LATVIA

Highlights

- **The Covid-19 crisis halted economic growth in 2020.** After moderate growth in 2019, GDP is falling significantly in 2020 due to the coronavirus-induced effects on domestic demand, investments and exports.
- **Anti-money laundering/combating the financing of terrorism (AML/CFT) reform is progressing.** A Moneyval assessment concluded that the regulatory framework updated in 2019 is generally compliant with Financial Action Task Force (FATF) standards.
- **The administrative-territorial reform has been passed.** Under this reform, the number of municipalities will be reduced from 119 to 42 following the next municipal elections in 2021. The reform aims to streamline local and regional development and improve public service delivery.

Key priorities for 2021

- **Stimulating infrastructure investments, including through effective EU funds absorption, will be critical for the recovery phase.** Besides financing public infrastructure projects to address existing gaps and stimulating private investment, the authorities should ensure that regional and income inequalities are addressed, including through improving access to quality healthcare and education.
- **Effective implementation of new AML legislation is needed.** This will contribute to a sound banking sector, which is crucial for the resumption of credit growth, as well as the development of capital markets and alternative financial instruments.
- **Education reform should continue in spite of limited fiscal space.** Structural reforms targeting vocational and adult education are critical in increasing employment and productivity, given the country's unfavourable demographics. As such, the authorities and stakeholders should prioritise and ensure the implementation of ongoing reforms and projects, such as the OECD-led skills strategy.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.4	3.3	4.0	2.1	-5.0
Inflation (average)	0.1	2.9	2.6	2.7	0.6
Government balance/GDP	0.2	-0.8	-0.8	-0.2	-5.4
Current account balance/GDP	1.3	0.7	-0.3	-0.6	2.0
Net FDI/GDP [neg. sign = inflows]	0.0	-2.0	-2.2	-2.9	-0.5
External debt/GDP	149.1	142.3	123.7	117.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	48.6	43.5	38.0	36.8	n.a.

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Covid-19: macroeconomic implications

The economy declined sharply in the first half of 2020. GDP growth had already been slowing in 2019 (2.2 per cent growth), and in the first half of 2020 Latvia had the steepest decline in GDP among the Baltic states. In the latter period, Latvia's GDP decreased by 5.4 per cent year-on-year, on the back of a significant fall in output in the second quarter of 8.9 per cent year-on-year. The drop in output was driven by the decrease in private consumption, which fell by 20.9 per cent year-on-year in the second quarter, caused by the imposed containment measures. Nevertheless, the relatively successful management of the epidemic led to a swift recovery of private consumption, as retail turnover recovered to 2019 levels by June 2020 on the back of pent-up demand. On the other hand, industrial production has been slower to recover.

The unemployment rate has ticked up considerably despite robust wage growth. The unemployment rate reached 8.6 per cent in June 2020 compared with 6.3 per cent before the pandemic, mainly due to the affected services sector. Nevertheless, in July 2020, driven by recovering labour demand, unemployment decreased to 8.2 per cent. As the employment support schemes will be discontinued by the end of the year, unemployment is likely to stabilise at current levels. On the other hand, wage growth was still positive in the first half, but did not have an effect on prices as deflation continued by August.

The general government budget deficit will widen considerably. The government deficit was just 0.2 per cent of GDP in 2019 but, given the significant fiscal stimulus package to address the coronavirus crisis, the International Monetary Fund (IMF) expects the fiscal deficit to be 5.4 per cent of GDP in 2020. The IMF also forecasts government debt to increase from 36.9 per cent of GDP in 2019 to 44.1 per cent of GDP by the end of 2020. The government is able to access diversified sources of financing, including eurobonds, the Nordic Investment Bank and the Council of Europe Development Bank.

The medium-term outlook is tilted to the downside. In line with the relaxation of measures, a rebound in the third quarter of 2020 took place on the back of recovering private consumption, but the recovery will likely be subdued by the end of 2020, in line with the wider EU economy. As such, the EBRD projects GDP to decline by 5.0 per cent in 2020 and recover by 3.5 per cent in 2021. This is nonetheless contingent on no other major outbreaks of Covid-19 in the second half of 2020. In the medium term, adverse demographics and the limited availability of financing may hold back output growth.

