LATVIJAS BANKA
EIROSISTĒMA

Latvia's Macro Profile

March 2023

Incl. macro comparison of LV, EE and LT.

Latvijas Banka has revised its macroeconomic forecasts

Latvijas Banka has published its latest March 2023 macroeconomic forecasts drawn up amid persistently high uncertainty.

- The inflation forecast has been revised downwards for the entire projection horizon: to 10.0% for 2023 (10.9% in the December 2022 forecast), to 2.7% for 2024 (4.4%) and to 2.6% for 2025 (3.0%).
- The gross domestic product (GDP) growth forecast for 2023 has been revised upwards to 0.5% (a 0.3% fall was projected in December) which in turn reduces the GDP growth in the coming years: to 3.7% for 2024 (a 4.4% rise was projected in December) and to 3.3% for 2025 (3.5%).

In response to the soaring inflation, major global central banks, including the European Central Bank (ECB), continued raising their interest rates.

- Inflation in the euro area remained significantly above the central bank target (2% in the medium term). Although it has currently reached its peak and follows a downward trend, it is expected to stay above the target for too long. Therefore, the central bank will continue acting within the scope of its mandate as long as it returns to its target.
- To ensure the return of inflation to its 2% target in the medium term, the Governing Council of the ECB is raising interest rates. In March, it was decided to increase the interest rates by another 50 basis points.
- The Governing Council of the ECB closely follows the information on tensions in the financial sector and is ready to use the instruments at its disposal to maintain price stability and financial stability.
- The euro area banking sector is resilient, with strong capital and liquidity positions. In any case, there are enough instruments at the disposal of the Governing Council of the ECB and the Eurosystem (comprising the ECB and the national central banks of the euro area) to provide liquidity support to the financial system and ensure the smooth transmission of monetary policy.

Lower energy and food prices and assumptions about their developments allow a downward revision of the inflation forecast.

- Inflation in Latvia remains high – it was the highest among the euro area countries in February.
- Due to falling global commodity prices, inflation in Latvia will also gradually subside over the course of 2023 and could fall below 3% at the end of the year.
- Average annual inflation will still be high in 2023 (10.0%); however, it could already end up below 3% in 2024–2025.
- Lower energy prices also have a favourable effect on core inflation by reducing production costs of goods and costs of providing services; nevertheless, it will remain relatively high.
- Although the impact of wage increase on core inflation has so far been assessed as minor, a stable rise in wages and subsequent pressure on core inflation are projected in the context of labour shortage.

The recession experienced by Latvia's economy in 2022 was shallow; however, the end of the year came as a surprise with a resilient consumption increase: owing to the GDP performance at the end of the previous year, the GDP forecast for 2023 constitutes a 0.5% rise instead of the previously estimated fall.

- Wage growth was moderate, and this year, it will be supported by an increase in the minimum wage. However, the elevated inflation will continue to reduce the population's purchasing power.
- Amid the high inflation, government support provided significant help to the population, especially in covering energy costs. Savings accumulated during the pandemic also let part of the population keep their consumer behaviour unchanged.

- With businesses facing weakening demand and climbing costs, labour demand declined somewhat – the number of job vacancies decreased.
- However, the projected short-lived recession and the expected labour shortage resulting from the rebound in activity make businesses retain their employees, and there is no significant change in the unemployment rate.
- At the same time, the investment growth prospects have not improved, taking into account the sluggish absorption of European Union (EU) funds as well as the elevated uncertainty and rising interest rates weakening the slow lending.

With the absorption of EU funds becoming more active and input prices normalising, 2024–2025 is expected to witness economic growth above 3% (3.7% and 3.3% respectively).

The most significant risks to Latvia's economic growth involve the persistently low investment level and deteriorating competitiveness. Following the steep rise over the previous years owing to a favourable exports structure, Latvia's global export market share remains resilient. Nevertheless, due to the accumulated input costs, exports could lag behind foreign demand. In the long term, investment is a precondition for a competitive economy.

The general government deficit (4% of GDP this year) could decrease in the future; however, efforts related to facilitating economic transformation are relevant. The full absorption of EU funds as well as an improved quality and availability of public services are important aspects.

