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Abbreviations

AS – joint stock company
CSB – Central Statistical Bureau of Latvia
DSGE model – Dynamic Stochastic General Equilibrium Model
EC – European Commission
ECB – European Central Bank
EONIA – euro overnight index average
EU – European Union
EURIBOR – Euro Interbank Offered Rate
FRS – US Federal Reserve System
GDP – gross domestic product
HICP – Harmonised Index of Consumer Prices
IMF – International Monetary Fund
MFI – monetary financial institution
OPEC – Organization of Petroleum Exporting Countries
OPEC+ – OPEC Member States and the Russian Federation, the Republic of Azerbaijan, the Kingdom of Bahrain, Brunei Darussalam, the Republic of South Sudan, the Republic of Kazakhstan, Malaysia, the United Mexican States, the Sultanate of Oman and the Republic of Sudan
PEPP – Pandemic Emergency Purchase Programme
SEA – State Employment Agency
TLTRO – targeted longer-term refinancing operation
UK – United Kingdom
US – United States of America
VAS – state joint stock company
VAT – value added tax

Introduction

In 2020, GDP declined less than expected on account of favourable financial conditions, government support and various economic agents that were able to adapt to the pandemic restrictions. Despite the vaccination roll-out leading to significantly higher expectations of the global economic recovery, the negative impact of the pandemic could still be observed at the beginning of 2021, and Latvia's GDP, most likely, also declined in the first quarter of the year. The tightened consumption restrictions and high uncertainty continue to stimulate the build-up of savings, with the growth rate of deposits standing at a 13-year high. The risk perception of banks and cautiousness of borrowers hamper the recovery of lending. Meanwhile, loans for house purchase remain on a moderate upward trend. However, the GDP growth forecast for 2021 overall was increased to 3.3%. With the number of vaccinated people growing, in the second half of 2021 the restrictions are expected to be eased and consumers – to have more opportunities to use their savings accumulated during the crisis. With the business confidence improving, investment activity will increase as well. Export expansion is expected to be in line with external demand growth. Moreover, the recovery is projected to be robust and to continue in 2022 against the backdrop of stronger GDP growth.

While the spread of Covid-19 has complicated the labour market situation, the availability of government support has helped prevent a steeper increase in the unemployment rate. Wage growth is supported by a raise of the minimum wage, wage increases for several public sector occupations as well as Covid-19 pandemic-related premiums.

With the consumer price deflation coming to an end, the rising prices of global commodities and services will drive consumer prices higher. While inflation is not expected to surge, in some months of 2021 the year-on-year inflation may temporarily approach the level of 3%. For 2021 overall, however, Latvijas Banka's inflation forecast has been raised to 1.8%. In 2022, inflation is expected to increase slightly further.

1. External Demand

Last year ended with good news about the efficacy of several developed vaccines, giving reason to expect that the pandemic will be contained in 2021. Meanwhile, several repeated Covid-19 outbreaks in different regions of the world, the slow rate of vaccination as well as new variants of the virus give rise to concerns over the pace of economic recovery.

In its January 2021 forecast, the IMF estimates that the global economy contracted by 3.5% in 2020. This result is better than projected by the IMF in autumn 2020 as it is based on a faster recovery in the third quarter of 2020 as well as higher economic resilience over the following virus outbreaks during which governments introduced much more targeted measures to contain the spread of the virus. The extensive monetary policy and fiscal policy support instruments employed by major central banks and governments respectively to mitigate the consequences of the Covid-19 pandemic crisis, dampened the decline in the economic activity.

In the view of the IMF, the future progress of economic recovery will vary across countries depending on the epidemiological situation, the pace of vaccination, the efficiency of the support measures introduced as well as the structural economic characteristics and the related cross-border transmission effects. Given these factors, the IMF expects the global economy to grow by 5.5% and 4.2% in 2021 and 2022 respectively. Compared to the autumn 2020 forecast, the assessment for 2021 was revised upwards by 0.3 percentage point, reflecting expectations of an accelerated vaccination roll-out and further strengthening of the economic activity stimulated by the fiscal support which is provided in major developed countries. Purchasing Managers' Index increased from 52.5 in September to 53.2 in February. The improvement in sentiment was primarily driven by a growing number of new orders as well as rising commodity prices owing to higher demand and overburdened supply chains. Over the coming months, the deterioration of the epidemiological situation may become the main obstacle to faster economic recovery.

At the end of the previous year, several downside risks did not materialise and the balance of risks improved. At the end of 2020, the EU and the UK reached a Trade and Cooperation Agreement, inter alia providing for zero tariffs and quotas on all goods complying with the appropriate rules of origin. The agreement significantly improved the EU-UK trade expectations. The UK Parliament ratified the agreement on 30 December 2020, whereas the European Parliament intends to ratify it in the first half of 2021. Meanwhile, 2021 started with the US Congress officially confirming the victory of Joe Biden, the Democratic candidate for the presidential election held in autumn. This gives reason to hope that the US will improve its trade relationships with its key cooperation partners and participate in the fight against climate change. Growth expectations for 2021 also improved on account of the economic stimulus package proposed by US President Joe Biden and approved in March. The package amounts to 1.9 trillion US dollars, i.e. 8.9% of GDP, constituting the third fiscal injection into the US economy during the Covid-19 crisis.

Improvements in the economic outlook were also reflected in rising commodity prices. Looking at the oil market, OPEC+ countries have continued to cut the group's total oil output by 7.2 million barrels per day, and Saudi Arabia is committed to voluntarily reduce its oil output by another 1 million barrels per day by April. As a result, in February 2021 the price of oil per barrel returned to its pre-pandemic level, exceeding 60 US dollars per barrel.

The US economic situation has improved significantly suggesting strong future growth. Following a record-high growth rate in the third quarter of 2020, which saw a 7.5% increase quarter-on-quarter, the US economy continued its recovery. In the last quarter of the year, its growth rate was 1.1% higher than in the previous quarter. The rapid expansion was largely supported by a rise in investment and private consumption. In 2020 overall, the

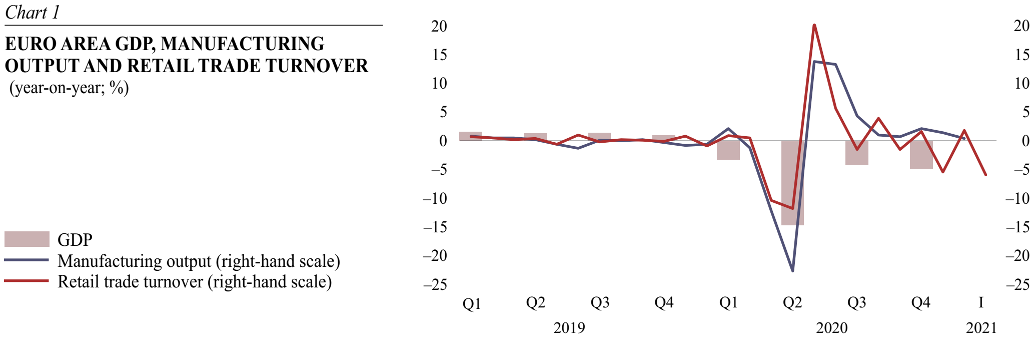
US economy contracted by 3.5%. Labour market data point to another improvement. In February 2021, the unemployment rate declined to 6.2%, while the increase in the number of jobs significantly exceeded analysts' expectations. Given the rising energy prices as well as the upward pressure of commodity prices, the US annual inflation reached 1.7% in February. The rise in inflation has affected the expectations that the monetary policy support measures could be phased out faster. According to the IMF forecasts, the rate of the US economic recovery will be 5.1% in 2021 and 2.5% in 2022.

One of the factors leading to a better-than-expected growth rate in the third and fourth quarters of 2020, was the rapid containment of Covid-19 in China and the following recovery in global trade. At the end of the year, China already recorded economic growth. Moreover, in 2020 overall its GDP grew by 2.3%. The Purchasing Managers' Indices point to slower growth in February 2021. Nevertheless, they suggest strong recovery in both services and manufacturing sectors. The IMF expects China's economy to grow by 8.1% and 5.6% in 2021 and 2022 respectively. Meanwhile, in the fourth quarter of 2020 Japan's economy was more resilient than initially expected. Its GDP increased by 2.8% quarter-on-quarter, whereas in 2020 overall it declined by 4.8%. At the same time, given the growing number of Covid-19 cases as well as the second state of emergency declared by the government in early January, growth is expected to slow down in the first quarter of 2021. In the second quarter, however, the economy will start its recovery supported by a significant government budget approved for this year. According to IMF forecasts, Japan's GDP growth will be 3.1% and 2.4% in 2021 and 2022 respectively.

In the last quarter of 2020, the euro area economy contracted by 0.7% quarter-on-quarter, whereas in 2020 overall euro area GDP declined by 6.6%, less than ECB had expected in its 2020 forecasts (–7.3%). In the second half of 2020, Europe faced repeated waves of Covid-19 outbreaks. Nonetheless, the experience gained during the first wave allowed governments to introduce more targeted restrictions which mostly affected the economic activity in the services and manufacturing sectors. Thus, in the last quarter of 2020 retail trade shrank by 1.2% quarter-on-quarter. Meanwhile, the output of manufacture recorded an increase of 3.0%, thereby supporting recovery. According to the Purchasing Managers' Index, the K-shaped recovery continued in the first two months of 2021 as the sentiment in the manufacturing sector strengthened, while that in the services sector remained pessimistic. Owing to the fiscal support, the labour market was resilient against the shocks of the Covid-19 pandemic crisis. In January 2021, the unemployment rate was 8.1%, only 0.7 percentage point higher year-on-year. On account of an upward pressure from external factors as well as increases in the tax rate on carbon dioxide emissions and the value added tax rate in Germany at the beginning of the year, euro area recorded a rise in inflation. While the price level was still 0.3% lower year-on-year in December 2020, it was already 0.9% higher year-on-year in February 2021. Inflation was also driven by changes in consumer behaviour observed in 2020. According to the March 2021 ECB staff macroeconomic projections, euro area GDP is expected to grow by 4% in 2021, almost unchanged from the December 2020 Eurosystem staff macroeconomic projections,

Chart 1

EURO AREA GDP, MANUFACTURING OUTPUT AND RETAIL TRADE TURNOVER
(year-on-year; %)



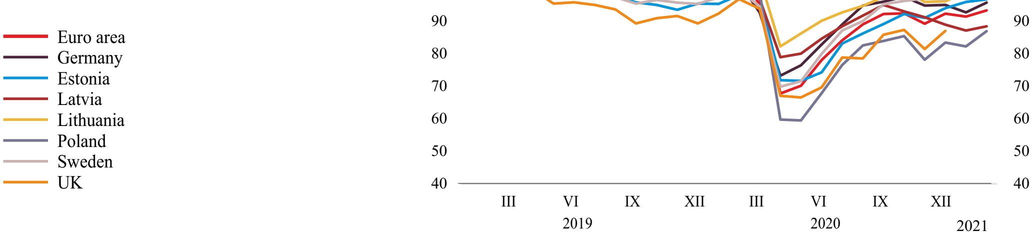
representing only a 0.1 percentage point improvement. Meanwhile, according to the March 2021 ECB staff macroeconomic projections for 2022, the euro area economy will grow by 4.1%.

Furthermore, in the last quarter of 2020 and in 2020 overall Latvia's major EU trade partners continued recording stronger economic growth than the euro area on average.

Following the relatively resilient performance during the crisis, the Baltic States continued their successful recovery. In 2020, Lithuania and Estonia fared well compared to most EU countries, with their economies only contracting by 0.8% and 2.9% respectively. The two largest Latvia's foreign trade partners were among the few EU countries that were able to expand their exports of goods in 2020. In 2021, the neighbouring countries are expected to continue their dynamic development, albeit slightly slower than euro area on average. Germany was also able to record growth in the fourth quarter, despite the structural issues and supply disruptions in the automotive industry. According to preliminary data, the total annual decline in Germany's economy was slightly less pronounced than in euro area on average. Strong fiscal stimulus as well as less stringent restrictions implemented over shorter time-frames compared to those implemented in other major economies allowed Germany to slow down the contraction of employment and encouraged renewed consumption of goods. Furthermore, stronger external demand facilitated the recovery of manufacturing at the end of the year. However, with Germany's production, including construction, declining by 2.5%, in January the recovery of its manufacturing was delayed, thus weakening Germany's prospects of starting the year with economic growth. According to the EC forecasts, Germany will be the first major EU country to reach the pre-crisis level of GDP.

Chart 2

ECONOMIC SENTIMENT INDICATORS
(long-term average = 100)



Sweden's economy contracted less than most EU economies in 2020 as it saw a less pronounced decline in the second quarter and stronger growth in the fourth quarter. At the turn of the year and in early 2021, the Covid-19 infection rate in Sweden was one of the highest in the world and, consequently, restrictions were tightened in Sweden. Nonetheless, for the entire duration of the pandemic and even after their tightening, Sweden's restrictions remained among the mildest globally. Furthermore, at the beginning of the year the economic sentiment in Sweden improved further un turned positive owing to strong industrial confidence. Other economic sectors also suggested expectations of robust development. According to the EC forecasts, Sweden's economy will grow by 2.7% and 4.0% in 2021 and 2022 respectively.

The UK fared much worse due to the fact that the services sector and the automotive industry represent a large share in the UK's economy which contracted by 10% in 2020. Thus, it will take longer for it to rebound to its pre-crisis level. Due to delays associated with the implementation of the new UK-EU trade regulation, UK's exports suffered a record-steep decline. This led to the decision to start implementing the new procedure on imports half a year later, i.e. in 2022, thus reducing obstacles and also improving the outlook of Latvia's exports to this country.

According to the preliminary data, Russia's GDP declined by 3.1% in 2020. This should be considered good performance, considering that, apart from the direct impact of the virus-related restrictions, Russia's economy also suffered from the plummeting oil prices. Therefore, due to the steep decline in the value of exports, Russia's positive trade balance deteriorated significantly, whereas private consumption shrank by more than 8%. The fall in economic activity was cushioned merely by an increase in government spending, envisaged to be gradually phased out on the back of oil prices which started rising again in 2021. Assuming that Covid-19 vaccines will be broadly available and the external environment will improve, the IMF forecasts developed at the beginning of 2021 envisage Russia's economy to grow by 3.0% and 3.9% in 2021 and 2022 respectively.

2. Financial Conditions

With the risks of the second wave of the pandemic materialising at the turn of the year, the ECB and the Bank of England decided on further monetary easing, whereas the FRS and the Bank of Japan chose to preserve the existing highly accommodative monetary policies. Despite the renewed upsurge in Covid-19 infections and the economic effect of the associated restrictions, financial markets remained optimistic. The positive sentiment is largely inspired by the supportive monetary and fiscal policies. Combined with the successful development and roll-out of the vaccines, this gives reason to expect a return to normal life in a foreseeable future.

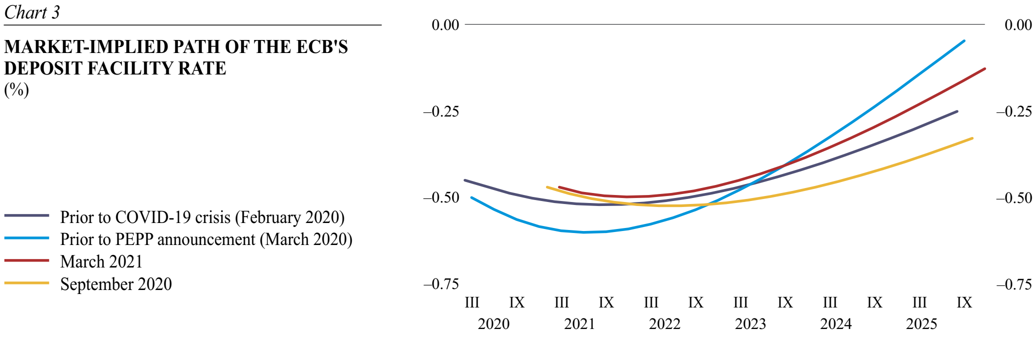
2.1 Decisions of the ECB and other major central banks

Following an assessment of the economic outlook, the Governing Council of the ECB decided to strengthen the degree of monetary accommodation by increasing the envelope of the pandemic emergency purchase programme (PEPP) by 500 billion euro and extending the horizon for purchases by another nine months. The PEPP envelope was increased to a total of 1850 billion euro, whereas the asset purchases will continue at least until the end of March 2022. With this decision, the ECB strengthened the market expectations of a strong monetary policy support to tackle market fragmentation and any disruptions in monetary policy transmission. At the same time, the ECB confirmed that, with a view to maintaining favourable financing conditions, the asset purchases within the framework of the PEPP can be recalibrated as needed, which means that the envelope may not be used in full or it can be increased if required by the economic and financial conditions. The amount of asset purchases made at the turn of the year was smaller, and at the end of February almost 47% of the PEPP envelope were used up. At the same time, at its March meeting, the Governing Council announced that it expected purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year.

