



LATVIA

Highlights

- **The economy is recovering after a moderate decline in 2020.** Following a gross domestic product (GDP) drop of 3.6 per cent in 2020, the economy has started a solid recovery in 2021 towards pre-Covid-19 crisis levels, mainly due to improvements in the manufacturing and services sectors.
- **The European Union (EU)'s Recovery and Resilience Facility (RRF) plan for Latvia reflects the government's reform priority areas.** The €1.8 billion plan foresees not only investments to improve energy efficiency and sustainable mobility, but also a broad digital transformation of business and administration, along with reduced regional socio-economic disparities.
- **The Economic Affairs Court has been established to help improve the business environment and reduce the shadow economy.** The newly constituted court, which began operating in March 2021, is the first specialised court in Latvia with jurisdiction including certain civil matters and economic, financial and corruption cases.

Key priorities for 2022

- **A strategy to sustainably reduce the fiscal deficit is needed.** Following recovery from the Covid-19 crisis, the level of general government debt should not exceed 50 per cent of GDP. However, the medium-term strategy of a return to budgetary prudence should not be at the expense of important planned investments in key sectors.
- **Further strengthening of absorptive capacities is needed for successful RRF implementation.** Along with the structural reforms and proposed implementation plan, it is necessary to improve the public expenditure process and continue with advancing public procurement transparency to absorb the funds effectively.
- **The government should continue to promote innovation.** The innovation capacity of the private sector should be strengthened by targeted policy incentives, such as increasing digital capacities or facilitating access to capital markets.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.3	4.0	2.5	-3.6	4.5
Inflation (average)	2.9	2.6	2.7	0.1	2.4
Government balance/GDP	-0.8	-0.8	-0.6	-4.5	-8.6
Current account balance/GDP	0.7	-0.3	-0.6	2.9	-1.0
Net FDI/GDP [neg. sign = inflows]	-2.0	-2.2	-2.9	-2.2	-1.7
External debt/GDP	142.3	123.7	117.7	125.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	43.5	38.0	36.6	35.6	n.a.

Covid-19: macroeconomic implications

The first half of 2021 saw a recovery in economic activity. Latvia recorded a milder GDP decline in 2020 than the EU average. The effects of the Covid-19 pandemic were mitigated by stable exports to Nordic trading partner countries and the country's relatively limited dependence on tourism. Intensified containment measures at the end of 2020 slowed the economy, but the recovery of the manufacturing and services sectors, as well as consumption, in the second quarter of 2021 contributed to GDP growth in the first half of the year of 5.2 per cent year-on-year. In the second quarter of 2021 industrial production increased by 2.4 per cent quarter-on-quarter, surpassing pre-Covid-19 crisis levels, while the manufacturing and energy sectors have been recovering from the beginning of the year. An additional positive signal comes from data on retail trade turnover, which from May 2021 exceeded comparable 2019 levels.

The labour market still shows the impact of the Covid-19 pandemic, but wages are rising. The unemployment rate peaked at 8.8 per cent in July 2020, falling marginally to 7.9 per cent by the second quarter of 2021. The real growth of the average wage in 2020 amounted to 9.0 per cent, and the increase in the minimum wage from the beginning of 2021 and the recovery of economic activities is contributing to further wage growth and inflationary pressures.

To stimulate economic recovery, the fiscal deficit is likely to remain elevated this year. Due to the temporary support measures introduced when the Covid-19 pandemic struck, the general government deficit in 2020 reached 4.5 per cent of GDP, interrupting a track record of budgetary prudence in recent years. The gross public debt level increased to 43.2 per cent of GDP, above the relatively stable pre-Covid-19 crisis level of 37.0 per cent of GDP. As the government still needs to allocate additional expenditures for economic recovery in 2021, the fiscal deficit is likely to be close to 9.0 per cent of GDP in 2021 before declining sharply in 2022.

