10. LATVIA

Latvia's economy is set to rebound strongly in 2021 thanks to sizeable government support measures and solid export performance. Following a temporary slowdown toward the end of 2021, GDP is forecast to return to strong growth in the second quarter of 2022 as the unwinding of excess savings drive up private consumption and a pick-up in EU fund inflows boosts investments. Inflation is set to rise due to a significant increase in energy prices. The labour market is expected to improve in line with economic activity, with the unemployment rate approaching pre-crisis lows by the end of 2023. The government deficit is projected to exceed 9% of GDP in 2021 and to decrease to around 2% by 2023.

Rising infection rate will temporarily slow the recovery in 2021

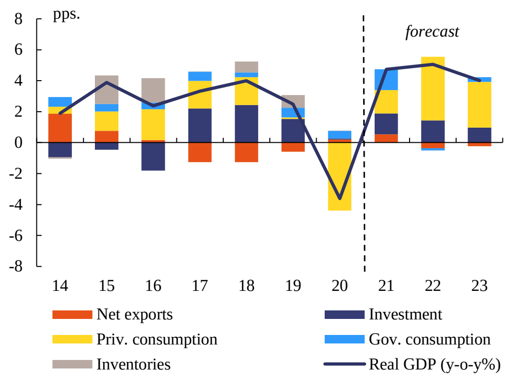
Real GDP is forecast to grow by 4.7% in 2021 driven mainly by exports and investment. The first half of the year saw strong growth in goods exports and investments. At the same time consumption held up well due to sizeable government support measures, which compensated for households' loss of income during the COVID-19 crisis. A gradual easing of last winter's pandemic-related restrictions supported growth up to the third quarter of 2021. However, rapidly rising infection rates prompted a tightening of containment measures in October and this is set to slow the economy in the final quarter of 2021 and in the beginning of 2022.

Rapid growth ahead remains contingent on vaccination success

Provided that vaccination progresses as planned, the economic recovery should resume in full swing by mid-2022. Private consumption and services exports are expected to be the main growth drivers as they still have some way to go before they reach their pre-pandemic levels. Investment is forecast to continue its solid march thanks to a pick-up in inflows of EU funds. Growth in goods exports is expected to continue benefitting from the EU recovery, although it is set to slow compared to 2021. Overall, real GDP growth for 2022 is forecast at 5.0%. In 2023, growth is projected to slow to 4.0%.

Private consumption will take over as the main growth driver supported by strong wage growth and extra savings accumulated over the past years. Export growth will continue benefitting from solid growth in the EU with services exports set to provide a particular boost once travel returns to a new normal. Investment growth will continue benefitting from still increasing EU fund inflows, while phasing out of nationally-financed investment aimed at supporting the post-pandemic recovery will mean that, overall, growth rates are expected to slow.

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



Risks to the forecast are tilted to the downside. In the short term, the recently announced containment measures may prove to be insufficient to curb the rapid growth in infections, leading to a further tightening of restrictions. In the medium term, failure to improve vaccination coverage swiftly may lead to prolonging of containment measures and delay the resumption of a rapid economic recovery.

Labour market set to tighten in the medium run

At around 8%, the unemployment rate held steady in the first half of 2021 thanks to the short-time work schemes and wage subsidies (financially supported by SURE). However, the pick-up in investment activity in the second half of the year is expected to provide an impetus to labour demand, lowering the unemployment rate further to 7.3% in 2021. In 2022 and 2023, rapid growth in the services sectors is set to add to the demand coming from investment, lowering the unemployment rate to 6.6% in 2023, close to its pre-crisis low. At the same time, the tightening of the labour market is set to support rapid wage growth.

Inflation expected to pick-up considerably

Consumer price inflation is set to reach 3.1% in 2021, driven by rapid energy price increases. The spike in energy prices in the second half of 2021 is set to carry over to next year, translating into 3.6% growth in the HICP in 2022. In 2023, inflation is forecast to slow to around 1% as energy prices reverse.

Fiscal support continues in 2022

In 2021, the government deficit is projected to reach 9.5% of GDP, mostly as a result of sizeable support measures of close to 5% of GDP. The first round of support measures was adopted in late 2020 and most of them expired by June 2021. The second round of support measures was adopted in October 2021 in response to the re-introduction of pandemic restrictions. The measures included income support to the households and businesses most severely affected by restrictions, a step-up in public investment, as well as an increase in spending in the healthcare sector.

