

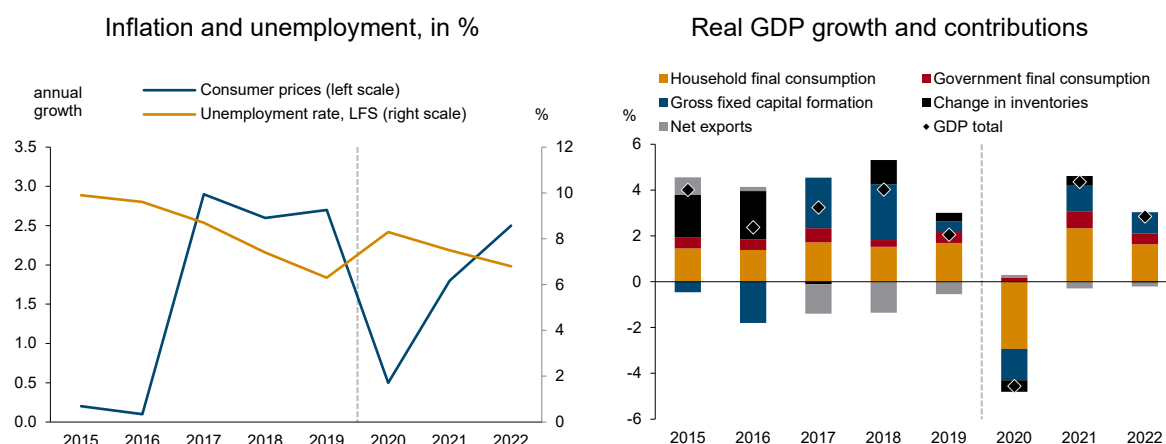


## LATVIA: After the slump, heading for a well-shaped recovery

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The Latvian economy has experienced a sharp decline, but seems to have bounced back quite quickly in the third quarter of 2020. Household consumption fell by more than 20% in the second quarter, but more recently has picked up again. The decline in external demand was much less than expected. Similarly, gross fixed capital investment fell only slightly, but is likely to be depressed in the second half of the year. In 2020, we expect GDP to shrink by 4.6%; this will be followed by strong growth of 4.4% in 2021 and a somewhat slower upswing of 2.8% in 2022.

Figure 4.11 / Latvia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**Following a contraction of GDP by almost 9% in the second quarter of 2020, the Latvian economy has shown signs of recovery in subsequent months.** In March-April, Latvia was one of the EU countries with the lowest rates of COVID-19 infections per million inhabitants, and the second wave of infections in autumn is also milder than in most other European countries. In the first half of the year, value added fell in almost all sectors of the economy – except for construction, where it increased by 5.3% in real terms. Household consumption contracted markedly, while investments stagnated.

**After an initial slump, exports have recovered more strongly than imports.** The slowdown in global economic activity resulted in Latvia's exports slumping in March-May. However, from June onwards, there was once again some nominal growth, with electrical machinery and equipment and wood products bouncing back most strongly. At the same time, there has been a more pronounced decline in imports of goods, driven not least by substantial import price deflation – in particular, cheaper fuels. This

has resulted in the current account turning positive (more than 2% of GDP) in 2020. Compared to goods, there has been a much sharper decline in trade in services, which is an important economic activity for Latvia. Income from travel collapsed and exports in transport services in 2020 will probably be half the figure for 2019. Activity in those two branches will recover only slowly in the next two years.

**Investments have so far fallen only slightly, but they are unlikely to bounce back any time soon.** In particular, we expect investment in real estate to decline in the coming quarters, both in non-residential and residential buildings. Recent figures show that construction companies have started to postpone the erection of planned buildings, while house prices declined slightly in the second quarter of the year. Meanwhile, the stock of mortgage loans continues to grow, demonstrating the eagerness of households with higher earnings to profit from the good conditions on the market (low real interest rates and the option to fix rates for years ahead). In the enterprise sector, capital investment in machinery and equipment has remained stable, while increased public sector investments have cushioned the overall investment decline.

**By contrast, household consumption has picked up strongly:** retail trade has recovered to close to (or even above) the levels of last year. As well as non-durables, households are also spending money on durables of all kinds. Thus, having slumped by more than 12% in real terms year on year in the first half of 2020, household consumption will rally in the second half and in 2021, when it will again become the most important driver of growth for the Latvian economy.

