

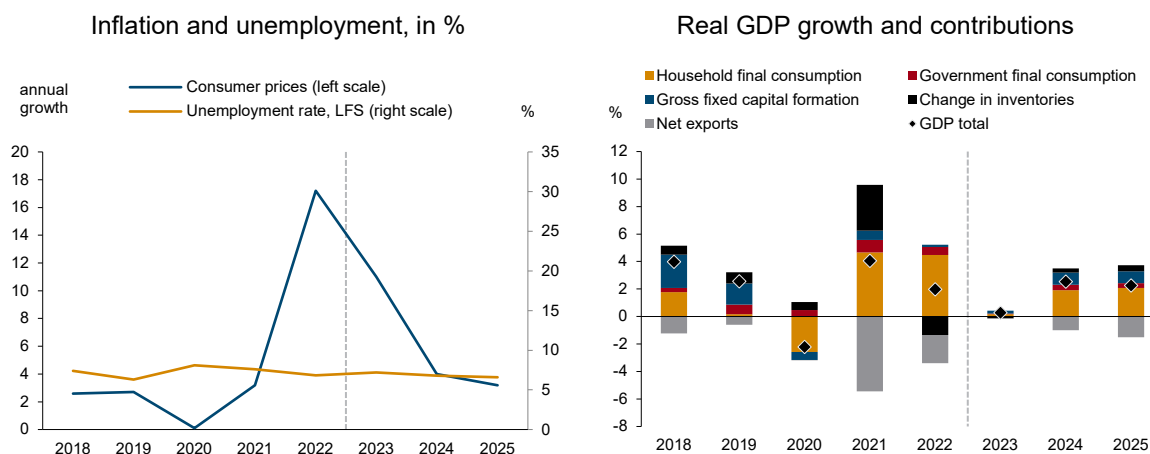


LATVIA: Stagnation with high employment levels

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After a boom in 2022, the effects of dwindling external demand and escalating prices will bring the economy close to stagnation this year (0.3%). Enterprises are largely refraining from investment, preferring to deplete their stocks. Moreover, the ongoing decline in the purchasing power of households will curb growth in consumption. Given the tight labour market, the unemployment rate will rise only slightly in 2023, then decline again next year. Assuming that the EU economy finds its way back on track by the end of 2023, we expect a revival in Latvia's GDP growth to 2.5% in 2024.

Figure 5.11 / Latvia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Latvian goods exports continued to grow in Q4 2022 in real terms. However, by December a decline was already under way, and this has continued in the first months of 2023. The international cyclical downturn and the strong rise in the cost of inputs used in production have reduced external demand for Latvian goods. Also the transport sector – relatively important in the country – has started to ail in this context. Confounding expectations, exports to Russia remained relatively stable in 2022 and early 2023. Moreover, there has been a big increase in exports to Kazakhstan, Kyrgyzstan, Armenia and other CIS countries – most likely a large proportion of those goods are re-exported to Russia and Belarus, circumventing EU sanctions. At the same time, we have started to see a sharp decline in Latvian imports from Russia and Belarus. In general, the lower growth in imports (in nominal terms) will result in the current account deficit declining from more than 6.4% of GDP last year to around 4% in 2023.

In common with the other Baltic states, Latvia was among the EU countries worst affected by the energy and commodity price increases of 2022. In February 2023, consumer price inflation declined to 20.3% – still above the level anticipated last year. Inflation is being driven particularly by alcohol, tobacco and food products, but also by recreation, health, etc. We expect consumer price inflation to remain in double digits in 2023, before falling to 4% in 2024.

The escalating inflation meant that average real net wages declined by almost 9% in 2022, and they will keep on shrinking in 2023. The government raised the statutory minimum wage in January 2023 by 24%, to EUR 620 a month. This implies at least a revival in the purchasing power of the lowest-income groups. Nevertheless, the still-high consumer price inflation means that we expect average real net wages to decline further, by 1.5% in 2023, and only to start increasing in 2024.

