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Contents

Abbreviations

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

Introduction

Latvijas Banka forecasts a less pronounced negative impact of the COVID-19 pandemic on the economy in 2020 than projected in June. The economic downslide decelerated as a result of easing the COVID-19 pandemic containment measures in the second quarter, and improvement in market participant confidence in summer resulted in fast recovery of several sectors. The current development of the COVID-19 pandemic both on global and regional scale calls for further cautiousness; nevertheless, the GDP forecast has been revised and the expected GDP decrease has been reduced to –4.7%. In the future, a more resilient external demand and the expected EU funds inflow will maintain the economic growth; however, a better base indicator for 2020 consequently slightly reduces the estimated GDP growth rate for 2021 to 5.1%.

Although the supporting monetary and fiscal policy measures helped moderate optimism return in the financial markets, financial conditions still are weaker than before the COVID-19 pandemic started. Deposits posted further growth in Latvia, whereas, with businesses refraining from using credit institution loans as a solution for overcoming the crisis caused by the COVID-19 pandemic, the credit portfolio is still on a downward trend.

The COVID-19 pandemic containment measures and contracting demand negatively affected the labour market, while at the same time the government support measures for maintaining employment and income dampened unemployment growth. However, with businesses optimising their costs, the rise in wages and salaries will remain slow. The period of deflation observed as a result of plummeting oil prices and a slowdown of economic activity will be short-lived. Moderating economic downslide and a more resilient labour market than projected in June are factors behind an upward revision of the inflation forecast to 0.2% and 1.4% for 2020 and 2021 respectively.

1. External Demand

Although the COVID-19 outbreak is the main factor behind the considerable fall in the global economic growth, the downward risks existing already before, i.e. trade wars, geopolitical tensions and negotiations on post-Brexit agreement, also maintain uncertainty and threaten the economic recovery. However, with a notable uncertainty related to the economic development persisting, in the summer months the recovery following the fall in economic growth related to the COVID-19 pandemic in many countries was considerably faster than estimated in the pessimistic forecast scenarios and slightly improved the still negative balance of risks for economic outlook.

The beginning of 2020 was associated with complex measures of strengthening economic growth; however, when on 11 March the World Health Organisation announced that the COVID-19 outbreak had turned into a pandemic, the issue on potential solutions for mitigating the consequences of economic development turbulences appeared on the agenda of governments and central banks of all countries. By the beginning of September, approximately 29 million persons had caught the COVID-19 virus; of them, more than 900 thousand have died. Among the countries most hit by COVID-19, with over one million cases, we find the US, India, Brazil and Russia. As regards Europe, the strongest outbreaks were observed in Spain, France and Italy, as well as in the UK and Germany. Although in summer months the numbers of COVID-19 cases dropped considerably in the European countries, the latest data point to an increasing possibility of the second wave of the COVID-19 pandemic.

Initially, several international institutions and central banks announced their forecasts of a considerable decrease in economic activity and, hence, a substantial fall in GDP growth was projected. According to the IMF forecasts in June 2020, the global GDP would shrink by 4.9% in 2020, but resume growth again by 5.4% in 2021, remaining at a 6.5 percentage point lower level vis-à-vis the forecast of January 2020. However, in June and July, along with easing of the COVID-19 restrictions, economic activity in some countries recovered slightly sooner than expected before, and the most pessimistic forecasts failed to materialise. Consequently, in early September, the ECB revised upwards its global economic growth projections for 2020 and 2021. At the same time, given the economic recovery seen in the summer months, according to the OECD estimates the global GDP would drop 4.5% in 2020, but improve by 5.0% in 2021.

The existing downward risks, e.g. the second wave of the pandemics and the length of the related restrictions (how people and governments will respond to the increasing number of COVID-19 cases and how strict the newly introduced restrictions will be, as well as their impact on economic activity), government support to households and businesses (whether the currently implemented programmes are extended or replaced with new measures supporting economic recovery), consumer behaviour (accumulation of savings and voluntary social distancing affecting both consumption and purchasing power), employment (how soon the employees still receiving furlough benefits or those having already lost their jobs are able to fully return to the labour market), and the global supply chain effectiveness (the impact of disruptions caused by the potential change and introduced restrictions on production and productivity) are likely to have a substantial effect on the future pace of the crisis caused by the COVID-19 pandemics. Along with the growing uncertainty about the impact of the second wave of the COVID-19 pandemics, the US and China trade relations, the UK and EU relations after the Brexit and the scheduled US presidential election in November also contribute to the uncertainty associated with the growth outlook.

In early April, in response to a fall in oil demand by approximately 30%, OPEC reached an agreement on oil production cuts by almost 10 million barrels per day (10% of total supply); as the global oil demand gradually improved, a new agreement on future oil output cuts was

reached, i.e. by 7.7 million barrels per day beginning with August. This generally allowed for stabilising the oil price in the global markets, with it fluctuating between 35 USD per barrel and 43 USD per barrel over the last few months.

In the second quarter, the US GDP growth fell by 9.1% year-on-year (by 0.3% in the first quarter). One of the major risks threatening the future progress of economic recovery is the high unemployment rate: it had reached 14.7% of economically active population in April, dropping down to 8.4% in August and still being well above the level seen in early 2020. At the end of August, FRS Chairman Jerome Powell announced a revised central bank strategy focusing on improving employment situation in the US by way of the average inflation targeting, i.e. where inflation has been running low for a longer time, it has been allowed to exceed its 2% target. For financial market participants, this signalled extension of the accommodative monetary policy implementation. With demand recovering and the oil price level stabilising, the US annual inflation rose to 1% in July.

In China, whose economy was the first to be affected by the COVID-19 pandemic and where the economic recovery started sooner, its growth rate was strengthening further along with the increasing domestic and external demand. In August, China's exports grew by 9.5% year-on-year, while imports, given a slower recovery of domestic consumption, shrank by 2.1%. In the second quarter, China's GDP expanded by 3.2%, albeit at a slower pace than in the last quarter of 2019 when the annual growth rate stood at 6.0%. In Japan, however, the recovery rate was stagnating notably on account of low industrial activity, weak consumption and demand for exports. Retail trade turnover, affected not only by the COVID-19 pandemic, but also by a consumption tax increase, continued on its downward trend observed since March and in July was 2.8% lower year-on-year. Japan's industrial activity had already been contracting since September 2019 and in July recorded a 15.7% decline in annual terms. GDP posted an annual change of –10.1% in the second quarter.

In the first half of 2020, the euro area saw record high declines in its economic indicators. In the second quarter, GDP posted a year-on-year decrease of 14.7% (–3.2% in the first quarter). The fall was smaller than projected before; nevertheless, it was the highest drop registered so far. In March and April, data on the volume of manufacturing output and retail trade turnover suggested that economic activity fell considerably due to the COVID-19 pandemic containment measures, followed by gradual lifting of the restrictions and a subsequent activity increase surpassing growth expectations in May and June. In July, retail trade turnover failed to continue on its positive trend and shrank by 1.3% month-on-month, albeit posting a slight increase of 0.4% in annual terms. As to the manufacturing output volume, it strengthened further in July growing by 4.1% compared to June, but stood 7.7% lower year-on-year. Purchasing Managers' Indices and economic sentiment indicators, characterising the expectations of the coming months, improved, albeit at a more moderate pace than in early summer. The September 2020 ECB staff macroeconomic projections for the euro area forecast that, given the better-than-expected macroeconomic indicators, euro area GDP would contract by 8.0% in 2020 in annual terms (a drop of 8.7% according to the June 2020 Eurosystem staff macroeconomic projections for the euro area) while growing by 5.0% in 2021 (5.2% growth according to the June 2020 Eurosystem staff macroeconomic projections).

In Latvia's major trade partners, the economic sentiment has also been improving rapidly already since May, but in August in the euro area and the EU it had recovered merely about 60% of the value it had lost during the March and April fall. Based on the information available in August, the assessment of the drop in Latvia's external demand in 2020 had been revised downwards and its development in the next couple of years was expected to be above the level estimated during the time of aggravating crisis.

Chart 1

EURO AREA GDP, MANUFACTURING OUTPUT AND RETAIL TRADE TURNOVER
(year-on-year; seasonally and calendar adjusted data; %)

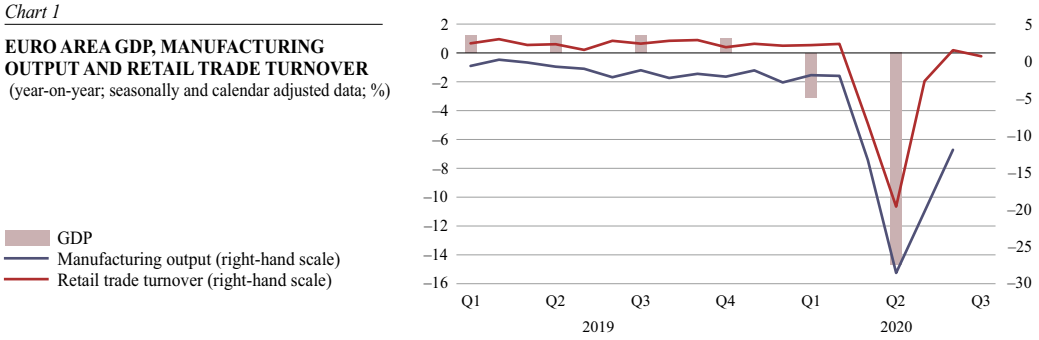
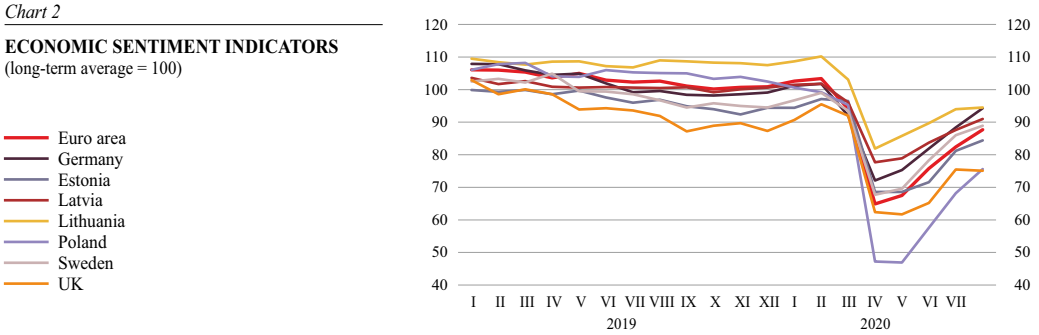


Chart 2

ECONOMIC SENTIMENT INDICATORS
(long-term average = 100)



In Germany, GDP shrank by 9.7% in the second quarter; however, its economy was more resilient to the crisis than that of the euro area on average. Although essential, the virus containment measures were not among the strictest ones in comparison with those in other countries, and their notable easing started quite soon, i.e. in mid-May. Despite a strong increase in orders of intermediate goods persisting, a rapid recovery in May was followed by a moderating growth rate in manufacturing in July. In July, German exports also lost pace of recovery; however, the drop in import growth was even faster, negatively affecting Germany's trade partners, including Latvia. The historically well-developed short-time working scheme allowed to prevent a notable rise in unemployment, and the decrease in retail trade, observed in April, was more than offset already in May. Government consumption growth slowed down the rate of decrease, and support measures were targeted not only for dampening the crisis in the short term (e.g. by reducing the VAT, compensation of income decreases for employees and businesses), but also meant guarantees and other stimulus for facilitating long-term investment.

Latvia's Baltic neighbouring countries were among the most resilient ones in the crisis, losing only slightly more than 5% of their GDP in the second quarter. In both countries, the restrictions policy helped to keep the number of COVID-19 cases relatively low, as well as a set of wide-scale government support measures (e.g., support to preserve household income) had been developed and implemented in a timely manner. Following the initial jump in April, the increase in unemployment rate slowed down considerably, employment expectations and retail trade confidence improved rapidly, the latter becoming positive in August. Industry and exports saw fast recovery, in July almost offsetting the crisis impact in Estonia and being slightly lower compared with the level a year earlier in Lithuania. Although the EC Summer forecast projected a GDP fall exceeding 7% for both countries, the resilience and rapid recovery of both the domestic market and exports ranked the Baltic neighbouring countries among the strongest economies after the crisis aggravation. Lithuania and Estonia were the major countries supporting recovery of Latvian exports.

In Latvia's major trade partners outside the euro area, except Denmark and Poland, restrictions were applied in a less strict manner, but the infection spread was higher. Apart from the direct impact of the virus-related restrictions, Russia's economy also suffered from the plummeting oil prices reducing the value of its exports. The fall in oil prices prevented

the government from providing substantial financial support to the economy. This will also curb Russia's further recovery after the crisis and economic development in the future (contribution of public investment to infrastructure was expected before). In the second quarter, the decrease was broadly based, with contributions from services, transport, industry and retail trade posting the largest drops. According to EC projections in spring, Russia's GDP would contract by 5% in 2020 and, with other growth-driving factors besides the expected public investment absent, a minor increase of 1.2% with downward risks would be seen in 2021.

Economic growth in Sweden posted a more pronounced fall than in other Scandinavian countries in the second quarter. Although the COVID-19 related restrictions decelerated its economic activity considerably less than in the region and EU overall, the COVID-19 spread was one of the highest. Sweden's efforts to prevent interference in economic activity failed to save Sweden from the weakening of the external environment and supply chain disruptions, thus negatively affecting the exporting sectors. In its Summer forecast package, the EC projected for Sweden one of the smallest growth decreases in 2020 (–5.3%); nevertheless, the results of the second quarter, with the rapid rise in unemployment translating in weaker retail trade indicators, were worse on the overall background. In April, considerably smaller deterioration of employment expectations was observed in Sweden; however, in August their recovery stopped in contrast to the continuous upward trend seen in most EU countries.

In the second quarter, even against the overall negative background, the UK stood out with a dramatic economic downslide exceeding 20% over the previous quarter. This was on account of a relatively later (not affecting activity in the first quarter) and fast introduction of restrictions, as well as the virus spread standing out in negative terms together with Sweden against the European background. The services sectors, industry and construction, all affected by the restrictions, were hardest hit. Up to August, the economic sentiment indicators demonstrated weak recovery, with a particularly low level persisting in services and industry, and consumer confidence and retail trade confidence also remained very negative. According to the EC Summer forecast, the UK would face one of the most pronounced downturns in Europe, i.e. –9.7% in 2020. July saw the economic recovery slow down, and in September, with the COVID-19 spread expanding rapidly, the UK resumed restrictions to socialising. The current economic development and recent political signals increasingly pointing towards a no-deal Brexit suggest that weaker-than-projected growth is likely to be expected. It should be taken into account that GDP growth of 6.0% for 2021 has been estimated assuming status quo in the UK and EU terms of trading.

Denmark and Poland registered a relatively low new coronavirus spread and strict restriction measures in the second quarter. Polish economy was hit harder contracting by 8.9% quarter-on-quarter, while Denmark's GDP dropped 6.9%. In both countries, employment and retail trade were not too badly affected (retail trade in Denmark even posted strong growth in the second quarter), but the weak domestic demand found reflection in sluggish services and investment. According to the EC Summer forecast, the impact of the crisis was assessed as relatively smaller, i.e. a GDP decrease of 5.2% and 4.6% in 2020 in Denmark and Poland respectively. Poland expects to have a larger government support package that might help the EC forecast on a relatively full recovery in 2021, with GDP growing by 4.3%, materialise.

2. Financial Conditions

With COVID-19 spreading outside China, financial markets became increasingly anxious about the economic outlook. The prices of riskier financial assets plummeted due to investor concerns about the solvency, profitability and future prospects of businesses. At the same time, an exceptionally high investor demand for liquidity observed during this crisis episode contributed to a fall in the prices of the so-called safe assets. Major central banks and governments introduced immediate monetary and fiscal support measures, securing the return of cautious optimism to the financial markets. Despite the rapid improvement of the financing conditions seen since the beginning of April, they still remain weaker than before the COVID-19 pandemic.

2.1 Decisions of the ECB and other major central banks

At the end of February 2020, with COVID-19 starting to spread in the euro area countries the financial markets were thrown into panic. Initially, it triggered a wide sell-off of risky assets, including shares and high-yield corporate bonds. This resulted in high volatility and rapidly dropping prices. With the tension intensifying, investors increasingly gave preference to liquidity and sold off also government bonds. The high uncertainty increased the investors' risk aversion, and business faced difficulties in accessing financing. This deterioration of the financial conditions posed risks to the monetary policy transmission mechanism.

On 18 March, at an emergency meeting, the Governing Council of the ECB announced the launching of a new Pandemic Emergency Purchase Programme (PEPP) to counter the risks to the monetary policy transmission mechanism and the economic growth posed by the escalating diffusion of COVID-19. The Governing Council of the ECB also confirmed its commitment to doing everything in its mandate in order to support all citizens of the euro area through this extremely challenging time by ensuring supportive financing conditions helping to absorb the COVID-19 shock.[1]

The PEPP is a new non-standard monetary policy instrument for purchasing private and public sector securities. Initially, the PEPP envelope was set at 750 billion euro, but, with the economic growth and inflation outlook deteriorating, a decision to increase the envelope to 1350 billion euro was taken on 4 June. Although for the purchases of government securities the benchmark allocation is the capital key of the national central banks, contrary to the asset purchase programme, the PEPP is more flexible in terms of purchase volumes, pace and distribution across asset classes and jurisdictions. The list of eligible asset categories has also been slightly expanded. Non-financial commercial paper is also eligible for purchases both under the PEPP, as well as debt securities issued by the Greek Government. This flexibility in asset purchases largely determined the fact that the PEPP was able to significantly improve the financing conditions in all asset categories through frontloading asset purchases and directing them to the most stressed market segments. The intention is to continue with the implementation of the PEPP until the Governing Council of the ECB judges that the crisis caused by the COVID-19 pandemic is over, but in any case until the end of June 2021. It was also decided that the maturing principal payments from securities purchased under the PEPP will be reinvested until the end of 2022.

