LATVIA: Government ready to bear the high cost of cutting economic ties with Russia

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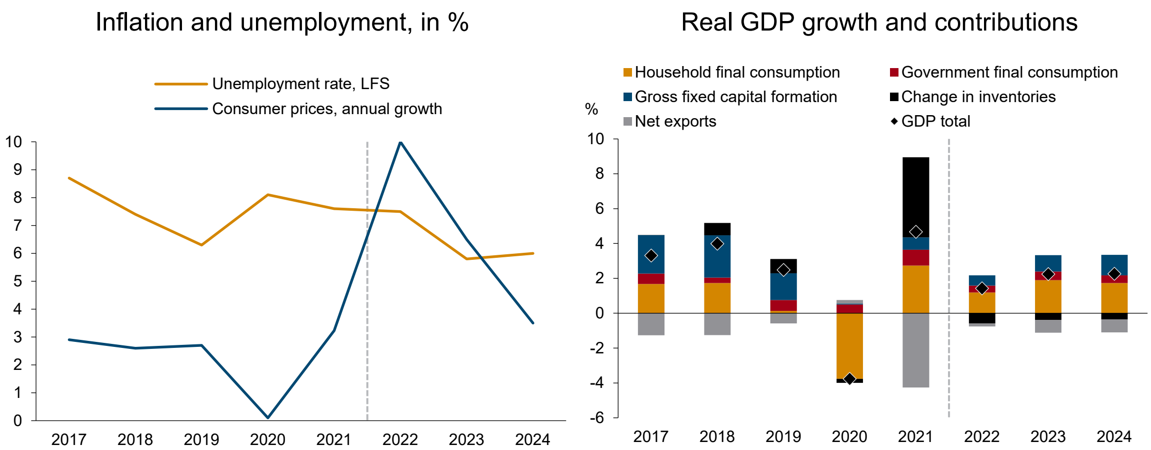
The Russian war in Ukraine will substantially drag down growth in the small, open economy of Latvia. Almost all sectors will be affected by a fall-off in demand and escalating prices. The influx of Ukrainian refugees (accounting for 0.5% of the Latvian population) may even induce additional consumption in the short run. In these uncertain times, enterprises will largely refrain from investment, preferring to deplete their stocks and wait for the price rises to stabilise. In 2022, we expect GDP growth to fall to 1.4%, but then to recover somewhat, to 2.2% in 2023. Our main scenario assumes no substantial intensification of economic sanctions. Later, we would expect a stabilisation of GDP growth in Latvia at 2.3% in 2024.

Figure 4.11 / Latvia: Main macroeconomic indicators



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

Following its collapse in 2020, trade bounced back strongly last year, and particularly in the latter half of 2021. The disruptions caused by the war will have a powerful effect on the Latvian economy via the trade channel. While trade with Ukraine and Belarus alike accounts for only a little more than 1% of Latvia's total trade, Russia remains an important trade partner. As well as 11% of Latvian exports, a further 7% of goods of Latvian origin found their way there in 2021. Thus, particularly the food, machinery and electronics industries, chemicals, plastics and textiles will suffer from the slump in Russian demand. In the case of imports, obviously all manner of energy products are dominant, including electricity. However, iron and steel, fertilisers and wood are also important inputs for Latvian production, and these will be costly to replace. The linkages between the neighbouring economies via foreign direct investment (FDI) are fairly weak. Nevertheless, over the past five years about 10% of

Latvia's FDI inward stock has stemmed from Russia. Investors have been particularly active in trade, real estate, energy and manufacturing. As for direct investment in Russia, Latvian entrepreneurs have been active in trade and financial and insurance activities. Given the war-induced shocks, which are aggravating price rises of the sort not seen since the 1970s, we predict a deterioration in external demand growth. However, Latvian consumers and producers are also reluctant to spend. Thus, we should not expect the current account deficit to grow by too much in 2022.

Contrary to speculation in the international press, the Latvian economy is not able to abandon Russian gas immediately; but the government is likely to ban such gas imports by June 2023. Last year, 90% of the country's natural gas came from Russia; however, substitutes can be delivered via the liquefied natural gas (LNG) terminal at Klaipėda in Lithuania. However, it does not have the capacity to supply both of its neighbouring Baltic states (i.e. Latvia and Estonia) with sufficient gas. Therefore, the Latvian government joined Estonia and Finland in order to install another terminal at Paldinski on the coast of Estonia. The project ensures additional gas supplies to the region already for the coming heating season this winter.

