

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



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MANAGEMENT
AND ECONOMICS

ECONOMIC BAROMETER

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The geopolitical situation and uncertainty continue to affect economic development in Latvia. Russia's war in Ukraine has slowed the recovery from the pandemic and led to higher energy prices and disruptions to trade and supply chains, weighing on economic growth. In 2023, GDP decreased by 0.3% compared to the previous year. In 2024, it is expected that the economy will return to growth, which will be promoted by the increase in EU-financed investments and the faster growth of exports due to the improvement of external demand, as well as the gradual increase in private consumption. In 2023, inflation stabilized, returning to the monthly price changes that existed before the Covid-19 pandemic. Average annual inflation will continue to decrease in 2024. The main influence on price changes is related to fluctuations in global energy and food prices and will be increasingly influenced by demand as wages are expected to continue to rise. Despite the negative impact of the Ukrainian war on economic development, the labour market is stable. However, in 2023, the growth of new jobs and employment has become slower compared to 2022. The situation on the labour market will also be stable in 2024, however, companies will increasingly face labour shortages. Unfavourable demographic processes narrow the labour supply and increase the risks of labour shortages.

Risks of a loss of competitiveness remain very high due to the gap between labour costs and productivity growth has widened because of the pandemic crisis. Labour costs are well above pre-pandemic levels, while productivity gains have been more moderate over the same period. 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 biggest challenge is innovation, which requires investments in research and development, as well as improving people's knowledge and skills. Funding of credit institutions for companies and the development of the capital market should be promoted. Inadequate funding for business development is one of the main causes of Latvia's growth lag behind Lithuania and Estonia in the last decade. Likewise, one of the most important tasks is strengthening energy security and using the opportunities of the green deal. Considering the geopolitical uncertainty, it is necessary to carry out a radical evaluation of budget expenditures and to effectively invest EU funds and the Recovery and Resilience Facility to strengthen the competitiveness of the economy.

THE GEOPOLITICAL SITUATION CONTINUES TO AFFECT GROWTH NEGATIVELY.

The recovery of Latvia's economy from the Covid-19 pandemic crisis in 2022 was interrupted by the war started by Russia in Ukraine. The economic development was significantly affected by the supply chain disruptions caused by the war, the sharp rise in energy and food prices, as well as the decrease in global demand. Growth slowed to 3% in 2022 as investment growth rates worsened.

In 2023, the economic development continued to be affected by the geopolitical situation and uncertainty, high prices and rising bank interest rates, negatively affecting private consumption and exports. Investments and public consumption, on the other hand, showed strong growth. In 2023, GDP was 0.3% lower than a year ago.

In the first quarter of 2024, GDP increased by 0.1% compared to the corresponding period of the previous year. The leading indicator tool created by LV PEAK shows that economic development is still affected by geopolitical uncertainty and low external demand. However, the situation tends to gradually

improve, as the economy is starting to grow in Latvia's largest export markets, which will positively affect the country's export opportunities (see infographic on page 11).

According to the consensus forecast of LV PEAK experts¹, overall, in 2024, GDP will grow by 1.5%. In 2025, growth will slightly accelerate, and GDP will increase by 2.6%, which will be facilitated by the increase in EU-financed investments and the faster growth of exports due to the improvement of external demand, as well as the faster growth of private consumption.

Given the current circumstances, to stabilize the situation the following tasks are considered urgent by LV PEAK experts: to strengthen the country's external and internal security; to promote investment attraction and productivity; to carry out structural reforms in the areas of education quality and health care; to significantly reduce bureaucracy, the shadow economy and corruption; to solve the labour shortage; to promote financing by credit institutions for companies. Also, experts believe that it is necessary to intensify the acquisition of EU funds and the Recovery and Resilience Facility, the use of green deal opportunities.

Table 1. The economic recovery is affected by geopolitical tensions.

	2021	2022	2023	2024f	2025f
GDP (% change on previous year)	6.7	3.0	-0.3	1.5	2.6
Unemployment (Unemployed persons % of economically active population, 15-74 years)	7.6	6.9	6.5	6.4	6.2
Gross Wages (Average gross wages, % change to previous year)	11.8	7.5	11.9	7.5	6.9
Inflation (Average annual inflation, %)	3.3	17.3	8.9	2.0	2.2

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

THE LABOR MARKET REMAINS STABLE.

Despite the negative impact of the Ukrainian war on economic development, in 2023 the Latvian labour market continued to recover from the negative consequences of the Covid-19 pandemic, unemployment decreased, and the employment rate increased. However, in 2023, the number of employees slightly decreased by 2 thousand or by 0.2% compared to 2022.

The decrease in the number of employees in 2023 was largely influenced by the slowing down of the economic growth rate, as well as the decrease in the number of working-age population.

Positive trends have been observed in the dynamics of unemployment since the middle of 2020. The unemployment rate in 2023 was 6.5% or 0.4 percentage points lower than in

2022. Unemployment rates are higher for young people, people with low skills and those living in rural areas.

The consensus forecast of LV PEAK experts shows that the unemployment rate will continue to decrease in 2024 to 6.4%, and in 2025 its level could be 6.2%.

LABOUR SUPPLY CONTINUES TO DECREASE.

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. Unfavourable demographic processes narrow the labour supply in the labour market and increase the risks of labour shortages.

