LATVIJAS BANKA
EIROSISTĒMA

Latvia's Macro Profile

December 2020

Incl. macro comparison of LV, EE and LT.

Latvia's Economic Developments and Outlook

On macroeconomic forecasts by Latvijas Banka

According to the assessment of Latvijas Banka's economists, the outlook for global and euro area economic growth is still subject to the evolution of the COVID-19 pandemic. The current COVID-19 statistics are concerning. Nevertheless, the positive vaccine trial results and the take-up of vaccines, which has already started in some countries, give reason for more optimism. Meanwhile, uncertainty remains high as the Brexit trade deal between the EU and the UK is still under negotiation and the trade tensions with the US continue despite the outcome of the US presidential election.

The world leading central banks, including the ECB, have implemented monetary policy to ensure very favourable financing conditions in the financial markets. Moreover, they stand ready to provide additional monetary policy support to the economy as needed.

The resurgence of the COVID-19 pandemic also calls for fiscal policy support. In the short term, wide-scale support measures help preserve household income and alleviate the liquidity constraints of businesses after the first wave of the COVID-19 pandemic. The Latvian government has decided to broaden the scope of support, and it is crucial to maintain public confidence during the discussions. At the same time, efficient implementation of government investment projects would ensure strong economic growth in the long run. Owing to Latvia's participation in the euro area and the accommodative monetary policy implemented by the ECB, in the present crisis the Latvian government has access to financing on very attractive terms. Furthermore, a relatively low level of government debt, which is projected to amount to approximately 45% of GDP in 2020, enables the government to borrow funds for productive investments.

On account of the resurgence of the COVID-19 pandemic and the global epidemiological developments, the renewed restrictions both in Latvia and its trade partners as well as the second state of emergency declared in Latvia, the economic growth outlook has become more pessimistic. Nevertheless, due to a stronger-than-expected GDP recovery in the third quarter, **the GDP forecast for 2020 has remained unchanged, with GDP expected to decline by 4.7%**. Since part of the renewed restrictions both in Latvia and its trade partners will remain in place until widespread implementation of the first medical solutions, **the GDP growth forecast for 2021 is more modest than before, having been revised downwards to 2.8%**.

The gradual economic recovery in 2021 and 2022 is based on the assumption that medical solutions will become available at the beginning of the next year, thus allowing for a broad resolution of the health crisis and a gradual relaxation of restrictions both in Latvia and worldwide. Moreover, the Next Generation EU package is expected to be made available in mid-2021. Thus, **in 2022** the economic growth rate is expected to accelerate and reach **5.3%**.

During the previous global financial crisis, the steepest drop was recorded in investment, whereas the crisis caused by the COVID-19 pandemic has the most notable impact on private consumption. The renewed restrictive measures and elevated uncertainty are expected to result in lower consumption in the short run. However, once the situation improves, the accumulated savings will strengthen spending. Investment growth will be supported by EU funds, government support measures and the Next Generation EU financing which will become available next year. Exports of goods will remain robust on account of less significant supply chain disruptions than those experienced at the beginning of the COVID-19 pandemic and owing to the structure of Latvia's exports of goods. During the current crisis, exports of food products remained resilient, and demand for wood and electronics is also expected to remain strong. In a shorter time frame, i.e. during the grain trade season, income from exports has also risen due to the record-high harvest volumes. Meanwhile, services exports, which reflect the weak flow of tourism and transportation services, are only expected to recover, once the COVID-19 pandemic-related concerns are largely eliminated.

The renewed restrictions introduced in response to the second wave of the COVID-19 pandemic further complicate the labour market situation. This has already been reflected by the business survey data suggesting that employment might shrink over the coming months. Nonetheless, a broader range of government support measures than those implemented in spring (in addition to furlough benefits, the support now also includes wage subsidies for the partially employed as well as the working capital subsidies) should avert a sharp rise in unemployment. However, in light of the projected weakening of economic activity, the financial situation of businesses might deteriorate leading to higher unemployment rate in 2021. While growing labour availability would dampen the rise in wages, in 2021 wage growth will be supported by increases in the minimum wage and the wages in the health care and education sectors.

