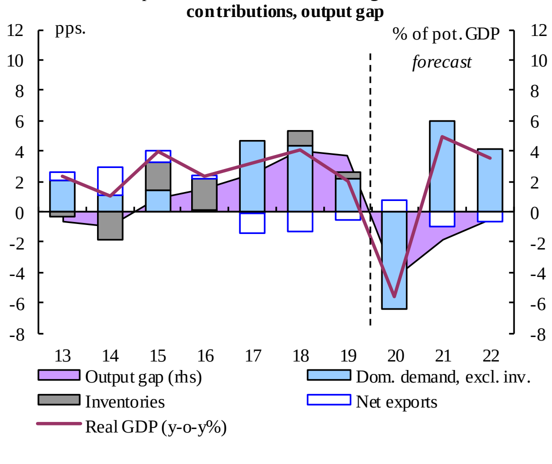
10. LATVIA

Latvia's GDP is projected to decline by 5½% in 2020 with consumption and exports set to decline the most. It is expected to recover most of the lost ground in 2021 thanks to a rebound in consumption and private investment. Growth should remain solid in 2022 at around 3½%. The government deficit is projected to reach 7½% of GDP in 2020 due to support measures and a drop in tax revenue. It is projected to narrow to 3% by 2022 as government revenues recover.

First half of the year was less dire than feared

In the second quarter of 2020, Latvia's seasonally-adjusted GDP was 9.2% lower than it was in the last quarter of 2019. Private consumption and exports suffered the most as consumers refrained from shopping both domestically and abroad. Employment declined only by 4.2% partly thanks to cushioning provided by a government-sponsored furlough scheme. The spread of the virus and the containment measures were milder in Latvia than in most other EU countries, helping the economy to mount a quick comeback with retail and industrial activity recording year-on-year growth already in May. However, non-retail services remained well below pre-pandemic levels throughout summer.

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



Consumption and investment to drive recovery

GDP is expected to recover fairly rapidly in the second half of 2020 leading to an annual decline of 5½%. The start of the 2021 is expected to remain slow due to ongoing restrictions and unfavourable trade conditions, but improved consumer sentiment, limited employment losses and relatively mild containment measures will all contribute to a V-shaped consumption pattern over the course of 2020. Consumption should strengthen in 2021 and 2022 as consumers draw down on accumulated savings, providing an extra boost to already buoyant consumer spending. Moreover, investment is set to benefit from strong private sector confidence and the construction of Rail Baltica, which should start at the end of this year. Exports are likely to take longer to recover as Latvia's principal export markets are forecast to follow a flatter recovery path and travel-dependent services exports are not expected to reach pre-crisis levels over the forecast horizon. All in all, GDP is forecast to grow by close to 5% in 2021, which should bring it almost back to where it was at the end of 2019, and by 3½% in 2022. This forecast does not include any measures funded by the Recovery and Resilience facility grant.

Slightly positive employment growth expected

Employment is expected to decline by some 3% this year and record a slight growth in both 2021 and 2022 as construction jobs compensate for the struggling services sector. At the same time, the ongoing decline in labour supply that dominated labour market dynamics before the crisis will increasingly be felt as the recovery gets going and will constrain the potential for employment growth.

Headline inflation is set to slow in 2020 due to weak demand and declining energy prices. In 2021, food and services prices are expected to drive inflation to around 1½%. In 2022, inflation is expected to recover close to the 2% mark.

The risks to the forecast are balanced. The recovery in 2020 could be swifter than assumed in our baseline scenario and a possibility of stimulus coming from public investment, in particular from the Recovery and Resilience Facility, may spur private investment in 2021 and 2022. On the other hand, the recent rise in infection rates could affect the recovery path over the coming quarters, impacting on demand and confidence.

Government deficit set to peak in 2020 before declining in 2021 and 2022

The government deficit is expected to increase from 0.6% of GDP in 2019 to 7½% of GDP in 2020. The sharp worsening is driven by the economic downturn and temporary stimulus measures. The drop in tax revenue broadly reflects the decline in consumption and the loss of jobs, while overall revenues to September 2020 have been stronger than expected in the spring forecast. Government spending has increased due to the measures adopted in response to the COVID-19 pandemic and due to higher unemployment spending. The overall impact of the measures is estimated at around 4% of GDP. Deferred taxes, which are unlikely to be collected, and earlier tax refunds cost some 0.5% of GDP. Social and employment support measures amount to 0.5% of GDP and support for certain sectors and provisions for loan guarantees are estimated at 3% of GDP.