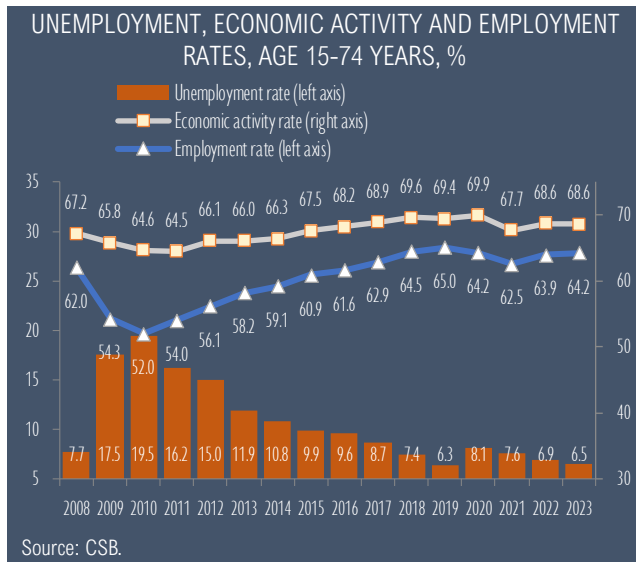
Also, it should be considered that the Covid-19 pandemic crisis has accelerated structural changes in labour demand. On the one hand, by accelerating the automation of jobs in labour-intensive industries - mainly by reducing the demand for low-

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.

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.

Graph 1. The labour market continues to recover from the Covid-19 crisis.



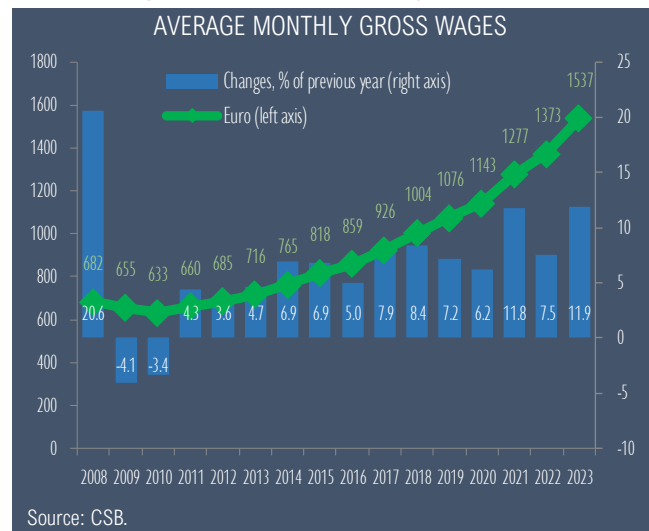
Seeing that the problem of labour shortage will worsen in the future, LV PEAK experts believe that it is necessary to strengthen the adult education system to ensure the transition of the workforce from unproductive areas to growing industries. The effectiveness of the adult education system will also play an important role in mitigating the negative consequences of Covid-19 and the Russia-Ukraine war and increasing the overall level of productivity of the national economy.

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

The monthly average gross wage continues to increase rapidly. In 2023, the average annual wage increase reached 11.9%, while the average gross salary increased to 1,537 euros. It should be noted that significant wage growth in Latvia has already been observed in previous years - the average wage growth since 2014 has exceeded 5% per year. However, in contrast to what was observed in previous years, net wages for the period from Q1 2022 to Q1 2023 were lower than the growth rate of inflation, leading to a reduction in purchasing power. As inflation rates ease, real net wage growth has started to pick up again since Q2 2023. In overall in 2023, the real net salary increased by 2.2% compared to 2022.

The forecast of LV PEAK experts shows that despite the geopolitical tension, salaries will continue to grow in 2024 by 7.5%, and in 2025 – by 6.9%.

Graph 2. Wages continue to rise sharply.

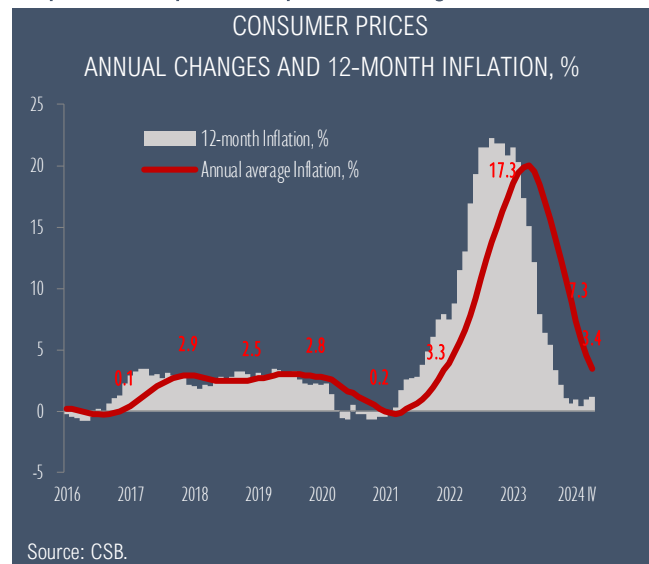


THE RAPID RISE IN PRICES IS BEHIND.

The economic adjustment after the pandemic conditions happened rapidly. The supply did not keep up with the growing demand, which led to a sharp rise in global prices in the second half of 2021.

The situation was further aggravated by the Russia's invasion of Ukraine in February 2022 - the prices of energy resources, food and raw materials increased significantly. In December 2022, consumer prices in Latvia were 20.8% higher than a year ago, while the annual average inflation rose to 17.3%. The biggest impact on the overall price increase in 2022 was the increase in the prices of food, electricity and fuel.