The ECB also decided to further recalibrate the conditions of the third series of targeted longer-term refinancing operations (TLTRO III) by raising the total amount of borrowing in TLTRO III operations and announcing that it would conduct three additional operations between June and December 2021. The period over which considerably more favourable terms will apply was also extended by twelve months (until June 2022). The especially favourable TLTRO III borrowing conditions will be made available only to credit institutions that achieve the corporate and household lending performance targets. The terms of the traditional asset purchase programme (APP) and the key ECB interest rates remained unchanged over the reporting period.

Chart 3

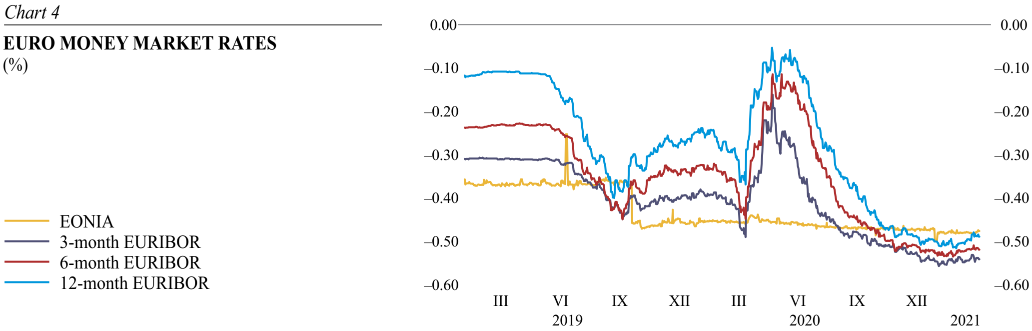
MARKET-IMPLIED PATH OF THE ECB'S DEPOSIT FACILITY RATE
(%)



Christine Lagarde, President of the ECB, has pointed out that economic developments continue to be uneven across countries and sectors, with the services sector being more adversely affected by the restrictions on social interaction and mobility than the industrial sector, which is recovering more quickly. Looking ahead, the ongoing vaccination campaigns together with the gradual relaxation of containment measures – barring any further adverse developments related to the pandemic – underpin the expectation of a firm rebound in economic activity in the course of 2021. Overall, the ECB continues to stress that the financing conditions should remain favourable, in order to ensure the convergence of inflation to the ECB's medium-term target of below, but close to, 2%. President of the ECB also pointed out that the risks surrounding the euro area growth outlook over the medium term have become more balanced, although downside risks remain in the near term. Better prospects for the euro area's external demand, bolstered by the sizeable fiscal stimulus, and the progress in vaccination campaigns are encouraging. Nevertheless, the ongoing pandemic, including the spread of virus mutations, and its implications for economic and financial conditions continue to be sources of downside risk.

Chart 4

EURO MONEY MARKET RATES
(%)



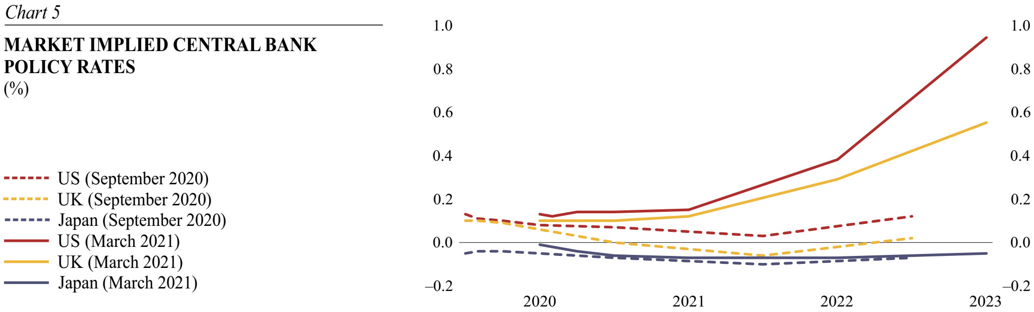
Financial markets do not expect any changes in the key ECB interest rates earlier than in 2023.

At the beginning of autumn, the FRS announced a change to its monetary policy goal. The FRS is mandated to achieve maximum employment and longer-term inflation of 2%. With inflation running persistently below its longer-run goal, it was judged appropriate to aim to achieve inflation moderately above 2% for some time so that to support the anchoring of longer-term inflation expectations. Although the target range for the federal funds rate has been left unchanged at 0.00%–0.25% since September, the FRS has enhanced its forward guidance by stating that it expects to maintain the target range at the existing level until labour market conditions have reached levels consistent with the FRS's assessments of maximum employment and inflation has reached the new target. At the same time, the FRS also continues its asset purchase programmes by increasing its holdings of both US Treasury securities and agency mortgage-backed securities at a monthly pace of 120 billion US dollars. The US economic forecast published by the FRS in December was revised upwards in comparison with the September forecast. Nevertheless, at the end of January, the FRS already admitted that the economic recovery was decelerating under the impact of the second wave of the COVID-19 pandemic. At the same time, the inflation expectations priced in by the US financial markets have risen and have sparked discussions among analysts as to whether the FRS should perhaps start signalling that it might reduce the stimulus. Nevertheless, Jerome Powell, the Chair of the FRS has announced that, at the current juncture, any talks about tapering would be premature. Over the most recent months, the rise in inflation expectations priced in by the financial markets is largely associated with the enormous US fiscal policy support. Consistent with higher inflation expectations, the financial markets also expect an earlier rise in the FRS interest rates (at the turn of 2023), contrary to the FRS guidance that the target range will remain unchanged in a foreseeable future.

Like the ECB, in face of a renewed rapid increase in Covid-19 infections, the Bank of England also decided to increase the target stock of purchased UK government bonds by an additional 150 billion British pounds sterling, thereby taking the cumulative amount of quantitative easing to 895 million British pounds sterling. At the same time, the Bank Rate was maintained at 0.1%. The Bank of England has been considering a negative Bank Rate for quite some time. Although steps have been taken to prepare for the implementation of a negative Bank Rate, at its February meeting, the Bank of England maintained that this is not a signal about the likelihood or imminence of a negative rate and a further analysis as to the potential effect of such a rate on its targets is required. As at the end of February, the financial markets no longer priced a negative Bank Rate in the future.

Chart 5

MARKET IMPLIED CENTRAL BANK POLICY RATES
(%)



The Bank of Japan has implemented no changes in its monetary policy since the beginning of September. The Bank of Japan is maintaining the short-term policy interest rate at –0.1% and the target level of 10-year government bond yields at around 0.0%. As to the asset purchases, the Bank of Japan indicates that it will preserve the current pace of purchases as long as it is necessary for achieving and maintaining the inflation target of 2% in a stable manner. The Bank of Japan is still reporting its readiness to take additional easing measures, if necessary, and it also expects short-term and long-term policy interest rates to remain at their present or lower levels. Financial markets do not price in any changes in the Bank of Japan's policy rates in a foreseeable future. At the same time, the Bank of Japan has launched a monetary policy strategy review, scheduled for completion in March 2021.

2.2 Global financial market developments

From the beginning of September 2020 to the end of January 2021, the sovereign bond markets of developed economies were relatively calm, but later, with the incoming news of the expected sizeable fiscal stimulus, inflation expectations in the United States started to rise steadily, triggering a sell-off of longer-term US Treasury bonds. Mirroring the developments in the United States, the yields of longer-term euro area government bonds also started to rise. From the beginning of September 2020 to 10 March 2021, the yield on the German 10-year government bonds has increased by 12 basis points, whereas the yield of the respective maturity US Treasury bonds grew by 89 basis points. Initially, the euro area government bond yields co-moved with the yields on the US Treasury bonds, but in the first week of March their movement reversed. The decline of the euro area government bond yields in the first week of March can be explained by the publicly-expressed concerns of the ECB executives about the tightening of the financial conditions and the subsequent ECB's decision, over the next quarter, to conduct purchases under the PEPP at a significantly higher pace than during the first two months of the year. This decision of the Governing Council of the ECB made market analysts realise that any expectations of a steeper rise in the euro area yields would be premature. An analysis of the spreads between benchmark bonds (German government bonds) and other euro area government bonds leads to a conclusion that the country-specific risks have decreased in the reporting period. Italy, where the yields on 10-year government bonds have decreased by 35 basis points since September, to stand at 0.68% on 10 March, is worth a special mention. There has been a change of the government in Italy in the reporting period, with Mario Draghi, the former President of the ECB, becoming the new Prime Minister, and this makes financial markets confident that the Italian government is set on the course to implement the highly required reforms. At euro area government debt securities auctions, bids for new issues still more than exceed the supply. Over the coming months, the yields on euro area government debt securities will continue to be largely affected by inflation expectations as well as the ECB's monetary policy. As long as the medium-term inflation does not sustainably converge with the level of 2%, the ECB can be expected to prevent any tightening of the financing conditions.

The spreads of the euro area corporate bonds relative to benchmarks have continued to narrow. The largest decrease in yields was reported specifically for high-yield debt securities. In the circumstances of continued fiscal measures implemented by governments to support economic activity and particularly favourable financing conditions maintained by central banks, investors continue to search for higher yields. The number of companies defaulting on their liabilities to the holders of their debt securities remains low. At the same time, new issues have primarily increased in the high-yield debt securities segment since the beginning of the year, suggesting that companies enjoy access to market financing and investors are optimistic about the future prospects. Further development of corporate bond yields will largely depend on the speed of containing the pandemic and successful restoration of the economic activity.

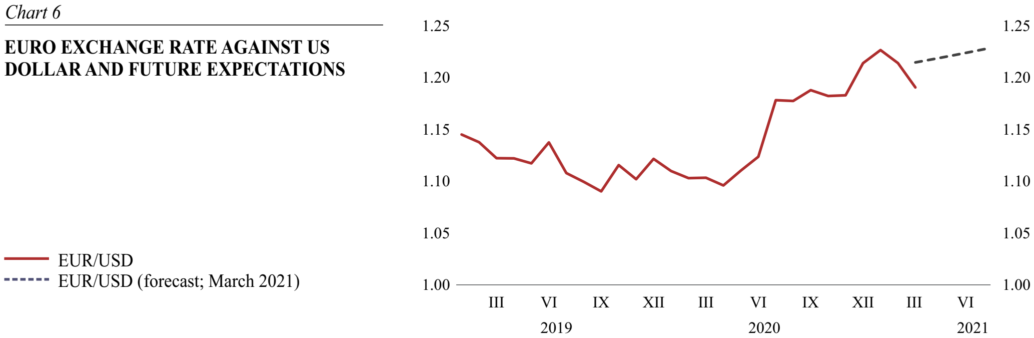
Since the beginning of September, stock markets in both the euro area and the United States exhibited individual brief episodes of higher volatility, as suggested by VSTOXX and VIX indices. The first episode of elevated volatility was observed at the end of October, with the emergence of the first news of the second wave of the pandemic, accompanied by the uncertainty surrounding the outcome of the US Presidential elections. The second episode was registered at the end of January, caused by concerns about new coronavirus strains and the slow progress with vaccine roll-out, whereas the third episode was observed at the end of February which coincided with financial markets pricing in the 1.9 trillion US dollar worth economic recovery plan of the US President Joe Biden. Inflation expectations rose steadily in anticipation of the fiscal stimulus in the United States, followed by an increase in longer-term US Treasury bond yields, prompting investors to adjust their debt portfolios accordingly. In each of those episodes, both EuroStoxx 600 characterising the European stock market and S&P 500 characterising the US stock market temporarily decreased. Nevertheless, in the whole period from the beginning of September 2020 to 10 March 2021, EuroStoxx 600 and S&P 500 appreciated by 17% and 10% respectively. A more impressive rise in the case of European stocks can be primarily explained by weaker previous growth. Looking at stock performance across European countries, better results as compared to the German Stock Index DAX were achieved by the French CAC 40, Italian FTSE MIB and Spanish IBEX 35 indices, appreciating by 12%, 21%, 22% and 23% respectively. Overall, the stock markets both in Europe and the United States are still largely affected by market sentiment, yet corporate earnings are also higher than projected by analysts in most cases. The role of market sentiment as the driver of stock prices is also confirmed by the previously-mentioned brief volatility surges, where adjustments were usually followed by steeper spikes. At the beginning of November, stock prices started climbing steadily against the background of the successful vaccine testing news, whereas at the beginning of February the market sentiment was improved by expectations of a more sizeable than expected fiscal stimulus in the United States as well as, in general, by the strengthening of the confidence that, with the vaccine roll-out proceeding smoothly, the pandemic could be contained in a foreseeable future. The last adjustment at the end of February was delayed by central bank signals, particularly the remark of the Chair of the FRS that any talk about monetary tightening is premature. Looking by sector, since the positive news about the vaccine testing, the largest improvements in stock prices were reported for cyclical sectors that were hit the hardest at the onset of the pandemic. Going forward, the stock market developments will significantly depend on the progress with vaccination and further containment of the pandemic. While vaccination is still only gathering pace, the key role will be played by the ongoing central bank support to favourable financing conditions.

From the beginning of September 2020 to 10 March 2021, the euro depreciated by 0.4%

0.4% against the US dollar (to 1.188 US dollars per euro). There was some volatility throughout the period, with the exchange rate peaking at the turn of 2020, when it climbed above 1.23 US dollars per euro for a short time. The appreciation of the euro against the US dollar observed in the autumn months was related to the general weakening of the US dollar against a broader basket of currencies. This was initially sparked by both the FRS announcement at the beginning of autumn of a change to a medium-term inflation objective and the uncertainty about the outcome of the US Presidential election, an additional factor being the successful vaccine development, causing a shift in cash flows to riskier assets. At the same, the historical relative attractiveness of interest rates, which swiftly changed in favour of the euro at the onset of the pandemic, continued to put an upward pressure on the euro. EU-UK Trade and Cooperation Agreement, signed at the turn of the year, also was positive news for the euro. The subsequent depreciation of the euro was related to both the expected sizeable fiscal stimulus in the United States and the relatively slow vaccine roll-out in the euro area as compared to the United States. Going forward, analysts have reduced their expectations of the euro's appreciation vis-à-vis the US dollar in comparison with what was projected in the autumn months. At the same time, they also do not anticipate a major weakening of the euro. Such an assessment is based on concerns that the economic recovery in the euro area will take longer than that in the United States, and this will also be reflected in the central bank decisions. In the coming months, the movement of the euro exchange rate against the US dollar will largely depend on successful and quick containment of the pandemic in the euro area, with the key factor being the pace of vaccination.

Chart 6

EURO EXCHANGE RATE AGAINST US DOLLAR AND FUTURE EXPECTATIONS



2.3 Financing conditions in the Latvian economy

Despite the second wave of the Covid-19 pandemic, Latvia's credit ratings remained unchanged, and the financial conditions remained favourable. The tight restrictions and deterioration of the business and consumer confidence continue to stimulate the build-up of forced and precautionary savings, maintaining a high growth rate of deposits with credit institutions. Lending recovery was dampened by a higher risk perception of banks upon expiry of the moratoriums on fulfilment of obligations and cautiousness in investment decisions. Overall, the financing conditions for households and businesses did not deteriorate significantly. A positive surprise was the housing market's adjustment to the new circumstances: despite the high uncertainty caused by the Covid-19 crisis, the demand for new loans increased, while the respective interest rates were reduced.

