Eurozone

EY Eurozone Forecast

September 2014

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Latvia
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain

Building a better working world
Outlook for Latvia

Solid growth and an investment pickup
Highlights

- Latvia’s current account is expected to move into surplus by 2017 and its fiscal deficit is stable at around 1% of GDP. This balanced recovery means Latvia should keep its place as one of the Eurozone’s fastest-growing countries and leaves the ruling party in a good position for re-election in October.

- After slowing to an expected 3.2% this year, GDP growth is forecast to pick up to 4.8% in 2015, and then about 5% a year in 2016–18.

- Growth has largely been driven by domestic demand in 2014, but contributions from exports and investment are set to strengthen in 2015–18. The external balance contrasts with the wide current account deficits before 2008, making the faster growth more sustainable.

- Relaxed monetary policy and a continued fiscal deficit mean there remains some risk of the economy overheating. But the pickup in inflation is forecast to be capped at below 2.5% over the medium term, and action has been taken to contain the rise in real estate investment.

- The relatively modest inflation increase indicates flexibility on the supply side, with substantial scope for productivity gains and improving skills supply, offsetting the losses from labor emigration.

- The forecast investment recovery confirms substantial progress in resolving the banking sector problems that required International Monetary Fund (IMF) assistance in 2008-11. Eurozone accession has removed exchange-rate risk from the private sector’s substantial euro-denominated debt, though high overall indebtedness could still restrain growth when Eurozone interest rates start to rise.

- External risks have risen as a result of the tensions in Ukraine and the escalation of European Union (EU) and US sanctions on Russia, and indeed Russia’s counter-sanctions. In addition, although short-term uncertainties may have risen ahead of Latvia’s general election in October, all parties remain generally pro-EU.

- Energy insecurity, highlighted by external events, is being addressed by EU-supported gas and electricity projects that will help to boost investment, but current reliance on Russian supplies remains a source of downside risk for Latvia to 2017.
Solid growth and an investment pickup

Investment and export growth to keep recovery balanced …

Latvia’s Eurozone accession in January has been followed by a pickup in GDP growth to 1% on the quarter and 3.5% on the year in Q2 (from 0.8% and 2.3% respectively in Q1). This supports our forecast of 3.2% growth this year, with exports set to slacken slightly in the second half of the year, but domestic demand remaining firm. Latvia remains on track to return to growth of around 5% a year in 2015-18, as investment picks up in response to rising export demand.

The forecast acceleration will be achieved with much better balance than in the previous (pre-2008) boom, which was brought to a sudden end when a downturn in capital inflows disrupted financing of the wide external deficit. This time, the faster growth of exports ahead of imports cut the current account deficit to under 1% of GDP in 2013 and is forecast to move it into surplus by 2017. This ensures continued repayment of the external debt that was run up during the 2008-09 crisis, risks on which have already been reduced by the adoption of the euro.

Investment growth is forecast to accelerate in 2015-16, in response to rising demand, higher profitability and continued low interest rates. Although public investment in large transport and energy projects will be an important contributor to this, faster growth ensures containment of the public sector deficit at around 1% of GDP. This will enable public debt ratios to keep falling, with central government debt only around 40% of GDP (less than half the Eurozone average) after the repayment of IMF loans.

… but trade disruption could restrain expansion in 2014-15

Because this year’s growth has relied on a rise in household consumption, which is now slackening, there are short-term risks arising from setbacks to export growth in the second half of the year. Even if temporary, Russia’s ban on food imports in response to EU sanctions is likely to have some adverse effects, especially on dairy sales, given that Russia accounted for around 25% of Latvian food exports before the crisis began.

Blockages of the Russian and Ukrainian markets could deepen if the conflict escalates, and the chances of finding alternative destinations within the Eurozone have fallen, as growth remains sluggish in its major economies. The downturn of

<table>
<thead>
<tr>
<th>Table 1</th>
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<tbody>
<tr>
<td>Latvia (annual percentage changes unless specified)</td>
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<tr>
<td></td>
</tr>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>Private consumption</td>
</tr>
<tr>
<td>Fixed investment</td>
</tr>
<tr>
<td>Stockbuilding (% of GDP)</td>
</tr>
<tr>
<td>Government consumption</td>
</tr>
<tr>
<td>Exports of goods and services</td>
</tr>
<tr>
<td>Imports of goods and services</td>
</tr>
<tr>
<td>Consumer prices</td>
</tr>
<tr>
<td>Unemployment rate (level)</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
</tr>
<tr>
<td>Government budget (% of GDP)</td>
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<tr>
<td>Government debt (% of GDP)</td>
</tr>
<tr>
<td>ECB main refinancing rate (%)</td>
</tr>
<tr>
<td>Euro effective exchange rate (1995 = 100)</td>
</tr>
<tr>
<td>Exchange rate (US$ per € )</td>
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</tbody>
</table>

Source: Oxford Economics.
industrial production in June after four months of increase, with a 1.3% drop leaving output 2% lower than a year ago, confirms the ongoing volatility of sales that the Ukraine crisis will exacerbate until resolved.

**Elections may add to short-term uncertainty**

The general election scheduled for October will add to short-term uncertainty, but the expected re-election of the ruling Unity Party (with a steady or increased share of the vote) keeps risks balanced. Unity is likely to form another coalition with center-right groups, ensuring the continuation of reforms aimed at promoting private sector growth and restricting public borrowing to infrastructure finance. Faster growth will also enable it to address opposition party concerns about inequality and social exclusion. The generally pro-EU stance of all parties means that the risk of disruptive extra-parliamentary action remains low.