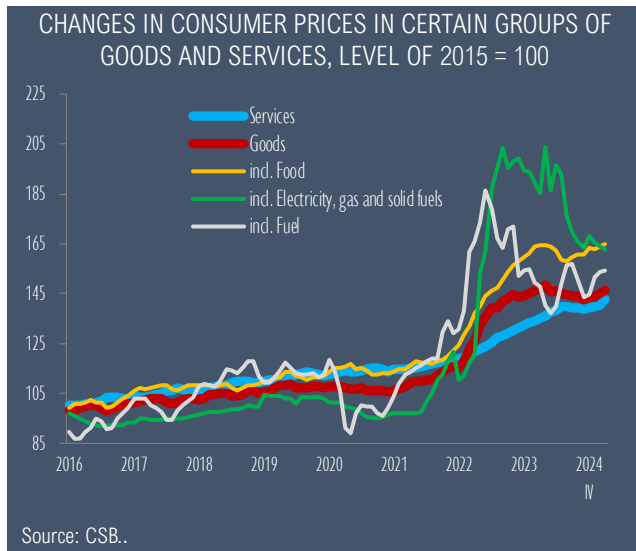
Graph 3. The rapid rise in prices is easing.



In 2023, prices stabilized. 12-month inflation decreased from 21.5% at the beginning of the year to 0.6% in December. Taking into account the base effect of inflation, in 2023 the average annual inflation was 8.9%. The biggest increasing effect on the average level of consumer prices during the year was the increase in the prices of services, which increased by

5.3%. At the beginning of 2023, food prices continued to rise rapidly, but in the second half of the year, characteristic monthly price increases were already observed. The average price level of alcoholic beverages and tobacco products increased by 8.3% during the year. The biggest reducing effect in 2023 was the drop in prices for electricity, gas, solid fuel and thermal energy.

Graph 4. The prices of energy resources are decreasing.



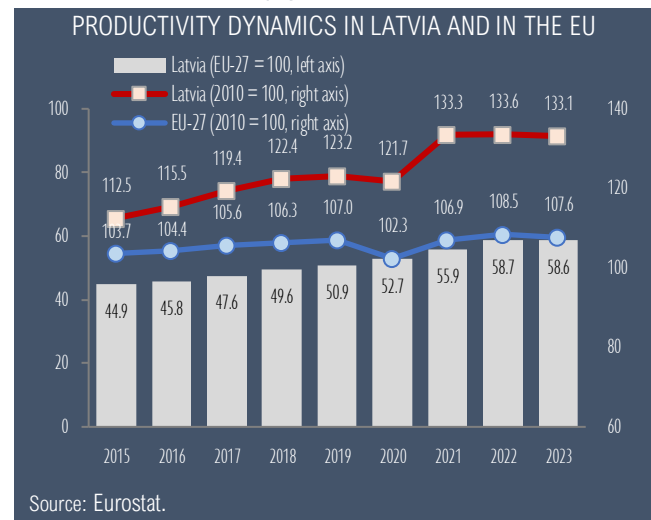
In April 2024, compared to April 2023, consumer prices increased by 1.1%. Annual average inflation in April was 3.4%. Annual average inflation is expected to continue to slow down gradually. The LV PEAK experts predict that the average annual inflation in 2024 will be 2%. Similar inflation rates are expected in 2025 as well.

THE DYNAMICS OF PRODUCTIVITY ARE VERY VOLATILE.

Since 2020, productivity dynamics have been affected by uneven adjustments in the product and labor markets in response to the containment measures of the Covid-19 pandemic and geopolitical upheavals. In 2020, productivity decreased by 1.2%, but already in 2021, as economic activities resumed, the rate of productivity growth accelerated and was 9.5% higher than a year ago, which can be partly explained by the low base effect. Economic growth was extensive in the following two years. Productivity in 2022 exceeded the level of the previous year by only 0.2%, while in 2023 it was 0.3% lower than a year ago.

The dynamics of productivity in Latvia in the long term has been fluctuating, but generally faster than the EU average, which ensured productivity convergence closer to the EU average level. However, in the last two years, the dynamics of productivity lags behind the EU average and the productivity gap still remained large. GDP per employed person in actual prices in the Latvian national economy in 2023 was only 58.6% (72.8% according to the purchasing power parity standard) of the average EU level.

Graph 5. The productivity gap remains wide.



LABOUR COSTS CONTINUE TO INCREASE.

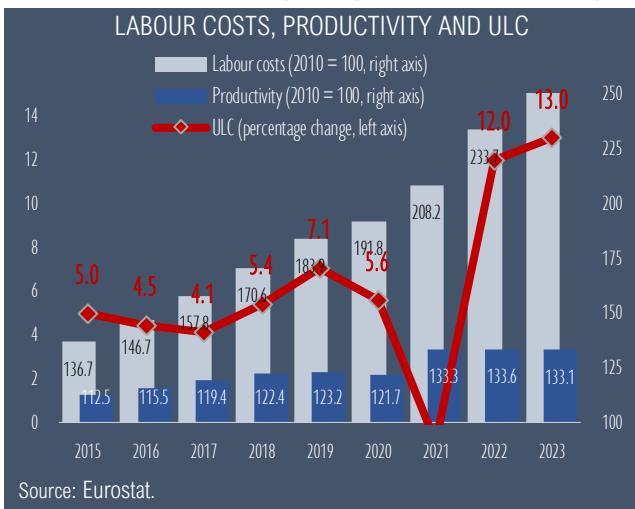
The decrease in economic activities has not significantly affected the dynamics of labour costs. From 2021 to 2023, labour costs increased by 37.2% (11.1% on average per year). On the other hand, unit labour costs (ULC) increased by 25.4% during this period, which was determined by the slow growth of productivity.