Macroeconomic fundamentals: Latvijas Banka's spring 2023 forecasts

	2023	2024	2025
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)			
GDP	0.5	3.7	3.3
Private consumption	0.7	4.2	4.1
Government consumption	–2.0	0.5	0.8
Investment	0.8	5.1	6.0
Exports	–0.4	2.9	3.3
Imports	–4.3	3.0	4.1
HICP inflation (annual changes; %)			
Inflation	10.0	2.7	2.6
Core inflation (excluding food and energy prices)	7.7	5.8	4.8
Labour market			
Unemployment (% of the economically active population; seasonally adjusted data)	7.4	7.3	7.0
Nominal gross wage (annual changes; %)	9.1	8.8	7.8
External sector			
Current account balance (% of GDP)	–2.8	–3.2	–3.8
Government finances (% of GDP)			
General government debt	41.6	40.0	39.8
Budget surplus/deficit	–4.0	–2.7	–1.5

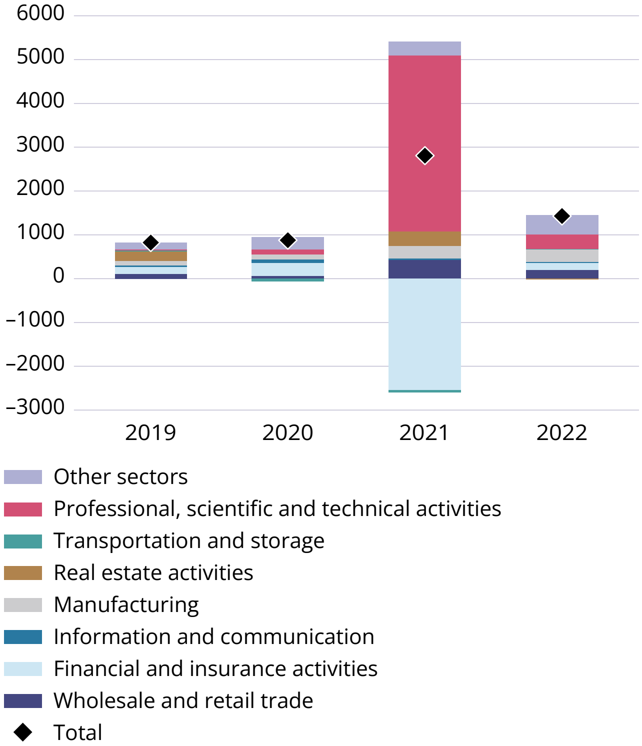
The cut-off date for the information used in the forecasts is 23 March 2023, and 15 February for the information used in some technical assumptions.

Foreign Direct Investment

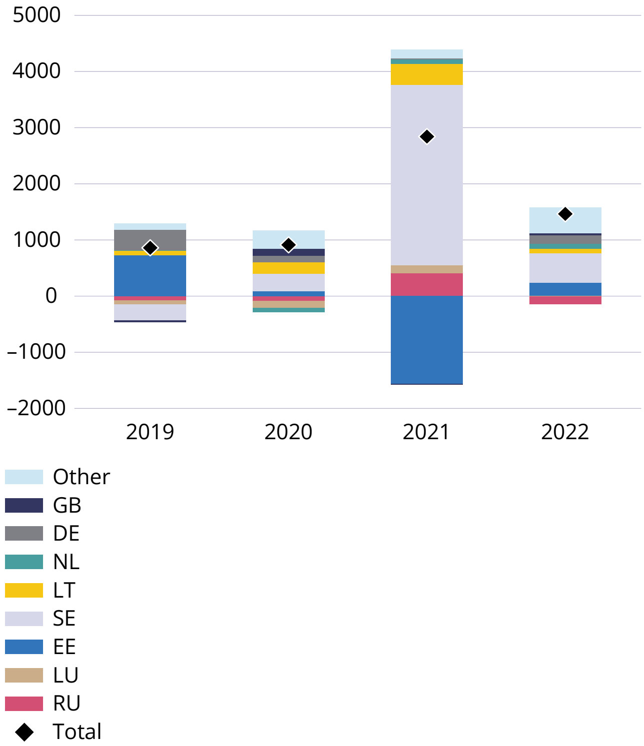
FDI inflows in Latvia

(millions of euro)

