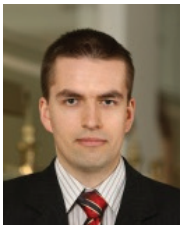
Sustainable Economic Growth Under Way



Oļegs Krasnopjorovs
Economist
Latvijas Banka

The year prior to Latvia's eurozone accession was marked by a rare combination of the fastest economic growth in the EU and zero consumer price inflation. It was the fourth consecutive post-crisis year of robust economic growth. Contrary to the pre-crisis period, this time economic growth is viewed as sustainable and not creating any internal or external imbalances. The output gap remained almost closed as headline GDP grew at par with its potential. Therefore, the impact of aggregate demand on consumer prices was modest, while supply factors, mainly fuel and heating prices, had a negative contribution.

Although real GDP growth decelerated somewhat from 5.2% recorded in 2012, it remained the fastest in Europe: the average GDP growth rate of the first three quarters of 2013 was 4.2%. Flash data for 2013 suggest a GDP per capita increase from 64% to 67% of the EU average in PPS terms, much higher than 59% reached in 2008 prior to the crisis and 47% in 2004 when joining the EU. During 2013, Latvia closed about 1/30 of its income gap vis-à-vis Germany, reflecting fast convergence of living standards.

Solid employment and real net wage growth made private consumption to become the main driver of GDP growth in 2013. In just three years the unemployment rate declined from the highest in the EU to a level just below the eurozone average, mainly due to job creation in the private sector. Real net wage growth reached a 5-year high, thanks to atypically low inflation and declining tax wedge on labour, whereas nominal gross wage dynamics remained stable and were broadly in line with labour productivity developments.

Fast income convergence, job creation and confidence restoration resulted in a gradual slowdown of labour outflow. Net emigration decreased three fold between 2010 and 2012, and shrank even further in 2013: the difference between passenger departures and passenger arrivals at Riga airport (flash indicator of migration trends) approached zero between the fourth quarter of 2012 and the third quarter of 2013.

Trade deficit in goods is partly compensated by trade surplus in services, resulting in a small current account deficit. Such a deficit is sustainable for Latvia, reflecting its FDI and EU funds net-receiver position, underlying its strong income convergence potential.

According to EC data, labour shortage claims are stable and modest; therefore, labour income share is not likely to rise beyond its historical average and wage growth is not expected to hamper competitiveness and/or undermine price stability, i.e. low and predictable inflation. Unit labour costs remained 15% and 21% below their historical peak in nominal and real terms respectively.

Supply-side driven income convergence is likely to continue in 2014 as well, and the output gap is expected to remain close to zero during the coming years. Prudent macroeconomic policies are likely to further strengthen investor climate and business activity. The already low budget deficit is likely to diminish further both in headline and cyclically adjusted terms; moreover, fiscal prudence is enhanced with the introduction of the Fiscal Council as of 2014. Two engines of potential GDP growth will be capital deepening and TFP, while labour contribution is unlikely to play a significant role as the working age population decline will be offset by a gradually increasing participation rate and a decreasing NAIRU.

All in all, 2014 is likely to become the fifth consecutive year of sustainable economic growth: fast income convergence without creating imbalances. GDP growth could reach 4.1% (4.0% according to the ECB methodology), while the HCPI inflation is projected at 1.7% (domestic CPI measure – 1.5%).