LATVIA: Faster recovery than expected, driven by release of pent-up demand

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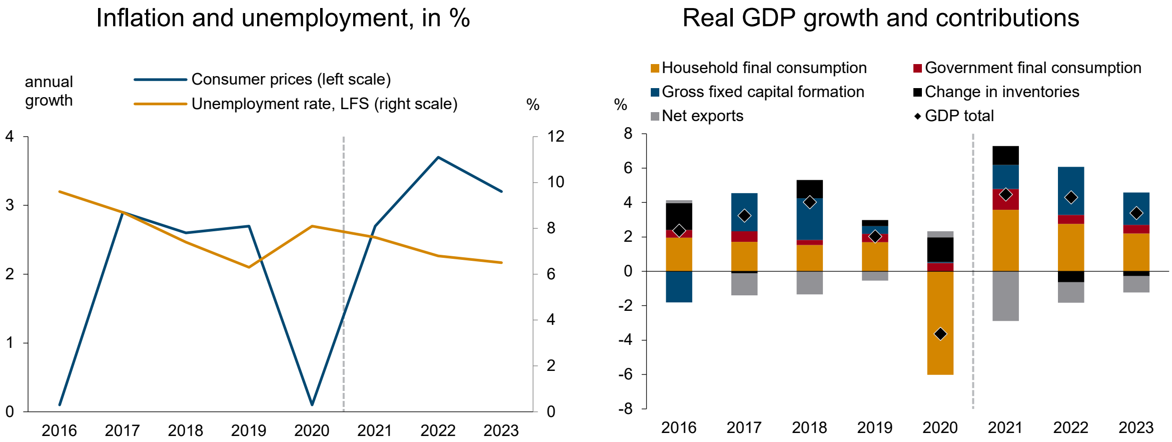
Following a relatively mild recession in 2020, the Latvian economy is experiencing a remarkably strong revival in 2021. Household consumption has recouped most of the 10% loss it experienced last year, while enterprises are replenishing their depleted stocks. Public consumption and investment are acting as a growth driver, and external demand has similarly rebounded. In 2021, we expect GDP growth to increase to 4.5% and to remain strong in 2022 (4.3%). That will be followed by a somewhat gentler increase of 3.4% in 2023.

Figure 4.11 / Latvia: Main macroeconomic indicators



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

Following a further decline in economic activity during the lockdown phase in the early months of this year, GDP bounced back strongly in Q2 2021 (+11.1% year on year). By mid-2021, the level of economic activity in most sectors had reached or surpassed that seen in 2019. Only transport and the hospitality and leisure sectors were (understandably) still lagging behind. With household consumption, foreign trade and investment again flourishing, a period of strong recovery is the baseline scenario for the forecast period 2021-2023.

Yet, risks are building that the approaching fourth wave of COVID-19 will have an adverse effect on the economy. Now, at the beginning of October, COVID-19 infections have already started to escalate, and there has been a big surge in coronavirus-related deaths in Latvia (as indeed throughout the Baltic states and in the south east of the EU). By the end of autumn, another lockdown could be inevitable. Progress with vaccination in Latvia is rather slow: by the beginning of October, only about 40% of the total population was fully vaccinated against COVID-19 (within the EU, only Bulgaria and

Romania have lower figures). Thus, harsher restrictions are likely to become necessary again to contain the spread of infections, given that the capacity of intensive care will probably be stretched not only this year, but throughout 2022. Declining business sentiment indicators – among both enterprises and consumers – were already reflecting increased concern in September 2021. This underlines the need to support economic activity through fiscal measures, comprising investments and income support alike, until the recovery is firmly established.

Compared to Q2 2020, when foreign trade collapsed, exports of goods this year have witnessed a strong – and unexpectedly rapid – recovery. In January-July 2021, there was a surge in foreign demand, particularly for mineral products, iron and steel, machinery and equipment, chemical and wood products. At the same time, imports of goods rebounded even more strongly: while the revival of commodity prices played a part, imports also increased in volume terms. Nevertheless, we expect the current account to remain positive this year, before turning negative in 2022 and 2023 due to the continuing economic upswing. In general, we expect growth in goods exports to decline slightly, following the rebound this year, and imports to pick up in line with household consumption. Compared to trade in goods, trade in services has rallied much more slowly. Exports of transport services, which fell by a third in 2020, only stabilised at that level in the first half of 2021. Income from travel declined further in the same period, to 20% of the pre-crisis (2019) level. ICT and other business services, which remained buoyant last year, have both gained further momentum in 2021.

