

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. 1 (1) June 2022

Latvia's economy continues to recover from the crisis caused by the Covid-19 pandemic thanks to extensive government and the European Union (EU) support measures and increased exports. In the 1st quarter of 2022, the gross domestic product (GDP) has increased by 6.7% compared to the 1st quarter of 2021. However, the Russian invasion of Ukraine is having a negative effect on growth prospects. Inflationary pressures are rising, especially in energy and food prices. The number of employees and the employment rate are still significantly lower than in 2019. Labor shortages and a tight labor market are contributing to wage growth. Although not projected to be the case and not currently the most plausible scenario, the economy is in danger of stagnating as economic growth deteriorates further. The risks of declining competitiveness remain very high, as the gap between productivity and labour costs has widened as a result of the pandemic crisis. In order to increase competitiveness, in addition to support measures for companies to shift from Russian market to others, as well as to significantly reduce bureaucracy, the 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.

GEOPOLITICAL TENSION AFFECTS LATVIA'S ECONOMIC RECOVERY.

In 2020, due to the Covid-19 crisis, GDP decreased by 3.8%. Thanks to strong growth in exports of goods and investment, and the easing of restrictions related to the pandemic, in 2021 Latvia returned to economic growth. The steady recovery was also reflected in an increase in consumption, supported by extensive state aid measures. In 2021, GDP increased by 4.5 percent.

Russia's military aggression in Ukraine has caused serious economic disturbance and supply chain disruptions, which will significantly reduce growth and increase inflation in 2022. The forecast of the consensus of LV PEAK experts¹ shows that in 2022, the GDP will grow by 2% and it is by 2-3 percentage points less than predictions before the Russian invasion of Ukraine.

LV PEAK forecasts that growth will increase to 3.1% in 2023, although the effects of high inflation and the economic consequences of the Russian invasion of Ukraine will still slow it down.

Due to the war in Ukraine, the future is still very uncertain and changeable. Downside risks to growth prevail, the most important of which are related to global geopolitical and trade tensions, as well as the possible return of the pandemic.

Given the current circumstances, to stabilize 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.

Table 1. The economic recovery is affected by geopolitical tensions

	2019	2020	2021	2022 f	2023 f
GDP (% change on previous year)	2.5	-3.8	4.5	2.0	3.1
Unemployment (unemployed persons % of economically active population, 15-74 years)	6.3	8.1	7.6	7.4	6.9
Gross Wages (average gross wages, % change to previous year)	7.2	6.2	11.7	9.8	7.1
Inflation (average annual inflation, %)	2.8	0.2	3.3	11.1	5.6

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

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

Although the labour market is improving in line with the growth of economic activity, the unemployment rate in 2021 was still 1.2 percentage points higher and the participation rate 1.7 percentage points lower than before the pandemic.

Positive trends in the dynamics of unemployment have been observed since mid-2020. Unemployment continued to decline in 2021 and early 2022. In April 2022, it was 6.8%, which is 1.2 percentage points lower than in April 2021.

The lifting of restrictions imposed by the Covid-19 pandemic, as well as the construction of already started state infrastructure facilities will continue to support the labour market in 2022. Therefore, the direct impact on the Latvia's labour market caused by the sanctions following Russia's military aggression against Ukraine and the narrowing of the Latvia's export market can be assessed as small.

In addition, the fall in the unemployment rate in the coming years will also be affected by the shrinking labour force due to demographic trends. The consensus forecast of LV PEAK experts shows that in 2022 the average unemployment rate will be 7.4%, but in 2023 it will continue to decrease and will be 6.9 percent.

THE COVID-19 PANDEMIC CRISIS HAS AFFECTED THE ECONOMIC ACTIVITY OF THE POPULATION.

Number of employees and employment rates remain significantly lower than before the pandemic. In 2021, compared to 2020, the employment rate decreased by 1.7 percentage points, but the number of employees - by 29 thousand or 3.2%, which was the largest decrease in the number of employees since 2010.

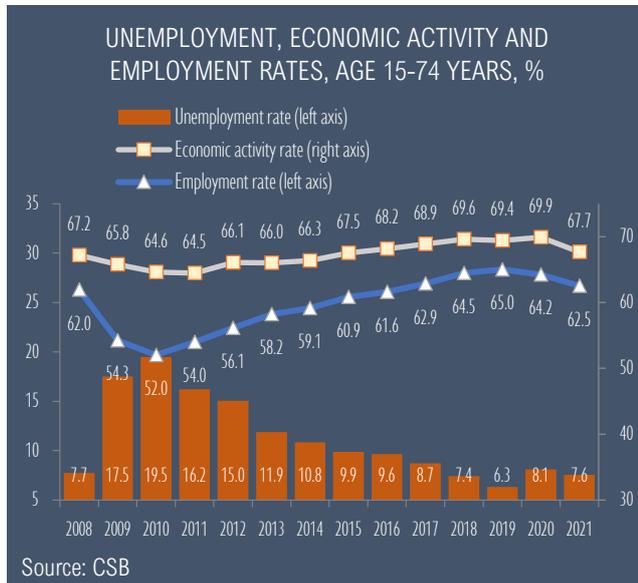
Declining employment rates and unfavourable demographic processes are narrowing labour supply and increasing the

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.

risks of labour shortages. In the short term, Ukrainian refugees will increase labour supply.

