LATVIJAS BANKA
EIROSISTĒMA

Latvia's Macro Profile

December 2022

Incl. macro comparison of LV, EE and LT.

Latvijas Banka has revised its macroeconomic forecasts

Latvijas Banka has published its latest December 2022 macroeconomic forecasts for Latvia. These forecasts are surrounded by a persistently high degree of uncertainty resulting from the unpredictable war started by Russia and the related developments in global prices, particularly those of energy.

Key points:

- **The baseline scenario of Latvijas Banka's forecasts remains unchanged from the September forecasts and provides for a temporary and shallow recession in Latvia's economy.**
- On account of the actual data (including statistical data revisions), Latvia's gross domestic product (GDP) growth projections for 2022 have been revised downwards to 2.1% (3.0% in September). Nevertheless, the overall economic outlook has remained broadly unchanged, and the development in 2023 is seen similar to the previous forecasts, projecting a 0.3% contraction (a 0.2% fall in September).
- This minor drop in GDP growth, however, will be accompanied by a more pronounced 5.6% contraction in household consumption. Lower purchasing power will have a negative effect on the population's welfare.
- Economic growth is expected to recover in 2024, reaching the previously projected 4.4%, and to increase by 3.5% in 2025.
- **Inflation remains high, and the assumptions concerning the growth of the global food prices and domestic wages used in Latvijas Banka's forecasts have been revised upwards.**
- That resulted in upward revisions of inflation projections over the entire projection horizon: inflation is expected to grow by 17.3% in 2022 (16.9% in September), by 10.9% in 2023 (9.2% in September) and by 4.4% in 2024 (3.4% in September). In 2025, inflation is projected at the level of 3.0%.

In response to the soaring inflation, major global central banks, including the European Central Bank (ECB), are raising their monetary policy rates. From March 2023 onwards, the ECB will start gradually reducing the asset purchase programme (APP) portfolio:

- The Governing Council of the ECB has raised the key euro interest rates for the fourth consecutive time, with the rates on deposit facility, main refinancing operations and marginal lending facility reaching 2.00%, 2.50% and 2.75% respectively.
- The Governing Council of the ECB judges that interest rates will still have to rise significantly to reach levels that are sufficiently restrictive to ensure a timely return of inflation to its 2% medium-term target.
- Keeping interest rates at a higher level will over time reduce inflation and will also guard against the risk of high inflation expectations taking root.
- Any further monetary policy decisions of the Governing Council of the ECB will be based on inflation outlook developments. The decisions will follow a meeting-by-meeting approach.
- From March 2023 onwards, the APP portfolio will decline at a gradual pace, as the Eurosystem will no longer reinvest all of the principal payments from maturing securities. The decline will amount to 15 billion euro per month on average until the end of the second quarter of 2023 and its subsequent pace will be determined over time.

With energy prices normalising, inflation in Latvia is expected to subside. The rise of the global food prices and wages, however, could be more pronounced and sustain a higher inflation than previously estimated:

- the government support measures are stabilising the purchasing power of households and (particularly the measures restricting the growth of energy prices) are a headwind to inflation growth. Nevertheless, in November, Latvia's inflation at 21.7% was the highest among the euro area countries;

- inflation is fuelled by a substantial increase in both energy and food prices. Successful restructuring of energy supply will also ease the pressures from energy prices in the economy, although these prices will most likely remain above their pre-crisis levels;
- a higher than previously projected inflation in the coming years will be sustained by more pronounced rises in both global food prices and domestic wages;
- the passthrough of costs, particularly wages and energy prices, to the prices on goods and services as well as the impact of wage increases on demand exert an upward pressure on core inflation. Its projections have been revised upwards and, at the end of the projection horizon in 2025, the average annual core inflation is expected to remain quite high at 5.0% .

Weak development of Latvia's economy was expected in the third quarter, and the economic outlook has remained broadly unchanged in comparison with September:

- with a more significant drop in GDP materialising already in the third quarter of 2022, the contraction of the economy at the end of the year could be smaller. At the same time, the revisions of the previous quarters' data by the Central Statistical Bureau have had a downward effect on the 2022 GDP growth;
- consumption will be supported by additional government support measures in an energy crisis and a substantial rise of the minimum wage in the years to come;
- nevertheless, the degree of caution among consumers will remain high due to the elevated inflation (both actual and projected).

