LATVIA: Waiting for the tide to float the boats

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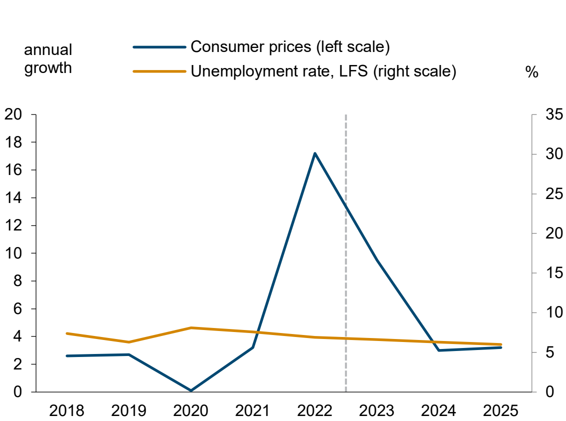
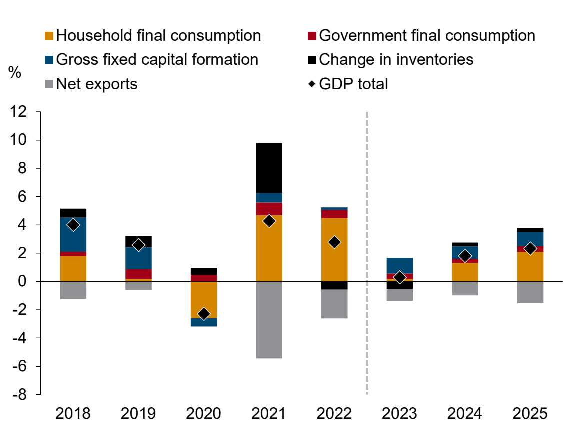
Whereas in 2022 economic activity remained quite lively right up to the end of the year, in 2023 the effects of dwindling external demand and reluctant household consumption are dampening GDP growth. Inflation is declining significantly, so that real incomes are again increasing in H2. While public investment has been expanding this year, enterprises are in the process of running down their stocks. Given the still rather tight labour market, the unemployment rate will fall slightly in 2023 – and even more so in the coming two years. Assuming that the EU economy finds its way back on track next year, we expect a subdued revival in Latvia's GDP growth, to 1.8% in 2024 and 2.3% in 2025.

Figure 6.11 / Latvia: Main macroeconomic indicators





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

Latvian goods exports declined in the first half of 2023 in real terms, and will continue to shrink throughout the year. The economies of the country's main trading partners are in the doldrums – or even in recession. An important factor is that housing construction in the Scandinavian countries is declining, which is putting pressure on Latvia's exports of building materials and of services. Also, the transport sector – relatively important in the country – is ailing in this context. Exports to Russia are on the decline, but at a slower pace than expected. In parallel, we see a big increase in exports to Kazakhstan, Kyrgyzstan, Armenia and other CIS countries – most likely a large proportion of those goods are then re-exported to Russia and Belarus. At the same time, Latvian producers are further disentangling themselves from Russian and Belarussian commodities and inputs. In general, and despite weakening exports, we expect the current account deficit to decline from more than 6% of GDP last year to slightly below 3% in 2023.

In common with the other Baltic states, Latvia was among the EU countries worst affected by the energy and commodity price rises of 2022, but inflation is again declining. By August 2023 it had already fallen to 5.4%. Nevertheless, food and beverages – important items in the consumer basket of low-income households – are still subject to quite rapid price rises, as are services. In the coming winter, we expect the prices of goods and services related to housing to increase again somewhat, since we have already seen a slight rise in wholesale energy prices. We expect consumer price inflation to fall to 3% in 2024.

Following the slump in real incomes in 2022, the declining inflation rate will bring about a revival of the purchasing power of households and private consumption as early as in the second half of 2023. Not only did the government raise the statutory minimum wage in January 2023 by 24% (to EUR 620 a month), but it has also scheduled another increase of 13% in 2024. This will help lower-income groups sustain their consumption levels. We thus expect that household expenditure will also experience an upswing in the second half of this year, and even more so in 2024.