In 2021, as economic activity increased, labour costs increased and were 8.5% higher than a year ago. Productivity growth (by 9.5%) reduced the pressure of labour costs on competitiveness and ULC decreased by almost 1%. The dynamics of labour costs were even faster in 2022 and with productivity remaining at the previous year's level, ULC increased by 12%. Also in 2023, labour costs continued to grow rapidly - exceeding the previous year's level by 13% and due to a slight decrease in productivity, ULC increased by 13%. A rapid increase in nominal ULC can be observed in all Baltic countries.

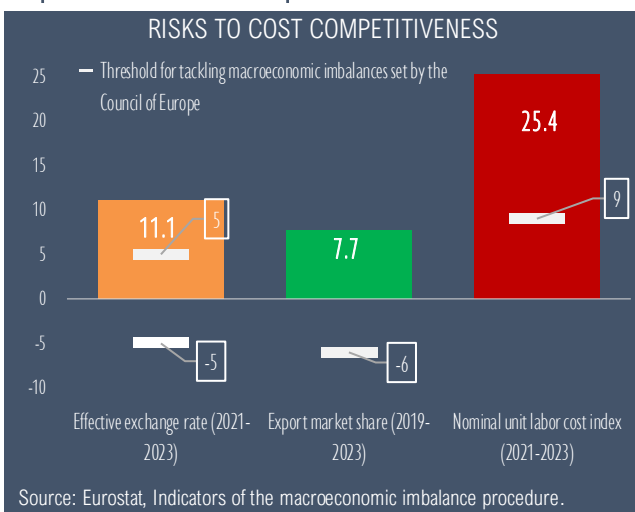
DESPITE THE WEAKNESS OF COMPETITIVENESS FACTORS, LATVIA'S EXPORT MARKET SHARE GROWS IN THE LONG-TERM VIEWPOINT.

Risks of weakening cost competitiveness are growing, as evidenced by the increase in the real effective exchange rate (REER) and ULC. However, the long-term dynamics of Latvia's export market share is still positive. In five years (2019-2023), Latvia's export market share increased by 7.7%. In 2023, Latvia's export market share decreased by 3.4%, which was mainly determined by the drop in the market share of goods exports - by 5%. The market share of services exports was also 1% lower than a year ago.

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 2023, labour costs have significantly exceeded pre-pandemic levels, while productivity growth has been more moderate over the same period. This indicates a widening of the productivity gap. Latvia's biggest challenge is increasing productivity, which is the only way to prevent increasing cost pressure on competitiveness. LV PEAK experts believe that productivity growth will increasingly have to be based on science-intensive activities, the proportion of which is currently small in the economy. Latvia's weakest point is innovation – investments in research and development, as well as 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.

BUDGET DEFICIT STILL HIGH.

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 2020–2022 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 SIP was also valid in 2023.

A high level of deficit in 2020–2023 is related to the package of large-scale support measures to mitigate the impact of Covid-19 and the war in Ukraine and to recover the economy. Latvia's general government budget deficit decreased from 7.2% of GDP in 2021 to 2.2% in 2023. On the other hand, although the general government debt is increasing in nominal terms, it has been stable in relation to GDP in recent years, in 2023 – 44.0% of GDP. The Parliament of Latvia has approved the budget for 2024 with a deficit of 2.8% of GDP.

Latvia's fiscal position is in a relatively favourable situation, as the national debt is relatively low and the country's credit rating is high. The Treasury can still refinance the national debt at reasonable interest rates.

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

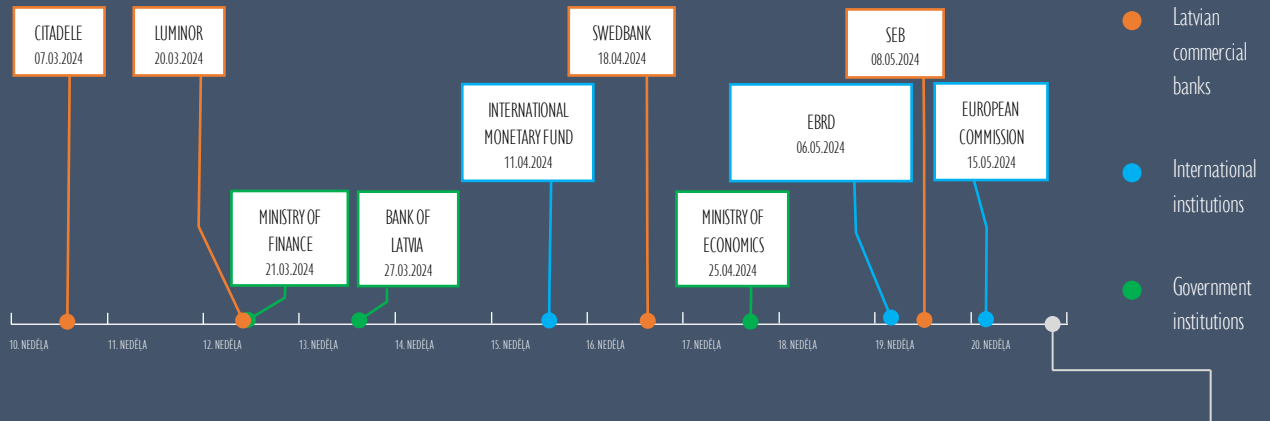
	2020	2021	2022	2023	2024f
Revenues, % of GDP	38.0	37.5	36.3	38.7	40.4
Expenditures, % of GDP	42.4	44.7	40.9	41.0	43.2
Balance, % of GDP	-4.4	-7.2	-4.6	-2.2	-2.8

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 EU funds and Recovery and Resilience Facility to strengthen the competitiveness of the economy.