Given the pandemic and negative sentiment, the decline in the loan portfolios of non-financial corporations and households should be considered moderate. Thanks to the accommodative monetary policy and bank relief measures to businesses working in the sectors suffering the most from the crisis, from December 2020 to February 2021, the amount of outstanding loans shrank by a mere 1.6%, with corporate loans experiencing a somewhat larger decline and household loans remaining broadly unchanged. Loans for house purchase remained unscathed by the crisis and did not suffer from a weaker demand either, increasing by 1.0% during the same period. The ratio of loans to GDP remained at the level of 38% in 2020. The aggregate domestic loan portfolio expanded significantly in January 2021 on account of a one-off factor, i.e. a credit institution purchasing a leasing company and refinancing its debt. As a consequence, the domestic loan portfolio (including loans to financial institutions) increased by 4.3%. This also formally brought the annual rate of change in domestic loans to a positive territory (3.9% in February), although, looking past the impact of the structural changes in the banking sector, reclassification of the institutional sectors and one-off factors, the rates remained negative at –1.4% for aggregate loans, –2.2% for loans to non-financial corporations and –0.2% for household loans. Some stabilisation in lending was signalled by a rebound in new corporate loans and household loans from the previous low levels. Over the six months from September 2020 to February 2021, new loans increased by 16.3% in comparison with the previous six-month period from March to August 2020 (an increase by 22.4% and 11.4% in the case of household loans and loans to non-financial corporations respectively). Along with the decline in lending by credit institutions, loans by non-bank financial institutions also contracted at an overall annual rate of 6.0% in December 2020, including 7.1% in the case of loans by leasing companies.

Chart 7

DOMESTIC LOANS
(outstanding amounts at the end of period; % of GDP)

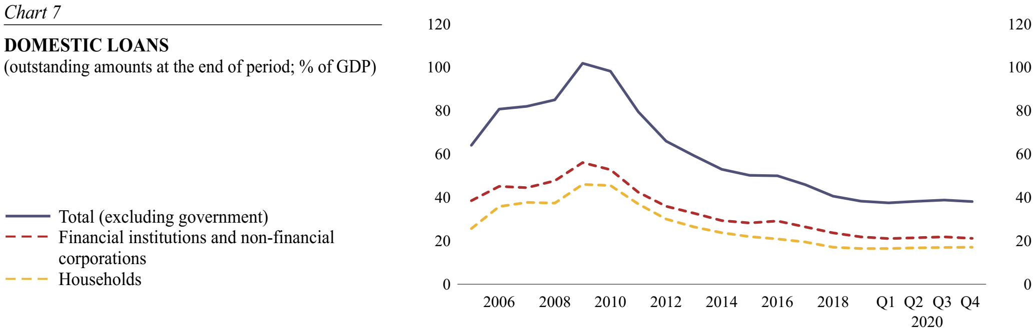
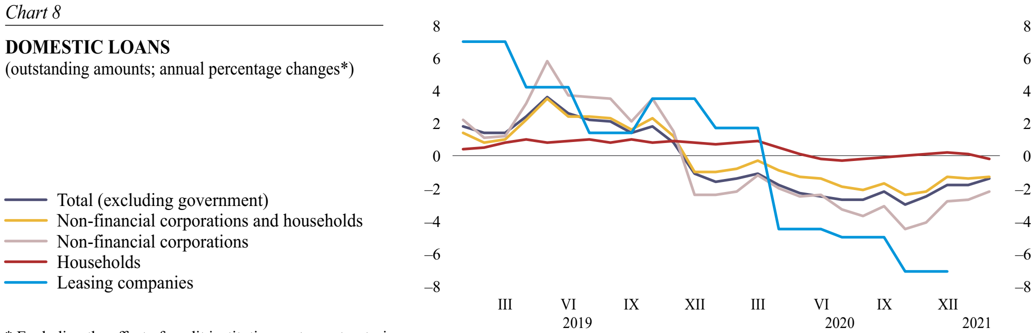


Chart 8

DOMESTIC LOANS
(outstanding amounts; annual percentage changes*)



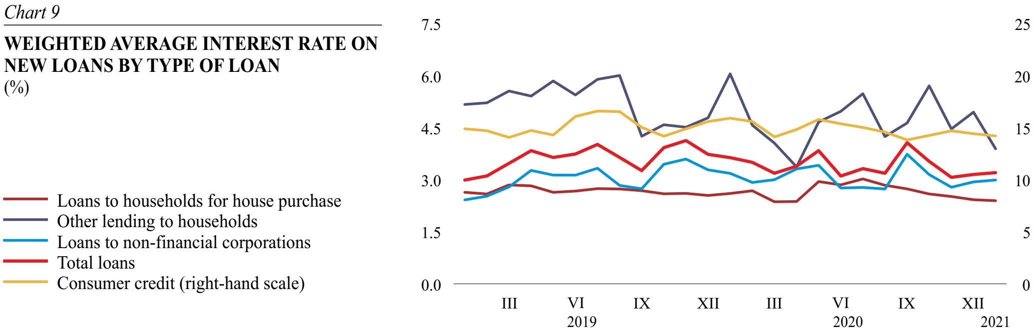
* Excluding the effect of credit institution sector restructuring.

As expected, the development of interest rates on loans to non-financial corporations was shaped by counteracting factors in the reporting period. After the first wave of the Covid-19 pandemic, the rates returned to the pre-crisis levels, followed by an increase when the second wave of the pandemic started gathering strength. On the one hand, the economic turbulences caused by the Covid-19 pandemic resulted in a higher credit risk of loans to non-financial corporations. Some significant credit institutions maintained tight credit standards in the reporting period and granted relatively little loans to non-financial corporations even at higher interest rates. Although according to the euro area bank lending survey responses, one of the surveyed Latvian credit institutions eased the credit standards on loans to non-financial corporations in the third quarter of 2020, this did not contribute to the return of the credit standards to the levels seen before the Covid-19 crisis. As a consequence, smaller credit institutions, traditionally granting riskier loans at a higher price, managed to increase their share in the new lending flows. With the moratorium concerning a universal approach of credit institutions to granting grace periods to loan repayments expiring in September, the proportion of renegotiated loans in new loans to non-financial corporations started to grow. Some credit institutions increased both the amount of renegotiated loans as well as their interest rates at the turn of the year, signalling that non-financial corporations have managed to renegotiate the terms of their existing loans. At the same time, an even higher rise in the interest rates on loans to non-financial corporations was prevented by the continuously high degree of monetary accommodation provided by the ECB, the support to businesses affected by the Covid-19 crisis provided by AS Attīstības finanšu institūcija Altum and other government support measures as well as the credit institutions' attempts to reduce the credit risk by requiring a larger collateral. From August 2020 to January 2021, the interest rate on new euro loans to non-financial corporations ranged from 2.7% to 3.7%, overall increasing by 0.2 percentage point (from 2.8% in July 2020 to 3.0% in January 2021). A higher credit risk premium can be expected to be priced in the interest rates of loans to non-financial corporations also in 2021, but it could decrease with the start of economic recovery following the Covid-19 crisis, improvement in the financial position of non-financial corporations and review of credit standards in some Latvian credit institutions.

A positive surprise in the period from August 2020 to January 2021 was the decline in the interest rate on loans for house purchase. The main reason behind the decrease was the effect from the AS Attīstības finanšu institūcija Altum housing guarantee programme, a rise in the share of collateralised loans and an improvement in the financial situation of some credit institutions. Overall, since July 2020, the interest rate on new euro loans to domestic households for house purchase decreased by 0.6 percentage point (2.4% in January 2021). In the second half of 2020, despite the Covid-19 crisis, household demand for loans for house purchase increased, as reported by two out of four Latvian credit institutions participating in the ECB's euro area bank lending survey. The credit institutions explained this change by the growing consumer confidence, housing market development and low level of interest rates. Another contributing factor could be the broadening of lending opportunities available to young families from the AS Attīstības finanšu institūcija Altum housing guarantee programme. With the demand growing, the amount of housing loans granted on the basis of new lending agreements increased in the second half of 2020. As the loans for house purchase were mostly secured by guarantees, they carried a lower interest rate and, with their share in the lending flows growing, the respective weighted average interest rate also declined. Moreover, according to the euro area bank lending survey, one out of four respondent Latvian credit institutions reduced its margin on loans to households for house purchase in the fourth quarter of 2020 on account of improved cost of funds and balance sheet constraints. In the first half of 2020, credit institutions also most often granted 1-year loan repayment holidays to households; therefore, the interest rates on housing loans do not reflect the real increase in household credit risk. Over the next half of the year, the interest rates on loans for house purchase will continue to be affected by the depth and duration of the Covid-19 crisis, as, with the loan repayment holidays and moratorium expiring, the quality of the previously-granted loans for house purchase could deteriorate and banks may have to revise upwards the lending rates in this segment.

Chart 9

WEIGHTED AVERAGE INTEREST RATE ON NEW LOANS BY TYPE OF LOAN
(%)



Consumer credit rates remained volatile. Nevertheless, some credit institutions slightly eased their terms and offered consumer credit at lower interest rates, particularly in the last quarter of 2020. The interest rate on new consumer credit and other lending to households in euro ranged from 9.6% to 11.9% in the reporting period. One of the four respondent Latvia's credit institutions admitted in the euro area bank lending survey that margins on consumer credit and other lending to households were reduced in the fourth quarter of 2020 on account of lower cost of funds and balance sheet constraints. Overall, the demand for consumer credit declined from August 2020 to January 2021, as suggested by a smaller amount of consumer credit and other lending to households granted on the basis of new loan agreements.

The protracted pandemic had a negative effect on the willingness and opportunities of spending and investment in both household and non-financial corporation sectors. At the same time, the solid export performance, rising wages, relatively low unemployment growth as well as the fact that several sectors escaped the negative impact of the crisis contributed to a solid build-up of savings on accounts with credit institutions. In February, the annual growth rate of domestic deposits reached 16.1%, the highest level since 2007. Deposits by both households and non-financial corporations expanded rapidly, with the annual growth rates in February standing at 14.9% and 16.7% respectively. From September 2020 to February 2021, domestic deposits with credit institutions overall increased by 1.2 billion euro or 8.9%, including a 662 million euro or 8.2% and a 450 million euro or 9.3% rise in the case of household deposits and deposits by non-financial corporations respectively.

Chart 10

CHANGES IN CREDIT STANDARDS AND DEMAND FOR LOANS TO NON-FINANCIAL CORPORATIONS
(net changes; % of surveyed Latvia's credit institutions)

Tightened credit standards
Demand for loans

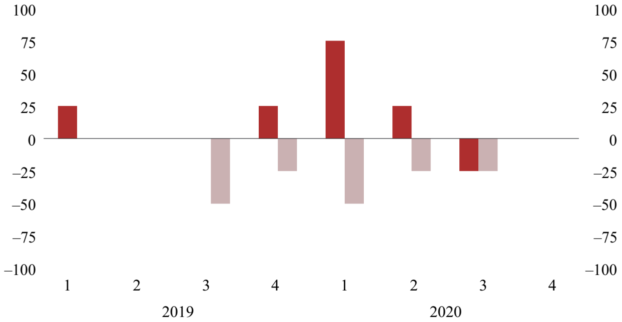
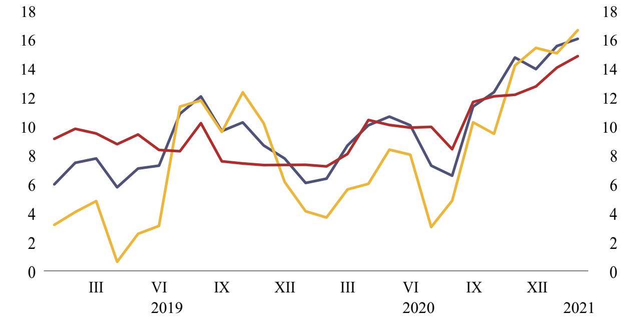


Chart 11

DOMESTIC DEPOSITS
(annual rate of change; %)

Total (excluding government)
Deposits by non-financial corporations
Deposits by households



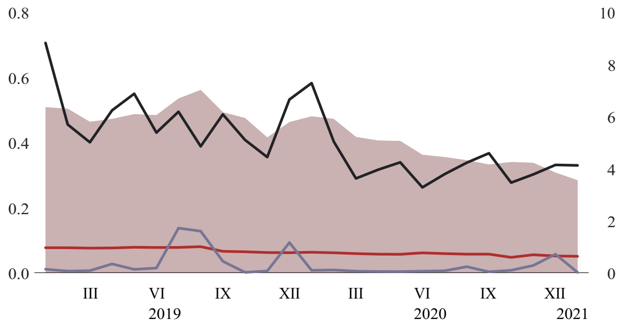
The cost of funds of Latvia's credit institutions on the domestic deposit market remained low. The interest rate on balances of euro deposits by domestic non-financial corporations and households, the same as the rate on new fixed term deposits, was close to 0% in the second half of 2020 and January 2021. Deposit rates remained low supported by the accommodative monetary policy of the ECB. A downward impact on deposit rates was also exerted by the changes in saving behaviour of households caused by the Covid-19 pandemic: the build-up of forced savings due to restrictions and precautionary savings due to uncertainty. With credit institution access to financing improving considerably, the need to compete for additional funding on the domestic deposit market and offer more favourable terms and conditions decreased. Moreover, the savings of households and non-financial corporations accumulated during the Covid-19 pandemic were mostly placed in demand deposits which are easier accessible but less profitable. The low level of deposit rates for Latvia's credit institutions enables credit institutions to offer domestic households and non-financial corporations loans at more favourable terms and conditions; nevertheless, in the circumstances of the Covid-19 crisis the key role is played by the lending policy changes implemented by the banks themselves, state support for loan guarantees as well as the level of borrowers' risk.

With the epidemiological situation in Latvia and its trade partners gradually improving, the growth of deposits by non-financial corporations could accelerate and the increase in private savings could slow down. Any noteworthy recovery in lending in the near term is unlikely, given the persisting risks to further economic development, the risk perception of credit institutions as the moratorium on fulfilment of obligations expires, negative economic sentiment and caution in investment decisions. Loan demand could shrink on account of loans being replaced by the funding available from the government support measures for sectors affected by the Covid-19 crisis, whereas household deposits could be temporarily pushed up by support to families with children and the allowance to pensioners, the disabled and persons who have lost their supporter, designated to reduce the negative impact of the Covid-19 spread.

Chart 12

INTEREST RATES ON DOMESTIC DEPOSITS AND SHARE OF FIXED-TERM EURO DEPOSITS
(%)

- Weighted average interest rate on euro deposits
- Weighted average interest rate on new euro deposits by non-financial corporations
- Weighted average interest rate on new euro deposits by households
- Share of fixed-term euro deposits in total deposits by non-financial corporations and households (right-hand scale)



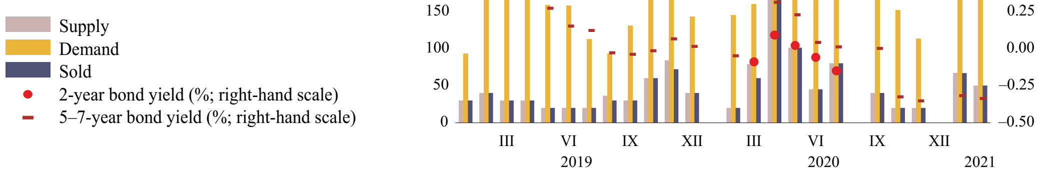
The international rating agency Fitch Ratings affirmed Latvia's long-term local currency and foreign currency issuer default rating at the previous A– level, revising the outlook from negative to stable. Fitch Ratings pointed out the limited effect of the Covid-19 outbreak on Latvia's economy and public finances due to effective and timely support measures to reduce the fallout from the Covid-19 outbreak as well as the resilience of Latvia's economy to external shocks. In January, the Japanese credit rating agency R&I affirmed Latvia's foreign currency issuer rating at A with a stable outlook. Regardless of the negative impact of the Covid-19 pandemic resulting in a sharp contraction of the Latvian economy, the economy's growth fundamentals remain intact so that the economy is likely to return to its growth trajectory once the pandemic settles down. In February, the international rating agency S&P Global Ratings raised Latvia's credit ratings to A+, maintaining a stable outlook on the economy.

