MARKETS

Snapshot

2014 03 11

Latvia: Economy grows strongly in 2013, future outlook clouded by uncertainty

According to today's revised GDP data, Latvian economy expanded by 3.6% in the fourth quarter of 2013, a modest upward revision from 3.5%. In 2013 economy grew by 4.1%, so a mild slowdown from 5.3% and 5.2% in previous two years. However, composition of growth drivers changed quite sharply. Private consumption growth slowed down mildly, from 5.8% to 5.4% while export growth dropped from 9.4% to 1.0% between 2012 and 2013. That was partly compensated by government consumption growth of 3.6% vs. -0.2% a year ago. Gross fixed capital formation dropped by 4.3% while it grew by 8.7% in 2012.

Nevertheless, things are not as clear cut as they appear on paper. Export composition changed quite dramatically in 2013. Metal exports collapsed, but these previously generated very little welfare for residents "per buck" as expenditure on energy and scrap increases imports or reduces other exports. At the same time, manufacturing sectors with greater impact on resident incomes like food, timber processing, apparel production, electronics did very well. Also the composition of service exports changed — business, IT, financial services boomed while transit business performed poorly, the later is heavily dependent on (mostly imported) capital stock and energy use. So it can be argued that the impact of export developments on incomes were quite positive and that is supported by strong growth of consumption by households who simultaneously continued to deleverage at a rapid pace – debt volumes fell, savings rose.

Future outlook has become much more uncertain due to recent events in and around Crimea. Latvia has very strong economic links with Russia. It is not the biggest market of merchandise exports in statistics, but could be in reality, if indirect exports through other Baltic states (often diverted there for procedural reasons) are included. Besides, Russia is by far the most important partner in the trade of services (27% of total exports last year). Sanctions against Russian officials, oligarchs or investment in hydrocarbons would not have large immediate effect, but there is a risk of retaliation as well as broader measures against the financial system that could make payments more difficult. Latvia will hold presidency in H1, 2015 and could experience political pressure through trade disruption, like Lithuania during its term in H1, 2014. We do not yet change our above-average 5% growth forecast for Latvia in 2014 as the situation is rapidly evolving. However, a forecast downgrade by 1-2 percentage points would be on the agenda in moderately unfavourable scenario.

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