Investment development will be dampened this year by the multiple uncertainties triggered by Russia's war against Ukraine. Confidence levels in the construction and service sectors, as well as in industry, fell markedly in March 2022. Only retail trade entrepreneurs still expect sales to hold up. Supply difficulties and escalating prices alike will induce entrepreneurs to run down their stocks, and to revise and postpone their investment plans. However, the budget of the Latvian government envisages a big rise in public investment this year of more than 8%. The largest single project is Rail Baltica – the high-speed rail track linking the Baltic states with Warsaw and Berlin – which is now entering its construction phase. The railway line is planned to commence operations in 2026.

Yet again, for another year, average employment fell against expectations in 2021. Nevertheless, there was a marked rise in vacancies in the second half of the year. Still, substantially lower numbers of jobs are being recorded in construction and transport, accommodation and hospitality, and manufacturing. Following the money-laundering scandal that erupted in the Latvian banking sector in 2018, employment in financial services has gradually declined in recent years. The effects of the overall fall in employment were still being cushioned in 2021 by the short-time work schemes introduced by the government. The unemployment rate has also declined gradually over recent months. However, we expect no recovery on the labour market this year and the unemployment rate to decline to 6% only in 2024. As elsewhere, refugees from Ukraine are welcome in Latvia, although up to mid-April their number was still relatively low: 13,000, which corresponds to about 0.5% of the Latvian population. Thanks to an EU directive adopted at the beginning of March, the refugees have direct access to the labour market and are provided with education and childcare, housing and health care.

The Latvian government's budget envisaged a substantial reduction in the deficit; but instead of another year of strong recovery, 2022 will see a slowdown in GDP growth. This has already resulted in additional unanticipated expenditure: a support package for low-income households to cushion the energy price rises. Moreover, the government has agreed to gradually increase spending on defence to 2.5% of GDP by 2025. The parliamentary elections scheduled for the end of the year will encourage the government to support economic activity and households, in order to win the approval of voters. This year, employees in health care, education and the so-called 'interior sector' (which includes the police and other emergency services, etc.) have received a wage increase, while the tax wedge for low earners is being reduced.

Opinion polls suggest that the elections (on 1 October 2022) will result in yet another big change in the composition of parliament. The most important left-wing party, which is strongly backed by Russian-speaking Latvians, has lost much of its support. Meanwhile, the revival of New Unity, a conservative people’s party, looks to be on the cards. It was formerly led by Valdis Dombrovskis, who was prime minister for several years but, since 2017, has been an EU Commissioner. The second and the third-largest parties in the 2018 elections, which both had populist programmes, are expected to be no longer represented in parliament, while the conservative and right-wing spectrum will gain support.

Following a deflationary period at the beginning of 2021, consumer prices started to pick up in Q2 2021 – and have not stopped since. Energy products have pushed up the costs of housing and transport; however, of late it is food products that have been the single biggest driver of the consumer price index (CPI). We expect inflation to peak around mid-2022 and to reach 10% on average this year. Thereafter, price rises are set to moderate, as the CPI declines to 6.5% in 2023 and 3.5% in 2024.

After a big increase in real wages of more than 8% in 2021, income will almost stagnate on account of the price rises this year. At the same time, of all the countries in the EU only Bulgaria has a lower minimum wage level than Latvia. Consequently, income inequality and poverty in Latvia are among the highest in the EU. We expect a substantial increase in the minimum wage from 2023. Also, the growth of average wages should return to 3% annually.

In its latest report Economic Survey of Latvia, published this March, the Organisation for Economic Co-operation and Development (OECD) points out that if the country wants to narrow the welfare gap vis-à-vis its EU peers, it should not only strive for investment in skills and innovation. Yet, it should increase public spending on health, active labour market policies, housing and long-term care – some of the areas where Latvia spends far less than the OECD average.

Until recently retail trade figures showed that households were eager to spend the income they had saved during the lockdown periods. However, the escalating prices will result in a decline in real incomes. Since housing, transport and food cannot easily be substituted, households will have to spend more cautiously on other goods. In our main scenario, we expect growth in private consumption to halve in 2022, compared to last year. Nevertheless, we would expect sales to rebound in 2023 and household consumption to become again an important driver of growth.

All in all, for obvious reasons we have had to revise our forecast for GDP growth in 2022 significantly downwards – from 4.3% in January to 1.4% now. International trade is losing momentum, due to the loss of a great deal of exports to Russia, Belarus and Ukraine, a slump in the economic activity of trade partners generally, and substantially rising prices not only for energy products, but also for other imported inputs. The overall increase in uncertainty will dampen private investment, while public investment will remain an important driver of growth. Household incomes will suffer from escalating prices in 2022; thus, consumption will remain subdued this year, but will pick up in 2023 and thereafter. The unemployment rate will remain stagnant this year and start to fall again only from 2023, declining to 6% in 2024. Our main scenario assumes the gradual containment of Russian hostilities and a strong willingness on the part of EU actors to cushion the economic effects of the crisis through fiscal and monetary policies. In this scenario, GDP growth will pick up gradually to 2.2% in 2023 and 2.3% in 2024.