Investment has bounced back substantially in 2021, following the flat line of 2020. Last year's stasis in investment was rather surprising: most other EU countries witnessed a steep decline. As expected, investment in real estate fell this year, particularly in residential buildings. However, the most recent rebound in housing prices, in line with overall demand from households, has resulted in an increase in construction projects in the pipeline: building permits granted in Q2 2021 are back at the level of 2019. There has also been a strong recovery in the number of projects commissioned by the public sector. Meanwhile, the household sector, which last year was cautious and preferred to build up its savings stock, is again taking out more credit, particularly mortgage loans. According to the latest figures, the loan stock of the enterprise sector, which fell by more than 10% in 2020, remains stagnant. This is another indication that the government needs to offer some economic stimulus to improve business sentiment.

Following the second lockdown, household consumption picked up strongly in Q2 2021. Retail trade figures show that a big backlog in demand for durable and non-durable goods will likely result in increased spending in the second half of 2021 and 2022. Thus, household consumption will again become the most important driver of growth in the Latvian economy.

The budget plan of the Latvian government envisages expenditure to support workers and enterprises that would lead to a deficit of 9% of GDP in 2021. Given the strong revival of the economy, these funds will most likely not be fully tapped. Meanwhile, the steady provision of loans, state guarantees and public investment in ailing businesses, plus the financing of short-time work schemes, is allowing the recovery to get firmly established. The preliminary budget for 2022 envisages wage increases for employees in health, education and the so-called 'interior sector' (which includes the police and other emergency services, etc.). Additional funds will be provided for regional and municipal development, while the budget deficit is expected to attain 4% of GDP in 2022. An important measure to relieve low wage earners is to raise non-taxable minimum income from EUR 300 in 2021 to EUR 500 in June 2022.

Employment recovered to pre-crisis levels in most sectors in Q2 2021, and vacancies are on the rise. Substantial job losses are still being recorded in accommodation and hospitality, transport and construction. Following the money-laundering scandal that erupted in the Latvian banking sector in 2018, employment in financial services has gradually declined over the past three years. The overall loss in employment has been cushioned by the short-time working schemes introduced by the government. About 5% of jobs (which would most probably have been lost otherwise) were supported by government measures in February of this year (in the second lockdown), and 2% were still being supported in June 2021. The SURE loan facility of the European Commission, which is designed to help finance short-time work schemes, was increased for Latvia towards the end of March 2021 to slightly over EUR 300m. The unemployment rate rose to 8.1% in 2020 on average, but has declined slightly in recent months. 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 slowdown in wage growth experienced in 2020 was fairly short lived; salaries are likely to rise sharply in 2021, by 8% in real terms. One important reason for this is the hike in the national minimum wage, from EUR 430 to EUR 500 a month, in January 2021. Within the EU, Latvia's minimum wage level only exceeds those of Bulgaria, Romania and Hungary. The revival in vacancy rates shows the scarcity of skilled labour; thus, wage growth will remain strong throughout the forecast period, while the planned increase in the non-taxable minimum wage will further strengthen the purchasing power of households.

Following a deflationary period in 2021, consumer prices started to pick up in Q2 2021. Global energy prices have soared, pushing up the domestic prices of fuel, heating, gas and electricity. We expect inflation to peak in 2022 at 3.7% and thereafter to decline somewhat, once commodity prices calm down again.

All in all, since our previous interim update in the summer, we have increased the forecast GDP growth rate for 2021 significantly – from 3.2% to 4.5%. External demand has rebounded quickly following this year's second lockdown, and capacity utilisation levels in the economy have almost returned to the peak levels of 2019. On the other hand, the release of pent-up demand has resulted in soaring household consumption and rapidly rising stocks of enterprises. However, the perils of the fourth wave of infections (and the almost inevitable restrictions) may attenuate the ongoing recovery. Still, our base scenario is for a further strong growth in demand in 2022. The government is prepared to offer further support to ailing enterprises and workers, and will increase its investments next year to support economic growth. Household incomes will continue to rise, spurred by a reduced income tax burden. Thus, private consumption will again grow steadily. The unemployment rate will fall more markedly only from 2022 onwards. We forecast GDP growth of 4.5% for 2021; in 2022, external and domestic demand should keep real GDP growth at 4.3%.