Although the end of the year and the beginning of next year in Latvia's economy will be marked by a recession, this recession is expected to be temporary and shallow:

- the economic downslide will be determined by lower purchasing power of households, as the wage growth is considerably outpaced by inflation. That will only partly be offset by the government support and use of savings, hence the effect on household welfare will be negative;
- a tight labour market along with the rising minimum wage and wage increases in certain areas of the public sector will sustain the average wage growth in the coming years, and the purchasing power will rebound in the second half of 2023;
- the first signs of growing unemployment can be partly explained by economically inactive population joining the labour market. A tight labour market in combination with a short-lived recession would allow businesses to avoid significant lay-offs;
- against the background of uncertainty and high costs, investment is not expected to improve in the nearest quarters, but it is projected to recover thereafter on account of the absorption of the European Union funds and stabilising costs;
- exports have so far shown surprising resilience, although the recession will most likely hit Latvia's trade partners as well. Export development will strongly depend on the competitiveness of Latvia's businesses, once the external demand recovers.

Timely, targeted, proportionate and limited in time government support in the crisis; at the same time, focus on structural changes in energy sector:

- the government support helps businesses and households overcome the energy price crisis. The government support should reach the most vulnerable households, it should not fuel inflation and at the same time it should stimulate energy savings;

- when the support ends, the government deficit will decline. However, with wages in certain sectors and spending on defence and domestic security being increased and spending more to attain the climate objectives, the improvement of the budget balance could be slower than previously projected;
- changes in the financing conditions faced by the government should also be taken into account, as higher borrowing rates mean larger debt service costs;
- in the coming years, the fiscal framework of the European Commission will be restored, which, although reformed, will still provide for a strong counter-cyclical fiscal policy implementation aimed at reducing the government debt;
- both energy independence and climate objectives require structural changes in the energy sector. The high degree of uncertainty surrounding the global energy demand as well as partial dependence on weather conditions require the sector to be able to quickly adjust.

Macroeconomic indicators: Latvijas Banka's projections

	2022	2023	2024	2025
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)				
GDP	2.1	–0.3	4.4	3.5
Private consumption	4.7	–5.6	5.4	5.0
Government consumption	4.7	–8.0	2.9	2.1
Investment	0.8	1.1	5.5	6.1
Exports	6.7	–0.5	3.3	3.2
Imports	5.9	–7.5	3.9	4.7
HICP inflation (annual percentage changes)				
Inflation	16.9	9.2	3.4	
Core inflation (excluding food and energy prices)	7.6	7.8	6.0	5.0
Labour market				
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	7.8	7.5	7.2
Nominal gross wage (annual changes; %)	8.5	9.2	8.9	7.8
External sector				
Current account balance (% of GDP)	–4.4	1.2	0.5	–0.3
Government finances (% of GDP)				
General government debt	42.1	42.5	41.3	40.0
Budget surplus/deficit	–7.4	–5.5	–3.0	–2.1

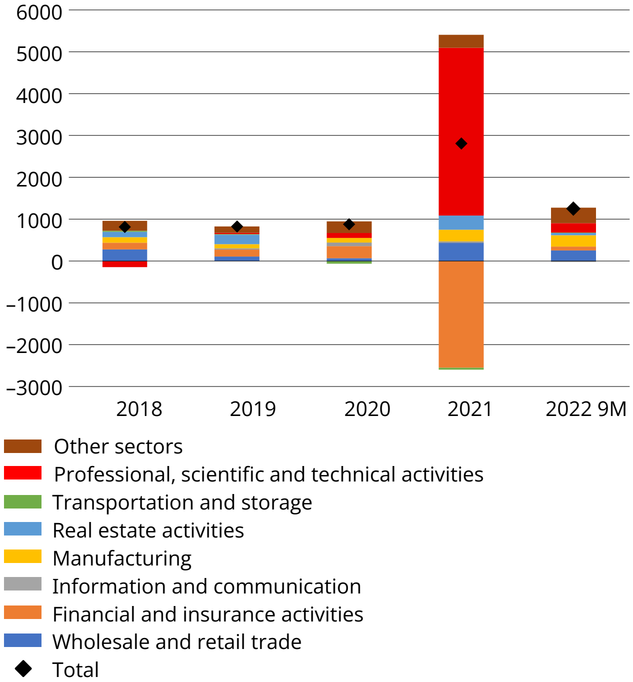
The cut-off date for the information used in the forecast is 30 November 2022, and 23 November for the information used in some technical assumptions.

