

UNIVERSITY OF LATVIA
FACULTY OF BUSINESS, MANAGEMENT AND ECONOMICS
PRODUCTIVITY RESEARCH INSTITUTE
"UNIVERSITY OF LATVIA THINK TANK LV PEAK"



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AND ECONOMICS

ECONOMIC BAROMETER

No. 2 (2) December 2022

The supply chain disruptions, the rise in the cost of energy resources and inflation caused by Russia's military aggression in Ukraine, as well as the decrease in global demand have a negative impact on Latvia's growth rates. In 2022, GDP is expected to grow by 2%, which is 2-3 percentage points less than was projected before the Ukrainian war, but in 2023, growth will be much more moderate - by 0.4%. The energy market and other commodity markets have contributed to inflation, which has even exceeded 20% in some months compared to the corresponding period a year ago. In 2023, inflation will remain high, but at a lower level than in 2022. Despite the economic turmoil, the labour market remains stable as the demand for labour remains high. Since many companies are still facing a labour shortage, unemployment will increase only moderately in 2023. Meanwhile, nominal wage growth is expected to continue to increase in 2023, but at a slower pace than inflation, leading to a decline in purchasing power. The risks of declining competitiveness remain very high, as the gap between productivity and labour costs has widened due to the pandemic crisis. To increase competitiveness, in addition to support measures for reorientation of companies from Russian markets to others, as well as significant reduction of bureaucracy, shadow economy and corruption, the most important thing is to activate policies aimed at raising productivity. Latvia's weakest point is innovation, which requires investment in research and development, and in improving people's knowledge and skills. Financing by credit institutions for companies, which is exploited relatively little compared to the EU average and is one of the main reasons for Latvia's growth lagging behind Lithuania and Estonia over the last decade, should be encouraged. Strengthening energy security is also one of the key tasks. Targeted support for at-risk groups must be provided in the conditions of rising energy and food prices. Considering the geopolitical uncertainty, it is necessary to carry out a radical assessment of budget expenditures and effectively invest the resources of the Recovery and Resilience Facility to strengthen the competitiveness of the Latvia's economy.

RUSSIA'S INVASION OF UKRAINE NEGATIVELY AFFECTS GROWTH PROSPECTS.

The war in Ukraine is the biggest threat to the economic development of Latvia and the whole world. Disruptions to supply chains, rising energy costs and inflation, as well as declining global demand are having a significant impact on the economy.

In the first quarter of 2022, the effects of the war were not yet fully felt in Latvia. GDP increased by 5.6% year-on-year. The rise was influenced by the gradual lifting of Covid-19 restrictions. However, already in the 2nd quarter, the annual growth rates fell to 2.9%, while in the 3rd quarter, the GDP

already decreased by 0.6%. The leading indicators tool created by LV PEAK shows that weak economic development will continue in the coming months, which will be affected by uncertainty and high inflation (see infographic on page 11).

The most difficult situation will be in the first half of 2023. Growth could return in mid-2023. According to the consensus forecast of LV PEAK experts¹ overall GDP will grow by 2% in 2022, which is 2-3 percentage points less than was projected before the Russian invasion of Ukraine. In 2023, GDP growth is predicted to be 0.4%. Downside risks to growth dominate, the most important of which are related to global geopolitical and trade tensions, as well as a slowdown in global demand.

Table 1. The economic recovery is affected by geopolitical tensions

	2019	2020	2021	2022	2023 f
GDP (% change on previous year)	2.6	-2.2	4.1	2.0 f	0.4
Unemployment (unemployed persons % of economically active population, 15-74 years)	6.3	8.1	7.6	6.7 f	6.9
Gross Wages (average gross wages, % change to previous year)	7.2	6.2	11.8	8.3 f	7.8
Inflation (average annual inflation, %)	2.8	0.2	3.3	17.3	8.4

Source: Central Statistical Bureau (CSB), f - LV PEAK expert consensus forecast.

Given the current circumstances, to stabilise the situation the following tasks are considered urgent by LV PEAK experts: to intensify support for companies for market reorientation; to significantly reduce bureaucracy, the shadow economy and corruption; to provide targeted support to at-risk groups in the face of rising energy and food prices and to promote financing by credit institutions for companies. Strengthening energy security and ensuring independence from Russia is also one of the key tasks.

The survey of Latvian residents aged 16 to 29 commissioned by LV PEAK to the Research Centre SKDS indicates that young people are generally quite pessimistic about the development of the economic situation in the short term, but in the long term the view is much more optimistic (see annex: Youth Sentiment Survey).

THE LABOUR MARKET STILL LAGS BEHIND THE PRE-PANDEMIC LEVEL.

Despite the negative impact of the Ukrainian war on economic development, in 2022 the Latvian labour market continued to recover from the consequences of the pandemic.

The number of employed persons increased by 20.8 thousand or 2.4% in the 3 quarters of 2022 compared to the

corresponding period of 2021. However, it still lags behind the pre-Covid-19 crisis level. The number of employees in the 3rd quarter of 2022 was 18.3 thousand or 2% less than in the 3rd quarter of 2019.

As employment increases, unemployment decreases. Positive trends have been observed in the dynamics of unemployment since the middle of 2020. The unemployment rate in the 3rd quarter of 2022 was 6.9% or 0.3 percentage points lower than in the 3rd quarter of 2021. At the same time, the unemployment rate in 2021 was still 1.2 percentage points higher than before the pandemic.

Also, the number of economically active population and the level of population participation in the labour market still lag behind the pre-pandemic period.

The LV PEAK expert consensus forecast shows that the average unemployment rate will be 6.7% in 2022, but it will slightly increase to 6.9% in 2023, as a sharp slowdown in growth is expected.

