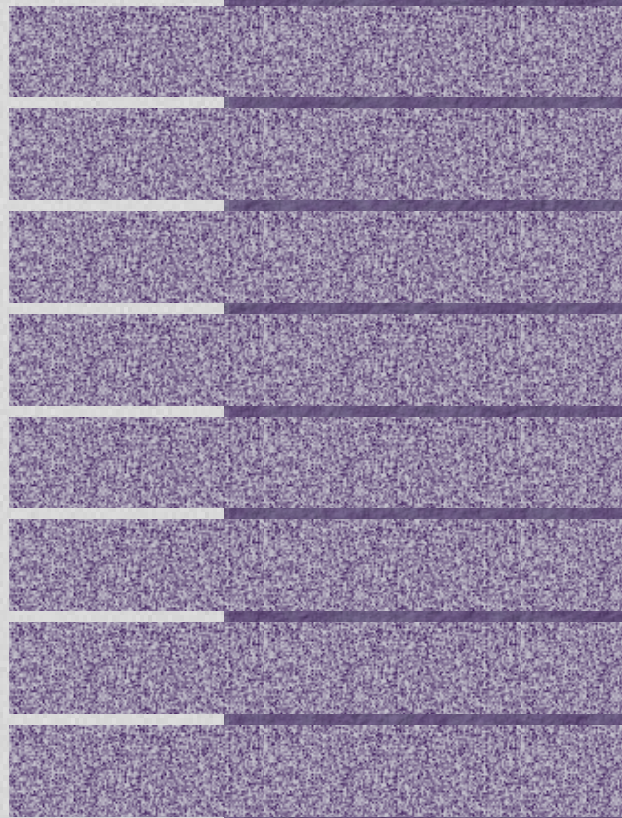


**MACROECONOMIC  
DEVELOPMENTS  
REPORT 2021**

**2021**



**SEPTEMBER**

# MACROECONOMIC DEVELOPMENTS REPORT

## September 2021

MACROECONOMIC DEVELOPMENTS REPORT  
September 2021, No 33

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## Abbreviations

AS	– joint stock company
CSB	– Central Statistical Bureau of Latvia
DSGE model	– Dynamic Stochastic General Equilibrium Model
ECB	– European Central Bank
EC	– European Commission
EONIA	– euro overnight index average
EU	– European Union
EURIBOR	– euro interbank offered rate
FCMC	– Financial and Capital Market Commission
FRS	– US Federal Reserve System
GDP	– Gross Domestic Product
HICP	– Harmonised Index of Consumer Prices
IMF	– International Monetary Fund
OPEC	– Organisation 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
VAT	– value added tax

## Additional information

The cut-off date for the information used in the publication Macroeconomic Developments Report (September 2021, No. 33) is 27 September 2021. The cut-off date for the information used in the forecast is 17 September 2021.

Data sources for charts are the EC (Charts 1, 2, 19, 20, 27, 32 and 2.1, 2.2, 2.3), Bloomberg (Charts 3–6, 11 and 26), Refinitiv (Chart 7), Latvijas Banka (3, 8–10, 24–29, 31, 32 and 1.3, 2.1–2.3, 3.1, 3.2), CSB (Charts 13–18, 20–25, 28–30 and 1.1, 1.2, 1.3, 2.1, 2.2, 2.3), the Treasury (Chart 12), SEA (Chart 22) and ECB (Chart 31).

Statistics tables will no longer be published together with the Macroeconomic Developments Report. Statistical data are available at: <https://www.bank.lv/en/statistics/stat-data/key-macroeconomic-indicators>.

## Introduction

The global economic recovery is currently driven by the countries that have succeeded in implementing the vaccination process, enabling them to ease restrictions faster and restart economic activity to the fullest extent possible. Thus, it is expected that the year 2021 will see robust global economic growth, but the year 2022 might bring even stronger-than-expected expansion of economic activity. In Latvia, GDP growth has recovered from the effects of the pandemic faster than projected. This has been supported by gradual relaxation of restrictions, government support, the favourable financial conditions as well as adaptability of consumers and businesses. An improvement in the economic sentiment of households and businesses was evident in Latvia at the beginning of summer, leading to higher spending. Although additional uncertainty about future growth and inflation rates arises from demand and supply imbalances, the GDP growth forecast for 2021 has been revised upwards to 5.3% primarily on account of the actual data and with the future outlook remaining broadly unchanged. In 2022, GDP growth is likely to be similar to that seen in 2021 (5.1%) – lower than previously estimated, bearing in mind both the rise from a higher level and prudent decisions taken by consumers and investors. Growth will be driven by private consumption in 2022, with households spending their savings accumulated during the pandemic; the contribution of investment will also increase due to government spending. External demand growth will facilitate exports; however, a steep rise in imports will make the trade balance enter a more negative territory. In 2023, GDP growth will return to a sustainable pace of long-term growth.

The labour market is recovering strongly, with unemployment declining even after the expiry of the furlough benefits provided to businesses by the government and with the pace of average wage growth remaining high both in the private sector and, even more, in the public sector.

A jump in the consumer price inflation has replaced the short period of deflation experienced during the first stage of the pandemic. Both producer and import prices as well as inflation expectations are following an upward path. Inflation is projected to peak at the turn of 2021 and 2022, with the annual growth rate of consumer prices temporarily exceeding 5%. Considerably higher energy prices, supply chain disruptions as well as (in the medium term) the effect of inflation expectations have prompted Latvijas Banka to increase the inflation forecast for 2021 to 2.8% and for 2022 – to 4.0%, envisaging a gradual decline in inflation in 2023.



## 1. External Demand

*In the first eight months of 2021, the availability of Covid-19 vaccines and the pace of vaccination began to increasingly affect the global economic growth prospects across countries. At the same time, the risks posed by the pandemic remain of topical importance both in the countries with a high vaccination coverage and in those with a low vaccination coverage. In addition, a considerable uncertainty about future growth and inflation rates arises from demand and supply imbalances affected by a more rapid expansion of demand along with a reduction in restrictions, disruptions in the supply chains of goods, the lack of raw materials and the ensuing surge in their prices.*

At the onset of summer, the new Delta variant of SARS-CoV-2 became increasingly widespread, quickly becoming the dominant strain in various parts of the world. To date, the rate of Covid-19 patients, those severely ill and deaths from the virus is lower in the countries reporting a high proportion of vaccinated population. Thus, taking into account the fact that the health system was less burdened, these countries continued to ease restrictions to a considerable extent despite the renewing uptrend in morbidity. Meanwhile, the current pandemic risks and the outbreaks of the Delta strain hindered easing of restrictions or required reinforcement of government measures in the countries where the share of the vaccinated population was smaller. At the same time, the potential new mutations of SARS-CoV-2 and concerns about the efficacy of vaccines in the longer term remain downside risks to the pace of economic recovery.

The global economic recovery is currently driven by the countries that have managed to ease restrictions faster and restart economic activities close to the pre-pandemic level. In line with the latest IMF forecast<sup>1</sup> published in July 2021, the global economic growth in 2021 will be 6%, while in 2022 – 4.9%. Compared to the assessment published in April 2021, the forecast for 2021 has remained unchanged, whereas that for 2022 has been revised upwards by 0.5 percentage points. This was largely on account of better growth expectations in the advanced economies. At the same time, in August and September the renewed concerns about further development of the pandemic in combination with other risks tempered the previous optimism and lowered expectations of analysts concerning the rate of economic recovery. Compared to the summer months, expectations of the surveyed economists by Bloomberg regarding global GDP growth in 2021 edged down from 6.0% to 5.9%, but for 2022 remained unchanged at 4.5%.

The pace of recovery experienced in the USA has been one of the strongest in the world: in the first and second quarters of 2021, quarterly growth rates of real GDP were 1.5% and 1.6% respectively. The IMF projects that the speed of US economic recovery will be 7.0% in 2021 and 4.9% in 2022 (compared to the April 2021 assessment, the forecast has been revised upwards by 0.6 and 1.1 percentage points respectively). At the same time, according to several analysts and the FRS, recovery in the USA is on-going, but has not yet reached a fully satisfactory level. Despite the high inflation growth, which climbed to 5.3% in August in year-on-year terms, the FRS hesitates to reduce the monetary policy support. At the same time, the FRS in its September meeting pointed out the following: if the dynamics of the economic recovery rate are in line with the forecasts, gradual ending of asset purchase programmes should be commenced in the near future. Two aspects mitigate the concerns about the high inflation: on the one hand, the number of vacancies is surging in the labour market, while, on the other hand, the proportion of people employed before the pandemic but currently adding to the numbers of unemployed is relatively large. China's growth rate continues to strengthen, albeit more moderately than previously expected – 0.6% in the first quarter of 2021 quarter-on quarter and 1.3% in the second quarter. More subdued

<sup>1</sup> International Monetary Fund, World Economic Outlook: Fault lines widen in the global recovery (July 2021). Available at: <https://www.imf.org/en/Publications/WEO/Issues/2021/07/27/world-economic-outlook-update-july-2021>

growth was driven by higher prices of raw materials as well as the restrictive measures of the COVID-19 pandemic implemented by China according to its "zero" policy. The IMF has also revised downwards its GDP growth forecast for China to 8.1% in 2021 (a decrease by 0.5 percentage points compared to the April forecast), while expectations with regard to China's GDP growth in 2022 have remained broadly unchanged – 5.7% (an increase by 0.1 percentage points vis-à-vis the April forecast). Japan, which commenced vaccination in a sluggish manner in the first half of 2021 and, compared to other advanced economies, continues fighting recurrent outbreaks of Covid-19 for the longest period of time following the experienced GDP decrease by 1.0% in the first quarter of 2021 compared to the previous quarter, recovered only marginally in the second quarter (by 0.5% quarter-on-quarter). This increase was supported by better-than-expected pickup in private consumption due in part to the XXXII Olympic Games and uptrend in investment. Moderate growth is expected to persist: according to the IMF projections, Japan's GDP growth rate in 2021 will be 2.8%, but in 2022 – 3.0% (compared to the April forecasts this implies a decrease by 0.5 percentage points in 2021 and an increase by 0.5 percentage points in 2022).

At the same time as growth is returning, various parts of the world also witness a rise in inflation affected by factors related to recovery from the pandemic and growing demand as well as supply side problems. In the view of the IMF, it is expected that in 2022, following the mitigation of one-off factors pushing up inflation, most countries will see inflation return to the pre-pandemic level. The stability of price increase will largely depend on the number of businesses transmitting higher raw material and transportation costs to prices (alternatively, efficiency can be improved or profitability reduced, within certain limits) and respectively – to what extent upward inflationary pressures will motivate the employed to ask for a pay rise. Meanwhile, developments of raw material prices, particularly those of oil prices, have been driven by several events affecting demand and supply this year. For instance, the surge of prices in the oil market experienced in June and July when the oil price reached its peak (77 US dollars per barrel) in 2021 was affected by the hesitation of OPEC+ participants to take decisions on a gradual reversal of the current oil output curbs. In September 2021, OPEC+ made a commitment to continue pursuing the agreement reached before which foresees a gradual increase in oil extraction by 440 thousand barrels a day until 2022. August saw the oil price drop somewhat on average (to 73 US dollars per barrel); by comparison: the oil price fluctuated around 60 US dollars per barrel in 2019. Prices of other raw materials have also picked up, significantly affecting producer prices – the Bloomberg industrial metals subindex, which includes prices of aluminium, copper, nickel and zinc, has climbed from the average level of 180 US dollars in 2019 to more than 250 US dollars in September.

Despite the risks posed by the pandemic and disruptions of supply chains, the euro area economy is recovering swiftly and approaching the pre-pandemic levels. Following the contraction of the economy by 0.3% quarter-on-quarter witnessed in the first quarter of 2021, it rebounded faster than expected in the second quarter (an increase of 2.2% quarter-on-quarter; the September ECB projections foresaw growth of 1.4%). The latest (September) ECB forecasts project a 5.0% growth in 2021, ensuring that the pre-pandemic level is achieved in the euro area. The GDP forecast for 2022 is 4.6%, but for 2023 – 2.1%. However, like elsewhere around the globe, supply chain disruptions and other one-off factors have ramped up the inflation rate. In August 2021, the euro area countries experienced a 3.0% price increase; however, it is expected that the price rise will be temporary. Overall, the ECB projects that the inflation rate will stand at 2.2% in 2021 before falling to 1.7% in 2022 and to 1.5% in 2023 when the upward impact of one-off factors diminishes. The main risks affecting forecasts are the ones linked to the Covid-19 pandemic and the supply side as well as a stronger than expected pass-through of prices to wages and priced-in higher inflation expectations.

Chart 1

**EURO AREA GDP, MANUFACTURING OUTPUT AND RETAIL TRADE TURNOVER**  
(quarterly changes; %)

■ GDP  
— Manufacturing output (right-hand scale)  
— Retail trade turnover (right-hand scale)

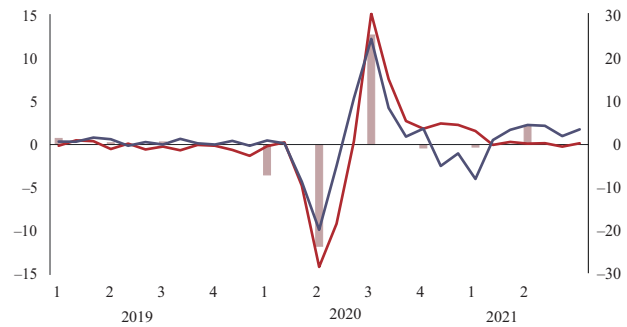
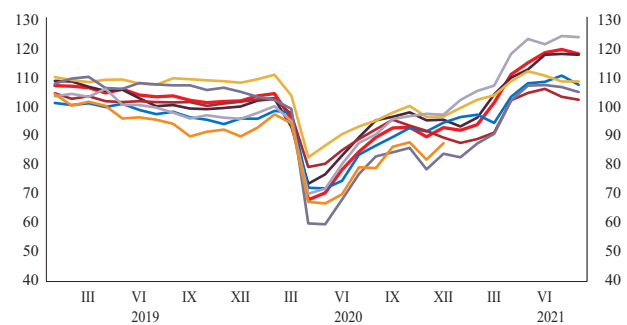


Chart 2

**ECONOMIC SENTIMENT INDICATORS**  
(long-term average = 100)

— Euro area  
— Germany  
— Estonia  
— Latvia  
— Lithuania  
— Poland  
— Sweden  
— UK



Improvements in the ECB projections for the economic growth in the euro area in September reflected a better-than-expected pace of economic recovery. With economic players adapting to the pandemic situation, administrative barriers being reduced and the vaccination coverage expanding, economic development in 2021 looks increasingly positive. The economic sentiment indicator has completely eliminated the impact of the pandemic in the EU and the euro area, reaching all-time highs in July and remaining close to this level also in August.

Following the resilient performance last year, the Baltic States continued their successful recovery. Economic growth in Lithuania decelerated somewhat in the second quarter, while Estonia ranked among the fastest growing EU economies, and the two countries were among the EU countries exceeding the pre-pandemic GDP level. The neighbouring countries saw private consumption rebound strongly; moreover, sizeable private sector investment, which will obviously entail raising economic growth projections for 2021, added more impetus to Estonia's rapid growth in the first half of the year. As of the last quarter of 2021, Estonia's domestic demand will be further fostered by an opportunity provided to the population to access the secondary level pension funds in advance.