Foreign Direct Investment

FDI inflows in Latvia

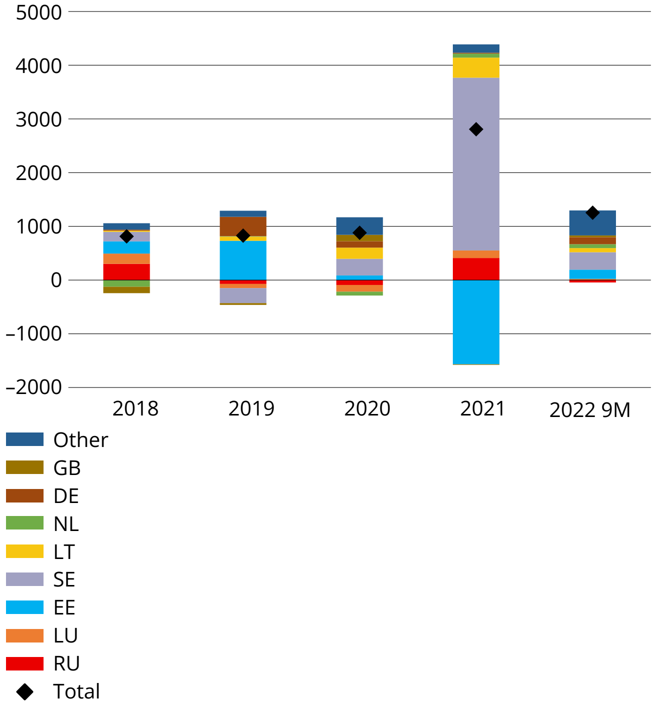
(millions of euro)

Breakdown by sector



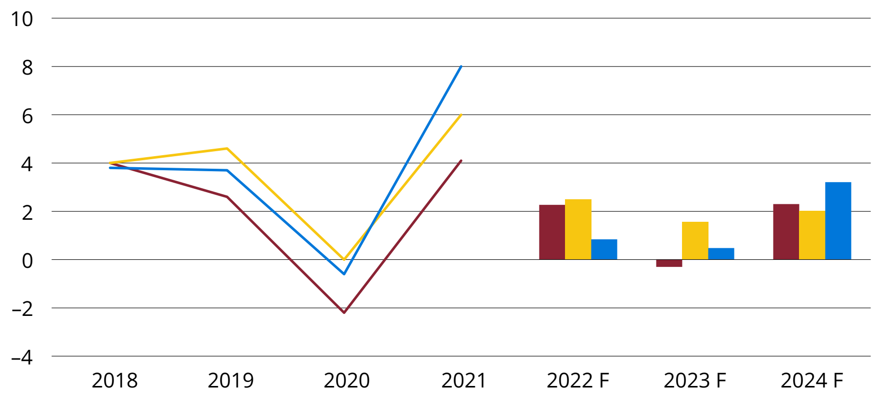
Source: Latvijas Banka.

Breakdown by country



Macroeconomic Indicators: Latvia, Lithuania and Estonia

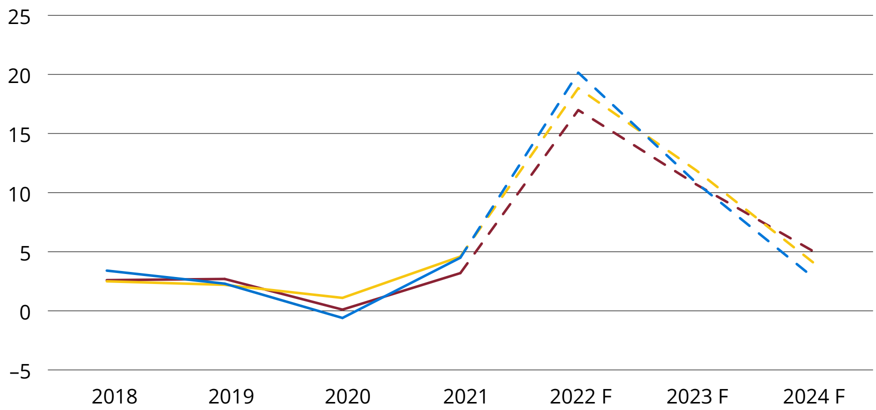
Real GDP
(%; year-on-year)



Latvia
Lithuania
Estonia

Source: Eurostat. Forecast: OECD.

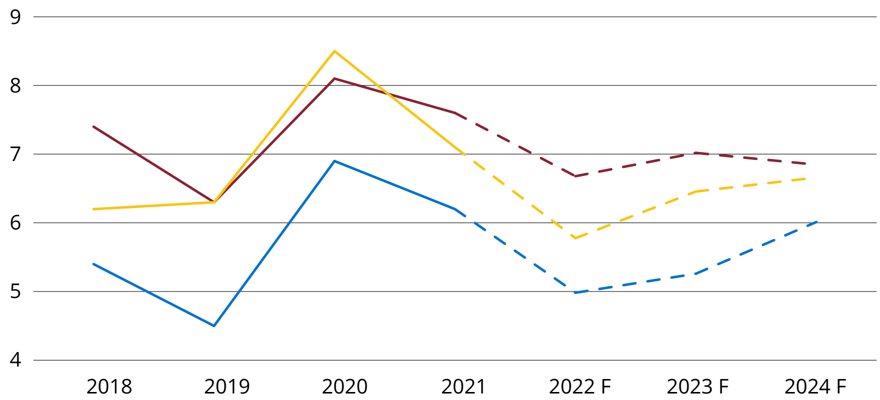
Inflation rate
(%; year-on-year)



Latvia
Lithuania
Estonia

Source: Eurostat. Forecast: OECD.