**Massive fiscal stimulus has cushioned the economic fallout from the crisis.** The initial fiscal stimulus package announced by the government in spring amounted to 12% of GDP (funds provided for 2020 and 2021). It comprised particularly loans and state guarantees to ailing businesses, sectoral support for the air and transport industry, and help for the education and health sectors. The EU Commission allowed the government to invest EUR 250 million in airBaltic, which is the main carrier in the Baltic region. Short-time working subsidies were also introduced. The budget plan for 2021 envisages additional measures to support economic growth; however, the budget deficit is expected to amount to only 4% of GDP again. Next year, the start of the construction of the main tracks and infrastructure (e.g. bridges and stations) for Rail Baltica, the high-speed rail project, will lead to a revival of public investment growth. Further investment projects will be front-loaded in 2021.

**Employment started to fall in the second quarter of 2020, by 1.5% year on year.** Substantial job losses were recorded in construction, as well as in accommodation and hospitality, domestic trade and transport. The decline in employment was cushioned by the short-time working allowances introduced by the government. These allowances cover 75% of the wages of employees, up to a monthly maximum of EUR 700. The scheme is supported by almost EUR 200 million via the SURE loan facility of the EU Commission, approved in April with the express purpose of keeping employees in work. The unemployment rate jumped to 8.9% in July, but has since declined slightly. We expect the situation on the labour market to improve in the coming quarters, and the unemployment rate to decline gradually to its pre-crisis level over the next three years.

**The drop in labour demand resulted in lower wage growth in the first half of 2020, but salaries still increased by more than 4% in real terms year on year.** Since the minimum wage has not been increased in 2020, the government decided to raise it from EUR 430 to EUR 500 a month from January 2021. Wage increases for public healthcare workers, teachers and academic staff have also been

agreed. Moreover, the non-taxable minimum will increase in 2021 and 2022, in order to strengthen the purchasing power of low-income households.

**Consumer price inflation has dropped substantially, but remains positive at 0.6% in 2020.** The decline is driven largely by falling prices for energy. Given a rebound in prices for imported goods and next year's expected wage increases, we anticipate that consumer price inflation will pick up in 2021 to 1.8% and then 2.5% in 2022.

**All in all, since our interim forecast in May, we have become much more optimistic and have increased the forecast GDP growth rate for 2020 from -8% to -4.6%.** External demand, in particular, contracted much less than expected during the slump in March-May 2020 and thereafter rallied more rapidly than had been imagined. Also, industrial production is once again close to the level of last year. Similarly, consumption has picked up much faster than anticipated. The government introduced a substantial rescue package, and will continue to invest next year to support economic growth. Household incomes will continue to rise, spurred by a strongly rising minimum wage, a reduced income tax burden and a declining unemployment rate. Thus, private consumption will again grow steadily. We forecast GDP growth of 4.4% for 2021; in 2022, further stabilisation will result in GDP increasing by 2.8% in real terms.