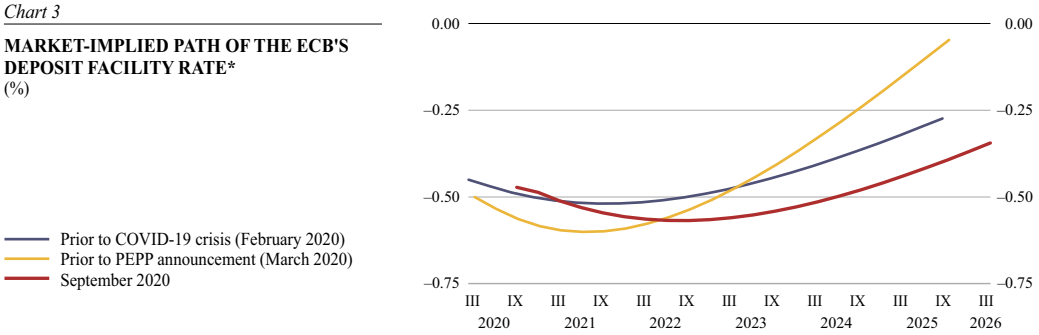
On 7 April, the ECB adopted a package of collateral easing measures to improve access to the central bank liquidity providing operations and ensure the continuity of financing flows, also aiming to avoid potential procyclical dynamics in lower investment grade securities market. Collateral requirements were further eased on 22 April by grandfathering the eligibility of securities that were investment grade securities on 7 April 2020 (except

[1] See more detail in the ECB's press release at *https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html.*

asset-backed securities; ABS) as long as their credit ratings remain at least at the level of BB. In response to the economic developments and in order to support further the provision of credit to households and businesses in the face of heightened uncertainty, the Governing Council of the ECB decided on further monetary support measures on 30 April. First, it decided to make the interest rate on targeted longer-term refinancing operations (TLTRO III) even more attractive for a certain period of time. Second, the ECB announced a new series of pandemic emergency longer-term refinancing operations (PELTROs). They were commenced in May 2020 and were maturing in a staggered sequence between July and September 2021 in line with the duration of the ECB's collateral easing measures. The attractive terms of the fourth round of the TLTRO III operations generated strong interest and banks borrowed the total amount of 1.31 trillion euros.

Chart 3

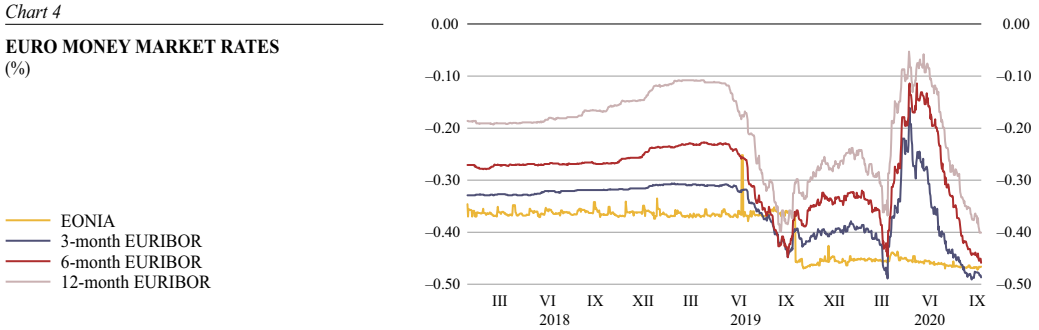
MARKET-IMPLIED PATH OF THE ECB'S DEPOSIT FACILITY RATE*
(%)



* ECB's deposit facility rate priced in EONIA swaps.

Chart 4

EURO MONEY MARKET RATES
(%)



At the press conference following the July 2020 meeting of the Governing Council of the ECB, Christine Lagarde, President of the ECB, pointed out that incoming information signals a resumption of euro area economic activity. The level of activity, however, remains well below the levels prevailing before the COVID-19 pandemic and the outlook remains highly uncertain. After the September meeting of the General Council of the ECB where no changes to the monetary policy were introduced, Christine Lagarde also said that the incoming data suggest a strong rebound in activity broadly in line with previous expectations, although the level of activity remains well below the levels prevailing before the COVID-19 pandemic.

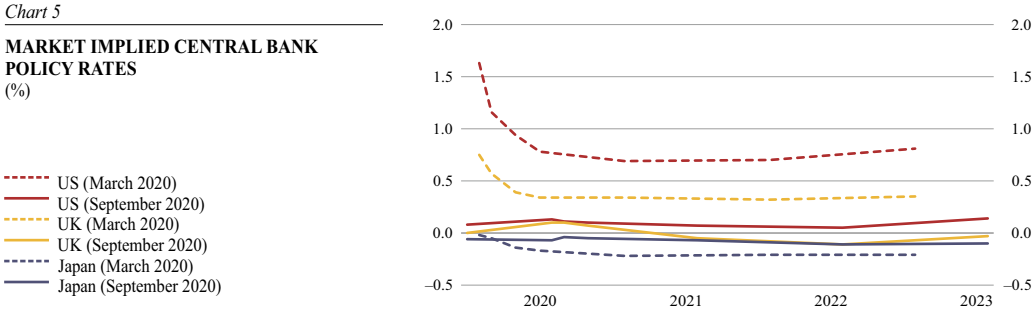
In anticipation of a significant deterioration of the financing conditions, the FRS reduced the target range for the federal funds rate by 100 basis points (to 0.00%–0.25%) already in the first months of the COVID-19 pandemic. Additionally, it was decided to increase the FRS's holdings of US Treasury securities by at least 500 billion USD and its holdings of agency mortgage-backed securities (CMBS and RMBS) by at least 200 billion USD. At the same time, the FRS announced new programmes to support the flow of credit to households and businesses. In the period up to 12 May, the terms and conditions of those programmes were improved in several steps, whereas the amounts were increased. Several programmes were established in cooperation with the US Department of the Treasury, enabling loans to individual special purpose vehicles purchasing corporate bonds on both

primary and secondary market, purchasing commercial paper, granting term asset backed securities loans and providing liquidity to money market funds. At the beginning of April, the FRS announced that, in addition to the above-mentioned programmes, it will establish a facility to facilitate lending to small businesses via the Small Business Administration's Paycheck Protection Program (PPP) by providing term financing backed by PPP loans. In cooperation with the US Department of Treasury a new Main Street Lending Program was also established, enabling credit institutions to sell 95% of eligible loans to a special purpose vehicle. Municipal Liquidity Facility was set up according to the same principle and in cooperation with the US Department of Treasury. Under this facility, a special purpose vehicle purchases short-term notes from American states, counties and cities. The maximum amount of all new programmes is up to 2.3 trillion USD. According to the FRS, economic activity and employment have picked up in recent months but remain well below their levels at the beginning of the year. Looking into the future, the path of the economy will depend significantly on the course of COVID-19. The ongoing public health crisis will continue to weigh on economic activity, employment, and inflation in the near term. This poses considerable risks also to the economic outlook over the medium term. In addition to that, the Chair of the FRS Jerome Powell announced at the press conference that the FRS was changing its 2% symmetric inflation target to a 2% medium-term inflation target, meaning that the FRS could maintain an accommodative stance of the monetary policy longer without having to worry about a moderate overshooting of the 2% inflation target.

In response to the deceleration of economic activity caused by the COVID-19 pandemic, the Bank of England also decided on easing its monetary policy stance. The Bank Rate was cut by 15 basis points (to 0.1%). In addition to that, during the initial stage of the pandemic, the Bank of England decided to increase its asset portfolio with 200 billion British pound sterling worth of UK government bonds and corporate bonds. With the situation worsening, at the beginning of summer, it was decided to increase the stock of those bonds by another 100 billion British pound sterling, to 745 billion British pound sterling. Moreover, at the very onset of the pandemic, in an anticipation that small and medium-sized enterprises could be facing financing problems, the Bank of England introduced a Term Funding scheme with additional incentives for small and medium-sized enterprises to encourage more active bank lending. At the same time, the Bank of England continues to stress that it will continue to monitor the situation closely and stands ready to act to support the economy and achieve the inflation target.

Chart 5

MARKET IMPLIED CENTRAL BANK POLICY RATES
(%)

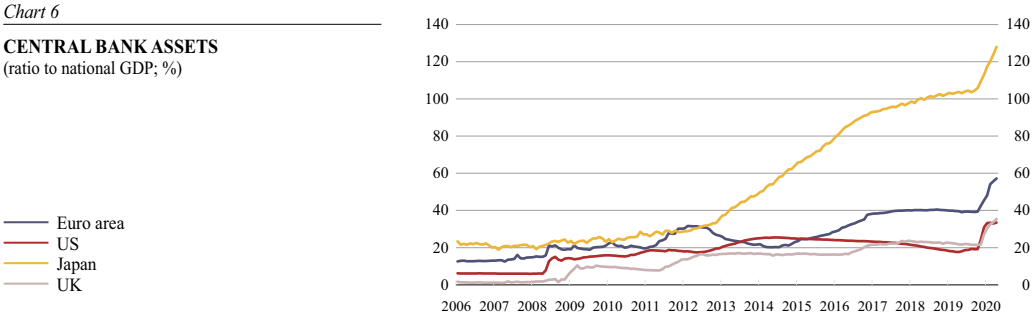


In light of the weakening economic activity as a result of the COVID-19 pandemic, the Bank of Japan announced several monetary easing measures at the beginning of March. At the unscheduled policy meeting of April 16, it was judged appropriate to enhance monetary accommodation. A new operation to provide interest-free loans against corporate debt as collateral was announced. It was also decided to increase the purchases of beneficiary interests in index-linked exchange-traded funds (ETFs) and investment equities issued by real estate investment corporations (J-REITs). At the same time, the policy rates were left unchanged. At its 27 April meeting, the Bank of Japan decided on a further enhancement of monetary easing by increasing the upper limit of its holdings of commercial paper and

corporate bonds four times (to 20 trillion yen; roughly 172.5 billion euro). In addition to that, the interest-free borrowing facility was strengthened by expanding the range of eligible collateral and making it available to a larger number of eligible counterparties. In order to provide further liquidity to the bond market and stabilise the yield curve at a low level, the limits on purchases of government debt securities were lifted. At its subsequent monetary policy meetings, the Bank of Japan reconfirmed that it will not hesitate to take additional easing measures if necessary.

Chart 6

CENTRAL BANK ASSETS
(ratio to national GDP; %)



2.2 Global financial market developments

At the onset of the global pandemic, government bond markets in advanced economies experienced sharp swings. Initially, the financial markets were thrown into panic, with investors giving preference to liquid and less risky assets, asset prices collapsed. Surprisingly to many observers, the safe-haven government bonds or benchmark debt securities were no exception, and in some crisis episodes investments were shifted exclusively into the most liquid assets, i.e. deposits and money market funds. The weighted average yield on the German 10-year government bonds increased from –0.60% at the beginning of March to –0.19% on 19 March, whereas the weighted average yield on the corresponding US Treasury bonds rose from 1.14% at the beginning of March to 1.19% on 18 March. This rise of the yields was explained by investors needing money to satisfy margin calls under leveraged trading strategies. From 1 March to 4 September, the weighted average yield on the German 10-year government bonds overall increased by 14 basis points (to –0.47%), whereas the weighted average yield on comparable US Treasury bonds fell by 42 basis points and stood at 0.72% at the beginning of September. With the COVID-19 pandemic spreading rapidly and economic activity decelerating, countries faced declines in their tax revenue. Euro area governments announced a wide range of measures to support economic activity and needed additional liquidity to finance their current budget spending as well as the newly announced support programmes. New debt security issues launched from the beginning of the year to the end of August exceeded the volume of the corresponding period of the previous year by 37%. Regardless the sizeable new issues, in the period from March to the beginning of September the yields on government debt securities in countries of Southern Europe overall changed insignificantly, albeit exhibiting quite a high degree of volatility. For example, prior to the ECB's announcement of the PEPP, the weighted average yield on Italian government debt securities jumped to 2.42% (on 17 March) and was 130 basis points higher than at the beginning of March. Primarily on account of the PEPP and other central bank and government measures, the weighted average yield on Italian, Spanish and Portuguese 10 year government bonds overall only changed by –9, +7 and +2 basis points accordingly in comparison with the pre-crisis levels. On 21 July 2020, the European Council agreed on the establishment of a new temporary recovery instrument "Next Generation EU", totalling 750 billion euro. For the first time ever, temporarily, a European budget has been put in place that complements the fiscal stabilisers at the national level, and it has increased investor confidence in a coordinated support to managing the crisis consequences of the COVID-19 pandemic. At the same time, despite the overall positive developments concerning the government debt securities, analysts believe that the

recovery of Southern European economies could be slower than expected, considering that tourism which is a major contributor to growth in those countries will need more time to recover than other sectors. Further development of the yields on the euro area government debt securities will primarily depend on the countries' ability to use the available funding to strengthen growth. A relatively high number of new COVID-19 cases and the expected government responses to the second wave of the COVID-19 pandemic also continue to be a source of uncertainty and risks.

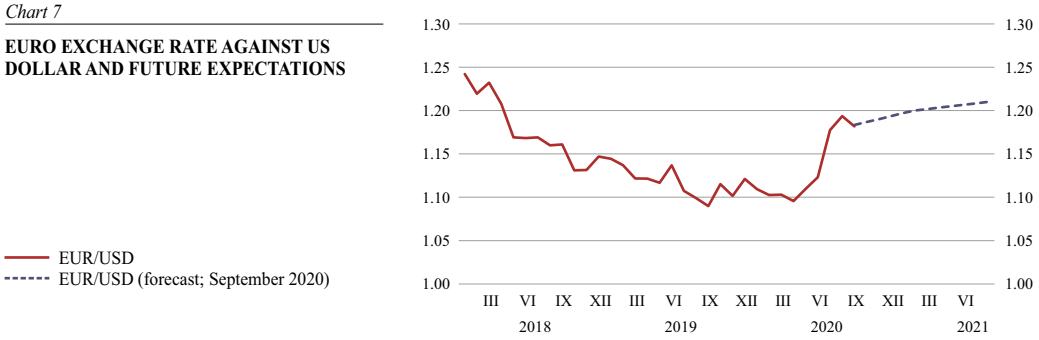
Corporate bond markets, much like government securities markets, also were highly volatile from the beginning of March until 4 September. The onset of the pandemic threw the bond market into panic, triggering a sell-off and a rapid rise of interest rates. Investors were concerned about the weakening economic activity and its effect on corporate cash flows. Seeing the build-up of elevated financial market stress, central banks responded by announcing asset purchase programmes that supported an improvement in the financing conditions and a gradual return of the corporate bond yields to a level close to the pre-pandemic level. The effect on corporate bonds varied depending on their rating, and, as expected in a crisis, investors gave preference to higher rated corporate debt securities. For a short period of time, high yield (low rating) firms had virtually no access to financial markets because of the weak investor demand. Central banks and governments invested a lot of effort to stabilise the situation, and the investor demand for corporate bonds recovered. From the beginning of the year to September, new issues of investment grade debt securities increased by 50% in comparison with the respective period of the previous year. New issues of high-yield (low rating) corporate debt securities also grew, albeit at a more moderate pace. Financing conditions for corporates are expected to remain stable, with the macroeconomic conditions improving and central banks continuing to provide active support to the markets through asset purchases.

Similar as in debt securities markets, stock markets have also been characterised by a high degree of volatility from the beginning of March to 4 September. At the beginning of the COVID-19 pandemic, markets collapsed, but after the announcement of support measures stock market indices both in Europe and in the US rebounded. US stock market index S&P 500 reached a new all-time high at 3580.84 points on 3 September, representing a 16.0% increase in comparison with the beginning of March. At the same time, EuroStoxx50 covering the stocks of 50 largest listed companies of the euro area has decreased by 2.07%, albeit climbing up 36.7% from the trough on 18 March. The most significant positive contributor to the euro area stock market recovery was the shrinking risk premium, suggesting that investors are ready to accept a lower expected return. At the same time, the weakness of the short-term corporate earnings prospects was the largest factor weighing on stock prices. Since the beginning of March, corporate earnings expectations for 2020 have been significantly downgraded in both the euro area and the US, with some improvement seen already in the 2021 earnings projections, although they are still weaker than expected before the pandemic. Overall, stock indices have rebounded significantly from the troughs they hit under the impact of the COVID-19 pandemic, yet the recovery has been uneven across the sectors. For example, the prices of stocks issued by euro area and US banks remain low, despite showing some improvement. EURO STOXX Banks 600 characterising the euro area banking sector has decreased by 25.6% from the beginning of March, whereas the US Banks Index has declined by 15.1%. The stock prices of energy companies also are lower than the overall index, which can be explained by the crashing of oil prices during the COVID-19 pandemic. The stock prices of tourism and recreational services companies are also still significantly below their pre-pandemic level. At the same time, the stocks of technology companies have been performing well, as their business was disrupted less and in some cases the demand for their services even increased several times. Although stock prices have reached their historical highs and seem high also in comparison with their earnings, the decisive steps taken by the governments and central banks will continue to support the

stock prices, so that they can remain at the existing level or even continue to rise when the macroeconomic situation improves.

Chart 7

EURO EXCHANGE RATE AGAINST US DOLLAR AND FUTURE EXPECTATIONS



From the beginning of March to 4 September, the euro appreciated by 7.4% against the US dollar (to 1.184). During the period, the exchange rate of the euro was highly volatile. In the second half of March, against the background of elevated financial market stress, the exchange rate of the euro against the US dollar fluctuated within the range of 1.07 to 1.11. This can be explained by the high degree of uncertainty preventing investors from giving preference to one or another currency. The ECB managed to surprise all sceptics with announcing the PEPP in this period. At the same time, there was a large deficit of the US dollars; therefore, the FRS announced the establishment of US dollar swap lines with other central banks, thereby easing the upward pressure on the US dollar. Over the summer months, the euro started to recover in the circumstances of a broader weakening of the US dollar caused by the FRS' policy decision to significantly lower the target range for the federal funds rate already in March and a gradual subsiding of the financial market stress. The strong appreciation of the euro can be explained by the relatively high attractiveness of the euro caused by the tightening differential between the policy rates of both regions. At the same time, the euro received additional support from the establishment of the recovery instrument "Next Generation EU".

2.3 Financing conditions in the Latvian economy

Accommodative monetary and fiscal policies have helped to ease the tensions caused by the COVID-19 pandemic, and deposits have continued on the previous upward trajectory. At the same time, Latvia did not experience the lending boom observed in many other euro area countries where businesses drew shorter-term financing to deal with the crisis, and Latvian credit institutions continued with shrinking their loan portfolios and projecting any recovery in lending growth in Latvia no sooner than in 2022. Over the first months of the crisis, lending rates increased due to the tendency to defer principal repayments, a lower loan demand and more cautiousness on the part of credit institutions. The COVID-19 pandemic affected also the saving and borrowing behaviour of households: the proportion of demand deposits and demand for unsecured loans tended to grow.

Given the current sentiment of consumers and credit institutions, the loan portfolio is shrinking, but the pace is low and not much different from the monthly trends observed before the crisis. The effect of the tightening of the credit standards and weaker borrowers' creditworthiness was partly offset by the high degree of the monetary accommodation and a flexible approach to the existing loan obligations pursued by the credit institution. The ratio of the loan portfolio to GDP fell below 40% in the first half of 2020, which is the lowest ratio since 2003.

From March to April, the domestic loan portfolio contracted by 0.3%, with loans to non-financial corporations and household loans shrinking by 0.5% and 0.3% respectively. Only the loans to non-bank institutions grew by 0.7%. The annual rate of change in domestic loans

(excluding the impact of restructuring of the credit institution sector and reclassification of the institutional sectors) became increasingly more negative: –2.8% in August for loans overall, –3.7% for loans to non-financial corporations and –0.2% for loans to households.

