Latvia

Highlights

- **The economy continues to stagnate in 2023, but inflation is falling.** Inflationary pressures in the past year have contributed to reduced private consumption, low investment growth and disruptions in industrial production.
- **European Union (EU) funds are being targeted at energy efficiency and the electricity transmission system.** In October 2022 the country received the first disbursement of €201 million as a part of the EU's Recovery and Resilience Facility (RRF) and is now planning to invest in the electricity transmission system with the support of EU funds amounting to €135 million between 2024 and 2033.
- **The government launched programmes to enhance leadership skills and innovation in higher education institutions.** The programmes are expected to be supported by the European Regional Development Fund (ERDF).

Key priorities for 2024

- **Further efforts are needed to achieve energy independence from Russia.** The authorities should push ahead with plans to disconnect from the Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) power system and connect instead to the European grid. Progress should also be made towards investing in reconstructing the energy system's substations, lines and distribution points.
- **The Green Economy Transition (GET) approach should be pursued vigorously.** The authorities should continue to focus on reducing greenhouse gas emissions and increasing the use of renewable energy based on improved energy and resource efficiency, including by using RRF funds to implement a programme on the energy efficiency of apartment buildings.
- **Further reforms of the higher education system are needed.** Following the programmes aimed at facilitating innovation and expanding leadership capabilities in 2023, the authorities should focus on increasing competitiveness by creating new opportunities to improve the development and governance of higher education institutions.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	0.6	-3.5	6.7	3.4	0.3
Inflation (average)	2.7	0.1	3.2	17.2	9.0
Government balance/GDP	-0.5	-4.5	-7.2	-4.6	-3.7
Current account balance/GDP	-0.6	2.9	-3.9	-4.7	-3.0
Net FDI/GDP [neg. sign = inflows]	-2.9	-2.2	-2.5	-3.2	-2.6
External debt/GDP	116.7	121.5	109.6	100.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	36.7	34.9	32.4	29.4	n.a.

Macroeconomic developments and policy response

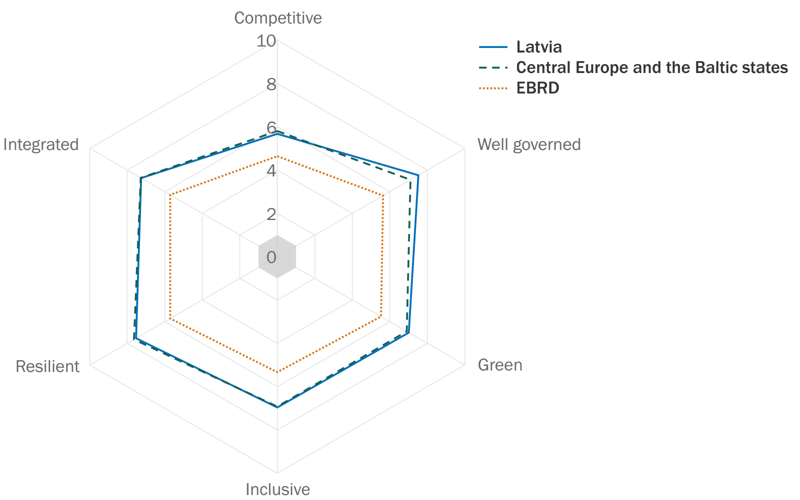
Economic growth remains subdued. The economy grew by 3.4 per cent in 2022, but high inflation and soaring energy prices have affected private consumption and investment. As a result, the gross domestic product (GDP) growth in the first half of 2023 was around zero year on year. Real wages have been falling because of the elevated inflation rate, while the ongoing war on Ukraine is taking a toll on Latvian exports. Industrial production has struggled, given energy supply difficulties and supply chain disruptions, which have led to a fall in manufacturing output.

Inflation is falling gradually from double-digit levels. The annual inflation rate peaked at 22 per cent in September 2022, but has fallen to single-digit levels since June 2023, with a further decline expected in the second half of the year, partly as a result of stabilising energy prices. Despite economic difficulties, the registered unemployment rate remains historically low, at 6.5 per cent in the middle of 2023, contributing to rising nominal wages and some persistence in inflationary pressures. Labour shortages are the main driver of wage growth, especially in the agriculture, mining and utilities sectors.