Table 4.11 / Latvia: Selected economic indicators

	2017	2018	2019 <sup>1)</sup>	2020 1Q	2020 2Q	2020 1-2Q	2020 Forecast	2021 Forecast	2022
Population, th pers., average	1,942	1,927	1,914	1,907	1,904	1,906	1,910	1,900	1,890
Gross domestic product, EUR mn, nom.	26,962	29,143	30,463	6,734	6,894	13,628	29,200	31,000	32,700
annual change in % (real)	3.3	4.0	2.1	-1.0	-8.9	-5.2	-4.6	4.4	2.8
GDP/capita (EUR at PPP)	19,600	20,920	21,560	.	.	.	.	.	.
Consumption of households, EUR mn, nom.	15,943	16,839	17,845	4,156	3,580	7,737	.	.	.
annual change in % (real)	2.9	2.6	2.9	-3.5	-21.2	-12.6	-5.0	4.0	2.8
Gross fixed capital form., EUR mn, nom.	5,559	6,449	6,758	1,335	1,547	2881.7	.	.	.
annual change in % (real)	11.4	11.8	2.1	4.7	-4.9	-0.6	-6.0	5.0	4.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	8.3	1.5	0.9	-1.4	1.9	-3.6	-3.0	2.0	3.0
Gross agricultural production									
annual change in % (real)	1.5	-10.0	20.7	.	.	.	.	.	.
Construction industry									
annual change in % (real)	18.7	21.8	2.9	14.8	-0.6	5.5	.	.	.
Employed persons, LFS, th, average	894.8	909.4	910.0	902.1	892.1	897.1	900	905	910
annual change in %	0.2	1.6	0.1	-0.2	-1.5	-0.8	-1.1	0.6	0.6
Unemployed persons, LFS, th, average	85.4	72.8	61.3	72.2	83.5	77.9	81	73	66
Unemployment rate, LFS, in %, average	8.7	7.4	6.3	7.4	8.6	8.0	8.3	7.5	6.8
Reg. unemployment rate, in %, eop <sup>3)</sup>	6.8	6.4	6.2	6.8	8.6	8.6	.	.	.
Average monthly gross wages, EUR	926.0	1,004.0	1,076.0	1,099.7	1,117.3	1,108.5	1,120	1,170	1,250
annual change in % (real, gross)	4.5	6.0	4.2	4.5	4.3	4.4	3.3	3.0	4.0
Average monthly net wages, EUR	676.0	742.0	793.0	812.0	824.0	818.0	820	860	920
annual change in % (real, net)	3.8	7.0	3.9	4.3	4.3	4.3	3.2	3.0	4.2
Consumer prices (HICP), % p.a.	2.9	2.6	2.7	1.4	-1.1	0.6	0.5	1.8	2.5
Producer prices in industry, % p.a.	2.5	4.3	1.8	-1.9	-3.2	-2.2	-3.0	1.5	2.0
General government budget, EU-def., % of GDP									
Revenues	37.9	38.5	38.7	.	.	.	36.4	36.3	36.5
Expenditures	38.7	39.4	38.9	.	.	.	44.4	40.3	39.5
Net lending (+) / net borrowing (-)	-0.8	-0.8	-0.2	.	.	.	-8.0	-4.0	-3.0
General gov.gross debt, EU def., % of GDP	39.0	37.1	36.9	.	.	.	49.0	48.0	47.0
Stock of loans of non-fin.private sector, % p.a.	-4.7	-5.2	0.6	-3.2	-4.3	-4.3	.	.	.
Non-performing loans (NPL), in %, eop <sup>4)</sup>	4.1	5.3	5.0	3.5	3.7	3.7	.	.	.
Central bank policy rate, % p.a., eop <sup>5)</sup>	0.00	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	339	-84	-197	71	261	332	650	450	450
Current account, % of GDP	1.3	-0.3	-0.6	1.1	3.8	2.4	2.2	1.5	1.4
Exports of goods, BOP, EUR mn	11,623	12,566	12,730	3,231.0	2,897	6,128	12,650	13,200	13,800
annual change in %	10.7	8.1	1.3	4.6	-7.5	-1.5	-0.6	4.3	4.5
Imports of goods, BOP, EUR mn	14,073	15,108	15,407	3,707	3,178	6,885	14,400	15,200	16,000
annual change in %	12.1	7.4	2.0	2.9	-17.9	-7.9	-6.5	5.6	5.3
Exports of services, BOP, EUR mn	4,992	5,333	5,588	1,181.0	988	2,169	4,550	5,000	5,500
annual change in %	8.0	6.8	4.8	-5.4	-29.5	-18.2	-18.6	9.9	10.0
Imports of services, BOP, EUR mn	2,717	3,021	3,167	694	533	1,227	2,550	2,800	3,100
annual change in %	9.6	11.2	4.8	-3.6	-31.5	-18.1	-19.5	9.8	10.7
FDI liabilities, EUR mn	1,005	374	949	230	91	321	450	.	.
FDI assets, EUR mn	496	-270	75	56	9	65	100	.	.
Gross reserves of NB excl. gold, EUR mn	3,620	3,578	3,700	3,955	3,882	3,882	.	.	.
Gross external debt, EUR mn	37,922	35,697	35,398	34,745	36,444	36,444	33,600	34,100	36,000
Gross external debt, % of GDP	140.6	122.5	116.2	119.0	124.8	124.8	115.0	110.0	110.0

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) Loans more than 90 days overdue, and from 2018 also including loans unlikely to be paid. - 5) Official refinancing operation rates for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.