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



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 in order 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.

Graph 2. Wages continue to rise sharply



LABOUR SHORTAGES CONTRIBUTE TO WAGE GROWTH.

The average gross monthly salary in 2021 increased by 11.7% - to 1,277 euros per month, which has been the fastest salary

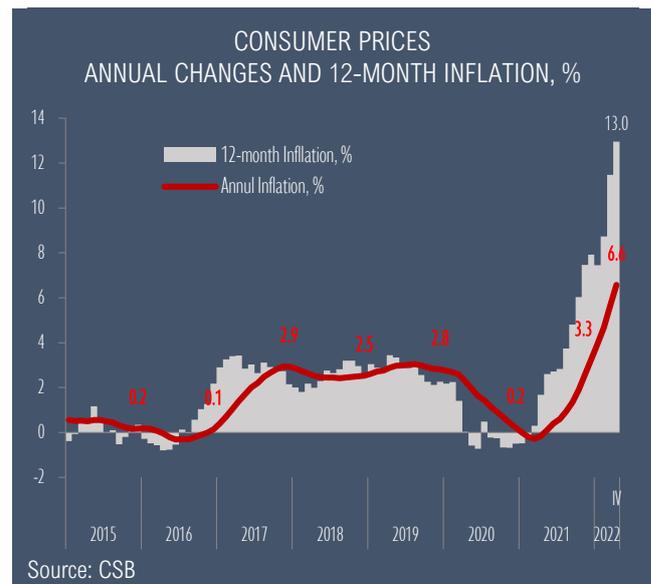
increase in the last 13 years. Both the process of wage convergence closer to that of the EU's economically developed countries and the growing shortage of highly skilled labour continue to maintain positive wage pressures.

The forecast of LV PEAK experts shows that despite the geopolitical tension, wages will continue to grow in 2022 - by 9.8%, but in 2023 - by 7.1 percent.

NEGATIVE SUPPLY DISTURBANCES COULD MAINTAIN HIGHER INFLATION.

Prior to the Covid-19 pandemic, a moderate increase in prices was observed in Latvia, from 2017 to 2019 average inflation fluctuate between 2.5 and 2.9%. However, during the pandemic in 2020, prices decreased because of significantly limited demand. In some months, 12-month price changes were even negative, but the average price level in 2020 increased by only 0.2 percent.

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

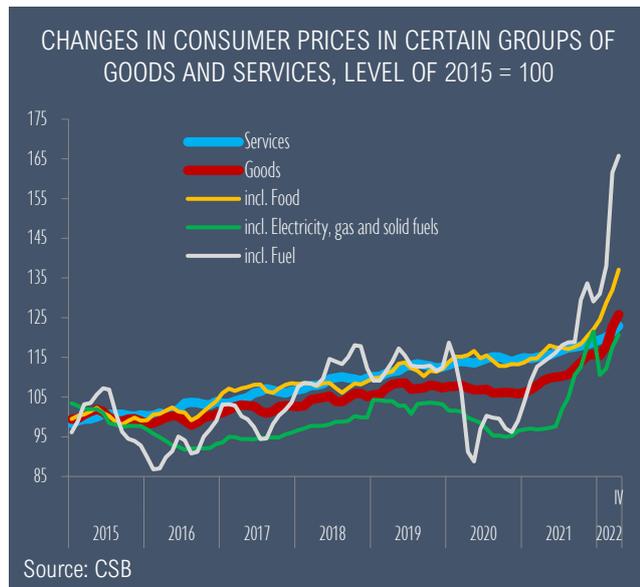


The adjustment of the economy to the conditions of the pandemic and vaccination affected the introduction of less and less restrictions and a relatively rapid economic recovery both in Latvia and globally. Logistics, supply chains and production capacity did not keep pace with the growing demand, which affected the rise in world prices in the second half of 2021, especially for metal, wood, etc. intermediate goods. Since the end of February 2022, the situation has been exacerbated by Russia's war in Ukraine, with energy and raw material prices rising sharply in times of great uncertainty.

