

# Latvia Business Forecast Report Q2 2014

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## Abstracts

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### Core Views

Latvia's economic recovery will continue into 2014 and beyond, although we emphasize that strong headline real GDP growth is largely a result of statistical base effects. We see growing scope for the government to ease up on its long-held policy of fiscal austerity going forward.

We anticipate the moderation in consumer prices in Latvia to pick up slightly in 2014. We forecast inflation to average 0.1% in 2013 and 1.1% in 2014. **Major Forecast Changes** We have revised up our expectations for the current account deficit, which we now expect to arrive at 1.2% in 2014, from a previous forecast of 2.2%

### Key Risks To Outlook

The prevailing risk to our forecasts for Latvia remains the persistent eurozone sovereign debt crisis. A further deepening of the crisis would pose downside risks to most of our forecasts.

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New Government: Business As Usual

Unity party member Laimdota Straujuma has been appointed the next prime minister of Latvia. The new government is expected to retain a broadly similar composition to the previous coalition, and we do not expect to see any major shifts in policy ahead of the parliamentary election in October 2014.

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Long-Term Political Outlook

Slower Growth And Ethnic Tensions Key Themes To 2024 the coming decade for Latvia will be marked by the scars of the global financial crisis of 2008/09. The country's governments will struggle to return the economy to pre-crisis growth and will pay the political and social price for this inability to promote growth and ease ethnic tensions.

### **CHAPTER 2: ECONOMIC OUTLOOK**

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Russia Weighs On Growth Outlook

Despite an improving outlook for regional economic activity, real GDP growth is showing signs of deceleration in Latvia. We believe this is partially due to exogenous factors, such as Russia's decision to route less cargo through Riga's port, and also due to weaker trade links with the eurozone.

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Despite the potential for a slight easing of fiscal austerity this year, Latvia's sovereign credit profile is one of the strongest in Emerging Europe, and the introduction of the Fiscal Discipline Law in 2013 combined with strong

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Sustainable External Account Deficits Ahead

Latvia's external accounts are still deleveraging from the 2005 to 2007 period of rapid financial inflows when hot money inflows pushed the current account deficit to unsustainable levels. With the deleveraging process still some way off completion, we do not expect to see a major change in the external accounts over the coming quarters. We expect Latvia to post sustainable current account deficits going forward.

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Passive monetary tightening and improved investor sentiment will compound policy inertia from the ECB has keep the euro strong heading into 2014. However, weak economic growth, high unemployment, euro strength, deflation risks, a potential LTRO-cliff and anaemic structural reform are becoming increasingly unpalatable for policymakers. As such, we expect substantial monetary intervention in 2014. If this comes in the form of an LTRO top-up, then the euro will initially hold firm before sliding by end-year as growth will remain weak.

Eurozone Currency Forecast

Regional Monetary Policy

ECB Cut: Pushing On A String

A cut in the ECB's refinancing rate will do little to ease monetary policy in the eurozone, given the fractured credit transmission channel and passive tightening resulting from banks repaying LTRO funds. While there are few easy options to ease policy in the near term, we warn that if the long running disinflationary trend evolves into full blown deflation, the ECB may have to look at more aggressive forms of policy stimulus.

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