Chart 8

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

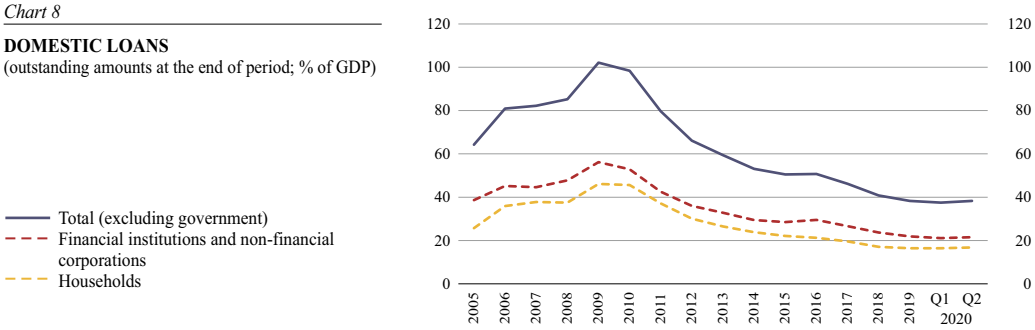
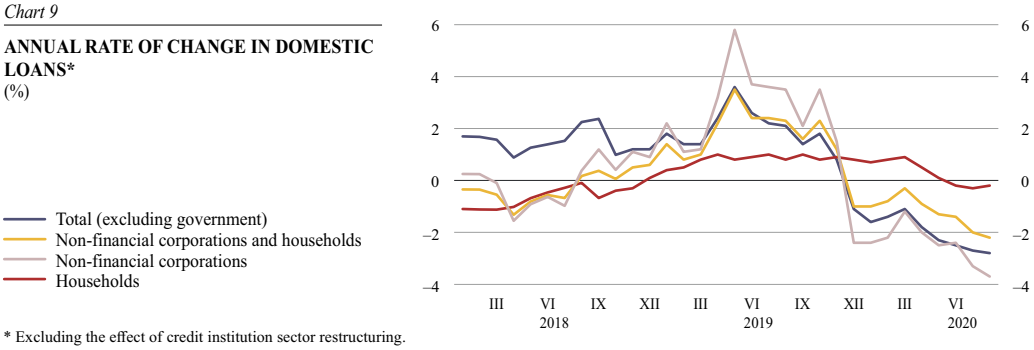


Chart 9

ANNUAL RATE OF CHANGE IN DOMESTIC LOANS*
(%)



* Excluding the effect of credit institution sector restructuring.

Although the crisis caused by the COVID-19 pandemic had a moderate effect on the shrinking of the existing loan portfolio, the impact on new loans in April and May was significant. There was a notable increase in renegotiated loans and a considerable decline in new loans over those months, followed by a period of rebound in new loans from June to August. Nevertheless, the amount of new loans granted in the first eight months of 2020 is 11.4% smaller than in the corresponding period of the previous year (17.5% and 6.3% smaller in the case of household loans and loans to non-financial corporations respectively).

The costs of borrowing for non-financial corporations increased during the initial stage of the crises caused by the COVID-19 pandemic on account of both higher interest rates applied to renegotiated loans in comparison with new loans and the efforts of smaller credit institutions with more expensive financing to boost their market shares. The most significant increase in borrowing costs and decrease in loans under the impact of the COVID-19 pandemic was observed in the segment of small and medium-sized enterprises, whereas the financing costs of large and well-established enterprises varied depending on the implemented projects. With the situation improving, the borrowing costs for non-financial corporations returned to their pre-crisis levels in June and July. Overall, the interest rate on new euro loans to non-financial corporations peaked at 3.4% in May and returned to the pre-pandemic level thereafter (2.9% in February and 2.8% in July). Over the first months of the crisis caused by the COVID-19 pandemic, the amount of renegotiated loans to non-financial corporations increased notably, whereas the amount of new loans decreased. Three out of four Latvia's major credit institutions participating in the euro area bank lending survey reported tightening credit standards for loans to non-financial corporations in the first quarter and one of them admitted tightening in the second quarter, with the most often quoted reason being deterioration of general economic situation and outlook, firm specific situation as well as borrower's creditworthiness. In both quarters, a lower demand for long-term loans was also reported, primarily on account of a decreased need for fixed investment and financing for mergers and acquisitions. A rise in the weighted average interest rate can be explained by an increase in renegotiated loans carrying higher interest rates than the

new loans combined with a decline in new loans. Slightly higher margins on loans to non-financial corporations in the first quarter of 2020 were reported only by one credit institution, with the underlying reasons being increased cost of funds and balance sheet constraints as well as risk perceptions. Interest rate statistics show that the interest rate on new euro loans in four Latvia's credit institutions with the biggest portfolios of loans to non-financial corporations decreased by 0.2 percentage point (to 2.5%) in the period under review. In other credit institutions, the weighted average interest rate on new euro loans to non-financial corporations grew by 0.6 percentage point (to 4.9%), with the share of those particular loans in total new loans also expanding in the period from March to June. Over the next reporting period, the evolution of the lending rates applied to non-financial corporations will depend on counteracting factors: continued transmission of further monetary accommodation measures implemented by the ECB on one side and potentially higher corporate credit risk due to the economic turbulences caused by the COVID-19 pandemic.

Chart 10

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

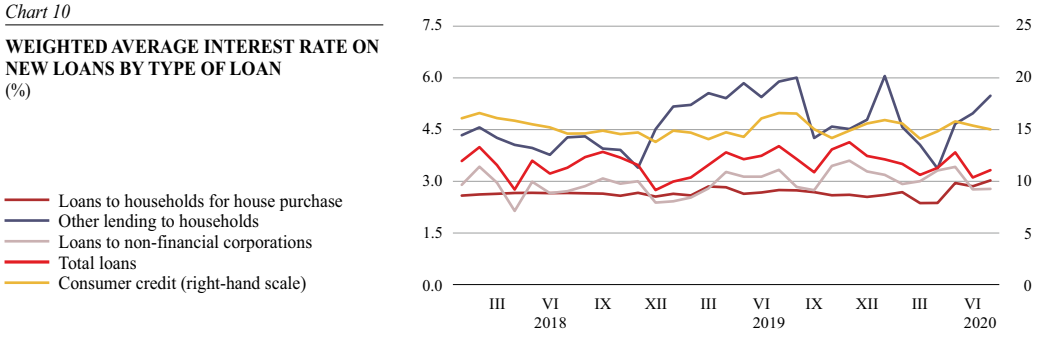
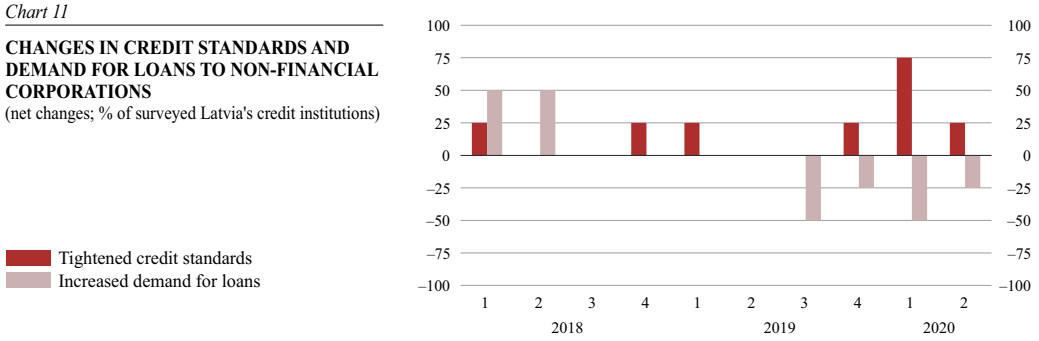


Chart 11

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



In the first months of the crisis caused by the COVID-19 pandemic, the interest rates on loans to households for house purchase reflected the fact that households tended to seek deferral of principal repayments and, once the restrictions were eased, give more preference to unsecured loans. This suggests purchases of cheaper properties outside the capital as well as loans for housing repairs or improvements. At the same time, no universal trend was observed in the credit institutions' decisions concerning their margins on loans to households for house purchase. Overall, the interest rate on new euro loans to domestic households for house purchase decreased to 2.4% in March and April, and peaked at 3.0% in July, exceeding the level observed before the crisis caused by the COVID-19 pandemic (2.7% in February). The decline in March and April can be explained primarily by the fact that Latvia's credit institutions allowed households to defer principal repayments and that part of the loans that were granted prior to the most significant financial turmoils of the last decade carry a lower interest rate than the new loans. In the above-mentioned period, the amount of renegotiated loans for house purchase exceeded the usual amounts many times. At the same time, the demand for new loans for house purchase contracted in April on account of households becoming less confident in their future. Moreover, to show solidarity, credit institutions did not take advantage of the situation to raise interest rates. In March and April, the weighted average interest rate on renegotiated loans for house purchase was 2.1% and 2.2% respectively, which is lower than usual (2.4%–2.9% in the previous 12 months) and

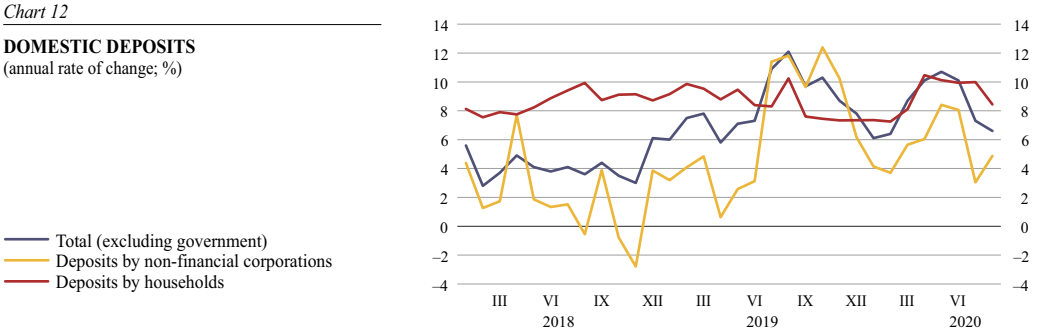
lower than on the respective new loans. In May, the weighted average interest rate on loans to households for house purchase returned to the levels observed before the crisis caused by the COVID-19 pandemic, as less household applications for deferral of principal repayments were received and, with the loan moratorium taking effect on 28 April, loan agreement modifications for households with no repayment arrears were no longer reflected in interest rate statistics. In June and July, interest rates on loans to households for house purchase went up as, with the household demand recovering, the proportion of unsecured loans increased. Unsecured loans are usually granted for purchasing property outside Riga, housing repairs or improvements; normally, they have a higher credit score and hence also a higher interest rate compared to collateralised loans. Moreover, the interest rate on unsecured loans increased significantly during the crisis caused by the COVID-19 pandemic also because credit institutions perceived the risks associated with household creditworthiness as higher as well as due to the emergence of new active players in the above-mentioned market segment. The interest rate on collateralised loans to households for house purchase decreased to 2.4% in July, shrinking by 0.1 percentage point in comparison with February, whereas the respective rate on unsecured loans grew by 1.7 percentage points, to 4.8%. The results of the ECB's bank lending survey show that one out of the four participating Latvia's credit institutions narrowed the margin on loans to households for house purchase in the first and the second quarters, while another one widened the margin in the second quarter, both explaining the change by an increase or a decrease of cost of funds and balance sheet constraints, and one credit institution also by changes in its risk perception. Monetary policy measures implemented by the ECB as well as household preference for credit institutions offering lower interest rates were factors limiting the rise of interest rates on loans to households for house purchase. The future path of those interest rates will depend on the depth and duration of the crisis caused by the COVID-19 pandemic. According to the baseline scenario, the rates could remain at their present levels or slightly increase on account of a further increase in household credit risk and the share of unsecured loans.

Interest rate on consumer credit was volatile in the reporting period, with households deferring principal repayments and both household demand and credit institution supply also changing. Although deferral of principal repayments was less common in the case of consumer credit than in the case of household loans for house purchase, at the beginning of the crisis caused by the COVID-19 pandemic, deferrals had a downward effect on the weighted average interest rate on consumer credit (15.6% in February, 14.2% in March and 14.8% in April). Demand for consumer credit bottomed out in April, and, with credit institutions growing more cautious and the perceived creditworthiness of households weakening, the weighted average interest rate on new credit peaked. Starting from May, both the amount of consumer credit granted and their interest rates returned to the previous levels. New loans increased gradually, and the weighted average interest rate on new euro loans to households slowly declined, to stand at 15.0% in July. Several Latvia's credit institutions cut their interest rates on consumer credit over the summer months. One of the four respondent Latvia's credit institutions admitted in the ECB's bank lending survey that margins on consumer credit and other lending to households were reduced in the second quarter of 2020 on account of lower cost of funds and balance sheet constraints as well as risk perceptions.

The uncertainties surrounding the future success in limiting the spread of COVID-19 and the ability of the economy to adapt to the new circumstances have made households cut back on their consumption significantly and increase savings. Along with limited export opportunities, this has decreased the corporate cash flows. Nevertheless, domestic deposits with credit institutions overall grew by 2.2% in the period from March to August, including a 4.2% and a 1.6% increase in the case of household deposits and deposits by non-financial corporations respectively. The annual growth rate of domestic deposits was 6.6% in August, with the respective rates in the household and non-financial corporation sectors standing at 8.4% and 4.9% respectively.

Chart 12

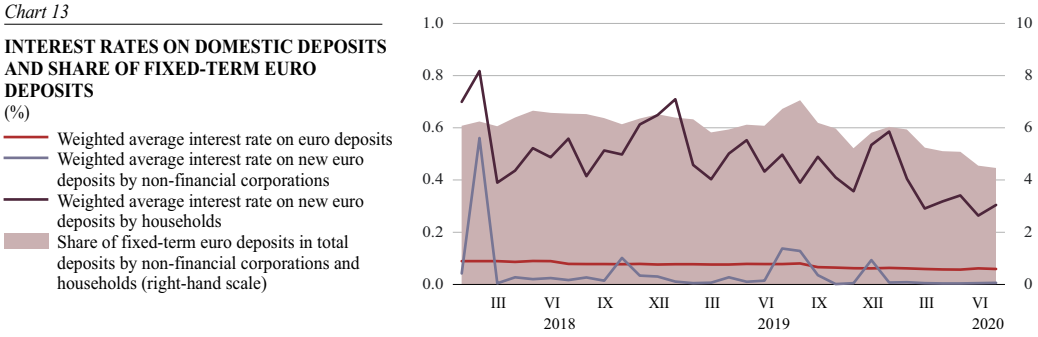
DOMESTIC DEPOSITS
(annual rate of change; %)



The cost of funds of Latvia's credit institutions on the domestic deposit market remained broadly unchanged. In July 2020, the weighted average interest rate on euro deposits by domestic non-financial corporations and households stood at 0.06%, same as in February. Meanwhile, the respective rates on new fixed-term euro deposits by non-financial corporations and households were 0.009% and 0.4% respectively (0.006% and 0.3% respectively in February). The decrease in the interest rates on fixed-term deposits was supported by the fact that during the COVID-19 pandemic preference was given to short-term deposits that are easier available in case of a need for additional liquidity. The low level of deposit rates has enabled Latvia's credit institutions to reduce the cost of funds, yet any further decrease is unlikely because of the limited possibilities to set deposit rates below the zero bound.

Chart 13

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



The flows from the payment accounts of households to those of businesses could increase with spending opportunities growing and retail trade recovering; nevertheless, no significant changes in deposit developments can be expected over the most recent months due to the risk of a renewed COVID-19 outbreak and the uncertainties surrounding the external demand. The above factors will have a role to play also with regard to lending, with both lenders and borrowers maintaining caution. Credit institutions will become more pessimistic lenders to non-financial corporations, whereas lending to households will also continue to stagnate and the annual rate of change of the lending portfolio will most likely be negative or close to zero over the next couple of years. At the same time, 1.185 billion euro were allotted to Latvia's credit institutions at the June auction of the ECB's TLTRO III which will, hopefully, be used to the designated purpose of supporting lending. Over the coming months, the shrinking of the loan portfolio will still be decelerated by deferral of payment obligations for a period of 6 months (12 months in the case of mortgage loans). According to the information at the disposal of the Finance Latvia Association, as at 20 September, due to the exceptional circumstances payment obligations were deferred already under 13 518 agreements, for the total amount of 1.1 billion euro (see Box 1 for Latvijas Banka assessment of the economic impact of loan payment holidays).

BOX 1. ECONOMIC IMPACT OF LOAN PAYMENT HOLIDAYS AND POTENTIAL RISKS

The state of stability and role of the financial sector during the present crisis caused by the COVID-19 pandemic are different than they were during the previous global financial crisis. The financial sector of the EU, including that of Latvia's, is currently significantly healthier than 12 years ago, and this time banks are part of the solution rather than that of the problem. An institutional framework has been established for the EU countries, where the authorities are developing a common model for action in several areas, thereby reducing the uncertainty and preventing the crisis from deepening. One of the examples with regard to borrowers is the Guidelines of the European Banking Authority allowing banks to grant payment holidays to borrowers affected by the crisis caused by the COVID-19 pandemic (moratorium on fulfilment of obligations; hereinafter – moratorium), without automatic reclassification of the exposures. This protects part of the borrowers from defaulting because of the liquidity shortages caused by the COVID-19 pandemic and also enables banks to continue lending freely. The above-measure in combination with furlough benefits, tax holidays and state guarantees for loans have significantly reduced the negative effect of the COVID-19 pandemic containment measures on the economy as well as have helped a considerable part of businesses and households to overcome their short-term liquidity problems.

Overall, banks (and their subsidiary leasing companies) have been granting relief within the moratorium framework as well as taking other individual support measures quite actively. The overall portfolio of loans under relief measures constituted 9.6% of the aggregate loans granted to non-financial corporations and households at the end of July. Looking by sector, most of the loans under relief measures were granted in the sectors of arts, entertainment and recreation (47.8%), accommodation and food service activities (35.6%) and real estate activities (18.7%). The relief granted to loans in the sectors of manufacturing, trade and transport as well as the household sector is more moderate: 7.6%, 7.2%, 9.3% and 7.1% of the loan portfolio respectively. Considering the uncertainty surrounding the future path of the COVID-19 pandemic, it is not unlikely that the support will have to continue.

With the pandemic dragging on, part of businesses and households may face renewed or prolonged liquidity shortages that could evolve into solvency problems over time. For example, in the circumstances of a persistently low demand the production equipment could be underutilised and its useful life could be shorter than expected. This could impair the businesses' ability to settle their obligations in the absence of the liquidity support measures: deferral of payments does not reduce the total amount of obligations and interest still has to be paid or it accumulates and increases the overall debt burden. Deferral of payment obligations is a suitable tool in a crisis, but it does involve certain risks.

First, when the government and credit institution support is provided for a long period of time, businesses may accumulate an excessive debt burden, they do not easily adapt to the new market conditions and have limited resources for making new investments. Support to non-viable businesses also increases the burden on government budget and hence also taxpayers, as well as strengthens the domino effect (when support is no longer available, defaulting non-viable businesses have a detrimental effect on the financial health of other businesses, thereby dampening lending and economic growth).