Like in the euro area overall and in the developed economies worldwide, growth in Germany accelerated in the second quarter. However, it lagged behind the one projected by Deutsche Bundesbank and still remains considerably below the pre-pandemic level. The services sector recovered along with the loosening of Covid-19 containment measures, while the growth of industry was hindered by delayed raw material supplies, and its value added followed a downward path in the second quarter. Thus, the earlier growth forecast of 3.7% in 2021 by Deutsche Bundesbank is expected to be reduced.

Compared to most EU countries, the Swedish economy contracted less in 2020, and because of the increase in investment and private consumption it nearly reached the pre-pandemic level in the first quarter of 2021. At the same time, the export volume fell in the second quarter, and the negative contribution of net exports to GDP followed an upward trend. Swedish producers also face challenges arising from raw material supplies, and these challenges will prevent their exports from developing at the same pace as foreign demand for their goods over the coming year. At the same time, the expected rise in demand in



Sweden's largest trade partners – Germany and the Nordic countries – will be strong enough, and a very high economic sentiment indicator of businesses and consumers along with increasing employment rates suggest that the future will also see good prospects for the expansion of domestic demand persisting.

The UK economy contracted by 9.8% in 2020, and its GDP also declined in the first quarter of 2021 owing to the COVID-19 containment measures. The country's economic growth resumed in the second quarter, and improvements were registered in all expenditure components; however, investment continued on a downward trend, albeit at a slower pace.

It was the increase in private consumption that had the greatest effect, and, following a considerable decline in the first quarter, exports rebounded, but they are hindered by customs difficulties related to the implementation of the new UK-EU trade regulation since the beginning of the year. The UK's economic recovery is still adversely affected by problems stemming from raw material supplies for its large automotive industry, while the extension of the major government measures to support the preservation of jobs, etc. and the approval of a new support programme will contribute to pursuing the path of economic recovery.

Russia's economic growth accelerated to 3.5% in the second quarter of 2021, reaching the pre-pandemic GDP level. Recovery was facilitated by rebound of private consumption as well as the global oil demand growth. With the delayed consumption factor diminishing, it is expected that the contribution of private consumption will moderate in the future; however, it will be additionally supported by lump sum payments to pensioners and public sector employees before elections. To reduce the inflation driven by food price and demand pressures, the Central Bank of Russia has resorted to raising interest rates.

## 2. Financial Conditions

*Major central banks continued with the implementation of highly accommodative monetary policies. With inflation hitting the levels unseen for a long time, the debates over the scope of monetary accommodation to be provided going forward have intensified. Nevertheless, according to the central banks, such elevated inflation readings are transitory, and a too early withdrawal of the monetary policy support should be avoided.*

*An improvement in the economic sentiment of households and businesses was observed in Latvia at the beginning of summer, leading to higher spending and appetite for borrowing. Along with the economy recovering and activity strengthening, competition among credit institutions tightened, contributing to a reduction of interest rates in the lending segments considered relatively safer; nevertheless, the lending rates in Latvia remain among the highest and access to loans among the poorest in a broader euro area perspective.*

### 2.1 Decisions of the ECB and other major central banks

Following an assessment of the economic outlook, the Governing Council of the European Central Bank has decided to maintain a particularly accommodative monetary policy stance. Key ECB interest rates continue to be at their historical lows. Net asset purchases within the framework of the regular asset purchase programme (AIP) continue at a monthly pace of 20 billion euro. The pandemic emergency purchase programme (PEPP) also remains active. In order to preserve favourable financing conditions, the monthly pace of net purchases within its framework was increased considerably over the spring and summer months as compared to the first two months of the year. At its September meeting, however, the Governing Council of the ECB judged that, based on a joint assessment of financing conditions and the inflation outlook, favourable financing conditions could be maintained with a moderately lower pace of net asset purchases than in the previous two quarters. The PEPP envelope remained unchanged at a total of 1850 billion euro, whereas the asset purchases will continue at least until the end of March 2022. 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.

At the beginning of July, the ECB's strategy review was completed. The new strategy statement provides for a symmetric commitment to the inflation target of 2% in the medium term (previously: close to, but below, 2%). Forward guidance on interest rates was also adjusted to reflect the strategy changes. The new ECB's strategy effectively provides for a slower response of the ECB's Governing Council to any short-term movements in inflation, with the outlook and confidence that inflation is robustly and sustainably converging towards the objective playing a central role in decision-making.

No changes were implemented in the conditions of the third series of the targeted longer-term refinancing operations (TLTRO III); yet, following the expiry of the special reference period at the end of March, it was obvious that a large part of the euro area banks was able to maintain the amount of eligible lending in order to enjoy a more favourable interest rate.

At the September press conference, Christine Lagarde, President of the ECB, noted that the recovery of the economy continues, and output is expected to exceed its pre-pandemic level by the end of the year. It was also admitted that the economy rebounded more than expected in the second quarter of 2021, and it is on track for strong growth in the third quarter. The recovery builds on the success of the vaccination campaigns in Europe, which have allowed a significant easing of the restrictions.

The ECB sees the risks to the economic outlook of the euro area as broadly balanced.

The analysts following the ECB's actions foresee that an announcement that the net asset purchases under the PEPP will be discontinued in March 2022 will be made at the December 2021 meeting. At the same time, they also expect some changes in the regular asset purchase programme, so that to smooth out the overall decline in the ECB's net asset purchases.

Financial markets do not expect any changes in the key ECB interest rates earlier than in 2024.

Chart 3

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

— Prior to COVID-19 crisis (February 2020)  
— Prior to PEPP announcement (March 2020)  
— 15 September 2021

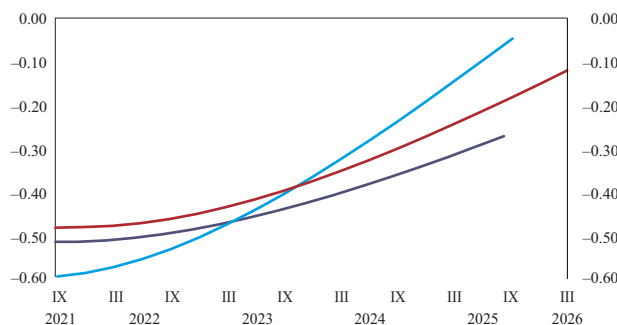
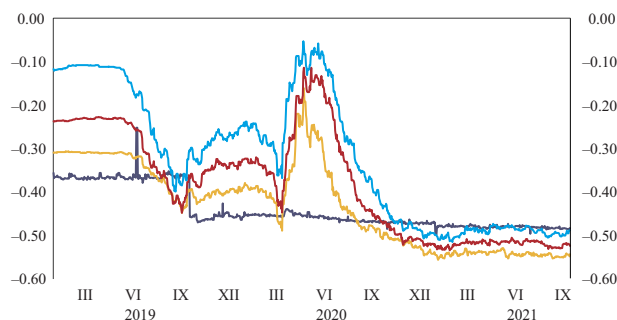


Chart 4

**EURO MONEY MARKET RATES (%)**

— EONIA  
— 3-month EURIBOR  
— 6-month EURIBOR  
— 12-month EURIBOR



The target range for the federal funds rate has been left unchanged at 0.00%–0.25% since the end of March. The FRS also continues its previous asset purchase programmes by increasing its holdings of both US Treasury securities and agency mortgage-backed debt securities at a monthly pace of 120 billion US dollars. Nevertheless, discussions about the need to reduce the FRS support are gathering strength. The annual personal consumption expenditures (PCE) inflation is above 4%, which, regardless of the change in the FRS strategy implemented last summer and targeting inflation moderately above 2%, still makes the management of a part of the Federal Reserve Banks uncomfortable. Jerome H. Powell, the Chair of the Board of Governors of the FRS, still regards the spike in inflation as temporary, but also acknowledges that, as concerns inflation, the progress required to cut the net asset purchases has already been made. As to the second goal of the FRS's dual mandate, maximum employment, Chair Powell believes that there has been a substantial progress, but there is still some ground to cover. At the Jackson Hole Economic Symposium that took place at the end of summer, he also remarked that ending the asset purchase programme would not necessarily mean an imminent rise in the interest rates.

Meanwhile, at the 22 September meeting of the FOMC, J.H. Powell announced that if the US economy continues to develop as expected, a moderation in the pace of asset purchases may soon be warranted. At the press conference, he said that the decision on ending the asset purchase programme could be announced already in November and the programme could be terminated in mid-2022. The dot plot published by the FRS regarding the target range for the federal funds rate shows that 50% of the Board members believe that the range could be raised already in 2022.

The Bank Rate set by the Bank of England has remained unchanged since the end of March at 0.1%. The cumulative amount of quantitative easing at 895 million British pounds

sterling has also remained unchanged, yet the debate over the need to continue with the asset purchases is getting stronger. Although the Monetary Policy Report of the Bank of England refers to the rise in inflation as transitory, it has led some members of the Monetary Policy Committee of the Bank of England to judge that the central bank should reduce the monetary stimulus. At the same time, other Committee members are more reserved in their opinions, pointing out that, although the economic growth is strong, it remains fragile, and the uncertainty associated with the spread of SARS-CoV-2 virus remains high. Looking forward, analysts are certain that the Bank of England will end the asset purchases as well as raise the Bank Rate at least twice as soon as next year. Financial markets have currently priced in a single 10 basis points rise already in spring 2022.

Chart 5

**MARKET IMPLIED CENTRAL BANK POLICY RATES (%)**

— US (April 2021)  
— UK (April 2021)  
— Japan (April 2021)  
- - - US (September 2021)  
- - - UK (September 2021)  
- - - Japan (September 2021)

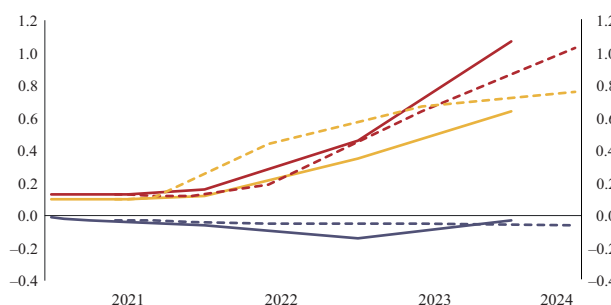
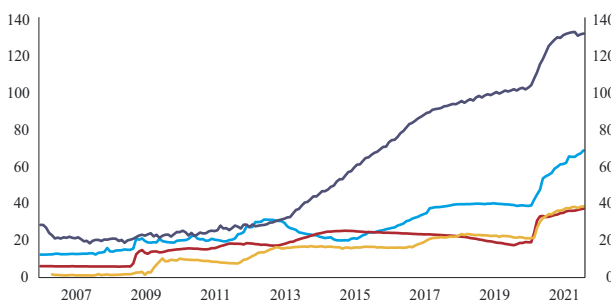


Chart 6

**CENTRAL BANK ASSETS (relative to GDP; %)**

— UK  
— US  
— Euro area  
— Japan



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  $0.0\%$ . At the end of March, the Bank of Japan published a strategy assessment, followed by a slight adjustment of its monetary policy instruments. Although the target level of 10-year government bond yields is still set at around  $0.0\%$ , the range of fluctuations has been slightly widened to  $\pm 0.25\%$  of the target. As to the purchases of exchange-traded funds, modifications were introduced, saying that purchases would be made only if the financing conditions deteriorate. In addition to that, at the beginning of summer, the Bank of Japan announced a new climate change response financing measure. Support from the Bank of Japan under the measure is available to credit institutions that provide funding to projects addressing climate change issues. These credit institutions have access to the deposit facility on more favourable terms or can receive interest-free loans for implementation of such projects. Analysts expect the Bank of Japan to continue to provide an ample degree of monetary accommodation. No changes in the policy rates are priced in by financial markets in a foreseeable future.

## 2.2 Global financial market developments

With major central banks maintaining a very high degree of monetary accommodation, the sovereign bond yields in the advanced economies have remained broadly unchanged in the period from the beginning of April 2021. The yield on the German 10-year government bonds has overall slightly decreased (by 1.4 basis points; to  $-0.31\%$ ), although there has been some moderate volatility during the reporting period. Changes in the US have been more significant, with the yield on comparable US Treasury bonds declining by 44 basis

points and closing the 15 September trading session at the level of 1.30%. A more notable drop in the bond yields on both sides of the Atlantic at the end of summer reflects the loss of momentum in economic growth and the outbreak of Covid-19 Delta variant, contributing to investors shifting to fixed yield securities markets. Minor increases in the yields on the French, Italian and Spanish government bonds (of 7.2 basis points, 3.4 basis points and 0.9 basis point respectively) as compared to the insignificant fall in the German government bond yield suggests that investors expect a continuation of ample monetary accommodation in the euro area and a transitory period of a higher inflation. At the same time, the yields on those government bonds remain low from a historical perspective (0.03%, 0.70% and 0.34% respectively). The future evolution of the government bond yields will largely depend on the central bank decisions and the economic development.

Corporate bond yields in the euro area have continued to decrease in the case of both investment grade corporate debt securities and high-yield debt securities. The sizeable government bond purchases made by central banks and the associated low yields on government bonds have supported the investors' preference for a higher risk and better remunerated corporate debt securities; therefore, the yields on corporate debt securities are also shrinking. Moreover, the decline in yields was more pronounced in the high-yield debt securities market and it was observed across all credit rating categories. The yields on investment grade corporate debt securities and high-yield debt securities in the US have also contracted. Overall, the high-yield debt securities have fared slightly better than the investment grade securities and that could be related to the fact that high-yield securities normally have a larger coupon and shorter maturities, which decreases their sensitivity to inflation and interest rate developments. In the coming months, the yields on corporate debt securities will remain dependent on the forward monetary policy guidance provided by central banks, general economic development and sectoral outlook, and will also most likely remain sensitive to inflation developments.

Stock markets have been growing since the beginning of April. The EURO STOXX index characterising the euro area stock market has increased by 7.5%, whereas S&P 500 index characterising the US stock market has grown even more, by 12.8%. The strong performance of the stock markets is explained by both an improvement in the economic situation and the solid earnings figures for the first and second quarters that for most businesses turned out to be much better than expected by analysts. Neither European VSTOXX, nor US VIX characterising the expected stock market volatility have grown significantly since the beginning of April, albeit remaining higher than before the pandemic. Nevertheless, despite the lack of any significant changes in volatility indices overall, there were individual sell-off episodes which were explained by the investors' concerns that the elevated inflation could make the central banks unwind their support sooner. Over the period under review, the most significant price increases in the euro area stock markets were observed for technology as well as personal hygiene and food products companies (a 21.4% and 17.8% rise respectively), whereas the biggest losses were experienced by travel and recreation, and insurance companies (an 8.3% and 3.5% drop respectively). Looking at the euro area stock market at a country level, the Spanish stock market index IBEX 35 appreciated by 0.6%, performing worse than the German DAX, Italian FTSE MIB and French CAC 40 (an increase of 4.0%, 4.5% and 8.5% respectively). Further stock market developments will largely depend on the pace of the economic recovery and the central banks' ability to communicate a gradual withdrawal of monetary support at the right time. Timely communication is of a paramount importance, as well as that the continued wait-and-see approach of the central banks would not result in a need of a more abrupt unwinding.