Although it did have to face a period of uncertainty amid soaring energy prices, Latvia got through the winter without gas supply problems. At the beginning of April, Latvia's gas storage facilities (which also serve the needs of its Baltic neighbours), were fuller than ever before at this time of year (34%). Planning for a Latvian liquefied natural gas (LNG) terminal is under way, with the objective of making the country more energy independent. Although it is not yet clear whether it will be constructed in Skulte (as has previously been mooted) or at another, larger port, building work could start as early as 2024.

Although the economy was already slowing, nevertheless employment increased towards the end of 2022; for 2023 we expect growth in employment to be close to zero. The number of jobs increased in 2022, particularly in manufacturing and the previously ailing hospitality sector. Job vacancy rates are still high and have declined only slightly in recent months. The unemployment rate, which continued to slide throughout 2022, only inched up in the first months of 2023. Although economic activity will stagnate this year, we expect unemployment to increase by only a little in 2023 and then to fall again gradually next year. By the end of January 2023, more than 36,000 Ukraine refugees – close to 2% of the Latvian population – were benefiting from temporary protection and residing in the country. Thanks to the favourable labour market conditions at the moment, about 25% of those refugees of working age have found a job in Latvia.

Investment will be damped down again in 2023 by the multiple uncertainties triggered by the expected stagnation in the EU and Russia's war with Ukraine. The European Central Bank's (ECB) raising of interest rates to curb inflationary developments will mean Latvian entrepreneurs remain cautious when planning their investments. Figures on the number of building permits granted suggest that investment in real estate will stay low throughout 2023. Having taken advantage of the (still relatively) cheap inputs and goods to build up their inventories throughout 2022, businesses have now started running those stocks down. However, the budget envisages a rise in public investment in infrastructure this year. After declining up until winter 2022/2023, confidence levels in all sectors – including construction and industry – have again been on the rise in recent months: it would seem that entrepreneurs were anticipating even worse developments and are now pleasantly surprised about the rather short period of stagnation ahead.

The Latvian government has supported households in coping with the soaring prices, particularly for energy during the heating period (up to the end of April). The measures have helped households not only to maintain their level of consumption in the face of declining real incomes, but actually to increase it substantially. In 2023, however, we will see a greater reluctance on the part of households to spend. We expect private consumption to remain rather stagnant, before reviving in 2024.

The updated budget plan of the new government envisages a small reduction in the deficit; should the economic upswing materialise in 2024, a return to close to 2% of GDP is likely. In particular, the government has boosted defence spending to almost 2.3% of GDP, and over the medium term – up to 2025 – an increase to 2.5% of GDP is planned. Russia's war with Ukraine has also prompted parliament to reintroduce compulsory military service for young men, having relied on a fully professional army for 13 years. The first round of conscription is scheduled for July 2023. Given the additional measures outlined above and the near stagnation of the Latvian economy, the budget deficit will decline only slightly – to 4.5% in 2023. Thereafter, the government plans to reduce it further – to 2.3% of GDP in 2024 and 2% in 2025.

As expected, following parliamentary elections in October 2022, Prime Minister Kariņš was able to form his second administration in December last year. The coalition government now consists again of Kariņš's conservative people's party New Unity (which made strong gains in the election) and the far-right National Alliance (which has been part of all coalition governments since 2011), and they are joined by a newcomer – the United List, a party with a focus on the regions. Thus, the new government's economic policy will remain more or less unchanged.

All in all, we have revised our forecast for GDP growth in 2023 slightly upwards – from 0% in the winter to 0.3% now. According to the baseline scenario, however, GDP growth will pick up in 2024 to 2.5%, and will remain at 2.3% in 2025. This scenario assumes a determined willingness on the part of EU actors to cushion the economic effects of the crisis through fiscal policies, and the readiness of the ECB to refrain from being too hawkish with its interest rate rises in the coming months.