In April 2022, consumer prices in Latvia were 13% higher than a year before, but average annual inflation rose to 6.6%. The

last time such fast price increase was 15 years ago. The biggest impact on inflation is the rise in food, electricity, heating and fuel prices. On an annual basis, in April food prices rose by 17.3%, electricity, gas and solid fuels by 24.4% and fuel by 46%. Overall these product groups accounted for half of all price increases.

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



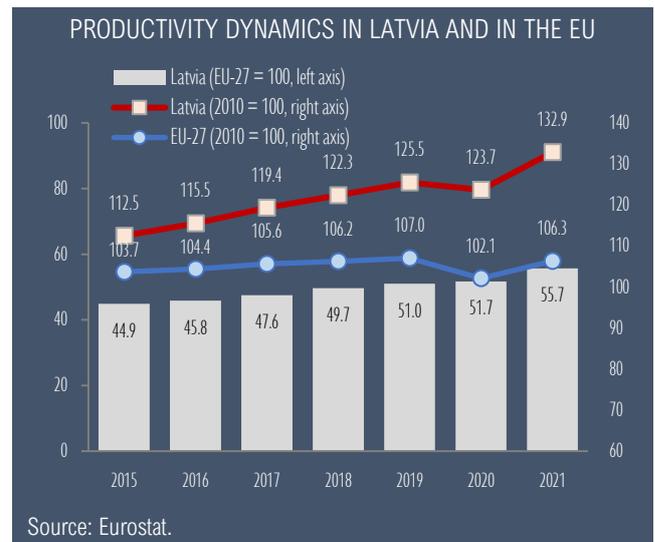
Inflation will remain high in the coming months LV PEAK forecasts that consumer price inflation will reach 11.1% on average in 2022, which will be determined most significantly by the rapid rise in energy prices. The rise in prices at the end of the year and in 2023 could slow down and the average annual inflation in 2023 could decrease to 5.6 percent.

Fiscal and monetary policy have an essential role to play in mitigating the effects of soaring prices. LV PEAK experts believe that it is very important that state support is timely and precisely targeted at the population groups that really need it. If you provide too generous support, there is a risk that inflationary pressures will only increase.

THE COVID-19 PANDEMIC HAS A NEGATIVE EFFECT ON PRODUCTIVITY.

Productivity dynamics since 2020 have been affected by uneven adjustments in product and labor markets in response to the Covid-19 pandemic. In 2020, productivity decreased by 1.5%, but already in 2021, as restrictions eased and economic activity resumed, productivity was 7.2% higher than a year ago.

Graph 5. The productivity gap is narrowing

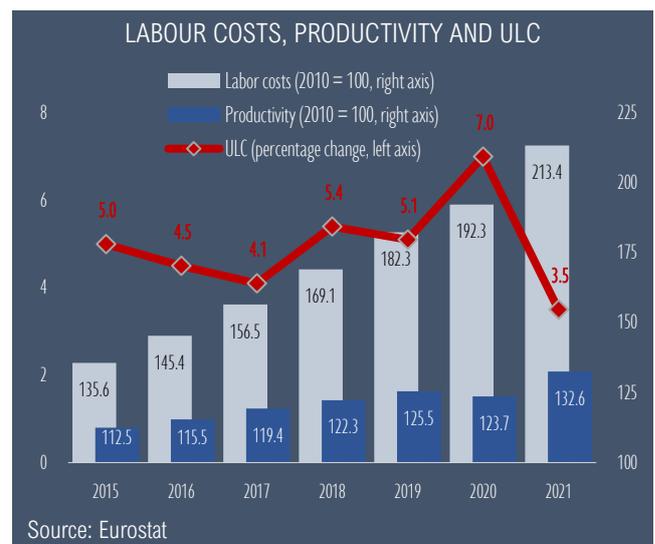


Although productivity growth has been almost 3.5 times faster than the EU average over the last decade, a large productivity gap remains. GDP per employee in Latvia in 2021 was 55.7% (73.5% according to the Purchasing Power Standards) from the EU average.

LABOUR COSTS CONTINUE TO INCREASE.

Due to the decline in economic activity, labour costs in 2020 also grew more slowly than in 2019 - by 5.5% (in 2019 - by 7.8%). Nevertheless, unit labour costs (ULC) increased by 7% due to a decrease in productivity (by 1.5%).

