



Latvia

Highlights

- **Gross domestic product (GDP) growth is falling and inflation is surging.** Despite better-than-expected growth in the first quarter of 2022, increased vulnerabilities driven by the repercussions of Russia's war on Ukraine are weighing on Latvia's economic activity and employment, and will keep inflation high for some time.
- **The government deployed comprehensive support measures to compensate households and businesses for increased energy prices.** With Covid-related aid being phased out, new measures included housing benefits, partial cover for heating bills and targeted support for companies.
- **Latvia has issued its first sustainability bond.** The first among Nordic and Baltic countries, Latvia established a sustainability bond framework and raised €600 million in support of its long-term agenda to promote climate mitigation measures as well as environmental and social policies.

Key priorities for 2023

- **Support measures to ease the effect of higher energy prices should remain well targeted and flexible.** This would ensure that the most vulnerable groups are receiving the most support, and households and businesses have the right incentives to support the transition to low-carbon energy sources.
- **The authorities should focus on designing and putting in place comprehensive inclusion measures.** The country's National Recovery and Resilience Plan (NRRP) contains measures designed to reduce labour shortages, skills mismatches and income inequality, and bridge the digital divide.
- **More capacity is needed to ensure that Recovery and Resilience Facility (RRF) targets are met.** The intention is to unlock almost one-third of the RRF grants in 2023. These funds will be key in accelerating the green transition, including through large investments in energy efficiency, sustainable mobility and climate change adaptation.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	4.0	2.6	-2.2	4.1	2.5
Inflation (average)	2.6	2.7	0.1	2.4	17.0
Government balance/GDP	-0.8	-0.6	-4.3	-7.0	-6.0
Current account balance/GDP	-0.3	-0.6	2.6	-4.2	-3.3
Net FDI/GDP [neg. sign = inflows]	-2.2	-2.8	-2.1	-2.5	-1.7
External debt/GDP	123.7	116.8	124.8	112.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	38.0	36.6	34.7	32.0	n.a.

Macroeconomic developments and policy response

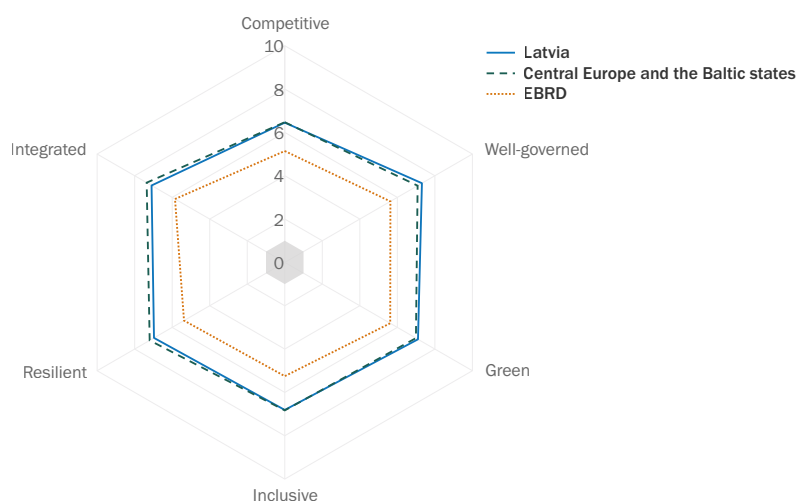
Growth has slowed in 2022. The economy performed relatively well in the first quarter of 2022, sustained by the easing of Covid-19 restrictions, private consumption and exports, but GDP growth slowed to 4.7 per cent year on year in the first half of 2022. Russia's war on Ukraine and trade disruptions, coupled with the energy crisis and surging inflation, adversely affected economic activity and households' disposable income. However, the unemployment rate stood at 6.6 per cent in September 2022, up from 6.4 per cent in June but below pre-pandemic levels. Increased employment and persistent labour shortages contributed to further wage growth, but these are expected to ease towards the end of 2022.