According to the results of the Youth Sentiment Survey, the prevailing opinion among young people is that the situation in the labour market will not deteriorate significantly in the short term.

¹ The experts of the University of Latvia Think tank LV PEAK represent the following institutions: the Productivity Board of Latvia, the Productivity Research Institute of the University of Latvia, the

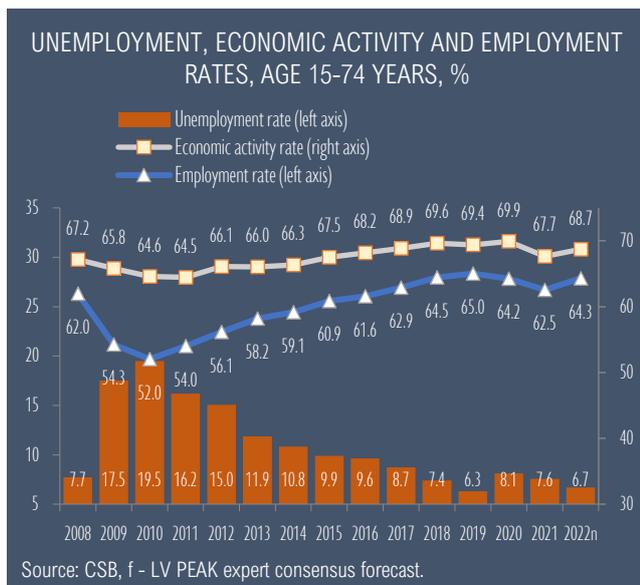
Faculty of Business, Management and Economics of the University of Latvia, the Fiscal Discipline Council, the Latvian Academy of Sciences, etc.

THE LABOUR MARKET WILL REMAIN TIGHT.

Even though unemployment may increase slightly in 2023, the labour market will remain tight. The lack of working hands is becoming more and more noticeable, as evidenced by the increase in the number of vacancies and the workload of jobs.

The decrease in the level of employment and unfavourable demographic processes narrow the supply of labour and increase the risks of labour shortage. In the short term, Ukrainian refugees will increase the labour supply.

Graph 1. The Covid-19 crisis has affected the labour market



Also, it should be considered that the Covid-19 pandemic crisis has accelerated structural changes in labour demand. On the one hand, by accelerating the automation of jobs in labour-intensive industries - mainly by reducing the demand for low- and medium-skilled labour without professional skills. On the other hand, increasing the proportion of highly qualified jobs, especially in information and communication services. Also, structural problems may deepen regional differences in the labour market, which may hinder labour market recovery in the future.

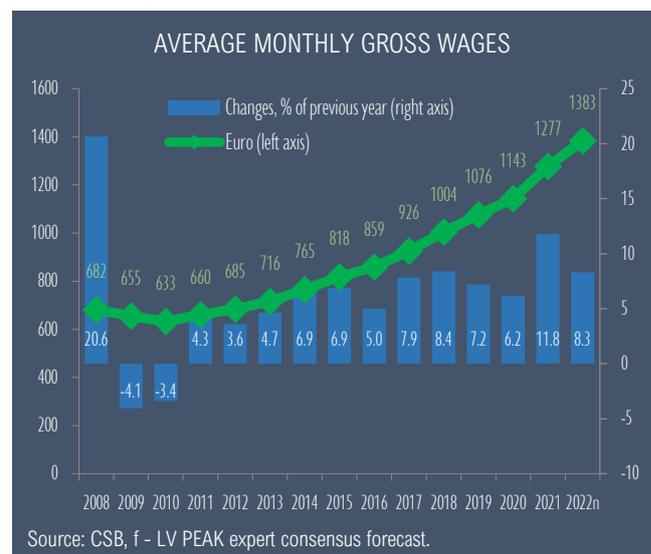
Seeing that the problem of labour shortage will worsen in the future, LV PEAK experts believe that it is necessary to strengthen the adult education system to ensure the transition of labour from unproductive to growing sectors. The efficiency of the adult education system will also play an important role in mitigating the negative effects of the Covid-19 pandemic and Russia-Ukraine war, as well as raising the overall level of economic productivity.

LABOUR SHORTAGES AND A TIGHT LABOUR MARKET ARE PROMOTING WAGE GROWTH.

The monthly average gross wage continues to increase rapidly. In the 3rd quarter of 2022, compared to the corresponding period in 2021, it increased by 6.3% - rising to 1,384 euros

per month. It should be noted that significant wage growth in Latvia has already been observed in previous years - the average wage growth over the last 5 years has been close to 7% per year. However, in contrast to what was observed in previous years, the net wage in the first 3 quarters of 2022 has decreased, considering the rise in consumer prices, which indicates a decrease in the purchasing power of salaried employees. This trend is expected to continue in the short term until the rapid rise in inflation continues.

Graph 2. Wages continue to rise sharply



The forecast of LV PEAK experts shows that despite the geopolitical tension, salaries will continue to grow - in 2022 by 8.3%, and in 2023 - by 7.8%.

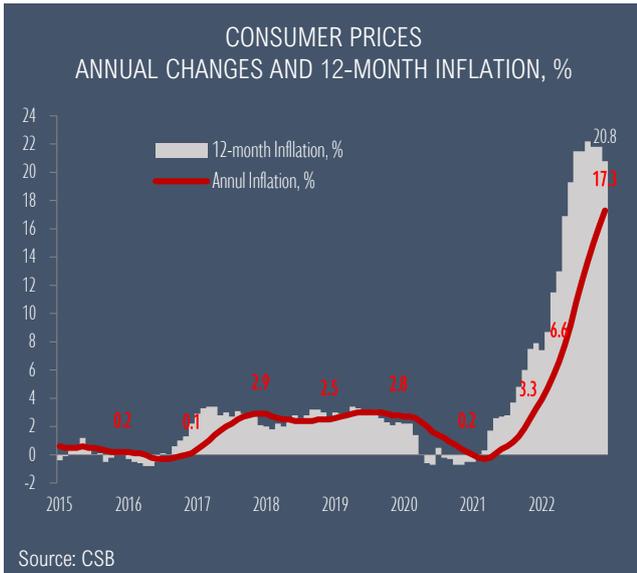
INFLATION WILL REMAIN HIGH IN THE NEXT MONTHS.

