LATVIA: Government backs households and enterprises to survive escalating energy prices

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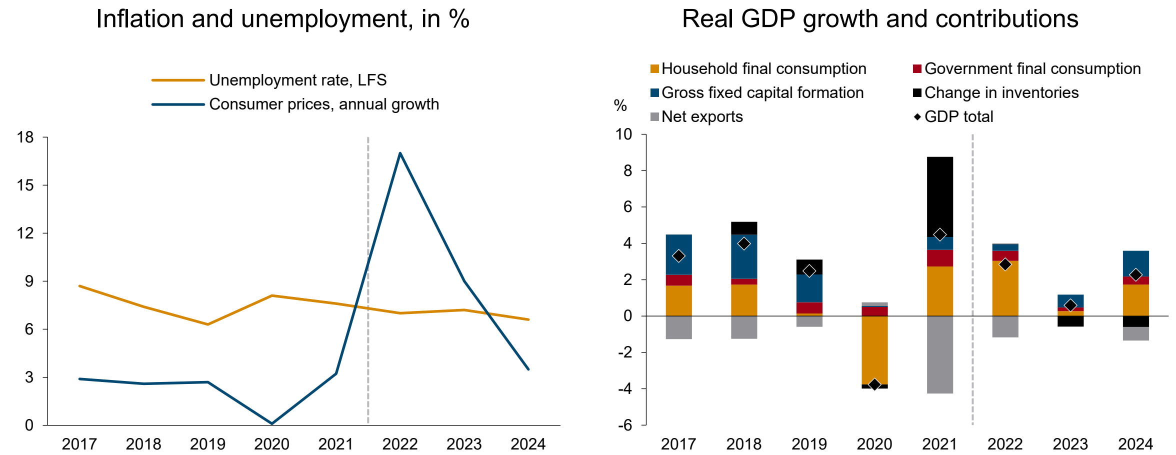
Although the boom continued in the first half of 2022, the Russian war in Ukraine will drag growth in Latvia down in the coming months. Almost all sectors will be affected by a substantial fall in demand growth and by escalating prices. Firms will largely refrain from investing, preferring to deplete their stocks. Moreover, the decline in the purchasing power of households will curb growth in consumption. However, the labour market will remain tight next year. For 2022, we still expect GDP growth to reach 2.9%, but it will then fall back to 0.6% in 2023. We expect a revival of GDP growth in Latvia to 2.3% in 2024 in line with the recovery in the EU.

Figure 6.11 / Latvia: Main macroeconomic indicators



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

Trade dynamics remained strong in the first half of 2022, but a substantial decline in growth is on the cards. Since economic activity remained upbeat in the EU, Latvian exports continued to grow satisfactorily. Moreover, the transport sector was able to profit from the most recent trade developments. Contrary to expectations, trade with Russia and Belarus remained relatively stable in the first half of the year, as the sanctions included wind-down periods. Thus, entrepreneurs in Latvia could still stock up on cheap inputs from Russia and Belarus, and this also resulted in the current account deficit reaching quite a high level. This was particularly on account of fertilisers, oil products, wood, and iron and steel products. In the following months, however, we started to see a sharp decline in imports and exports, reflecting the severance of economic ties. Although we expect imports to attenuate towards the end of the year, the current account deficit will attain 5.6% in 2022.

The reduction in Russian gas supplies to the West, as well as the war-induced disruption to Ukrainian exports, has resulted in escalating prices worldwide. Along with the other Baltic states, Latvia has been the worst affected of the EU countries by the recent commodity price increases. In August 2022, the consumer price index (CPI) soared by 21.5%. Inflation is being driven particularly by energy for heating and transport, but also by food products. We expect inflation to have peaked by the end of 2022, resulting in an average of 17% for the year. Thereafter, the price rises are set to moderate; however, the CPI will still hit 9% in 2023 and 3.5% in 2024.

Latvia imported heavily from Russia in previous years. However, the country has enough gas to last through the winter. Its gas storage facilities are adequately filled (also to serve the needs of its Baltic neighbours), and from the end of the year there will be access to liquefied natural gas (LNG) via the new Estonian terminal in the port of Paldiski. This has enabled parliament to pass an amendment to the energy law, banning Russian gas imports from January 2023.

Despite the projected rise in net wages of more than 10% in nominal terms in 2022, real wages will decline by about 6% on account of high inflation. The government has postponed a planned increase in the statutory minimum wage to January 2023. The Ministry of Welfare has proposed an increase of at least 28%, to EUR 640 a month. Because of this and the tightness of the labour market, we expect average real net wages to increase again by 2% in 2023 and by even more in 2024.

