LATVIA

Highlights

- **A weak external environment weighs on exports and investment**. The direct impact of the Russia-Ukraine crisis is limited, although the lingering geopolitical uncertainty and the anaemic eurozone recovery are holding back economic growth.
- **The unbundling and liberalisation process in the gas sector advanced.** The government approved in March 2015 the unbundling plan of the gas utility, Latvijas Gaze. Under the new plan, one company will deal with distribution and trade, and the other with storage and transmission. Full ownership unbundling of the natural gas transmission and storage system operators is foreseen by the end of 2017.
- **A new European Union (EU) operational programme "Growth and Employment" has been approved.** Latvia stands to benefit from a substantial allocation of EU Structural and Investment Funds over the coming seven years (€4.4 billion, or about 2.8 per cent of annual GDP). This funding will increasingly shift away from the traditional grant-based instruments and towards commercially based financial mechanisms that leverage private funds.

Key priorities for 2016

- **The funding environment for innovative enterprises needs to be expanded to include new financial instruments.** This will enable a leveraging of EU funds from private investors, and support of the EU operational programmes through repayable instruments, including equity, loans and guarantees.
- **Regional integration of the power market should be enhanced**. Full liberalisation of electricity tariffs for all consumers commenced in January 2015. However, the lack of transmission system capacity still eliminates being able to take full advantage of cross-border trade of energy.
- **Better governance of state-owned enterprises (SOEs) could strengthen Latvia's competitiveness**. The Public Persons Enterprises and Capital Shares Governance Law, was finally adopted in October 2014 and entered into force in January 2015, although the timing and pace of implementation remain uncertain.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	6.2	4.0	3.0	2.4	2.3
Inflation (average)	4.2	2.3	0.0	0.7	0.2
Government balance/GDP	-3.4	-0.8	-0.9	-1.5	-1.4
Current account balance/GDP	-2.8	-3.2	-2.3	-1.9	-1.6
Net FDI/GDP [neg. sign = inflows]	-5.0	-3.2	-1.6	-1.0	-2.5
External debt/GDP	144.6	137.2	131.4	138.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	112.6	65.8	58.5	51.4	n.a.

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Macroeconomic performance

Domestic demand continues to be the main driver of growth. The current fall in fuel prices has resulted in a boost to household real disposable income. The overall investment rate remains relatively low for a converging economy at about 23 per cent of GDP. Following a contraction in 2013, gross fixed capital formation saw meagre growth of only 0.5 per cent in 2014 as banking sector credit to the corporate sector continued to decline. As the new phase of EU Structural and Investment Funds are disbursed beginning in 2015, public investment in particular is set to recover.

Exposure to the contraction in the Russian economy weighs on Latvia's trade performance. After registering an average growth of about 12 per cent annually in the post-crisis period 2010-12, export volumes increased by 5.2 per cent in 2014. In value terms, exports to Russia decreased by 5.6 per cent in 2014, although total exports saw marginal positive growth over the same period as exporting companies had some success in re-orienting sales to other markets.

Given the ample capacity reserves, and deflationary pressures in the eurozone, inflation has remained in check. There are pressures from rapid real wages (which have increased by about 15 per cent over the last two years), and on the supply side from an electricity market liberalisation.

The government continues to ease austerity measures. After years of post-crisis fiscal consolidation, the government plans to somewhat relax spending restraint, as a result of encouraging revenue trends, while remaining in line with the EU's Stability and Growth Pact. Following a significant improvement in 2012, the budget deficit reached 1.4 per cent of GDP in 2014. Under the ongoing competitiveness programme, plans are under way to reduce labour taxation.

Economic growth is expected to improve in 2016. This year's projected GDP growth rate has been trimmed down to 2.3 per cent, primarily due to persistent uncertainties related to the weak external environment. In 2016, Latvia is expected to see more rapid GDP growth as domestic demand, in particular through investments, is likely to strengthen, fuelled by improving credit availability and fresh disbursements of the EU structural funds.