In 2021, the government deficit is projected to narrow to 3½% of GDP, as most of temporary measures are scheduled to cease. The budget for 2021 presents new revenue and expenditure-increasing measures, with a broadly neutral effect on the government balance. The social security contribution rate is reduced by 1 percentage point (-0.3% of GDP) and the application threshold for income tax allowance is increased (-0.1% of GDP). An introduction of a minimum mandatory social contribution and an increase in the micro enterprise tax is forecast to yield 0.3% of GDP. The state energy company is expected to pay higher dividends worth 0.3% of GDP. Wage increases for health workers and a rise in minimum social benefits account for most of the expenditure growth.

In 2022, the deficit is projected to narrow further to just over 3% of GDP, under a no-policy change assumption. Tax revenue should grow broadly in line with GDP, with some positive effect from measures adopted in 2021. Expenditure growth will be mostly driven by further increases in public sector wages and social benefits.

The government debt-to-GDP ratio is expected to increase from 37% in 2019 to 47½% in 2020, mostly due to the large government deficit and the drop in GDP. The debt ratio is set to decline in 2021 and 2022, as the economy recovers and government borrowing shrinks, and thanks to a partial reduction in large cash resources, which were accumulated in 2019 and 2020.

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	30463.3	100.0	3.6	3.3	4.0	2.1	**-5.6**	**4.9**	**3.5**
Private Consumption	18092.2	59.4	3.8	3.0	2.6	2.2	**-11.4**	**8.5**	**4.8**
Public Consumption	5807.3	19.1	1.5	3.4	1.6	2.6	**2.9**	**3.0**	**2.0**
Gross fixed capital formation	6758.4	22.2	3.0	11.4	11.8	2.1	**-0.8**	**2.6**	**4.6**
of which: equipment	2456.5	8.1	2.9	9.3	3.9	2.2	**-4.0**	**3.0**	**5.3**
Exports (goods and services)	18317.1	60.1	6.9	6.4	4.3	2.1	**-7.5**	**4.2**	**4.0**
Imports (goods and services)	18572.3	61.0	6.2	8.6	6.4	3.0	**-8.6**	**6.0**	**5.2**
GNI (GDP deflator)	30032.9	98.6	3.6	3.2	2.6	2.3	**-4.1**	**4.9**	**3.5**
Contribution to GDP growth: Domestic demand			3.9	4.6	4.3	2.2	**-6.4**	**5.9**	**4.2**
Inventories			0.5	-0.1	1.1	0.4	**0.0**	**0.0**	**0.0**
Net exports			-0.6	-1.3	-1.4	-0.5	**0.7**	**-1.0**	**-0.7**
Employment			-0.3	0.0	1.5	-0.1	**-3.2**	**0.4**	**0.8**
Unemployment rate (a)			11.9	8.7	7.4	6.3	**8.3**	**8.0**	**7.5**
Compensation of employees / head			9.3	7.6	8.1	8.8	**3.1**	**3.7**	**3.6**
Unit labour costs whole economy			5.2	4.2	5.4	6.5	**5.8**	**-0.8**	**0.9**
Real unit labour cost			0.5	1.2	1.4	4.0	**4.7**	**-2.0**	**-0.5**
Saving rate of households (b)			3.0	5.8	7.5	6.0	**20.3**	**14.2**	**12.0**
GDP deflator			4.7	3.0	3.9	2.4	**1.0**	**1.3**	**1.4**
Harmonised index of consumer prices			3.8	2.9	2.6	2.7	**0.3**	**1.3**	**1.8**
Terms of trade of goods			0.9	0.9	1.6	0.9	**2.1**	**-0.5**	**-1.0**
Trade balance (goods) (c)			-15.5	-9.1	-8.7	-8.8	**-6.5**	**-7.7**	**-8.6**
Current-account balance (c)			-6.4	1.3	-0.3	-0.6	**2.3**	**1.2**	**0.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-4.7	2.2	1.5	0.8	**3.3**	**2.7**	**1.6**
General government balance (c)			-2.5	-0.8	-0.8	-0.6	**-7.4**	**-3.5**	**-3.3**
Cyclically-adjusted budget balance (d)			-2.4	-1.7	-2.3	-2.0	**-5.7**	**-2.8**	**-3.1**
Structural budget balance (d)			-	-1.7	-2.3	-2.2	**-5.7**	**-2.8**	**-3.1**
General government gross debt (c)			27.1	39.0	37.1	36.9	**47.5**	**45.9**	**45.5**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.