**Financial sector stable, despite concern over foreign deposits**

This year’s sharp rise in capital flight from Russia, expected to bring a comparable rise in Latvia’s already large non-resident deposits, will present both opportunities and risks to the financial system.

Beneficially, the inflow will promote the funding through deposits of domestic credit expansion, reducing the reliance on foreign financial markets that led to systemic problems in 2008. Although some of the early deposits from Russia were channeled into real estate purchases, prompting fears of a bubble, the rise in the main house price index slowed to 7% in 2013, with lower rates outside Riga. Earlier faster increases were a recovery from equally large falls after 2008.

The European Commission and the European Central Bank assessed these and associated risks following the 2012–13 shift of Russian capital from Cyprus to Latvia, concluding that they were not an obstacle to entry into the Eurozone (and its stability mechanism) in January 2014. The largest banks tend to have much lower non-resident deposits and the average (estimated at 50% of all deposits in early 2013) is pulled up by smaller banks that specialize in them.

However, the danger of a disruptive sudden withdrawal of deposits has been raised by the escalation of EU sanctions against Russia, which may push depositors into pre-emptive action in case their holdings are targeted. Financial sanctions from the US may become tougher than the EU’s, and have already led some US banks to withdraw provision of international dollar transfers for Latvian banks.

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**Table 2**

**Forecast for Latvia by sector (annual percentage changes in gross added value)**

<table>
<thead>
<tr>
<th>Sector</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>4.1</td>
<td>3.2</td>
<td>4.8</td>
<td>5.2</td>
<td>5.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.1</td>
<td>11.6</td>
<td>3.2</td>
<td>3.1</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Agriculture</td>
<td>-0.7</td>
<td>-1.2</td>
<td>2.3</td>
<td>3.0</td>
<td>3.0</td>
<td>2.8</td>
</tr>
<tr>
<td>Construction</td>
<td>7.5</td>
<td>12.1</td>
<td>6.1</td>
<td>6.1</td>
<td>4.9</td>
<td>4.7</td>
</tr>
<tr>
<td>Utilities</td>
<td>-3.3</td>
<td>0.4</td>
<td>1.8</td>
<td>3.1</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>Trade</td>
<td>3.2</td>
<td>5.4</td>
<td>6.1</td>
<td>7.1</td>
<td>6.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Financial and business services</td>
<td>6.6</td>
<td>6.1</td>
<td>5.6</td>
<td>6.1</td>
<td>5.6</td>
<td>5.2</td>
</tr>
<tr>
<td>Communications</td>
<td>6.1</td>
<td>6.0</td>
<td>5.1</td>
<td>5.6</td>
<td>5.1</td>
<td>4.5</td>
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<tr>
<td>Non-market services</td>
<td>6.3</td>
<td>1.5</td>
<td>3.6</td>
<td>3.6</td>
<td>3.1</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.

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**Figure 1**

**Real GDP growth**

Source: Oxford Economics; World Bank.

**Figure 2**

**Current account balance**

Source: Oxford Economics.
Solid growth and an investment pickup

Supply-side resilience supports sustained acceleration ...

Even with these constraints, Latvia is set to remain one of the fastest-growing Eurozone economies for most of 2014-18, outgrowing the larger economies by expanding and diversifying exports to them and using investment financed without heavy reliance on foreign investment. With wood products, minerals, metals and machinery comprising around half of exports by value, and food another 15%, even a modest pickup in Eurozone activity could deliver a significant trade-related demand boost.

Comparably fast growth in Lithuania (still Latvia’s largest trading partner in 2012-13, accounting for around 18% of trade turnover, and set to join the Eurozone in January 2015) and Estonia will help to offset the effect of this year’s slowdown in Russia, which accounted for around 10% of Latvia’s trade last year.

The Eurozone’s hesitant exit from recession, although a potential constraint on exports, will have some compensating benefits – notably greater pressure on enterprises to find cheaper-sourced imports, continuation of relaxed monetary policy and less upward pressure on European mineral and energy prices.

The forecast acceleration of GDP growth to about 5% in 2015-18 reflects the capacity of the supply side to absorb increased demand without causing imports or inflation to rise unsustainably. Labor supply remains plentiful in most areas, with unemployment still above 10% in July. And low interest rates and the major banks’ return to health provide a foundation for the sales and profit growth needed to drive domestic investment.

Although inflation is set to pick up in 2014-15 from 0.6% year-on-year in July, the rate is set to stay below 1% in 2014 and to rise to just below 2.5% in 2016-18. Annual wage growth picked up to 7.7% in Q1 2014, the highest in the EU, with private sector business pay outstripping the public sector. But while this may exceed current rates of productivity growth, it is delivering a domestic demand boost that is largely met out of local production, and may in the longer term help to re-attract some highly skilled workers currently employed abroad.

... as EU helps tackle energy vulnerabilities

Longer-term risks arise mainly from Latvia’s energy supply, which is still heavily reliant on Russian oil and gas pipelines and vulnerable to any lasting breakdown in relations between Russia and the EU. Although it may initially put upward pressure on fossil fuel prices, the crisis has increased the willingness of larger Eurozone partners to support energy diversification projects for the region, notably the opening of a Baltic natural gas terminal at Lithuania’s Klaipeda port (due to open at end-2014) as well as additional electricity interconnections, and the construction of a new Baltic nuclear plant if Lithuania revives its earlier plans to host one.
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