Graph 6. Labour costs are growing faster than productivity



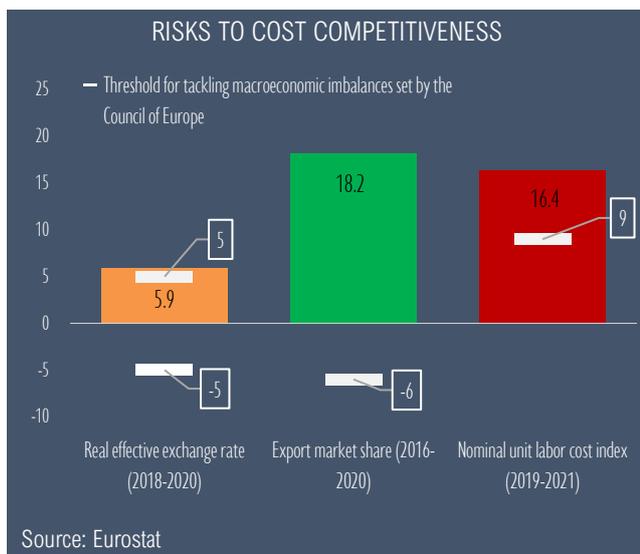
In 2021, labour costs continued to rise and were 11% higher than a year ago. Productivity growth (by 7.2%) reduced the pressure of labour costs increase on competitiveness. The

growth of ULC in 2021 was more moderate than a year before (increased by 3.5%). Rapid increase in nominal ULC is observed in all Baltic countries.

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

The risks to the weakening of cost competitiveness are growing, as evidenced by the appreciation of the real effective exchange rate (REER) and the ULC. However, the dynamics of Latvia's export market share is still positive. In 2020, it increased by 10.2%, but in five years (2016-2020) - increased by 18.2%. This was due to the growth of the export market share of goods by 24.7% and an increase in the market share of exports of services by 3.4 percent.

Graph 7. Risks to cost competitiveness increase



INCREASING PRODUCTIVITY IS A KEY FACTOR FOR GROWTH.

The Covid-19 pandemic crisis adjustments have not significantly reversed the long-term trend in labour cost developments, which will remain relatively fast. Rising labour costs are largely driven by unfavourable demographic trends, growing demand and high competition in the EU's open labour markets.

In 2021, 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 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.

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

	2018	2019	2020	2021
Revenues, % of GDP	38.5	37.6	38.8	37.6
Expenditures, % of GDP	39.4	38.2	43.3	44.9
Balance, % of GDP	-0.8	-0.6	-4.5	-7.3

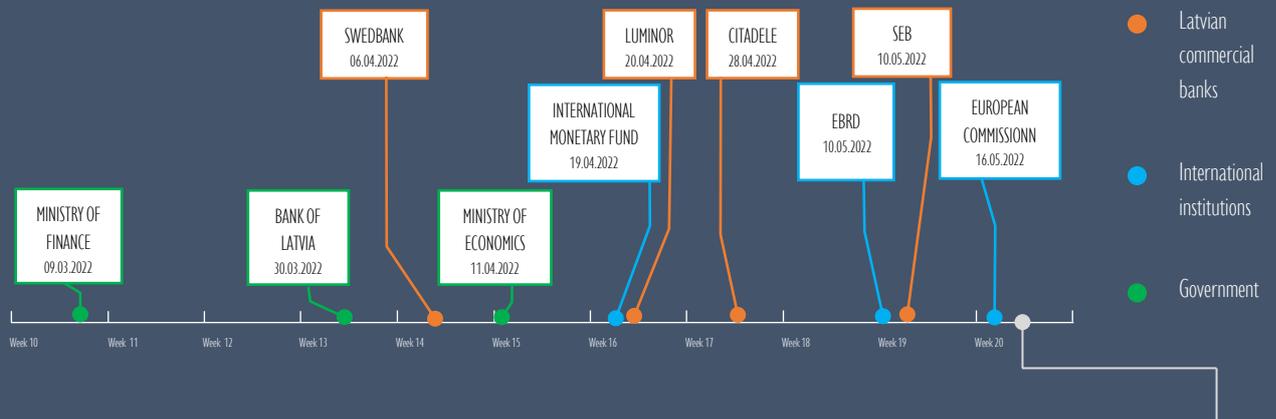
Source: CSB

The high deficit levels in 2021 and 2022 were determined by a large package of support measures to reduce the impact of Covid-19 pandemic and for economic recovery, the impact of which the Ministry of Finance of Latvia has estimated at 2.2 billion euros or 6.9% of GDP. The 2022 budget was approved with a deficit of 4.8% of GDP. It envisages the end of most support measures related to the Covid-19 pandemic crisis. However, in view of the Russia-Ukraine war and all its consequences, the budget could be changed.

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.