The annual consumer price dynamics remain in deflationary territory and are overall in line with projections. Three quarters of products have seen their prices rise higher than the headline inflation, and the period of deflation is expected to be short-lived. The impact of the restrictions put in place to contain the spread of COVID-19 on the prices of services, those of accommodation, air transportation and package holidays in particular, is negative. Meanwhile, the prices of several other services continue rising as the restrictive measures and lower customer flows increase the service costs per customer.

A slowdown in economic activity and in wage growth also affects the price dynamics. Therefore, **the inflation forecast was revised slightly downwards to 0.1% for 2020 and 1.1% for 2021**. The forecast for 2021 also takes into account retention of the reduced VAT rate on the fruit and vegetables typical of Latvia. News about successful COVID-19 vaccine trials have strengthened demand for oil and facilitated a rise in its price. In the medium term, against the background of moderate economic and oil price recovery, inflation is expected to continue on a gradual upward trend and **reach 1.6% in 2022**.

Macroeconomic fundamentals: actual data and Latvijas Banka projections (P)

Baseline scenario	2019	2020 (P)	2021 (P)	2022 (P)	2023 (P)
Economic activity (annual percentage changes; at constant prices; seasonally adjusted data					
GDP	2.1	–4.7	2.8	5.3	3.7
Private consumption	2.1	–13.0	6.8	10.0	4.3
Government consumption	2.6	3.3	3.4	1.7	2.0
Investment	3.0	–2.2	3.9	6.6	3.6
Exports	2.2	–5.3	6.2	4.6	3.1
Imports	3.0	–7.8	6.6	7.5	3.0
HICP inflation (annual percentage changes)					
Inflation	2.7	0.1	1.1	1.6	1.7
Underlying inflation (excluding food and energy)	2.2	1.0	1.5	1.5	2.0
Labour market					
Unemployment (% of the economically active population)	6.3	8.2	8.5	7.5	7.2
Nominal gross wage (annual percentage changes)	7.2	3.7	5.3	5.1	5.5
External sector					
Current account balance (% of GDP)	–0.6	2.5	2.0	0.1	–0.3
Government finances (% of GDP)					
General government debt	36.9	44.5	43.9	43.0	42.4
Budget surplus (+)/deficit (–)	–0.6	–5.0	–3.8	–1.5	–0.4

Latvia's Economic Developments and Outlook

Latvijas Banka has developed **alternative economic growth scenarios** contingent upon the evolution of the COVID-19 pandemic and the course of implementation of the medical solutions. The mild scenario is based on the assumption that the medical solutions will be rolled out swiftly over 2021. According to this scenario, restrictions might be lifted earlier and normal conditions for the economic development might return sooner than predicted in other scenarios. Meanwhile, according to the severe scenario, the implementation of the medical solutions would take more time. Thus, the COVID-19 restrictions would be lifted gradually over the entire forecasting horizon, i.e. until 2023, leaving a long-lasting negative impact on GDP.

Macroeconomic fundamentals: Latvijas Banka projections (P)