During the Covid-19 pandemic in 2020, significantly limiting demand, prices also fell. In some months, the 12-month price changes were even negative. The average price level increased by only 0.2 percent in 2020.

The adjustment of the economy to the conditions of the pandemic happened rapidly. Logistics, supply chains and production capacity could not keep up with growing demand, which led to a sharp increase in global prices in the second half of 2021, especially for metal, wood, etc. intermediate consumption goods. From the end of February 2022, the situation was worsened by Russia's military activity in Ukraine - the prices of energy resources and raw materials rose sharply. The last time such a rapid price increase in Latvia was 15 years ago.

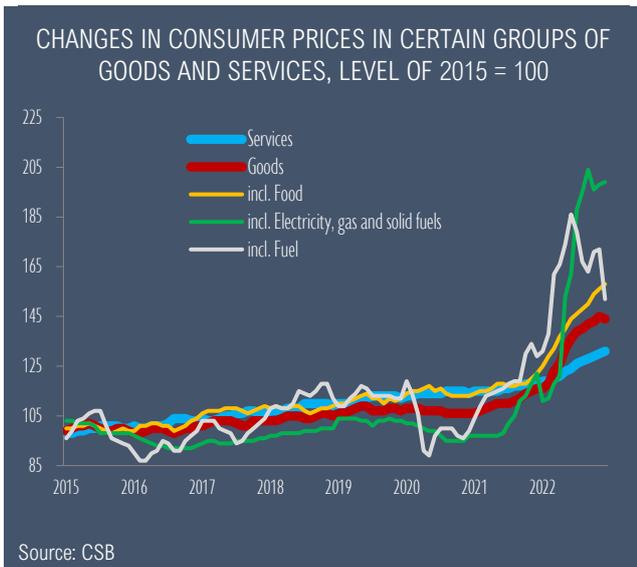
In December 2022, consumer prices in Latvia were by 20.8% higher than a year ago, while the annual average inflation rose to 17.3%. The biggest impact on inflation in 2022 was the increase in the prices of food, electricity and fuel. In December, on an annual basis, food prices increased by 29.3%, electricity, gas and solid fuel - by 63.9%, and fuel - by 17.8%.

Graph 3. Prices have been rising sharply since the second half of 2021



Inflation will remain high in the coming months as well. LV PEAK predicts that the price increase could slow down in the spring of 2023, and the average annual inflation will decrease to 8.4 percent in 2023.

Graph 4. Inflation is affected by high energy and food prices



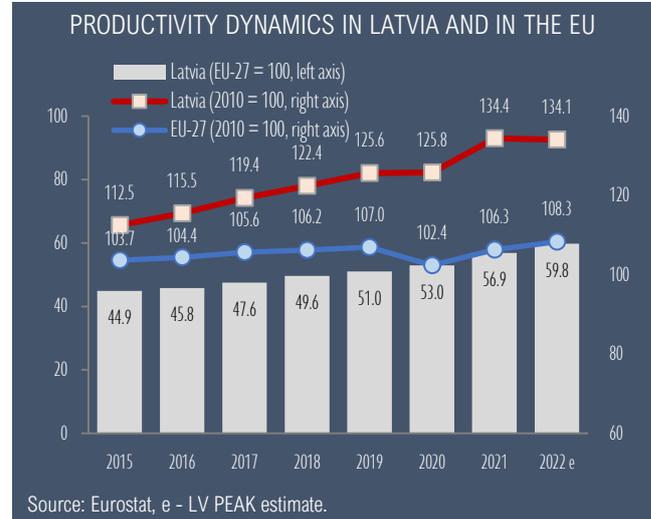
In this heating season, the support provided by the state plays an important role in mitigating the negative impact of high prices on residents. At the same time, LV PEAK experts believe that it is very important that state support is precisely targeted at poorer population groups that need it the most.

THE DYNAMICS OF PRODUCTIVITY ARE VERY VOLATILE.

Since 2020, productivity dynamics have been affected by uneven adjustments in the product and labour markets in response to the containment measures of the Covid-19 pandemic and geopolitical upheavals. In 2020, productivity

increased by only 0.1%, but already in 2021, as restrictions eased and economic activities resumed, the rate of productivity growth accelerated and was 6.8% higher than a year ago. In the three quarters of 2022, compared to the corresponding period of the previous year, productivity decreased by 0.3 percent.

Graph 5. The productivity gap is narrowing



Although productivity growth has been almost 3.5 times faster than the EU average in the last ten years, a large productivity gap still remained. GDP per employed person in actual prices in Latvia was provisionally almost 60% of the average EU level in 2022.

LABOUR COSTS CONTINUE TO INCREASE.

Due to the decrease in economic activities, in 2020 labour costs also increased more slowly than in 2019 - by 5% (in 2019 - by 7.8%). Despite this, unit labour costs (ULC) increased by 4.8%, driven by slow productivity growth (by 0.1%).