Second, although banks have very sound performance ratios and high levels of capitalisation in comparison with the previous global financial crisis, a significant extension of the loan moratorium or providing government loan guarantees and subsidised loans for a long period of time may pose risks to the financial sector's stability. An increasingly lower creditworthiness of existing and potential borrowers and growing debt-to-income ratio intensifies the risk of potential losses for banks and thereby limits their ability to finance

the economy. The smoothness of the recovery and growth after the end of the COVID-19 pandemic will depend on the lending ability of banks and the ability of borrowers to undertake new obligations. These considerations are complemented by the fact that the relief on loans subject to the moratorium may be extended, but not indefinitely.

Although the available fiscal safety net as well as the expected support from the recovery instrument "Next Generation EU" would allow to hope for an extension of the fiscal support measures and introduction of new support measures, not all of the so-far implemented and planned support measures would have a purely positive effect on the economy should they be continued or renewed. Continuing with support measures requires paying increasingly more attention to the debt burden on businesses and households and measures that do not add to that burden like, for example, equity investment. Support measures will also have to be increasingly focussed on restoration and further improvement of the production capacity lost during the crisis.

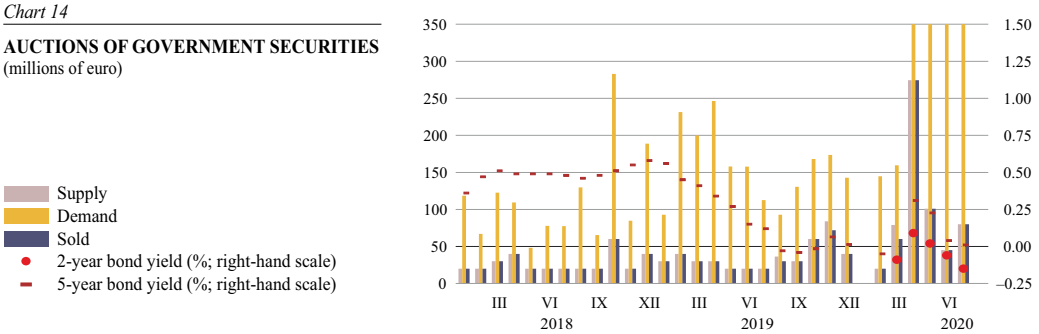
At the height of the COVID-19 outbreak, the international rating agency Fitch Ratings affirmed Latvia's long-term local currency and foreign currency issuer default rating at A–, revising the outlook from stable to negative, as the effect of the COVID-19 pandemic potentially increases the government spending and contributes to economic downturn. The international rating agency S&P Global Ratings affirmed Latvia's long-term credit rating at A+ and maintained a stable outlook on the economy, as it was obvious that the fiscal discipline observed by the Latvian government before the pandemic had provided it with sufficient flexibility to support the economy during the COVID-19 pandemic.

The government drew financing from external markets in March and April for the purpose of mitigating the crisis caused by the COVID-19 pandemic and overcoming its consequences. In March, Latvia re-opened an existing external bond issue maturing in 2026 and launched a tap issue in the amount of 550 million euro on external markets, with the yield set at 0.406%. The spreads relative to the swap rate and the respective maturity German government bond yield are 54 basis points and 94 basis points respectively. In April, the Treasury released new 3-year government bonds maturing in 2023 at a 0.209% yield and a 0.125% coupon rate on international financial markets, raising 1 billion euro. The spreads of those Latvian government bonds relative to the swap rate and the respective maturity German government bonds were 49 basis points and 86 basis points respectively.

The government also borrowed from the domestic market where 16 primary auctions of domestic government securities were held in the period from March to August. 2-year, 5-year and 7-year bonds were issued. Total supply was 579.5 million euro, the bids were 3.8 times higher, whereas the total amount allotted was 560.5 million euro. The weighted average yield on 5-year bonds decreased from –0.05% in February to –0.07% in July. The weighted average yield on 2-year bonds declined from –0.13% in mid-March to –0.15% in July. The government bond yields decreased on account of stabilising financial market conditions in comparison with the initial turbulences caused by the COVID-19 pandemic as well as increased monetary accommodation provided by the Eurosystem.

Chart 14

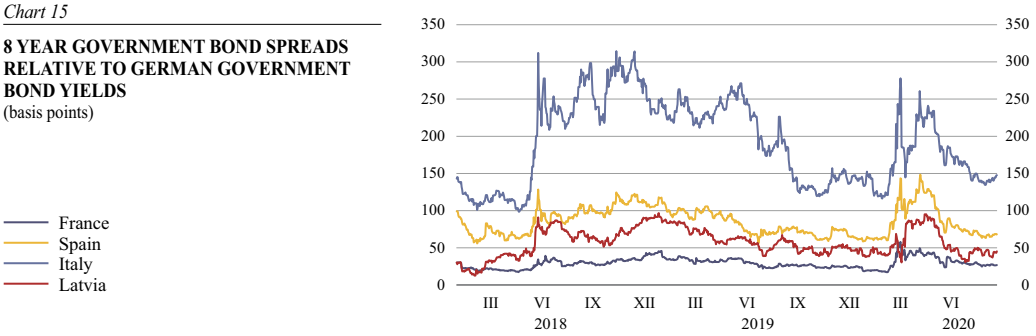
AUCTIONS OF GOVERNMENT SECURITIES
(millions of euro)



On the secondary market, the yield on external Latvian government bonds with the residual maturity of 8 years declined from –0.12% to –0.20% (on 4 September), whereas the spread relative to the respective maturity German government bonds narrowed from 58 basis points to 40 basis points. Other euro area countries also saw similar declines.

Chart 15

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



Covered bonds, a new instrument for the Baltic corporate bond market, are entering the market and, following the establishment of an adequate regulatory framework, will provide new opportunities for the development of the debt securities market in Latvia. Estonian Luminor Bank AS issued the first covered bonds in the Baltic region with the maturity of 5 years for the total amount of 500 million euro. The spread over the mid-swap rate was set 25 basis points, i.e. the yield of those bonds was –0.18%. This was the first time when a Baltic company could borrow at negative interest rates. The bids exceeded 1.6 billion euro. Almost all the bids came from investors outside the Baltic countries, and the covered bonds were listed on the Irish Stock Exchange. Luminor Bank AS plans to continue with the covered bond issues, adding Lithuanian and Latvian assets to the cover pool. The inaugural bond issue was based on Estonian assets only.

AS Latvenergo announced its plans to issue green bonds in the amount of 200 million euro. In line with the AS Latvenergo strategy goals, the proceeds will be invested in implementation of environment-friendly investment projects. The intention is to issue bonds with an up to 10 years maturity within the programme framework. Other conditions of the offer will be defined in the final regulations of the respective issue.

Against the background of favourable financing conditions, Latvia's share price index OMXR increased by 8.6% in the period from the end of February to 4 September, whereas the Baltic share price index OMXBBGI grew by 2.3%. Initially, OMXR decreased by about 20% under the effect of the crisis caused by the COVID-19 pandemic, yet, with the financial market tensions easing, the index returned to the pre-crisis level in three months. The prices of major corporate shares increased over the reporting period: the shares of AS Olainfarm, AS GRINDEKS and AS Latvijas Gāze gained 12.8%, 10.0% and 7.2% respectively. The largest turnover was reported for the shares of AS Olainfarm (5.0 million euro) and AS GRINDEKS (2.0 million euro). AS Olainfarm reported that the sales of the first six months of 2020 were similar to those of the corresponding period of the previous year, whereas the turnover of AS GRINDEKS increased by 37%.

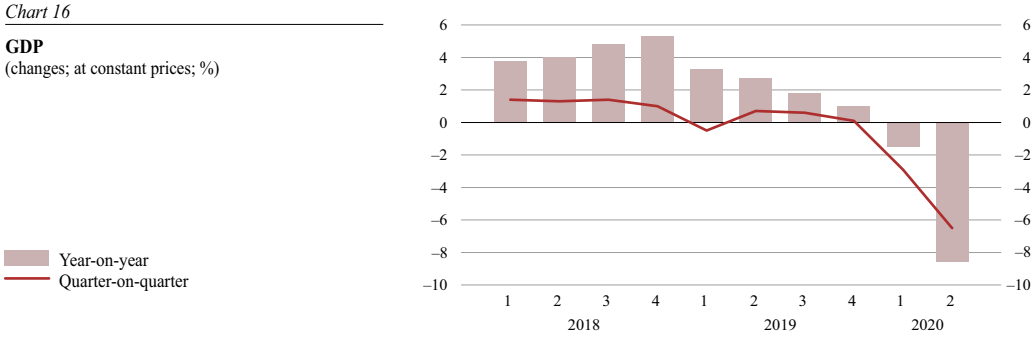
3. Sectoral Development[1]

Given the timely implementation of the social distancing and other precautionary measures to contain the outbreak of the coronavirus COVID-19 in Latvia, it was possible to keep them less stringent than in many other European countries and to start their gradual easing earlier. Thus, in the second quarter some sectors such as manufacturing, construction, trade and tourism[2] suffered less, and the GDP decline was less pronounced than in the EU and euro area on average.

In Latvia, a more severe economic downturn caused by the COVID-19 pandemic was prevented by the government support measures that helped improve consumer and business sentiment. Overall, however, in the first half of the year Latvia experienced a significant economic decline. Moreover, several sectors such as transport and energy were already on the downslide in the first quarter of the year due to both fundamental and temporary factors (weather conditions, freight reorientation, a move towards a green economy) which were unrelated to the COVID-19 pandemic, and their downslide is likely to persist in the coming quarters.

Chart 16

GDP
(changes; at constant prices; %)



3.1 Manufacturing

The manufacturing output reflects well the industrial confidence indicator trends which were first drastically affected by the uncertainty surrounding a decline in orders and a decrease in capacity utilisation due to the COVID-19 shock and – over the summer when the COVID-19 impact lessened and the restrictions were eased both in Latvia and its export partners – by a rise in optimism. Following a rapid decline in March and April, the manufacturing output improved somewhat in May, whereas in June and July it grew very swiftly reaching the output level recorded for the respective period of 2019. According to the turnover data, the strong improvement was primarily underpinned by an increase in export value. Despite these improvements, the fall in value added in manufacturing observed since May has been significant and the second quarter performance has been overall weak posting –6.1% and –6.5% quarter-on-quarter and year-on year respectively.

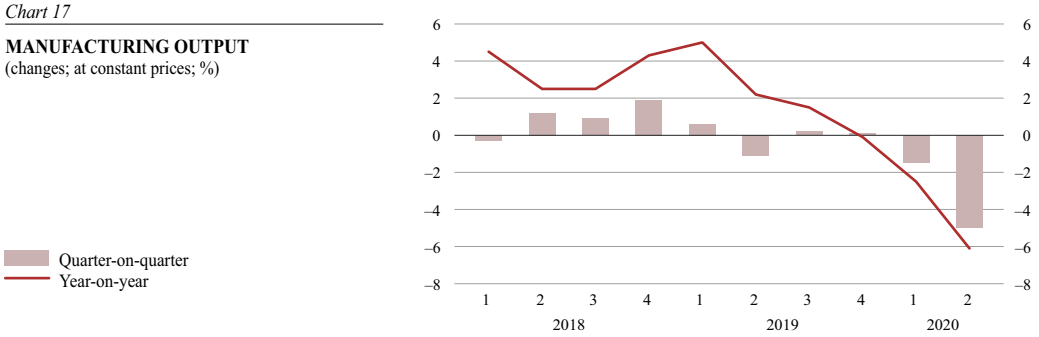
Over the recent months, the wood industry has been the largest contributor to growth in the manufacturing industry. This year, the development of the sector was facilitated by several factors: since the weather conditions in the spring and summer unfavourably affected the reproduction of insects, Latvian forests have seen less damage this year (it should be noted, however, that the problem still persists in Central Europe); furthermore, demand for wood products has been relatively high (in the Do-It-Yourself segment in particular) and the prices are expected to increase overall (this is not the case for all segments; for instance the pulpwood prices have not recorded a rise). These factors have an overall favourable impact

[1] This chapter analyses GDP and sectoral value added at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).
[2] The large sector combining trade, accommodation, catering, transport and storage (as defined by Eurostat) in Latvia overall suffered less than in the EU on average.

on the profitability of the logging and wood industry companies, facilitating a rise in the volume of production.

Chart 17

MANUFACTURING OUTPUT
(changes; at constant prices; %)



Industrial confidence surveys show a further improvement also in July, with the assessment of both employment and output and export orders on a rise. However, confidence indicators declined somewhat in August, possibly on account of an increase in uncertainty due to the intensification of the impact of the COVID-19 pandemic.

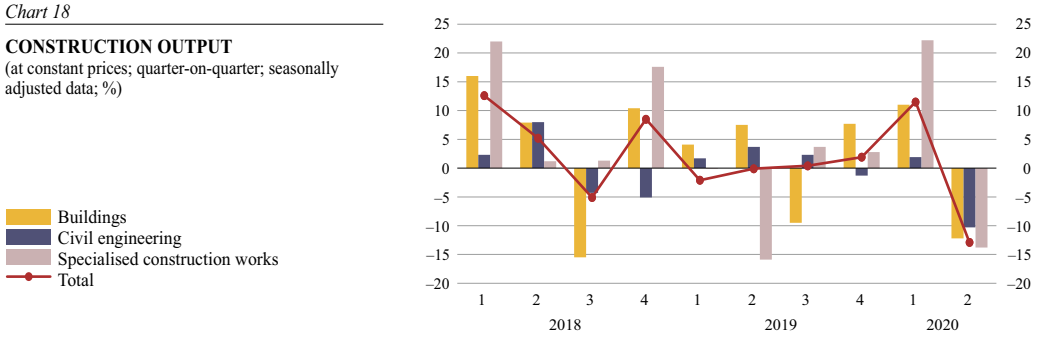
3.2 Construction and the real estate sector

In the second quarter, construction growth was dampened by a shortage of large construction objects as well as the suspension of and/or restrictions on construction works during the state of emergency declared due to the COVID-19 outbreak. As a result, the construction sector's value added declined by 11.0% quarter-on-quarter, while the year-on-year decrease was insignificant (0.6%).

Following the declaration of the national state of emergency, the construction sector's activity was significantly impaired and the sector was unable to maintain its promising growth rate observed at the beginning of the year. In individual construction objects, the works were substantially scaled down or temporarily suspended. Following the closure of borders, the delivery of construction products was delayed. Moreover, to ensure the compliance with the nation-wide restrictions, the number of workers on construction sites was reduced significantly. Fall in demand, concern and uncertainty about the future economic situation in the country and the shortage of large construction objects had a negative impact on the construction sector's growth.

Chart 18

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



In the second quarter of 2020, the construction output declined by 12.9% quarter-on-quarter, with the decrease affecting all segments. The annual rate of change in the construction output remained virtually unchanged year-on-year. A year-on-year decline in the construction output was recorded in the segment of civil engineering on account of a volume decline in the construction of roads and railways as well as hydrotechnical structures. As to the construction of buildings, decreases were reported for the construction of industrial buildings, commercial buildings and apartment blocks. Meanwhile, the highest year-on-year increase in the construction volume was observed for several types of specialised

construction works such as electrical and pipeline installation as well as demolition of buildings and construction site preparation.

The annual growth rate of the overall construction costs continued to decelerate already for the sixth subsequent quarter as a result of declining annual growth rates of wages and salaries and maintenance costs of machinery and mechanical appliances as well as falling prices of construction materials. In the second quarter of 2020, construction costs rose by 1.4% year-on-year, inter alia, wages and salaries of workers increased by 7.2%, maintenance and operational costs of machinery and mechanical appliances moved up only by 0.5%, whereas building material prices declined by 0.6%. The number of building permits granted in the second quarter of 2020 decreased somewhat in relation to the state of emergency declared in Latvia in March due to the COVID-19 pandemic. This caused confusion in the construction sector; therefore, some construction projects were postponed to a later time when the economic situation would be more stable.

Construction is among the sectors where the negative impact of the crisis caused by the COVID-19 pandemic can be mitigated by the government investment support measures, thereby improving the sector's outlook. Therefore, in the second half of the year the construction output is expected to grow, facilitated by the financing from the EU funds and the support provided by the government to mitigate the negative impact of the COVID-19 pandemic. A significant contribution to the overall construction sector growth might come from the construction of roads as the segment's strong development observed this year has fostered fierce competition and a decrease in road reconstruction prices. At the beginning of the year, 255.3 million euro (1.2 million euro more than in 2019) were allocated for the national road network. In early April, the government decided to allocate additional 75 million euro for the reconstruction of roads.

VAS Valsts nekustamie īpašumi keeps ensuring the continuity of the works associated with the buildings of national significance. In April, real estate developers pointed out that their launched apartment projects will be successfully continued and commissioned; however, they are not planning to launch any new residential building projects in the nearest future. This suggests that the construction of residential buildings is not expected to record growth in the coming quarters. Nevertheless, several significant projects commenced in the previous year will continue in 2020, and some new projects will be launched. For instance, in Riga several large-scale construction projects have been approved, and they will help stimulate the economy and the construction sector in particular: the project of Skanste territory revitalisation, the construction of the Ice Hall in the Daugava Stadium, the construction of the new building of the Faculty of Computer Science and Information Technology of the Riga Technical University, continued reconstruction of Mežaparks open-air stage. Furthermore, in the second half of 2020 construction works are also set to begin in the centre of Riga within the framework of the Rail Baltica project. Until the end of 2020, the Ministry of Defence plans to finalise five projects related to the National Armed Forces' infrastructure objects in Ādaži base. To ensure modern, safe and convenient railway infrastructure for passengers already in the next couple of years, VAS Latvijas dzelzceļš announced a procurement for the design and construction of 48 stations and stops to modernise the passenger infrastructure of several electrified railway lines.

The real estate market indicators also reveal the negative impact of the crisis caused by the COVID-19 pandemic in the second quarter, with the sector's value added declining by 4.8% both quarter-on-quarter and year-on-year. The number of the real estate purchases registered with the Land Register recorded a year-on-year decline of 23% in Latvia overall, inter alia, a 38% year-on-year decrease in Riga. April recorded the steepest fall in the number of real estate transactions, with the contraction mostly observed in the segment of new apartment projects. Nevertheless, in May the real estate market activity already started to recover gradually, and in July and August the number of transactions already recorded year-on-

year increases of 5% and 4% respectively in Latvia overall, while still decreasing further in Riga. The information published by real estate companies on transactions with standard apartments suggests further price stabilisation, with the prices rising only by 1.2% year-on-year on average.