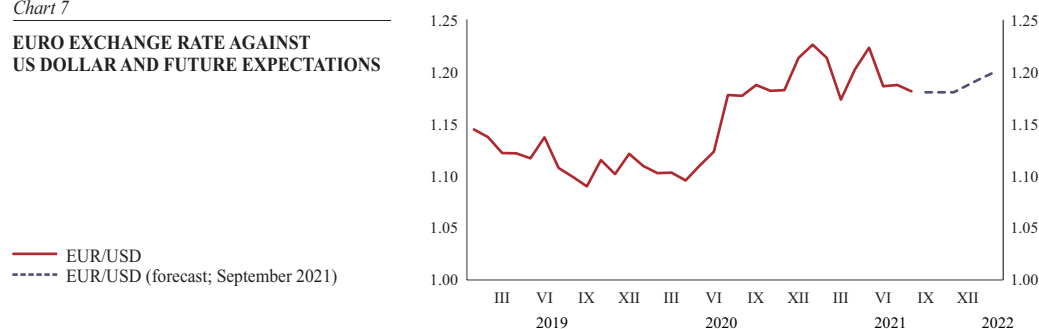
From the beginning of April to 15 September, the euro slightly appreciated by 0.7% against the US dollar (to 1.1817 US dollars per euro). A somewhat steeper rise in the euro's exchange rate up to the end of May can be partly explained by the favourable economic growth data and vaccination progress in the euro area. Later, a major role in the development



of the euro's exchange rate vis-à-vis the US dollar was played by the FRS starting to signal that the existing highly accommodative monetary policy could be revisited and tightened, resulting in the euro's depreciation. At the same time, however, on several occasions, the Chair of the FRS J.H. Powell has also highlighted the maximum employment goal of the dual mandate of the FRS, which could take a longer time to reach. Looking forward, analysts expect that the euro's exchange rate against the US dollar will linger around 1.18 until December, followed by a slight appreciation. Lack of major volatility up to December can be explained by the market expectations that December could be the month when the ECB and FRS both announce their decisions about the future policy course.

Chart 7

**EURO EXCHANGE RATE AGAINST US DOLLAR AND FUTURE EXPECTATIONS**



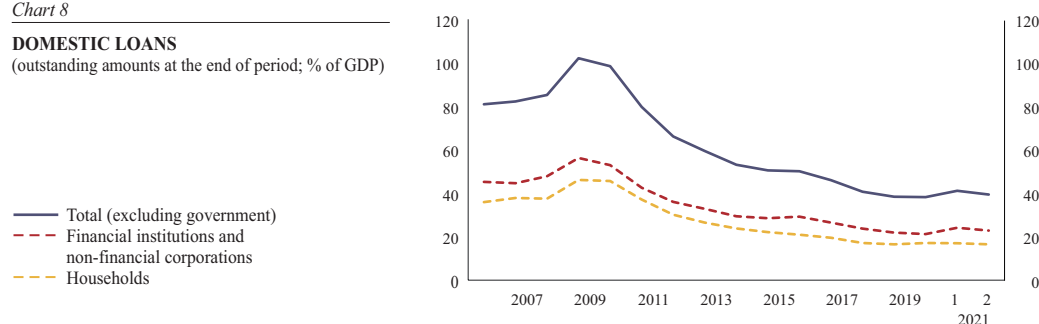
### 2.3 Financing conditions in the Latvian economy

Over the most recent months, lending activity has slightly improved, with a moderate increase observed in loans for house purchase and consumer credit also recovering gradually. At the same time, corporate lending has been more volatile. Nevertheless, the growing volume of new loans suggests positive dynamics also in this segment.

From March to August 2021, loans to non-financial corporations and households increased by 1.5%, although 2/3 of this rise were attributable to a one-off factor: in July, the first phase of the deal between AS Citadele banka and ABLV Bank AS in liquidation for the purchase of the majority of ABLV's mortgage loan portfolio was completed, with AS Citadele banka adding several thousands of mortgage loan agreements worth 112 million euro to its mortgage loan portfolio. Loans to non-financial corporations contracted by 2.9% over the first six months of 2021, whereas household loans grew by 4.1%, including a 4.6% increase in loans for house purchase and a 4.4% increase in consumer credit. In August, the annual growth rate of domestic loans reached 7.5%, albeit remaining close to zero, when excluding the impact of the restructuring of the banking sector and the reclassification of institutional sectors as well as that of one-off factors (0.1% overall, including a 3.3% decrease in loans to non-financial corporations and a 2.0% growth in household loans).

Chart 8

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



Loan-to-GDP ratio has slightly improved in 2021 (39.4% in the second quarter), but it still remains one of the lowest in the EU. A solid increase in new loans pointed to stabilisation in lending to households: over the last six months (from March to August), the amount of new loans granted to households was 32.4% larger than in the previous six-month period (from

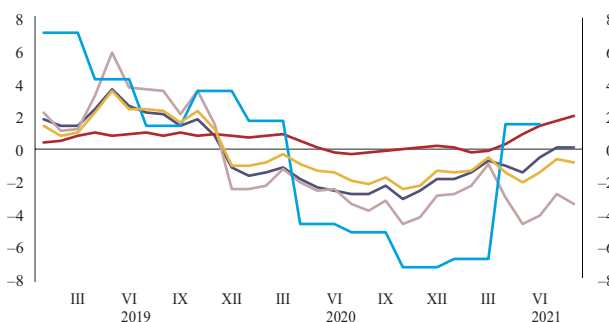
September 2020 to February 2021). At the same time, the monthly amounts of new loans to non-financial corporations remained highly volatile. The contribution of the non-bank sector to lending has returned to a positive territory, with the annual growth rate of loans overall standing at 6.1% in June, including that of loans by leasing companies at 1.5%.

Chart 9

**DOMESTIC LOANS**

(outstanding amounts; annual changes\*, %)

- Total (excluding government)
- Non-financial corporations and households
- Non-financial corporations
- Households
- Loans granted by leasing companies



\* Excluding the effect of credit institution sector restructuring.

Interest rates on large corporate loans and secured household loans for house purchase decreased, whereas those on riskier loans, i.e. small and medium-sized corporate loans, other lending to households as well as household loans for house purchase which are not secured by a guarantee increased on account of pricing in a higher credit risk premium. The overall level of the interest rates on corporate loans in the period from January to August was determined by the downward trend in the interest rates on large loans. Loans above 1 million euro continued to have a dominant role in the overall flow of new corporate loans in euro. Against the background of the economic recovery, Latvia's credit institutions were more supportive of large enterprises in the first half of 2021: the credit standards applicable to them were eased more often and margins on average loans were also reduced, at the same time widening the margins on riskier loans. According to the credit institutions, the margins on average loans to large enterprises were reduced due to competition from other credit institutions; nevertheless, the ability of large enterprises to access financing outside the credit institution system on more favourable terms is also likely to have had a downward effect on margins. According to the euro area bank lending survey, credit institutions applied more favourable lending policies towards large enterprises also as a result of a higher risk tolerance of credit institutions and willingness to lend funding to financially stronger and more promising enterprises with a lower credit risk. The interest rate on new euro loans to non-financial corporations contracted by 0.8 percentage point during the reporting period (from 3.0% in January 2021 to 2.2% in August). The respective interest rate on large loans (over 1 million euro) declined by 0.9 percentage point (from 2.9% in January 2021 to 2.0% in August), whereas the interest rate on small and medium-size loans (up to 1 million euro) increased by 0.4 percentage point (from 3.8% in January 2021 to 4.2% in August). Interest rates on loans to non-financial corporations are likely to decline somewhat more also in the second half of 2021 on account of competition from other Latvia's credit institutions and lower demand for loans. More lenient approach of credit institutions to granting riskier loans could be a factor preventing a decline in interest rates on small and medium-size loans.

The interest rates on household loans for house purchase remained broadly unchanged from January to August 2021. As a result of stronger competition from other credit institutions, the interest rates on secured household loans for house purchase, which are usually long-term loans and involve a collateral, slightly decreased in the reporting period in almost all major credit institutions and in the market segment overall. The respective interest rates were kept at a low level also by the support available from the housing guarantees programme of AS Attīstības finanšu institūcija Altum. At the same time, the rising demand for household loans for house purchase was a factor preventing a more significant decline in the interest rates: according to the euro area bank lending survey, in the first half of 2021, the demand increased (in three out of four surveyed Latvia's credit institutions) on account

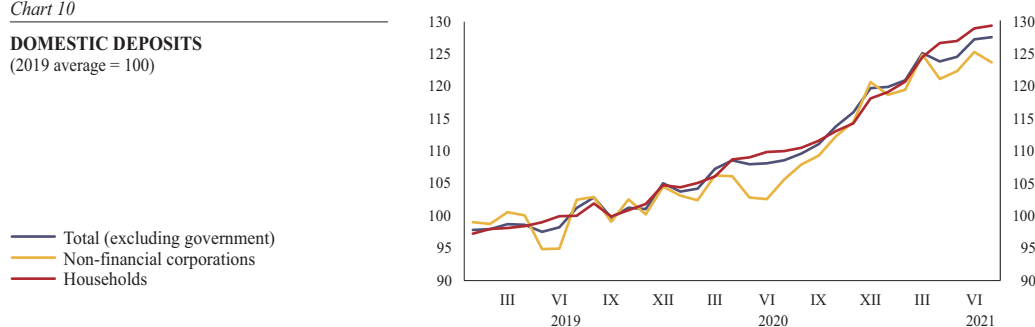
of growing household confidence, internal funds, as well as a positive view of households on the housing market development prospects and expectations of a rise in housing prices. From January to August 2021, interest rates were also slightly increased on unsecured housing loans that are usually short-term loans and most often taken for the purpose of real estate renovations. The expected rise in interest rates due to deteriorating quality of previously granted housing loans and the expiry of the loan moratorium was reflected in higher renegotiated interest rates only in August. Overall, from January to August 2021, the interest rate on new secured and unsecured euro loans to domestic households for house purchase grew by 0.1 percentage point (2.5% in August 2021). Over the second half of the year, the interest rates on loans for house purchase will still be affected by the magnitude and duration of the upcoming waves of Covid-19 pandemic, and, in the case of more adverse developments, the quality of previously granted loans for house purchase could deteriorate and result in upside risks to the lending rates in this segment. At the same time, an improvement in lending in the circumstances of a stable demand could contribute to lending to higher credit risk households for purchases of more expensive housing.

The interest rate on consumer credit and other lending to households overall increased slightly on account of rising interest rates on other lending to households. At the same time, the interest rate on consumer credit followed a downward trend, with individual credit institutions reducing the margins as a result of an improvement in their financial position and tightening competition. Overall, the interest rate on new consumer credit and other lending to households in euro increased to 10.7% in the reporting period (9.9% in January 2021). The demand for consumer credit initially decreased in the first months of 2021, but afterwards, when the economy started to recover, the Covid-19 pandemic related restrictions were eased and the EU digital Covid-19 certificate reopening travel opportunities was introduced, bounced back to the previous year's level on account of consumer credit and other lending to households granted based on new loan agreements.

Households continued to build up their savings on bank accounts: the increase as compared to the respective period of the previous year was stable from March to August, ranging from 16% to 17%, although the monthly growth rate decelerated, with the increase in household deposits even becoming somewhat negative in August for the first time in the last two years. At the same time, corporate cash flows were more volatile, with import and investment transactions depleting the savings in individual months. Nevertheless, the annual growth rate of corporate deposits also was high, ranging from 14% to 22% during the above-mentioned period. In August, the annual growth rate of domestic deposits was 16.0%, down from 17.7% in June which was the highest level achieved since 2007. From March to August, the overall rise in domestic deposits with banks was entirely attributable to household deposits rising by 343 million euro or 3.8%, while deposits by non-financial corporations slightly contracted by 15 million euro or 0.3%. In March and April, household deposits largely increased on account of the disbursements of a lump sum benefit in the amount of 500 euro per child and a lump sum state benefit in the amount of 200 euro for Latvia's residents receiving pension or state social security benefit from Latvia.

Chart 10

**DOMESTIC DEPOSITS**  
(2019 average = 100)



The cost of funds for 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 increasingly approaching 0% in the first half of 2021. The low level of deposit rates continues to be underpinned by the ECB's monetary policy actions. A downward impact on deposit rates was also still exerted by the changes in the household savings behaviour caused by the Covid-19 pandemic, i.e. the build-up of forced savings as a result of 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, an even larger proportion of the savings of households and non-financial corporations was placed in demand deposits which are easier accessible but less profitable. The low level of deposit rates enables Latvia's credit institutions to offer domestic households and non-financial corporations more favourable lending terms and conditions; nevertheless, the key role is played by the shift in bank lending policies and borrower demand, state support for loan guarantees as well as the level of borrowers' risk.

If the crisis caused by the Covid-19 pandemic is managed successfully, the recovery of the external and domestic demand and improvement of the economic sentiment could gradually have a positive effect on lending growth. With further reopening of the economy and more spending opportunities, deposit growth can be expected to moderate progressively. Nevertheless, it is unlikely that with the uptake of vaccines remaining low and the next pandemic wave approaching, businesses and households will become less cautious in the coming months; therefore, for the time being, savings will continue to grow, but the attitude towards new debt could be quite reserved, thereby increasing the gap between the credit resources required for economic development and those that are actually invested.

Favourable financing conditions, continuously growing corporate and household deposits and the rising economic activity are factors contributing greatly to the development of Latvia's securities market. Several enterprises have announced their intention to issue securities in an initial public offering. At the same time, along with the drafting and adoption of the new Law on Covered Bonds, the legal framework for a new type of instrument has been created. This instrument can be issued by credit institutions, and it is secured by a dedicated pool of assets.

All three major credit rating agencies – Moody's, S&P Global Ratings and Fitch Ratings – confirmed Latvia's ratings at their previous levels (A3, A+ and A– respectively) and maintained a stable outlook. The rating agencies stressed that the economic impact of the Covid-19 pandemic turned out to be smaller than initially projected, the government debt increase was moderate, and Latvia had achieved significant progress in combating money laundering in the financial sector.

On 30 June, Latvia launched eurobonds in the amount of 500 million euro in the external market, maturing in January 2029. This issue was required considering a US dollar denominated eurobond issue in the amount of 331 million euro maturing in June. The bids totalled 2.6 billion euro, whereas the average yield and the coupon rate had been set at 0.003% and 0% respectively. The spread of the average yield at the auction over the swap rate was 6 basis points, whereas the spread over the respective German government bond yield was 39 basis points. The yield was 6 basis points lower than initially estimated because of the relatively small amount offered. At the same time, as no eurobonds are maturing next year, the total redemption amount also will be smaller.

The favourable financing conditions prevailing in the euro area also have enabled Latvia's government to continue with the practice of placing securities that were initially issued in external markets in the domestic market (one ISIN for securities issued in both the domestic and external markets). Nine auctions were held from April to mid-September for

4-, 7- and 10-year securities, with the bids totalling 679.8 million euro and securities in the amount of 210.5 million euro sold. The yield on 7-year securities overall edged up from -0.25% in February to -0.21% in September, peaking at -0.11% in mid-June. Similar to the developments in the euro area securities market, the average yield on Latvia's 10-year government bonds remained broadly unchanged in the secondary market, moving from 0.01% on 1 April to 0.00% on 15 September. The spread over the respective maturity German government bonds remained unchanged at 31 basis point.