Breakdown by sector



Breakdown by country

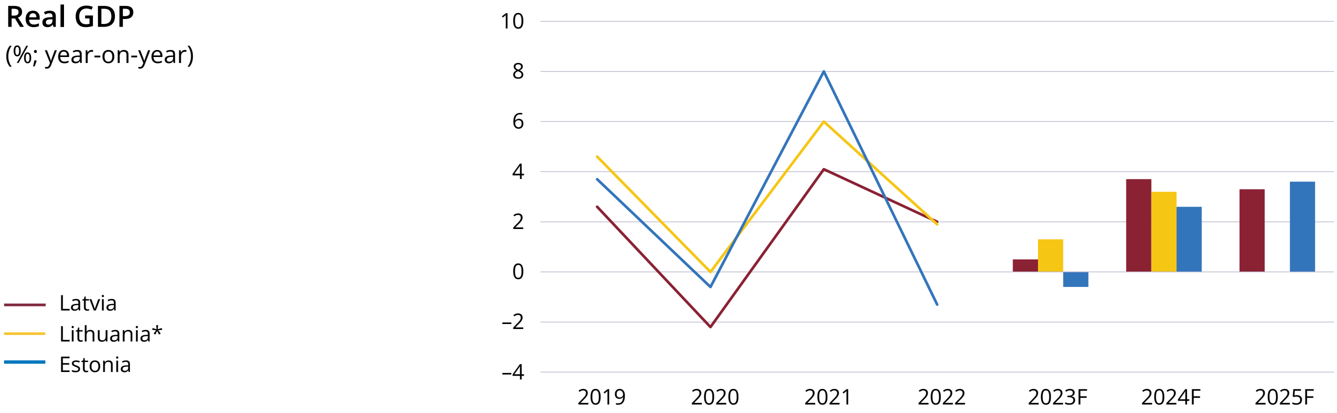


Source: Latvijas Banka.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

Real GDP

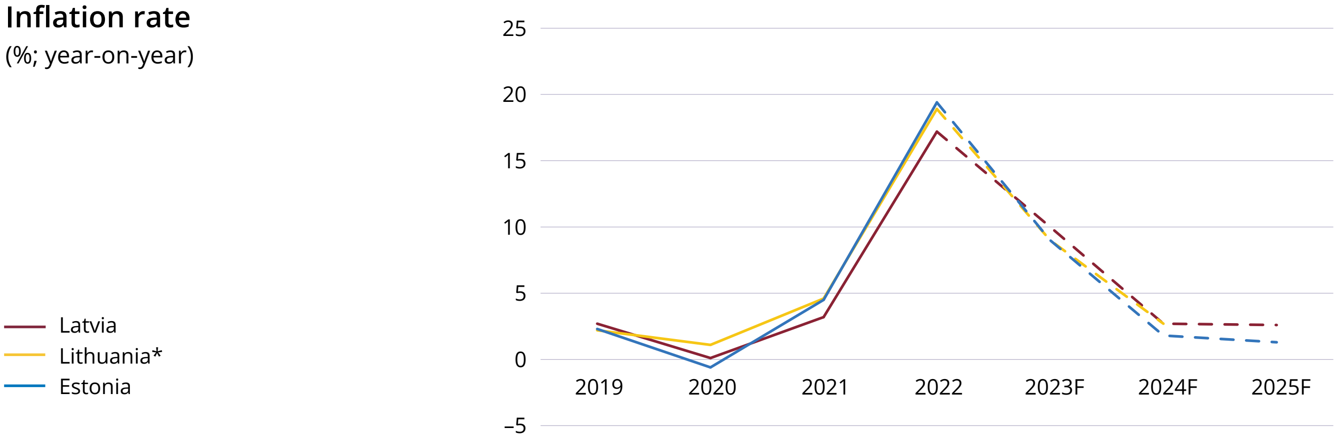
(%; year-on-year)



*Forecast for Lithuania until 2024.
Source: Eurostat. Forecast: Eesti Pank, Lietuvos bankas, Latvijas Banka.

