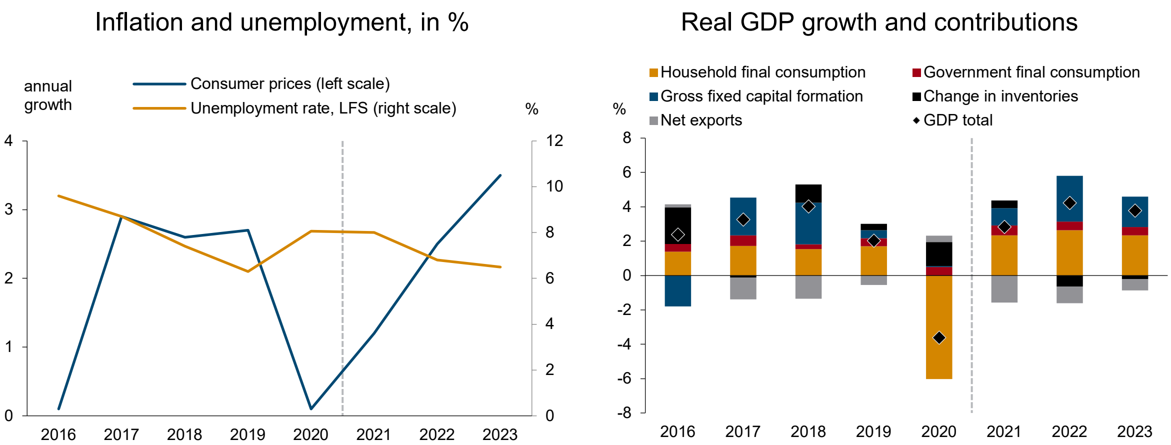
LATVIA: Trying to overcome the economic spillover effects of the pandemic

SEBASTIAN LEITNER

With GDP declining by 3.6% the Latvian economy has experienced a milder recession than expected; however, the subsequent revival of 2021 will be restrained. Last year household consumption slumped by more than 10%, while capital investments remained afloat. For this year we see a continuation of the revival in household consumption, but also external demand. Similarly, gross fixed capital investment will gain momentum, also boosted by public expenditures. In 2021 we expect GDP to increase by 2.8%; this will be followed by strong growth of 4.2% in 2022 and a somewhat slower upswing of 3.8% in 2023.

Figure 4.11 / Latvia: Main macroeconomic indicators



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

In 2020 the overall decline in GDP at 3.6% in real terms was somewhat less than expected. 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 was also milder than in most other European countries. Following the economic slump in the second quarter of the year, growth resumed in all sectors of the economy, except for hospitality, transport, financial services and surprisingly also ICT.

The second wave of infections resulted in a reinforcement of restrictions in November 2020 and extensions into the second quarter of 2021. Infection levels peaked in January at about 300 cases per 100 persons, well below the average of other European countries. Distance learning was introduced and only lifted for pupils in primary schools from mid-March onwards. Personal services could be offered again from the beginning of March onwards. Further lifting of restrictions planned for April this year may be introduced with delay. The resurgence of infections throughout Europe in March may also induce the Latvian government to act with more caution, since at the same time progress concerning vaccination of the population is rather slow. By beginning of April still only 8 vaccination doses per 100 persons had been administered – in line with Bulgaria and Russia but lower than in all other EU countries.

Exports of goods recovered strongly in the second half of 2020 resulting in even higher total annual growth last year than in 2019. The slump in March-May was recouped and strong demand was recorded for metals, machinery and equipment, plastics and wood products. At the same time, imports of goods remained depressed, while import price deflation reduced the amount of traded goods even more in nominal terms. This resulted in the current account turning strongly positive (more than 3% of GDP) in 2020. In general we expect growth in goods exports to remain lively and imports to revive in line with household consumption. Compared to trade in goods, however, there was a much sharper decline in trade in services, an important economic activity for Latvia. Income from travel more than halved and exports in transport services were reduced by a third in 2020. Activity in those two branches will recover only slowly in the next two years.