Chart 11

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

— France  
— Spain  
— Italy  
— Latvia

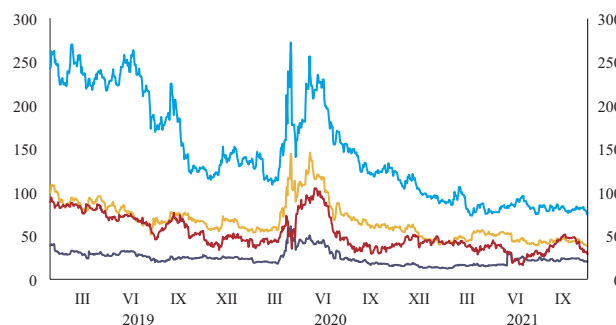
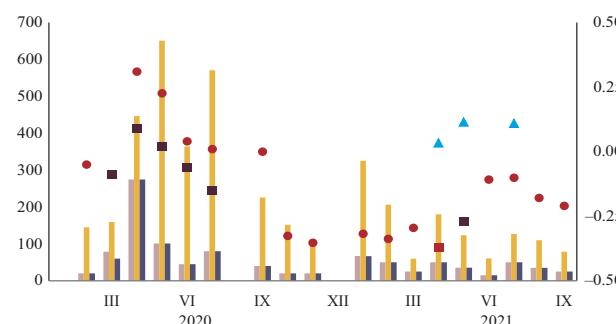


Chart 12

**AUCTIONS OF GOVERNMENT SECURITIES**  
(millions of euro)

■ Bids  
■ Demand  
■ Sold  
■ 2-4-year bond yield (%) (right-hand scale)  
● 5-7-year bond yield (%) (right-hand scale)  
▲ 8-10-year bond yield (%) (right-hand scale)



Several enterprises have announced their intention to issue equities in an initial public offering (AS Virši-A, AS DelfinGroup), as well as to issue debt securities (AS Augstsprieguma tīkls, AS Latvenergo, AS Attīstības finanšu institūcija Altum). AS Latvenergo issued 7-year green bonds in the amount of 50 million euro at a fixed annual interest rate of 0.5%. The bids exceeded supply 4.6 times. The proceeds from the green bond issue will be invested in the reconstruction of the Daugava hydroelectric power station cascade, energy efficiency improvements, nature protection and other projects. AS DelfinGroup issued 2-year bonds in the amount of 5 million euro with an annual coupon rate of 9.75% in a closed offering. The bids totalled 9.3 million euro.

The FCMC allowed several exchange-traded companies to place mandatory share buyout offers: AS Valmieras stikla šķiedra (and the company was voluntarily delisted from the stock exchange), AS Olainfarm, AS Rīgas autoelektroaparātu rūpnīca. At the same time, the shares of AS Baltic Technology Ventures were delisted from an alternative market at the decision of the FCMC.

The common tendencies observed in equity markets also are evident in Latvia's stock market, where the OMXR index had improved by 15.5% on 15 September 2021 as compared to 1 April, whereas the Baltic share index OMXBBGI had grown by 35.3%. The steepest rise was observed for the shares of AS SAF TEHNIKA, AS MADARA Cosmetics, AS Olainfarm, appreciating by 80.2%, 38.5% and 29.6% respectively. The largest turnover in the period was reported for the shares of AS Olainfarm (4.5 million euro) and AS SAF TEHNIKA (1.9 million euro). AS SAF TEHNIKA increased its turnover significantly as well as continued to invest in new products and product modifications. The performance of AS MADARA Cosmetics was also noteworthy.



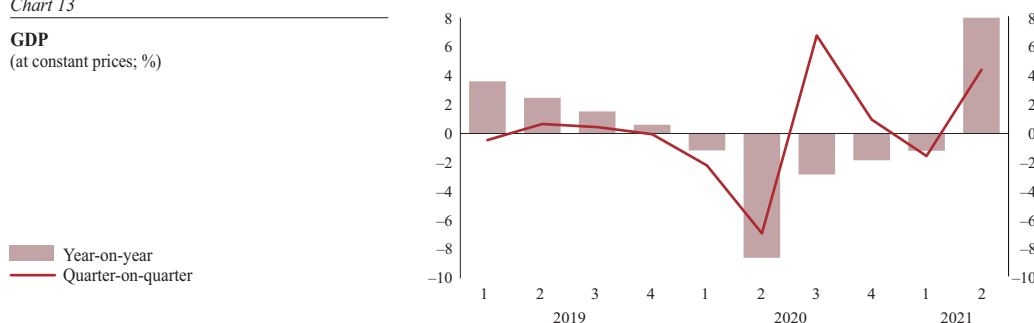
## 3. Sectoral Development<sup>1</sup>

*With both Latvia and its trade partners gradually lifting a number of restrictions introduced to combat Covid-19, economic growth recovered swiftly in the second quarter, and Latvia's GDP was even slightly above the pre-crisis level. The situation across sectors is heterogeneous: better results were observed in the sectors producing goods and the services sectors which were less affected by the restrictions on gathering and movement as well as caution on part of consumers.*

Although restrictions were in force for a longer period during the second wave of the pandemic, the Latvian economy suffered less due to adaptability of economic agents and the provided support measures. Thus, the first quarter of 2021 saw GDP contracting by 1.6% – less than during the period when the state of emergency was declared for the first time because of Covid-19. In the second quarter, a decline in morbidity rates made it possible to ease restrictions and gradually improve the availability of services. This resulted in a strong economic revival and GDP growth reaching 4.4% in quarterly terms. During the pandemic, the services sectors more directly affected by the restrictions have experienced the most pronounced growth fluctuations. The fluctuations encountered by the trade and manufacturing sectors have been weaker with other factors, in addition to the Covid-19 pandemic, having also played a significant role, e.g. prices of raw materials, shortages of components, etc. The value added of several sectors, including manufacturing, trade, financial and public services, exceeds the pre-pandemic level. Better than expected growth of the transport sector might be explained by an increased role of delivery services during the pandemic.

Chart 13

**GDP**  
(at constant prices; %)



### 3.1 Manufacturing

Despite the continuing difficulties related to shortages of various components, higher raw material prices, the lack of freight containers and growing transportation costs the manufacturing sector outperforms the forecasts once again and scores good growth rates. At the same time, the sharp rise in prices leads to a further widening of the gap between the physical volume and turnover. This applies notably to exported products whose sales volumes increase faster than in the local market.

The following developments can be observed in manufacturing subsectors.

- The future outlook of the wood industry remains broadly unchanged, unless difficulties arise due to the sanctions imposed by Belarus. Bark beetles have caused less damage to Latvia's forests this year, the demand and prices remain high. Overall, the sector will witness a favourable situation as long as customers are ready to pay a higher price. It is true that prices are not high in all segments and that not all of the businesses dealing with further processing of products succeed in aligning the rise in costs with the final product price.

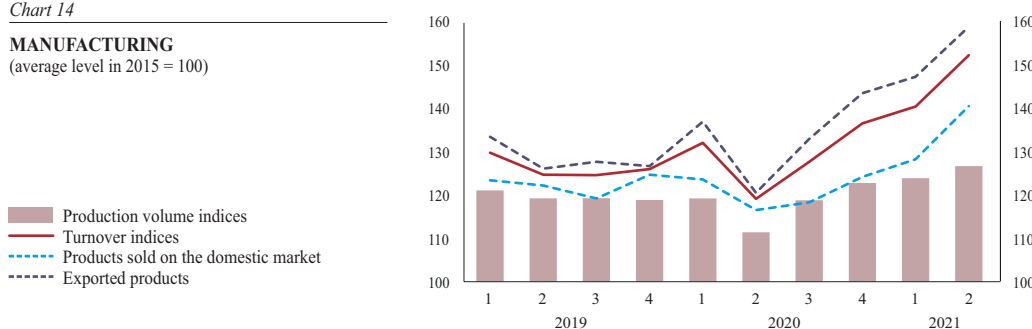
<sup>1</sup> This chapter analyses GDP and sectoral value added at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

- The first half of the year was entirely successful for the manufacture of pharmaceutical products – a subsector whose data are not disclosed due to the dominance of large businesses. AS GRINDEKS registered outstanding growth in the previous year and has already been turning the planned record high levels into a tangible reality this year (in the first half of the year, turnover increased by 22% and profit – by 55% year-on-year<sup>1</sup>). AS Olainfarm has also experienced a rise in turnover and profit (100% and 77% respectively in year-on-year terms<sup>2</sup>).
- The stagnating dynamics observed in food processing for a number of years are still present. At the same time, manufacture of beverages enjoyed a speedy improvement in the second quarter, following worse progress made in the previous quarters.
- A number of small sectors achieved a good overall result in the first half of the year: manufacture of furniture, manufacture of chemicals and chemical products, printing, manufacture of building materials, etc.

Overall, manufacturers adapted to the pandemic-related restrictions relatively quickly, they used their potential, reacted rapidly to changes in the raw material and final product markets as well as of them even expanded their export markets. On the whole, it is reasonable to adhere to optimistic prospects, and the effects of new waves of the pandemic on industry is becoming increasingly blurred.

Chart 14

MANUFACTURING  
(average level in 2015 = 100)



### 3.2 Construction and the real estate sector

In the first half of 2021, the performance of the construction sector was weaker than projected and compared to the first half of 2020 it recorded a decrease in output volumes almost in all basic sectors of construction, except specialised construction activities. This was driven by several factors: 1) the base effect and the adverse weather conditions affecting construction in the first quarter of 2021; 2) the effects of the Covid-19 pandemic that led to logistics problems and lower capacity utilisation during the first wave of the pandemic; and 3) the massive increase in market demand throughout most of the world caused by boosting the economy with investment in construction that posed problems of the availability of some building materials and increased construction costs globally. Although the value added of the construction sector grew by 2.6% in the second quarter compared to the previous one, it could not offset the downturn experienced in the first quarter.

In the second quarter of 2021, construction output at constant prices shrank by 0.7% quarter-on-quarter, but it increased moderately (by 1.1%) compared to the respective period of the previous year. This was mainly due to an uptrend in specialised construction works (completion of works) and completion and release for use of several large objects of construction, e.g. the entertainment area of Domina Shopping, a library in Ogre, SIA Getļņi EKO facility for processing biodegradable waste and the Ice Hall in the Daugava Stadium.

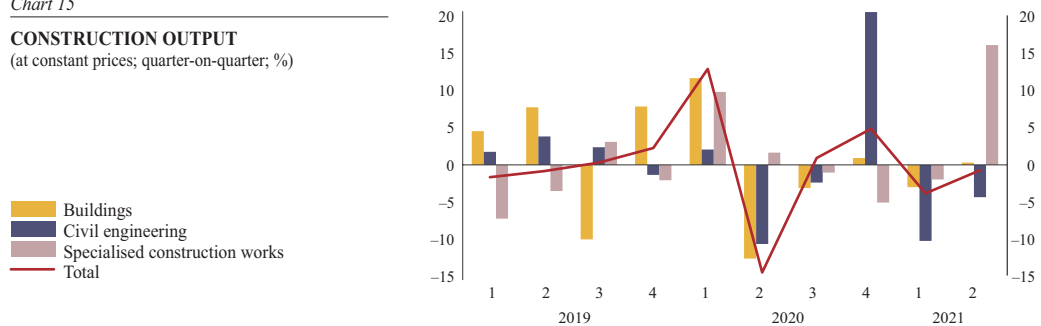
<sup>1</sup> See: Grindex Group recorded a record-high turnover and profit in the first half of 2021.

<sup>2</sup> JOINT STOCK COMPANY/LIMITED LIABILITY COMPANY XXX (nasdaqbaltic.com)

Risks relating to climbing prices and costs become ever more pronounced in the construction sector. The total construction costs have picked up since early 2021. In July 2021, the overall level of construction costs edged up by 8.2% year-on-year. This was mainly driven by surging prices of building materials (metal, cement, glass, dolomite chippings, sand, some products of wood, e.g. OSB plates). The rise in the average wage of workers in the construction sector is similar to economic growth. However, shortages of skilled labour together with climbing global demand and prices of building materials and their limited supply have increased the total costs dramatically, casting more doubts on the sector's resilience to the risk of overheating. The pickup in construction costs has an adverse effect not only on investors' willingness to make new investment but also on the execution of the agreements concluded previously, giving rise to concerns about the failure to carry out the planned works and to meet the deadlines and thus also about the termination of several agreements and the failure to complete objects of construction.

Chart 15

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



However, high activity is expected to continue in the construction sector as suggested by the growing number of building permits (by 37%) and an increase in construction areas approved therein during the second quarter. Over the next few years, a sizeable inflow of funds intended for construction of various infrastructure facilities, public and municipal buildings is expected to reach the construction sector from the European Recovery and Resilience Facility as well as from the European Structural Funds within the multi-annual budgetary framework. At the same time, the sector will receive funding for the implementation of several major construction projects, e.g. Rail Baltica and Liepāja prison in the coming years. Meanwhile, the need for gradual renewal of the housing stock will determine growth in construction of residential buildings.

The construction confidence indicator has been improving since March owing to more positive assessment of the expected orders, however, it remains in negative territory. This is driven by shortages of raw materials, technical equipment and skilled labour, a rise in costs as well as by the risks of overheating of the construction sector related to large public procurement scheduled for 2022.

In the second quarter of 2021, the value added of the real estate market sector, following a weaker result registered at the beginning of the year, elevated by 1.6% quarter-on-quarter and by 0.3% year-on-year. In the first eight months of 2021, the number of real estate transactions registered in the Land Register increased by 18% year-on-year in Latvia, but in Riga – by 19%. The activity and demand in the housing market have grown in all segments.

The year 2021 is characterised by a rise in real estate prices, which have been surging since May. In August, the average standard apartment price increased to 877 euro/m<sup>2</sup>, rising by 1.8% month-on-month. Overall, standard apartment prices have picked up by 8.7% in 2021. Price hikes are related to the rise in construction costs, demand expansion and changes in construction regulations requiring greater energy efficiency of buildings. The highest increase in standard apartment prices has occurred in the vicinity of Riga. According to the real estate market analysis carried out by SIA ARCO REAL ESTATE, the first eight months

of 2021 saw standard apartment prices move up in year-on-year terms, e.g. by 17% in Ogre, by 18% in Jūrmala, by 16% in Salaspils and by 19% in Jelgava.

The Covid-19 pandemic has brought about several new trends in the real estate market, e.g. business-class housing is purchased more often, and the number of transactions in land and private houses has followed an upward trajectory (particularly in Pierīga). The Covid-19 pandemic has introduced changes in the daily lives of people, and the need to perform remote work at home has led to an increased interest in life outside major cities.

The real estate market activity is expected to continue. This is evident from the information provided by banks on loans to households for house purchase and the increase in the number of concluded agreements. This can also be seen from the need to renew the housing stock, from the number of transactions in the segment of private houses that experiences the most buoyant growth seen over the past few years.

