Economic situation and forecasts – growth slows down, risks remain high

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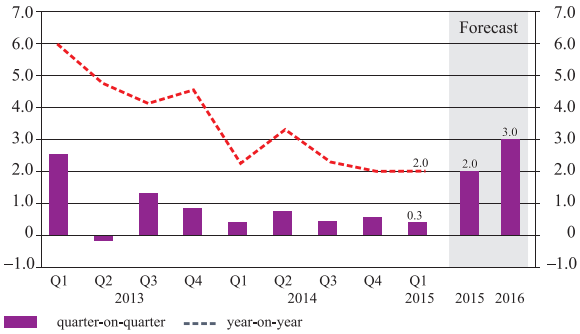
At the beginning of June, Latvijas Banka published the latest Macroeconomic Developments Report, which describes the current state of the economy and provides a view on macroeconomic forecasts. In 2014, gross domestic product (GDP) grew by 2.5%. This was the slowest pace of the post-crisis period; however, taking into account the complicated external environment, this result should be considered as at least a moderate one. In 2014, the economy of Latvia was negatively influenced by external events. On the one hand, the economic growth was held down by slow and uneven growth of the euro area. On the other hand, the economic conjuncture has been deteriorating in Ukraine, already since the start of the year. This escalation of the political situation in Ukraine has led to economic sanctions both on and on behalf of Russia. As a result, extreme depreciation and volatility of the Russian rouble and the related weakening of the Russian economy followed. However, the direct impact of economic sanctions on the economy of Latvia has been small, as sanctions were imposed only on a minor part of Latvia's exports of goods. Yet these sanctions and the weakening of the Russian economy had substantial negative confidence effects, with market participants' economic outlook deteriorating notably and their behaviour with respect to making purchases and investment becoming more conservative. The worsening economic situation has also been one of the main factors explaining the weak investment dynamics and contracting number of new loans.

Figure 1
GDP growth
(%; seasonally adjusted)



Sources: CSB and Latvijas Banka calculations.

In this very complicated external environment, the growth of Latvia's economy was mostly driven by the domestic-demand-oriented sectors. The largest contributors to overall GDP growth were trade, construction and public services. The economic growth based on domestic demand was determined by further improvements in the labour market, where the decreasing unemployment and strong wage growth further boosted disposable income. Private consumption was also positively influenced by low inflation level and oil prices, the latter leading to lower gasoline prices and heating tariffs. As a result, the private consumption growth has been somewhat lagging behind the growth of disposable income. Apparently, households have been increasing savings due to uncertainty in the economic environment.

Various economic and situational survey data suggest that in the initial part of 2015 the economic growth in the euro area has been slightly stronger than anticipated before. In the first quarter of 2015, euro area's GDP grew by 0.4% quarter-on-quarter (seasonally adjusted data), and the industrial output data have been modest. The monetary policy implemented by the ECB has improved market participants' confidence which is starting to positively affect also the real economy. However, the situation is still very fragile, especially taking into account the uncertainty regarding the situation in Greece.

Recently, Latvijas Banka revised the GDP forecast for 2015 down from 2.7% to 2.0%, taking into account the escalation of geopolitical tensions, depreciation of the Russian rouble, weakening of Russia's economy, and the latest macroeconomic data. Currently, Latvijas Banka considers these assumptions realistic, and there is no need to change the forecast, which for 2015 remains at 2.0%. Provided that the external market recovers further and geopolitical situation does not deteriorate, GDP in Latvia could grow somewhat faster in 2016, at around 3%, and be close to the potential growth level. Nevertheless, the risks, both positive and negative, to economic growth remain very high.

Meanwhile, the forecast of inflation (HICP) has been revised downwards, from 0.9% to 0.7%, due to lower oil and natural gas prices which also affect the heating tariffs. In 2015, inflation will be mostly maintained by the demand side, which in turn will be driven by a further wage growth. Additionally, some effects will come from previously made decisions regarding electricity market liberalisation and higher tariffs in the local public transport. It is expected that in 2016 inflation would recover to around 2% on the back of gradually rising commodity prices and improving economic growth in both the euro area and Latvia.