Although the economy is stagnating at the moment, employment is projected to increase slightly in 2023. The decline in industrial production has resulted in the number of manufacturing jobs falling slightly. Bigger declines are reported for transport and both wholesale and retail trade. In business services, however, there is steady growth in jobs. Job vacancy rates are still high and have declined only slightly in recent months. We expect the unemployment rate to rise by only a little in 2023 and then to fall again gradually next year. By the end of July 2023, about 42,000 Ukraine refugees – more than 2% of the Latvian population – were benefiting from temporary protection and residing in the country. Thanks to the favourable labour market conditions at the moment, about 20% of those refugees have found a job in Latvia.

Following anaemic developments last year, 2023 has shown an upswing in investment activity, particularly by public institutions. However, the raising of interest rates by the European Central Bank (ECB) to curb inflationary developments has meant that Latvian entrepreneurs remain cautious in planning their investments. Following growth in construction output in the first half of 2023, recent figures on the number of building permits granted suggest that investment in real estate will again decline in the medium term. Having taken advantage throughout 2022 of the (still relatively) cheap inputs to build up their inventories, businesses had already started to run down those stocks in Q2 2023. However, the budget envisages a rise in public investment in infrastructure this year, in order to use the allocations from EU funds, particularly the Recovery and Resilience Facility.

The government deficit is likely to attain 3.5% of GDP in 2023, on account of government support for households and enterprises to deal with the burden of high energy bills. Should the economic upswing materialise, a return of the fiscal deficit to close to 2% of GDP is likely towards 2025. The government will move forward in increasing defence spending over the medium term to 2.5% of GDP in 2025.

Since Prime Minister Kariņš lost the support of his coalition partners – his notion of bringing the Progressive party into government was rejected – he stepped down in August. On 15 September, Evika Siliņa, also from the conservative people's party New Unity, took over as prime minister, making Latvia now the third Baltic country to be ruled by a woman. The other partners in the coalition government remain the same: the far-right National Alliance (which has been part of all coalition governments since 2011) and the United List, a party with a focus on the regions. Thus, the new government's economic policy will likely remain more or less unchanged. Prime Minister Siliņa, who served as Minister of Welfare under Mr Kariņš, has recently spoken in favour of an increase in the level of pensions, in order to sustain their purchasing power.

All in all, we have revised our forecast for GDP growth in 2023 downwards – from 0.8% in the summer to 0.3% now. According to the baseline scenario, however, GDP growth will pick up to 1.8% in 2024 and 2.3% in 2025. This scenario assumes a determined willingness on the part of EU actors to refrain from becoming too austerity oriented in the face of the ongoing stagnation. And that includes the ECB refraining from being too hawkish with its interest rate rises in the coming months.