Policy response to Covid-19

The economic stimulus package has been comprehensive. In March 2020 the government announced a support package of about €2 billion (7 per cent of GDP). Key measures include: loans and guarantees amounting to €250 million; a sectoral support package of €875 million covering the air and transport industry, the health and education sectors as well as infrastructure projects; deferral of tax payments worth €196 million; and the job retention scheme covering 75 per cent of salaries or €700 per month for affected firms. Other measures include subsidised working capital loans and export credit guarantees through the state-owned development institution ALTUM. ALTUM will also manage a €100 million investment fund targeted at impacted large enterprises. Lastly, the EC approved the state's €250 million investment in airBaltic, which was aimed at stabilising the aviation industry, alongside state aid earmarked for the agricultural, forestry and tourism sectors.

The economy will likely benefit from the expected EU stimulus. Following the EU recovery fund deal, Latvia has been earmarked around €10.5 billion for the 2021-27 period. A plan to absorb these funds towards improving the innovative potential of the economy, addressing infrastructure, education and healthcare gaps, and accelerating the green transformation will be crucial, on top of ensuring the recovery post-2020. At the same time, it will require state capacity to effectively deploy such funds.

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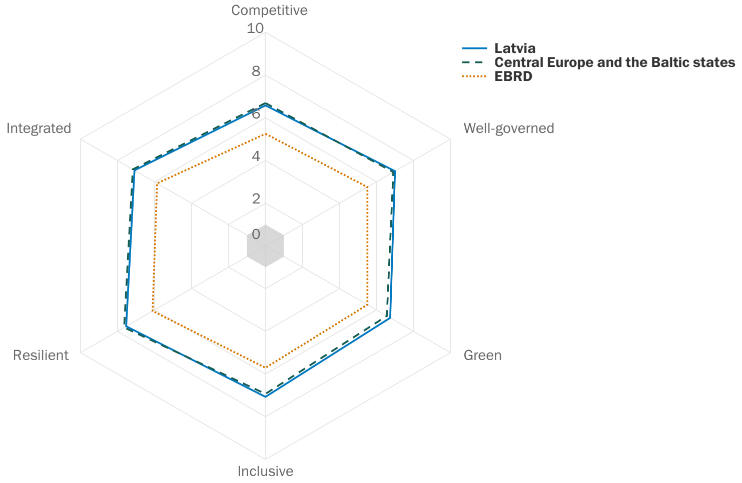
Assessment of transition qualities (1-10)



Structural reform developments

Latvia has improved the AML framework, as per the latest Moneyval evaluation. Following the adoption of new laws in 2019, Latvia has strengthened the Financial and Capital Market Commission, enabled the government to expel banks involved in money laundering, and focused the courts and prosecutors on more serious financial crimes. The number of sanctions and investigations has increased, although the EC has noted the need for further efforts to ensure effective supervision and enforcement. A generally positive report from Moneyval, published in January 2020, rating Latvia as largely compliant with EU regulations, means that the country avoided being placed on the FATF grey list.

The territorial administrative reform is consolidating local administration. In June 2020 the parliament adopted the administrative-territorial reform for consolidating local authorities from 119 to 42 municipalities. This reform is intended to create economically viable administrative territories that are able to provide cost-effective public services. The reform has been met by calls from municipalities and the Chamber of Local Authorities to postpone the process until sufficient consultations are conducted. The comprehensive reorganisation of local administration will enter into force after the local elections in mid-2021.

Tax system reform is ongoing despite a lack of political consensus and economic uncertainty. The current government recently proposed the reform of the tax system aimed at reducing the labour force tax burden, which includes lowering the social tax by 1 per cent, increasing the differentiated non-taxable minimum application threshold, as well as adopting minimal social contributions. The labour tax burden in Latvia is one of the highest in the OECD region, while additional tax revenue sources are needed to ensure enough funding for supporting the healthcare and education systems.

Regional gas market integration has progressed along with greening of the energy market. The roadmap for the regional gas market integration with Finland and the Baltic states was adopted in April 2020, and further progress is expected based on the common gas market that became operational in January 2020 between Finland, Estonia and Latvia. The reform aims to create a more competitive regional market that also supports the energy security of the Baltic states. In January 2020 the government adopted the national energy and climate strategy for 2030, which targets greater energy efficiency, an increase in the share of renewable sources in final consumption to 50 per cent, and reduced emissions by 6 per cent compared with levels in 2005.