Unemployment rate
(% of economically active population)



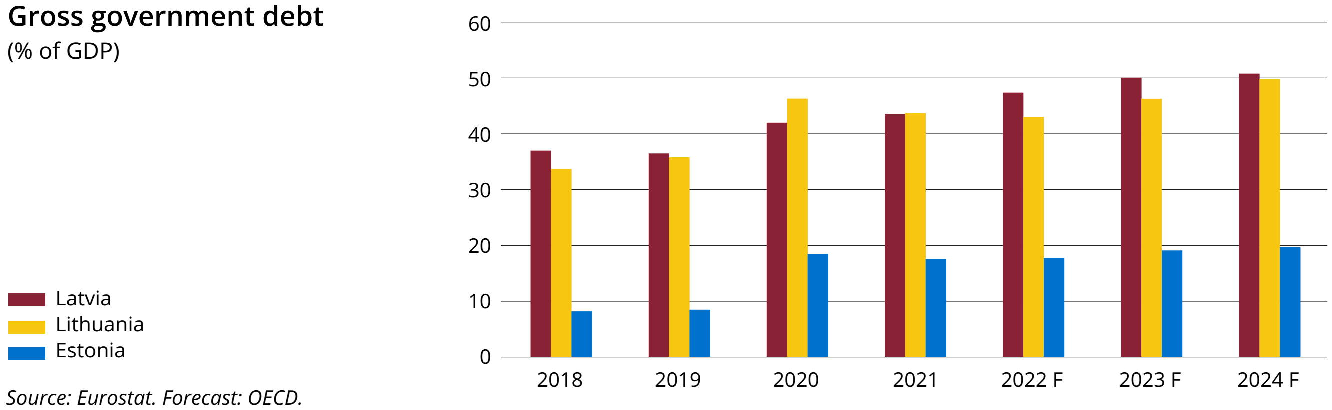
Latvia
Lithuania
Estonia

Source: Eurostat. Forecast: OECD.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

Gross government debt

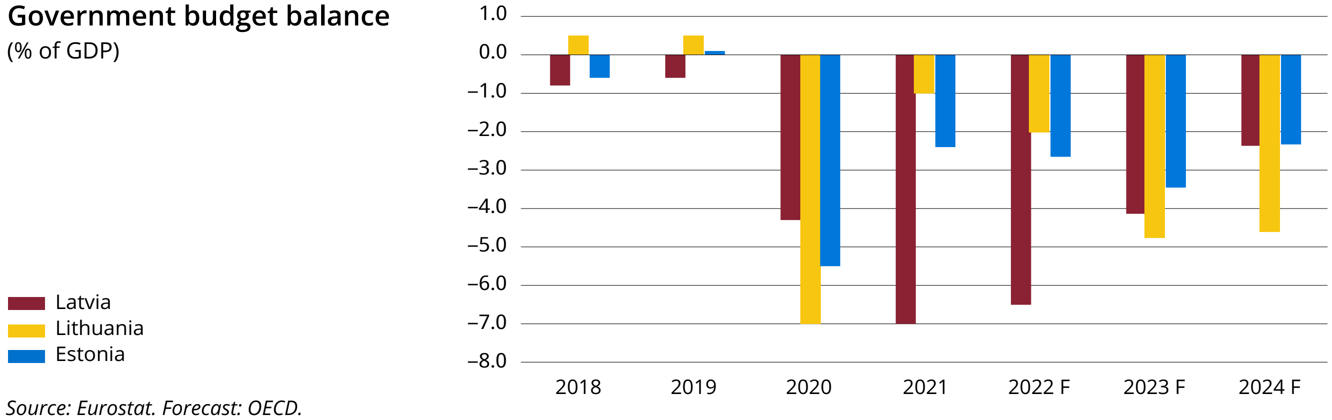
(% of GDP)



Source: Eurostat. Forecast: OECD.