Since September 2020, the Latvian government is placing its securities that were previously released on international markets on the domestic market (same ISIN for securities launched on both the domestic and international markets). The above securities were scheduled to mature in 2025, 2026 and 2027. In October, the average yield on bonds maturing in 2026 was –0.33%, whereas in February the average yield on bonds maturing in 2028 was –0.25%. The advantage of the above issues is that there is already quite a large amount of those bonds in circulation, they are highly liquid and are eligible for the use in the Eurosystem's asset purchase operations.

On the secondary market, the average yield on Latvian government bonds maturing in 2028 remained broadly unchanged, moving from –0.20% on 1 September 2020 to –0.19% on 9 March 2021. The high degree of monetary accommodation provided by the ECB supported a further decline in the yields on government securities, while higher global inflation expectations over the most recent months and contributed to an increase in those yields. The spread vis-à-vis corresponding maturity German government bonds narrowed from 36 basis points to 26 basis points, similar as in other euro area countries.

Chart 13

AUCTIONS OF GOVERNMENT SECURITIES
(millions of euro)



In December, Luminor Bank AS issued 300 million euro worth bonds on the Baltic private sector securities market, with a simultaneous buy-back in the amount of 250 million euro. The new bonds were with a 4-year maturity and the average coupon rate of 0.792% In February, AS mogo issued bonds in the amount of 30 million euro, also partly rolling over the previous bond issues; the maturity of the bonds was 3 years and the coupon rate was 11%.

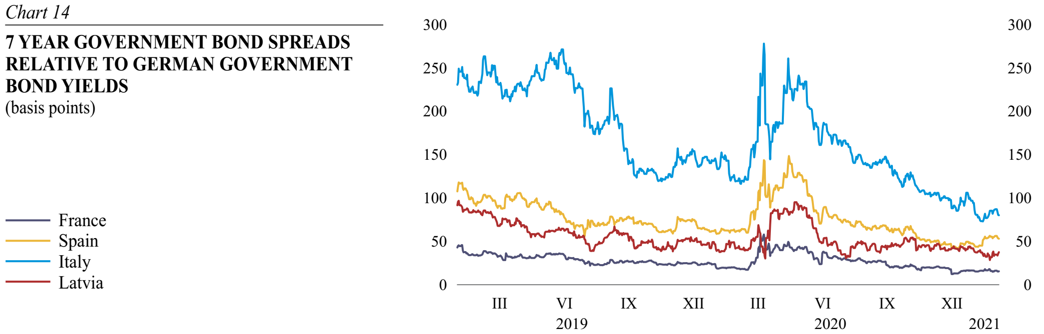
At the same time, AS GRINDEKS decided on delisting the company's shares and submitted a share repurchase proposal. Thus, 19 February was the last day when those shares were listed on stock exchange, and from 1 September 2020 to 9 March 2021 their capitalisation decreased by 15.2% (to 770.3 million euro). AS VALMIERAS STIKLA ŠĶIEDRA and AS Rīgas juvelierizstrādājumu rūpnīca also intend to delist their shares.

From 1 September 2020 to 9 March 2021, Latvia's share index OMXR and the Baltic share index OMXBBGI grew by 0.5% and 23.4% respectively. The share prices of Latvian companies changed significantly. The shares of AS MADARA Cosmetics and AS SAF TEHNIKA appreciated by 108.2% and 63.0% respectively, whereas the shares of AS GRINDEKS and AS Valmieras stikla šķiedra depreciated by 36.6% and 40.7% respectively; the latter sold its controlling stake to Duke I S. à r.l. registered in Luxembourg. The largest turnover in the period was reported for the shares of AS Olainfarm (2.9 million euro) and AS MADARA Cosmetics (0.9 million euro).

The FCMC presented a 10-step programme for the development of Latvia's capital market. The most important steps in the programme are investment of the state-funded pension scheme assets in Latvia's capital market, provision of qualitative information to issuers, promotion of passive investment and protection of investor interests. Finance Latvia Association presented a 15-point sectoral plan to facilitate access to funding for business development. The plan is focussed on four key areas: lending, capital market development, financial literacy and sustainable finance.

Chart 14

7 YEAR GOVERNMENT BOND SPREADS RELATIVE TO GERMAN GOVERNMENT BOND YIELDS
(basis points)



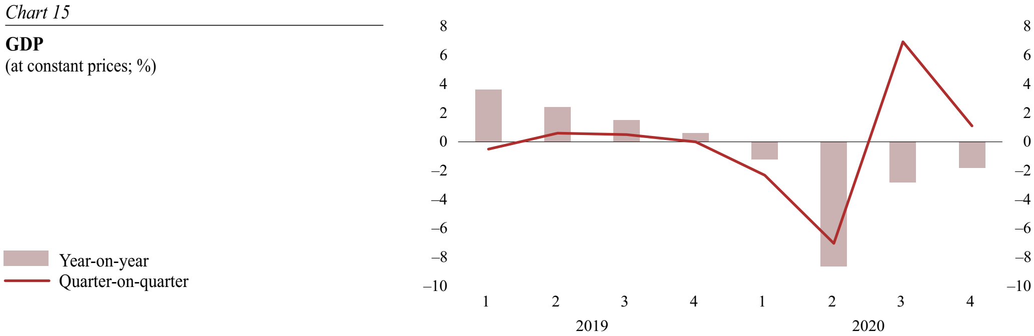
AS Attīstības finanšu institūcija Altum established its Investment Fund with an objective of supporting well-managed and promising businesses in temporary difficulties because of the Covid-19 crisis as well as developing the capital market. The total amount of the Fund is 100 million euro, and half of it consists of state financing, whereas the other half is private pension fund investments. The Fund can invest in a company's capital, grant loans as well as invest in corporate bonds. In February, the Fund completed the first transaction by purchasing AS ELKO GRUPA bonds in the amount of 2.9 million euro.

3. Sectoral Development[1]

At the end of 2020, with the spread of COVID-19 intensifying, the gradually increasing impact of social restrictions was offset by the ability of both businesses and consumers to adapt to teleworking as well as by other one-off and temporary factors, e.g. in agriculture and wood industry. Economic sectors recorded diverging growth: performance of industrial sectors was good, particularly that of the export-oriented ones, but contribution of several services sectors was adversely affected by the reinforcement of the COVID-19 pandemic containment measures.

Chart 15

GDP
(at constant prices; %)



The economic situation in the second half of 2020 was better than projected, and the effects of the newly announced state of emergency were not yet reflected in GDP contraction in the fourth quarter (GDP increased by 1.1% quarter-on-quarter). Opportunities for businesses to provide full-value services remotely are very divergent across sectors. Therefore, against the backdrop of the overall economic growth, the accommodation and food services as well as the recreational and cultural services sectors suffered from the recurrent contraction of economic activity already in the fourth quarter. Despite the government support and the population's opportunities to use their savings following the easing of restrictions, some of the capacity of the above sectors could be lost in case the pandemic lasts longer. Therefore, their return to the pre-crisis level could be slower than in the economy on average.

3.1 Manufacturing

Irrespective of restrictions and the rapid spread of COVID-19, contribution from manufacturing was far better than projected. This was largely due to a significant contribution from the wood industry. Compared to the third quarter, which enjoyed relatively summery weather and was less affected by COVID-19, the sector's value added increased by 4.2% in the fourth quarter and picked up by 4.0% year-on-year. However, the performance in the first quarter of 2021 is expected to be weaker. It has already been marked by the contracting output in manufacturing observed in January.

In the fourth quarter and in 2020 as a whole, manufacturing growth was notably affected by wood industry, which enjoyed favourable price and demand conditions and had also suffered less from insect damage in Latvian forests and those of Europe in general. At the same time, the impact of the pandemic was also evident as the restrictions and teleworking facilitated the popularity of the do-it-yourself segment. Many rushed to improve their homes with new floorings, cabinets, saunas and other practical and recreational elements.

The fourth quarter was also successful for manufacture of electrical and other equipment, printing, manufacture of rubber and plastic products and manufacture of parts for motor vehicles as well as for the sectors whose data are not disclosed for reasons of confidentiality (i.e. manufacture of pharmaceutical products, manufacture of computer and electronic

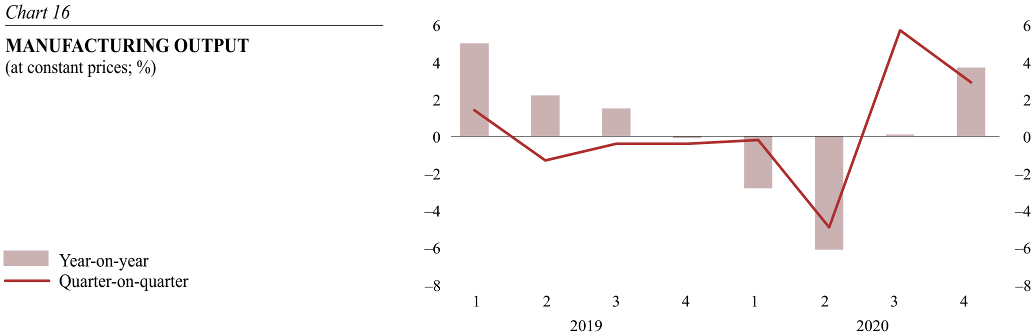
[1] This chapter analyses GDP and sectoral data at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

products and/or manufacture of other transport equipment). The year-end proved less successful for producers of food products and for the sector of repair and installation of machinery and equipment.

Unfortunately, the year 2021 has started with new problems to contend with, and there are reasonable grounds to project that manufacturing output will nevertheless edge down in the first quarter. The industrial confidence indicator is gradually deteriorating. Moreover, this is also the case in the sectors that delivered growth in the previous quarter. Preliminary statistical indicators for manufacturing output in January already mark a fall in the monthly rate of change (1.7%). The annual growth rate nonetheless remains positive (2.8%), but it is twice as low as it was in the preceding months. In business surveys, producers, more often than a year ago, point out the need to address other problems constituting a barrier to their activity (most of these problems are probably related to the availability of logistics as well as raw materials and components). However, the problem of labour availability has diminished considerably. Meanwhile, according to businesses, insufficient demand has already been one of the most significant barriers since mid-2019.

Chart 16

MANUFACTURING OUTPUT
(at constant prices; %)



3.2 Construction and the real estate sector

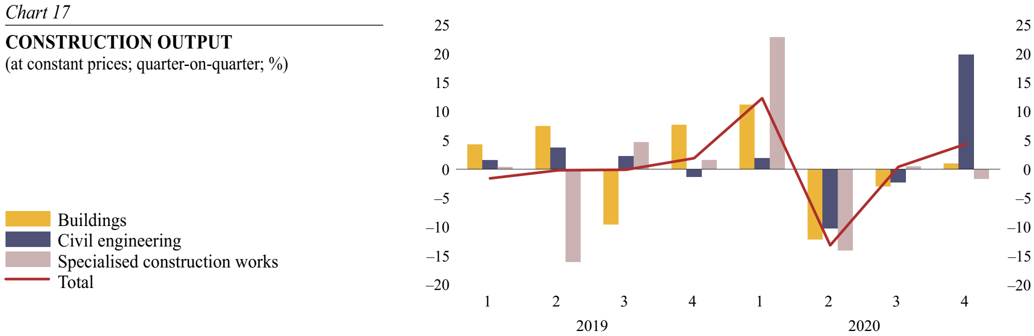
Additional funding for road repairs allocated by the government in spring enabled the construction sector to boost growth at the end of the year, following a weaker performance in the second and third quarters, i.e. the value added in the fourth quarter increased by 6.5% quarter-on-quarter (by 2.0% year-on-year). It was construction of roads that ensured construction growth at the end of the year and in 2020 as a whole (3.4%). Construction of buildings (agricultural non-residential outbuildings, apartment blocks and offices) and specialised construction activities also followed an upward path. Meanwhile, the construction of commercial and production buildings as well as utility infrastructure facilities declined.

The construction confidence indicator remains stable and negative primarily due to the order assessment, since private investors fear uncertainties of the future. This can prevent new private buildings from being placed on the market. Inflows of additional investment in the sector have not introduced adjustments to construction costs, and the annual growth rate of the overall costs continued to decelerate. This was mainly a result of a drop in building material prices and deceleration in the growth rate of builders' wages. The rising number of new buildings at the end of the year observed both in the residential and non-residential building segments as well as the number of issued building permits suggest that moderate construction activities are ongoing in all segments. The growth in construction of buildings will be driven by the need to renew the existing housing stock. The effect of the second wave of the COVID-19 pandemic and the related restrictions on the construction sector's growth has been immaterial. However, against the backdrop of uncertain economic development, the implementation of some private investment projects has been postponed and, with the cost risk increasing, their implementation at the planned level might be jeopardised, thus preventing the sector's growth in the medium term.

In 2020, the value added of the real estate market sector remained almost at the level of 2019 (–0.4%). Following the sharp decrease in the real estate market activity during the first wave of the pandemic, the second half of 2020 saw it recover. In the fourth quarter, the value added of the real estate sector rose by 0.2% quarter-on-quarter and by 4.0% year-on-year. After the first wave of the pandemic, the recovery of the above sector was driven by a higher demand for real estate located outside Riga as well as by a considerable expansion of the state support programme for house purchase, including the subsidies programme for house purchase for families with several children, but at the end of the year the number of transactions in the real estate market of Riga also moved up, including transactions with standard apartments. The pandemic has had a greater effect on the number of transactions, but prices have been less affected. In 2020, prices of standard apartments dropped by 1.5% on average, but the number of the real estate purchases registered with the Land Register in Latvia (including Riga) picked up by 2% (by 8% in Riga) compared to 2019.

Chart 17

CONSTRUCTION OUTPUT
(at constant prices; quarter-on-quarter; %)



Prudent growth is expected to remain in the real estate market, since the demand for almost all kinds of real estate (houses, land, apartments) exceeds supply. Construction of new apartment blocks in Riga is ongoing, and pre-war buildings undergo renovation. VAS State Real Estate also keeps ensuring the continuity of the works associated with the buildings of national significance.

3.3 Trade

Trade, compared to other services sectors, is a sector whose many segments are suitable for development of more enhanced provision of remote services. Each wave of the pandemic witnessed a considerable growth in online sales volumes, demonstrating people's adaptation to the new realities. In 2020, the value added of trade edged down by 2.3%, including a marginal decline in the fourth quarter, when a proportion of retail sales was not available in person anymore. Cancellation of public events also reduced consumption needs, which would normally be related to preparations for festive occasions. Thus, recent months saw a substantial decrease in retail sales of non-food goods, particularly clothing and household goods (except household electrical appliances in January).

During the second wave of the COVID-19 pandemic, mobility indicators of retail trade remain low for a longer period than during the first wave. Short-term data show both a fall in retail trade volumes in January and a low level of activity in the segment of first-time registered motor vehicles in January and February, which in turn points to a drop in sales of motor vehicles. Despite the availability of government support and its expansion in recent months to help to stabilise the labour market situation and income level, consumer spending behaviour is cautious. Sentiment of customers and retailers remains relatively pessimistic, and together with the above indicators it generally suggests that the first quarter is expected to record a decline in the sector's growth.

3.4 Transportation

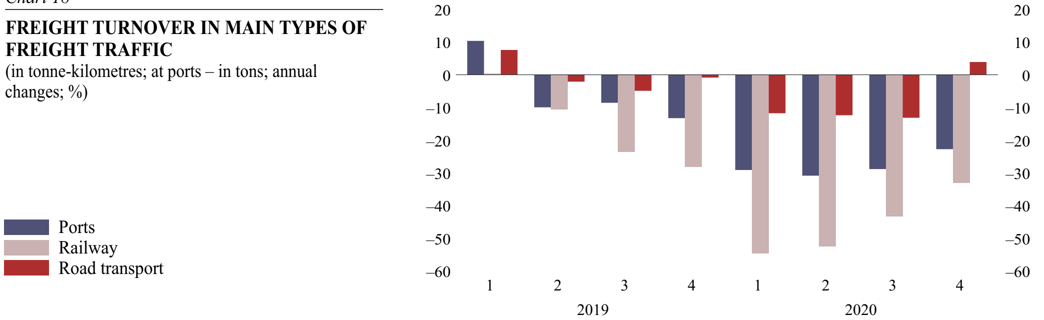
With freight transportation following a downward path and passenger transportation volumes decreasing, the transport sector still witnesses decelerating growth. In 2020, the value added of the transport sector decreased by 14.7%, and exports of transport services also edged down.