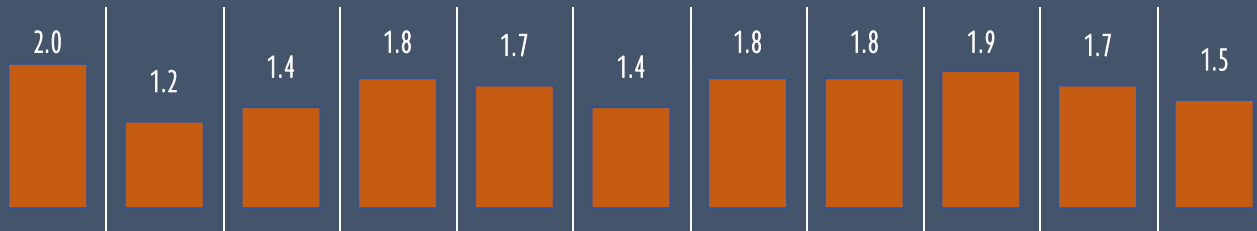
INFOGRAPHIC

FORECASTS OF LATVIA AND INTERNATIONAL INSTITUTIONS –THE ECONOMY IS GRADUALLY RECOVERING, INFLATION CONTINUES TO DECLINE

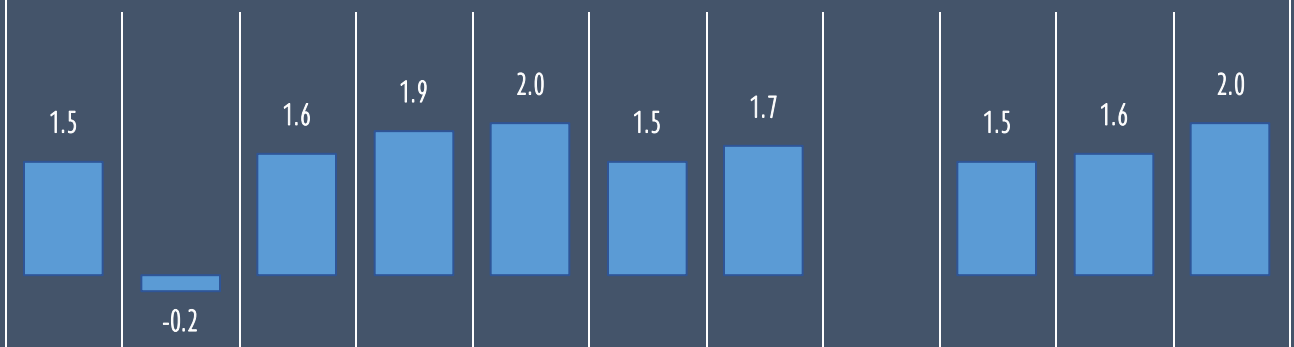


CITADELE	LUMINOR	MINISTRY OF FINANCE	BANK OF LATVIA	IMF	SWEDBANK	MINISTRY OF ECONOMICS	EBRD	SEB	EUROPEAN COMMISSION	LV PEAK EKSPERT CONSENSUS FORECAST
Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	17.05.2023.