In early 2020, prior to the declaration of the state of emergency due to the COVID-19 pandemic, the premium real estate market saw the highest activity since the introduction of changes in the issuance terms for temporary residence permits in 2014. According to the information provided by real estate developers to the media, the crisis caused by the COVID-19 pandemic did not have a significant downward impact on demand for (i.e. buyers' interest in) housing, including apartments. Meanwhile, the nature of demand and the buyer profile has changed. Moreover, customers have become more inclined to take a "wait-and-see" stance. Currently, the new customer is a family wishing to purchase land, a house or a bigger apartment with more rooms in order to prepare in case the situation worsens. With demand for larger apartments expanding, a shortage of 3-room apartments in the most popular housing districts became noticeable in the market. Following the uncertainty arising from the COVID-19 pandemic in the spring, optimism returned to the real estate market and the overall economy in the summer. It is expected that the growing need for larger housing with additional rooms for remote work or studies will remain relevant beyond 2020, and the demand for smaller apartments as the second housing or investment is also unlikely to fade. The regional real estate market was not significantly affected by the crisis caused by the COVID-19 pandemic: most Latvian households that are able to purchase housing are still facing supply shortages. In Latvia overall and in Pieriga in particular, the interest in purchasing land and a private house has risen. In early 2020, the potential buyers showed notable interest in investment apartments that could be offered for short-term rent. Currently, however, such demand is almost non-existent.

3.3 Trade

In the first half of 2020, the development of the trade sector was relatively uneven. During the period of the most severe restrictions imposed to contain the COVID-19 pandemic (in March–May), the retail trade sector suffered less likely due to its focus on the domestic consumption and the provision of basic necessities. Meanwhile, the subsector of trade and repair of motor vehicles saw a sharp decline over this period.

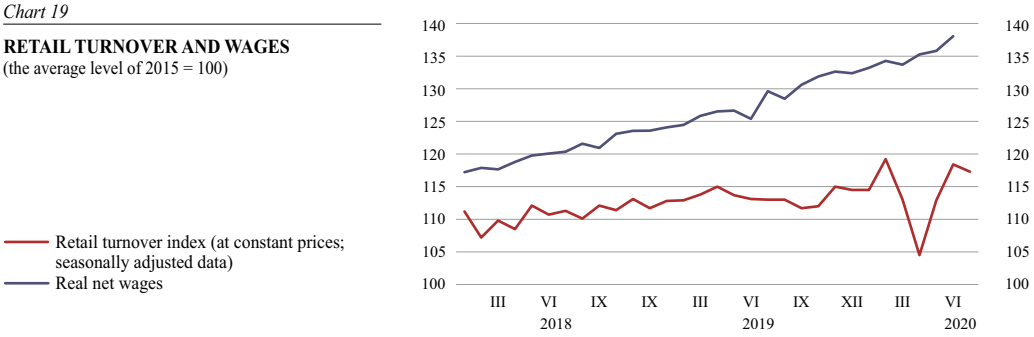
With households becoming more cautious with their spending and evaluating their priorities, the turnover of trade and repair of motor vehicles, as suggested by subsector turnover data, declined by approximately 24% quarter-on-quarter, significantly affecting the value added changes in the trade sector in the second quarter. The value added of trade recorded a steeper rate of decrease than the overall GDP, i.e. 7.7% quarter-on-quarter and 8.8% year-on-year. The fall in the wholesale and retail trade turnover was less notable. Moreover, in May and June retail trade growth rebounded sharply after gradual lifting of restrictions, i.e. easing of social distancing measures and opening of shopping centres on weekends and holidays. With consumers stockpiling food and pharmaceuticals, a peculiar boom in purchases of these products was observed already in March, thus the second quarter did not record similar trade volumes for these product groups, despite their significance in every-day consumption.

Income data suggest that the overall household income declined less than private consumption. Furthermore, the labour market situation, i.e. registered unemployment, has ceased to deteriorate. Thus, with the epidemiological situation remaining relatively stable, both the sectors where the provision of services was very limited due to the pandemic and the retail trade sector might experience a stronger recovery in the second half of 2020. At the same time, the latest monthly data, i.e. retail trade turnover in July and the retailer confidence indicator component suggesting the performance assessment for the next months, are

becoming more moderate reflecting the new global recovery from the COVID-19 pandemic, which began in the summer months, as well as caution with respect to the autumn season.

Chart 19

RETAIL TURNOVER AND WAGES
(the average level of 2015 = 100)



3.4 Transport

With the volume of freight transported by rail and cargoes loaded and unloaded at ports declining, the transport sector reported a negative development already before the coronavirus COVID-19 outbreak, and the COVID-19 pandemic brought additional challenges to the sector. Transport services by air, which previously provided a positive contribution to the exports of transport services, have become the largest negative contributor due to the crisis. In the second quarter, the sector's value added declined by 17.4% quarter-on-quarter and by 26.6% year-on-year.

With the volume of the handled coal cargoes declining rapidly, the overall volume of cargoes loaded and unloaded at ports shrank by 30.1% year-on-year in the first half of 2020. The cargo volumes of other groups of goods also contracted. The volume of cargoes shrank in all ports, with the Port of Ventspils recording the steepest drop in the cargo volume, mostly due to the negative contribution of the coal and oil products. The decline in coal cargoes handled at Latvia's ports can be attributed to several factors such as the mild winter resulting in lower demand, reorientation of Russia's transit flows to the local ports as well as the gradual global movement towards more sustainable resources. The increase in the cargo volume expected in the third quarter due to exports of grain will not be sufficient to offset the negative impact associated with the volume decline in coal cargoes. In the first half of 2020, transport by rail, which is closely linked to port operation, recorded a freight turnover decline of 54.0% year-on-year. The transit freight volume shrank notably on account of the above reasons. Meanwhile, the volume of domestic freight transport expanded.

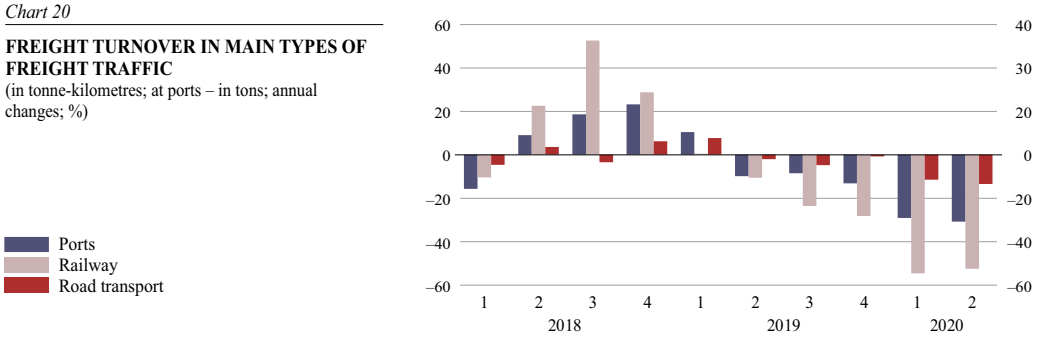
The decline in the volume of port and railway transport services is mostly associated with the above trends, whereas the air transport sector was completely unprepared for the COVID-19 pandemic crisis. The number of passengers transported by air, which had recorded 12.9% growth in January and February of 2020, declined by 62.9% overall in the first half of 2020 due to the COVID-19 containment measures. While passenger transportation has seen some improvement since the lifting of the national state of emergency on 9 June, air traffic is still disrupted as the number of cases abroad has remained high. Moreover, with self-isolation requirements remaining in place and people being more cautious, the demand for passenger transport by air is unlikely to recover quickly to its pre-crisis level. AS Air Baltic Corporation and VAS STARPTAUTISKĀ LIDOSTA "RĪGA" collectively laid off 1200 employees, and AS Air Baltic Corporation reduced its aircraft fleet. The volume of freight transported by air also shrank largely owing to supply chain disruptions.

The performance of transport by road was also significantly affected by the COVID-19 pandemic which disrupted supply chains, impeded logistics and suppressed the demand for international transport. In the first half of 2020, freight turnover by road shrank by

12.6% due to a decline in the international freight transport. Although the borders are open for freight transport and the self-isolation requirements do not apply to drivers, the trade partners are recovering only gradually, and the freight transport sector will need time to resume its growth. Furthermore, the adopted Mobility Package[1] is likely to reduce the competitiveness of Latvia's freight transport by road and have a negative impact on the sector in the future.

Chart 20

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



[1] A set of legal acts laying down uniform rules for EU international road transport. The above legal acts stipulate the obligation to return the vehicle to the country of its registration on a regular basis (every eight weeks), as well as lay down the rules on reducing the time-frame of cabotage, etc.

4. GDP Analysis from the Demand Side[1]

In Latvia, the restrictions to contain the COVID-19 pandemic were less stringent. Moreover, the products that were in high demand during the crisis (e.g. agricultural products, food, wood products, chemicals, pharmaceutical products and information and communication services) accounted for a relatively large share in the structure of Latvia's goods and services' exports. For these reasons, in the second quarter of 2020 Latvia's economy – against the background of other EU economies – suffered less and developed more successfully than projected at the beginning of the crisis: Latvia's GDP fell by 6.5% and 8.6% quarter-on-quarter and year-on-year respectively. As a comparison, the euro area economy declined by 15.0% and the overall EU economy decreased by 14.1% in annual terms.

4.1 Domestic demand

In the second quarter, investment recorded less positive results than in the first quarter. In addition to the previously observed dynamics of contracting imports of capital goods, the decline in investment was also suggested by worsening construction sector performance. Nevertheless, the third quarter is expected to bring output growth in construction, facilitated by the financing from the EU funds and the government support for mitigating the negative impact of the COVID-19 pandemic. Overall, investment will be further supported by the government measures implemented to kick-start the economy after the crisis caused by the COVID-19 pandemic. The funds under the EU instrument "Next Generation EU" will still be available in the subsequent years thus allowing Latvia and the EU overall to address the consequences of the crisis more successfully.

Chart 21

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

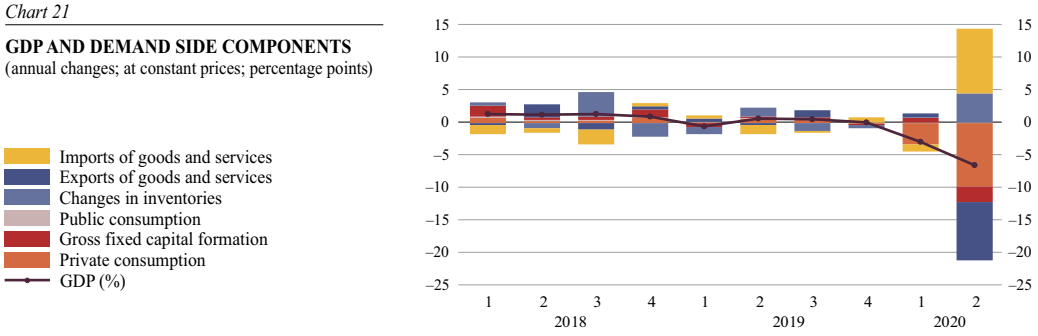
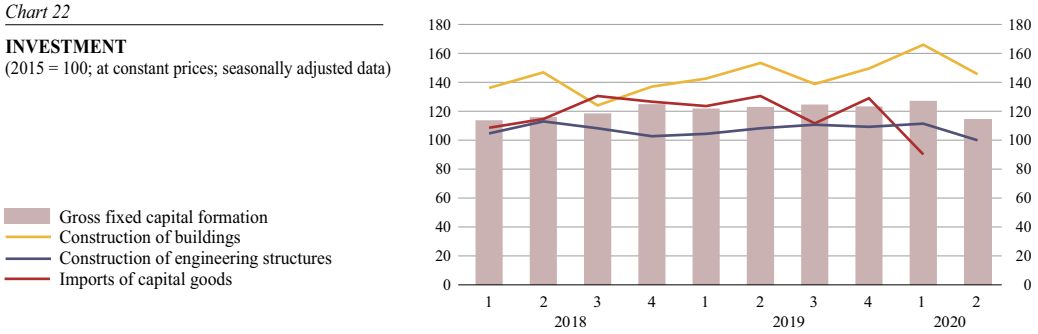


Chart 22

INVESTMENT
(2015 = 100; at constant prices; seasonally adjusted data)



In the first quarter, private consumption recorded a surprisingly rapid contraction which became even more pronounced in the second quarter. The decline was inevitable as some of the planned spending was never carried through, i.e. more distant travels as well as large cultural and sporting events were postponed. Moreover, many households received significantly lower income but at least part of the lost income was compensated by the

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

government support measures as well as the unemployment and furlough benefits. In view of the rapid contraction in private consumption and the build-up of savings due to precautionary considerations and pent-up consumption and taking account of the fact that income has remained overall stable, the consumption is expected to pick up more rapidly in the third quarter and the coming quarters.

Chart 23

INDICATORS CHARACRERISING CONSUMPTION AND CONSUMER CONFIDENCE
(2015 = 100; consumer confidence – net responses; %)

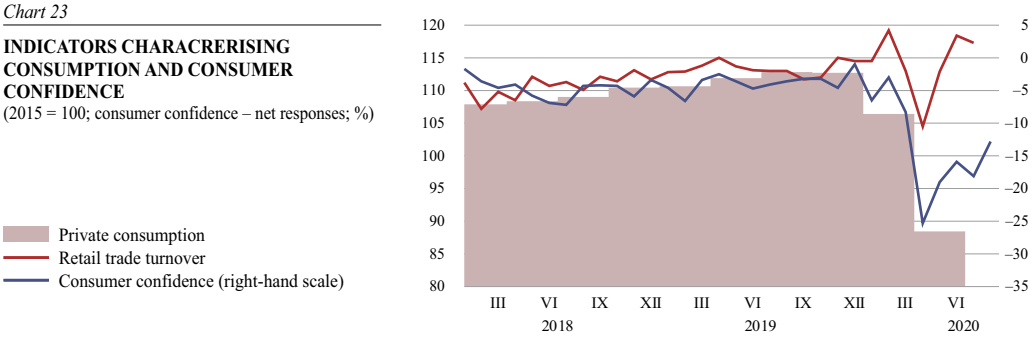
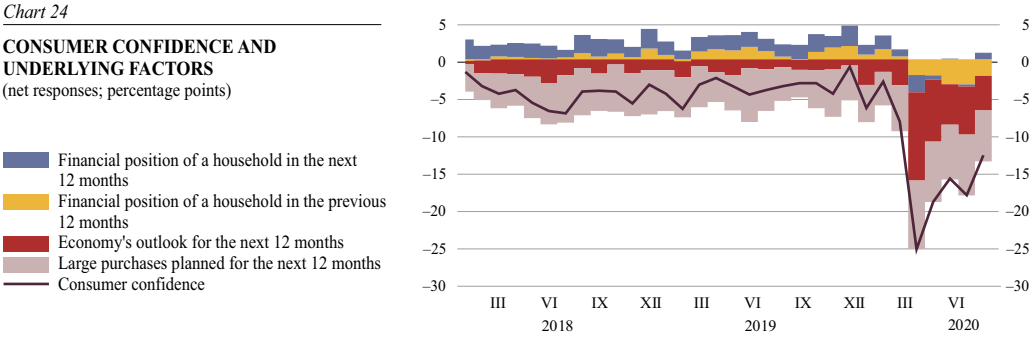


Chart 24

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



4.2 Government consumption

The positive dynamics of the public consumption is maintained by the support measures implemented to address the problems caused by the COVID-19 pandemic, and the associated expenditure is expected to increase further in the second quarter.

In the general government sector, the effects of the COVID-19 pandemic crisis were most severe in May, and the tax revenue improved over the following months. Thus, the general government budget deficit in 2020 is expected to be overall lower than previously projected. Fiscal stimulus to provide liquidity to businesses and preserve household income has helped to mitigate the crisis, thus contributing to higher tax revenue. At the same time, economic stimulus measures facilitating public investments have not been sufficiently powerful.

In the second quarter of 2020, tax revenue declined by 9.7% year-on-year, and similar decreases were recorded for consumption and labour tax revenue. However, the first two months of the third quarter showed some improvement as tax revenue increased, on average, by 1% year-on-year (preliminary data), despite the tax revenue forgone due to tax support measures. The tax deferrals, as stipulated by Article 3 of the Law on Measures for the Prevention and Suppression of Threat to the State and Its Consequences Due to the Spread of COVID-19, granted by 12 August 2020 for almost all types of taxes totalled 130.6 million euro. 44% of the deadline extensions were granted for social insurance contributions (predominantly to the tax payers working in the transport and storage sectors, manufacturing sector as well as the accommodation and catering sectors), while 34% were granted for VAT payments (predominantly, in the sectors of wholesale and retail trade, repair of motor vehicles and motorcycles as well as accommodation and catering). Overall, the tax extensions granted so far represent half of the amount initially expected by the government. However, applications may be submitted until the end of the year.

Meanwhile, the impact of the crisis caused by the COVID-19 pandemic on the budget expenditure was evident sooner than the respective impact on the tax revenue. Expenditure increased rapidly already in March, with its annual growth reaching 17.5% in April. Overall, in the second quarter general government expenditure grew by 8.6% as compared to the respective period of 2019. Upon launching the plan to mitigate the negative impact of the spread of the COVID-19 pandemic and support economic recovery, the government current expenditure rose by 10.6% year-on-year in the second quarter. Meanwhile, in the second quarter the capital expenditure declined year-on-year by 12.4%, despite the government's decisions to increase public investment. At the beginning of the third quarter (i.e., in July), the annual growth rate of total expenditure shrank to 2.8%, with the current expenditure continuing to grow and the capital expenditure remaining below the level of 2019. Thus, while the procurements concluded within the framework of road and municipal infrastructure projects gives reason to believe that government investment will expand in the second half of the year, their implementation has been delayed, and the capital expenditure transfer to 2021 may be more significant that initially planned.

The scope of the fiscal support measures to mitigate the consequences of the crisis caused by the COVID-19 pandemic varies across the Baltic States. A comparison of the implemented individual measures shows that the amount of the support provided to the health sector and businesses (in the form of grants) has been similar in all three countries, whereas the support provided to preserve household income has been much more significant in Estonia and Lithuania than in Latvia. The stimulus provided to the economy in the form of public procurements, including the investment projects, has been insignificant in Latvia and Lithuania, whereas Estonia had made some progress already at the end of July. For a detailed comparison of the implemented fiscal support measures, see Table 1.

Table 1

IMPLEMENTED INDIVIDUAL GOVERNMENT SUPPORT MEASURES TO MITIGATE THE CRISIS CAUSED BY THE COVID-19 PANDEMIC IN THE BALTIC STATES
(% of 2019 GDP)

Support measure	Latvia (as at 6 September)	Lithuania (as at 3 July*)	Estonia (as at 31 July)
TOTAL	0.6	1.2	1.4
Support to preserve household income, including	0.3	0.8	0.9
furlough benefits	*0.2*	*0.3*	*0.9*
average overall amount of furlough benefits per employee in the respective period (euro)	*974.21*	*766.55*	*1866.61*
other social benefits	*0.1*	*0.5*	*0.0*
Business support	0.2	0.2	0.2
Health care support	0.1	0.1	0.1
Support in the form of public procurements (infrastructure projects)	0.0	0	0.1

* The furlough benefit data are for 6 September 2020.
Sources: the Treasury, the Ministry of Finance of Estonia and the Government Strategic Analysis Center of Lithuania.