The volume of cargoes loaded and unloaded at ports and that of freight transportation by rail has already been contracting for a considerable time. The major factor behind this is a steep fall in the volume of coal cargoes. This long-term trend relates to reorientation of Russian transit flows to the local ports and the phasing out of fossil fuel elsewhere. Although the record-high agricultural yields provided a positive contribution of grain cargoes in 2020, and the contribution of wood cargoes was also positive at the end of the year, it could not offset the deceleration in coal cargoes. The volume of cargoes loaded and unloaded at ports shrank by 28.0%, while the turnover of rail freight – by 46.9%. The January data on port operation suggest that similar development was also registered in early 2021.

The number of passengers transported by air decreased by 74.2% in 2020 due to the material impact of the COVID-19 pandemic crisis on the air transport sector. Flights to third countries were resumed on 17 March 2021, allowing the air transport sector to recover slightly. However, with morbidity rates remaining high in Latvia and Europe alongside with countries continuing the implementation of restrictions for the control of the virus spread, it is unlikely that the air passenger flow will return to the pre-crisis level in the near term. Since AS Air Baltic Corporation and VAS STARPTAUTISKĀ LIDOSTA "RĪGA" carried out collective redundancies and reduced the aircraft fleet due to operational constraints, the sector will need time to recover. The COVID-19 pandemic has also had a significant effect on road transport, impeding logistics, delaying deliveries as well as disrupting supply chains. This situation led to a contraction of freight turnover by road by 8.4% in 2020, with freight turnover in international transport falling strongly. The demand for international freight transportation will edge up in parallel with a gradual recovery of trade partners from the crisis; however, it will also take time in this area. When assessing freight transportation by road in a longer run, next steps of the Mobility Package I will play a major role. The EC study[1] concludes that the application of cabotage quotas and the requirement to return the vehicle to the country of establishment on a regular basis (every eight weeks) can increase emissions and have an adverse effect on the environment. However, in the event that the current version of the Mobility Package I enters into force, it will reduce competitiveness of Latvian freight transport by road. Overall, the transport sector will continue to weigh on GDP dynamics also in 2021.

Chart 18

FREIGHT TURNOVER IN MAIN TYPES OF FREIGHT TRAFFIC
(in tonne-kilometres; at ports – in tons; annual changes; %)



[1] https://ec.europa.eu/transport/modes/road/news/2021-02-mobility-package-i-studies_en

4. GDP Analysis from the Demand Side[1]

Domestic demand was negatively affected by national restrictions, income declines and high uncertainty, all of which has constrained people in their consumption and investment decisions. Nevertheless, businesses and consumers are minimising the negative effects by adapting to the situation and by employing new digital or other solutions. The public consumption dynamics are driven by the support measures implemented to mitigate the impact of the Covid-19 pandemic crisis. Latvia's external demand was more resilient compared to that of other European countries. Furthermore, the structure of Latvia's exports was also more favourable and enjoyed more robust demand during the pandemic.

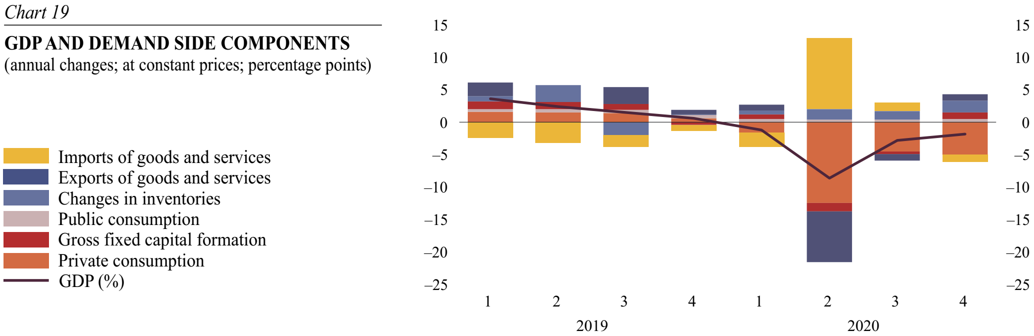
4.1 Domestic demand

Similar to the situation observed in spring 2020, at the beginning of the Covid-19 pandemic, in the fourth quarter of 2020 consumption recorded the most notable decline. This development was largely driven by the measures introduced mostly in the services sector to contain the pandemic, inter alia restrictions on travel, cultural, sporting and other activities, thus making spending on such services impossible. This time, however, the contraction was much less pronounced than estimated based on the impact seen in spring. This means that businesses and consumers have become more adapted to the situation and have created new digital or other solutions to maintain their production output and consumption. While such processes were projected, they have turned out to be more efficient and significant than expected. In 2021, household consumer spending will be facilitated by one-off benefits paid out to families with children, pensioners and persons with disabilities – or the so-called "helicopter money" – an atypical solution to stimulate consumption and mitigate the uneven impact on households caused by the crisis.

The crisis situation has had a negative and comprehensive impact on the consumer confidence. However, compared to the crisis of 2008–2010, the assessment of the households' financial situation is much more optimistic, while the economic situation and forecasts are almost as negative. This leads to the conclusion that behaviour and confidence were affected by this crisis more negatively than income. Nevertheless, there is substantial evidence suggesting that the impact of the crisis was uneven; therefore, these confidence indicators may be greatly polarised.

Chart 19

GDP AND DEMAND SIDE COMPONENTS
(annual changes; at constant prices; percentage points)



Investment activity was sluggish at the end of 2020 and throughout the year. Amid heightened uncertainty, private sector investors were cautious, and part of investors postponed their investment plans. Meanwhile, the decision to allocate additional funds for the improvement of infrastructure as well as other types of support reinforced the government investment. However, not all projects were brought to life.

Looking by type of investment, in the fourth quarter as well as in 2020 overall the

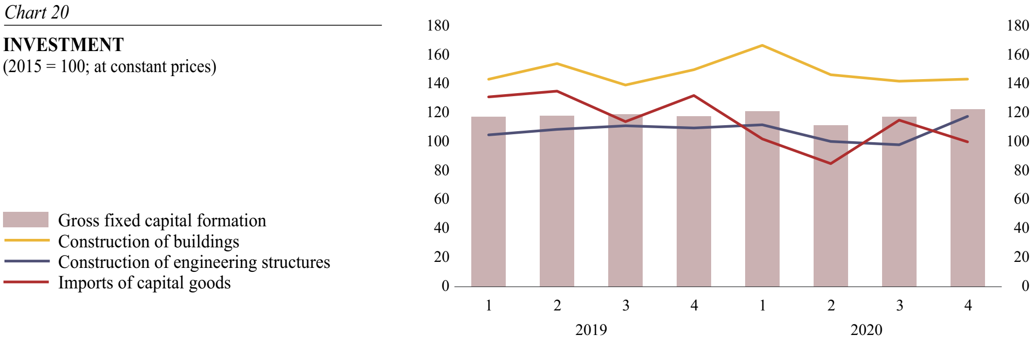
[1] This chapter analyses GDP and demand components at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

most negative contribution came from transport equipment, whereas the most positive contribution was made by other construction and production equipment. The category of production equipment also includes computers and other ICT equipment which, amid the rising popularity of remote work, is in high demand. Civil engineering performance suggests growth and helps maintain the overall level of investment.

Chart 20

INVESTMENT

(2015 = 100; at constant prices)

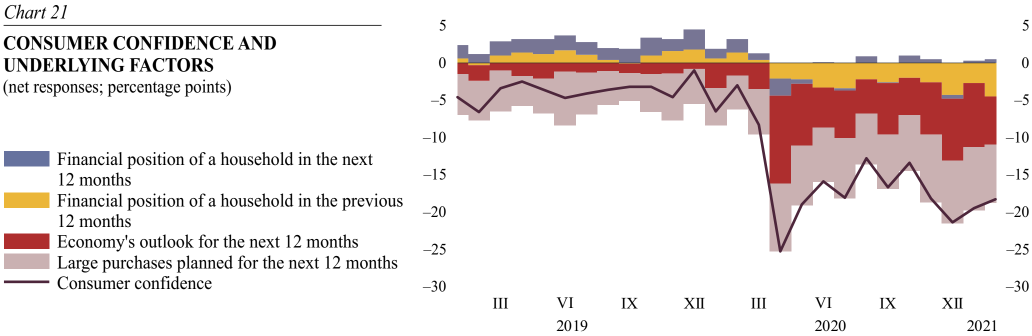


EU financing will continue to play an important role in facilitating investment and strengthening economic growth. Over the coming years, the economy will see significant inflows of additional EU funds, including those available within the Rail Baltica project and the EU Recovery and Resilience Facility (RRF). The estimated total costs of the Rail Baltica project in Latvia amount to nearly 2 billion euro. However, due to delays in works, the project deadline may be moved to 2030 (currently – 2026), thus increasing the risk of higher total costs. Moreover, given that the 2021-2027 long-term EU budget is currently still in its drafting stage, there is a lack of clarity regarding the overall flow of the project funds. Nevertheless, the EU framework regulations governing the implementation of the RRF plan have been approved, thus allowing for further drafting of the 1.65 billion euro investment plan for the period until 2026. For the time being, Latvia has chosen to draft the plan covering 70% of the potentially available financing, as the remaining available financing will be calculated by the European Commission in August 2022, based on the GDP growth data. The RRF provides an opportunity to facilitate investment inflows in the economy through public support, without increasing the level of government debt.

Chart 21

CONSUMER CONFIDENCE AND UNDERLYING FACTORS

(net responses; percentage points)



4.2 Government consumption

In the second half of 2020, the public consumption was further affected by the decisions taken to mitigate the Covid-19 pandemic crisis to meet the liquidity needs of businesses and help preserve household income. Moreover, since the beginning of 2021 the government support to mitigate the crisis has increased significantly. Therefore, the budget deficit is projected to be higher this year.

Following a rapid decline in the second quarter of 2020, the general government sector tax revenue rose again in the second half of 2020. With the economic situation improving in the third and fourth quarters, the tax revenue grew slightly year-on-year by 1.4% and 0.6% respectively. The data for January 2021 also suggest that, despite the strict restrictions imposed in various sectors, the tax revenue has not declined significantly compared to January of the previous year, i.e., the pre-pandemic period, shrinking by a mere 3.3%. However, since early 2021 it has been difficult to estimate the revenue from individual taxes due to the fact that a significant share of tax revenue, i.e. 108.4 million euro or 13.9% of total tax revenue in January, has been recorded in the single tax account.

Pursuant to the State Revenue Service data, the tax deadline extensions granted based on the impact of the Covid-19 pandemic over the period from the start of the pandemic until 8 March 2021 reached a total of 209.4 million euro. Of the deadline extensions granted in 2020, the largest share, i.e., 45.3%, were granted for the social security contributions, followed by 32.5% extensions granted for VAT payments and 14.5% – for personal income tax payments. With the easing of restrictions, the economy recovering and businesses beginning to partly repay their taxes that had been subject to deadline extensions, this support instrument is expected to be employed less in 2021.

Meanwhile, the Covid-19 pandemic crisis significantly affected the budget expenditure already in the second quarter of 2020, and the impact continued into the second half of the year as the expenditure grew by 8% year-on-year, with similar increases recorded for both current and capital expenditure. In 2021, the government expenditure will also grow due to decisions on additional support measures to mitigate the consequences of the Covid-19 pandemic crisis, in particular, social benefits, including one-off benefits paid out to parents (500 euro per child), pensioners and persons with disabilities (200 euro), as well as health-care related support and additional spending on infrastructure projects. Looking by sector, the most comprehensive support is aimed at the health care sector. Meanwhile, support in the form of subsidies is also intended for farmers and those working in the cultural and tourism services and other sectors. Over the first three months of 2021, the amount of the working capital grants paid out under the State Revenue Service programmes continued to increase. By contrast, in early March the furlough benefits and wage subsidies as well as the rate of increase in their applications began to decline.

In 2020, the general government budget deficit is estimated to be 5.3% of GDP. More accurate information will be available after the Eurostat communication at the end of April. Meanwhile, given the extensive new support measures implemented in 2021 to mitigate the Covid-19 pandemic crisis, the budget deficit is projected to grow to 7.7% of GDP.

The general government debt valuation for 2021 has increased compared to its 2020 December forecast, with the debt level reaching 48.6% of GDP (2020 valuation – 44.7% of GDP). The debt development is largely shaped by the expansion of the support measures associated with the Covid-19 pandemic, inter alia new support instruments intended to preserve household income as well as significantly increased financing for the health care sector and business grants.

4.3 Trade balance

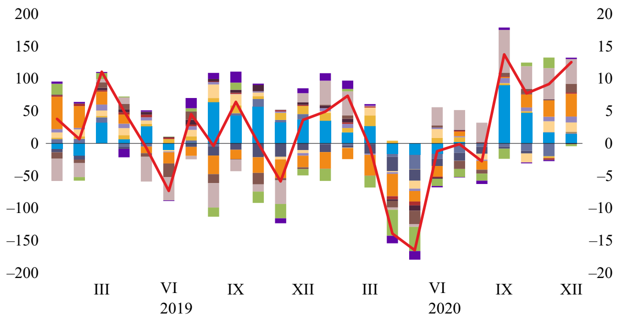
The trade balance was also clearly affected by the epidemiological problems and restrictions. Both in the crisis and during the recovery phase, Latvia's exports of goods was supported by both Latvia's trade partners, which have seen their economies develop more successfully against the backdrop of the rest of Europe, and the structure of products produced by Latvia's exporters as they have enjoyed more resilient demand during the pandemic. In the second half of 2020, Latvia's exports of goods even increased. However, the overall export volume did not expand due to the difficulties in cross-border supply of services. Broad restrictions on international travel have remained in place at the beginning of 2021, thus impeding the recovery in services exports. Exports of goods will be facilitated by strong demand. Moreover, its growth will largely hinge on the possibilities to increase the production and sales volumes against the backdrop of the record-high levels reached in 2020.

In the third quarter of 2020, trade in goods recovered swiftly and the best-performing sectors, which had cushioned the drop during the crisis, continued their successful development also in the fourth quarter despite the restrictions which, with varying levels of strictness, remained in place both in Latvia and its trade partners. The crisis even brought about additional demand in individual sectors, with exports of electrical machinery and equipment accounting for the largest increases. The record-high grain harvest was met with strong global demand and rapidly rising prices in the second half of 2020. Exports of wood also benefited from higher demand and prices and significantly expanded at the end of the year. However, the rise in exports of goods in the second half of 2020 did not offset the stagnation in cross-border supply of services which saw no significant recovery from its crisis low. Exports of travel services, which were hit most severely, only reached one fifth of their previous year's level in the last quarter of 2020 and were even lower than in the second quarter. Meanwhile, other business services as well as construction and computer services managed to maintain their growth during the year of the pandemic. However, they were unable to offset the contraction in the value of travel-related services.

Chart 22

EXPORTS OF GOODS AND GROUPS OF EXPORT GOODS
(year-on-year; millions of euro)

Agricultural products
Beverages
Food products
Mineral products
Products of the chemical industry
Plastics and plastic products
Wood and wood products
Paper and paper products
Textiles
Basic metals and metal products
Machinery and mechanical appliances
Transport vehicles
Other goods
Total exports (%; right-hand scale)



With domestic demand recovering, in the second half of 2020 imports bounced back as the decline in imports of intermediate goods moderated and imports of capital goods recorded a year-on-year growth in the third quarter. Increases in imports of machinery and electrical equipment, basic metals and products of the chemical industry suggested a recovery in the supply of capital goods. At the end of the year, however, the rise in the value of exports of goods was even more pronounced resulting in a positive goods and services trade balance in the fourth quarter and throughout 2020.