Table 5.11 / Latvia: Selected economic indicators

	2019	2020	2021	2022 ¹⁾	2023	2024	2025
					Forecast		
Population, th pers., average	1,914	1,900	1,884	1,876	1,870	1,860	1,850
Gross domestic product, EUR m, nom.	30,679	30,294	33,588	39,081	43,500	46,400	49,000
annual change in % (real)	2.6	-2.2	4.1	2.0	0.3	2.5	2.3
GDP/capita (EUR at PPP)	21,730	21,620	23,230	26,110	.	.	.
Consumption of households, EUR m, nom.	17,479	16,822	18,868	23,248	.	.	.
annual change in % (real)	0.3	-4.5	8.4	8.0	0.3	3.2	3.5
Gross fixed capital form., EUR m, nom.	7,102	7,003	7,500	8,492	.	.	.
annual change in % (real)	6.9	-2.6	2.9	0.7	1.0	4.0	4.0
Gross industrial production ²⁾							
annual change in % (real)	0.9	-1.5	6.7	0.9	-2.5	2.0	4.0
Gross agricultural production							
annual change in % (real)	23.4	4.9	-8.1	0.7	.	.	.
Construction industry							
annual change in % (real)	2.9	2.7	-6.1	-11.4	.	.	.
Employed persons, LFS, th, average ³⁾	910.0	893.0	869.5	891.2	896	900	905
annual change in %	0.1	-1.9	-3.0	2.5	0.5	0.5	0.5
Unemployed persons, LFS, th, average ³⁾	61.3	78.7	70.6	65.2	70	66	64
Unemployment rate, LFS, in %, average ³⁾	6.3	8.1	7.6	6.8	7.2	6.8	6.6
Reg. unemployment rate, in %, eop ⁴⁾	6.2	7.7	6.7	6.1	.	.	.
Average monthly gross wages, EUR	1,076	1,143	1,277	1,373	1,500	1,600	1,700
annual change in % (real, gross)	4.2	6.0	8.2	-8.3	-1.5	2.5	3.0
Average monthly net wages, EUR	793	841	939	1,006	1,100	1,170	1,240
annual change in % (real, net)	3.9	5.8	8.1	-8.7	-1.5	2.5	3.0
Consumer prices (HICP), % p.a.	2.7	0.1	3.2	17.2	11.0	4.0	3.2
Producer prices in industry, % p.a.	1.8	-2.2	13.4	34.6	15.0	2.0	1.0
General governm. budget, EU def., % of GDP							
Revenues	37.6	37.8	37.1	39.5	38.0	37.0	38.0
Expenditures	38.2	42.2	44.1	44.3	42.5	40.0	40.0
Net lending (+) / net borrowing (-)	-0.6	-4.3	-7.0	-4.8	-4.5	-3.0	-2.0
General gov. gross debt, EU def., % of GDP	36.5	42.0	43.7	41.0	42.0	41.0	40.0
Stock of loans of non-fin. private sector, % p.a.	-1.4	-3.8	3.2	7.0	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	5.1	3.1	2.5	1.8	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	0.00	2.50	.	.	.
Current account, EUR m	-178	788	-1,414	-2,495	-1,800	-1,200	-800
Current account, % of GDP	-0.6	2.6	-4.2	-6.4	-4.1	-2.6	-1.6
Exports of goods, BOP, EUR m	12,761	13,440	16,195	20,491	22,200	23,300	24,200
annual change in %	1.4	5.3	20.5	26.5	8.3	5.0	3.9
Imports of goods, BOP, EUR m	15,400	14,992	18,969	24,967	26,700	27,600	28,500
annual change in %	2.1	-2.6	26.5	31.6	6.9	3.4	3.3
Exports of services, BOP, EUR m	5,589	4,707	5,192	6,999	7,600	8,000	8,300
annual change in %	4.9	-15.8	10.3	34.8	8.6	5.3	3.8
Imports of services, BOP, EUR m	3,152	2,862	3,574	4,796	5,100	5,000	4,900
annual change in %	4.3	-9.2	24.9	34.2	6.3	-2.0	-2.0
FDI liabilities, EUR m	999	816	3,185	1,175	.	.	.
FDI assets, EUR m	80	168	2,338	-120	.	.	.
Gross reserves of CB excl. gold, EUR m	3,700	3,982	4,504	3,819	.	.	.
Gross external debt, EUR m	35,803	36,751	36,834	39,289	40,000	40,800	40,200
Gross external debt, % of GDP	116.7	121.3	109.7	100.5	92.0	88.0	82.0

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) In % of labour force (LFS). - 5) Loans more than 90 days overdue, and from 2018 also including loans unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.