10. LATVIA

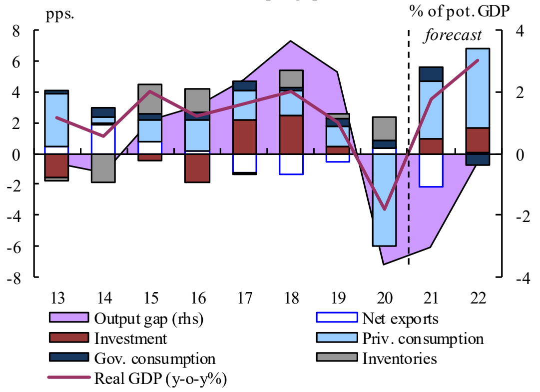
Economic growth is expected to recover in the second half of 2021 and in 2022 driven by private consumption and investment, notably public investments related to Rail Baltica and implementation of the Recovery and Resilience plan. The labour market is expected to improve accordingly, with labour shortages possibly resurfacing by the end of the forecast horizon. The government deficit is projected to further increase to almost 7¼% of GDP in 2021 due to temporary support measures, before narrowing to 2% by 2022.

Strong GDP rebound from a weak start in 2021

Real GDP contracted by 3.6% in 2020, as face-to-face services like tourism, hospitality and cultural services were massively affected by the COVID-19 restrictions. Other sectors of the economy were less affected by the temporary disruptions in the first half of 2020 and even expanded in 2020, as a whole. Private consumption declined by 10%, while investment remained at the 2019 level and exports of goods benefited from good harvests and demand for electric equipment.

In 2021, GDP growth is projected at 3.5% in 2021. The year started with high infection rates and tight restrictions, as the spread of COVID-19 surged towards the end of 2020. Real GDP contracted by 2.2% q-o-q in the first quarter, but should rebound in the following quarters. Private consumption has been supported by fiscal measures and is expected to recover once the restrictions are eased and pent-up demand is released. Investment will increase with improving business sentiment. Exports should benefit from a pick-up in external demand and the removal of travel restrictions. At the same time, domestic demand for durable goods and holidays abroad will increase imports.

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



The strong economic recovery in the second half of 2021 is set to contribute to GDP growth of 6.0% of GDP in 2022. By the third quarter of 2022 GDP is forecast to reach the level it was at the end of 2019. Private consumption growth is expected to increase on the back of the recovery in employment. Moreover, investment is set to benefit from strong private sector confidence and sizable EU funding inflows, including financing for the construction of Rail Baltica and from the Recovery and Resilience Facility. Exports of goods are expected to further increase in view of the strong demand in the main export markets, while recovery in services exports is projected to be more protracted – not reaching the pre-pandemic level over the forecast horizon.

Tighter labour market in the medium run

Employment declined by 2.3% in 2020 with large job losses in the affected labour-intensive service sectors. Labour demand is expected to rebound with the economic recovery over 2021 and 2022. The unemployment rate is estimated to move up to 8.2% in 2021 before declining below 7% in 2022. Wages increased by 5.3% in 2020, as companies retained and hired well-paid specialists, while low-wage workers faced job losses. Public sector wage increases and the higher national minimum wage will contribute to wage growth in 2021. Wage pressures are expected to mount in 2022 in view of labour supply constraints, but rehiring of low-wage earners should dampen the increase in the average wage.

Consumer price inflation was softened in 2020, relfecting declining energy prices and low service prices, in view of the weak demand. Higher energy and service prices over the forecast period are set to increase headline inflation to 1¾ % in 2021 and 2% in 2022.

Risks to the forecast are balanced. Delays in the roll-out of vaccinations in Latvia and in controlling the spread of the COVID-19 virus may delay the economic recovery. On the other hand, domestic demand could be stronger if the accumulated saving are reduced faster and the EU fund inflows generate stronger private investment dynamics.

Temporary support drives fiscal deficits

The government deficit increased to 4.8% of GDP in 2020. The deterioration was driven by the decline in tax revenue in line with falling consumption, job losses and by the adoption of emergency support measures adding up to 3½% of GDP. Those include deferred taxes, a part of which is unlikely to be collected, earlier tax refunds, social and employment support measures, higher spending for health and support for the crisis-affected sectors. Moreover, public investment spending was increased and the state increased its share capital in the strugling transport companies, mostly in the national airline.

In 2021, the government deficit is projected to further increase to 7¼% of GDP, as a result of additional support measures of around 3% of GDP adopted in response to the emergence of the high infection rates at the end of 2020. Wages and purchases in the healthcare sector are set to increase. Support for employees and businesses is notably increased compared to 2020, as well as investments, mostly in roads, have been expanded. A majority of these measures are expected to end by May or June 2021, while the implementation of some investment projects will extend into 2022.