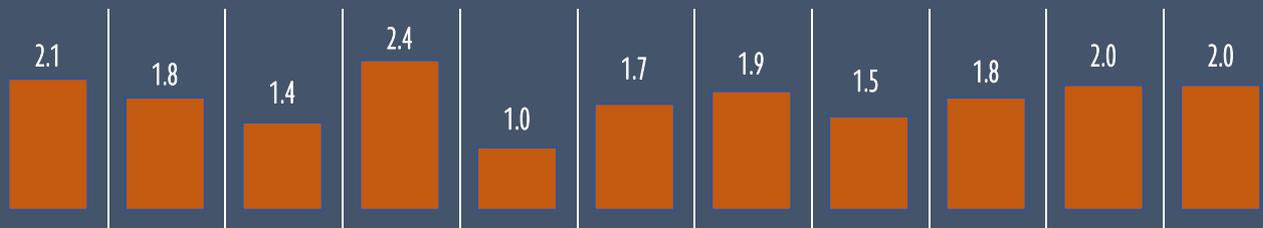
INFOGRAPHIC

FORECASTS OF LATVIAN AND INTERNATIONAL INSTITUTIONS - ECONOMIC GROWTH WILL SLOW UP, RAPID INFLATION WILL REMAIN

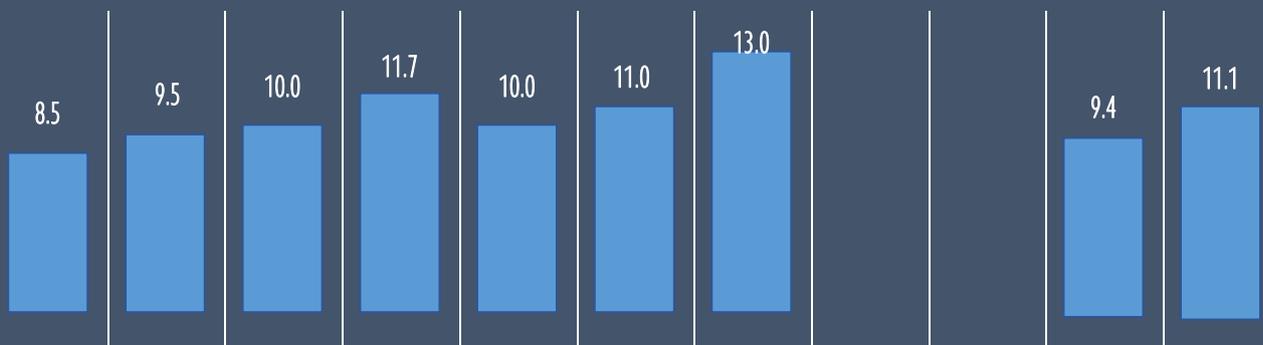


MINISTRY OF FINANCE	BANK OF LATVIA	SWEDBANK	MINISTRY OF ECONOMICS	IMF	LUMINOR	CITADELE	EBRD	SEB	EUROPEAN COMMISSION	LV PEAK EXPERT CONSENSUS FORECAST
Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔
										18.05.2022.

GDP FORECASTS 2022, Growth rate, %



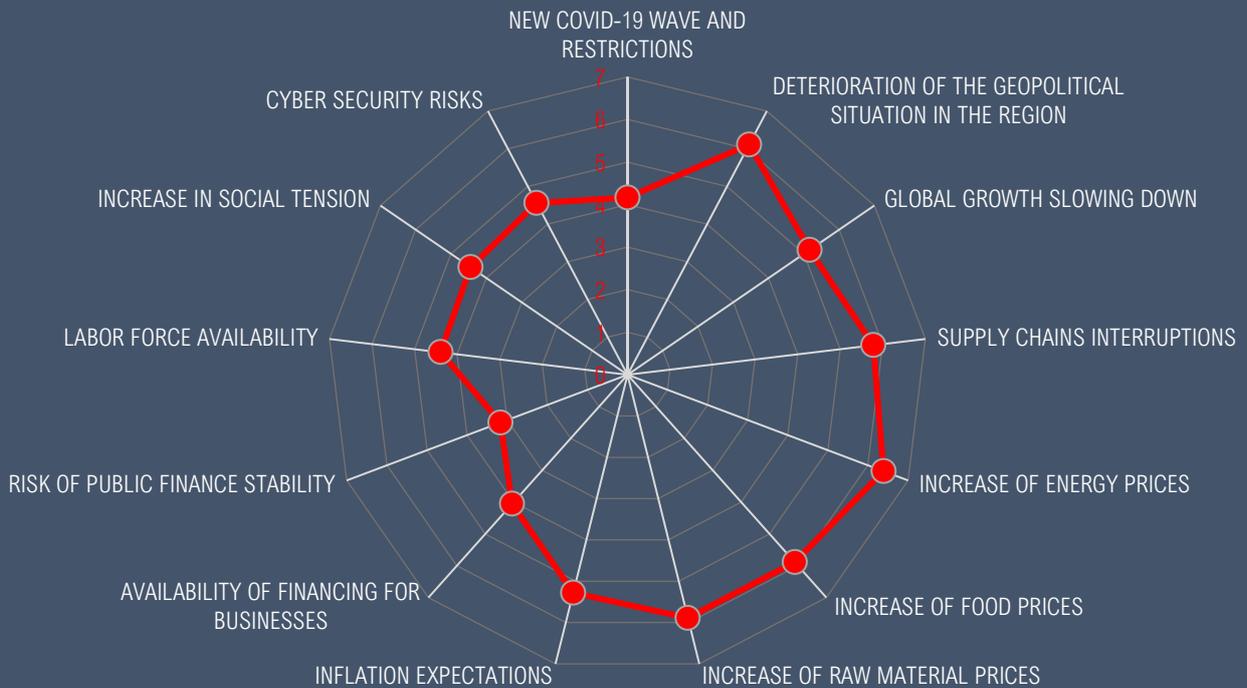
INFLATION FORECASTS 2022, Annual prices changes, %