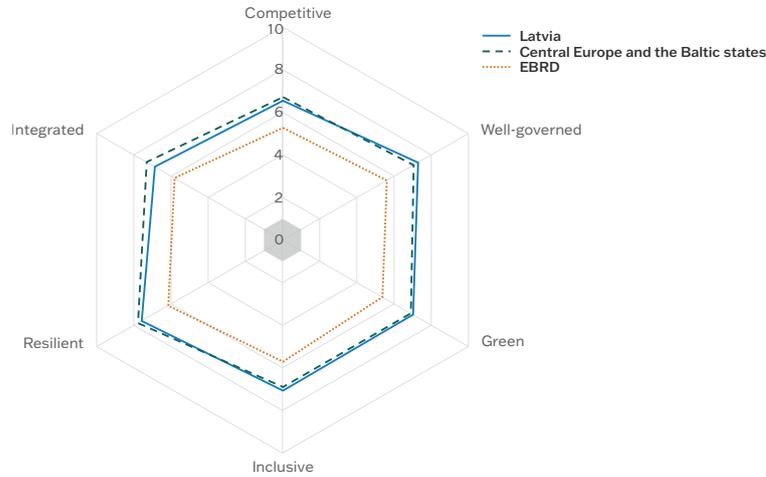
Short-term growth prospects are favourable, but vaccine hesitancy is a risk. EU funds, especially through public sector investments, are likely to add to the GDP growth rate in 2021, which is expected to be 4.5 per cent. In 2022, GDP growth is likely to accelerate to 5.5 per cent. However, compared with the EU average, Latvia was relatively resistant to vaccination against Covid-19, but the vaccination rate improved by the end of October, with 62 per cent of people receiving at least one dose of the jab. A lack of herd immunity creates a risk of new lockdowns, as temporarily reintroduced in October 2021, aggravated by potential new variants of the virus.

Policy response to Covid-19

The government's policy response to Covid-19 prevented major disruptions to the economy. With stimulus packages implemented in 2020 that amounted to around 7 per cent of GDP, Latvia has managed to support its health system and compensate for losses in vulnerable sectors, for example, through coverage of 75 per cent of the cost of workers' downtime. Most support was directed towards loans and guarantees for businesses. Due to market shocks, the European Central Bank and Latvia's financial sector supervisor granted banks forbearance measures; using liquidity and capital buffers, banks could therefore support businesses and households through the Covid-19 pandemic. A loan payment moratorium up to 12 months for firms and individuals was valid until the end of 2020.

The 2021 budget is providing further support for the post-Covid-19 recovery. In December 2020 parliament adopted the 2021 budget, which assumed a €744 million increase in expenditures compared with 2019. The largest share of increased budgetary funding has been directed to healthcare, including increased wages for healthcare workers, a guaranteed minimum income and an increase in the minimum pension and state social insurance benefit. Following a budget revision in the middle of 2021, the Finance Ministry now expects the budget deficit to be smaller than expected.

Assessment of transition qualities (1-10)



Structural reform developments

The RRF is targeting the green and digital transitions. More than half of the €1.8 billion allocation is dedicated to two priority areas: green transition (38 per cent of total funds), including the electrification of public transport and investments in energy efficiency and renewables, and digital transition (21 per cent), including the digitalisation of public administration and fostering a rising level of digital skills. Additional actions will address productivity and research and development investments, which are below the EU average. Further upskilling of the administration will be needed to maximise funds absorption.

An 18-month programme to improve the insolvency framework was completed in March 2021. Through improving the insolvency framework and debt restructuring, the Ministry of Justice, in cooperation with the European Commission and the European Bank for Reconstruction and Development (EBRD), has issued guidelines for identifying and managing the financial difficulties of corporates. Targeted at small and medium-sized enterprises, the aim is to increase their resilience and encourage timely reactions before insolvency.

Latvia has confirmed its credibility in the financial markets despite the impact of the Covid-19 pandemic. The relatively moderate GDP contraction in 2020 and the sustainable debt burden have given the country a stable credit rating and the prospect of favourable borrowing. In March 2021 the government issued a €1.25 billion 10-year Eurobond, with a zero coupon and yield of 0.105 per cent, the lowest coupon level of Latvian debt security issuance. In addition, in June 2021, the government issued a €500 million seven-year Eurobond, also with a zero coupon, and a yield of 0.003 per cent.

The newly established Economic Affairs Court began operating in March 2021. The new court has been set up to improve the quality of judicial institutions and address the shadow economy. Specifically, the court will expedite the resolution of commercial disputes, investigate financial fraud and resolve issues of company law, investor dispute and competition law. The establishment of the court is a continuation of work to prevent money laundering and financial crime. More concrete and closer cooperation with the United States of America in this area started after a bilateral cooperation agreement was signed in November 2020.

The parliament adopted a covered bond law in May 2021. With covered bonds, Latvia will be able to get a source of long-term, secure and low-risk funding, as well as strengthen its competitiveness and regional integration. The legal part was financed through the EU Structural Reform Support Programme and supported by the EBRD.

The tax changes package introduced in 2021 should mitigate the effects of the Covid-19 crisis. To support business activities, a 30-day deadline for value added tax (VAT) overpayment refunds was introduced. Employers were given the opportunity to compensate employees for expenses related to remote working, and social insurance rates were reduced by 0.5 per cent for both employers and employees. Concerning personal income tax, the income threshold was increased from €1,200 to €1,800, up to which the non-taxable amount applies. After three years, the monthly minimum wage was raised from €430 to €500, still among the lowest in the EU (adjusted for purchasing power standards).

