, and promotion of the rule of law and innovation. Moreover, a specialised court for handling economic cases is expected to be established by 2021. According to the American Chamber of Commerce, the slow and unpredictable proceedings of complicated economic crime cases have contributed to corruption and make Latvia appear less attractive for investors. In the World Bank *Doing Business 2020* report, Latvia remained at 19th position (out of 190 countries).

The government has set targets to shrink the shadow economy. According to the action plan prepared by the government in April 2019, the shadow economy should be reduced from 21.3 per cent of GDP in 2017 to 17.1 per cent in 2022. The priority measures aim to improve tax payments and introduce fair competition in those economic sectors with the highest risks of informality, such as the construction and retail sectors.