Table 4.11 / Latvia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	1,927	1,914	1,900	1,883	1,870	1,855	1,840
Gross domestic product, EUR m, nom.	29,154	30,647	29,457	32,923	36,700	40,000	42,300
annual change in % (real)	4.0	2.5	-3.8	4.7	1.4	2.2	2.3
GDP/capita (EUR at PPP)	20,950	21,700	20,990	23,070	.	.	.
Consumption of households, EUR m, nom.	16,884	17,435	16,413	17,803	.	.	.
annual change in % (real)	2.9	0.2	-6.6	4.9	2.2	3.5	3.2
Gross fixed capital form., EUR m, nom.	6,449	7,102	7,217	7,755	.	.	.
annual change in % (real)	11.8	6.9	0.2	2.9	2.5	4.0	5.0
Gross industrial production 2)							
annual change in % (real)	1.5	0.9	-1.5	6.7	5.0	4.0	5.0
Gross agricultural production							
annual change in % (real)	-9.0	23.4	2.7	-7.1	.	.	.
Construction industry							
annual change in % (real)	21.8	2.9	2.7	-6.1	.	.	.
Employed persons, LFS, th, average 3)	909.4	910.0	893.0	869.5	870	874	877
annual change in %	1.6	0.1	-1.9	.	0.1	0.5	0.3
Unemployed persons, LFS, th, average 3)	72.8	61.3	78.7	70.6	71	54	56
Unemployment rate, LFS, in %, average 3)	7.4	6.3	8.1	7.6	7.5	5.8	6.0
Reg. unemployment rate, in %, eop 4)	6.4	6.2	7.7	6.7	.	.	.
Average monthly gross wages, EUR	1,004	1,076	1,143	1,277	1,430	1,570	1,690
annual change in % (real, gross)	5.7	4.2	6.0	8.2	1.5	3.0	4.0
Average monthly net wages, EUR	742	793	841	939	1,040	1,140	1,220
annual change in % (real, net)	7.0	3.9	5.8	8.1	1.0	2.5	3.5
Consumer prices (HICP), % p.a.	2.6	2.7	0.1	3.2	10.0	6.5	3.5
Producer prices in industry, % p.a.	4.3	1.8	-2.2	13.4	12.0	5.0	1.0
General governm. budget, EU def., % of GDP							
Revenues	38.5	37.6	38.7	37.0	39.0	38.0	37.0
Expenditures	39.3	38.2	43.2	44.3	44.5	41.5	39.0
Net lending (+) / net borrowing (-)	-0.8	-0.6	-4.5	-7.3	-5.5	-3.5	-2.0
General gov. gross debt, EU def., % of GDP	37.1	36.7	43.3	45.0	47.0	46.0	44.0
Stock of loans of non-fin. private sector, % p.a.	-5.2	-1.4	-3.8	3.2	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	5.1	3.1	2.5	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-60	-203	845	-940	-1,400	-750	-850
Current account, % of GDP	-0.2	-0.7	2.9	-2.9	-3.8	-1.9	-2.0
Exports of goods, BOP, EUR m	12,588	12,761	13,428	16,241	18,500	20,500	22,000
annual change in %	8.3	1.4	5.2	20.9	13.9	10.8	7.3
Imports of goods, BOP, EUR m	15,108	15,403	14,917	18,680	21,800	23,800	25,500
annual change in %	7.4	2.0	-3.2	25.2	16.7	9.2	7.1
Exports of services, BOP, EUR m	5,336	5,577	4,375	4,817	5,500	6,100	6,500
annual change in %	6.9	4.5	-21.6	10.1	14.2	10.9	6.6
Imports of services, BOP, EUR m	3,019	3,151	2,541	3,062	3,600	3,900	4,200
annual change in %	11.2	4.4	-19.4	20.5	17.6	8.3	7.7
FDI liabilities, EUR m	373	975	820	4,581	.	.	.
FDI assets, EUR m	-269	78	166	2,922	.	.	.
Gross reserves of CB excl. gold, EUR m	3,578	3,700	3,982	4,504	.	.	.
Gross external debt, EUR m	35,942	35,802	36,775	36,816	40,400	42,000	42,300
Gross external debt, % of GDP	123.3	116.8	124.8	111.8	110.0	105.0	100.0

1) Preliminary and wiiw estimates. - 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 from 2018 also including loans unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

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