INFOGRAPHIC

MAIN RISKS TO ECONOMIC GROWTH IN THE SHORT TERM - INCREASED PRICES AND THE GEOPOLITICAL SITUATION IN THE REGION

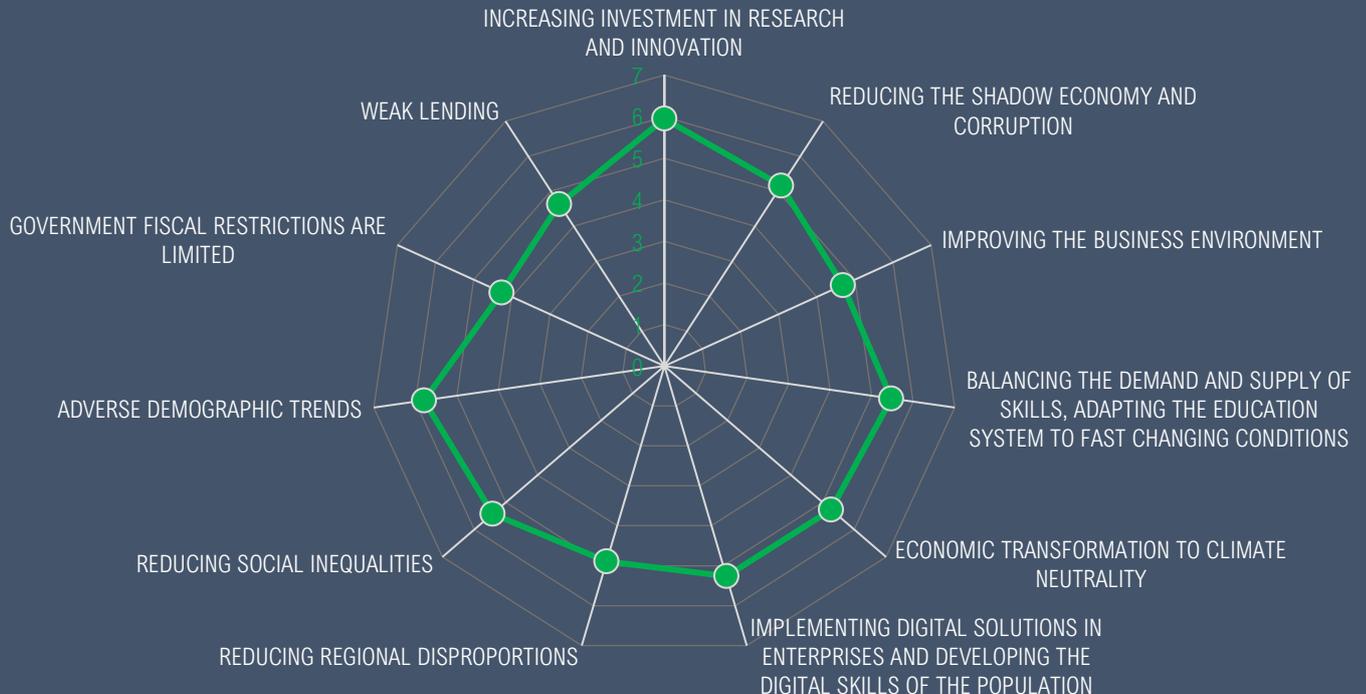
The LV PEAK expert survey asked to assess the potential risks to short-term economic growth on a scale from 1 (very low risk) to 7 (very high risk). The main risks identified are rising energy prices and a deteriorating geopolitical situation in the region. Rising food and commodity prices, possible supply chain disruptions and consumer inflation expectations were also assessed as high risks.