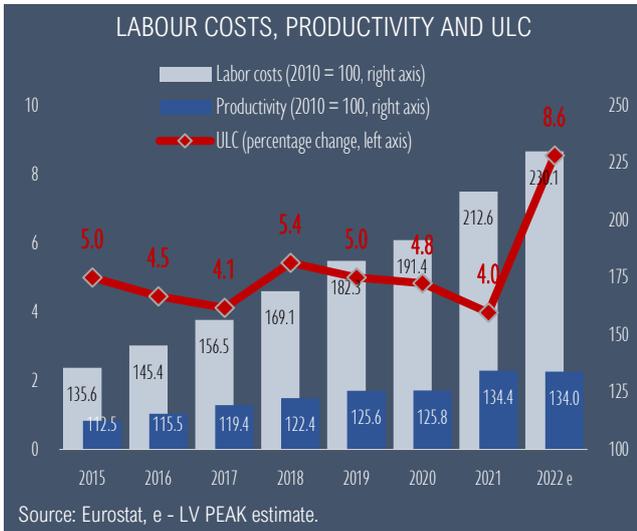
In 2021, labour costs continued to rise and were 11% higher than a year ago. The increase in productivity (by 6.8%) reduced the pressure of rising labour costs on competitiveness. ULC growth in 2021 was more moderate than a year ago (increased by 4%). The dynamics of labour costs in the three quarters of 2022 was slightly more moderate than in 2021, however, due to the decrease in productivity, ULC increased by 8.6%. A rapid increase in nominal ULC can be observed in all Baltic countries.

DESPITE THE WEAKENING OF COST COMPETITIVENESS FACTORS, LATVIA'S EXPORT MARKET SHARE IS INCREASING.

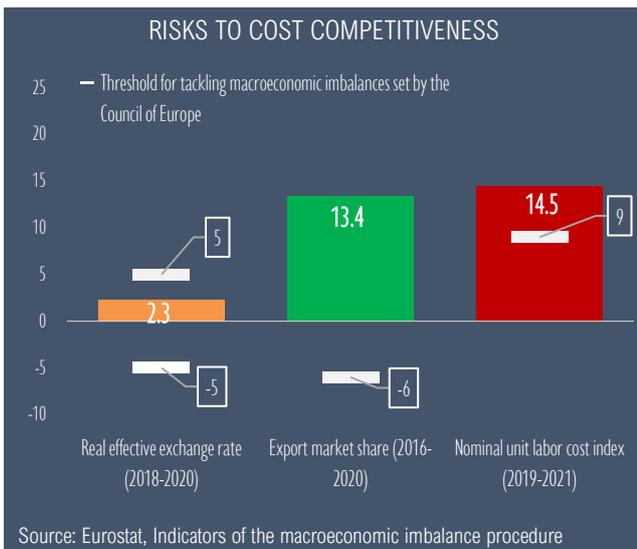
Risks of a weakening of cost competitiveness are growing, as evidenced by the increase in the real effective exchange rate (REER) and ULC. However, the dynamics of Latvia's export market share is still positive. In 2020, it increased by 10.2%,

and in five years (2016–2020) – it increased by 18.2%. This was determined by the increase in the market share of the export of goods – by 24.7% and the increase in the market share of the export of services by 3.4 percent.

Graph 6. Labour costs are growing faster than productivity



Graph 7. Risks to cost competitiveness increase



INCREASING PRODUCTIVITY IS A KEY FACTOR FOR GROWTH.

The corrections caused by the crises do not significantly change the long-term trends in the dynamics of labour costs, which will continue to be quite rapid. The increase in labour costs is largely influenced by unfavourable demographic trends, growing demand and high competition in the EU's open labour markets.

In 2022, labour costs have significantly exceeded pre-pandemic levels, while productivity growth has been more modest over the same period. This indicates an increase in the productivity gap. Latvia's biggest challenge is to increase

productivity, which is the only way to prevent increasing cost pressures on competitiveness.

According to LV PEAK experts, productivity growth will have to be increasingly based on science-intensive activities, which currently account for a small share of the economy. Latvia's weakest point is innovation – investment in research and development, as well as in improving people's knowledge and skills. However, policy makers must not forget the "old" problems, such as infrastructure deficiencies, regional differences, social inequalities, etc. Increasing productivity and competitiveness requires a comprehensive and broader approach: strong performance in one area cannot compensate for poor performance in another.

THE COVID-19 PANDEMIC HAS CAUSED A SIGNIFICANT CHANGE IN THE FISCAL POLICY IMPLEMENTED TO DATE.

In 2020, the EU's general exemption clause in the Stability and Growth Pact (SGP) was activated allowing the EU countries to increase their general government deficits in 2020, 2021 and 2022 to the extent necessary to mitigate the economic damage caused by the pandemic. Considering the Russia's invasion of Ukraine and all the consequences related to it, the general exemption clause of the SGP will also be valid in 2023.

A high level of deficit in the years 2020 – 2022 was determined by a large package of support measures to mitigate the impact of Covid-19 and to recover the economy. The 2022 budget was approved with a deficit of 4.8% of GDP. However, the budget deficit will be higher because of the war in Ukraine. According to the assessment of the European Commission and the Ministry of Finance, it could reach 7% of GDP in 2022. The year 2023 will begin with a temporary or technical state budget, which the government approved in mid-October 2022 with a budget deficit of 3.3% of GDP. The full budget for 2023 will be adopted by the new Saeima (Parliament of Latvia).