Thus, taking account of higher budget revenues and a slower introduction of the COVID-19 pandemic containment measures, the general government budget deficit is estimated at 4.5% of GDP in 2020. The impact of the pandemic on the fiscal measures is still significant, with the budget deficit deteriorating by 4 percentage points compared to that of 2019 (0.2% of

GDP). However, the fall is expected to be smaller than projected in June 2020 (–7.3% of GDP).

Meanwhile, in view of a lower budget deficit and taking account of the actual change in the level of debt against the overall balance of accounts, the government debt assessment for 2020 was revised downwards from almost 50% of GDP to 48% of GDP; nonetheless, the year-on-year increase remained significant at 11 percentage points.

4.3 Trade balance

The restrictions put in place due to the exacerbation of the spread of the coronavirus COVID-19 as well as the dramatic decrease in economic activity shaped the external trade developments in the second quarter of 2020. With a dramatic fall in the volume of services exports and a less substantial decline in exports of goods, the dynamics of exports of goods and services paint a picture similar to that of the sectoral structure. Foreign trade data suggest a steep decline in the volume of exports of the groups of goods associated with re-exports (e.g. transport vehicles). The structure of imports reveals a similar situation as the decline in the volume of services is more significant. However, several sectors of the economy saw the COVID-19 shock abate already in May, and a rapid recovery started in June. Similar dynamics were observed for exports of goods which in June almost reached the level seen in the respective period of 2019. Exports recovered for a broad range of goods. Moreover, the flow of goods recovered most quickly to the countries that are geographically the closest, i.e. the Baltic neighbouring countries and Russia. Meanwhile, the cross-border supply of services was harder hit, and remained at the lowest point (reached in April) until the end of the quarter.

The trade tensions between the US and China still persisted in the external environment, and signals of a no-deal Brexit intensified. The economic confidence indicators for the trade partners, even though with an upward trend, remained well below their pre-crisis levels.

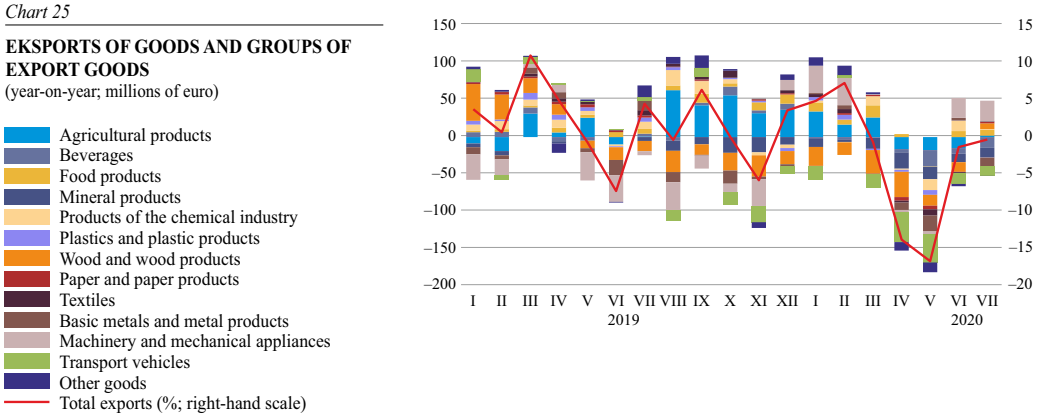
Latvia's exports shrank significantly during the crisis; nonetheless, the contraction was among the smallest in the euro area. Exports slightly improved already in May, with the seasonally and calendar adjusted export value increasing by 1.5%. Furthermore, the export volume expansion in July almost offset the 14.1% year-on-year decline seen in April. Already at the end of the second quarter, the export value of several product groups exceeded the level seen in the respective period of 2019. For instance, during the crisis caused by the COVID-19 pandemic, demand for food products remained stable. Furthermore, exports in the chemical industry expanded rapidly in June, largely on account of an increase in the exports of pharmaceuticals. The highest export value volatility was observed for transport vehicles, a group of goods associated with re-exports, as their export value fell in April and May and recovered in June and July. This group of goods as well as agricultural products were the most notable drivers of decline. Meanwhile, the largest groups of Latvia's export goods, wood and articles of wood as well as machinery and equipment, were more resilient and slowed down the overall rate of decline. The recovery was also notably supported by the products of the chemical industry, inter alia, the pharmaceuticals that remained relevant during the health crisis.

The cross-border supply of services was harder hit, and remained at the lowest point (reached in April) until the end of the second quarter. Exports of travel services were the worst affected since the movement restrictions hampered the cross-border movement and people continued to exhibit caution with respect to leisure and business travels. In the field of transport services, in addition to the previous fall in the export value of transport services by sea and rail and their expected decline in the future due to lower freight volumes from Russia, exports of transport services by air and road contracted most notably. Construction services were less affected by the crisis, and their contribution remained slightly positive.

Business and financial services were also relatively less affected as most of these services can be provided remotely. Given that the movement restrictions were eased over the summer, services exports are expected to have increased slightly. However, the latest information on the rising number of infection cases and renewed restrictions give rise to concern about poor results in the fourth quarter.

Chart 25

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



Foreign trade prices continued to decline in the second quarter. In June, exports of goods in real terms recorded a year-on-year decline of less than 1%. Import prices continued decreasing much faster than export prices, and in June real imports even expanded somewhat, despite weaker dynamics in nominal terms. The rapid decline in the value of imports was also affected by a one-off base effect, i.e. a contraction in the imports of machinery due to the high base (the imports of aircraft engines after their repair in April and May 2019). With the industrial activity resuming and the demand for imports of intermediate goods increasing (as suggested by a much larger contribution from machinery and electrical equipment and the products of the chemical industry), the value of imports of goods recovered more quickly than the value of exports. However, in the second quarter overall the decline in the value of imports exceeded that of exports, and the goods trade balance improved. The impact of restrictions on the imports of services was relatively similar, with their positive balance declining only slightly in the second quarter.

With the most severe phase of the crisis coming to an end and the situation stabilising, the actual results and projections with respect to the international trade for the rest of the year improved slightly. However, the increase in COVID-19 infections in Europe gives rise to concern about the development of the trade in the fourth quarter when it might be hampered by renewed restrictions.

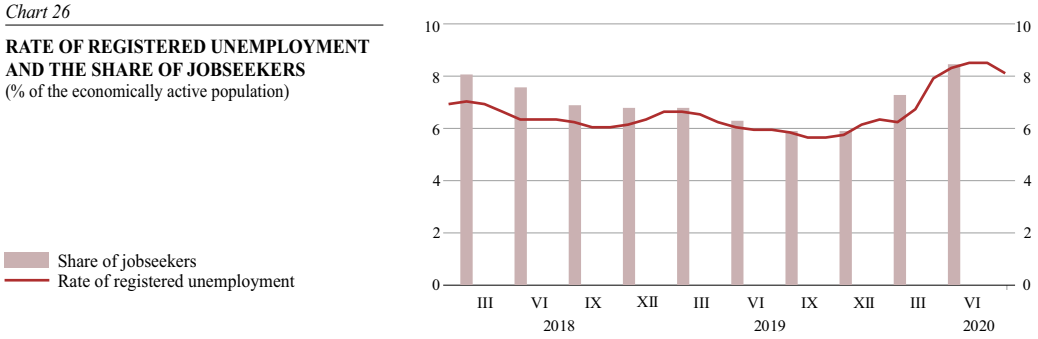
5. Labour Market, Costs and Prices

As a result of the measures adopted to contain the COVID-19 pandemic, the activity of businesses was disrupted, thus having a negative effect on the labour market development. At the same time, with the economic activity moderating less than could be expected at the onset of the crisis and additional state support mechanisms being implemented to promote employment, the rise in unemployment has been more moderate than projected. With businesses searching for ways to reduce costs and the labour supply rising, wage growth will be sluggish in the last months of the year. Consumer prices decreased in the first months of the COVID-19 pandemic. This was on account of a sharp decline in oil prices and the contraction in economic activity. However, the period of deflation will be short-lived since the impact of the crisis caused by the COVID-19 pandemic on the labour market and, consequently, on domestic labour costs turned out to be considerably smaller than previously projected. Moreover, oil prices also started to pick up again. Thus, inflation will rise gradually over the medium term.

In March when the state of emergency was declared in the country, the economic activity of several sectors such as accommodation and food service activities, air transport, arts, entertainment and recreation services sectors, came to a near standstill. At the same time, the economic activity of other sectors also deteriorated owing to supply chain interruptions and a lower demand. Therefore, the rate of registered unemployment increased already at the end of the month.

Chart 26

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



Although furlough benefits helped limit further accelerated unemployment growth, it reached 8.6% in the second quarter of 2020 (6.0% at the end of 2019). The currently available data for the third quarter do not suggest further accelerated unemployment growth as the number of unemployed persons registered with the SEA continues to decrease. Following a considerable decline, employment expectations of businesses have improved in the second quarter. The results of the consumer survey also suggest that the consumer perception of the likelihood of unemployment in the coming months has become more positive in August. At the same time, while sentiment indicators are improving, they are still below the pre-crisis level. Taking into account the latest incoming data, the unemployment forecast for 2020 has been revised downwards (8.1% of the economically active population; the June forecast – 9.6%), while, with businesses becoming more effective, unemployment rates will decline only gradually, standing above the level of 2019 in 2021 (7.8% of the economically active population; the June forecast – 10.3%).

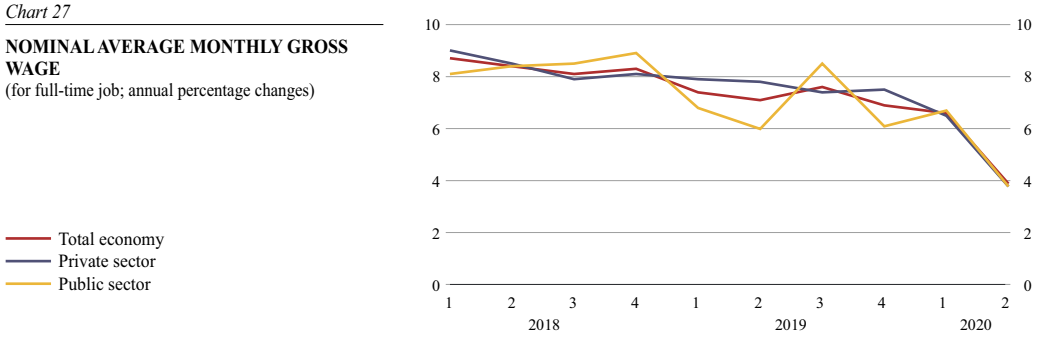
With the financial indicators of businesses deteriorating as a result of the crisis caused by the COVID-19 pandemic, the cost reduction issue has gained even more importance; therefore, the pace of remuneration growth has moderated. In the second quarter of 2020, the average monthly gross wages and salaries increased by 3.9% year-on-year as compared to a 6.6% rise in the first quarter. The sectors particularly heavily hit by the crisis have recorded a decline in the rate of increase in remuneration. Labour supply is expected to remain high in

the coming months, continuing to hinder remuneration growth. At the same time, with the economic activity recovering and demand for skilled labour growing, wages and salaries will rise more rapidly in 2021. Wages and salaries are expected to increase by 3.9% in 2020 (the June forecast – –0.1%) and 5.0% in the year to come (the June forecast – 1.3%) due to more sustainable economic growth.

Overall, the impact of the crisis caused by the COVID-19 pandemic on consumer prices was negative. The deflation of consumer prices was mainly driven by a steep decline in the prices of some goods and services (e.g. the annual decrease in the prices of fuel and accommodation services exceeded 20%). At the same time, the prices of other goods and services continued to increase, and three fourths of the product prices grew faster than headline inflation. The consequences of the spread of the coronavirus COVID-19 may be also partly reflected by a rise in fruit prices observed also in other euro area countries (the impact of supply chain disruptions and higher demand). However, concerns that supply chain disruptions will significantly push up the prices of imports of industrial goods and producer prices (and consequently also consumer prices) have not, so far, materialised.

Chart 27

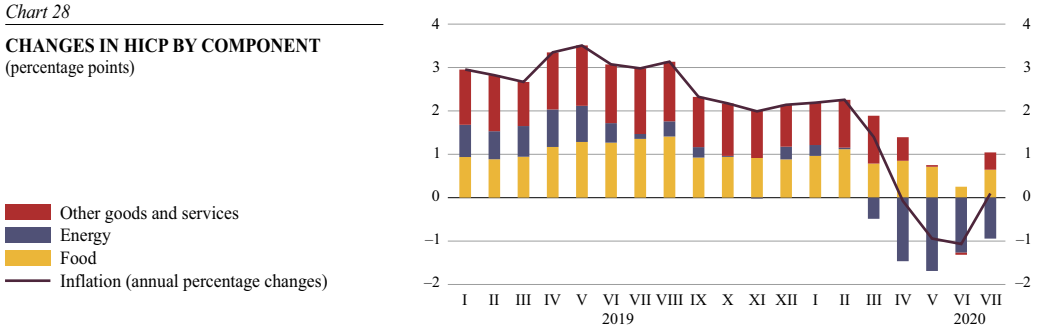
NOMINAL AVERAGE MONTHLY GROSS WAGE
(for full-time job; annual percentage changes)



The slowdown in economic activity usually contributes most to lower services prices. However, the prices of several services continued to grow since their costs per customer (e.g. in catering, hairdressing salons and beauty care) were pushed up as a result of the introduction of the COVID-19 pandemic containment measures and lower customer flows. The fall in the prices of air transportation and package holidays has been insignificant, despite the much cheaper fuel which is an important cost component of these services. Even the decrease in the prices of accommodation services which is significant and commensurate with the one recorded in 2009 could be more pronounced as the hotel occupancy rates during the first wave of the COVID-19 pandemic decreased more than over the period of the global financial crisis.

Chart 28

CHANGES IN HICP BY COMPONENT
(percentage points)

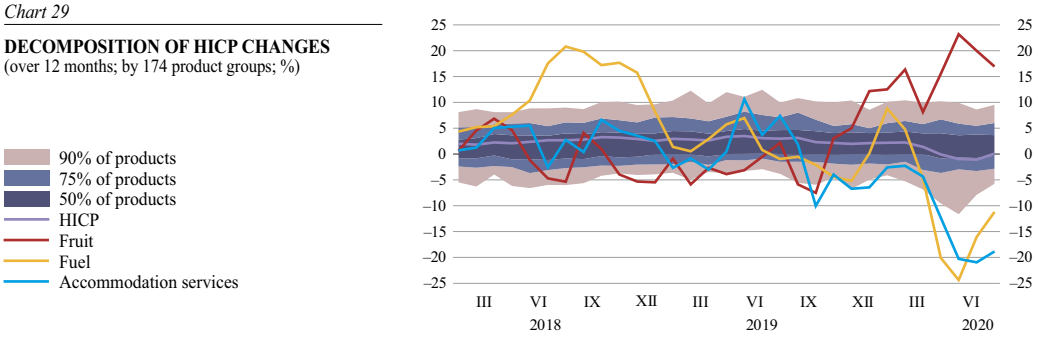


The global price of wood increased rapidly, mainly reflecting a higher demand for wood due to the big amount of house refurbishing works during the COVID-19 pandemic. The rise in wood prices was also exacerbated by the concerns over the sufficiency of wood supplies, taking into account the increasingly wide spread of bark beetles in forests due to mild winters (some time ago, bark beetles, on the contrary, were considered a wood price

reducing factor). Latvijas Banka's calculations suggest that a higher wood price reflected, for example, in the prices of firewood and furnishings, may push up Latvia's inflation by 0.1 percentage point in 2021 and 2022.

Chart 29

DECOMPOSITION OF HICP CHANGES
(over 12 months; by 174 product groups; %)

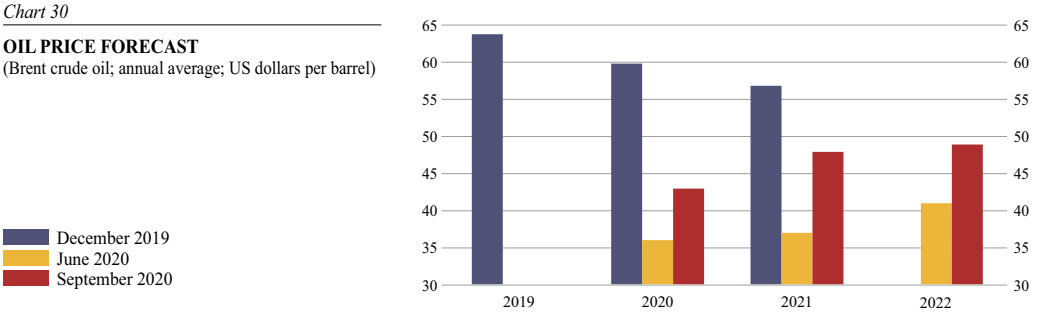


In the first four months of 2020, the oil price declined markedly (from 70 US dollars per barrel to 20 US dollars per barrel). This was on account of the negative impact of the spread of COVID-19 on the global economic development and the failure of Saudi Arabia and Russia to agree on cuts in oil production. In May and June, the gradual lifting of the measures to contain the COVID-19 pandemic and the new OPEC+ agreement on oil output curbs pushed up the price of oil to 45 US dollars per barrel. The oil price has already remained at the present level for three months: despite the ongoing recovery of the economic activity of several countries, the level of oil inventories is still relatively high, with some OPEC+ countries failing to comply with oil production cuts.

Although the oil price forecast was revised slightly upwards, the effect of higher oil prices on inflation thus far has been weaker on account of the strengthening of the euro against the US dollar. Market participants predict a relatively gradual increase in the oil price – the current Brent crude oil price is approximately 45 US dollars per barrel, but the oil supply price after two years is 50 US dollars per barrel. The rebound in oil prices has already found reflection in the fuel prices; if the oil price is in line with the market expectations, the fuel prices will rise gradually also in the future. At the same time, the prices of natural gas and heating react to the oil price with a few months' lag. For example, AS RĪGAS SILTUMS reduces the heating tariff four times in 2020 (in April, June, August and October), and it is not expected to increase in the coming months.