Inflation rate

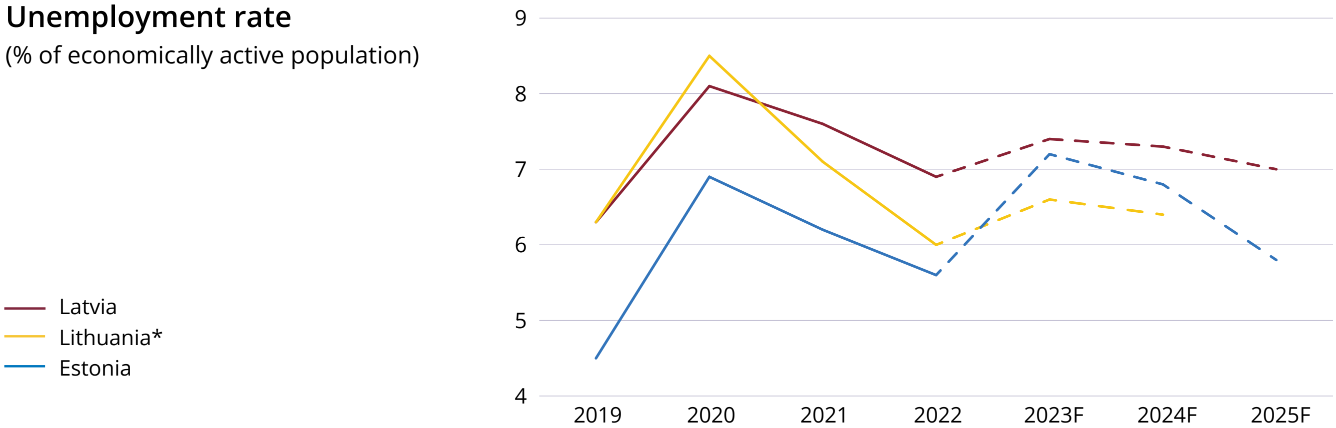
(%; year-on-year)



*Forecast for Lithuania until 2024.
Source: Eurostat. Forecast: Eesti Pank, Lietuvos bankas, Latvijas Banka.

Unemployment rate

(% of economically active population)

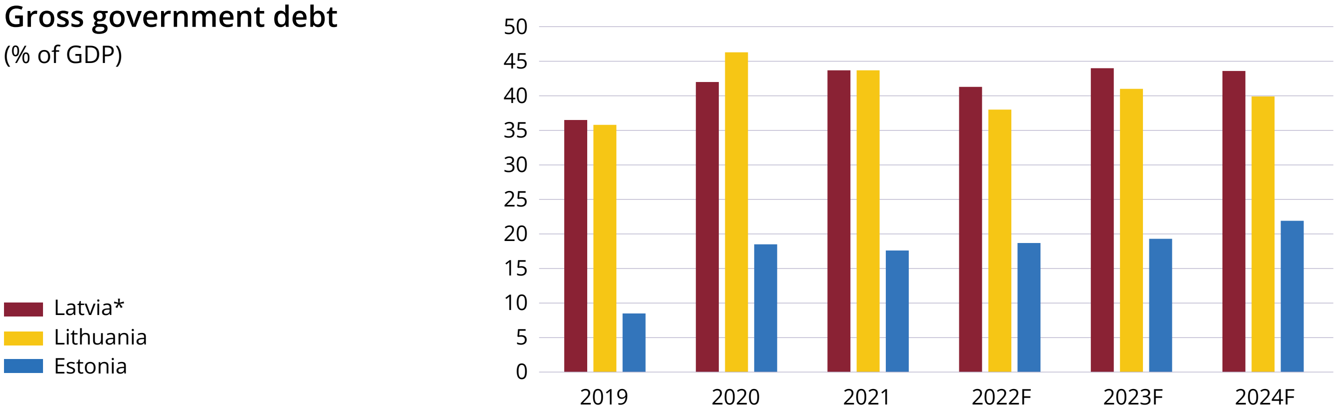


*Forecast for Lithuania until 2024.
Source: Eurostat. Forecast: Eesti Pank, Lietuvos bankas, Latvijas Banka.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