Table 2. The budget deficit widened significantly because of the Covid-19 pandemic

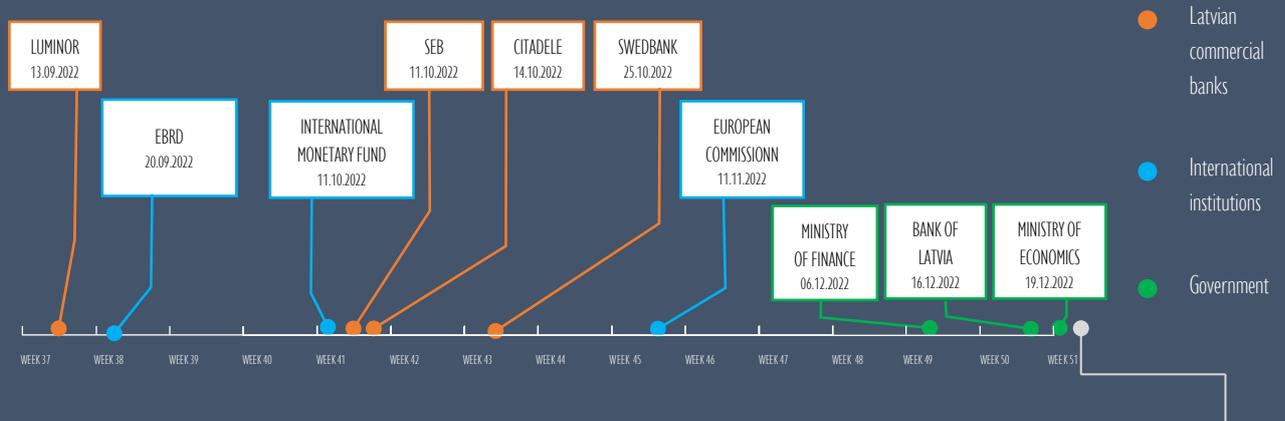
	2018	2019	2020	2021	2022f
Revenues, % of GDP	38.5	37.6	37.8	37.0	36.3
Expenditures, % of GDP	39.4	38.2	42.2	44.0	43.3
Balance, % of GDP	-0.8	-0.6	-4.3	-7.0	-7.0

Source: CSB, f – the European Commission forecast.

Given the geopolitical uncertainty, LV PEAK experts believe that it is necessary to carry out a radical assessment of budget expenditures and effectively invest the resources of the Recovery and Resilience Facility to strengthen the competitiveness of the economy.

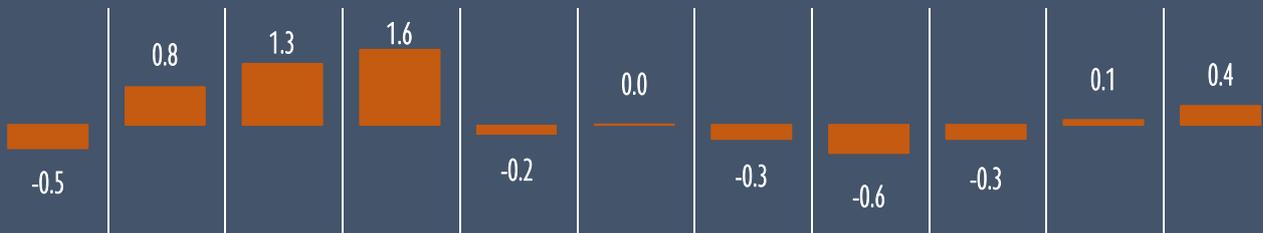
INFOGRAPHIC

FORECASTS OF LATVIAN AND INTERNATIONAL INSTITUTIONS – ECONOMY SLOWS DOWN, HIGH INFLATION WILL REMAIN



LUMINOR	EBRD	SEB	IMF	CITADELE	SWEDBANK	EUROPEAN COMMISSION	MINISTRY OF FINANCE	BANK OF LATVIA	MINISTRY OF ECONOMICS	LV PEAK EXPERT CONSENSUS FORECAST
Source: →	Source: →	Source: →	Source: →	19.12.2022.						

GDP FORECASTS 2023, Growth rate, %



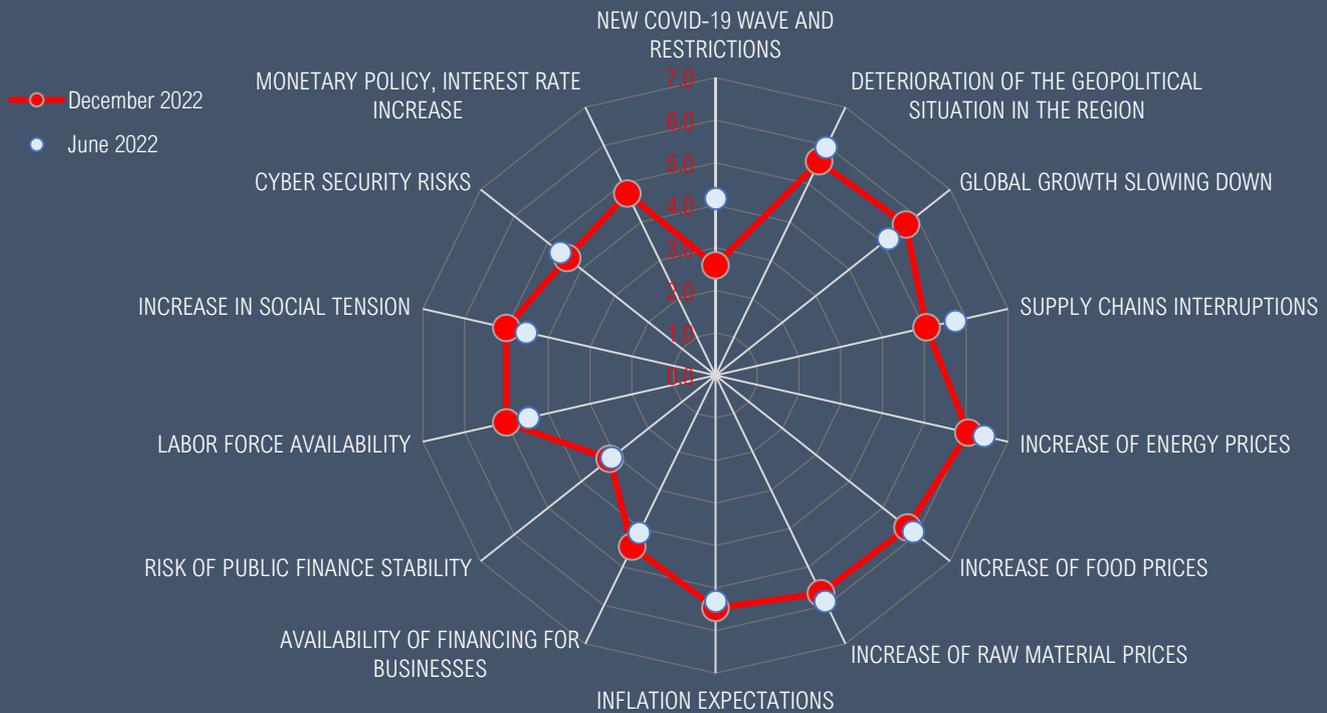
INFLATION FORECASTS 2023, Annual prices changes, %