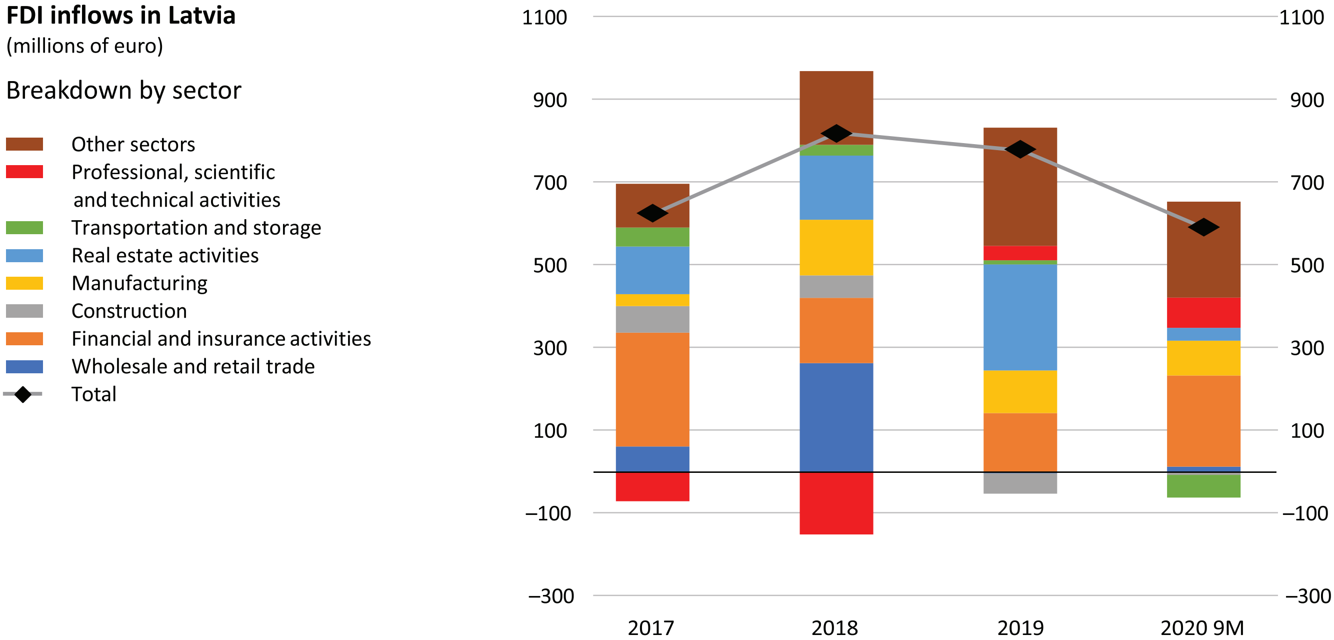
Mild scenario	2020 (P)	2021 (P)	2022 (P)	2023 (P)
GDP (annual percentage changes; at constant prices; seasonally adjusted data)	–4.4	3.7	5.6	3.7
HICP inflation (annual percentage changes)	0.1	1.4	2.2	2.1
Unemployment (% of the economically active population)	8.2	8.1	7.0	6.5
Severe scenario	2020 (P)	2021 (P)	2022 (P)	2023 (P)
GDP (annual percentage changes; at constant prices; seasonally adjusted data)	–5.0	1.4	4.8	3.6
HICP inflation (annual percentage changes)	0.1	0.8	1.2	1.5
Unemployment (% of the economically active population)	8.2	9.1	8.5	8.2

The forecasts were finalised on 25 November 2020, and the cut-off date for technical assumptions is 18 November.

Foreign Direct Investment

FDI inflows in Latvia
(millions of euro)

