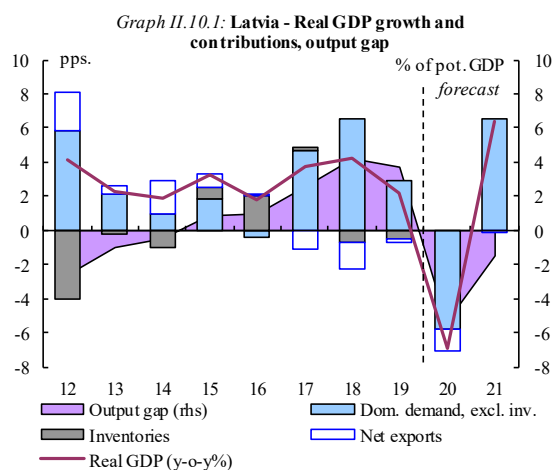# 10. LATVIA

Latvia's GDP is projected to decline by 7% in 2020, followed by a fairly rapid recovery in 2021. Investments and exports are expected to suffer the most amid border closures and declining foreign demand, while consumption is expected to fare better than in other countries thanks to a relatively milder lockdown. The government deficit is projected to reach 7% of GDP in 2020 due to income and liquidity support measures as well as a drop in tax revenue. The deficit is projected to decline to 4½% in 2021, as the government is expected to maintain its support while the economy recovers fully.

The economy was strong before the crisis

In 2019, Latvia's GDP grew by 2.2%, driven mostly by solid private consumption amid slowing investment and export growth. The labour market remained tight, driving rapid wage growth. Economic growth since the last crisis in 2009 has been sound with a balanced current account, low credit growth, and falling private and public debt ratios. As a result, Latvia entered the crisis with overall macroeconomic conditions favourable to a relatively swift recovery, provided that the current crisis impact remains short-lived. Crucially, public debt remains low, providing room for support measures during the lockdown and in the recovery phase.

Graph II.10.1: **Latvia - Real GDP growth and contributions, output gap**

Investment and exports will suffer the most

Latvia managed to contain the spread of the virus at low levels. As a result, the lockdown restrictions in Latvia are milder than in most other EU countries. With the exception of international transport services and businesses involving mass gatherings, like concerts, theatres and sports competitions; most other businesses are allowed to remain open, subject to social distancing requirements. However, many non-essential retailers and catering businesses have closed

voluntarily due to lack of demand. Given Latvia's above EU-average share of exports, the shock to its economy will mostly stem from declining foreign demand. Moreover, the uncertainty related to the duration of the measures both at home and abroad are expected to lead to a postponement of new investment projects, thus leading to a significant decline in investment, with a moderate lag. Government investment, however, is set to go on as planned, providing some support to the economy.

All in all, real GDP is projected to shrink by some 7% in 2020, with investment and service exports poised for the largest declines. The baseline scenario assumes that after a steep decline in the first two quarters of 2020, a fairly rapid recovery will follow in the second part of the year. Private consumption and investment should lead the way, the latter being supported by the beginning of the Rail Baltica project, a large railway infrastructure project to integrate the Baltic states with the EU rail network. In 2021, real GDP is expected to grow by some 6½%, bringing economic activity in the final quarter of 2021 back to the level it was in the final quarter of 2019.

Labour market projected to recover quickly

Employment is expected to decline by some 2½% this year. Government-subsidised employee furlough scheme is expected to cushion most of the employment loss in the short-term and therefore help foster the recovery in 2021. Headline inflation is set to slow significantly in 2020 due to both falling demand and rapidly declining energy prices. It is expected to rebound in 2021 along with the pick-up in demand and wage growth.

While there are significant downside risks to the baseline scenario, country-specific risks are balanced. Lacking domestic supply-side restrictions, investment and goods exports could prove more resilient than expected. On the negative side, damage to consumer confidence

could last longer than currently assumed, leading to a slower recovery in private consumption.