Chart 30

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

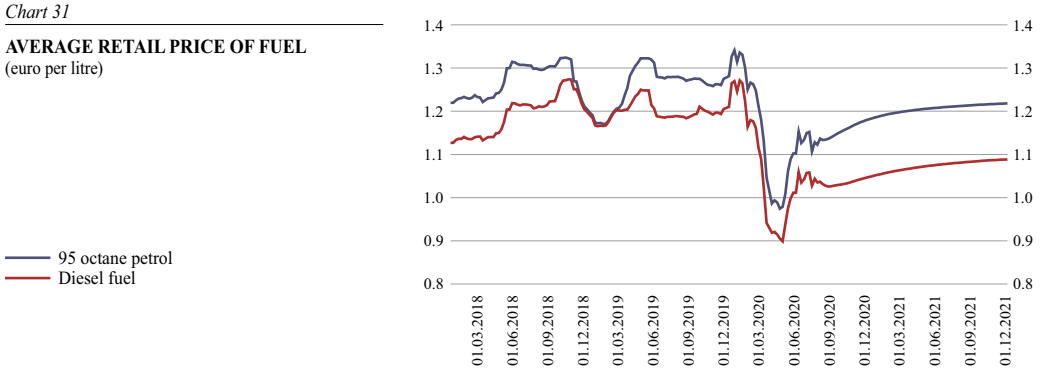


The global food prices have not followed a uniform trend. For instance, the mild autumn temperatures predicted for Europe could be good for the harvesting of grain, thus reducing its price. Conversely, the prices of dairy products increased somewhat due to a stronger demand in Asian countries. The meat price forecast was revised downwards as the global demand for pork and beef turned out to be weaker than projected. The sugar price forecast was revised upwards, reflecting both the draught in Thailand (the second largest exporter of sugar in the world) and a gradual rise in the price of oil due to which ethanol is increasingly produced instead of sugar. It should be noted that the public demand for long life food products (e.g. buckwheat and canned products) rose at the beginning of the COVID-19

pandemic, leading to an increase in their consumer prices; however, it did not make a notable contribution to headline inflation due to its minor share in the consumer basket.

Chart 31

AVERAGE RETAIL PRICE OF FUEL
(euro per litre)



6. Conclusions and Forecasts

Owing to the gradual lifting of restrictions along with successful COVID-19 containment in Latvia and a somewhat more optimistic sentiment among consumers and businesses, in the second quarter the economic downturn was less pronounced than expected, and in the summer months several sectors already almost reached their previous business volumes. At the same time, the economic sentiment both in Latvia and its major trade partners was stabilised by the government support measures and the expected financing under the European economic recovery instrument "Next Generation EU". This contributed to a slight upward revision of the external demand assessment as well as the assessment of the domestic income and consumption levels which have been estimated to be more resilient. The latest global and regional pandemic developments call for more caution with respect to the fourth quarter outlook, a trend already suggested by the sentiment survey results.

Taking into account the above data and the current developments, the GDP contraction forecast for 2020 has been revised upwards to –4.7% (–7.5% in the June forecast). Over the medium term, the GDP is expected to increase on account of higher external demand as well as the financing under the European economic recovery instrument which will facilitate new investment and exports. The 2020 performance was better than previously projected; the GDP growth forecast for 2021, however, was revised downwards to 5.1%, as opposed to 6.7% projected in June. The outlook for the sectoral growth drivers has remained unchanged in most sectors. Nevertheless, the actual situation in the first half of 2020 in many sectors turned out to be better than estimated in June, and the 2020 forecast was revised mainly on account of the latest data.

As before, the recovery is still projected to be the slowest in the hospitality sector as well as the recreational and cultural services sectors since several mass events can no longer take place or they have been postponed. Moreover, such events cannot be organised within a short time-frame after the easing of restrictions. As was already expected, the transport sector might not regain its previous role in the economy over the medium term. The sector's growth assessment for 2020 has not deteriorated; however, in addition to the impact of the fundamental factors observed so far, over the medium term the sector will also be affected by the European Commission Mobility Package adopted in July. With external demand recovering, manufacturing growth is expected to improve. The development of the construction sector will be supported by government investment over the medium term.

Mass restrictions implemented domestically and in Latvia's major trade partners in response to the second wave of the pandemic may cause yet another contraction in GDP in 2020 (for Latvijas Banka's assessment of the potential impact of a repeated COVID-19 outbreak on Latvia's GDP growth, see Box 2).

BOX 2. POTENTIAL IMPACT OF A REPEATED COVID-19 OUTBREAK ON LATVIA'S GDP GROWTH

At the beginning of the summer, the number of infection cases decreased considerably in most EU Member States. In view of the favourable conditions, the governments of the EU countries eased their restrictions[1], thus supporting the gradual recovery of economic activity. However, the number of cases in the EU started to increase rapidly towards the end of the summer. Moreover, in several countries, e.g. Croatia, Greece and Romania, the 14-day cumulative number of COVID-19 cases per 100 000 people is already higher than in the spring[2]. However, despite the rapidly growing infection indicators, the governments have not yet introduced restrictions similar to those implemented in the spring.

[1] Oxford Covid-19 Government Response Tracker.
[2] European Centre for Disease Prevention and Control.

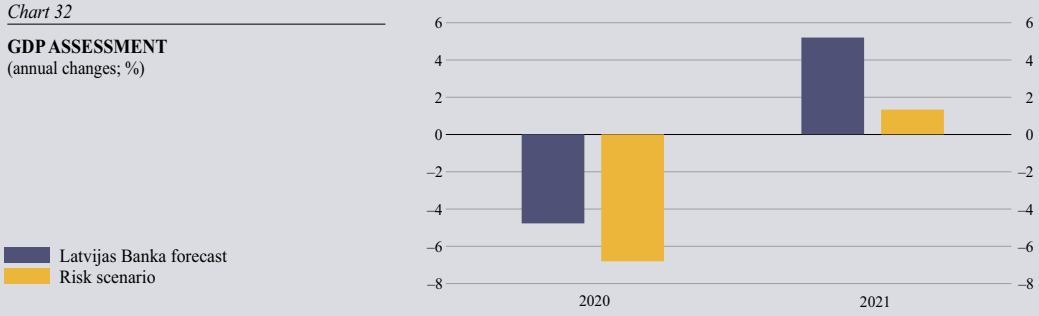
With the number of cases growing further, discussions on the tightening of restrictions may become increasingly important, inter alia, in Latvia. Although the current[1] number of cases in Latvia is lower than in most EU countries, a repeated rise in the number of cases and renewed tightening of restrictions in Latvia and other countries may pose a potential risk that would negatively affect Latvia's economic growth.

The impact of the materialisation of such a risk on Latvia's economic growth is illustrated with the help of the dynamic factor model[2] based on the following assumptions:
1) with the number of cases growing and the restrictions becoming tighter, in October the dynamics of the model's leading indicators follows that observed in April 2020 (with the respective level also remaining unchanged in November and December);
2) in the first quarter of 2021, the economic growth will accelerate rapidly according to the projections made in the third quarter of 2020;
3) during other periods, the GDP dynamics correspond to Latvijas Banka's forecasts (as published in the Macroeconomic Developments Report).

The obtained results (see Chart 32) suggest that in the event of such a scenario, the 2020 GDP fall would be much more significant than expected according to Latvijas Banka's forecasts. Moreover, the slowdown in economic activity would have a material negative impact on GDP changes in 2021.

Chart 32

GDP ASSESSMENT
(annual changes; %)



However, the calculations do not take into account the fact that households and businesses may be better equipped to adapt to a repeated economic shock, should the number of cases increase and restrictions become tighter. Therefore, the obtained results most likely reflect a relatively pessimistic view on the potential impact on GDP changes.

[1] In the first half of September 2020.
[2] For the purposes of forecasting the GDP quarterly growth rate, the model incorporates information on several leading indicators (retail trade turnover index (excluding the retail trade of automotive fuel), employment expectations index and industrial output index). The model specification is similar to that described by Boriss Siliverstovs in his research papers of 2012 and 2016 (Siliverstovs, Boriss. Are GDP Revisions Predictable? Evidence for Switzerland. *Applied Economics Quarterly (formerly: Konjunkturpolitik), Duncker & Humblot, Berlin*, vol. 58, issue 4, 2012, pp. 299–326. *https://elibrary.duncker-humblot.com/journals/id/22/vol/58/iss/1630/art/6995/*; Siliverstovs, Boriss. The Franc Shock and Swiss GDP: How Long Does It Take to Start Feeling the Pain? *Applied Economics*, *Taylor & Francis Journals*, vol. 48, issue 36, August 2016, pp. 3432–3441. *https://www.tandfonline.com/doi/full/10.1080/00036846.2016.1139678*).

It is also possible that the escalation of the political situation in Belarus and the potential imposition of economic sanctions could result in a decline in the demand for freight transportation. In should be noted, however, that GDP growth may be stronger in the projection period in the event that a medical solution for COVID-19 is developed rapidly and successfully and the use of funds available under the European economic recovery instrument "Next Generation EU" is purposeful and oriented towards innovation and productivity and their provision is not delayed significantly.

Given that the contraction in economic activity was less pronounced than expected and the labour market situation improved significantly, the inflation forecast was revised upwards.

The inflation is expected to stand at 0.2% in 2020 (as compared to 0.0% in the June forecast) and reach 1.4% in 2021 (as compared to 0.2% in the June forecast). The projections were revised upwards mainly on account of a significantly better labour market situation and steeper wage growth than expected. Looking by component, the services sector was the biggest contributor to the upward revision of inflation. The current forecast has been produced based on the 2020 average oil price of 43 US dollars per barrel (the average oil price used in the June forecast was 36 US dollars per barrel).

Chart 33

GDP
(at constant prices; annual changes; seasonally and calendar adjusted data; 2020–2022: Latvijas Banka forecast; %)

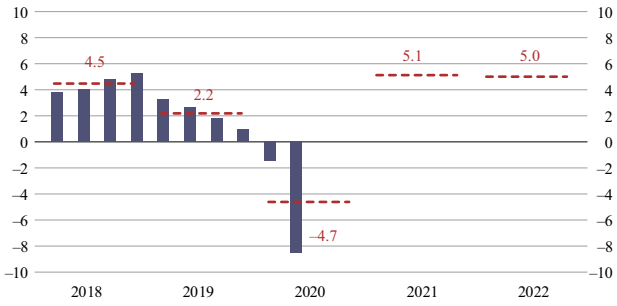
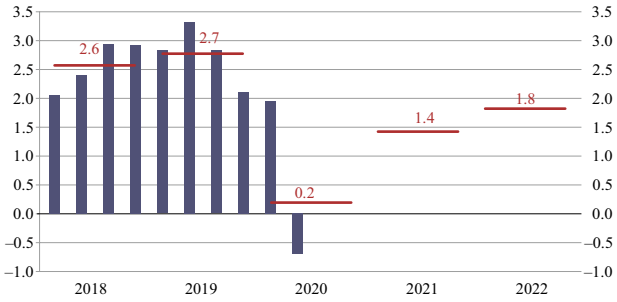


Chart 34

HICP
(annual changes; 2020–2022: Latvijas Banka forecast; %)



Risks to the inflation forecasts are balanced. If the VAT on the local fruit and vegetables remains reduced for an extended period, inflation in 2021 might be 0.2 percentage point lower. While a significant impact of supply chain disruptions on inflation has not been observed so far, the next COVID-19 outbreak may result in tighter logistics restrictions and, thus, higher inflation.

Table 2
FORECASTS OF MACROECONOMIC INDICATORS

Indicator	2020	2021	2022
GDP (annual change at constant prices; seasonally and calendar adjusted data; %)	–4.7	5.1	5.0
INFLATION (annual HICP; %)	0.2	1.4	1.8
LABOUR MARKET			
Unemployment (% of the economically active population)	8.1	7.8	7.2
Nominal gross wage (annual change; %)	3.9	5.0	5.8
CURRENT ACCOUNT BALANCE (% of GDP)	2.0	–0.4	–1.8
FISCAL SECTOR (% of GDP)			
Government debt	48.0	45.3	45.2
General government budget surplus/deficit (–)	–4.5	–1.2	–0.7

7. Analysis of Scenarios

7.1 The efficiency of social benefits in reducing income inequality and poverty

Motivation

High income inequality and a large number of people at risk of poverty[1] are topical economic problems in Latvia that may pose challenges to its future development. Therefore, it is essential to strengthen the social security system which is playing a less important role in reducing inequality and poverty in Latvia than in most of the EU countries[2].

The Constitutional Court of the Republic of Latvia has also noted that it is necessary to improve the situation of people at risk of poverty and ruled in cases No 2019-27-03[3], No 2019-25-03[4] and No 2019-24-03[5] that the guaranteed minimum income (GMI), the income level for determining the status of a needy person and the amount of the state social security benefit for unemployed persons with a disability and seniors are incompatible with the Constitution of the Republic of Latvia and shall become null and void as from 1 January 2021. These rulings of the Constitutional Court illustrate that many social support instruments have not been reviewed for a long time. For example, the amount of the state social security benefit and, consequently, the old age pension base have not been changed since 2006 (64.03 euro until 2019). The income level for determining the status of a needy family and person has not also been reviewed since 2009 (128 euro). In 2014, the amount of the state social security benefit granted to persons with a disability has been increased to 64.03 euro (to 106.72 euro to persons having a disability since childhood), and the gradation of the minimum pension according to the disability category has been introduced[6]. Overall, the pace of reviewing the amount of social support has been substantially lagging behind the rate of growth of the rest of the economy, thus increasing income inequality and the risk of poverty of the respective population groups.

The rulings of the Constitutional Court emphasize that the improvement of the situation of people at risk of poverty, including persons with a disability and seniors, is one of the national priorities. Thus, the government is obliged to ensure that a person could meet at least his/her basic needs with the help of the social security system instruments available to him/her, thus reducing social inequality and promoting social inclusion of these persons.

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[1] This indicator reflects the share of people whose equivalent disposable income falls below 60% of the median value for the country.

[2] See Chart 2 reflecting the role of social transfers in inequality and poverty indicators of EU countries in Fadejeva, Ludmila. Income Inequality and Poverty: Where We Are and How to Improve the Situation (makroekonomika.lv, Latvijas Banka, 06.12.2019); *https://www.makroekonomika.lv/ienakumu-nevienlidziba-un-nabadziba-kur-esam-un-ka-uzlabot-situaciju*. See also the OECD material *Social spending % GDP (indicator). doi: 10.1787/7497563b-ne; https://data.oecd.org/socialexp/social-spending.htm#indicator-chart*.

[3] Case No 2019-27-03 initiated by the Constitutional Court with respect to the compatibility of Paragraph 2 of Cabinet Regulation No 1605 "Regulations Regarding the Amount of the State Social Security Benefit and Funeral Benefit, Procedures for the Review thereof and Procedures for the Granting and Disbursement of the Benefits" of 22 December 2009 with Article 1, the second sentence of Article 91 and Article 109 of the Constitution of the Republic of Latvia. The judgement is available at *https://www.satv.tiesa.gov.lv/press-release/norma-kas-nosaka-valsts-sociala-nodrosinajuma-pabalsta-apmeru-neatbilst-satversmei/.*

[4] Case No 2019-25-03 initiated by the Constitutional Court with respect to the compatibility of the words "if its average monthly income during the last three months per each member of the family does not exceed 128.06 euro" of Paragraph 2 of Cabinet Regulation No 299 "Regulations Regarding the Recognition of a Family or Person Living Separately as Needy" of 30 March 2010 with Article 1 and Article 109 of the Constitution of the Republic of Latvia. The judgement is available at *https://www.satv.tiesa.gov.lv/press-release/norma-kas-paredz-videjo-ienakumu-limeni-kadu-neparsniedzot-persona-vai-gimene-atzistama-par-trucigu-neatbilst-satversmes-1-un-109-pantam/.*

[5] Case No 2019-24-03 initiated by the Constitutional Court with respect to the compatibility of Paragraph 2 of Cabinet Regulation No 913 "Regulation on the Guaranteed Minimum Income Level" of 18 December 2012 with Article 1 and Article 109 of the Constitution of the Republic of Latvia. The judgement is available at *https://www.satv.tiesa.gov.lv/press-release/norma-kas-nosaka-garanteto-minimalo-ienakumu-limeni-neatbilst-satversmes-1-un-109-pantam/.*

[6] When granting the state social security benefit to persons with group I disability, the coefficient of 1.3 was applied to the base value, while the coefficient of 1.2 was applied to persons with group II disability.

There are several solutions to expand social support, and each of them has different influence channels. To illustrate this, Latvijas Banka has assessed the impact of various elements of the social security system on disposable income and poverty indicators in Latvia by employing the EUROMOD microsimulation model[1].

Simulation

At the proposal of the Ministry of Welfare of the Republic of Latvia, the following changes in GMI, the state social security benefit and the minimum old age and disability pensions have been analysed:

GMI – 109 euro to the first person in a household and 76 euro to each subsequent person in a household (instead of the current amount of 64 euro). The income level of a needy person – 272 euro to the first person in a household and 190 euro to each subsequent person in a household (instead of the current amount of 128.06 euro).

The state social security benefits – the amount of the state social security benefit granted to persons who have reached the retirement age – 109 euro (instead of the current amount of 80 euro). The amount of the state social security benefit granted to persons with a disability (employed persons having a disability since childhood) – 190.40 euro (to persons with group I disability), 163.20 euro (to persons with group II disability) and 136.00 euro (to persons with group III disability) instead of the previous amounts of 159.50 euro, 147.23 euro and 122.69 euro; to other employed persons with a disability – 152.60 euro (to persons with group I disability), 130.80 euro (to persons with group II disability) and 109 euro (to persons with group III disability) instead of the previous amounts of 104 euro, 96 euro and 80 euro; a supplement of 30% (to persons with group I disability) and 20% (to persons with group II disability) of the amount of the benefit an employed person with a disability of the respective group is eligible for shall be paid to unemployed persons with a disability. The state social security benefit in case of loss of supporter – up to the age of six years (including) – 136 euro, from the age of seven years – 163 euro (instead of 107.50 euro and 129 euro respectively).

The minimum old age pension (base) – 136 euro, 163 euro to persons having a disability since childhood (instead of 80.00 euro and 122.69 euro respectively). The amount of the minimum old age pension for each year of length of insurance will be determined by applying the coefficient of 1.1 to the calculation base of the old age pension and increased by 2% of the calculation base of the minimum old age pension for each subsequent year exceeding the period of length of insurance needed for granting an old age pension.

The minimum disability pension (base) – 260.80 euro to persons having a disability since childhood (group I disability), 228.20 euro (group II disability) and 163.00 eiro (group III disability) instead of the current amounts of 196.30 euro, 171.77 euro and 122.69 euro respectively. 217.60 euro to other persons with a disability (group I disability), 190.40 euro (group II disability) and 136.00 euro (group III disability) instead of the current amounts of 128 euro, 112 euro and 80 euro respectively.

The assessments have addressed the impact on the share of people at risk of poverty and the Gini coefficient. To mutually compare the instruments, the impact illustrates changes that would result from the additional budget expenditure in the amount of 1 million euro for the financing of the respective instrument.