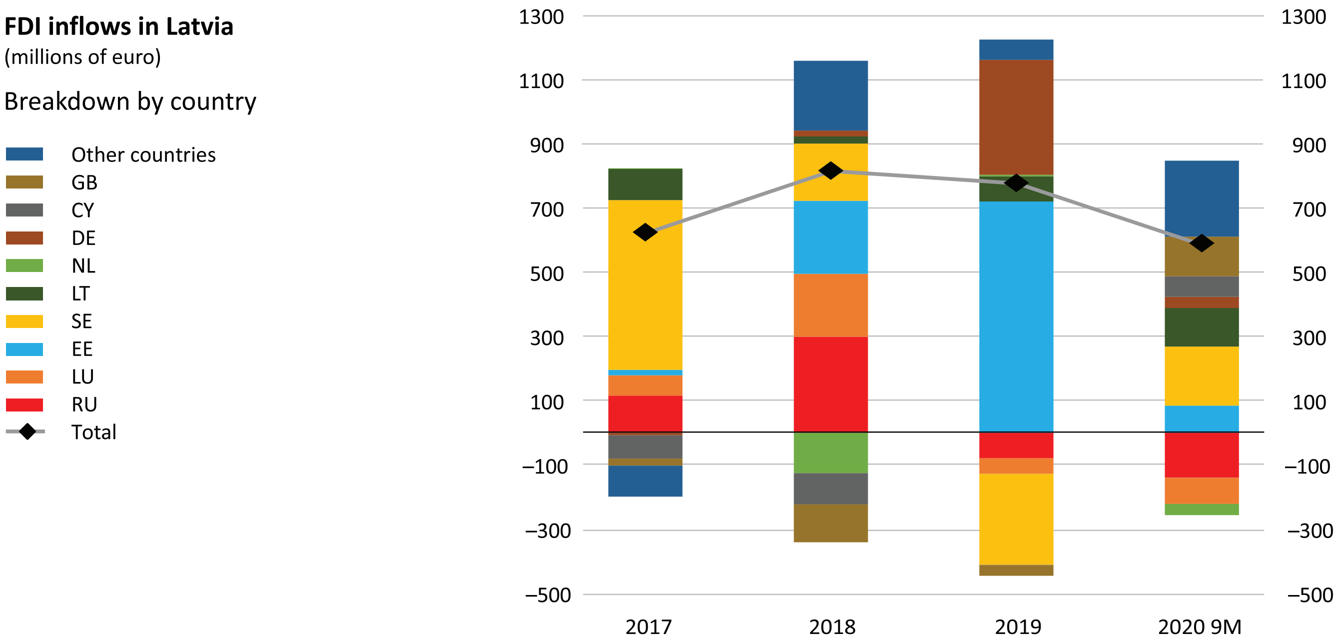
Breakdown by sector



Source: Latvijas Banka.

FDI inflows in Latvia
(millions of euro)

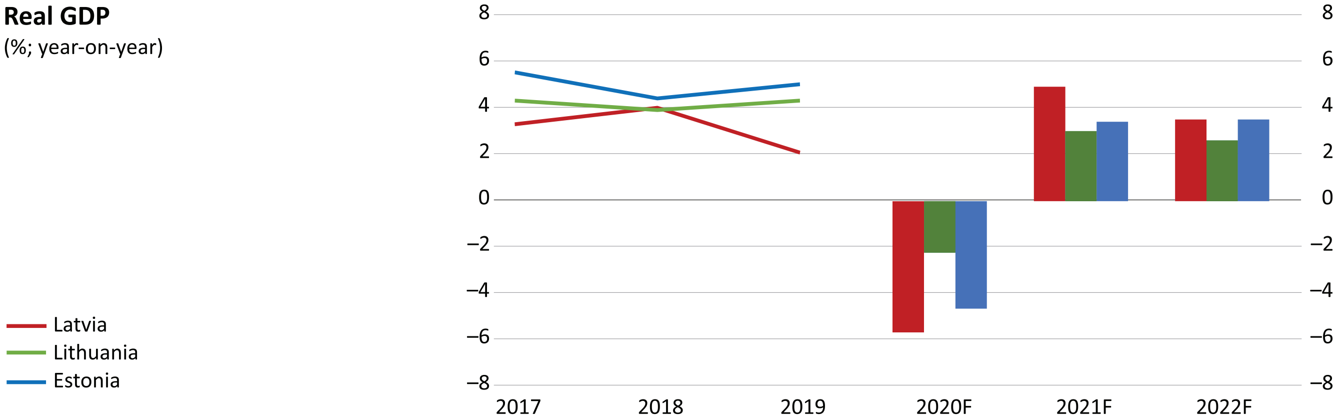
Breakdown by country



Source: Latvijas Banka.