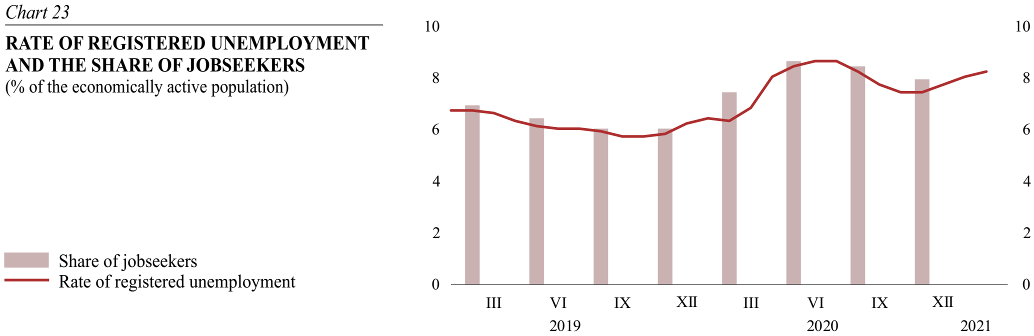
5. Labour Market, Costs and Prices

Covid-19 takes hold, with containment measures still in place, and this presents challenges to the labour market. The unemployment rate will follow an upward trend in early 2021, although this year the availability of the government support will prevent an upswing in unemployment. The most notable factors affecting the wage growth will be the raising of the minimum wage, the increase in the wages of medical and teaching staff, as well as the short-term Covid-19 related premiums for medical staff. February is likely to have been the last of the coming months to record consumer price deflation. The increase in consumer prices will be fuelled by the rising global prices of raw materials and the growing prices of services caused by the pent-up demand and elevated costs. Although it is unlikely that producer and importer price developments and inflation expectations of businesses and consumers would trigger a steep rise in inflation, annual inflation might briefly approach the rarely seen level of 3% in some periods of 2021.

With the economic situation deteriorating at the beginning of the year, the number of unemployed persons registered with the SEA has also increased. Although the outlook of employers regarding employment in the coming months has not deteriorated, it is, however, still lagging behind its pre-crisis level. The recovery of the economic activity and the availability of the government support will avert a further rise in unemployment until June. Unemployment forecasts remain close to the December estimates (8.3% of the economically active population in 2021; the forecast for December – 8.5%), while a steeper acceleration of the economic activity will reduce the unemployment rate for 2022 to 7.3% at the end of 2021 (the forecast for December – 7.5%).

Chart 23

RATE OF REGISTERED UNEMPLOYMENT AND THE SHARE OF JOBSEEKERS
(% of the economically active population)



In 2020, the wage growth has been much faster than projected. This is largely related to structural changes. Employers have more frequently fired or put less qualified or less experienced staff earning lower wages on downtime. This is evidenced by the wage and salary fund statistics which only show a modest increase. This, in turn, implies that the average labour income has statistically risen, although only a few are likely to have experienced a wage increase. In 2021, the pick-up in wages will be mainly driven by the raising of the minimum wage from 430 euro to 500 euro and the increase in the wages of medical and teaching staff, as stipulated by laws and regulations. A temporary positive contribution will also come from the pandemic related premiums for medical staff. Meanwhile, no substantial pressure on wage rises is expected since labour supply will be high. Financial resources of businesses will also be limited after the crisis, and this may hinder wage growth in the sectors hit by the crisis. Due to the above-mentioned factors, wages are expected to increase by 6.9% this year (the forecast for December – 5.3%). At the same time, with the economic activity recovering and demand for skilled labour growing, the average wage will rise by 5.7% in 2022 (the forecast for December – 5.1%).

In February, consumer price deflation was still driven by a decline in the prices of some specific product groups (e.g. accommodation services and fuel), with three fourths of the product prices growing faster than the total indicator. At the beginning of the year, producer price changes slightly exceeded zero, mostly due to energy and wood processing sectors. The price dynamics of these two components reflect shifts in the global commodity markets.

Chart 24

NOMINAL AVERAGE MONTHLY GROSS WAGE
(for full-time job; annual percentage changes)

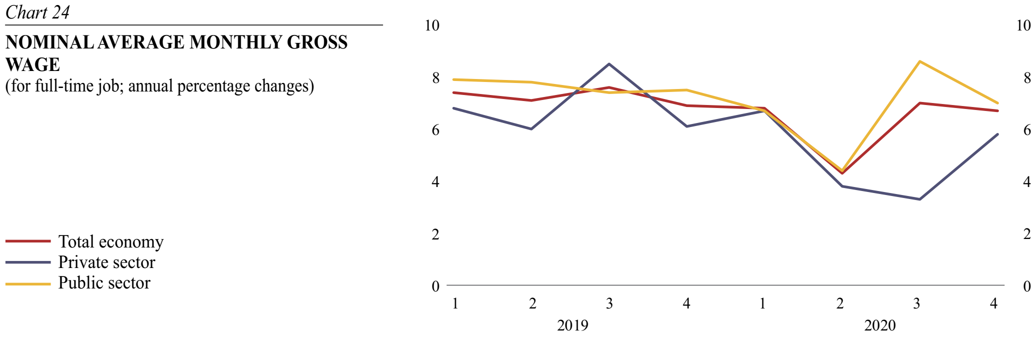
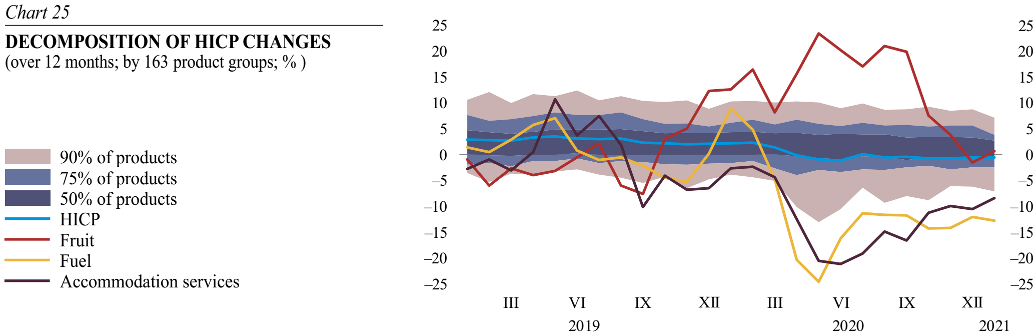


Chart 25

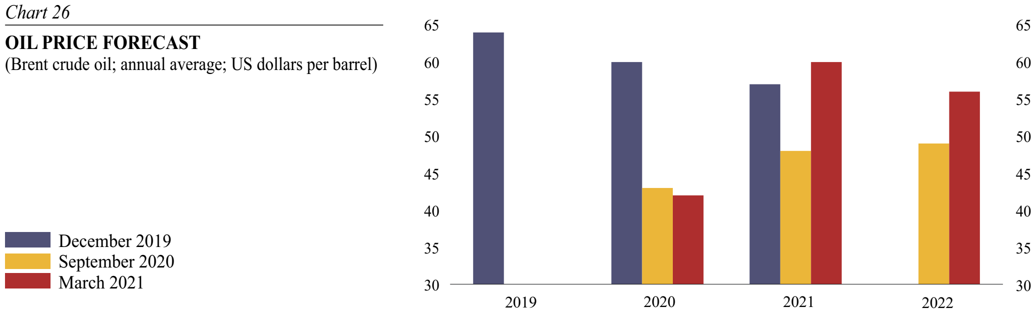
DECOMPOSITION OF HICP CHANGES
(over 12 months; by 163 product groups; %)



The price of oil expressed in US dollars returned to its pre-pandemic level. Since the end of 2020, the rise in oil prices has mainly mirrored hopes that vaccines would be effective in curbing the pandemic. An upward trend in oil prices was also supported by the developments in oil markets such as the oil production cuts maintained by OPEC+, the shrinking stocks of oil products and the persistent relatively low number of US shale oil production platforms. Although some analysts believe in a potential oil price surge even above 100 US dollars per barrel, most investors, however, anticipate a moderate drop in oil prices in the medium term, based on spare capacity to increase oil production in OPEC+ countries, the new US administration's signals on the improvement of the relationship with Iran, as well as the potential delay in containing the pandemic. The impact of higher oil prices on inflation in Latvia was slightly offset by the appreciation of the euro against the US dollar. The rising oil prices were reflected in fuel retail prices with a few weeks' lag. Moreover, heating and natural gas tariffs started to move up slowly from record low levels at the turn of the year: if the rise in oil prices turns out to be steady, tariffs will most likely continue to increase.

Chart 26

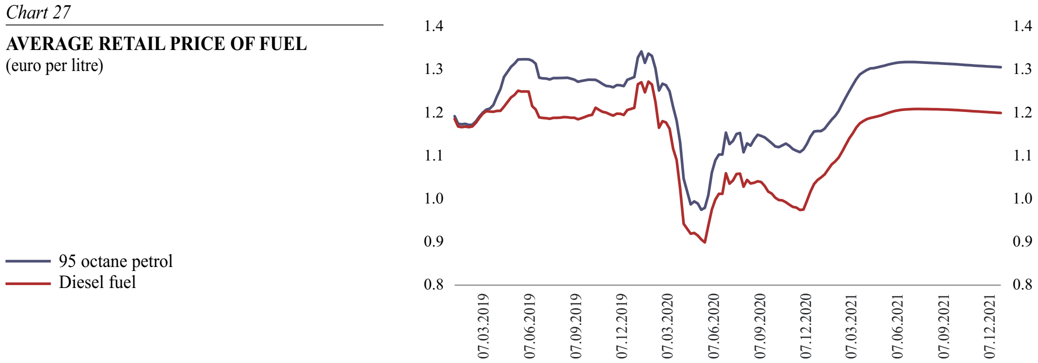
OIL PRICE FORECAST
(Brent crude oil; annual average; US dollars per barrel)



Following a temporary decrease in autumn 2020, the global wood prices reached new record highs, mainly reflecting a higher demand for wood due to the huge amount of house refurbishing works during the Covid-19 pandemic. An increased demand for new housing in the US substantially pushes up the demand for wood. At the same time, Canada (the main exporter of wood to the US) stopped the very active felling of trees due to bark beetle damage. Investors believe that, although the prices of wood might remain unusually high in the short run, the demand for wood should return to the normal level in the medium term. The prices of wood may also decline due to the potential overproduction as producers are currently trying to fully utilise capacities to reap maximum benefit from the high wood prices.

Chart 27

AVERAGE RETAIL PRICE OF FUEL
(euro per litre)



The global food prices have picked up over recent months. The prices of cereals increased notably, reflecting both a strong demand from importing countries (China) and lower exports from Russia (the export tax introduced to reduce the rise in food prices in the domestic market) and Ukraine (due to a weaker harvest). Minor increases in the global prices of dairy products (a high demand from China and Western European countries) and the prices of meat (a strong demand at the time when the avian influenza virus is detected in some European countries and swine fever is again observed in China) were also recorded. The rising prices of sugar reflect an increase in the oil price due to which ethanol is increasingly produced instead of sugar. The public demand for long life food products (e.g. buckwheat) rose at the beginning of the Covid-19 pandemic, leading to a rise in their consumer prices, and also at this point, the retail price of buckwheat is significantly higher than a year ago.

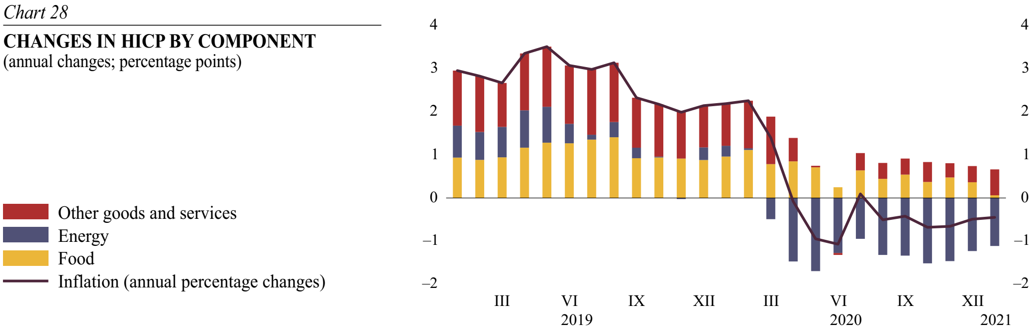
Producer prices of durable goods sold on the domestic market rose by 5% over the course of 2020. However, due to the lower import prices consumer prices for industrial goods increased only by less than half of per cent in 2020. Concerns that supply chain disruptions will significantly push up the import and consumer prices for industrial goods have not materialised so far. Producer price inflation expectations, although higher than at the beginning of the pandemic, are still lagging behind their pre-pandemic level.

Following a decrease in the first months of the pandemic, the prices of services started to pick up again in the second half of 2020. The prices of services are also expected to rise in the coming months. This will be driven by both the demand and cost factors. Some services were not available in the preceding months; therefore, the pent-up demand will reduce the household savings and boost their consumption as soon as the Covid-19 pandemic restrictions are eased. Moreover, the costs of several services per customer are higher than before the pandemic, due to the social distancing rules and because the minimum wage was raised significantly at the beginning of 2021. As a result of the interaction between the demand and cost factors, several hairdressing salons and beauty parlours which reopened in March have already increased their prices.

For some services which were not available, only price estimates were provided in the last months (in some cases it was assumed that the price level remained unchanged). This means that the increase in the minimum wage and the effect of the pent-up demand were not yet reflected in the prices of, for example, hairdressing salons in February. Similarly, the prices of transportation services by air do not yet capture the impact of the rising fuel prices. The impact of these factors will show up in the consumer price statistics only when the easing of the social distancing rules allows the service providers to work with greater capacity.

Chart 28

CHANGES IN HICP BY COMPONENT
(annual changes; percentage points)



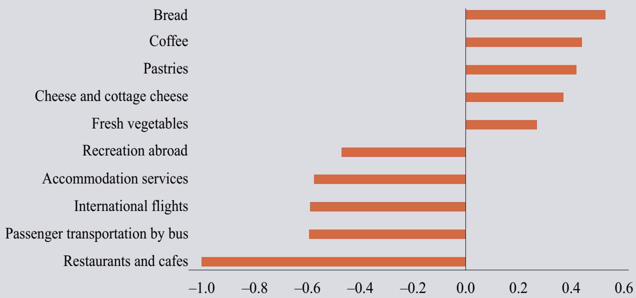
The box analyses the impact of the consumption structure changes caused by the pandemic on inflation.

BOX. DOES THE CONSUMPTION STRUCTURE CHANGES CAUSED BY THE PANDEMIC AFFECT INFLATION?

The Covid-19 pandemic has significantly affected the spending habits of consumers and changed the basket of the goods and services they buy on a day-to-day basis respectively. Several services were limited and, in some months, even unavailable because of the pandemic. Households also consumed less goods and services owing to precautionary behavior. Such changes in consumption patterns are also reflected in the consumer price weights in 2021[1]. The weight of processed food (e.g. bread and pastries) has increased, while that of services, especially restaurant and cafe services, has decreased (see Charts 29 and 30).

Chart 29

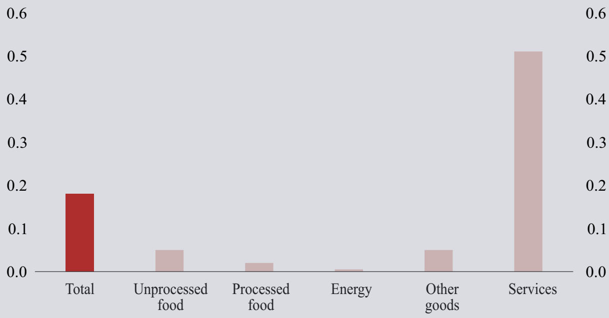
CHANGES IN CONSUMER PRICE WEIGHTS FOR INDIVIDUAL GOODS AND SERVICES
(2021; percentage points)*



* The chart shows the most pronounced changes in the weights of individual consumer prices in 2021 as compared to 2020.