Simulation of the model

GMI is an instrument that contributes to the largest decrease in the share of people at risk of poverty and income inequality (Gini coefficient; see Chart 35). As the GMI benefit applies to each family member, its impact is particularly strong in the case of households with

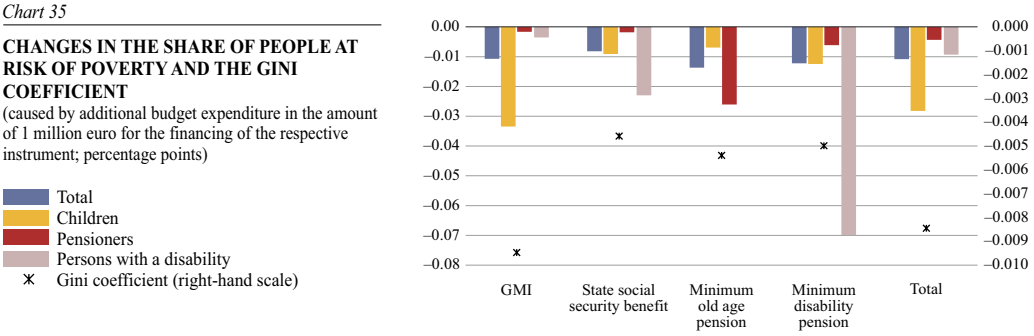
[1] EUROMOD is a tax-benefit microsimulation model for the EU that is maintained and developed by the Institute for Social and Economic Research (ISER) at the University of Essex, in collaboration with national expert teams from EU Member States. The Latvian national expert team is based at the Baltic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

children. At the same time, its impact on the poverty indicators of pensioners and persons with a disability is minor since the average income of these persons, on average, exceeds the guaranteed minimum income.

The Gini coefficient has been calculated by using equivalent household disposable income.

Chart 35

CHANGES IN THE SHARE OF PEOPLE AT RISK OF POVERTY AND THE GINI COEFFICIENT
(caused by additional budget expenditure in the amount of 1 million euro for the financing of the respective instrument; percentage points)



Note. The level of equivalent disposable income on the basis of which the poverty threshold (60% of the median) is calculated has been fixed at the level of the baseline scenario; therefore, the result reflects changes in percentage points in the number of persons in households which are exposed to the risk of poverty, excluding changes in the criterion for the risk of poverty in the scenarios.

The impact of the state social security benefits and the minimum pensions on the Gini coefficient and the total share of people at risk of poverty in the country is broadly similar, while varying considerably across population groups. The increases in the minimum old age pension would further reduce the number of people at risk of poverty among pensioners, but the raising of the minimum disability pension – among persons with a disability.

Although the contribution of the state social security benefit to the reduction of the risk of poverty is relatively smaller and seemingly overlaps with the disability pension in terms of impact, it should be taken into account that it is granted to other groups of people who are not eligible for the disability or the old age pension (e.g. people who do not have a service record).

Conclusions

The review of the social policy instruments is one of the elements towards lower income inequality and a smaller number of people at risk of poverty. Therefore, the impact of different social policy instruments on the inequality and poverty indicators in Latvia was assessed by using the EUROMOD microsimulation model.

Overall, the obtained results suggest that the attractiveness of different instruments depends on whether it is intended to reduce the total number of people at risk of poverty or to provide more targeted support to a certain group of population. Namely, a higher level of GMI is the most effective instrument to reduce the total number of people at risk of poverty (without significantly affecting pensioners and persons with a disability). By contrast, the minimum old age pension and the minimum disability pension are aimed at supporting the respective groups of population.

7.2 The reduction of the labour tax wedge

Motivation

The labour tax wedge in Latvia is higher than in a large fraction of the OECD Member States (including Lithuania and Estonia). As wages of employees and the taxes applicable thereto represent a significant component of business expenditure, high labour taxes push up the prices of goods produced and services provided in Latvia, thus making Latvian businesses less competitive both domestically and abroad. Therefore, the issue with regard to the reduction of the labour tax wedge has become topical in the context of the adoption of the budget for 2021.

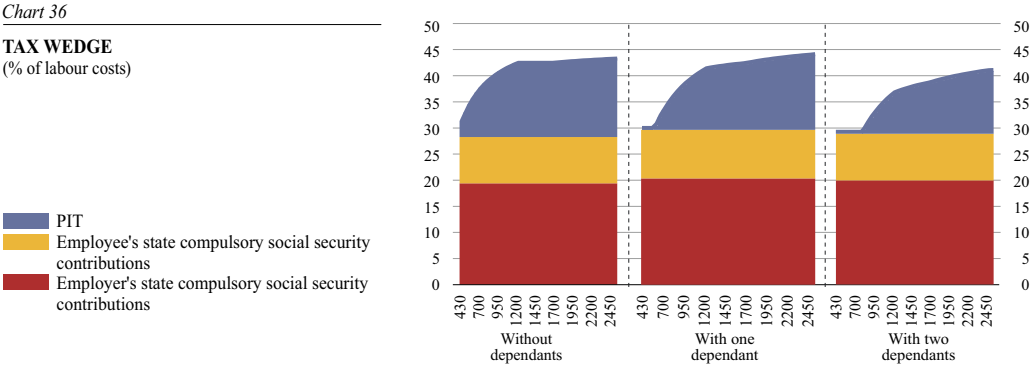
Several solutions for reducing the labour tax wedge may be considered. Moreover, each of them entails different economic influence channels. To illustrate this, Latvijas Banka has assessed the impact of various solutions for reducing the labour tax wedge on Latvia's economy by using the DSGE model for Latvia[1].

Simulation

Two taxes – the personal income tax (PIT) and the state compulsory social security contributions, together accounting for approximately 35%–45% of the labour costs – are the main wage taxes in Latvia (additionally the solidarity tax is applicable to the portion of the wage exceeding 62 800 euro per year). The state compulsory social security contributions account for the bulk of the tax wedge, and this is particularly evident with regard to the low wage earners and the employed persons to whom the state compulsory social security contributions are the only labour tax applicable in some cases.

Chart 36

TAX WEDGE
(% of labour costs)



First, two scenarios of reducing the labour tax wedge are considered:
1) the easing of the burden of the state compulsory social security contributions paid by employer;
2) the easing of the burden of the state compulsory social security contributions paid by employee whereby its influence channels are identical to those of the reduction of the wedge of PIT.

In both scenarios, the tax wedge is reduced immediately and to a level where a decrease in tax revenue would be 1% of GDP. The economic impact of the reduction of the labour tax wedge in different labour market circumstances is then analysed.

The simulation is performed by employing the DSGE model for Latvia where a distinction is made between different types of government spending, including consumption, investment, cyclical unemployment benefits and other transfers to households of two types as well as interest expense. The budget revenue is grouped in the following categories: the consumption tax, labour income tax, the state social security contributions paid by employee and employer and the income tax on capital gains. The government may borrow both domestically and abroad. The model contains a wage bargaining mechanism with a different impact of the bargaining power of employers and employees within a cycle, a financial accelerator, an import content of consumption, investment and exports as well as other factors characterising Latvia's economy. The estimation of the model has been performed by employing 28 macroeconomic time series, including nine fiscal ones.

Scenarios

1. The reduction of the tax wedge on the employer or the employee side. The reduction of the state compulsory social security contributions paid by employer will directly lead to a decrease in the production costs of businesses which, under the circumstances of

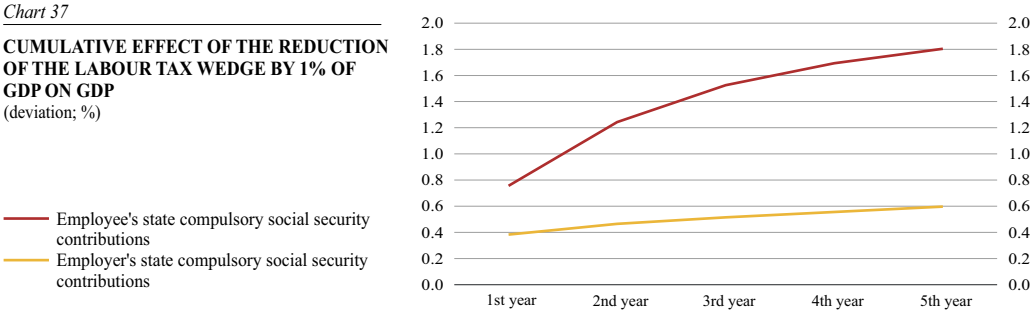
[1] Bušs, Ginters, Grüning, Patrick. *Fiscal Policy and Business Cycle in a Monetary Union.* Latvijas Banka Working Paper (coming soon).

competition, passes through to relatively lower prices of domestic products in the medium term.[1] This, in turn, boosts competitiveness in the domestic and external markets.

At the same time, with demand increasing, businesses boost employment and investment. Moreover, a higher labour demand is also reflected in a higher rate of remuneration to employees. Thus, the rises in employment and remuneration lead to growth in household income and consumption. If the tax is reduced in the circumstances when there are no shortages of labour, the impact on employment and GDP is substantial. Over the medium term (over a five-year period), the lowering of the rate of the state compulsory social security contributions paid by employer would increase Latvia's GDP by 1.8% (see Chart 37).

Chart 37

CUMULATIVE EFFECT OF THE REDUCTION OF THE LABOUR TAX WEDGE BY 1% OF GDP ON GDP
(deviation; %)



At the same time, the reduction of the employee's state compulsory social security contributions (and PIT) does not imply direct changes in the production costs of businesses; therefore, no rise in the competitiveness of domestic products is recorded. In this scenario, a lower labour tax wedge is reflected in higher employees' disposable income, which contributes to growth in private consumption (and, to some extent, also investment). However, its medium-term impact on employment and GDP is considerably lower, as compared with a case in which the labour tax wedge on the employer side is reduced since a large portion of consumer and investment goods are imported.

2. When is it better to reduce the labour tax wedge? The calculations assume that the burden of the state compulsory social security contributions has been reduced at the time when there are no shortages of labour (the circumstances of high unemployment), for instance, over the period of the economic recession. Under such circumstances, employees have little possibilities of bargaining about wage increases; thus, the reduction of the tax wedge mostly goes to the benefit of employers. At the same time, due to mutual competition of businesses the gains from reducing the tax wedge are also reflected in cheaper local products, which improves competitiveness in the domestic and external markets and enhances the positive effects on employment and consumption.

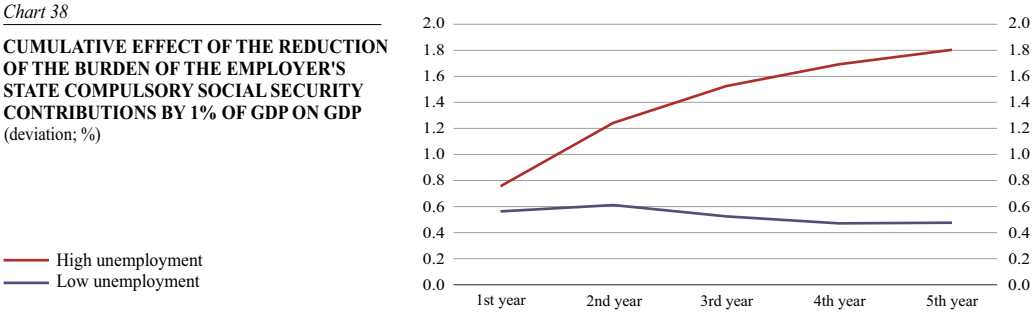
By contrast, if the state compulsory social security contributions paid by employer are reduced in a situation of labour shortages (low unemployment), the employers' efforts to increase employment exert an upward pressure on labour costs.[2] Thus, the impact on competitiveness and GDP is considerably less pronounced (see Chart 38).

[1] Although there is a price friction in the short run due to which not all businesses reduce prices immediately (the model has estimated it), the competition among manufacturers of similar products and similar service providers will exert a downward pressure on producer prices over time.

[2] In this case, the flexibility of the employee's bargaining power relative to the situation on the labour market as estimated in the data for Latvia has been used; see Bušs, Ginters, Grüning, Patrick. *Fiscal Policy and Business Cycle in a Monetary Union.* Latvijas Banka Working Paper (coming soon).

Chart 38

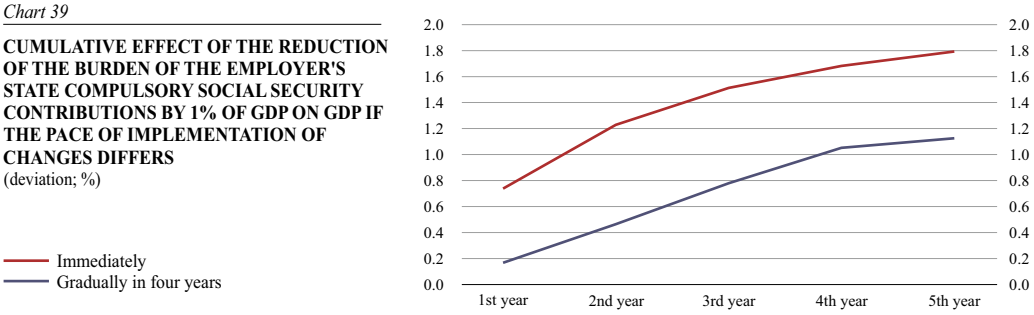
CUMULATIVE EFFECT OF THE REDUCTION OF THE BURDEN OF THE EMPLOYER'S STATE COMPULSORY SOCIAL SECURITY CONTRIBUTIONS BY 1% OF GDP ON GDP
(deviation; %)



3. Is it better to reduce the state compulsory social security contributions paid by employer immediately or gradually? The calculations assume that the tax wedge has been reduced in one step. If changes were made gradually, for example, within a period of four years (in which case, the decrease in revenue would grow by 0.25% of GDP each year), the economic gains would be lower. As the economic activity is expected to recover little by little, the flexibility of labour costs relative to the situation in the labour market will increase gradually; therefore, the effectiveness of each subsequent step of the process of reducing the labour tax wedge by lowering the state compulsory social security contributions will also deteriorate (see Chart 39).

Chart 39

CUMULATIVE EFFECT OF THE REDUCTION OF THE BURDEN OF THE EMPLOYER'S STATE COMPULSORY SOCIAL SECURITY CONTRIBUTIONS BY 1% OF GDP ON GDP IF THE PACE OF IMPLEMENTATION OF CHANGES DIFFERS
(deviation; %)



Conclusions

Overall, Latvijas Banka's calculations suggest that the reduction of the labour tax wedge by lowering the state compulsory social security contributions has a positive effect on the economic growth. The most pronounced impact on the economy is registered when:
– the burden of the state compulsory social security contributions paid by employer is reduced;
– the state compulsory social security contributions are reduced in an environment in which there is ample supply of labour (under the circumstances of high unemployment);
– the state compulsory social security contributions are reduced immediately rather than gradually.

Therefore, given the deceleration in the economic activity caused by the COVID-19 pandemic and the increase in the number of unemployed, currently this is an appropriate moment to reduce the labour tax wedge.

However, the reduction of the labour tax wedge would also lead to lower revenue from taxes, but even their current amount is hardly sufficient to provide adequate financing for the implementation of the government functions. Therefore, the reduction of the labour tax wedge should be carried out along with the tax revenue boosting measures. Shifting the tax wedge away from labour taxes towards consumption taxes would be an optimal solution for Latvia's economy.

Additional Information

General notes

The cut-off date for the information used in the publication Macroeconomic Developments Report (September 2020, No. 31) is 25 September 2020.

The Macroeconomic Developments Report (September 2020, No. 31) published by Latvijas Banka is based on data provided by the CSB, ECB, Treasury, AS Nasdaq Riga, Euribor-EBF and Latvijas Banka.

Data sources for charts are the EC (Charts 1, 2, 22–24 and 31), Bloomberg (Charts 3–6, 15 and 30), Reuters (Chart 7), Latvijas Banka (Charts 3, 8–13, 26 and 28–39), the CSB (Charts 8, 16–21, 23, 25–29, 33 and 34), the Treasury (Chart 14) and the SEA (Chart 26).

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

Details may not add because of rounding-off.

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

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

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

Money and banking sector

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

In the publication, the following terms have been used:

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

Non-MFIs – entities other than MFIs.

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

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

Financial auxiliaries – financial corporations that are primarily engaged in auxiliary financial activities, i.e. activities that are closely related to financial intermediation but are not financial intermediation themselves, e.g. investment brokers who do not engage in financial

intermediation services on their own behalf, corporations that provide infrastructure for financial markets, central supervisory institutions of financial institutions and the financial market provided that they are separate institutional units. In Latvia, the FCMC and the AS Nasdaq Riga shall also be regarded as financial auxiliaries. Financial auxiliaries' data are included in OFIs data.

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

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

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

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

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

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

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

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

1) consolidated balance sheet of MFIs obtained by netting out inter-MFI positions in the aggregated balance sheet of Latvia's MFIs (Table 4). Due to slight accounting methodology differences, the sum of the inter-MFI positions is not always zero; therefore, the balance is reported under the item Excess of inter-MFI liabilities;

2) selected items in the monthly financial position report of MFIs (excluding Latvijas Banka) by group of countries (Table 5);

3) information characterising the maturity profile and types of deposits (including repurchase agreements) of Latvia's financial institutions, non-financial corporations and households with MFIs (excluding Latvijas Banka; Tables 6 and 7abc), as well as government and non-resident deposits (Table 7d);

4) information characterising the maturity profile and types of MFI (excluding Latvijas Banka) loans to Latvia's financial institutions, non-financial corporations and households (Tables 8, 9ab and 10), as well as government and non-resident loans (Table 9c);

5) information characterising MFI (excluding Latvijas Banka) securities holdings (Table 11).

Interest rates

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

Information on interest rates on deposits and loans applied in transactions with non-financial corporations and households provided by credit institutions, branches of foreign credit institutions and credit unions registered in the Republic of Latvia is collected (Tables 12ab). Interest rate statistics is collected on new business and outstanding amounts. All rates included in the interest rate statistics are weighted average rates. When preparing the interest rate statistics, credit institutions use annualised agreed rates (AAR) or narrowly defined effective rates (NDER) and annual percentage rate of charge (APRC). Credit institutions have to select the calculation of the AAR or the NDER based on the terms and conditions of the agreement. The NDER can be calculated on any deposit or loan. In addition to the AAR or the NDER, the APRC is reported for loans to households for house purchase and consumer credits.

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

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

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

Interbank market lending interest rates (Table 14) are reported as weighted average interest rates on new business, aggregating the information submitted by credit institutions, prepared based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 102 "Regulation for Compiling the 'Report on Monetary Market Transactions'" of 16 May 2013).

Foreign exchange and exchange rates

Information characterising the foreign currency selling and buying transactions is reported based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 36 "Regulation for Purchasing and Selling Cash Foreign Currency" of 13 May 2009 and Latvijas Banka Regulation No. 101 "Regulation for Compiling Reports on Foreign Currency Purchases and Sales" of 16 May 2013). The principal foreign exchange transactions (Table 16) comprise the cash and non-cash transactions conducted by credit institutions and branches of foreign credit institutions, reported by transaction type and counterparty, and currency. Non-cash foreign exchange transactions (Table 17) comprise non-cash transactions performed by credit institutions and branches of foreign credit institutions, reported by major currency.

Weighted average exchange rates (cash transactions; Table 18) are reported based on the information provided by credit institutions and branches of foreign credit institutions as well as currency exchange bureaus.