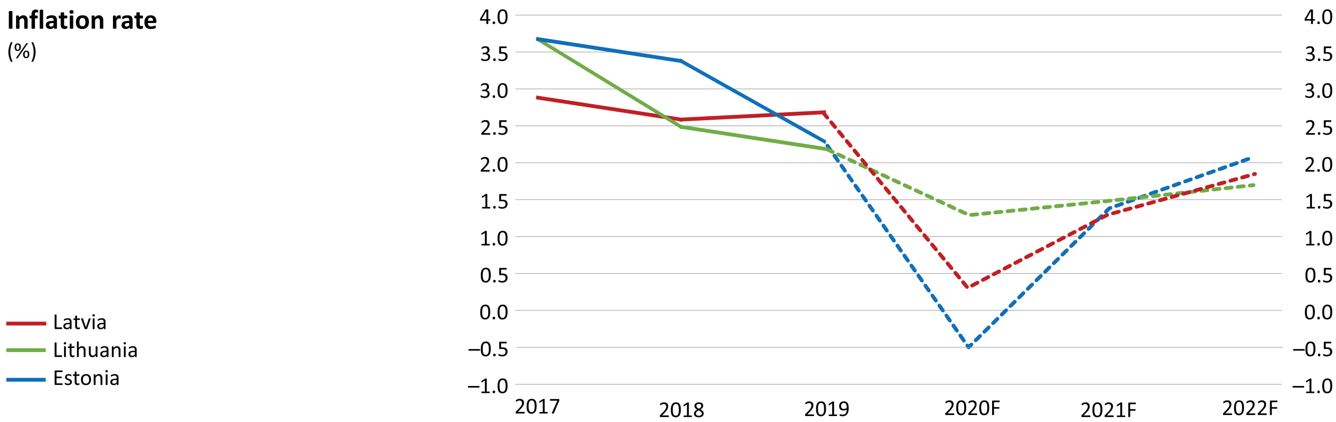
Macroeconomic Indicators: Latvia, Lithuania and Estonia

Real GDP
(%; year-on-year)



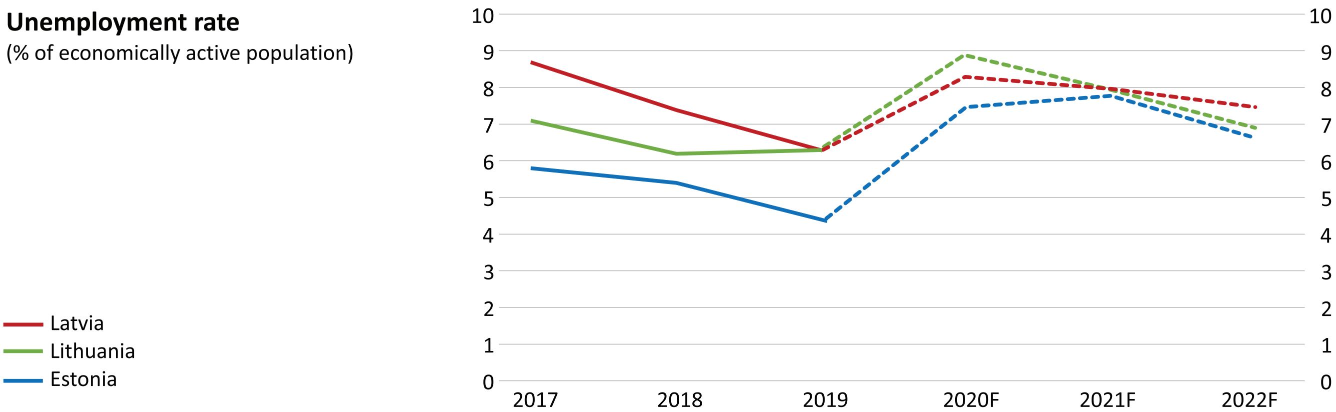
Source: Eurostat (s.a. data) ; Forecast: European Commission.