INFOGRAPHIC

MAIN RISKS TO ECONOMIC GROWTH IN THE SHORT TERM – HIGH PRICES LEVEL AND GLOBAL ECONOMIC GROWTH

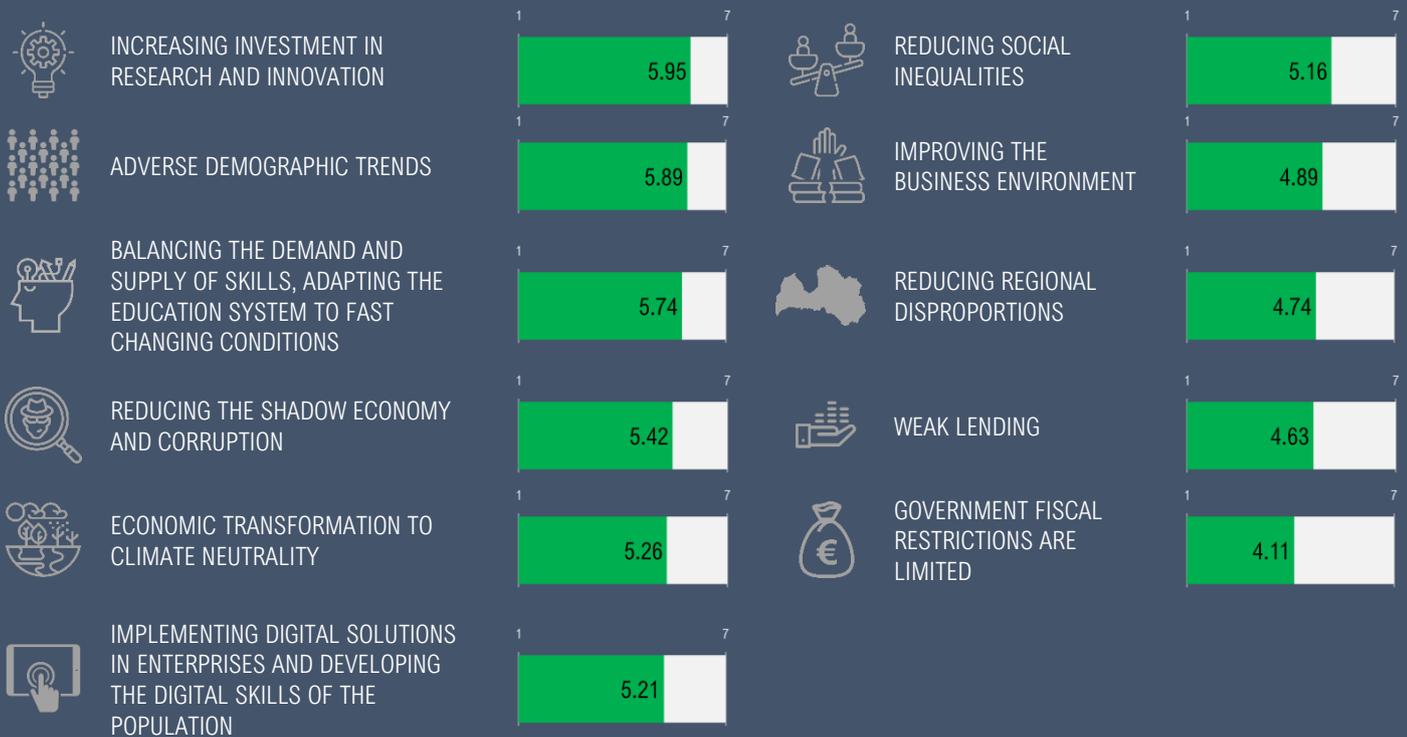
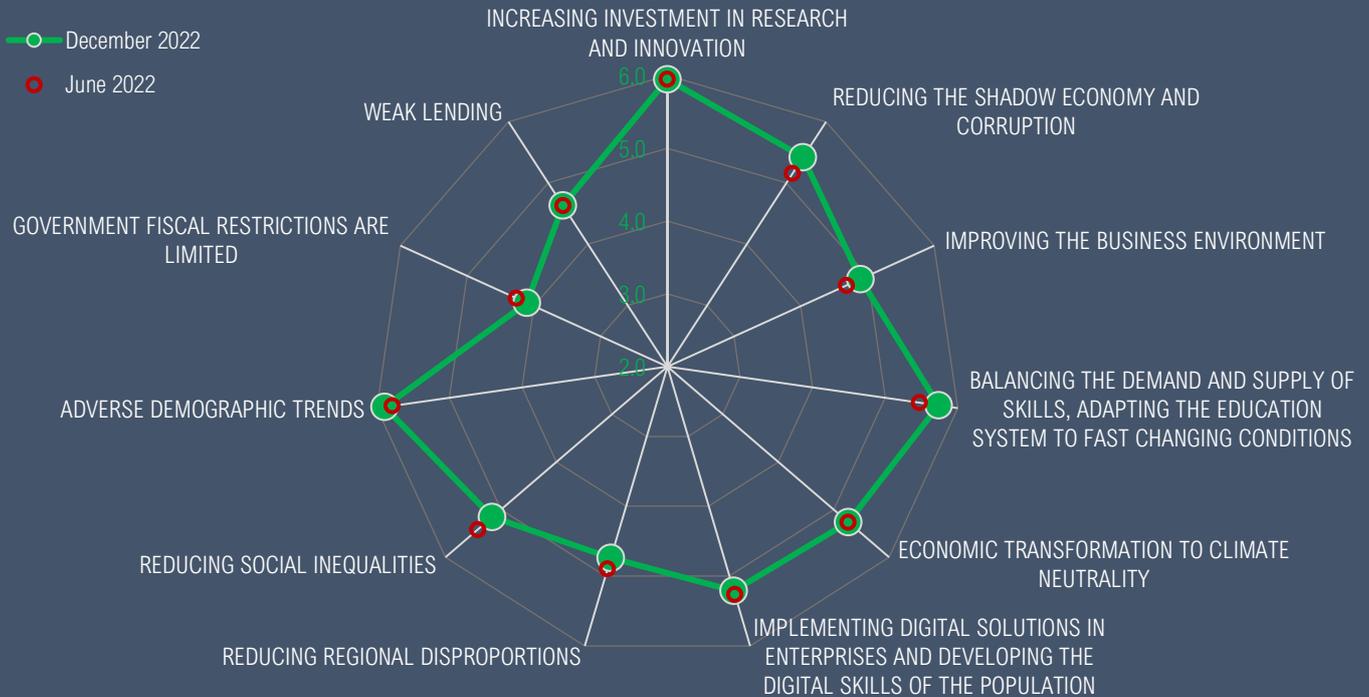
The LV PEAK expert survey asked to assess the potential risks to short-term economic growth on a scale from 1 (very low risk) to 7 (very high risk). The main risks identified are the increase in the prices of energy resources, food and raw materials and the high inflation expectations, as well as the possible slowdown in the growth of the Global Economy and the geopolitical situation in the region.