In 2022, the deficit is projected to decrease to 2% of GDP, as the bulk of the temporary fiscal support introduced in 2020 and 2021 is set to end. Tax revenue ratio to GDP is projected to increase between 2019 and 2022, as a result of tax-increasing policy measures adopted in the budget for 2021. Moreover, large EU fund inflows are set to increase both government revenue and expenditure, including financing from the RRF at around 1% of GDP from 2022, as presented in the Stability Programme. Government expenditure is projected to be some 3 percentage points of GDP higher in 2022 than in 2019, also driven by higher social spending in line with indexations and policy changes, and by wage increases in the public sector, notably for healthcare workers.

The government debt-to-GDP ratio increased from 37% in 2019 to 43.5% in 2020, due to the government borrowing and the drop in GDP. The debt-to-GDP ratio is expected to reach around 47% in 2021, but to decline in 2022, on the back of the lower fiscal deficit and the rebound in GDP.

Table II.10.1:

Main features of country forecast - LATVIA

	2019		Annual percentage change						
mio EUR	**Curr. prices**	**% GDP**	**01-16**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP	30420.9	100.0	3.6	3.3	4.0	2.0	**-3.6**	**3.5**	**6.0**
Private Consumption	18092.2	59.5	3.9	3.0	2.6	2.2	**-10.0**	**6.5**	**8.9**
Public Consumption	5774.0	19.0	1.5	3.4	1.6	2.6	**2.6**	**4.8**	**-3.6**
Gross fixed capital formation	6758.4	22.2	3.0	11.4	11.8	2.1	**0.2**	**4.3**	**7.1**
of which: equipment	2456.5	8.1	2.9	9.3	3.9	2.2	**-2.2**	**2.8**	**3.5**
Exports (goods and services)	18317.1	60.2	6.9	6.4	4.3	2.1	**-2.7**	**6.5**	**6.1**
Imports (goods and services)	18572.3	61.1	6.2	8.6	6.4	3.0	**-3.3**	**10.2**	**6.0**
GNI (GDP deflator)	29990.5	98.6	3.6	3.2	2.6	2.3	**-2.1**	**2.3**	**5.9**
Contribution to GDP growth:	Domestic demand		4.0	4.6	4.3	2.2	**-5.4**	**5.6**	**6.0**
	Inventories		0.5	-0.1	1.1	0.3	**1.4**	**0.0**	**0.0**
	Net exports		-0.6	-1.3	-1.4	-0.5	**0.4**	**-2.1**	**0.0**
Employment			-0.3	0.0	1.5	-0.1	**-2.3**	**0.1**	**1.8**
Unemployment rate (a)			11.9	8.7	7.4	6.3	**8.1**	**8.2**	**6.9**
Compensation of employees / head			9.3	7.6	8.1	8.8	**5.3**	**3.9**	**4.3**
Unit labour costs whole economy			5.2	4.2	5.4	6.6	**6.7**	**0.5**	**0.2**
Real unit labour cost			0.5	1.2	1.4	4.2	**6.7**	**-1.7**	**-1.9**
Saving rate of households (b)			3.0	5.8	7.5	6.0	**16.5**	**15.1**	**9.2**
GDP deflator			4.7	3.0	3.9	2.3	**0.1**	**2.2**	**2.1**
Harmonised index of consumer prices			3.8	2.9	2.6	2.7	**0.1**	**1.7**	**2.0**
Terms of trade goods			0.9	0.9	1.6	0.9	**3.2**	**-0.8**	**0.1**
Trade balance (goods) (c)			-15.5	-9.1	-8.7	-8.8	**-5.0**	**-6.9**	**-7.2**
Current-account balance (c)			-6.4	1.3	-0.3	-0.6	**3.0**	**-0.4**	**-0.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-4.7	2.2	1.5	0.8	**4.7**	**1.6**	**2.3**
General government balance (c)			-2.5	-0.8	-0.8	-0.6	**-4.5**	**-7.3**	**-2.0**
Cyclically-adjusted budget balance (d)			-2.5	-1.7	-2.2	-1.6	**-3.2**	**-6.2**	**-1.9**
Structural budget balance (d)			-1.1	-1.7	-2.2	-1.6	**-3.3**	**-6.2**	**-1.9**
General government gross debt (c)			27.1	39.0	37.1	37.0	**43.5**	**47.3**	**46.4**

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