GDP FORECASTS 2024, Growth rate, %



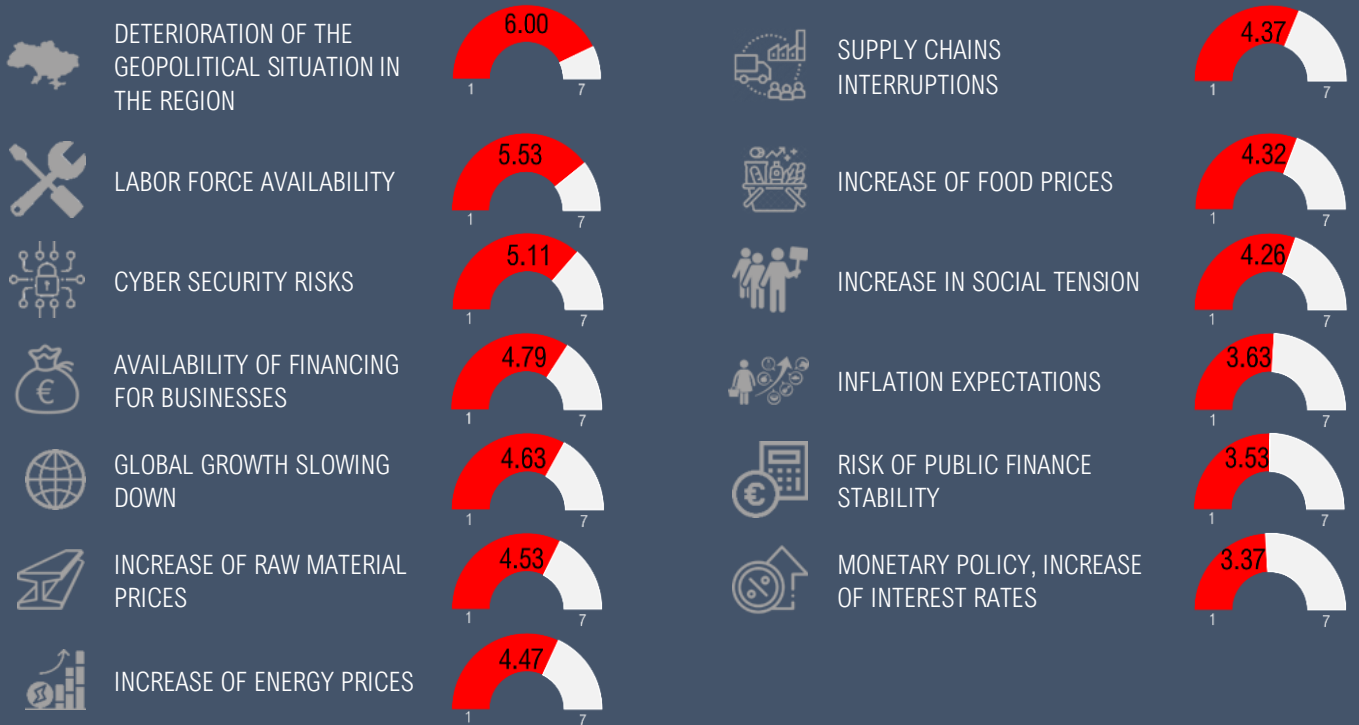
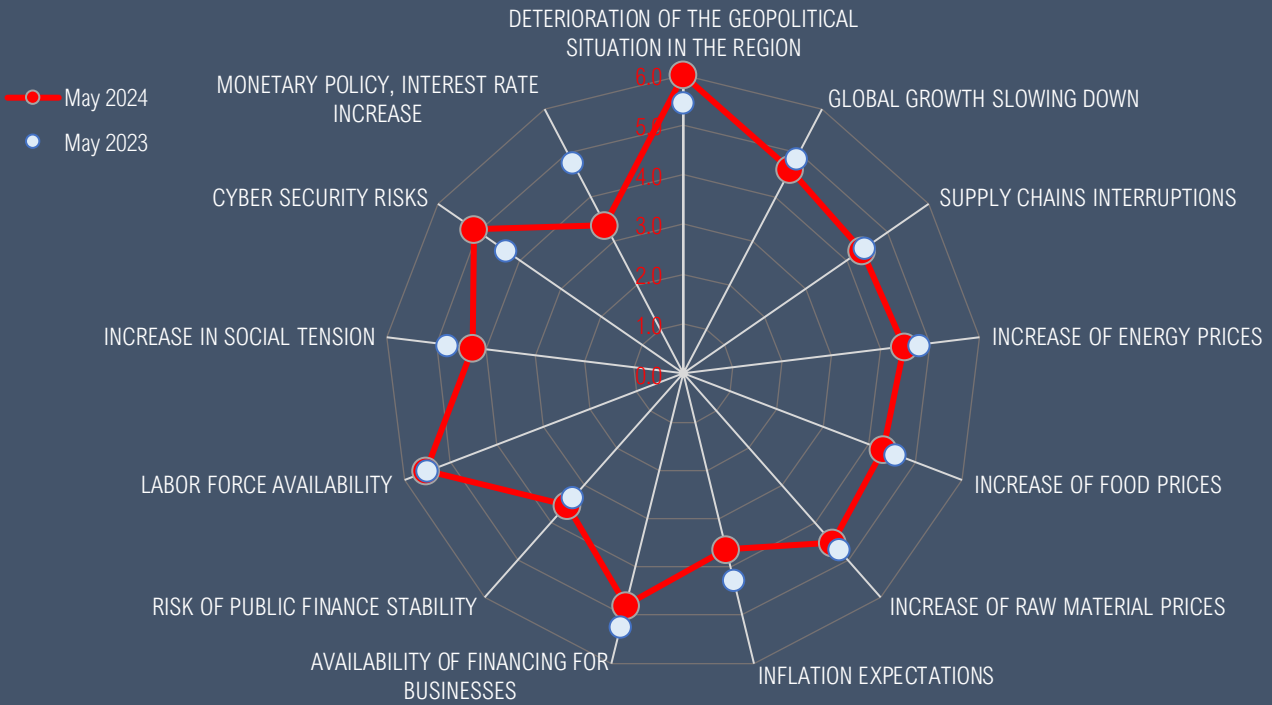
INFLATION FORECASTS 2023, Average annual inflation, %



INFOGRAPHIC

MAIN RISKS TO ECONOMIC GROWTH IN THE SHORT TERM – GEOPOLITICAL SITUATION AND CYBER SECURITY, AVAILABILITY OF WORKFORCE IMPORTANT FOR GROWTH AND FINANCIAL RESOURCES FOR INVESTMENT

