10. LATVIA

Latvia entered 2022 with a solid growth momentum, with consumption, investment and exports set for a strong showing. However, due to Latvia's relatively high exposure to trade with Russia, GDP growth is expected to slow to 2.0% in 2022. The impact will be felt both in terms of lost export revenue as well as in the rising prices of key raw material imports that will add to the inflation woes coming from the global commodity markets. In 2023, growth is expected to pick up to 2.9%, albeit still dampened by the impact of high inflation and the economic fallout from Russia's invasion of Ukraine. The general government deficit is expected to remain elevated at 7.2% of GDP in 2022, due to sizeable support to mitigate the impact of high energy prices and to ensure security of national energy supply, and to decline to 3.0% of GDP in 2023.

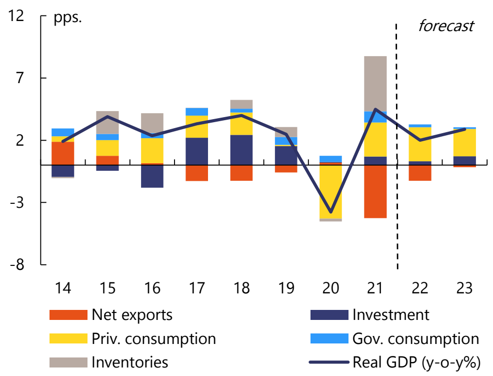
Strong growth momentum eroded by high inflation

In 2021, Latvia's economy grew by 4.5% surpassing its pre-pandemic level. However, the recovery has been uneven – while goods exports and public consumption spearheaded the recovery, household consumption remained subdued and exports of services remained significantly below their pre-crisis level. The employment recovery, while still solid, lagged somewhat behind that of GDP.

While Latvia was on course for another year of strong growth, driven by recovering household consumption and rapid growth in EU-funded investment, Russia's invasion of Ukraine has profoundly changed Latvia's growth prospects for both 2022 and 2023. The war's impact will play out through two main channels – a loss of trade and spiking prices. Latvia's exports to Russia and Belarus accounted for some 4.3% of GDP in 2021. While most of these exports are expected to dry up, the impact on GDP is set to be limited since a substantial part of them were re-exports with relatively low domestic value added. Additionally, disruptions of supply of metal and wood raw materials as well as of fertilisers, for all of which Russia is a major supplier to Latvia, is expected to add to already strong price pressures coming from energy. This is set to result in double digit price growth in industry and construction with expected knock-on effects on consumer prices in both 2022 and 2023. The high inflation and materials shortages are expected to dampen growth of investments and private consumption. Nevertheless, the latter is forecast to grow at a steady pace as it continues to recover from the impact of the COVID-19 restrictions. Consequently, real GDP is forecast to grow by 2.0% in 2022.

In 2023, growth is expected to pick up to 2.9% benefitting from solid growth in real disposable incomes, driven by solid wage and employment growth as well as increased inflows of EU funds. Exports are set to bounce back from the loss of the Russian market. However, with high price growth in many parts of the economy expected to persist and with the war impacting negatively on investment decisions and inbound tourism, growth is expected to remain subdued.

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



Labour market to remain tight

The recovery of the services sectors is expected to drive employment growth in 2022. However, once employment reaches its pre-pandemic level, further growth is expected to be limited by a structural decline in labour supply. People fleeing from Ukraine are expected to temporarily add to the labour supply and employment growth. However, since they are expected to stay for only a few months on average, their long-term impact on the labour market is set to be limited. The employment growth is, thus, set to ease in 2023. Nevertheless, the unemployment rate is set to continue declining due to the shrinking labour force. The tight labour market is set to drive rapid wage growth in both 2022 and 2023.

Energy and food prices set to drive a spike in inflation

Consumer price inflation is set to reach 9.4% in 2022, driven by rapid growth in energy and food prices. While global energy commodity price growth is expected to relent in spring 2023, the knock-on effects of rapid price growth in industry and construction are expected to drive consumer price inflation over the forecast horizon. While Latvia's intention to cease importing Russian gas as from 2023 is expected to keep energy prices at a high level for longer, they are expected to decrease in the second half of 2023. Nevertheless, combined with price growth in other components, inflation is set to average 3.5% in 2023.