Government deficit set to increase in 2020 as tax revenues fall and spending grows

The government deficit declined to 0.2% of GDP in 2019, driven by higher revenue from taxes on labour and non-tax revenues, while taxes on consumption underperformed. In 2020, a sharp deterioration of the government deficit to some 7% of GDP is projected, as a result of the economic downturn and the adoption of temporary stimulus measures. The expected tax revenue loss accounts for most of the deterioration. A lower tax intake is linked to the drop in economic activity, as well as a tax deferral measure with a deficit-increasing impact of around 1% of GDP in 2020. Government expenditure is set to expand more than previously planned due to the measures put in place in response to the COVID-19 pandemic and due to higher unemployment spending. Additional financing for the healthcare sector accounts for 0.1% of GDP. Moreover, the existing resources in the healthcare sector have been mobilised to fight the pandemic. Temporary downtime payments to idled employees and other income support measures amount to 0.5% of GDP. Finally, sector

specific support and loss provisions for loan guarantees are estimated to increase the government deficit by 1.2% of GDP.

In 2021, the government deficit is projected to narrow to 4½% of GDP under a no-policy change assumption. The temporary expenditure measures are projected to cease in 2021. However, underlying expenditure growth is assumed to be sustained in line with pre-crisis plans. As a result, the expenditure-to-GDP ratio is expected to increase by some 2½ percentage points between 2019 and 2021. Tax revenue is expected to grow in line with the pick-up in GDP in 2021, while the 2020 tax deferrals are projected to be partly recovered by 2023. Moreover, dividend payments in 2021 based on the returns for 2020 are expected to be weak.

The government debt-to-GDP ratio is expected to increase from 37% in 2019 to 44% in 2021, mostly due to the large government deficits in 2020 and 2021. The increase in the debt ratio should be softened by a partial reduction in large precautionary cash resources, which were accumulated at the end of 2019.

Table II.10.1:

Main features of country forecast - LATVIA

		2018		Annual percentage change						
	mio EUR Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	29056.1	100.0	3.8	1.8	3.8	4.3	2.2	-7.0	6.4
Private Consumption	17172.6	59.1	3.8	1.5	3.1	4.2	2.9	-6.1	7.0
Public Consumption	5242.3	18.0	1.0	2.9	3.2	4.0	2.6	2.9	2.0
Gross fixed capital formation	6553.8	22.6	4.8	-8.2	11.3	15.8	3.1	-12.0	9.2
of which: equipment	2565.0	8.8	3.5	11.2	9.3	13.1	2.0	-15.0	12.0
Exports (goods and services)	17870.8	61.5	7.6	4.0	6.4	4.0	2.0	-10.3	7.8
Imports (goods and services)	17924.7	61.7	6.0	3.8	8.4	6.4	2.3	-8.3	8.0
GNI (GDP deflator)	28554.5	98.3	3.8	2.1	3.6	3.0	3.4	-6.3	6.4
Contribution to GDP growth:	Domestic demand		4.3	-0.4	4.7	6.5	2.9	-5.8	6.5
	Inventories		0.0	2.1	0.2	-0.7	-0.5	0.0	0.0
	Net exports		-0.3	0.1	-1.1	-1.5	-0.2	-1.2	-0.1
Employment			-0.5	-0.3	0.0	1.6	-0.1	-2.6	0.9
Unemployment rate (a)			12.2	9.6	8.7	7.4	6.3	8.6	8.3
Compensation of employees / head			9.5	7.3	7.6	8.5	8.8	0.3	3.9
Unit labour costs whole economy			5.0	5.1	3.7	5.7	6.4	5.0	-1.5
Real unit labour cost			0.1	4.2	0.7	1.6	3.6	3.5	-3.7
Saving rate of households (b)			1.2	4.5	4.4	6.3	9.8	18.5	14.5
GDP deflator			4.9	0.9	3.0	4.0	2.6	1.4	2.3
Harmonised index of consumer prices			4.0	0.1	2.9	2.6	2.7	0.2	1.9
Terms of trade of goods			0.2	3.5	0.9	1.6	0.9	2.1	0.5
Trade balance (goods) (c)			-15.7	-7.5	-8.3	-8.1	-8.1	-8.2	-7.9
Current-account balance (c)			-7.1	1.4	1.0	-0.7	0.6	1.1	1.2
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-5.4	2.5	1.7	1.1	2.8	2.6	3.4
General government balance (c)			-2.7	0.2	-0.8	-0.8	-0.2	-7.3	-4.5
Cyclically-adjusted budget balance (d)			-2.5	-0.2	-1.7	-2.4	-1.5	-5.2	-3.8
Structural budget balance (d)			-	-0.4	-1.7	-2.4	-1.7	-5.2	-3.8
General government gross debt (c)			25.5	40.9	39.3	37.2	36.9	43.1	43.7

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.