Table 6.11 / Latvia: Selected economic indicators

	2020	2021	2022 1)	2022	2023	2023	2024	2025
				January-June			Forecast	
Population, th pers., average	1,900	1,884	1,879	1,870	1,885	1,885	1,885	1,880
Gross domestic product, EUR m, nom.	30,265	33,617	39,063	17,945	19,321	42,900	45,000	47,500
annual change in % (real)	-2.3	4.3	2.8	4.9	0.1	0.3	1.8	2.3
GDP/capita (EUR at PPP)	21,600	23,250	25,940	.	.	.	.	.
Consumption of households, EUR m, nom.	16,822	18,868	23,247	10,706	12,012	.	.	.
annual change in % (real)	-4.5	8.4	8.0	11.9	-0.5	0.3	2.2	3.5
Gross fixed capital form., EUR m, nom.	7,003	7,500	8,508	3,506	4,094	.	.	.
annual change in % (real)	-2.6	2.9	0.7	1.4	7.8	5.0	4.0	4.5
Gross industrial production 2)								
annual change in % (real)	-1.5	6.7	0.9	4.2	-6.4	-4.0	2.0	4.0
Gross agricultural production								
annual change in % (real)	4.9	-8.1	1.9	.	.	.	.	.
Construction industry								
annual change in % (real)	2.7	-6.1	-11.4	-11.6	16.1	.	.	.
Employed persons, LFS, th, average 3)	893.0	869.5	891.2	882.3	889.2	900	905	910
annual change in %	-1.9	-3.0	2.5	2.3	0.8	1.0	0.5	0.5
Unemployed persons, LFS, th, average 3)	78.7	70.6	65.2	65.4	60.2	64	61	58
Unemployment rate, LFS, in %, average 3)	8.1	7.6	6.9	7.0	6.4	6.6	6.3	6.0
Reg. unemployment rate, in %, eop 4)	7.7	6.7	6.1	5.9	5.5	.	.	.
Average monthly gross wages, EUR	1,143	1,277	1,373	1,332	1,494	1,500	1,580	1,680
annual change in % (real, gross)	6.0	8.2	-8.3	-4.5	-2.9	0.0	2.5	3.0
Average monthly net wages, EUR	841	939	1,006	975	1,092	1,100	1,160	1,230
annual change in % (real, net)	5.8	8.1	-8.7	-5.2	-3.0	0.0	2.5	3.0
Consumer prices (HICP), % p.a.	0.1	3.2	17.2	12.8	15.5	9.5	3.0	3.2
Producer prices in industry, % p.a.	-2.2	13.4	34.6	31.0	12.7	13.0	2.0	1.0
General governm. budget, EU def., % of GDP								
Revenues	37.9	37.0	35.8	.	.	38.0	37.0	38.0
Expenditures	42.3	44.2	40.2	.	.	41.5	39.8	40.3
Net lending (+) / net borrowing (-)	-4.4	-7.1	-4.4	.	.	-3.5	-2.8	-2.3
General gov. gross debt, EU def., % of GDP	42.0	43.7	40.8	.	.	41.0	41.5	41.0
Stock of loans of non-fin. private sector, % p.a.	-3.8	3.2	7.1	5.6	3.4	.	.	.
Non-performing loans (NPL), in %, eop 5)	3.1	2.5	1.8	2.3	1.6	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	788	-1,414	-2,494	-1,554	-883	-900	-900	-900
Current account, % of GDP	2.6	-4.2	-6.4	-8.7	-4.6	-2.1	-2.0	-1.9
Exports of goods, BOP, EUR m	13,440	16,195	20,491	9,588	9,331	20,700	21,500	22,300
annual change in %	5.3	20.5	26.5	32.6	-2.7	1.0	3.9	3.7
Imports of goods, BOP, EUR m	14,992	18,969	24,967	11,749	11,115	24,200	25,200	26,300
annual change in %	-2.6	26.5	31.6	36.5	-5.4	-3.1	4.1	4.4
Exports of services, BOP, EUR m	4,707	5,192	7,000	3,095	3,616	7,100	7,400	7,700
annual change in %	-15.8	10.3	34.8	35.3	16.8	1.4	4.2	4.1
Imports of services, BOP, EUR m	2,862	3,574	4,796	2,126	2,614	4,700	4,700	4,700
annual change in %	-9.2	24.9	34.2	37.5	23.0	-2.0	0.0	0.0
FDI liabilities, EUR m	816	3,185	1,174	479	649	2000	.	.
FDI assets, EUR m	168	2,338	-119	-392	213	-300	.	.
Gross reserves of CB excl. gold, EUR m	3,982	4,504	3,819	4,285	4,006	.	.	.
Gross external debt, EUR m	36,763	36,854	39,270	38,152	39,950	39,500	39,600	39,000
Gross external debt, % of GDP	121.5	109.6	100.5	97.7	93.1	92.0	88.0	82.0

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 those unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

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