Table 4.11 / Latvia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	1,927	1,914	1,900	1,918	1,906	1,890	1,885	1,880
Gross domestic product, EUR m, nom.	29,143	30,421	29,334	13,613	14,847	31,500	34,100	36,400
annual change in % (real)	4.0	2.0	-3.6	-5.3	5.1	4.5	4.3	3.4
GDP/capita (EUR at PPP)	20,890	21,500	21,400	.	.	.	.	.
Consumption of households, EUR m, nom.	16,839	17,845	16,147	7,737	8,101	.	.	.
annual change in % (real)	2.6	2.9	-10.3	-12.6	3.5	6.5	5.0	4.0
Gross fixed capital form., EUR m, nom.	6,449	6,758	6,868	2,881	3,036	.	.	.
annual change in % (real)	11.8	2.1	0.2	-0.7	4.0	6.0	12.0	8.0
Gross industrial production 2)								
annual change in % (real)	1.5	0.9	-1.5	-3.6	8.1	7.0	6.0	4.0
Gross agricultural production								
annual change in % (real)	-9.0	21.0	3.7	.	.	.	.	.
Construction industry								
annual change in % (real)	21.8	2.9	2.7	5.5	-4.7	.	.	.
Employed persons, LFS, th, average 3)	909.4	910.0	893.0	896.8	862.5	870	870	870
annual change in %	1.6	0.1	-1.9	-0.9	.	-3.0	0.6	0.6
Unemployed persons, LFS, th, average 3)	72.8	61.3	78.7	78.9	74.1	72	63	60
Unemployment rate, LFS, in %, average 3)	7.4	6.3	8.1	8.1	8.0	7.6	6.8	6.5
Reg. unemployment rate, in %, eop 4)	6.4	6.2	7.7	8.6	7.4	.	.	.
Average monthly gross wages, EUR	1,004	1,076	1,143	1,112	1,222	1,270	1,410	1,540
annual change in % (real, gross)	5.7	4.2	4.0	4.7	8.7	8.0	7.0	6.0
Average monthly net wages, EUR	742	793	841	820	903	930	1,030	1,130
annual change in % (real, net)	7.0	3.9	4.0	4.6	8.8	8.0	7.0	6.0
Consumer prices (HICP), % p.a.	2.6	2.7	0.1	0.6	1.1	2.7	3.7	3.2
Producer prices in industry, % p.a.	4.3	1.8	-2.2	-2.2	4.9	5.5	4.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	38.6	37.8	39.1	.	.	36.3	36.5	36.5
Expenditures	39.4	38.4	43.6	.	.	44.3	40.5	38.5
Net lending (+) / net borrowing (-)	-0.8	-0.6	-4.5	.	.	-8.0	-4.0	-2.0
General gov.gross debt, EU def., % of GDP	37.1	37.0	43.5	.	.	49.0	50.5	48.0
Stock of loans of non-fin.private sector, % p.a.	-5.2	-1.4	-3.8	-4.3	-1.4	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	5.1	3.1	3.8	3.2	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-60	-203	845	306	-652	-1,000	-900	-750
Current account, % of GDP	-0.2	-0.7	2.9	2.2	-4.4	-3.2	-2.6	-2.1
Exports of goods, BOP, EUR m	12,588	12,761	13,428	6,183	7288	15,000	16,100	17,700
annual change in %	8.3	1.4	5.2	-0.9	17.9	11.7	7.3	9.9
Imports of goods, BOP, EUR m	15,108	15,403	14,917	6,962	8422	17,600	19,200	20,800
annual change in %	7.4	2.0	-3.2	-6.9	21.0	18.0	9.1	8.3
Exports of services, BOP, EUR m	5,336	5,577	4,375	2,137	2156	4,400	5,000	5,600
annual change in %	6.9	4.5	-21.6	-19.6	0.9	0.6	13.6	12.0
Imports of services, BOP, EUR m	3,019	3,151	2,541	1,205	1340	2,800	3,150	3,600
annual change in %	11.2	4.4	-19.4	-19.3	11.2	10.2	12.5	14.3
FDI liabilities, EUR m	373	975	820	313	914	1400	.	.
FDI assets, EUR m	-269	78	166	55	-86	-200	.	.
Gross reserves of CB excl. gold, EUR m	3,578	3,700	3,982	3,882	4,124	.	.	.
Gross external debt, EUR m	35,942	35,802	36,775	36,763	36,260	39,400	40,900	43,700
Gross external debt, % of GDP	123.3	117.7	125.4	125.3	115.1	125.0	120.0	120.0

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) In % of labour force (LFS). - 5) Loans more than 90 days overdue, and from 2018 also including loans unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

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