Gross government debt

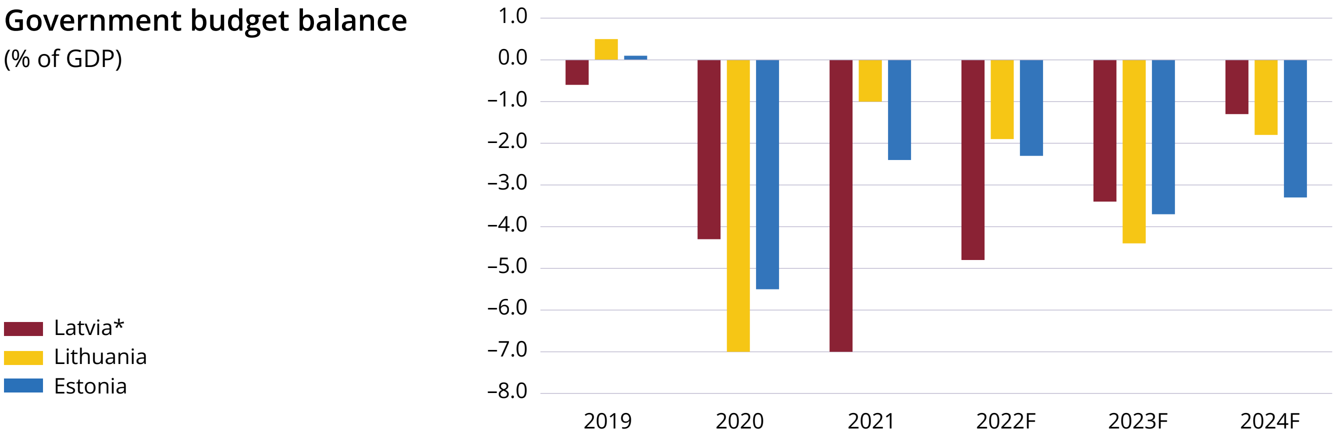
(% of GDP)



*Operational Latvijas Banka data for 2022.
Source: Eurostat. Forecast: European Commission.

Government budget balance

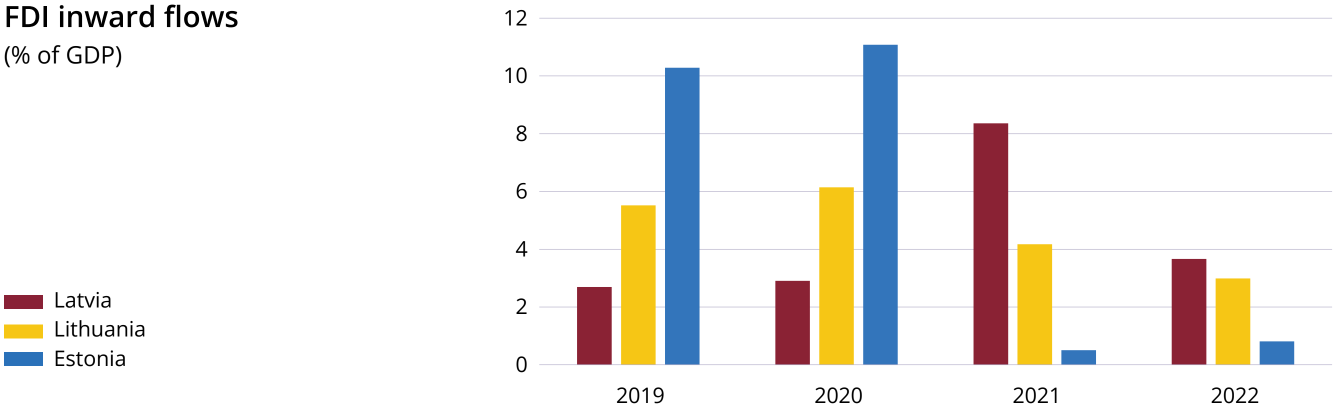
(% of GDP)



* Operational Latvijas Banka data for 2022.
Source: Eurostat. Forecast: Eesti Pank, Latvijas Banka, European Commission.