Inflation rate
(%)



Source: Eurostat; Forecast: European Commission.

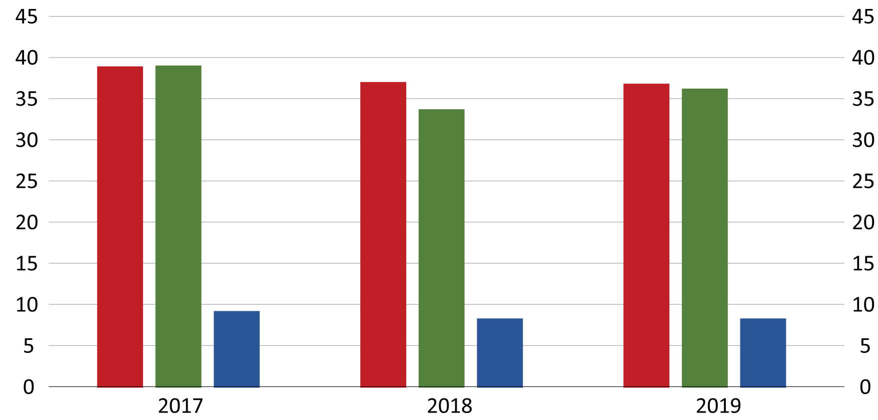
Unemployment rate
(% of economically active population)



Source: Eurostat; Forecast: European Commission.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

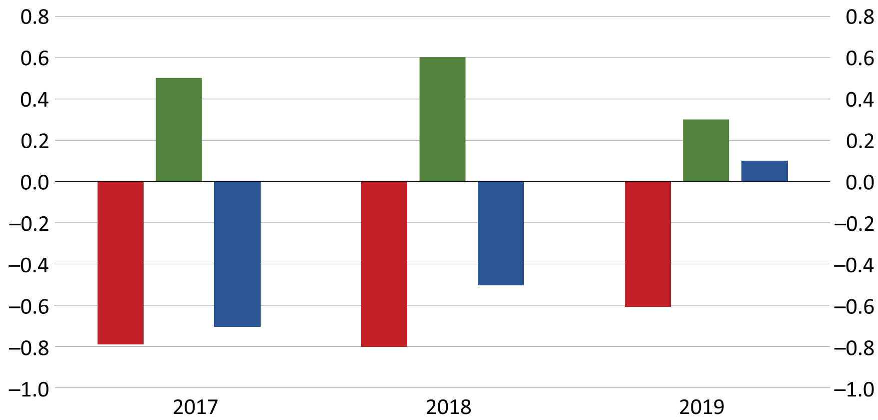
Gross government debt
(% of GDP)



Latvia
Lithuania
Estonia

Source: Eurostat.

Government budget balance
(% of GDP)



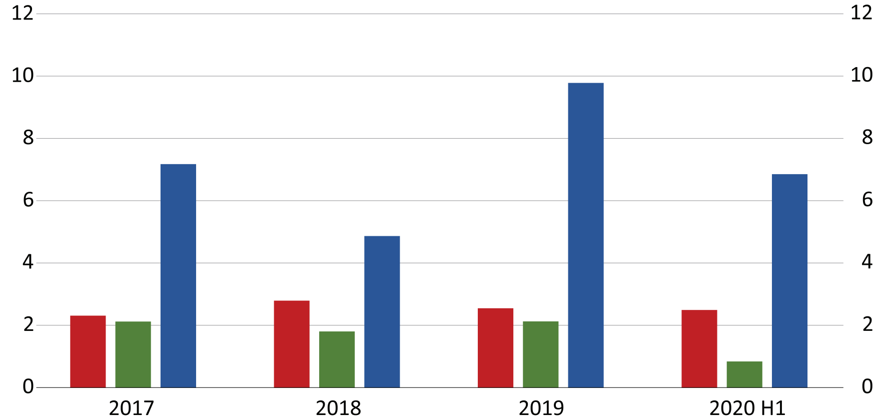
Latvia
Lithuania
Estonia

Source: Eurostat.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

Inward FDI flows
(% of GDP)