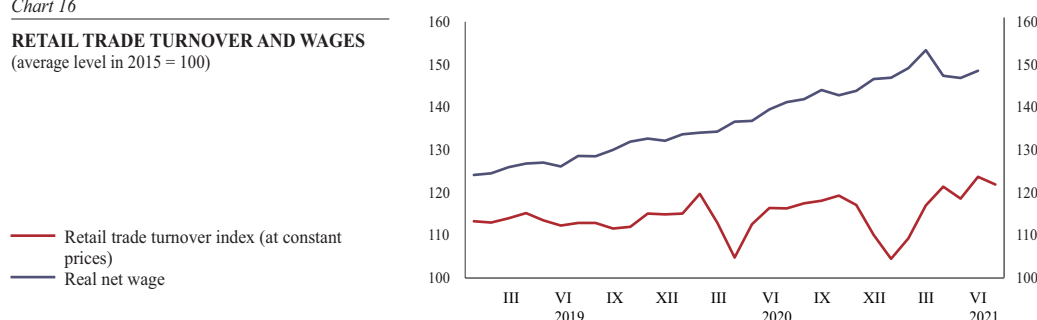
### 3.3 Trade

Growth in the trade sector was surprisingly moderate in the second quarter (2.1% quarter-on-quarter) compared to the strong dynamics of real turnover observed in retail trade, wholesale and sales of motor vehicles. A reduction in restrictions notably affected retail trade indicators, since points of sale were rapidly made available to the public after the prolonged closure, thus boosting the overall retail trade turnover. The rise in retail trade turnover decelerated when more and more services involving public gatherings could benefit from the easing of restrictions. Sales of motor vehicles also rebounded along with the easing of restrictions and the improving sentiment of economic agents which is particularly important in the areas of spending not related to the basic goods. Servicing of foreign trade flows may have contributed to wholesale growth – imports skyrocketed in the second quarter.

In July, retail trade turnover failed to continue on its positive trend. This may be attributed in part to the high level of spending in the second quarter. Access to other services also improved gradually, and the population may have already made a number of postponed purchases shortly after reopening of points of sale. At the same time, consumer sentiment started to deteriorate. The appraisal of future development provided by retailers is weaker than that of the performance during the previous months. Retailer surveys reveal considerably higher price expectations in the coming months.

Chart 16

**RETAIL TRADE TURNOVER AND WAGES**  
(average level in 2015 = 100)



### 3.4 Transport

With the global economy recovering and the Covid-19 pandemic containment measures being eased due to vaccination coverage, the transport sector also experiences moderate recovery and rebound in economic activity. However, the adverse trends observed in Latvia's ports and rail transport for an extended period continued. The volume of cargoes loaded and unloaded at Latvia's ports shrank by 9.6% in the first half of 2021 year-on-year. The decline in cargo volumes at ports is mostly related to the phasing out of fossil fuels (coal and oil products) and reorientation of Russian transit flows to Russian ports. The ports of Riga and

Ventspils were most affected, while the volume of cargoes loaded and unloaded at Liepāja port and Latvia's small ports (whose volume of cargoes loaded and unloaded accounts for less than a quarter of the volume of cargoes loaded and unloaded at all Latvia's ports) increased in the first half of the year. The rise is related to an increase in the volume of grain and wood cargoes driven by the improving demand for exports of these product groups from Latvia. The turnover of rail freight dropped by 7% in the first half of 2021 year-on-year. This was due to the prolonged decline in cargo turnover owing to the above factors, mainly as a result of shrinking international freight transportation by rail.

It is the road transport sector that has managed to recover most rapidly, reaching the previous level, since the spread of Covid-19 and the related restrictions had a relatively small effect on the functioning of the sector. Freight turnover by road climbed by 17.9% in the first half of 2021 year-on-year, with international and domestic freight transport increasing significantly. It is true that the Mobility Package, which will fully enter into force in 2022, may hamper the sector's future development.

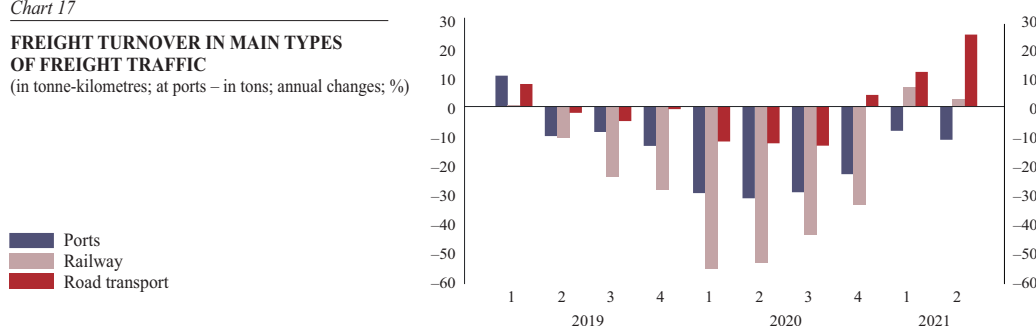
The reduction of movement restrictions has contributed to a marginal increase in passenger flows; however, passenger transportation remains at a very low level in Latvia. Air traffic is experiencing the slowest recovery: Riga Airport recorded a decrease in the number of passengers by 69.3% in the first half of 2021 year-on-year. This suggests that air traffic is still far from the pre-pandemic level. A glimmer of hope concerning a gradual rebound of air traffic in the near future is offered by the high vaccination coverage in the EU. However, it will depend to a considerable degree on the spread of Covid-19 in autumn, since a widespread occurrence of the virus might make travellers take additional precautions.

The value added of the transport sector edged up by 3.1% in the first half of 2021 year-on-year, and it was mainly driven by an uptrend in freight transportation by road. At the same time, the sector's overall value added will still lag behind its pre-pandemic level for some time.

Chart 17

**FREIGHT TURNOVER IN MAIN TYPES OF FREIGHT TRAFFIC**

(in tonne-kilometres; at ports – in tons; annual changes; %)



### 3.5 Tourism

With restrictions in Latvia and other countries easing, the population's willingness and possibilities to travel are increasing gradually, as indicated by a rise in demand for air tickets. The second quarter also saw the value added of the accommodation and food service activities sector elevating by 27.7% quarter-on-quarter; however, it remains considerably below the pre-pandemic level. The accelerating vaccination rate witnessed in spring and the easing of restrictions in some countries made it possible to expect that foreign tourist activity would recover more in summer and autumn; however, the tourism sector has not experienced a buoyant improvement of the situation. During the summer months, the increase in the number of tourists was very small, and it was mainly the domestic tourism activities that continued to support the sector. In the first seven months of 2021, the number of foreign and local visitors serviced at Latvia's tourist accommodations recorded a 27% decline compared to the corresponding period of the previous year. Both exports and imports of tourist trips



posted no substantial improvement either. It is expected that international travel activity will rebound to the previous level in 2023 at the earliest. This is related to both the persisting fear of the risks of infection and the economic situation, since people have lost their job and/or their income has decreased due to the pandemic.

## 4. GDP Analysis from the Demand Side<sup>1</sup>

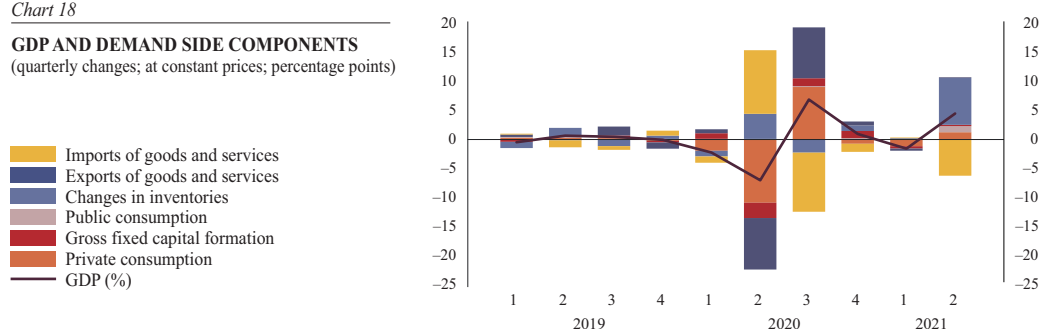
*GDP growth is recovering from the negative effects of the pandemic faster than expected. Gradual relaxation of restrictions in spring, government support as well as adaptability of consumers and businesses have contributed to economic recovery. The negative consumer confidence might primarily be related to tensions arising from differences in public opinion and to a lesser extent – to household financial position. Thus, GDP could also continue growing faster than readings of sentiment indicators and other survey data might reveal. Government investment is expected to increase substantially over the coming years.*

### 4.1 Domestic demand

Development of expenditure components is very different from the expected one and from the interpretation of various preliminary data. The second quarter was marked by a sudden strong upward trend in imports that has not been reflected accordingly in demand growth at a time when inventories increased significantly. Meanwhile, the expansion of private consumption in quarterly terms (as well as compared to the pre-pandemic level) seems to be underestimated, and it lags behind dynamics of other indicators characterising consumption.

Chart 18

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



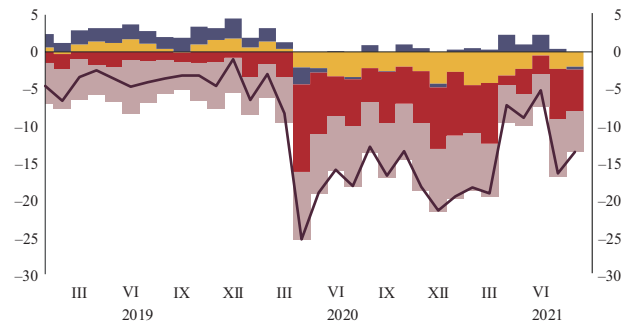
Private consumption was the driver of GDP changes through all the waves of the pandemic – it reduced GDP growth during restriction periods and boosted it when people had more freedom to go shopping, meet friends and relatives and enjoy services offered by restaurants, theatres, etc. The same is not true for the second quarter. During that period, the wage bill continued to increase moderately, a wider range of opportunities was offered to households for spending their forced savings made in the preceding periods and the benefit paid to families with children – the "helicopter money". Retail trade data also revealed spending growth. However, the expansion of private consumption in GDP expenditure was modest in the second quarter (2.2% quarter-on-quarter). The annual increase plays a major role; however, the very low base that gives an exaggerated impression of the magnitude of growth should be taken into account. At least part of the private consumption this time, probably, has not been estimated and is reported as an increase in inventories. Although consumer confidence indicators still point to a high level of dissatisfaction, this could be more related to the intensification of contradictions between public views and attitudes towards decisions made by officials and to a lesser extent – to household financial position.

<sup>1</sup> This chapter analyses GDP and demand components at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

Chart 19

**CONSUMER CONFIDENCE AND UNDERLYING FACTORS**  
(net responses; percentage points)

- Financial position of a household in the next 12 months
- Financial position of a household in the previous 12 months
- Economy's outlook for the next 12 months
- Large purchases planned for the next 12 months
- Consumer confidence

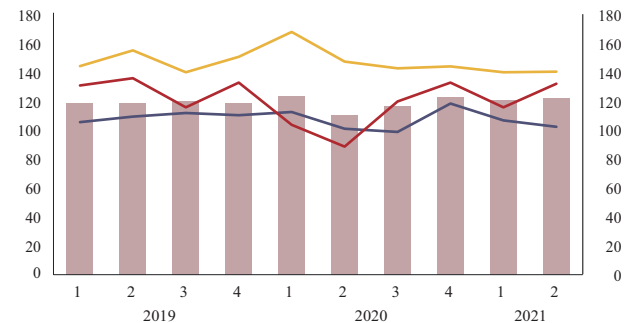


This year has seen weaker than expected development of investment (a 0.9% increase quarter-on-quarter). Although there is a great deal of talk concerning government support and readiness to promote various infrastructure projects and other investment to the maximum extent possible, the available data do not show a notable increase in contribution of government investment. Also, the private sector can hardly claim that its investment has mounted significantly. This speaks for itself amid the climate of uncertainty, which was additionally affected by problems relating to the availability of building materials and their increased costs. Therefore, construction activity has been relatively weak, with only imports of capital goods recording a steeper rise, preventing their investment dynamics from entering the territory of negative changes. Government investment, including funding provided by the Next Generation EU recovery plan and that for the Rail Baltica project will increasingly affect further investment development. Construction capacity and the cost rise, requiring the revision of cost estimates of investment projects, will be the main sources of investment constraints. Activities of the construction cartel can also lead to certain tensions relating to project implementation; however, it has no systemically important effects on the construction volume.

Chart 20

**INVESTMENT**  
(2015 = 100; at constant prices)

- Gross fixed capital formation
- Construction of buildings
- Construction of engineering structures
- Imports of capital goods



**4.2 Government consumption**

In the second quarter, government consumption accelerated by 5.2% quarter-on-quarter. In the first eight months of 2021, the public consumption was further affected by the decisions taken in relation to the Covid-19 pandemic crisis to support the liquidity needs of businesses and help to maintain household income. Sizeable support has been put into effect in the social field (including the financial support to families for each child as well as the benefit to pensioners), while the amount of the grants paid to the businesses affected by the Covid-19 crisis to ensure the flow of working capital exceeded half a billion euros. At the same time, several investment and health programmes related to the pandemic have been revised, shifting expenses from 2021 to the years to come.

The tax revenue of the general government sector has posted a 12.0% rise in the first eight months of 2021 year-on-year. With the economy recovering from the crisis, revenue from almost all types of taxes has followed an upward path. Revenue from taxes on consumption increased substantially, with VAT payments mounting by 17.3% year-on-year and the trade

sector making the largest contribution. Meanwhile, excise tax revenues have elevated by 4.9% in the budget compared to the first eight months of 2020 due to both higher tax rates and an uptrend in consumption of excise goods (mainly on account of a rise in the circulation of diesel which picked up by 6.8% in the first seven months of 2021 year-on-year). This year, revenue from taxes on labour has been adversely affected by a higher non-taxable minimum (both with regard to the employees and pensioners) and the decrease in the mandatory social insurance contributions by 1 percentage point. Meanwhile, the increase in the number of employees belonging to the segment of those receiving the highest wages, the transition of taxpayers subject to the alternative tax regime to the general tax regime as well as gradual lifting of containment measures have been contributing to a positive route. Thus, the PIT revenue has decreased by 4.6% compared to the first eight months of the previous year. However, the drop continues on a downward trend (-11.4% in the first half of the year), while the revenue from the mandatory social insurance contributions has increased by 3.9%.

Meanwhile, the effects of the Covid-19 pandemic crisis on the budget expenditure also continued in 2021. In the first eight months of the year, expenditure climbed by 19.1% year-on-year (mainly current expenditure); however, expenditure growth is decelerating gradually (growth reached 23.1% in the first half of the year). The upward trend in social benefits followed by an increase in wages and subsidies as well as grants dominate in the expenditure growth structure affecting public consumption. This expenditure is mainly related to the implementation of government support measures during the pandemic: lump sum benefits to families with children and pensioners, allowances paid for working under circumstances of the Covid-19 pandemic and grants to maintain the working capital flow. Overall, it has been intended to spend more than 2.2 billion euro for reducing the fallout from the Covid-19 pandemic and various support measures (the fiscal impact; Latvijas Banka's assessment) by rescheduling certain investment and health care related spending to 2022 and 2023, thus also extending the support period. Up to 12 September, the fiscal support for the suppression of consequences of the spread of Covid-19 infection provided in 2021 amounted to 1.6 billion euro but from the outbreak of the pandemic – to 2.9 billion euro. Meanwhile, capital expenditure increased by 3.0% in the first eight months of 2021 year-on-year (following a decrease by 4% in the first half of the year). At the same time, capital expenditure in 2021 will be overall lower than expected mainly due to more sluggish implementation of projects co-financed by EU funds. This means spillovers to 2022 when investment will be stepped up within the framework of the planned projects (including Rail Baltica, Covid-19 investment projects, funding from the Next Generation EU recovery plan). Overall, the level of public investment will rise over the next few years, primarily owing to EU co-financed projects.