INFOGRAPHIC

MAIN MEDIUM-TERM CHALLENGES FOR GROWTH REMAIN - INVESTMENTS IN RESEARCH, NEW PRODUCTS, HUMAN CAPITAL

The LV PEAK expert survey asked to assess the potential challenges to economic growth in the medium term on a scale from 1 (very low) to 7 (very high). The main challenges are insufficient investment in research and development of new products. Human capital has an important role to play in future growth, with the unfavorable demographic situation and the matching of skills supply and demand also being identified as major challenges.



INFOGRAPHIC

PRODUCTIVITY IN LATVIA

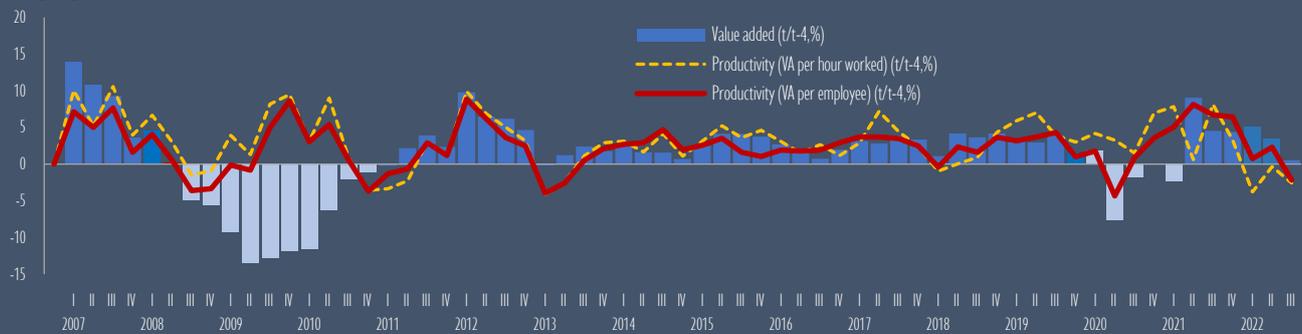
GROWTH RATES OF VALUE ADDED, EMPLOYMENT AND PRODUCTIVITY