Government budget balance

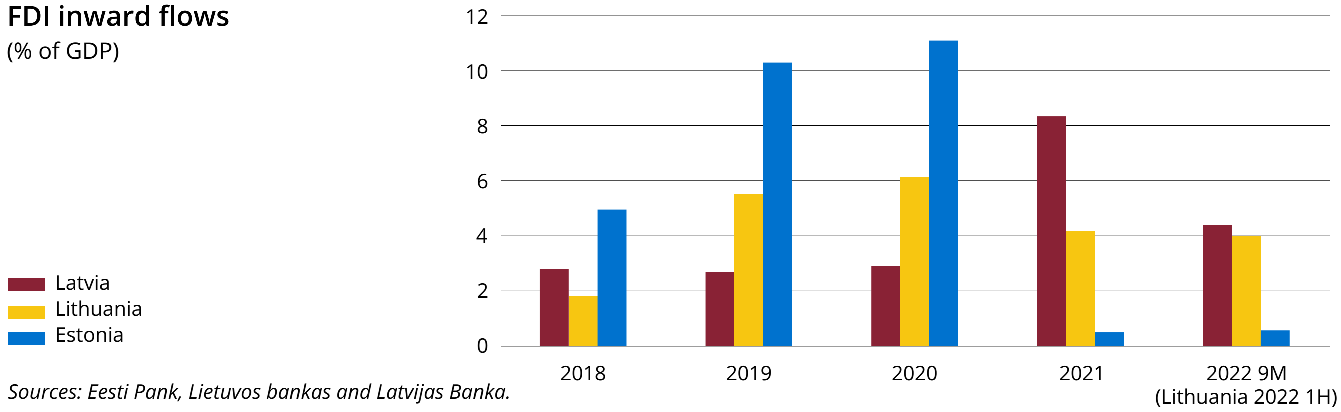
(% of GDP)



Source: Eurostat. Forecast: OECD.

FDI inward flows

(% of GDP)



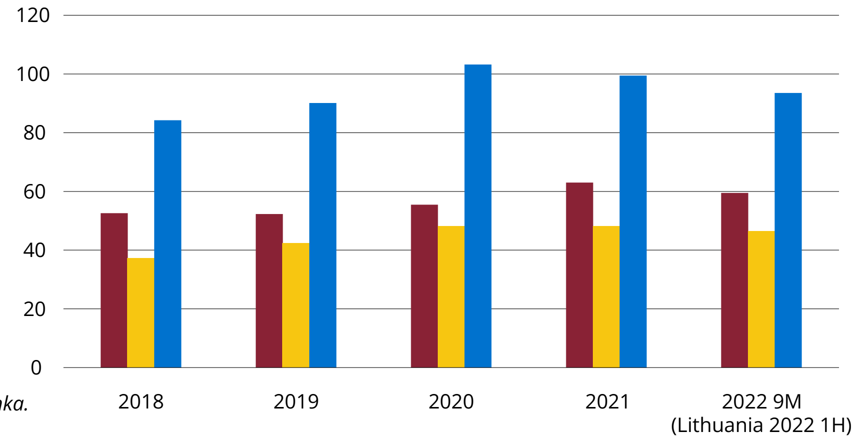
Sources: Eesti Pank, Lietuvos bankas and Latvijas Banka.

Macroeconomic Indicators: Latvia, Lithuania and Estonia

FDI inward stocks

(% of GDP)

Latvia
Lithuania
Estonia

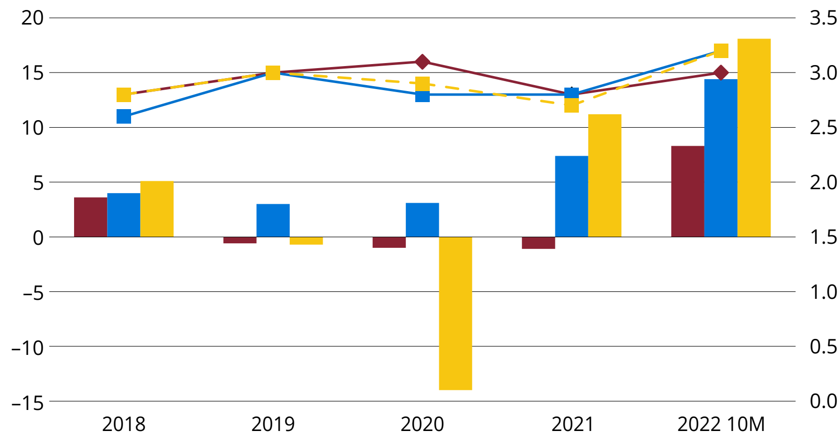


Sources: Eesti Pank, Lietuvos bankas and Latvijas Banka.

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.