The latest estimates of the general government budget deficit suggest that it will reach 6.7% of GDP in 2021, representing an improvement by 3.2 percentage points compared to the June projections. This is driven predominantly by a more positive economic outlook, lower budget expenditure and higher tax revenues. Government investment is expected to increase substantially over the coming years. However, this will occur mostly on account of EU co-financed projects, with the positive impact of total investment on economic growth offsetting the adverse effects of national co-financing on budget balance. Thus, the budget balance improves in the medium term. The government debt assessment for 2021 has been revised downwards from 48.9% to 45.9% of GDP due to the updated budget balance and macroeconomic assessment. According to Latvijas Banka's estimates, the government debt will remain below 50% of GDP in the medium term.

### BOX 1. REDUCTION OF VALUE ADDED TAX RATE ON ALL FOOD PRODUCTS TO 5%<sup>1</sup>

The reduced VAT rate on fruit and vegetables typical of Latvia (5% instead of 21%) has been in force since the beginning of 2018. Some representatives of the agricultural sector and economists encourage extending the range of products subject to the reduced VAT rate by applying it to all food products. From their perspective, this would help to reduce income inequality in society, since low-income households spend a higher proportion of their budget on food. The authors analyse whether low-income households would benefit most from the reduced VAT rate.

It is true that low-income households spend a greater proportion of their budget on food (Chart 1.1). However, in euro terms, higher-income households (Quintile 5) spend more money on food than lower-income households (Quintile 1)<sup>2</sup> – in 2019 this expenditure stood at 129 euro and 74 euro a month per household member respectively. Thus, if all food products were subject to a reduced VAT rate, high-income households would benefit more than low-income households.

Chart 1.1

#### STRUCTURE OF HOUSEHOLD CONSUMPTION EXPENDITURE DEPENDING ON ITS INCOME LEVEL (%; in 2019)

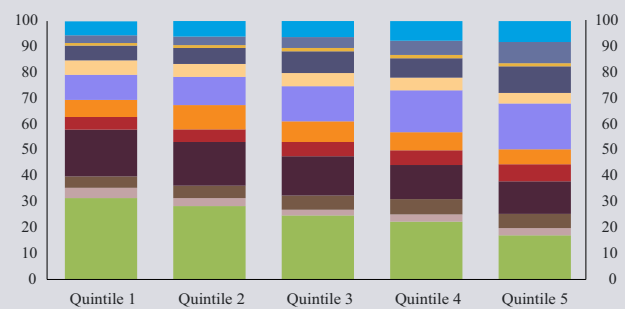
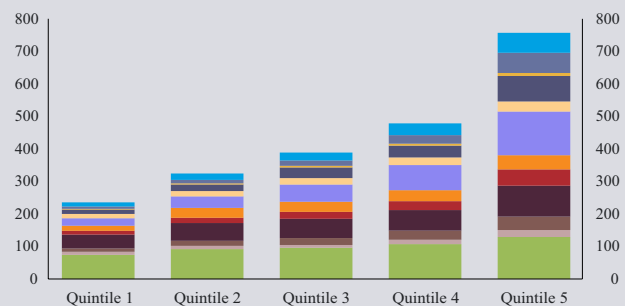


Chart 1.2

#### CONSUMPTION EXPENDITURE PER MONTH PER HOUSEHOLD MEMBER DEPENDING ON HOUSEHOLD INCOME LEVEL (euro; in 2019)

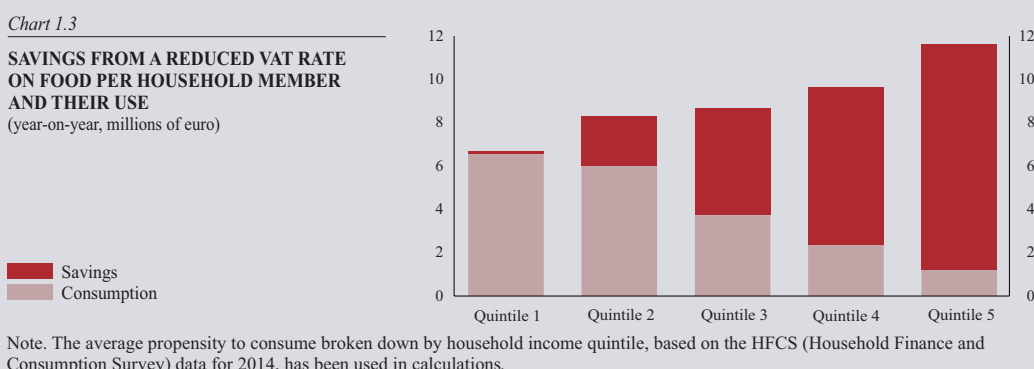


The authors' calculations show that if the VAT rate of 5% is applied to all food products, high-income households would save on average 12 euro a month per household member, while the respective savings of low-income households would be only 7 euro per month. As long as low-income households, most probably, shift the bulk of their savings to consumption, the savings of high-income households will increase notably (Chart 1.3).

<sup>1</sup> Prepared by Klāvs Zutis and Oļegs Krasnopjorovs, economists of Latvijas Banka.

<sup>2</sup> A quintile group is a fifth or 20% of the surveyed households, which are grouped in ascending order according to their disposal income per household member. Respectively, Quintile 1 is comprised of the lowest-income household group, but Quintile 5 – of the highest-income household group.





It should also be noted that the demand for food products is marked by a rather low elasticity in terms of price – changes in the demand for food products are significantly lower than price changes. Thus, in the case of the VAT reduction, food prices, most likely, will decrease less than the full effect of VAT rate reduction. With traders not transferring the VAT reduction to product prices in full, households benefit less from such a tax policy.

Taking account of the fact that high-income households would benefit more from the reduced VAT rate on food and that gaps in pass-through of the reduced rate to the final product prices remain, the reduction in VAT rate is an ineffective tool for fighting income inequality. Social benefits to be provided for the most deprived people would reduce income inequality by a great deal more.

### 4.3 Trade balance

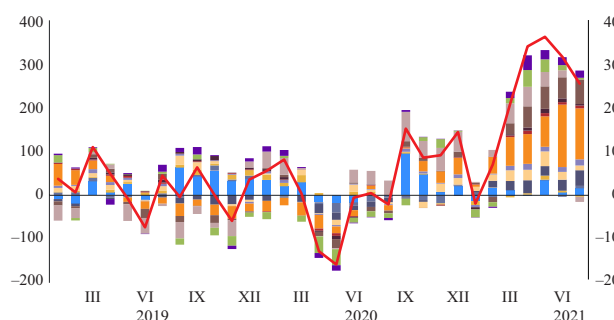
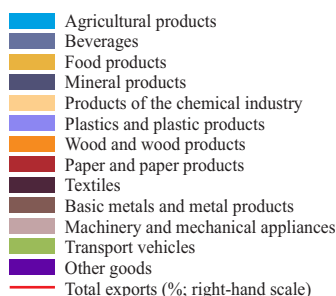
The share of exports in GDP is equal to private consumption; however, its development has been different. Exports have been much steadier than consumption, and this has been driven by the record-high grain harvest and exports of wood products, coupled with a decline in services during the restriction periods. In real terms, the rising exports of goods and services stood at 0.2% in the second quarter compared to the previous quarter.

With the rapid recovery of the flows of goods imports, the trade balance of goods and services became negative again in the first half of 2021. Despite the concerns about the disruptions in global supply chains of raw materials, the second quarter of 2021 experienced a surge in goods imports that offset their slower development compared to exports since the onset of the Covid-19 crisis in the second quarter of 2020. Goods imports were facilitated by the recovery of domestic demand as well as by an uptrend in raw material supplies in the exporting sector. Growth in the value of exports, following the record highs reached in the last quarter of 2020, continued on account of price hikes. The prices of raw materials and consumer goods remain high. They maintained the increase in the export value of Latvian goods in the first half of 2021, while the increase in real volumes of exports has stalled, reaching the all-time highs. The first half of the year saw growth in export value follow an upward path for a broad range of goods on account of exports of products of wood standing out due to the growth in global demand for construction services and the high price level. An upward development was observed in exports of articles of base metals and chemical products, growth in export value of machinery and electrical equipment continued unabated. However, the persistently dry weather conditions experienced in summer have had an adverse effect on the quality of grain harvest. Therefore, it is expected that the total grain yield in 2021 might be 18.2% lower than in 2020.

Chart 21

**EXPORTS OF GOODS AND GROUPS OF EXPORT GOODS**

(year-on-year, millions of euro)



Meanwhile, exports of services rebounded in the second quarter of 2021 year-on-year. This was supported by an increase in the provision of other economic services (e.g. advertising, market research, trade services). Long-term downward trends continued in exports of transport services and, compared to the weak performance witnessed in the first half of the previous year, it was only the road transport sector that experienced recovery. The expected rebound in tourism did not occur either, and the value of travel services fell even compared to the negligible value of services provided in the second quarter of the previous year.

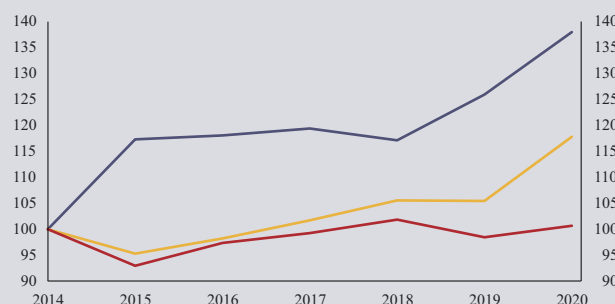
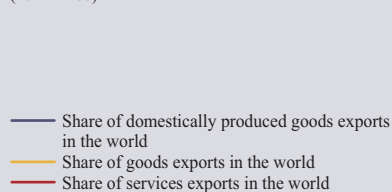
The strong rebound in goods imports determined a sharp decline in the goods and services trade balance (to  $-4.5\%$  of GDP) in the second quarter. With domestic demand expanding more rapidly, goods and services imports were also expected to grow faster. However, the sizeable growth observed in the second quarter (quarterly increase by  $9.9\%$ ) is striking, and it also changes the aspect of projections, i.e. taking account of the high base reached, the upward trend in imports will decelerate considerably or the next quarters will even see imports decline.

**BOX 2. COST COMPETITIVENESS<sup>1</sup>**

Latvia's exports and their market shares are continuously developing in a successful manner. Exports of goods, following a decline at the onset of the Covid-19 pandemic, recovered and the last year as a whole saw them generating higher income than before the crisis, but exports of services are still below the pre-crisis level. However, face-to-face customer services have been affected worldwide. Thus, the export competitiveness indicator, which reflects changes in Latvia's export market shares globally, suggests that exports of both goods and services performed successfully last year (Chart 2.1).

Chart 2.1

**LATVIA'S EXPORT MARKET SHARES IN IMPORTS OF ITS TRADE PARTNERS**  
(2014 = 100)



Notably, market shares have increased despite the fact that Latvia's real effective exchange rate has been continuously rising by approximately  $1.5\%$  a year, and the real effective exchange rate that has been calculated using unit labour costs has increased much faster.

<sup>1</sup> Prepared by Andrejs Bessonovs and Santa Bērziņa, economists of Latvijas Banka.

This means that the expansion of market shares has occurred despite appreciation in the real effective exchange rate, thus reducing price and cost competitiveness.

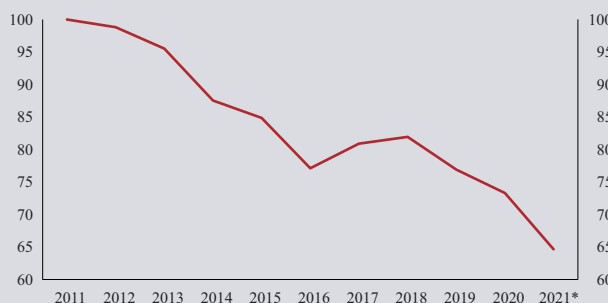
Moreover, risks relating to climbing costs have heightened in 2021, and some of these risks are linked to the rise in global raw material prices affecting producers across the world; however, the steep rise in wages is a phenomenon of domestic costs. Furthermore, evidence suggests that profitability of exports has been weakened by the rise in domestic costs (Chart 2.2). The expected significant inflows of financing from the EU funds into the economy can contribute to labour demand (particularly in construction) that can add to the pressure on wages stemming from labour shortage. Therefore, assessment of effects of cost-competitiveness on export performance has become more important.

To calculate the real effective exchange rate, various price and costs indicators are used: the consumer and producer price index, GDP deflator and unit labour costs. According to the authors' calculations, changes in the real effective exchange rate as adjusted by the GDP deflator provide the best explanation for export development in Latvia.

The calculations also suggest that over the last decade changes in the real effective exchange rate have not been the major factor determining export development, and that global demand plays the crucial role in development of real exports (Chart 2.3). However, appreciation of the real effective exchange rate has a statistically significant negative impact on export development – this has led to a 5.1% decrease in the export potential over the past seven years. Thus, development of the real effective exchange rate requires further close monitoring and analysis that would allow an earlier detection of a build-up of imbalances related to cost competitiveness.

Chart 2.2

**EXPORT PROFITABILITY**  
(ratio of changes in export unit value to changes in unit labour costs in manufacturing; 2011 = 100)

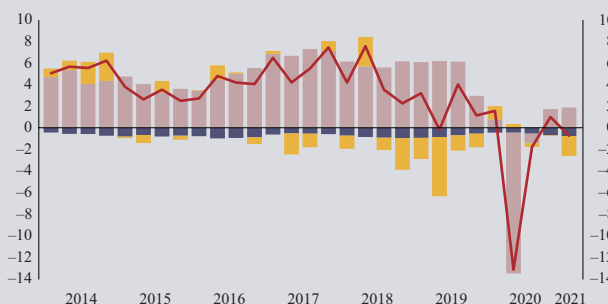


\* Q4 2020 – Q2 2021 on average.

Chart 2.3

**EXPORTS**  
(at constant prices; annual changes; %; contribution)

Real effective exchange rate  
Global demand  
Other factors  
Total real exports



Notes. The total exports have been assessed using the ARDL cointegration model in the period from 1996 to the first quarter of 2021. The global demand reflects the weighted imports of Latvia's trade partners. The real effective exchange rate is deflated by the GDP deflator.

