Latvia

Highlights

- **The resurgence in private consumption is gradually lifting the economy.** After a contraction in real gross domestic product (GDP) in 2023, households' rising disposable incomes are giving the economy a significant boost in 2024.
- **The Rail Baltica project has received a major financial injection.** The European Commission has allocated €1.2 billion for the project, with €346 million earmarked for Latvia, to address delays and enhance regional connectivity through improved transport routes.
- **A second Recovery Fund payment is accelerating key reforms in justice and infrastructure.** In May 2024, Latvia received from the European Commission €336 million, following an initial €201 million, to digitalise the justice system, construct up to 700 low-cost rental apartments, improve national and regional highways, and establish industrial parks.

Key priorities for 2025

- **The tax system should be reformed to reduce the burden on lower-income groups and improve public-sector efficiency.** Such changes are essential in order to attract investment, reduce the fiscal deficit, and enhance economic growth amid slowing convergence with the European Union (EU).
- **The planned increase in defence spending should be channelled into building domestic industrial capabilities and fostering innovation.** This will drive productivity, create high-tech jobs and enhance national security through advanced manufacturing and cybersecurity.
- **The authorities should selectively list state-owned companies on the stock exchange to improve corporate governance and market capitalisation.** Unlike its Baltic peers, Latvia has no state-owned companies listed, which limits investment opportunities and market growth.

Main macroeconomic indicators (per cent)

	2020	2021	2022	2023	2024 proj.
GDP growth	-3.5	6.7	3.0	-0.3	0.9
Inflation (average)	0.1	3.2	17.2	9.1	1.6
Government balance/GDP	-4.4	-7.2	-4.6	-2.2	-3.0
Current account balance/GDP	2.9	-3.9	-5.1	-3.8	-1.9
Net FDI/GDP [neg. sign = inflows]	-2.1	-2.6	-3.4	-1.5	-2.0
External debt/GDP	121.5	109.6	100.5	98.6	na
Gross reserves/GDP	na	na	na	na	na
Credit to private sector/GDP	34.9	32.4	29.8	28.5	na

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Macroeconomic developments and policy response

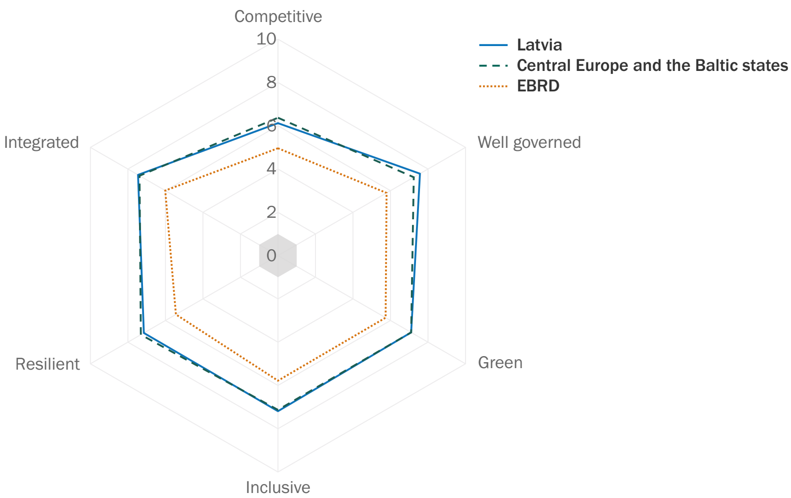
The economy is improving after last year's recession. Following an impressive post-Covid recovery, the Latvian economy contracted by 0.3 per cent in 2023, weighed down by falling household consumption and weak demand from key international markets. Real GDP growth returned to positive territory in the first half of 2024, albeit by just 0.1 per cent year on year, mostly driven by higher household consumption. Robust nominal wage growth, above 11 per cent in the first quarter of 2024, and sharply falling inflation to 0.8 per cent in July 2024, have dovetailed to restore consumer confidence to some extent. The labour market remains strong, with the unemployment rate at 6.7 per cent in June 2024. Exports have continued to suffer, impacted by low demand from the Nordic countries, especially for wood and metal products. Despite stabilising inflation, a Luminor Bank survey from May 2024[1] reveals that businesses have not fully recovered from the recent inflationary surge. Inflation and rising costs remain a significant concern for 40 per cent of small and medium-sized enterprises (SMEs).

Elevated financing costs and weak demand have put investments on hold. Investments experienced a robust recovery in 2023, growing by 8.2 per cent, largely fuelled by accelerated public-sector construction projects supported by EU co-financing from the previous budget (2014-20, with the funds to have been spent by the end of 2023). However, in the first half of 2024, investments largely came to a halt across both the public and private sectors. While EU-co-financed investments from the new programming period are expected to take time to gain momentum, private-sector companies have paused investments, awaiting lower interest rates and a more solid recovery in demand, both domestically and internationally. Inward foreign direct investment (FDI) flows contracted from 3.4 per cent of GDP in 2023 to 1.5 per cent of GDP in the first half of 2024.