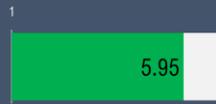
INFOGRAPHIC

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

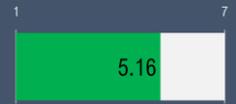
The LV PEAK expert survey asked to assess the potential challenges to economic growth in the medium term on a scale from 1 (very low) to 7 (very high). The main challenges are insufficient investment in research and development of new products. Human capital has an important role to play in future growth,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



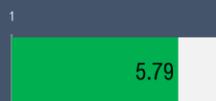
INCREASING INVESTMENT IN RESEARCH AND INNOVATION



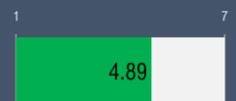
REDUCING THE SHADOW ECONOMY AND CORRUPTION



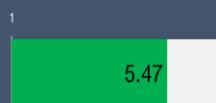
ADVERSE DEMOGRAPHIC TRENDS



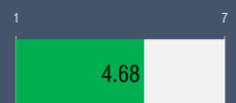
REDUCING REGIONAL DISPROPORTIONS



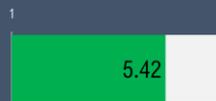
BALANCING THE DEMAND AND SUPPLY OF SKILLS, ADAPTING THE EDUCATION SYSTEM TO FAST CHANGING CONDITIONS



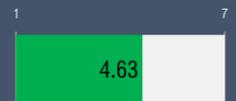
IMPROVING THE BUSINESS ENVIRONMENT



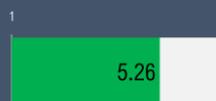
REDUCING SOCIAL INEQUALITIES



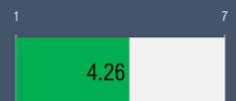
WEAK LENDING



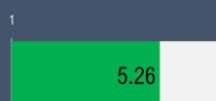
ECONOMIC TRANSFORMATION TO CLIMATE NEUTRALITY



GOVERNMENT FISCAL RESTRICTIONS ARE LIMITED



IMPLEMENTING DIGITAL SOLUTIONS IN ENTERPRISES AND DEVELOPING THE DIGITAL SKILLS OF THE POPULATION



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



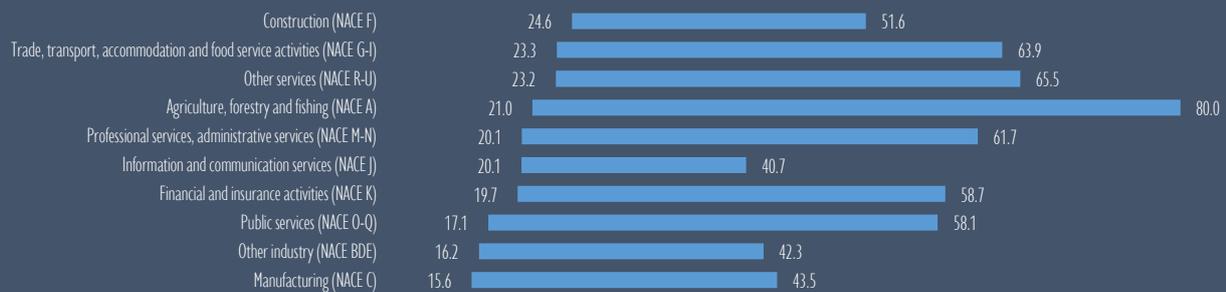
PRODUCTIVITY OF INDUSTRIES IN LATVIA 2000-2021