Deficit to remain elevated in 2022

The government deficit reached 7.3% of GDP in 2021 and was mainly driven by the sizeable support to the economy during the COVID-19 pandemic.

In 2022, the government deficit is projected to remain at 7.2% of GDP. Main deficit-increasing measures for the 2022 budget include an increase in income tax allowance, a sizeable investment package and an increase in wages for employees in healthcare, investigation and border control, and education. Moreover, support to households and companies to mitigate the surge in energy prices, creation of a national energy supply security reserves as well as higher spending on defence and support to people fleeing Ukraine are set to ensure the deficit remains unchanged despite COVID-19 support measures being significantly lower in 2022 than in 2021.

Since most of the 2022 expenditure measures are expected to expire by end of the year, the government deficit in 2023 is projected to decrease to 3.0% of GDP. Key expenditure measures affecting the 2023 budget balance include some remaining COVID-19 support measures, like the purchase of vaccines, finalisation of public investment projects and support for companies to stimulate private investment, as well as increased spending in defence and support to the people fleeing Ukraine.

The forecast also incorporates expenditures financed by RRF grants, which are set to gradually increase from 0.4% of GDP in 2022 to 1.0% of GDP in 2023.

The debt-to-GDP ratio is expected to reach 47.0% in 2022 and to decrease in 2023 due to lower deficit.

Table II.10.1:

Main features of country forecast - LATVIA

		2021			Annual percentage change						
		mio EUR	Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP			32866.5	100.0	3.4	4.0	2.5	-3.8	**4.5**	**2.0**	**2.9**
Private Consumption			18027.4	54.9	3.7	3.0	0.2	-7.4	**4.8**	**5.0**	**3.8**
Public Consumption			6591.5	20.1	1.4	1.7	3.4	2.6	**4.4**	**1.1**	**0.7**
Gross fixed capital formation			7754.5	23.6	2.5	11.8	6.9	0.2	**2.9**	**1.3**	**2.8**
Exports (goods and services)			21058.0	64.1	6.8	4.5	2.1	-2.2	**6.2**	**1.3**	**4.1**
Imports (goods and services)			21740.6	66.1	5.7	6.4	3.0	-2.5	**13.5**	**3.2**	**4.0**
GNI (GDP deflator)			32823.4	99.9	3.3	2.6	2.6	-2.3	**4.4**	**1.9**	**2.7**
Contribution to GDP growth:	Domestic demand				3.7	4.5	2.3	-3.7	**4.3**	**3.3**	**3.0**
	Inventories				0.3	0.7	0.8	-0.2	**4.4**	**0.0**	**0.0**
	Net exports				-0.4	-1.3	-0.6	0.2	**-4.3**	**-1.3**	**-0.2**
Employment					-0.4	1.5	-0.1	-2.3	**-2.6**	**0.7**	**0.5**
Unemployment rate (a)					11.7	7.4	6.3	8.1	**7.6**	**7.3**	**7.1**
Compensation of employees / head					9.5	8.1	7.8	5.5	**11.0**	**5.6**	**6.0**
Unit labour costs whole economy					5.6	5.4	5.1	7.0	**3.5**	**4.2**	**3.5**
Saving rate of households (b)					3.6	6.8	8.9	17.0	**15.8**	**13.9**	**10.7**
GDP deflator					4.8	3.9	2.6	-0.1	**6.8**	**7.2**	**5.1**
Harmonised index of consumer prices					3.8	2.6	2.7	0.1	**3.2**	**9.4**	**3.5**
Terms of trade goods					0.9	1.6	0.9	3.2	**2.5**	**-3.1**	**1.5**
Trade balance (goods) (c)					-15.0	-8.6	-8.6	-5.1	**-7.4**	**-10.9**	**-9.9**
Current-account balance (c)					-5.8	-0.2	-0.7	2.9	**-0.5**	**-3.9**	**-3.2**
General government balance (c)					-2.5	-0.8	-0.6	-4.5	**-7.3**	**-7.2**	**-3.0**
Structural budget balance (d)					-1.3	-2.1	-1.5	-3.3	**-6.9**	**-6.6**	**-2.7**
General government gross debt (c)					28.8	37.1	36.7	43.3	**44.8**	**47.0**	**46.5**

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