Major structural reform developments

The government made further progress in strengthening the business environment. In order to ensure predictability in the tax system, in September 2014 the government approved amendments that limit the frequency of changes in the system. There will also be a mandatory delay between adoption and implementation of any changes in the tax law. Tax regulations constitute one of the key business obstacles, together with inefficient government bureaucracy, access to finance and corruption, as for instance highlighted in *World Competitiveness Report 2015-2016*. The World Bank's *Doing Business 2016* report ranks Latvia 22nd globally (out of 189 countries).

Competition in gas and electricity markets has strengthened. The overall reform of the energy sector, which was approved by parliament in February 2014, has been designed to comply with the EU's Third Energy Package. In March 2015 the government approved the unbundling plan of the principal gas utility, Latvijas Gāze. One part of the company will deal with distribution and trade, and the other with storage and transmission. Also the legislation on third party access to the gas transmission system was adopted by the regulator on 10 September 2015, followed by the government's adoption of amendments to the energy law on 15 September 2015 that foresee full ownership unbundling of the natural gas transmission and storage system operators by the end of 2017. Ownership unbundling constitutes a key step towards improving the functioning of the EU internal energy market. In addition, the full liberalisation of the electricity retail market took effect in January 2015, triggering an immediate increase of electricity prices on average by 28 per cent. At the same time, some support mechanisms were introduced aimed to offset the electricity price hikes to the most socially vulnerable persons. The Lithuanian-Swedish energy interconnector, which will be completed by 2016, will provide access to relatively cheaper energy from Sweden to all Baltic states, and thus is likely to put some downward pressure on electricity prices.

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The share of high-tech exports almost doubled in the aftermath of the post-crisis recovery. While the share of exports of high technology products within total exports saw a decline at the aggregated EU-28 level, Latvia managed to increase this share from only 4.8 per cent in 2010 to 9.2 per cent in 2014. Nevertheless, research and development (R&D) expenditures are extremely low, at only 0.6 per cent of GDP, much below the government's target or levels in other countries in the region. Insufficient cooperation between research institutions and businesses is the key obstacle to the commercial utilisation of research results. A comprehensive EU indicator of innovation spending and outcomes ranks Latvia at third-lowest place in the EU.

Energy efficiency could be a significant factor in boosting productivity. In 2014, labour productivity increased by 4.2 per cent, the highest such increase among the central Europe and the Baltic states (CEB) countries. At the same time, unit labour costs increased by 4.7 per cent, prompting some concern over international competitiveness. As energy intensity in Latvia is more than double the EU average, further investments in energy savings could improve resource efficiency, and ultimately result in productivity gains.

New EU Structural Funds are aimed at boosting competitiveness and tackling unemployment. During the 2007-2013 planning period Latvia was eligible for up to €4.5 billion in EU funds. Latvia's payment rate stood at 92.8 per cent as of the end of August 2015. The new operational programme "Growth and Employment" was approved by the European Commission (EC) in November 2014, in particular addressing development priorities along with the "Europe 2020" objectives. During the subsequent planning period (2014-2020), €4.4 billion will be available, of which the greatest share is envisaged for sustainable transport, followed by investments in resources efficiency, education and carbon emissions reduction. The remainder will be allocated to research and innovation, social inclusion and reduction of poverty, support of SME competitiveness, employment and mobility and access to IT.

A new financing institution is expected to support SME lending. In late 2014 the three principal state investment funds were merged: Altum, the Latvian Guarantee Agency and the Rural Development Fund. This merger was approved by the EC in June 2015, on the basis that the new institution would address market failures without unduly distorting competition. The new financial institution, the Latvian Single Development Institute (SDI), has been created to facilitate access to finance SMEs. Aggregate credit has shrunk by more than 30 per cent since August 2009, and most of the new operations are directed through financial intermediaries.

Poor governance in state-owned companies has been a long-standing problem in Latvia. The framework law on state-owned enterprises, the Public Persons Enterprises and Capital Shares Governance Law, was adopted in October 2014 and entered into force in January 2015. The timing and pace of implementation remain uncertain. Domestic competition has therefore been less intense than is desirable, underlined by relatively high price-cost margins. A recent assessment by the EC noted that reforms of the Competition Council remain inadequate.