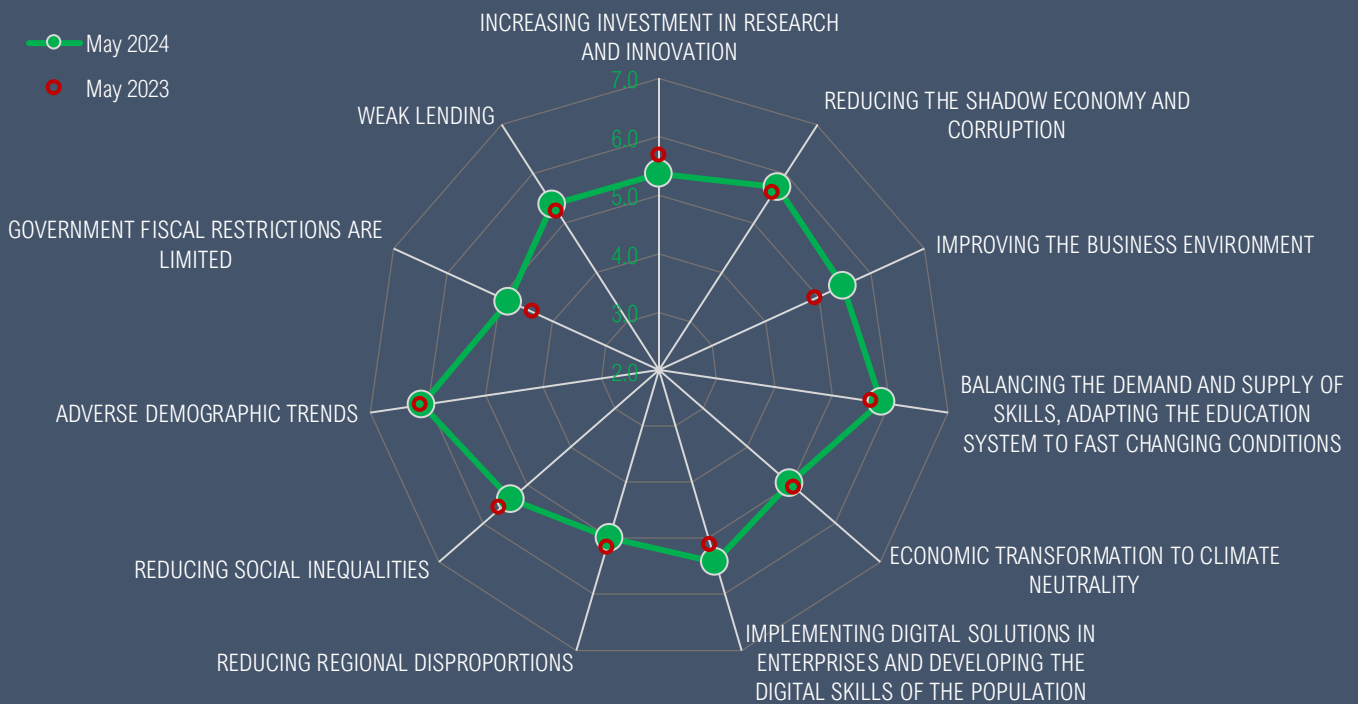
The LV PEAK expert survey asked to assess the potential risks to short-term economic growth on a scale from 1 (very low risk) to 7 (very high risk). The main risks identified are the deterioration of the geopolitical situation in the region, the availability of labour, cyber security risks, the availability of financial resources for companies and the growth of the global economy. Inflation risks are decreasing.



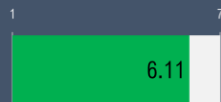
INFOGRAPHIC

MAIN MEDIUM-TERM CHALLENGES FOR GROWTH – INVESTMENT IN HUMAN CAPITAL, DEMOGRAPHIC TRENDS, SHADOW ECONOMY AND BUSINESS ENVIRONMENT

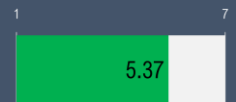
The LV PEAK expert survey asked to assess the potential challenges to economic growth in the medium term on a scale from 1 (very low) to 7 (very high). The main challenges are unfavourable demographic trends, balancing the demand and supply of skills, adapting the education system to rapidly changing conditions, reducing the shadow economy and corruption, improving the business environment, introducing digital solutions in companies and raising the digital skills of the population.



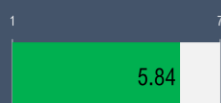
ADVERSE DEMOGRAPHIC TRENDS



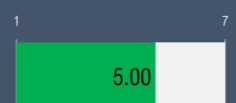
REDUCING SOCIAL INEQUALITIES



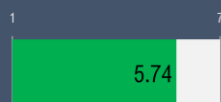
BALANCING THE DEMAND AND SUPPLY OF SKILLS, ADAPTING THE EDUCATION SYSTEM TO FAST CHANGING CONDITIONS



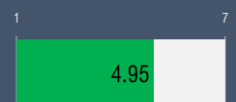
REDUCING REGIONAL DISPROPORTIONS



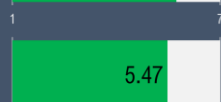
REDUCING THE SHADOW ECONOMY AND CORRUPTION



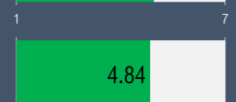
ECONOMIC TRANSFORMATION TO CLIMATE NEUTRALITY



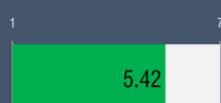
IMPROVING THE BUSINESS ENVIRONMENT



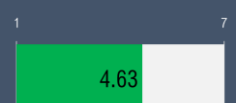
GOVERNMENT FISCAL RESTRICTIONS ARE LIMITED



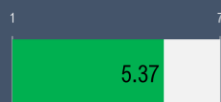
IMPLEMENTING DIGITAL SOLUTIONS IN ENTERPRISES AND DEVELOPING THE DIGITAL SKILLS OF THE POPULATION