thousands EUR per employee, at current prices



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

current prices, EU=100



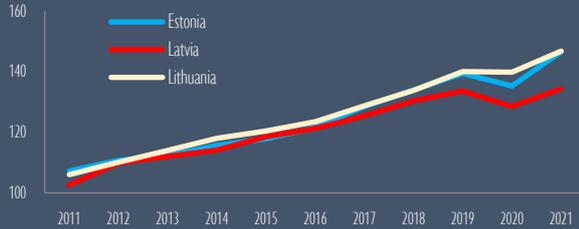
Source: Eurostat

INFOGRAPHIC

COMPARISON OF THE BALTIC STATES

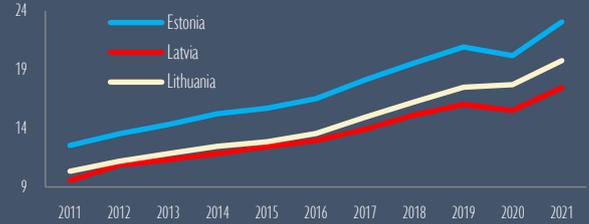
GROSS DOMESTIC PRODUCT

Growth at constant prices, 2010 = 100



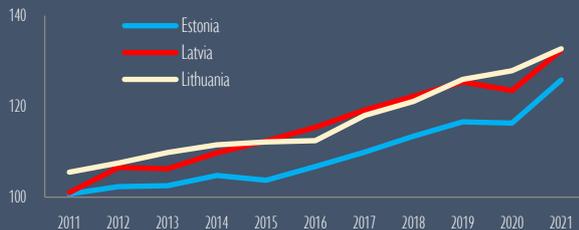
GROSS DOMESTIC PRODUCT PER CAPITA

At current prices, thousand EUR



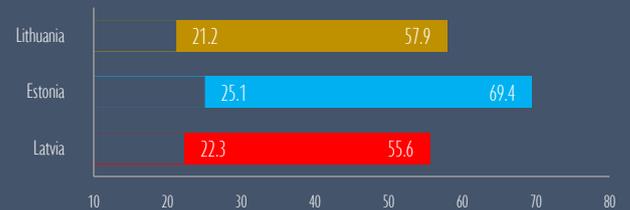
PRODUCTIVITY

Growth at constant prices, 2010=100



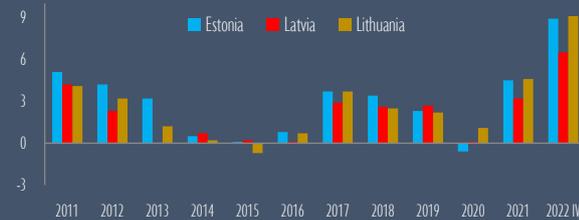
CONVERGENCE OF PRODUCTIVITY

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



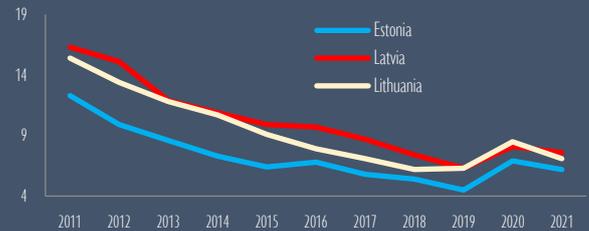
INFLATION

Harmonized index of consumer prices, annual average changes, %



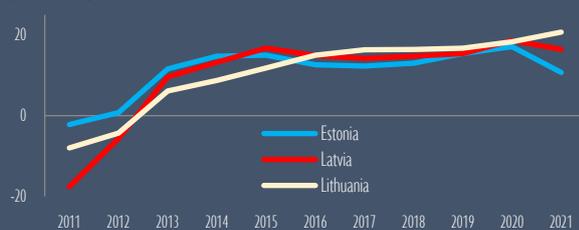
UNEMPLOYMENT

Unemployment rate in age group 15-74, %



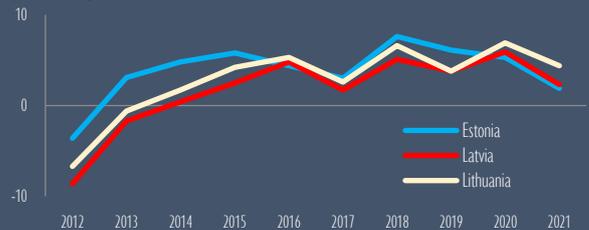
NOMINAL ULC

3-year changes in unit labor costs, %



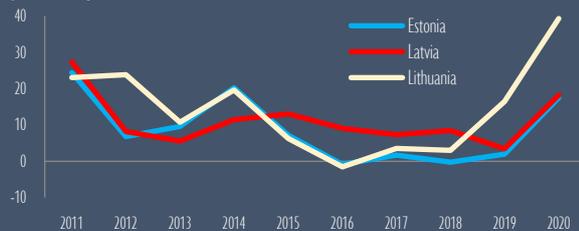
REAL EFFECTIVE EXCHANGE RATE

3-year changes, %



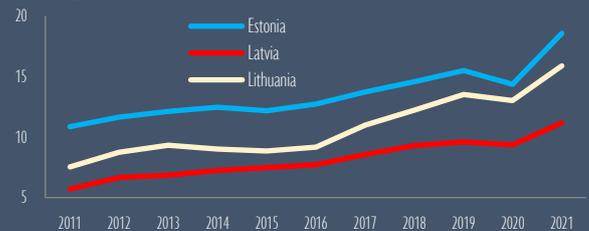
EXPORT MARKET SHARES

5-year changes, %



EXPORTS PER CAPITA

At current prices, thousand EUR



Source: Eurostat