changes against previous year, %



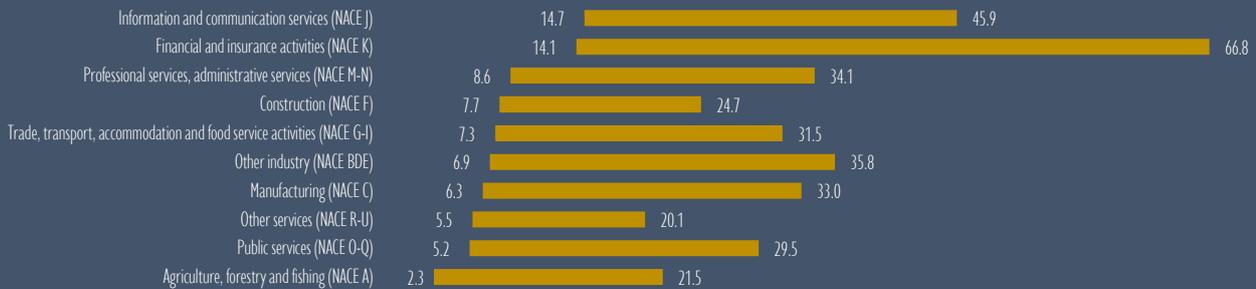
DYNAMICS OF LATVIA'S VALUE ADDED, NUMBER OF EMPLOYEES AND HOURS WORKED

change against corresponding quarter of the previous year, %, unadjusted data



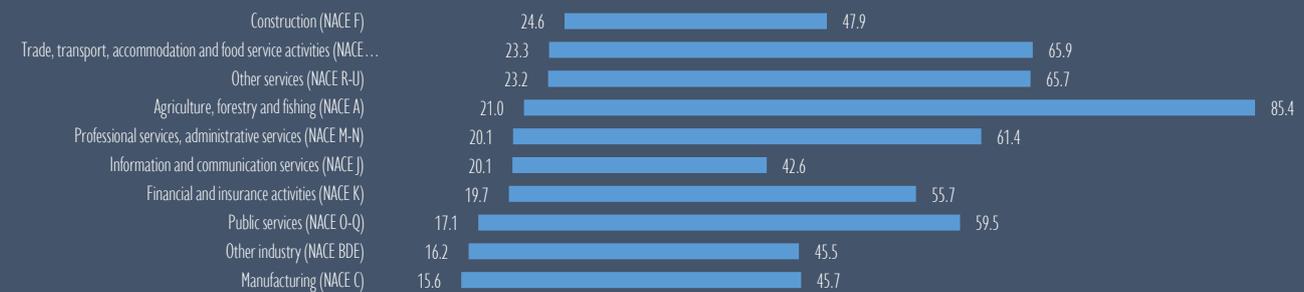
PRODUCTIVITY OF INDUSTRIES IN LATVIA 2000-2021

thousands EUR per employee, at current prices



PRODUCTIVITY OF LATVIA'S INDUSTRIES AGAINST THE EU AVERAGE LEVEL 2000-2021

current prices, EU=100



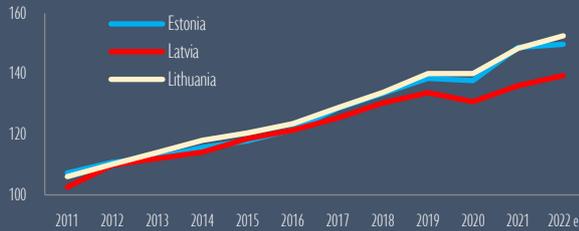
Avots: Eurostat

INFOGRAPHIC

COMPARISON OF THE BALTIC STATES

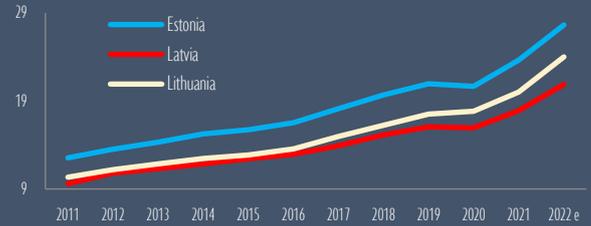
GROSS DOMESTIC PRODUCT

Growth at constant prices, 2010 = 100



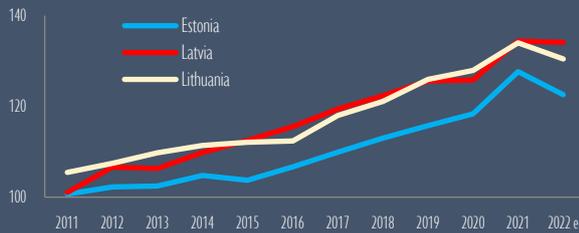
GROSS DOMESTIC PRODUCT PER CAPITA

At current prices, thousand EUR



PRODUCTIVITY

Growth at constant prices, 2010=100



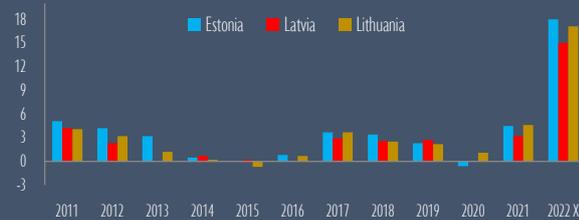
CONVERGENCE OF PRODUCTIVITY

From 2000 to 2021, at current prices, EU = 100



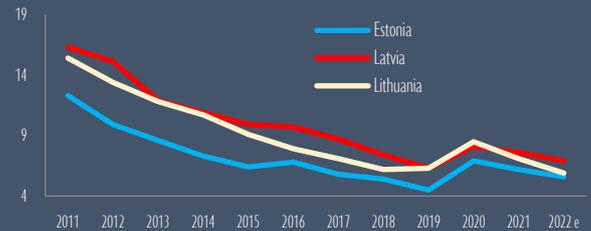
INFLATION

Harmonized index of consumer prices, annual average changes, %



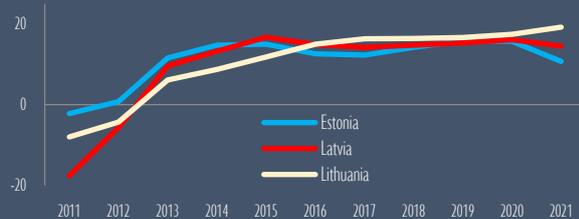
UNEMPLOYMENT

Unemployment rate in age group 15-74, %



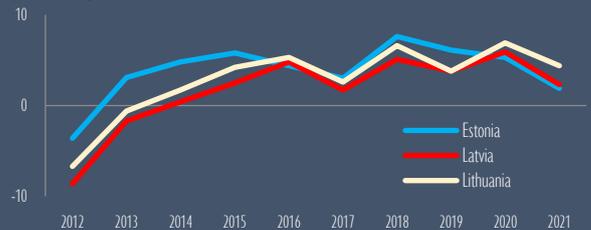
NOMINAL ULC

3-year changes in unit labor costs, %



REAL EFFECTIVE EXCHANGE RATE

3-year changes, %



EXPORT MARKET SHARES

5-year changes, %



EXPORTS PER CAPITA

At current prices, thousand EUR



Source: Eurostat, e - LV PEAK estimation