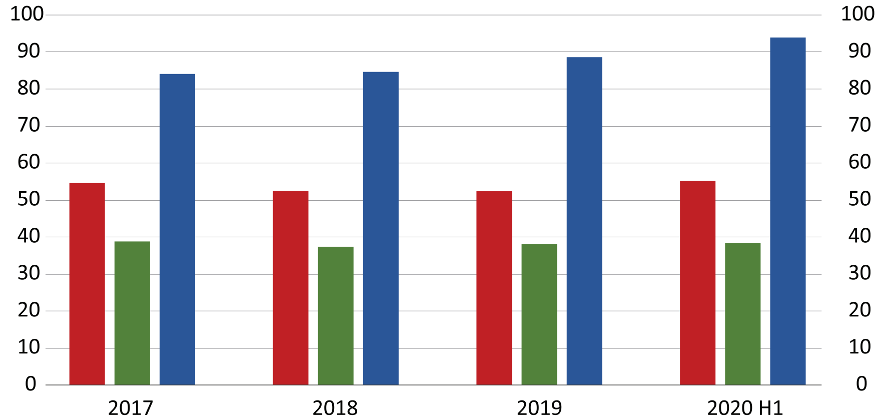
- Latvia
- Lithuania
- Estonia



Sources: Eesti Pank, Lietuvos bankas, Latvijas Banka, Eurostat. Calculations by Latvijas Banka.

Inward FDI stocks
(% of GDP)

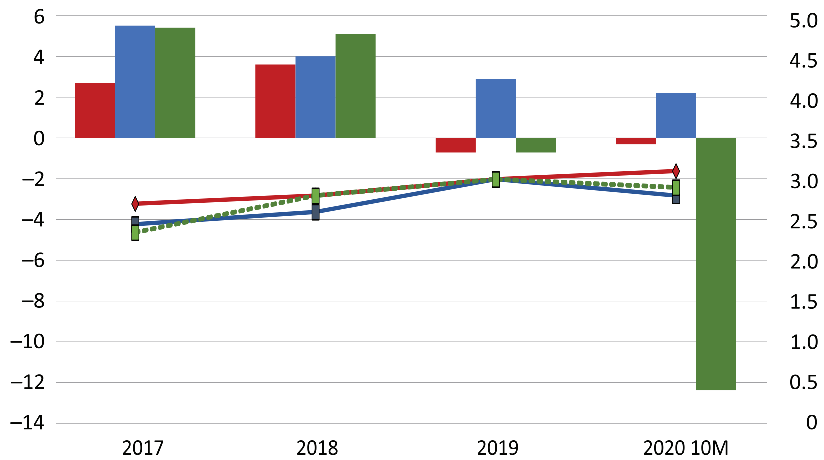
- Latvia
- Lithuania
- Estonia



Sources: Eesti Pank, Lietuvos bankas, Latvijas Banka, Eurostat. Calculations by Latvijas Banka.

Adjusted* loans to euro area non-financial corporations and interest rates on new euro loans
(%; year-on-year)

- Loans to non-financial corporations – Latvia
- Loans to non-financial corporations – Estonia
- Loans to non-financial corporations – Lithuania
- Interest rate on loans to non-financial corporations – Latvia (weighted average; right-hand scale)
- Interest rate on loans to non-financial corporations – Estonia (weighted average; right-hand scale)
- Interest rate on loans to non-financial corporations – Lithuania (weighted average; right-hand scale)



Sources: ECB, Latvijas Banka, Eesti Pank and Lietuvos bankas.
** The effect of reclassifications and other adjustments have been deducted.*