FDI inward flows

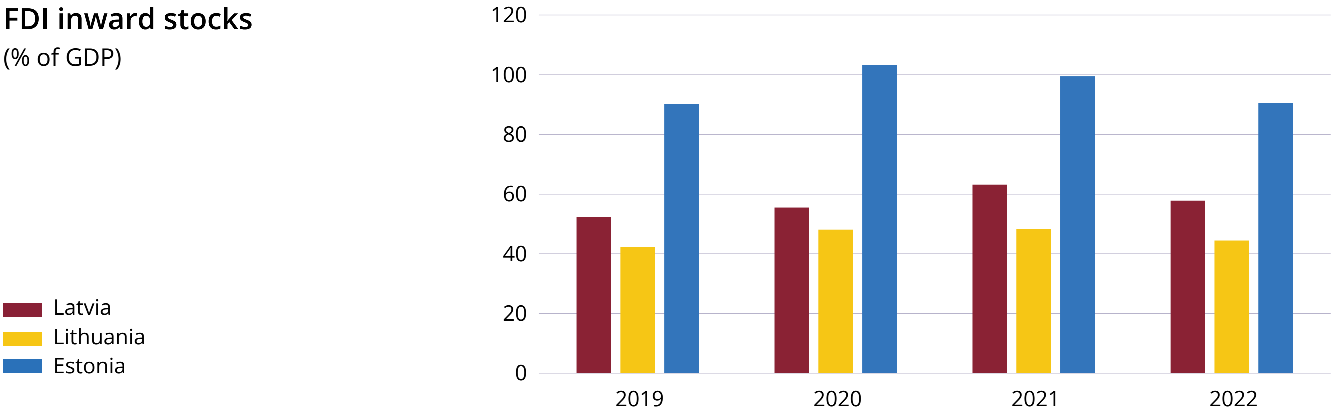
(% of GDP)



Sources: Eesti Pank, Lietuvos bankas, Latvijas Banka.

FDI inward stocks

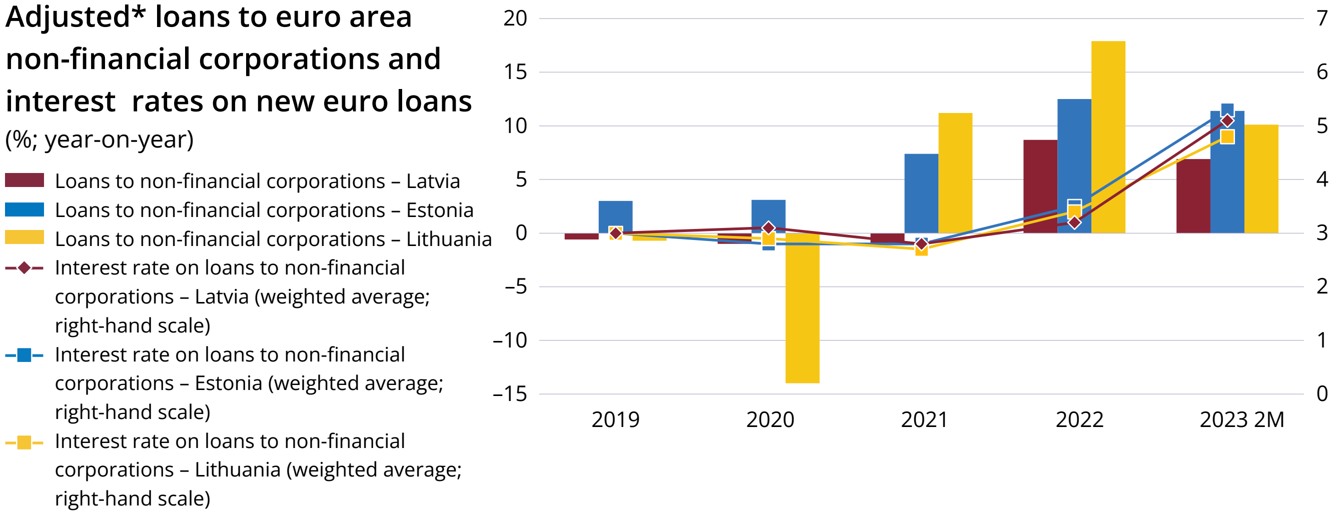
(% of GDP)



Sources: Eesti Pank, Lietuvos bankas, Latvijas Banka.

Adjusted* loans to euro area non-financial corporations and interest rates on new euro loans

(%; year-on-year)



Sources: ECB, Latvijas Banka, Eesti Pank and Lietuvos bankas.

* The effect of reclassifications and other adjustments have been deducted.