Slow economic growth and higher spending weigh on public finances. The general government deficit narrowed to 2.2 per cent of GDP last year but is expected to widen to 3.0 per cent of GDP in 2024, before narrowing again in the following years. Greater government spending, especially on employee compensation and defence, which saw growth of 17.8 per cent and 15.6 per cent, respectively, put a significant strain on the state budget in the first half of 2024. As a result of the former, public-sector gross wages saw a strong increase of more than 16 per cent in the first quarter of 2024, above the 9 per cent growth for private-sector wages. Amid the improving outlook, a less expansionary fiscal approach for 2024 is justified.

Growth will continue in the short term. Robust real wage growth, coupled with one of the lowest inflation rates in the EU by mid-2024, is expected to cautiously drive household expenditure, as savings buffers, depleted by the high inflation of 2022, are rebuilt. In 2024-25, inflation is projected to stabilise around the European Central Bank's target at 2 per cent, although service inflation is likely to remain elevated due to persistent wage and cost pressures within the sector. The recovery in exports will be heavily contingent on economic improvements in the Nordic countries, which are slowly emerging from stagnation. Investment is expected to gain momentum as both domestic and external demand conditions improve. We therefore project real GDP growth of 0.9 per cent in 2024, rising to 2.4 per cent in 2025.

Assessment of transition qualities (1-10)



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[1] As reported at https://emergingmarketwatch.com/browser#/article/1270288

Structural reform developments

New funding is boosting the Rail Baltica project. The European Commission allocated an additional €1.2 billion to the Rail Baltica railway line in July 2024, with €346 million earmarked for Latvia. Including co-financing from the Baltic states, total funding amounts to €1.5 billion. Latvia's portion will be used for priorities such as constructing the main track in the Misa-Latvia-Lithuania border section. The government also approved €61.03 million of national co-financing for the project in August 2024. This funding is crucial for the project's progress, as delays have been reported, particularly at the Riga Airport and Riga Central stations. The Rail Baltica project aims to enhance regional connectivity and stimulate economic activity through improved transport routes.

The government is planning to privatise a major state-owned enterprise (SOE). Privatisation is being prepared for the state-owned carrier, airBaltic, which posted a €33.85 million profit in 2023. The Latvian state currently holds almost 98 per cent of the airline's shares and aims to maintain at least 25 per cent plus one share after the initial public offering (IPO), ensuring veto power. AirBaltic's simplified share structure and recent financial performance, with turnover up by 33.2 per cent, strengthen its market appeal. The IPO's timing is set to be decided by the end of 2024. Should the IPO materialise, airBaltic will be the first Latvian SOE to be listed on the stock exchange.

A second Recovery Fund payment is boosting important reforms, including in the justice system and infrastructure. In May 2024, Latvia received from the European Commission the second Recovery Fund payment of €336 million, requested in December 2023. This follows the initial payment of €201 million and aims to maintain ongoing projects and initiate new ones. The Ministry of Finance announced that 89 per cent of the total available funding of €1.97 billion has been allocated for project selection. The second tranche will support the digitalisation of the justice system, construction of up to 700 low-cost rental apartments, improvement of national and regional highways, and establishment of industrial parks. The pace of fund absorption needs to accelerate if the country is to use all available funding by the end of 2026.

The Baltic states are exiting the Russian power grid. In July 2024 the electricity transmission system operators (TSOs) of Estonia, Latvia and Lithuania signed a declaration of non-renewal of the BRELL (Belarus, Russia, Estonia, Latvia and Lithuania) agreement, informing Russian and Belarusian operators of their withdrawal from the electricity ring. On 8 February 2025 the Baltic TSOs will disconnect the Estonian, Latvian and Lithuanian electricity systems from the Russia-controlled electricity system IPS/UPS and will start a joint isolated operation test. Afterwards, on 9 February 2025, they will synchronise with the electricity network of continental Europe. The EU has committed €1.2 billion to support this transition, covering about three-quarters of the costs.

Cooperation with Ukraine is being enhanced. In April 2024, Latvia signed a bilateral defence agreement with Ukraine, pledging assistance over the next decade in cyber defence, demining and the development of unmanned aerial vehicles. Annual military aid, equal to 0.25 per cent of Latvia's GDP, will amount to approximately €112 million in 2024. This agreement aims to support Ukraine's fight against aggression and facilitate its entry into the EU and NATO. The Ukrainian parliament ratified a related agreement on technical and financial cooperation, providing a framework for Latvia's development cooperation programmes and reconstruction projects in Ukraine.

Mortgage refinancing is being simplified. In December 2023, the government introduced legislation to make refinancing mortgages cheaper and easier. This move aims to boost competition and reduce the high concentration in the mortgage lending market, where the four largest credit institutions hold nearly 100 per cent of the market share. Borrowers will be able to refinance loans through a different creditor without the original lender's consent, and the fee charged by the new creditor cannot exceed 1 per cent of the transaction amount. The legislation also eliminates the state fee for registering mortgage rights in the land register. This initiative is part of broader efforts to improve mortgage affordability and follows the introduction of a subsidy on mortgage interest payments in November 2023. ●