Prices are rising sharply. The harmonised index of consumer prices (HIPC) inflation rate hit 22.0 per cent year on year in September 2022, the highest rate since the 1990s. Housing and utility-sector prices saw the strongest growth (51.6 per cent year on year), followed by the food sector, with a significant increase of 27.5 per cent year on year. In response, the government introduced several support mechanisms to help mitigate the effects on households and businesses. In January 2022 parliament approved a €250 million support package to compensate firms and households for energy price increases. Children and young adults up to the age of 24 and pensioners received monthly allowances of €50 and €20, respectively, until April 2022. Longer-term measures to the end of the year include €7 million in compensation to help households withstand hikes in heating and gas prices. In addition, parliament allocated €64 million and €21 million, respectively, to indemnify 100 per cent of the power distribution fee and the mandatory procurement component of electricity bills. In August 2022 parliament approved amendments to the law on support measures for reducing the effects of increased energy prices, setting aside an additional €422.25 million to partially cover increases in heating bills and to expand the range of housing benefit recipients.

The general government budget tightened. The fiscal deficit, which stood at 7.0 per cent of GDP in 2021, is expected to decrease to 6.0 per cent in 2022, with a smaller gap in the first six months of the year compared with the same period 12 months prior. Government support for the Covid-19 crisis has been phased out slowly, but aid for Ukrainian refugees and compensation for the rise in energy prices has been substantial; the latter required a sizeable budgetary spending increase, with total planned support worth 6.0 per cent of GDP. Furthermore, spending on defence is set to rise from 2.2 per cent of GDP to 2.5 per cent over the next three years.

The economic outlook is complicated by the consequences of Russia's war on Ukraine. Subdued economic activity in the European Union, accompanied by supply-chain disruptions and rampant inflation, are likely to negatively affect Latvia's exports and consumption, but this will be partially offset by sustained demand for some of Latvia's main export products, including wood and food products. Our latest forecasts see GDP growth decrease to 2.5 per cent and 0.8 per cent in 2022 and 2023, respectively. Additional funds under the RRF will become available in 2023 (see below) and should support economic growth medium term.

CHART Assessment of transition qualities (1-10)



Structural reform developments

The government is supporting businesses through financial aid and structural assistance.

The government approved an additional €100 million financial aid package in May 2022 to help companies and entrepreneurs navigate the repercussions of the war on Ukraine. Subject to parliamentary approval, unused funds from the Covid-19 crisis will be used to provide working capital and liquidity to those businesses affected by the war, related sanctions on Russia and countersanctions. Part of the package will also be spent on facilitating access to finance, as well as providing more structural assistance to companies, including support in adapting their business models, improving their export capacity and expanding to new markets. Further anti-inflationary measures, agreed by the government in August 2022, will include targeted assistance for energy-intensive businesses (companies with spending on energy resources higher than 10 per cent of total expenses) in the form of grants.

Efforts to strengthen energy resilience are being stepped up. The government's decision to ban Russian gas imports by 2023 has prompted the reorientation of gas supply. Latvia will be able to consume gas supplied by the Klaipeda terminal in Lithuania, as well as the Paldiski terminal in Estonia, which is currently under construction and should become operational in November 2022. To limit gas consumption, the government will introduce a plan for the public administration, setting common targets for energy saving in the upcoming winter season.

The authorities are targeting digital, inclusion and rule-of-law reforms in the early implementation stages of the RRF. In June 2022, following the completion of nine reform targets, Latvia requested that the European Commission disburse the first tranche of the country's €1.8 billion RRF allocation. The Commission provided a positive preliminary assessment of the milestones, which were achieved in the key areas of digital transition, inclusion and rule of law. Inclusion measures comprise the development of a minimum income support strategic framework, as well as amendments to existing rental legislation to improve affordable housing in the country. In the area of digital transformation, the country adopted two important frameworks on the organisation of remote learning in educational institutions and the development of last-mile broadband connection infrastructure, helping to narrow the digital divide. Improvements in public procurement were achieved, with the establishment of a regulatory framework to reduce corruption risks and improve the competition environment. Lastly, an amendment to the existing law on money-laundering prevention helped to shore up anti-money laundering/countering the financing of terrorism legislation.

Green transition is being targeted in the next round of the RRF. Latvia will need to achieve an additional 49 targets by the second quarter of 2023 to unlock the next payment under the RRF, which amounts to €503 million. Work has already started in the field of green transition, including financing for energy-efficiency projects in public and private buildings and the greening of the Riga Metropolitan Transport System.

Latvia has issued its first sustainability bond. The bond, issued in December 2021 with an eight-year maturity, raised €600 million. The first among the Baltic and Nordic countries to issue a sovereign sustainability bond, Latvia established a sustainability bond framework in order to attract investments to support the country's green agenda, in line with its financial development plan 2022-23. The issuance attracted strong interest from more than 120 investors, with an order book exceeding €2.5 billion.