Investment has not fallen in 2020; a slight upswing is expected for the second half of this year. Last year's stagnation in investment was surprising, given that most other EU countries saw a steep decline. Based on figures for building permits, we expect investment in real estate to stagnate in the coming quarters, particularly in residential, but also non-residential buildings. House prices have declined only in the second quarter of last year; they are likely to stagnate until overall demand rebounds. Meanwhile, households are increasing their savings and the stock of mortgage loans is not growing. In the enterprise sector, capital investment in machinery and equipment has remained stable, while increased public sector investment has cushioned the overall investment decline.

Both the first and second lockdown strongly compressed household consumption, which will only pick up more strongly in the second half of 2021: retail trade remains well below 2019 levels even at the beginning of 2021.Since mass-incomes have however not fallen dramatically, the household savings rate has improved strongly. For the second half of 2021 and 2022 this will mean a lot of backlog demand for durable and non-durable goods, when spending will be possible again. Then household consumption will again become the most important driver of growth for the Latvian economy.

The Latvian government counteracted the economic fallout from the crisis with substantial fiscal measures. These comprise loans, state guarantees and also public investment in 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 support airBaltic, the main carrier in the Baltic region, and Riga's airports in order to prevent bankruptcies. Short-time work subsidies were introduced both for full- and part-time employees as well as for the self-employed. Companies can attain monthly grants to compensate for the decline in the flow of their working capital. In total however, the government deficit remained relatively low at 5.4% of GDP in 2020. The budget plan for 2021 envisages additional measures to support economic growth; however, the budget deficit is expected to decline to 4% of GDP. The start of 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 decline in the second quarter of 2020, and decreased in total by 1.5% year on year in 2020. Substantial job losses were recorded in accommodation and hospitality, domestic trade and transport, but also in construction. At the same time employment remained stable in manufacturing and ICT and the number of business service jobs increased. The decline in employment was cushioned by the short-time working schemes introduced by the government. About 5% of the workforce (that would most probably be unemployed otherwise) receives idle-work payments. This covers 75% of employees' wages, up to a monthly maximum of EUR 1000. The SURE loan facility of the EU Commission, approved in April with the purpose of keeping employees in work, supports these allowances by about EUR 200 million by now. The unemployment rate increased to 8.1% in 2020 on average, but has already declined slightly in the past 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 drop in labour demand resulted in a slowdown in wage growth; however salaries still increased in 2020 by more than 6% in real terms year on year, while for this year a further increase of over 5% is likely. Only in the hospitality sector and transport did wages decrease or stagnate. Since the minimum wage was not increased in 2020, the government decided to raise it from EUR 430 to EUR 500 a month from January 2021 onwards. Although it will rise by 15% this year, Latvia's wage level is still quite low; it exceeds only that of Bulgaria, Romania and Hungary within the EU. The non-taxable minimum will increase in 2021 and 2022, in order to strengthen the purchasing power of low-income households. Part of the wage increase however is due to the crisis-induced structural changes on the labour market, i.e. low-wage earners were more affected by job losses in the past quarters.

Consumer prices started to drop in the second half of last year and will continue to do so until the second quarter of 2021. The decline was driven largely by falling energy prices, which however rebounded towards the end of last year. Given ongoing rises in the prices of services due to this year's wage increases and a rebound in food prices, we anticipate that consumer price inflation will pick up in 2021 to 1.2% and then 2.5% in 2022.

All in all, since our previous report in autumn 2020, we have had to lower the forecast GDP growth rate for 2021 from 4.4% to 2.8%. On the one side this is due to the much better than expected developments in 2020. External demand rebounded quickly after the first lockdown; by the end of 2020 capacity utilisation levels had returned to 'almost normal' levels in several sectors of the economy. Thus, the rebound in growth cannot be that strong in 2021. On the other hand, the second wave of infections and the subsequent prolonged restrictions will delay the release of pent-up consumer demand. Therefore only in the second half of 2021 and 2022 will household consumption recover. External demand, which developed much better than had been imagined, will continue to grow steadily. Imports, which declined particularly due to reluctant household demand, will pick up again. The government will continue to support employers and workers and will continue to invest next year to support economic growth. Household incomes will continue to rise, spurred by a strongly rising minimum wage and 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 2.8% for 2021; in 2022, external and domestic demand should accelerate, resulting in real GDP growth of 4.2%.

