Euler Hermes Economic Research

Country Report

Latvia

Cyclical upswing amid first reforms

General Information

GDP	USD27.7bn (World ranking 95, World Bank 2016)
Population	1.96mn (World ranking 148, World Bank 2016)
Form of state	Parliamentary democracy
Head of government	Maris KUCINSKIS (Prime Minister)
Next elections	2018, legislative

Strengths

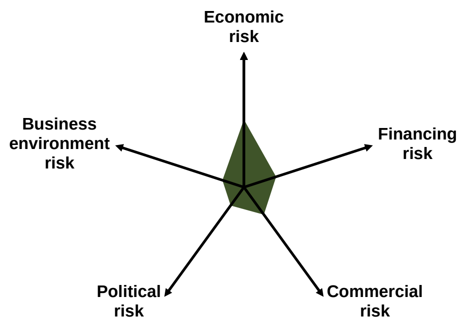
- Low systemic political risk
- Good international relations
- Competitive business environment
- Eurozone membership provides for low transfer and convertibility risk
- Sound public finances and access to international capital markets

Weaknesses

- Small industrial base
- Low R&D spending (0.44% of GDP in 2016) relative to Euro area R&D spending (2.1% of GDP in 2016)
- Unfavorable export structure, largely dependent on Russia (geopolitical risk) and other Baltic States
- Banking sector remains vulnerable due to the high level of (volatile) non-resident deposits
- Regional inequalities and mismatch on labor markets (between workers and jobs)

Country Rating

BB1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Lithuania	18%	1	18%	Lithuania
Estonia	12%	2	12%	Germany
Russian Federation	8%	3	11%	Poland
Germany	7%	4	8%	Estonia
Sweden	6%	5	8%	Russian Federation

By product (% of total)

Exports		Rank		Imports
Cork and wood	10%	1	8%	Road vehicles
Telecommunications	8%	2	6%	Telecommunications
Wood manufactures	6%	3	6%	Petroleum products
Road vehicles	5%	4	4%	Pharmaceuticals
Cereals	5%	5	4%	Electrical machinery

Source: Unctad (2016)

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Economic Overview

Robust exports and consumer spending

The Latvian economy is set to grow +4.4% in 2017, after a mere +2% in 2016. GDP growth has become broad-based. It was driven by strengthening exports (cyclical upswing in EU countries and Russia), a rebound in investment (EU structural fund transfers), as well as robust consumer spending bolstered by sound wage growth. While exports and private consumption (e.g. thanks to a higher minimum wage) should remain strong in 2018, investment expansion will slow down, contributing to somewhat slower GDP growth. However, geopolitical risk related to Russia could undermine the currently positive export dynamics.

On the supply-side, the mismatch between qualified workers and jobs on the labor market remains an urgent issue. The government has adopted a series of structural reforms destined to improve the quality of education and vocational training. The business environment in Latvia is favorable as reflected in its 19th rank out of 190 economies in the World Bank's *2018 Doing Business* survey.

Sound macroeconomic conditions

Deflationary pressures abated and inflation is set to rise to an average +3% in 2017, as strong business activity has driven up labor costs, before easing to +2.5% in 2018. However, faster than anticipated growth in energy prices poses an upside risk to this forecast.

Expansionary fiscal policy in the form of higher health-care spending and welfare payments to low-income households, as well as the tax exemption of corporate profits will move the fiscal balance into small deficits in 2017-2019. Nonetheless, public debt is projected to fall below 40% of GDP. Overall, the fiscal stance is prudent and public debt remains on a sustainable path over the next years.

Banks in Latvia appear sufficiently capitalized while liquidity is adequate. Private sector credit growth has recovered after a long period of deleveraging. However, the high amount of non-resident deposits (now declining) in the banking system is a source of vulnerability despite tighter regulation.

Sluggish reduction of external debt

The current account is expected to shift to small, unproblematic deficits in 2017-2018 as a result of strengthening import growth. The latter stems from strong consumer spending and rising energy prices.

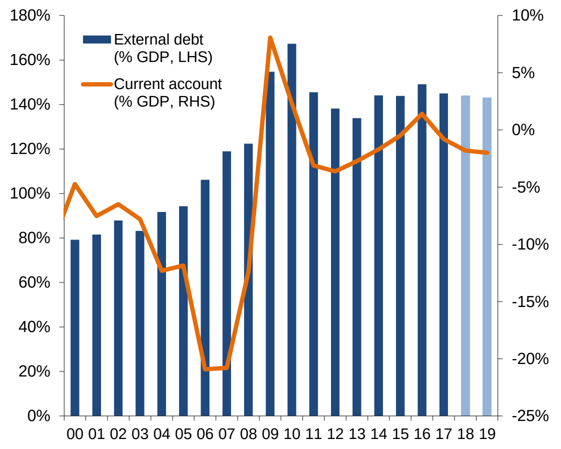
A major weakness remains the relatively high level of external debt which has only shrunk modestly since it peaked in 2010, to currently 145% of GDP. The largest part of the debt is held by the banking sector, 32% in Q2 2017 (two thirds of which is non-resident deposits).

Key economic forecasts

	2016	2017e	2018f	2019f
GDP growth (% change)	2.0	4.4	3.9	3.8
Inflation (%, yearly average)	0.1	3.0	2.5	2.5
Fiscal balance (% of GDP)	0.0	-1.0	-1.5	-1.5
Public debt (% of GDP)	40.1	38.0	37.5	37.0
Current account (% of GDP)	1.4	-0.8	-1.8	-2.0
External debt (% of GDP)	149.1	145.0	144.0	143.0

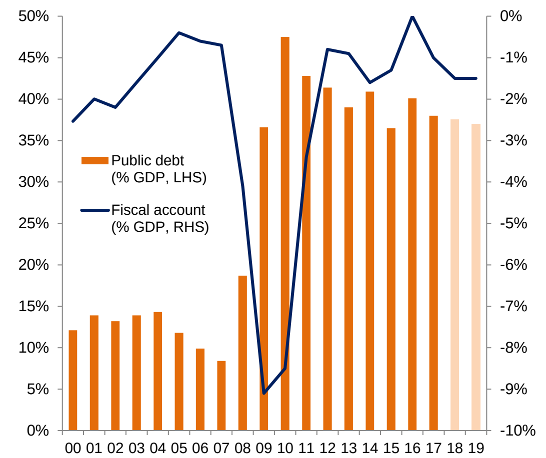
Sources: National Statistics, IHS, Euler Hermes

Current account and external debt (% of GDP)



Sources: National statistics, IHS, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: Eurostat, Euler Hermes

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