## 5. Labour Market, Costs and Prices

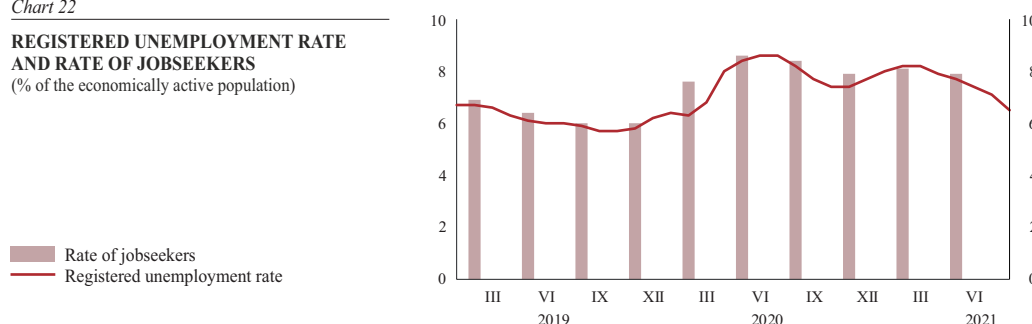
*Labour market is recovering swiftly. Although government support measures were phased out in June, unemployment continues on a downward trend. The average pace of remuneration growth is relatively high and steady, both because of administrative decisions and higher demand for labour.*

*A brief period of deflation was followed by an outburst of consumer price inflation. Both producer and import prices and perceived and expected inflation follow an upward trend. Therefore, inflation is expected to peak at around the turn of the year, with the annual growth rate of consumer prices temporarily exceeding 5%.*

Despite the deceleration in economic activity, the government support provided through furlough benefits and wage subsidies averted a rise in unemployment at the beginning of 2021. With the government support measures having expired in June, both registered and actual unemployment rates continue to decline. At the end of summer, the decreasing number of unemployed persons registered with the SEA reflects a more favourable economic situation and the fact that the entitlement of a number of registered unemployed persons to unemployment benefits has expired and they, while probably still being unemployed, are no longer registered with the SEA. This is also confirmed by a fall in the overall unemployment rate, although less pronounced than that of registered unemployment. Unemployment expectations are lower than in the corresponding period of the previous year, and an increasing number of businesses indicate that labour shortage significantly weighs on business activities. This suggests that unemployment will tend to decline also in the near future.

Chart 22

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

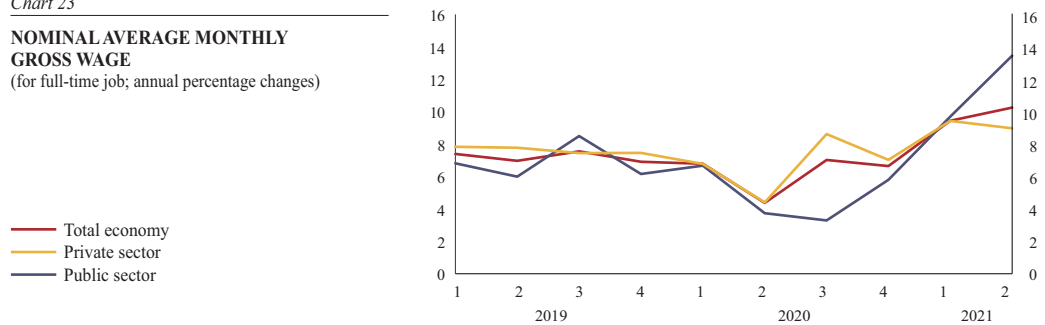


The unemployment forecast has been revised downwards based on the actual data and a better outlook for the economy and labour market developments. The unemployment rate is projected to stand at 7.5% of the economically active population in 2021 and is expected to decline gradually also in 2022 (to 6.8% of the economically active population).

In the first half of 2021, the average remuneration has increased faster than previously projected, reflecting a rise in the minimum wage at the beginning of the year and an increase in the wages of the medical and teaching staff, as well as pushing up the demand for labour. The average remuneration has been increasing both in the public and the private sectors since the beginning of 2021. The wage growth in the public sector was more pronounced and, although the Covid-19 related premiums were lower than previously expected, the remuneration for those employed in the local government structures increased at a relatively faster pace. In line with the structural changes and with the labour demand gradually recovering in the sectors hit the hardest by the crisis, it is expected that more people with lower wages will return to the labour market in the near future; however, the increasing labour shortage contributes to a steeper rise in the overall level of remuneration. Due to the above-mentioned factors, the wage growth forecast for 2021 has been revised upwards to 8.9%. The average wage is expected to rise by 7.5% in 2022 amid sustained economic growth and increased demand for labour.

Chart 23

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



In August, the annual inflation rate climbed to its highest level in almost a decade (3.6%). The rise in inflation was driven by several factors: the increasing global commodity prices, higher prices of administrative and public utility services, the global shortage of shipping containers, as well as the rising labour costs and the effect of the postponed consumption.

Chart 24

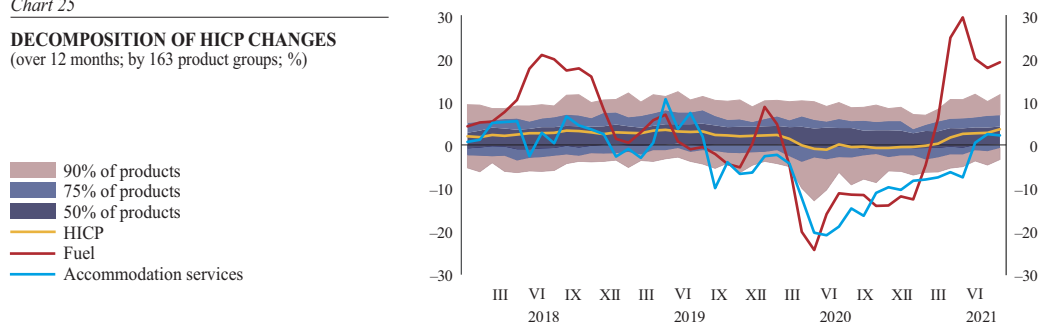
**HICP COMPONENTS**  
(annual changes; percentage points)



The surge in inflation is largely stemming from the increase in energy prices on global stock exchanges and its direct effect on the prices of fuel and public utility services. Both the deflation seen at the beginning of the pandemic and the current outburst of inflation are largely determined by some specific prices (e.g. that of fuel). Inflation for most products remains low. For example, the prices of three quarters of products increase less than the current inflation rate.

Chart 25

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



Following a significant fall at the beginning of the pandemic and an equally notable rise in the following months, the global oil price stabilised at its pre-crisis level (approximately 70 US dollars per barrel). Most of the oil market participants do not expect further increases in oil prices. While still maintained by OPEC+ countries, the oil production cuts are being gradually reduced; the US government also encourages OPEC Member States to use more actively the spare capacity to increase oil production. Oil price developments will be also dampened by a persistently high level of stocks of oil products in the coming months. Considering the relatively swift pass-through of oil prices to fuel retail prices in Latvia (most of the impact occurs within a month), no further escalation of fuel prices in Latvia is expected, with the current oil price forecast remaining unchanged. A significant increase in

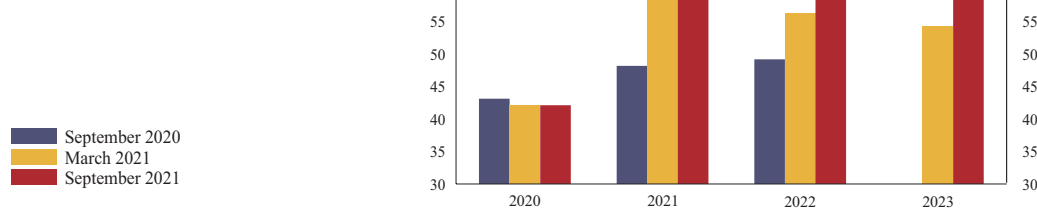


the prices of administrative and public utility services (electricity, gas supply and heating) in the second half of 2021 was announced in summer, and this may push up the overall price level by around one percentage point.

Chart 26

**OIL PRICE FORECAST**

(Brent crude oil; on average per year;  
US dollars per barrel)



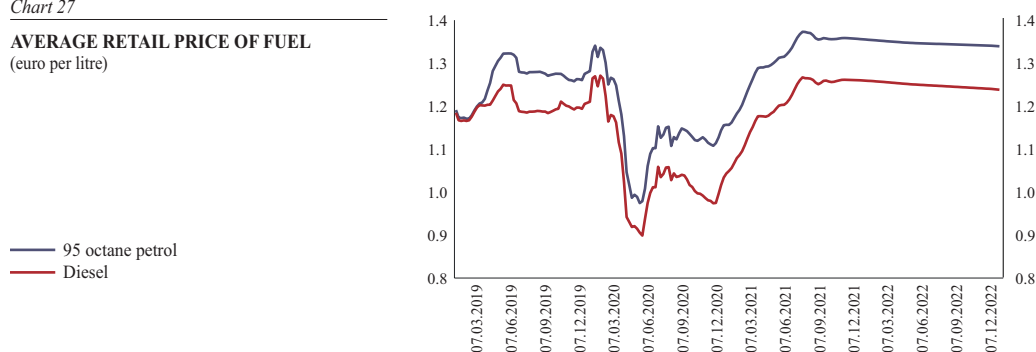
The steep rise in producer prices in Latvia's industry was mostly on account of the surging prices of products of wood, reflecting the global wood price increases during the pandemic. Currently, however, the global wood price has declined in comparison with the record high level and is only slightly higher than before the pandemic. Therefore, it is unlikely that the rise in producer prices would be sustainable. The drop in the global wood price was primarily fuelled by the significantly weaker demand from the US, as well as the growing investment in production capacity. However, further decreases in wood prices will be hampered by the persistently low levels of wood stocks, as well as the impact of the pent-up demand (lower prices might lead to the recovery of the part of demand that has decreased due to the preference to wait and see in the period of high prices). It should also be noted that the wood price volatility has a relatively limited impact on consumer price inflation.

Global food prices continue on an upward trend. The increase in grain prices is driven by both strong demand and poor quality of the wheat harvest in Europe, with part of the harvest being qualified as suitable for the use of fodder. High demand from Asia contributes to further rises in global prices of dairy products and meat. At the same time, the rising prices of sugar reflect both a poorer than previously projected harvest in Brazil and a higher propensity to produce ethanol as a result of oil price hikes. The pass-through of global food prices to retail prices in Latvia takes several months; consequently, a large part of the current rise in global food prices will affect food retail prices in 2022. However, considering also the slow pass-through, retail prices of processed food in Latvia are growing at a somewhat slower pace than expected over recent months. This might be on account of the gradual opening of the retail giants Lidl and Mere in Latvia, which would mean tighter competition among retail chains and thus lower mark-ups. Some retail chains could reduce the product prices already before the expansion of the newcomers, thus trying to limit their ambition for expansion.

The rapidly rising commodity prices caught the attention of many mass media. However, consumer price inflation is increasing at a much slower rate than commodity prices. First, commodities are just one of the cost components of finished goods. Latvijas Banka's analysis suggests that, with the oil price rising by 10%, the level of consumer prices in Latvia increases by 0.6% in the medium term, while, with the global food (cereals, dairy products, meat, sugar, coffee) prices growing by 10%, consumer prices go up by 0.9%. Second, the pass-through of global commodity prices to inflation occurs gradually, with a lag of several months. If the commodity price dynamics moves to the opposite direction in this period, a full pass-through to inflation is not yet reflected. For example, while it is possible to find the lowest point during the pandemic against which the current oil price is three times higher, currently the oil price has in fact just returned to its pre-pandemic level. The plunge in the oil price at the beginning of the pandemic lasted for such a short period of time that it was only partly passed-through to consumer prices. Therefore, currently there is no reason for concerns that three times more expensive oil will have a dramatic impact on inflation.

Chart 27

**AVERAGE RETAIL PRICE OF FUEL**  
(euro per litre)



The price developments in services are overall moderate, with the rise in service prices not exceeding 2% in annual terms. The pace of increase in service prices is most likely to accelerate on account of both the pent-up demand and the cost factors in the coming months. The costs of several services per customer are higher than before the pandemic, due to the physical distancing requirements and the growth in wages. Already now, the prices of some services have increased significantly. For example, in March when the services of hairdressing salons became available after a several months' break, the costs of a woman's haircut increased by 8%, while those of a man's haircut rose by 10% within a month; haircut prices continued to climb at a more moderate pace also in the months to come.

The rise in the prices of industrial goods (about 2% over a year) is driven by higher producer prices for goods sold on the domestic market and the gradually growing import prices. The global shortage of shipping containers disrupts supply chains and has pushed up the container prices to their historical highs in certain routes. With the prices of shipping containers used in the long-term contracts also rising, the impact of the global container crisis on the prices of industrial goods may persist even for several years.

Inflation expectations have grown substantially since the beginning of the year. Producer and consumer inflation expectations have reached the highest levels of several years, albeit remaining below the levels observed prior to the global financial crisis. Due to this reason, inflation might moderate at a slower than expected rate in the medium term.

**BOX 3. BY HOW MUCH WILL INFLATION IN LATVIA RISE IF GLOBAL PRICES CONTINUE TO CLIMB?<sup>1</sup>**

The current outburst of inflation is largely driven by higher global commodity prices, partly reflecting the investors' optimism concerning the prospects of the global economic recovery. For example, the oil price returned to its pre-pandemic level in mid-2021, while the global food commodity price index reached the highest level of the last decade. Although Latvia's current inflation forecast baseline scenario does not project a further increase in global commodity prices, an alternative scenario analysis is conducted under the assumption that commodity prices will continue to rise. The simulation assumes that oil prices and global food commodity prices have increased by 10% since October 2021 in comparison with the baseline scenario.

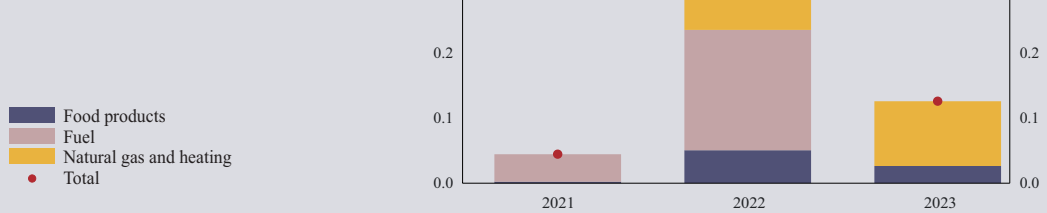
With the oil price persistently rising by 10%, the increase in consumer prices may push up this year's inflation by 0.04 percentage point throughout the remainder of 2021; inflation might be 0.39 percentage point higher next year, but 0.13 percentage point higher the year after (see Chart 3.1). Moreover, the oil price affects several consumer price components

<sup>1</sup> Prepared by Andrejs Bessonovs and Oļegs Krasnopjorovs, economists of Latvijas Banka.

simultaneously. The direct impact on fuel prices is seen already within a month following the oil price changes. More expensive fuel pushes up the transport costs, thus increasing the prices of food products and some services. The increase in the oil price has usually also a delayed upward pressure on natural gas and heating prices subject to administrative regulation.