The labour market slack created over the past two years by the pandemic was taken up, and employment increased substantially in the first half of 2022. The number of jobs grew, particularly in manufacturing and the previously ailing hospitality sector. The share of job vacancies returned to its pre-COVID level and remained there in Q2 2022. The unemployment rate has continued to decline gradually over recent months. Although economic activity will stagnate next year, we expect unemployment to increase only a little in 2023. As elsewhere, refugees from Ukraine are welcome in Latvia. Up to end-September, more than 36,000 had arrived – a figure close to 2% of the Latvian population. Thanks to the favourable labour market conditions at the moment, about 25% of the refugees of working age have found a job in Latvia.

Investment will be further dampened both this year and next by the multiple uncertainties triggered by Russia's war with Ukraine. Confidence levels in all sectors – including construction and industry – fell throughout the year and even more markedly in September 2022. Even retail trade entrepreneurs – who until recently were anticipating favourable sales developments – have started to voice negative sentiments. After building up their stocks with cheap inputs and goods in the first half of the year, businesses have now started running down their stocks. Figures on the number of building permits granted show that investment in real estate will remain low in 2023. However, the budget of the Latvian government envisages a steep rise in public investment in infrastructure in 2023. The largest single project is Rail Baltica, which is now entering its construction phase.

The Latvian government has already applied a range of measures to contain the escalating energy prices and to support real household incomes. As far back as late autumn 2021, when energy prices started to climb, both vulnerable households with disabled people or children and people over the age of 60 started to receive monthly benefits of between EUR 15 and EUR 50 per target person. Moreover, the government defrays half of the standing charge for electricity distribution for all households. Moreover, above certain consumption levels it covers 50-90% of the energy price increase for households, businesses and other legal entities, such as educational or healthcare establishments. All these measures will apply until at least April 2023, and additional plans to subsidise large, energy-intensive companies are still under discussion. All in all, the measures agreed upon and enacted up to October 2022 add up to more than 4% of GDP, which is in the upper range of EU countries.

The government budget plan envisaged a substantial reduction in the deficit; however, the war in Ukraine and the energy price hike will keep it at a high level this year and next. The government has particularly boosted defence spending to 2.2% of GDP, and over the medium term – up to 2025 – an increase to 2.5% of GDP is planned. The reintroduction of compulsory military service for young men is in the pipeline: until now, Latvia has been the only Baltic state with a professional army. The first round of conscription is scheduled for January 2023. In view of the additional measures outlined above to support households and enterprises throughout the heating season, the deficit will amount to 6.5% in 2022 and will still be 4% in 2023. Thereafter, the plan is to reduce it again to 2% of GDP.

As expected, the general election (on 1 October 2022) resulted in yet another sweeping change in the composition of parliament. The four strongest parties from the last election (2018) suffered a dramatic decline in voter support or else have split, so they are no longer represented in parliament. Among them is the social-democratic Harmony party, which used to be strongly backed by Russian-speaking Latvians. Those voters seem to have switched to the For Stability! party, which was founded just a year ago. Prime Minister Kariņš is likely again to lead a transformed coalition government: the election brought strong gains for his conservative people's party New Unity, which used to be led by Valdis Dombrovskis, who was prime minister for several years but, since 2017, has been an EU Commissioner. PM Kariņš has several new potential partners for his coalition to choose from on the conservative-to-populist spectrum. We expect the new government to follow the path of economic policies already pursued by the previous one.

Following a release of pent-up demand in the first half of 2022, retail figures show that private consumption started to drop off in the summer. The strong decline in real incomes caused by escalating prices will result in a reduction in household consumption in the second half of this year and stagnation in 2023. A rebound is only expected in 2024.

All in all, we have revised our forecast for GDP growth in 2022 upwards – from 2.1% in the summer to 2.9% now. According to the baseline scenario, GDP growth will almost stagnate in 2023, reaching only 0.6%, but will revive to 2.3% in 2024. This scenario assumes a strong willingness on the part of EU actors to cushion the economic effects of the crisis through fiscal policies.

