Euler Hermes Economic Research

Country Report

Latvia

Growth decelerated in 2016 but should pick up in line with investment in 2017

General Information

GDP	USD27.0bn (World ranking 102, World Bank 2015)
Population	1.98mn (World ranking 148, World Bank 2015)
Form of state	Parliamentary democracy
Head of government	Maris KUCINSKIS (Prime Minister)
Next elections	2018, legislative

Strengths

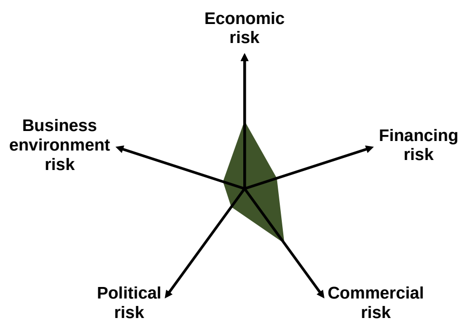
- Low systemic political risk
- Good international relations
- Eurozone membership provides for low transfer and convertibility risk
- Resilience to the crises in the Eurozone and Russia
- Solid public finances and access to international capital markets
- Strong business environment

Weaknesses

- Very high external debt burden
- Small industrial base
- Unfavourable export structure, largely dependent on Russia and other Baltic States.
- Banking sector vulnerability

Country Rating

BB1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Lithuania	16%	1	14%	Lithuania
Russia	14%	2	13%	Russia
Estonia	10%	3	10%	Poland
Belarus	6%	4	9%	Germany
Poland	6%	5	8%	Estonia

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	12%	1	10%	Refined Petroleum Products
Non-Edible Agricultural Prod.	8%	2	5%	Fertilizers
Beverages	5%	3	4%	Telecommunications Equipment
Telecommunications Equipment	5%	4	3%	Beverages
Crude Oil	4%	5	3%	Miscellaneous Hardware

Source: Chelem (2014)

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Economic Overview

Feeble investment curtails growth

Real GDP growth decelerated to just +0.3% y/y in Q3 2016, down from an average +2% in H1 and +2.7% in full-year 2015. This took the average of the first three quarters of 2016 to +1.5% y/y, which was mainly driven by domestic consumption and inventories. Consumer spending increased by +3.4% y/y and public consumption by +1.3% y/y in Q1-Q3. Fixed investment plunged by -22.8% y/y, largely because the use of EU funds for investment has fallen considerably below expectations. In part, however, this was compensated for by a sharp rise in inventories which added +5.9pps to Q1-Q3 growth. Lackluster export growth of +1.9% y/y was outpaced by imports (+4.4% y/y) so that net exports subtracted -1.6pps from Q1-Q3 growth.

Going forward, fixed investment should recover under a revised government plan for the use of EU funding, especially for infrastructure projects. Combined with robust consumer spending, this should lift full-year real GDP growth from an expected +1.6% in 2016 to around +2.4% in both 2017 and 2018. Further delays in the absorption of EU funds pose a downside risk to this forecast.

Solid macroeconomic fundamentals

As expected, deflation has given way to mild inflation in 2016. After falling in the first six months, consumer prices have gradually picked up since July and reached an increase of +1% y/y in October 2016. Euler Hermes forecasts average inflation of +1.3% in 2017. Meanwhile, after more than six years of continuous decline, bank lending to the private sector has finally began to grow again in early 2016 though, at +2.1% y/y as of August, it has remained modest so far.

Public finances remain sound. Euler Hermes expects annual fiscal deficits of around -1% of GDP in 2016-2018 and public debt should stabilize at slightly below 40% of GDP.

The current account balance is favorable. Following moderate deficits in 2013-2015, low energy prices led to a surplus of EUR215mn in Q1-Q3 2016 and a full-year surplus of +0.5% of GDP or so is expected. As energy prices are set to pick up gradually, a return to modest external shortfalls is forecast for 2017-2018.

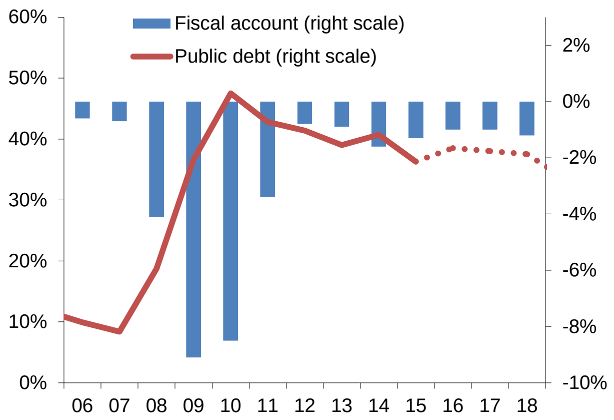
Gross external debt remains the weak spot. It soared to an alarming level of 168% of GDP in 2010, built up by earlier large current account deficits. The ratio declined to 134% in 2013, but has since grown again and stood at 154% in mid-2016. Hence external debt remains a cause of concern and requires close monitoring.

Key economic forecasts

	2015	2016e	2017f	2018f
GDP growth (% change)	2.7	1.6	2.4	2.5
Inflation (%, end-year)	0.3	1.0	1.5	2.0
Fiscal balance (% of GDP)	-1.3	-1.0	-1.0	-1.2
Public debt (% of GDP)	36.3	38.5	38.0	37.5
Current account (% of GDP)	-0.9	0.5	-0.5	-1.0
External debt (% of GDP)	142.0	153.8	150.0	145.0

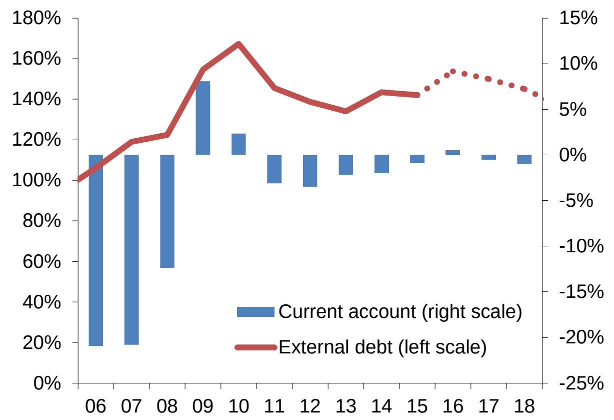
Sources: National statistics, IHS, Euler Hermes

Public finances (% of GDP)



Sources: Eurostat, Euler Hermes

Current account and external debt (% of GDP)



Sources: National statistics, IHS, Euler Hermes

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