Table 4.11 / Latvia: Selected economic indicators

	2017	2018	2019	2020 1)	2021	2022 Forecast	2023
Population, th pers., average	1,942	1,927	1,914	1,910	1,890	1,885	1,880
Gross domestic product, EUR m, nom.	26,962	29,143	30,421	29,334	30,500	32,600	35,000
annual change in % (real)	3.3	4.0	2.0	-3.6	2.8	4.2	3.8
GDP/capita (EUR at PPP)	19,680	20,890	21,500	21,170	.	.	.
Consumption of households, EUR m, nom.	15,943	16,839	17,845	16,147	.	.	.
annual change in % (real)	2.9	2.6	2.9	-10.3	4.0	4.5	4.0
Gross fixed capital form., EUR m, nom.	5,559	6,449	6,758	6,854	.	.	.
annual change in % (real)	11.4	11.8	2.1	0.2	4.5	12.0	8.0
Gross industrial production 2)							
annual change in % (real)	8.3	1.5	0.9	-1.5	2.0	3.0	3.0
Gross agricultural production							
annual change in % (real)	1.5	-9.0	21.0	4.7	.	.	.
Construction industry							
annual change in % (real)	18.7	21.8	2.9	2.7	.	.	.
Employed persons, LFS, th, average	894.8	909.4	910.0	895.8	900	905	910
annual change in %	0.2	1.6	0.1	-1.6	0.5	0.6	0.6
Unemployed persons, LFS, th, average	85.4	72.8	61.3	78.6	78	66	63
Unemployment rate, LFS, in %, average	8.7	7.4	6.3	8.1	8.0	6.8	6.5
Reg. unemployment rate, in %, eop 3)	6.8	6.4	6.2	7.7	.	.	.
Average monthly gross wages, EUR	926.0	1,004.0	1,076.0	1,120.0	1,190	1,290	1,400
annual change in % (real, gross)	4.7	5.7	4.2	4.0	5.0	6.0	5.0
Average monthly net wages, EUR	676.0	742.0	793.0	830.0	880	960	1,040
annual change in % (real, net)	4.1	7.0	3.9	4.0	5.0	6.0	5.0
Consumer prices (HICP), % p.a.	2.9	2.6	2.7	0.1	1.2	2.5	3.5
Producer prices in industry, % p.a.	2.5	4.3	1.8	-2.2	0.5	2.0	3.0
General governm.budget, EU-def., % of GDP							
Revenues	37.9	38.5	37.9	40.6	36.3	36.5	36.5
Expenditures	38.7	39.4	38.4	45.7	40.3	39.5	38.0
Net lending (+) / net borrowing (-)	-0.8	-0.8	-0.6	-5.1	-4.0	-3.0	-1.5
General gov.gross debt, EU def., % of GDP	39.0	37.1	37.0	49.8	47.0	44.0	41.0
Stock of loans of non-fin.private sector, % p.a.	-4.7	-5.2	-1.4	-3.8	.	.	.
Non-performing loans (NPL), in %, eop 4)	4.1	5.3	5.0	3.1	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	339	-84	-197	866	483	83	-417
Current account, % of GDP	1.3	-0.3	-0.6	3.0	1.6	0.3	-1.2
Exports of goods, BOP, EUR m	11,623	12,566	12,730	13,281	14,000	15,000	16,000
annual change in %	10.7	8.1	1.3	4.3	5.4	7.1	6.7
Imports of goods, BOP, EUR m	14,073	15,108	15,407	14,754	15,900	17,500	19,000
annual change in %	12.1	7.4	2.0	-4.2	7.8	10.1	8.6
Exports of services, BOP, EUR m	4,992	5,333	5,588	4,402	5,000	5,500	6,000
annual change in %	8.0	6.8	4.8	-21.2	13.6	10.0	9.1
Imports of services, BOP, EUR m	2,717	3,021	3,167	2,589	3,000	3,300	3,800
annual change in %	9.6	11.2	4.8	-18.3	15.9	10.0	15.2
FDI liabilities, EUR m	1,005	374	949	684	.	.	.
FDI assets, EUR m	496	-270	75	155	.	.	.
Gross reserves of CB excl. gold, EUR m	3,620	3,578	3,700	3,982	.	.	.
Gross external debt, EUR m	38,142	35,939	35,673	38,700	38,100	39,100	42,000
Gross external debt, % of GDP	141.5	123.3	117.3	130.0	125.0	120.0	120.0

1) Preliminary and wiiw estimates. - 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.