Table 6.11 / Latvia: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	1,914	1,900	1,884	.	.	1,870	1,855	1,840
Gross domestic product, EUR m, nom.	30,647	29,457	32,867	14,988	17,656	39,500	43,300	45,800
annual change in % (real)	2.5	-3.8	4.5	5.0	4.7	2.8	0.6	2.3
GDP/capita (EUR at PPP)	21,700	20,990	23,010	.	.	.	.	.
Consumption of households, EUR m, nom.	17,435	16,413	17,803	8,191	10,175	.	.	.
annual change in % (real)	0.2	-6.6	4.9	2.0	11.4	5.6	0.5	3.2
Gross fixed capital form., EUR m, nom.	7,102	7,217	7,755	3,151	3,610	.	.	.
annual change in % (real)	6.9	0.2	2.9	4.3	2.4	1.5	3.0	6.0
Gross industrial production 2)								
annual change in % (real)	0.9	-1.5	6.7	8.1	4.2	2.0	-0.5	4.5
Gross agricultural production								
annual change in % (real)	23.4	2.7	-7.1	.	.	.	.	.
Construction industry								
annual change in % (real)	2.9	2.7	-6.1	-4.7	-11.6	.	.	.
Employed persons, LFS, th, average 3)	910.0	893.0	869.5	862.5	882.3	887	891	895
annual change in %	0.1	-1.9	-3.0	-4.1	2.3	2.0	0.5	0.5
Unemployed persons, LFS, th, average 3)	61.3	78.7	70.6	74.1	65.4	67	69	63
Unemployment rate, LFS, in %, average 3)	6.3	8.1	7.6	8.0	7.0	7.0	7.2	6.6
Reg. unemployment rate, in %, eop 4)	6.2	7.7	6.7	7.4	5.9	.	.	.
Average monthly gross wages, EUR	1,076	1,143	1,277	1,235	1,330	1,400	1,560	1,660
annual change in % (real, gross)	4.2	6.0	8.2	9.9	-4.6	-6.0	2.0	3.0
Average monthly net wages, EUR	793	841	939	911	974	1,030	1,130	1,200
annual change in % (real, net)	3.9	5.8	8.1	9.9	-5.3	-6.5	1.0	2.5
Consumer prices (HICP), % p.a.	2.7	0.1	3.2	1.1	12.8	17.0	9.0	3.5
Producer prices in industry, % p.a.	1.8	-2.2	13.4	4.9	31.0	32.0	7.0	0.0
General governm. budget, EU def., % of GDP								
Revenues	37.6	38.8	37.6	.	.	41.0	38.0	37.0
Expenditures	38.2	43.3	45.0	.	.	47.5	42.0	39.0
Net lending (+) / net borrowing (-)	-0.6	-4.5	-7.3	.	.	-6.5	-4.0	-2.0
General gov. gross debt, EU def., % of GDP	36.7	43.3	44.8	.	.	45.0	46.0	44.0
Stock of loans of non-fin. private sector, % p.a.	-1.4	-3.8	3.2	-1.4	5.6	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.1	3.1	2.5	3.2	2.2	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-177	790	-1,415	-980	-1,554	-2,200	-1,500	-1,500
Current account, % of GDP	-0.6	2.7	-4.3	-6.5	-8.8	-5.6	-3.5	-3.3
Exports of goods, BOP, EUR m	12,761	13,440	16,194	7,233	9,588	21,000	22,900	24,500
annual change in %	1.4	5.3	20.5	16.9	32.6	29.7	9.0	7.0
Imports of goods, BOP, EUR m	15,400	14,991	18,968	8,606	11,749	25,400	27,000	28,600
annual change in %	2.1	-2.7	26.5	23.2	36.5	33.9	6.3	5.9
Exports of services, BOP, EUR m	5,589	4,706	5,193	2,288	3,095	6,100	6,700	7,200
annual change in %	4.9	-15.8	10.3	1.9	35.3	17.5	9.8	7.5
Imports of services, BOP, EUR m	3,152	2,861	3,573	1,546	2,126	3,900	4,300	4,700
annual change in %	4.3	-9.2	24.9	14.7	37.5	9.2	10.3	9.3
FDI liabilities, EUR m	1,000	816	3,183	1,001	479	2,000	.	.
FDI assets, EUR m	80	168	2,338	-47	-392	500	.	.
Gross reserves of CB excl. gold, EUR m	3,700	3,982	4,504	4,124	4,285	.	.	.
Gross external debt, EUR m	35,803	36,751	36,834	36,342	38,290	39,500	41,100	41,200
Gross external debt, % of GDP	116.8	124.8	112.1	110.6	96.9	100.0	95.0	90.0

1) Preliminary. - 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 unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

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