Chart 30

IMPACT OF THE CHANGE IN WEIGHTS ON INFLATION
(January 2021; percentage points)*



* The chart uses the consumer price data in accordance with the European Classification of Individual Consumption according to Purpose (ECOICOP5). The inflation projection estimates are based on Latvijas Banka's Short-Term Inflation Projections (STIP) model (Latvijas Banka Working Paper 1/2020).

Such a dynamic shift in the goods and services basket has also somewhat affected the headline inflation. This means that inflation has picked up since the weight of the goods and services whose prices have been on the rise over the last year (e.g. the prices of bread)

[1] The Eurostat recommendations stipulate that the estimates of HICP weights for 2021 should be based, as far as possible, on a wider range of information on consumption expenditure for 2020. For more information, see "Guidance on the Compilation of HICP Weights in Case of Large Changes in Consumer Expenditures".

has increased and the weight of the goods and services whose prices follow a downward trend (e.g. the prices of flights and recreation abroad) has decreased. The estimates indicate that the services prices have been most affected by the change in weights as they were 0.5 percentage point higher in January 2021 due to the shifting weights.

Looking ahead, our estimates suggest that overall the impact of the consumption structure changes on the average inflation for 2021 will not be strong – a positive effect on inflation of January will be largely offset in the coming months[1]. It is expected that the Covid-19 restrictions will be eased and demand will recover in the second half of 2021. As a result, some services will become more available and the prices of, for example, accommodation services will rise somewhat. However, the impact of these services will not be severe as they account for the smallest share in the consumption basket.

[1] The exact impact will be known at the end of the year after the publication of the inflation data for December 2021.

6. Conclusions and Forecasts

In 2020, GDP declined less than expected owing to successful containment of the pandemic, monetary and government support, adaptability of consumers and businesses as well as temporary factors unrelated to the pandemic, e.g. exceptional grain harvest and a steep rise in the wood industry output.

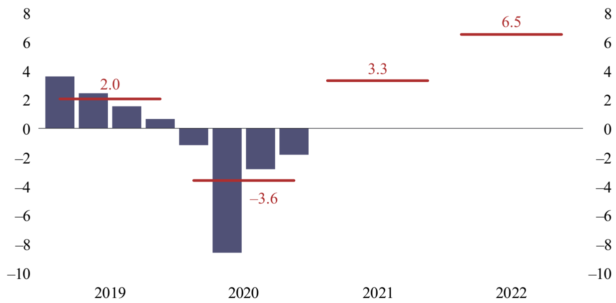
In early 2021, GDP is expected to decrease, whereas in 2021 overall GDP growth may reach 3.3%, compared to the December 2020 forecast of 2.8%. Although the state of emergency was extended, the government support provided to overcome the crisis was also increased. With the infection rates declining only moderately, uncertainty remains high, encumbering investment decisions and, together with the adverse impact of the pandemic on employment and income, resulting in more cautious spending behaviour of consumers. At the same time, due to restrictions, many services are still unavailable or cannot be remotely provided to their full potential. Under such conditions, the level of savings will remain high in the first half of 2021.

Assuming that vaccination will proceed in line with the plan[1], restrictions are expected to be reduced considerably from the second half of 2021, improving both consumption opportunities and consumer and business confidence. The fiscal measures supporting household income and more active spending of the precautionary and forced savings, which was impossible during the pandemic due to restrictions, will drive a rapid recovery of the private consumption. This year, the rapid public consumption growth will be related to the increased fiscal support for softening the crisis impact. Investment decisions will be supported by the improving sentiment of economic agents. Moreover, the financing of the Recovery and Resilience Facility will gradually become available. The expansion of exports of goods and services is projected to be in line with external demand as it recovers gradually. With external and – particularly – domestic demand improving, imports of goods and services will also see significant growth, reflected in a negative foreign trade balance.

The rapid recovery is projected to remain resilient in the second half of the year and to continue in 2022 with 6.5% GDP growth.

Chart 31

GDP
(annual changes; %; at constant prices; seasonally and calendar adjusted data; 2021–2022: Latvijas Banka forecast)



In the first two months of 2021, the consumer price dynamics remained negative year-on-year. However, February is likely to have been the last of the coming months to record consumer price deflation. The projected inflation for 2021 is 1.8%, higher than the December 2020 projection of 1.1%. The projection was revised upwards mainly due to higher oil and cereal prices. Following a period of deflation during the first two months of 2021, inflation is expected to record robust growth, with the annual inflation reaching 3% in some months. Consumer prices will also be supported by a rise in service prices on account of the pent-up demand and elevated costs. Consumer price inflation is projected to reach 2.2% in 2022.

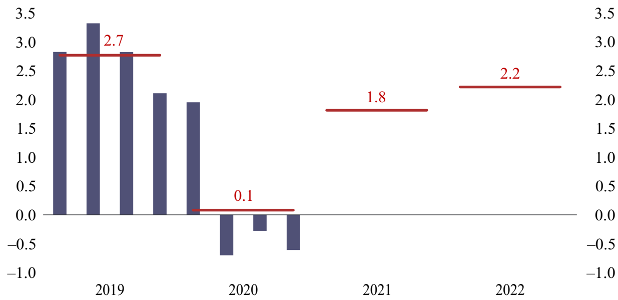
The short-term risks to the GDP and inflation forecasts are on the downside and mainly hinge on the opportunities to contain the pandemic. If the vaccination does not proceed

[1] See https://covid19.gov.lv/sites/default/files/2021-01/vmzin_p_050121_covid_vak.pdf.

as planned and there are any delays in containing the spread of the coronavirus, including its mutations, the economic recovery is likely to decelerate and the upward effect of the postponed consumption on service prices could be smaller than estimated. Nevertheless, the medium-term risks are tilted to the upside and a more vigorous rebound in global demand as a result of the ample fiscal stimuli could provide an additional impetus also to Latvia's economic growth. Food prices could grow more than expected due to higher global demand, whereas the prices of industrial goods could increase more as a result of limited supply.

Chart 32

HICP
(annual changes; %; 2021–2022: Latvijas Banka forecast)



Table

MACROECONOMIC FUNDAMENTALS: ACTUAL DATA AND LATVIJAS BANKA PROJECTIONS (P)

	2020	2021 (P)	2022 (P)	2023 (P)
Economic activity (annual percentage changes; at constant prices; seasonally adjusted data)				
GDP	–3.6	3.3	6.5	3.6
Private consumption	–9.9	10.5	10.3	4.0
Government consumption	2.6	16.7	–6.5	1.3
Investment	0.0	4.9	6.5	4.1
Exports	–2.7	6.2	4.3	3.1
Imports	–3.2	11.8	3.4	2.8
HICP inflation (annual percentage changes)				
Inflation	0.1	1.8	2.2	1.8
Underlying inflation (excluding food and energy)	0.9	1.0	1.5	2.1
Labour market				
Unemployment (% of the economically active population)	8.1	8.3	7.3	7.0
Nominal gross wage (annual percentage changes)	6.2	6.9	5.7	5.4
External sector				
Current account balance (% of GDP)	3.0	–0.3	–0.6	–0.8
Government finances (% of GDP)				
General government debt	44.7 (P)	48.6	46.7	45.1
Budget surplus/deficit	–5.3 (P)	–7.7	–1.2	–0.2

7. Analysis of Scenarios

7.1 The government financial support provided during the second wave of the Covid-19 pandemic and its impact on the economy

Prepared by Linda Oliņa, Economist of the Monetary Policy Department, and researcher Andrejs Zlobins.

Motivation

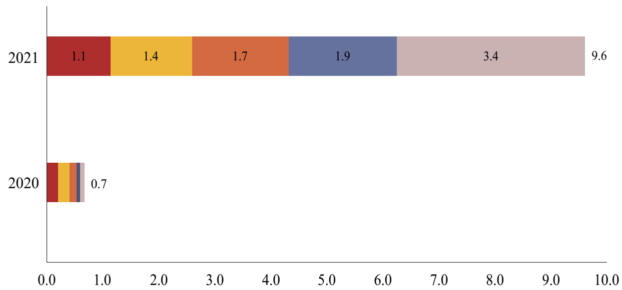
In autumn 2020, Latvia saw the resurgence of the Covid-19 pandemic, leading to the reintroduction of containment measures that not only affect the daily lives of people, but also weigh on economic activity. This means that individuals and entrepreneurs are facing different serious challenges, including permanent or temporary closures of businesses. In this situation, the government support measures to overcome the Covid-19 crisis may play a significant role in preserving household and business income and maintaining the operation of businesses.

In Latvijas Banka's assessment, the government financial support to mitigate the crisis caused by the second wave of the Covid-19 pandemic might have slightly surpassed 3.0 billion euro[1] or 10.3% of GDP in 2020 (as on 10 March 2021; see Chart 33) since the fourth quarter of 2020. A small percentage (less than 200 million euro or 0.7% of GDP) of the amount of the support was already paid at the end of 2020.

Chart 33

SIZE OF SUPPORT MEASURES DURING THE SECOND WAVE OF THE COVID-19 PANDEMIC IN 2020 AND THE EXPECTED SUPPORT LEVEL IN 2021
(% of GDP in 2020)

Funding for the infrastructure (investment)
Support to businesses and sectors
Support to the health care sector
Support to households and support measures helping preserve household income
Liquidity support to businesses



Note. Some support measures have been available since the beginning of the crisis caused by the Covid-19 pandemic, and they have been also expanded during the second wave of the pandemic. The measures include a possible extension of deadlines for tax payments and the government infrastructure investment both in the health care sector and the municipal investment projects within the extended borrowing limit. Since last spring, businesses have continued to have access to the support package in the form of financial instruments.

The government support measures can be divided into five categories:

– The first category is aimed at preserving household income, with the most comprehensive support expected in the event of a standstill or a partial standstill in the form of one-off benefits (500 euro per child paid out to parents and 200 euro paid out to pensioners and other target groups) and other social benefits, as well as the premiums for the employees of the health care, welfare and interior sectors.

– The second category is aimed at providing support to businesses and sectors, including to farmers, fishers and manufacturers of food products, as well as to the tourism, culture and public transport sectors, in the form of grants to maintain the working capital flow.

– The third category might include the measures in support of the sectors of the economy; however, it is reported separately due to the large amount of financing aimed at strengthening the capacity of the health care sector both for the purchase of equipment and medical products and the provision of testing and vaccination.

– The fourth category is aimed at providing additional financing for the implementation of

[1] The calculation includes the financial instruments offered by AS Attīstības finanšu institūcija Altum in the form of guarantees.

the government investment projects, with the funds allocated for the restoration of roadways, the infrastructure of the health care sector and the culture and public building projects.

– The fifth category of the support measures is related to support to businesses to provide liquidity in the form of financial instruments provided within the scope of the support programmes offered by AS Attīstības finanšu institūcija Altum. Besides, businesses still have the possibility to extend the deadline for tax payments up to three years.

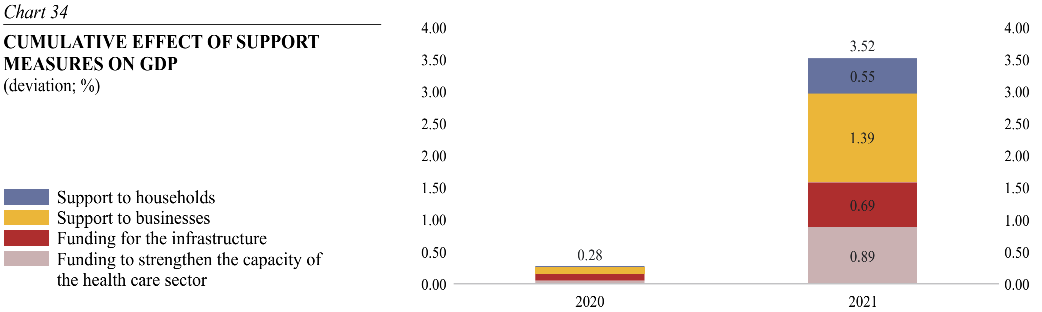
When the government support reaches households and businesses, the funds are further injected in the economy through purchases of goods and services. Latvijas Banka has assessed the potential impact of the government financial support on Latvia's economy by employing the DSGE model for Latvia, supplemented by a detailed modelling of the fiscal sector[1].

Simulation

The fiscal support measures have been divided into four groups in the simulation[2]: support to households, support to businesses, financing for the infrastructure and financing to strengthen the capacity of the health care sector. The total amount of support included in the simulation is lower than the one intended to support the economy respectively – it was 0.6% of GDP in 2020 and is projected to be 7% of GDP in 2021. Support to households has been simulated as government transfers to households and as subsidies to businesses since grants to meet the working capital needs account for a large share of the support measures provided to businesses, with the government basically covering a part of production costs. The financing for the infrastructure has been modelled as government investment, while the funds to strengthen the capacity of the health care sector – partly as government consumption and partly as investment, given the nature of the impact of the measures.

Chart 34

CUMULATIVE EFFECT OF SUPPORT MEASURES ON GDP
(deviation; %)



The simulation results shown in Chart 34 suggest that the government support measures will increase Latvia's real GDP by 3.5% in 2021, with the largest contribution (approximately 40%) coming from the support measures provided to businesses. The support granted to businesses, including in the form of grants to meet the working capital needs, will cover a part of current expenditure and allow for continuity of economic activity of businesses. This, in turn, makes it possible to maintain employment and consumption.

The government investment in the infrastructure and the health care sector increases the overall investment volumes and hence the productivity of the economy, while the support to households maintains consumption. The magnitude of the impact of government investment and transfers is to some extent reduced by the share of imports in the government investment and the consumption basket of households.

When comparing the impact of the government support measures on Latvia's GDP at 3.5% with an output gap in 2021 (Latvijas Banka's calculations suggest about –3% of the potential output), the amount of fiscal stimulus is considered commensurate and will help

[1] Bušs, G., Grüning, P. Fiscal DSGE Model for Latvia. Latvijas Banka Working Paper No. 5/2020.
[2] The simulation does not include liquidity support to businesses in the form of guarantees since new funds are not injected into the economy, but it serves as additional collateral.

the economy return to full employment and use of other production resources as soon as possible.

Conclusions

The government financial support is an important factor in maintaining the operation of businesses and preserving household income in times of crisis. Taking into account the assessment of the support measures, the simulation results overall suggest that the support measures contribute significantly to maintaining economic growth in 2021, increasing Latvia's GDP by 3.5%. Overall, the structure of the government support measures is quite extensive, providing support to different groups of population. An increased focus on the instruments for maintaining the operation of businesses and helping preserve employment and household income, thus also indirectly providing support to employees, is also a positive development. Support to businesses is an important factor in ensuring the future growth path as it helps to sustain the capacity of the supply side of the economy, preventing a wave of mass defaults. The amount of government support is viewed as commensurate also in terms of the output gap.

7.2. Assistance to households with children in times of crisis

Prepared by Ludmila Fadejeva and Kārlis Vilerts, economists of the Monetary Policy Department.

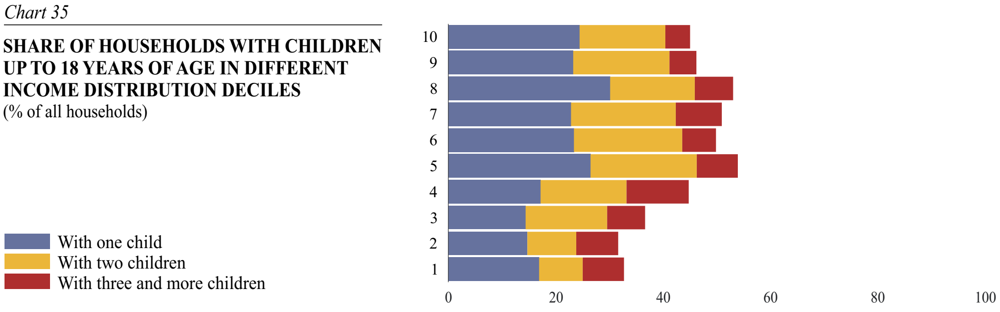
Motivation

The Covid-19 pandemic and the related restrictions have affected almost every household in Latvia. The pandemic has resulted in job losses, postponed investment and changes in the pace of people's everyday life at least in the short term. This could be of particular relevance to households with children which have to meet remote learning needs that frequently involve additional costs. Therefore, to mitigate the adverse impact of the pandemic, the state paid a lump-sum benefit of 500 euro per child to parents in March 2021.