Chart 3.1

**IMPACT OF 10% INCREASE IN OIL PRICES ON CONSUMER PRICES IN LATVIA (%)**



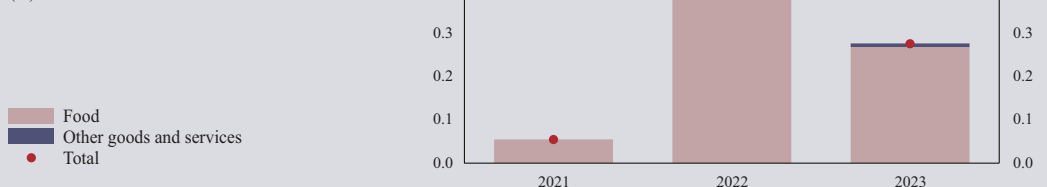
Note. The simulation assumes that oil prices have increased by 10% since October 2021 in comparison with the baseline scenario. The pass-through of global commodity prices to inflation in Latvia is based on Latvijas Banka's 'Working Paper No. 1/2020.

With global food commodity prices rising by 10%, the increase in consumer prices may push up inflation for 2021 by 0.05 percentage point over the remainder of 2021; inflation might be 0.56 percentage point higher in 2022, but 0.28 percentage point higher in 2023 (see Chart 3.2). The food retail prices record a notably weaker rise than the respective global food commodity prices since food products are usually also linked with other cost components such as labour costs, fuel price and other factors. The pass-through of global food commodity prices to consumer prices in Latvia occurs relatively slowly and takes several months (particularly for food products with a long shelf life such as sugar). The rise in food prices also gradually leads to notable increases in catering services. Thus, a significant part of the simulated increase in food commodity prices in October 2021 will affect consumer prices in 2023.

To sum up, the prices of global commodities are a factor that has a substantial impact on the inflation dynamics in Latvia. If global food commodity and oil prices continue to increase, inflation in Latvia may exceed Latvia Banka's current inflation forecast. However, it is also evident that consumer price changes in Latvia are much less notable than the volatility in global commodity prices and that this impact occurs gradually with a significant lag.

Chart 3.2

**IMPACT OF 10% INCREASE IN GLOBAL FOOD COMMODITY PRICES ON CONSUMER PRICES IN LATVIA (%)**



Note. The simulation assumes that oil prices have increased by 10% since October 2021 in comparison with the baseline scenario. The pass-through of global commodity prices to inflation in Latvia is based on Latvijas Banka's Working Paper No. 1/2020.

## 6. Conclusions and Forecasts

The economy has shown rapid recovery faster than previously expected. Thus, the GDP growth forecast for 2021 has been revised upwards to 5.3% (by 2 percentage points vis-à-vis the June forecast), mainly on account of the actual data and with the future outlook remaining broadly unchanged.

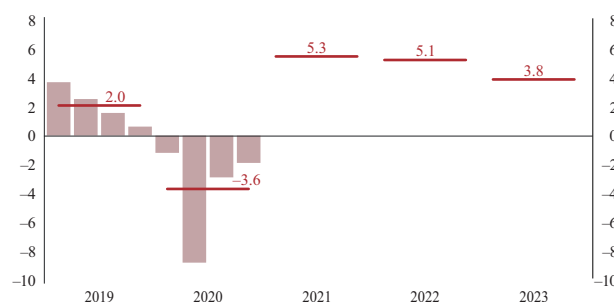
In 2022, the GDP growth is likely to be similar to 2021, i.e. to stand at 5.1%. In 2022, the rate of increase might be 1.4 percentage points slower than estimated in the June forecast, taking account of the momentum from the higher level, the latest data on the upsurge in Covid-19 infections, lower than anticipated vaccination rates and, consequently, also the cautious approach to consumption and investment decisions, even if the scope of restrictions is not substantially extended. This leads to an estimation that the economic growth could temporarily decelerate towards the end of 2021 and at the beginning of 2022. In 2022, the growth is expected to be largely supported by private consumption, with households spending their savings accumulated during the pandemic, and the contribution of investment is likely to increase due to government spending. However, domestic demand will be dampened by the caution associated with the spread of the virus. A favourable performance of exports has been projected based on higher external demand, while a steeper rise in imports is reflected in a more negative trade balance.

In 2023, the GDP growth forecast (3.8%) has remained similar to that of June, thus reflecting a return to a sustainable pace of long-term growth.

Looking by sector, a strong rebound in construction is expected over the projection horizon where a significant increase in projects commissioned by the public sector, especially in 2022, enhances the risk of overheating. The main constraints faced by the sector are the capacity shortages and the rising cost. The contribution of public services to growth has temporarily increased significantly and will gradually normalise. The sectors most affected by the gathering restrictions (e.g. accommodation and food service activities, arts and entertainment) will need slightly more time than others to return to their pre-crisis levels of value added. The transportation sector will lag behind the overall growth rate over the projection horizon, thus contributing less to the GDP growth.

Chart 28

**GDP**  
(at constant prices; seasonally and calendar adjusted data; %; Latvijas Banka's forecast data for 2021–2023)

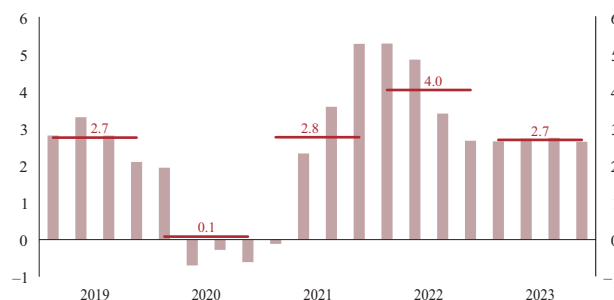


Inflation has increased to its highest level in less than a decade and will rise further also in the coming months. The rate of inflation is expected to peak at around the turn of the year, with the annual growth rate of consumer prices temporarily exceeding 5%. Inflation is expected to stand at 2.8% in 2021 (+0.8 percentage point compared to the June forecast), while, according to Latvijas Banka projections, it will reach 4.0% in 2022 (+1.1 percentage point compared to the June forecast). The rise in the projected rate of inflation is largely due to simultaneous increases in heating, natural gas and electricity prices in the second half of 2021, pushing up the overall price level by around 1 percentage point. Inflation is expected to stand at 2.7% in 2023 (+0.7 percentage point compared to the June forecast). The increase in the projected level was mostly on account of the impact of the global container crisis on disruptions in supply chains in the medium term and the second round effects of the current

inflation outburst on the medium-term inflation (via rising inflation expectations). It is expected that underlying inflation (inflation, excluding food and energy prices) will continue to pick up gradually until 2023.

Chart 29

**HICP**  
(annual changes; %; Latvijas Banka's forecast data for 2021–2023)



The risks to economic growth are balanced. If the epidemiological situation does not weigh on consumer confidence with respect to spending their savings, the growth is likely to keep momentum. However, the economic growth may slow down more markedly than estimated in the forecast at around the turn of the year if the severity of the pandemic requires significantly tighter restrictions or supply-side bottlenecks persist for a longer period. A longer persistence of the global shortage of shipping containers and its stronger escalation effect on the prices of industrial goods, as well as the producer and consumer inflation expectations constitute a medium-term upside risk to the inflation forecast.

Table

**LATVIJAS BANKA'S FORECASTS OF KEY MACROECONOMIC INDICATORS**

	2021	2022	2023
<b>Economic activity</b> (annual percentage changes; at constant prices; seasonally adjusted data)			
GDP	5.3	5.1	3.8
Private consumption	5.9	8.9	4.8
Government consumption	5.8	3.7	1.5
Investment	3.9	6.9	3.3
Exports	5.7	5.8	3.8
Imports	11.7	2.6	3.4
<b>HICP inflation</b> (annual percentage changes)			
Inflation	2.8	4.0	2.7
Underlying inflation (excluding food and energy)	1.8	2.2	3.1
<b>Labour market</b>			
Unemployment (% of the economically active population; seasonally adjusted data)	7.5	6.8	6.5
Nominal gross wage (annual percentage changes)	8.9	7.5	5.5
<b>External sector</b>			
Current account balance (% of GDP)	-2.1	-0.5	-0.8
<b>Government finances</b> (% of GDP)			
General government debt	45.9	47.2	45.8
Budget surplus/deficit	-6.7	-4.0	-2.2



## 7. Macroeconomic Consequences of Weak Lending. Scenario Analysis<sup>1</sup>

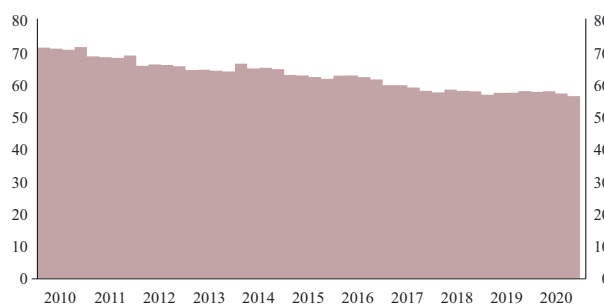
### Motivation

Lending activity in Latvia has been sluggish over the past 10 years. Therefore, the total volume of loans to businesses and households is one of the lowest in the EU. The household segment is experiencing lending activity growth, while there is little evidence that the situation might change in the corporate segment in the near term. The volume of new loans continues to stagnate, and lending rates are still among the highest in the euro area.

Credit institution loans represent a significant component of a healthy economy, they are an important source of financing for firms willing to implement new business ideas, innovation and investment projects for which own resources are not always sufficient. Data of corporate balance sheets also confirm the role played by loans in Latvia – the share of borrowings (including from banks) in total liabilities stood at 57% in 2021. However, the indicator dynamics are tilted to the downside, since borrowings in firms' liabilities currently appear to be far less important than in 2010 and 2015 (72% and 63%) respectively.

Chart 30

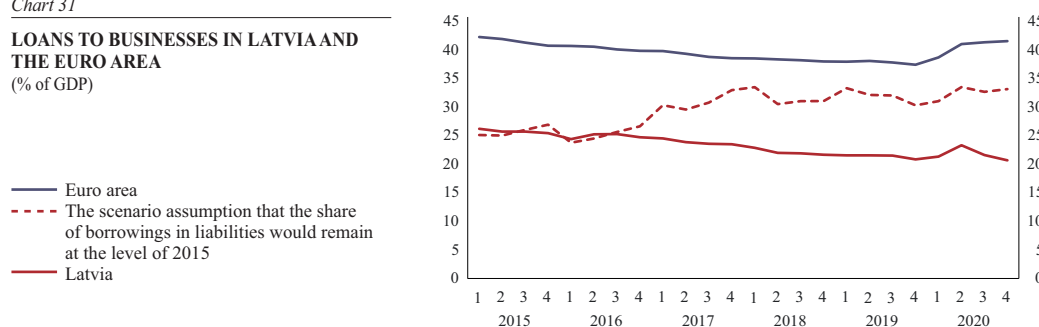
**RATIO OF CORPORATE BORROWINGS TO LIABILITIES**  
(%)



In order to keep the share of borrowings in liabilities at the level reached in 2015, the portfolio of loans to businesses should be nearly 58% higher at present.<sup>2</sup> This means that the corporate loan portfolio should have increased by 9.2% every year instead of 0.1% known to date. Moreover, should such a scenario materialise, loans to businesses (percentage of GDP) would still be well below the euro area average.

Chart 31

**LOANS TO BUSINESSES IN LATVIA AND THE EURO AREA**  
(% of GDP)



Notes. The adjusted time series does not include one-off decreases in the loan portfolio that emerged as a result of structural changes.<sup>3</sup> It is assumed that changes in loans in the respective quarter correspond to the averages of the previous and next quarters.

The following question may arise: what the likely investment activity and economic growth would have been if lending dynamics had complied with this scenario since 2015 instead of continuing on a downward path? To answer the question, Latvijas Banka has calculated

<sup>1</sup> Prepared by Andrejs Zlobins and Kārlis Vilerts, economists of Latvijas Banka.

<sup>2</sup> The assumption that credit institution loans would ensure an increase in the share of all borrowings.

<sup>3</sup> The establishment of Luminor Bank AS in October 2017 and the cancellation of the ABLV Bank AS licence in July 2018.

the potential impact of the slow lending activity on investment and economic growth by employing the DSGE model for Latvia<sup>1</sup>.

### Simulation

The assessments include the following assumptions:

1. as of 2016, the share of corporate borrowings in liabilities remains at the level of 2015 (63%);
2. the difference between the actual amount of borrowings and the amount calculated in Assumption 1 is covered by bank loans and is primarily used to finance investment.

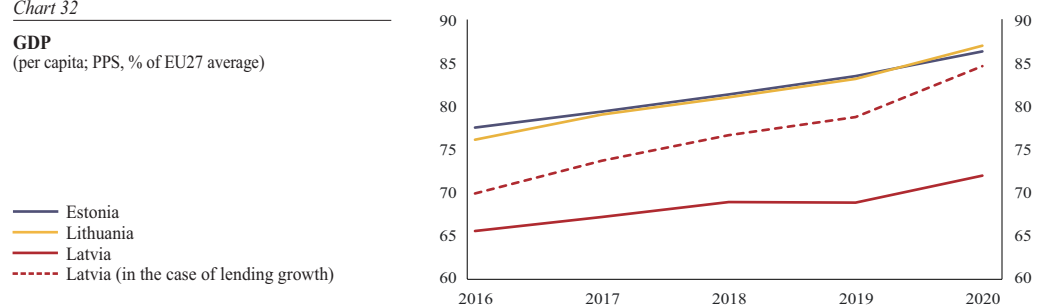
### Simulation of the model

The results obtained suggest that if the share of borrowings had remained at the level reached in 2015, investment activity in Latvia would have been considerably higher than today, i.e. over five years, the investment level could have been almost twice the actual outcome.

Investment allows for boosting production and generating new products, thus also providing an opportunity to create new jobs. This also results in GDP growth. Model-based estimates suggest that if the share of borrowings in corporate liabilities had remained unchanged since 2015, Latvia's economic convergence towards the EU average would have been much higher, coming closer to the indicators achieved in Lithuania and Estonia. Moreover, higher employment and economic activity also boost budget revenue that makes it possible to address social problems, e.g. the high income inequality and poverty.

Chart 32

**GDP**  
(per capita; PPS, % of EU27 average)



### Conclusions

Our estimates suggest that sluggish mobilisation of borrowings has markedly slowed down corporate investment activity over the past few years and thereby also the economic growth rate. This finding should also be taken into account in the next period of economic upturn – it will be very difficult to provide a dynamic environment for investment and innovation in the absence of active corporate lending and thus the economic convergence towards the EU average will be slower.

The causes of weak corporate lending activity can be found on both the demand and supply sides. Businesses still have to do their homework to foster transparency of the financial situation. This would not only lead to a greater availability of loans but also enhance mutual trust and reduce the costs of handling loan applications. However, there are some reasons to believe that banks are also responsible for loan availability problems. One of the reasons is the relatively high lending rates – in 2020 interest rates on new loans to businesses were more than twice as high as the euro area average. They seem to be disproportionately high given that there is little evidence showing that the credit risk of businesses in Latvia is twice as high as the euro area average. Along with the introduction of the euro in Latvia, macroeconomic risks have declined significantly. Moreover, economic developments during the pandemic period suggest that the resilience of businesses and households to crisis

<sup>1</sup> Bušs, Ginters, Grüning, Patrick (2020). Fiscal DSGE Model for Latvia. Latvijas Banka Working Paper 5/2020.

situations has substantially improved compared to 2009. After all, the data provided by credit institutions also reveal that the share of delinquent loans is relatively small. Moreover, the share of credit funds recovered during the insolvency process is also equivalent to the level reached in developed European countries (see EBA report, p. 24).