The general government budget deficit is declining. The government's fiscal deficit amounted to €137.7 million (around 0.4 per cent of GDP in 2022) in the first half of 2023, nearly 40 per cent lower than in the same period in 2022. Key spending priorities include pursuing the country's energy transition and maintaining national security as the war on Ukraine persists. The government is continuing to compensate for high energy prices with a spending package amounting to €417 million (0.96 per cent of GDP) in the first half of 2023 and a €34 million support package for Ukrainian refugees. These measures are planned to be phased out gradually.

Low economic growth is set to continue. The economy is projected to return to modest growth in the second half of 2023, following the contraction in the second quarter. We forecast 0.3 per cent GDP growth in 2023, increasing to 2 per cent in 2024. The outcome will be largely influenced by falling, but still significant, price growth and persistently weak consumer sentiment reflecting inadequate private consumption. Low investment is expected to continue, but a slight boost is likely given structural EU funds are available. Downside risks to the forecast remain, associated with high core inflation supported by wage increases.

Assessment of transition qualities (1-10)



Structural reform developments

Support programmes to be phased out. Crisis-support programmes covering energy price subsidies and support for Ukrainian refugees are planned to be progressively withdrawn in favour of one-off safety measures and possible compensation for future energy surges. The energy support included a fixed tariff of up to 100 kWh for households, compensation for central heating costs, transfers to households in difficult situations, and a suspension of the electricity services tariff for legal entities.

The pan-Baltic capital market is set to benefit from single index classification. The new single index, which was launched at the same time as the August 2023 Index Review, will allow the three markets to be integrated into the Morgan Stanley Capital International (MSCI) universe and will raise the region's profile among international investors who track MSCI indices. The approach is in line with efforts made by the ministries of finance in Estonia, Latvia and Lithuania, the European Bank for Reconstruction and Development, the European Commission and Nasdaq Baltic to create a single pan-Baltic capital market, as outlined by a memorandum of understanding signed in November 2017. The approach is also a building block of the EU's capital markets union initiative.

Higher education reforms are under way. The government launched new programmes funded by the ERDF in January 2023, following the legislative changes adopted in 2022. The programmes cover modules to enhance leadership and support innovative projects in higher education institutions. Latvia ranked third lowest among all EU member states on the European Innovation Scoreboard in 2023, lagging behind in financing research and development in particular. In addition, Latvia is expected to receive a total of €82.5 million in RRF grants to improve the capacity of educational institutions.

Latvia is moving towards energy independence from Russia. Along with its neighbours Lithuania and Estonia, the country is focused on disconnecting from the BRELL power system. The three Baltic countries have signed an agreement to accelerate this disconnection and focus on connecting to the European grid in early 2025. This means that the countries will officially inform all parties of their disconnection from the Russia-linked grid as early as August 2024. Latvia and Estonia signed a memorandum of understanding in May 2023 to jointly use the liquefied natural gas (LNG) terminal in the port of Paldiski in Estonia, via a floating storage regasification unit. The agreement aims to enable countries to purchase LNG if there are disruptions in natural gas supply.

EU funds are supporting investment in the electricity transmission system. A total of €509.8 million will be allocated to investments connecting Latvia to the EU energy system. Of this total, approximately €135.8 million will come from EU funds. The measures are aimed at reducing dependence on Russian electricity while synchronising with the European grid. The allocation plan will run until 2033 and includes €188.8 million for the network and between €21 million and €30 million to be invested annually in reconstructing substations, lines or distribution points.

A new energy efficiency programme is in place. The energy efficiency of apartment buildings 2022-26 programme financed by the RRF was launched in December 2022. The programme includes €57.3 million of financial assistance in the form of subsidies, loans and guarantees to improve efficiency and energy management, and the use of renewable energy sources. When completed, the programme is expected to deliver at least 30 per cent energy savings in multi-family buildings.

A large solar park is being built. European Energy, a privately owned Danish renewable energy developer, will build a solar park in the south-western part of the country. The project entered the final development stages in August 2023, and the park is expected to be connected to the Latvian grid by 2025. When completed, the installed capacity of the park is set to be 115 MW, projected to generate enough energy for around 57,000 Latvian households per year.