Although nearly every household with children, most likely, incurs additional expenses, the level of family income and the affordability of additional spending vary greatly. EU-SILC survey data suggest that households with children are mostly concentrated in the middle of the income distribution and in its wealthiest part (Chart 35). The question could therefore be raised whether the benefit of 500 euro per minor is sufficiently well targeted and whether other options of the provision of financial support should be considered.

Chart 35

SHARE OF HOUSEHOLDS WITH CHILDREN UP TO 18 YEARS OF AGE IN DIFFERENT INCOME DISTRIBUTION DECILES
(% of all households)



Note. The 1st decile – 10% of households with the lowest income, the 10th decile – 10% of households with the highest income.

Latvijas Banka used the EUROMOD microsimulation model[1] to assess the potential impact of the 500 euro benefit on disposable income of various households in Latvia. Several alternatives for the provision of more targeted support to households with children whose disposal income is on average lower were considered.

[1] EUROMOD is a tax-benefit microsimulation model for Europe developed and maintained by the Institute for Social and Economic Research (ISER, University of Essex) in collaboration with national expert teams. The Latvian national expert team is based at the Baltic International Centre for Economic Policy Studies (BICEPS). https://www.EURmod.ac.uk/about/country-by-country/latvia.

Simulation

Pursuant to the amount of support (180 million euro) approved by the Cabinet of Ministers, several alternative options of financial support have been analysed:

– Scenario 1: 500 euro per child;

– Scenario 2: 720 euro per child to households whose disposal income per household equivalent consumer does not exceed 1000 euro[1] or 150% of the equivalent disposable income median in 2019;

– Scenario 3: 450 euro per child to households with one or two children and 680 euro per child to households with three or more children.

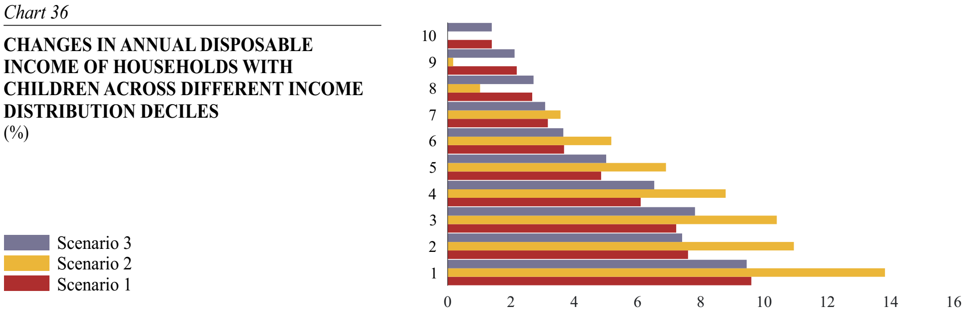
The assessments consider the effects on household equivalent disposal income across different income distribution deciles.

Simulation of the model

The results obtained suggest that the benefit of 500 euro affects households with children at the low-income end most significantly (Chart 36; Scenario 1). The benefit increases annual disposal income of 10% of the poorest households (1st decile) by approximately 10%. Meanwhile, the impact on disposal income of 10% of the wealthiest households is about 1.5%. Thus, although low-income households, in relative terms, receive the greatest financial support, it is also provided to the wealthiest households. Moreover, taking account of the fact that income of households with children is medium high, the bulk of the support, in absolute terms, will be paid to households with average or high income (Chart 37).

Chart 36

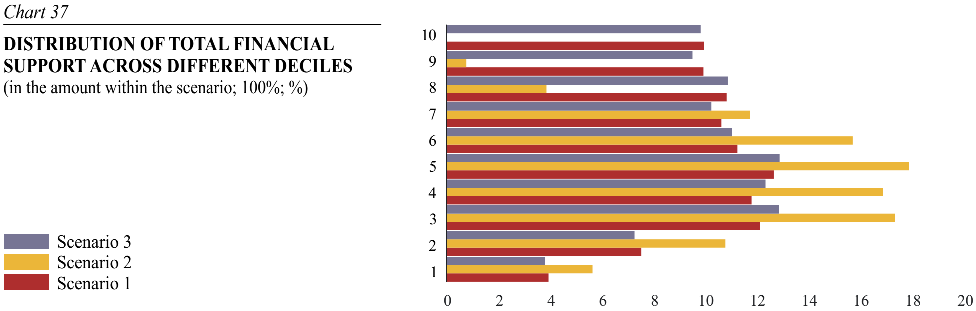
CHANGES IN ANNUAL DISPOSABLE INCOME OF HOUSEHOLDS WITH CHILDREN ACROSS DIFFERENT INCOME DISTRIBUTION DECILES
(%)



Note. The 1st decile – 10% of households with the lowest income, the 10th decile – 10% of households with the highest income.

Chart 37

DISTRIBUTION OF TOTAL FINANCIAL SUPPORT ACROSS DIFFERENT DECILES
(in the amount within the scenario; 100%; %)



Note. The 1st decile – 10% of households with the lowest income, the 10th decile – 10% of households with the highest income.

To make the financial support more targeted, it should only be paid to the households whose disposal income per equivalent consumer is below 1000 euro or 150% of median (Scenario 2). In this scenario, disposal income of the lowest-income households edges up even by 14%, but the wealthiest households receive no financial support. Although this type of support is more targeted (almost all support in question is provided to low and average-income households), it also has some disadvantages. First, its administration is complicated,

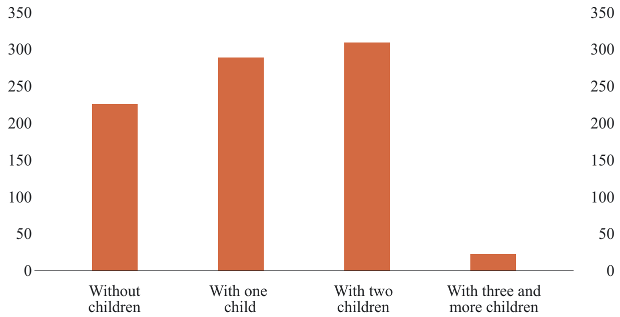
[1] The number of household equivalent consumers is determined using the weight 1 for the first adult, 0.5 – for all the other adults and 0.3 – for children.

since information about household income becomes available to public institutions with some time lags. Second, practically all households with children have incurred additional expenses due to the crisis therefore limitation of support may not coincide with the purpose of the financial support.

In Scenario 3, households with several children get more support, i.e. households with one or two children receive the benefit of 450 euro per child, but those with three and more children – 680 euro per child. In this scenario, the impact on disposal income across different income distribution deciles is similar to the case of 500 euro benefit; however, this form of support has some advantages. This scenario, as compared with other scenarios, would involve a steeper increase in average disposal income of families with three and more children. Families with several children might need more support, since the ability of such households to undertake additional expenses is overall more limited than that of other households. The Household Finance and Consumption Survey conducted in Latvia in 2017 suggests that the average level of savings made by households with three and more children was significantly lower than that in households with one or two children, or without any children (Chart 38).

Chart 38

DEPOSIT MEDIAN FOR DIFFERENT TYPES OF HOUSEHOLDS
(2017; euro)



Conclusions

The overall conclusion is that, in relative terms, households with relatively low income will make the most of the 500 euro benefit per child which will significantly increase their disposal income, thus helping to cover the costs generated by the pandemic. However, owing to the household structure, the same amount of benefit for all households also means that most of the financial support will reach households with average and high income.

Regarding alternatives, it can be concluded that solutions to more targeted support to low-income households with children are available; however, it might be complicated to administer them.

When seeking alternatives within the range of solutions that are easy to administer, more support to households with several children should be highlighted. Although a significant portion of financial support would go to relatively wealthy households also in this case, households with several children might top the list of beneficiaries of greater support, taking account of the fact that their financial preparedness for the crisis is on average lower than that of other households.

Additional Information

General notes

The cut-off date for the information used in the publication Macroeconomic Developments Report (March 2021, No. 32) is 26 March 2021. The cut-off date for the information used in the forecast is 16 March 2021, and 17 February for the information used in some technical assumptions.

The Macroeconomic Developments Report (March 2021, No. 32) published by Latvijas Banka is based on data provided by the CSB, ECB, Treasury, AS Nasdaq Riga, Euribor-EBF and Latvijas Banka.

Data sources for charts are the EC (Charts 1, 2, 20, 21–27 and 35–37), Bloomberg (Charts 3–5, 15 and 26), Refinity (Chart 6), Latvijas Banka (Charts 3, 7–12 and 25–38), the CSB (Charts 7, 15–20, 22–25, 28–32 and 38), the Treasury (Chart 13) and the SEA (Chart 23).

Beginning with the December 2019 issue, the only data source for Statistics tables is Latvijas Banka.

Details may not add because of rounding-off.

FOB value is the price of a commodity on the border of the exporting country, including the transportation and insurance costs only up to the border.

CIF value is the price of a commodity on the border of the importing country, including the transportation and insurance costs only up to the border.

"–" – no transactions in the period; "x" – no data available, no computation of indicators possible or insufficient number of respondents to publish information.

Money and banking sector

Calculation of monetary aggregates includes the balance sheet data of Latvijas Banka and information from the financial position reports of other MFIs, prepared using methodology of Latvijas Banka (see Latvijas Banka Regulation No. 132 "Regulation for Compiling the 'Monthly Financial Position Report' of Monetary Financial Institutions" of 16 May 2014).

In the publication, the following terms have been used:

MFIs – financial institutions forming the money-issuing sector. In Latvia, MFIs include Latvijas Banka, credit institutions and other MFIs in compliance with the List of Monetary Financial Institutions of the Republic of Latvia compiled by Latvijas Banka. In the EU, MFIs include the ECB, the national central banks of the euro area, credit institutions and other MFIs (money market funds) in compliance with the original List of MFIs published by the ECB.

Non-MFIs – entities other than MFIs.

Financial institutions – other financial intermediaries, excluding insurance corporations and pension funds, (hereinafter, OFIs), financial auxiliaries, insurance corporations and pension funds.

OFIs – financial corporations that are primarily engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and close substitutes for deposits from their customers other than MFIs, or insurance technical reserves. OFIs are corporations engaged in lending (e.g. financial leasing companies, factoring companies, export/import financing companies), investment funds, investment brokerage companies, financial vehicle corporations, financial holding corporations, and venture capital corporations. OFIs data include also financial auxiliaries' data.

Financial auxiliaries – financial corporations that are primarily engaged in auxiliary financial activities, i.e. activities that are closely related to financial intermediation but are not financial intermediation themselves, e.g. investment brokers who do not engage in financial intermediation services on their own behalf, corporations that provide infrastructure for financial markets, central supervisory institutions of financial institutions and the financial market provided that they are separate institutional units. In Latvia, the FCMC and the AS Nasdaq Riga shall also be regarded as financial auxiliaries. Financial auxiliaries' data are included in OFIs data.

Non-financial corporations – economic entities producing goods or providing non-financial services with the aim of gaining profit or other yield.

Households – natural persons or groups of natural persons whose principal activity is consumption and who produce goods and services exclusively for their own consumption, as well as non-profit institutions serving households. The following are also regarded as households in the Republic of Latvia: persons engaged in individual entrepreneurship provided that they have not registered their activity with the Commercial Register of the Enterprise Register of the Republic of Latvia.

Holdings of securities other than shares – financial assets, which are instruments of the holder, usually negotiable and traded or compensated on secondary markets and which do not grant the holder any ownership rights over the issuing institutional unit.

The following information is published in accordance with the ECB methodology:

1) aggregated balance sheet of MFIs (excluding Latvijas Banka), i.e. the sum of the harmonised balance sheets of Latvia's MFIs, excluding Latvijas Banka (Table 3);

2) monetary aggregates and counterparts (Table 2) reflect Latvia's contributions to the euro area M3 and counterparts to M3. These are obtained from the consolidated balance sheet of MFIs. Latvia's contributions to the following monetary aggregates are calculated and published:
– overnight deposits in all currencies held with MFIs;
– deposits redeemable at a period of notice of up to and including 3 months (i.e. short-term savings deposits) made in all currencies and deposits with an agreed maturity of up to and including 2 years (i.e. short-term time deposits) in all currencies held with MFIs;
– repurchase agreements, debt securities with a maturity of up to and including 2 years issued by MFIs, and money market fund shares and units.

Analytical accounts of Latvijas Banka (Table 1) are also published comprising the national contribution to the euro area monetary base and the counterparts.

In view of the fact that Latvijas Banka collects more comprehensive information, the following is also published:

1) selected items in the monthly financial position report of MFIs (excluding Latvijas Banka) by group of countries (Table 4);

2) information characterising the maturity profile and types of deposits (including repurchase agreements) of Latvia's financial institutions, non-financial corporations and households with MFIs (excluding Latvijas Banka; Tables 5 and 6abc), as well as government and nonresident deposits (Table 6d);

3) information characterising the maturity profile and types of MFI (excluding Latvijas Banka) loans to Latvia's financial institutions, non-financial corporations and households (Tables 7, 8ab and 9), as well as government and non-resident loans (Table 8c);

4) information characterising MFI (excluding Latvijas Banka) securities holdings (Table 10).

Interest rates

The interest rates calculation includes information from MFI reports prepared in compliance with Latvijas Banka Regulation No. 133 "Regulation for Compiling Interest Rate Reports of Monetary Financial Institutions" of 16 May 2014. Based on the methodology laid out in the above Regulation, credit institutions, branches of foreign credit institutions and particular credit unions registered in the Republic of Latvia have to provide information on interest rates on deposits and loans applied in transactions with resident non-financial corporations and households.

Information on interest rates on deposits and loans applied in transactions with non-financial corporations and households provided by credit institutions, branches of foreign credit institutions and credit unions registered in the Republic of Latvia is collected (Tables 11ab).

Interest rate statistics is collected on new business and outstanding amounts. All rates included in the interest rate statistics are weighted average rates. When preparing the interest rate statistics, credit institutions use annualised agreed rates (AAR) or narrowly defined effective rates (NDER) and annual percentage rate of charge (APRC). Credit institutions have to select the calculation of the AAR or the NDER based on the terms and conditions of the agreement. The NDER can be calculated on any deposit or loan. In addition to the AAR or the NDER, the APRC is reported for loans to households for house purchase and consumer credits.

The interest rates on new business with overnight deposits and deposits redeemable at notice and on their outstanding amounts coincide.

Interest rates on new loans are reported on the basis of the initial rate fixation period set in the agreement, whereas overdraft interest rates are reported on loan balances.

When reporting the interest rates on consumer credit and other credit to households with the maturity of up to 1 year and loans to non-financial corporations with the maturity of up to 1 year, interest rates on overdraft are included.

Interbank market lending interest rates (Table 13) are reported as weighted average interest rates on new business, aggregating the information submitted by credit institutions, prepared based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 102 "Regulation for Compiling the 'Report on Monetary Market Transactions'" of 16 May 2013).

Foreign exchange and exchange rates

Information characterising the foreign currency selling and buying transactions is reported based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 36 "Regulation for Purchasing and Selling Cash Foreign Currency" of 13 May 2009 and Latvijas Banka Regulation No. 101 "Regulation for Compiling Reports on Foreign Currency Purchases and Sales" of 16 May 2013). The principal foreign exchange transactions (Table 15) comprise the cash and non-cash transactions conducted by credit institutions and branches of foreign credit institutions, reported by transaction type and counterparty, and currency. Non-cash foreign exchange transactions (Table 16) comprise non-cash transactions performed by credit institutions and branches of foreign credit institutions, reported by major currency.

Weighted average exchange rates (cash transactions; Table 17) are reported based on the information provided by credit institutions and branches of foreign credit institutions as well as currency exchange bureaus.