In 2022, the deficit is projected to decrease to 4.2% of GDP. While the bulk of the temporary support introduced in 2020 and 2021 is set to end, the 2022 budget includes additional measures amounting to around 2% of GDP. The main measures for 2022 are an increase in non-taxable income tax allowance and increases in wages to healthcare and social workers as well as teachers. The budget also contains a sizeable investment package aimed at supporting the economic recovery. In 2023, the budget is forecast to reach balance under the no-policy-change scenario thanks to solid growth in tax revenue and the expiry of the support measures adopted for 2022.

The forecast also incorporates expenditures financed by RRF grants, which are set to gradually increase from 0.1% of GDP in 2021 to 0.8% of GDP in 2023. The total EU fund inflows are expected to peak in 2023 at 3.3% of GDP.

The government debt-to-GDP ratio is expected to reach 48.2% in 2021 and to increase further to 50.7% in 2022 before declining in 2023.

Table II.10.1:

Main features of country forecast - LATVIA

		2020			Annual percentage change						
	mio EUR	Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP		29511.0	100.0	3.4	4.0	2.5	-3.6	**4.7**	**5.0**	**4.0**
Private Consumption		16597.0	56.2	3.7	3.0	0.2	-7.6	**2.7**	**7.5**	**5.2**
Public Consumption		5970.7	20.2	1.4	1.7	3.4	2.6	**6.6**	**-0.6**	**1.5**
Gross fixed capital formation		7217.0	24.5	2.5	11.8	6.9	0.2	**5.5**	**5.8**	**3.8**
of which: equipment		2680.3	9.1	2.2	3.9	14.5	-2.0	**6.9**	**4.3**	**4.4**
Exports (goods and services)		17803.2	60.3	6.8	4.5	2.1	-2.2	**6.6**	**4.9**	**3.8**
Imports (goods and services)		17457.2	59.2	5.7	6.4	3.0	-2.5	**5.8**	**5.5**	**4.1**
GNI (GDP deflator)		29503.6	100.0	3.3	2.6	2.6	-2.2	**3.6**	**4.9**	**3.9**
Contribution to GDP growth:	Domestic demand			3.7	4.5	2.3	-3.8	**4.2**	**5.4**	**4.2**
	Inventories			0.3	0.7	0.8	0.0	**0.0**	**0.0**	**0.0**
	Net exports			-0.4	-1.3	-0.6	0.2	**0.5**	**-0.4**	**-0.2**
Employment				-0.4	1.5	-0.1	-2.3	**1.2**	**0.5**	**0.3**
Unemployment rate (a)				11.6	7.4	6.3	8.1	**7.3**	**6.9**	**6.6**
Compensation of employees / head				9.5	8.1	7.8	5.5	**7.1**	**5.0**	**6.7**
Unit labour costs whole economy				5.6	5.4	5.1	6.9	**3.4**	**0.4**	**2.9**
Real unit labour cost				0.7	1.5	2.5	7.0	**-0.1**	**-2.4**	**0.8**
Saving rate of households (b)				3.6	6.8	8.9	17.0	**20.9**	**14.8**	**14.7**
GDP deflator				4.8	3.9	2.6	-0.1	**3.5**	**2.9**	**2.0**
Harmonised index of consumer prices				3.8	2.6	2.7	0.1	**3.1**	**3.6**	**0.8**
Terms of trade goods				0.9	1.6	0.9	3.2	**-1.8**	**-1.9**	**-1.4**
Trade balance (goods) (c)				-15.0	-8.6	-8.6	-5.0	**-5.8**	**-7.3**	**-8.5**
Current-account balance (c)				-5.8	-0.2	-0.7	2.9	**1.1**	**-0.2**	**-1.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.0	1.6	0.8	4.7	**3.2**	**2.5**	**1.9**
General government balance (c)				-2.5	-0.8	-0.6	-4.5	**-9.5**	**-4.2**	**-2.0**
Cyclically-adjusted budget balance (d)				-2.5	-2.0	-1.4	-3.0	**-8.6**	**-4.0**	**-2.1**
Structural budget balance (d)				-1.3	-2.0	-1.4	-3.1	**-8.6**	**-4.0**	**-2.1**
General government gross debt (c)				28.8	37.1	36.7	43.2	**48.2**	**50.7**	**49.8**

(a) Eurostat definition. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.