WEAK LENDING



INCREASING INVESTMENT IN RESEARCH AND INNOVATION

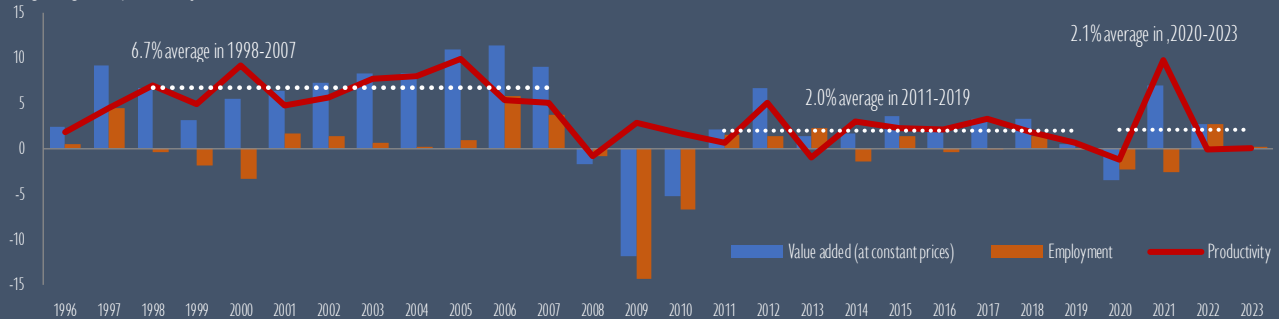


INFOGRAPHIC

PRODUCTIVITY IN LATVIA

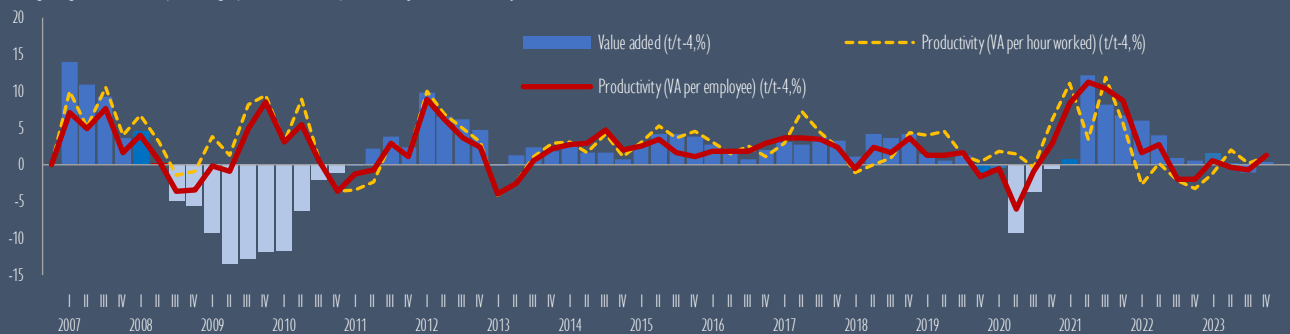
GROWTH RATES OF VALUE ADDED, EMPLOYMENT AND PRODUCTIVITY

changes against previous year, %



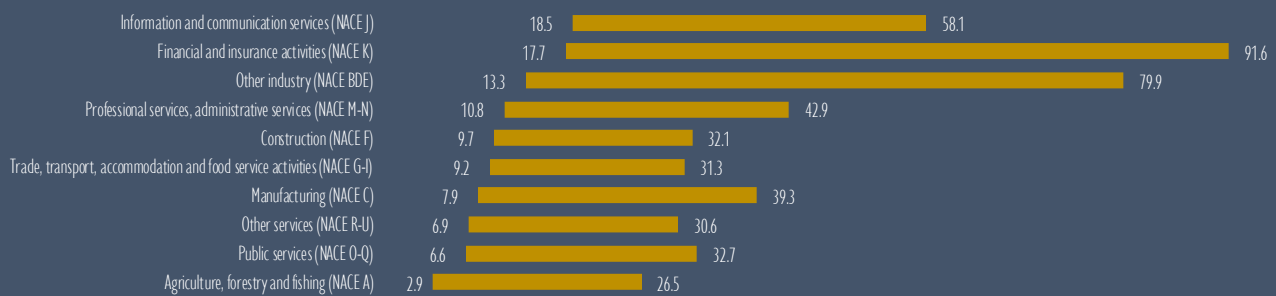
DYNAMICS OF LATVIA'S VALUE ADDED, NUMBER OF EMPLOYEES AND HOURS WORKED

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



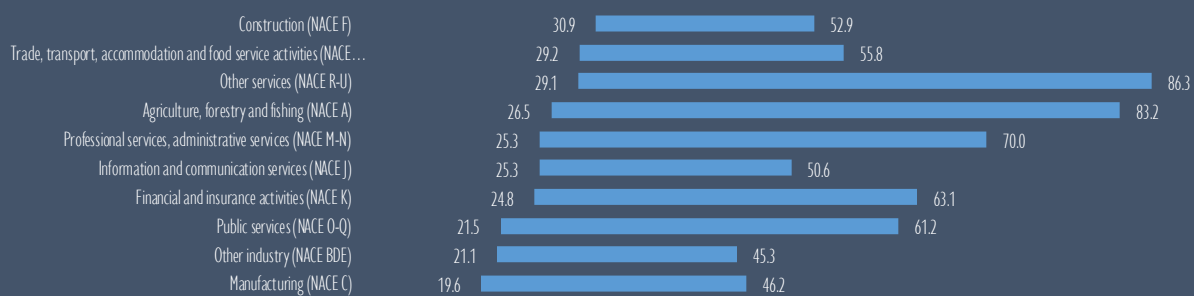
PRODUCTIVITY OF INDUSTRIES IN LATVIA 2000-2022

thousands EUR per employee, at current prices



PRODUCTIVITY OF LATVIA'S INDUSTRIES AGAINST THE EU AVERAGE LEVEL IN INDUSTRY 2000-2022

current prices, EU=100

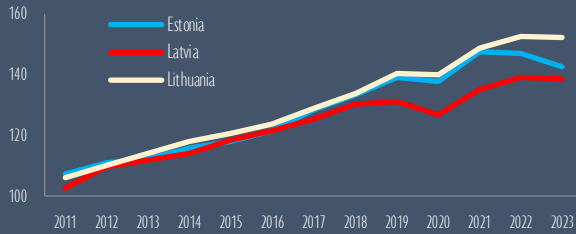


Source: Eurostat.

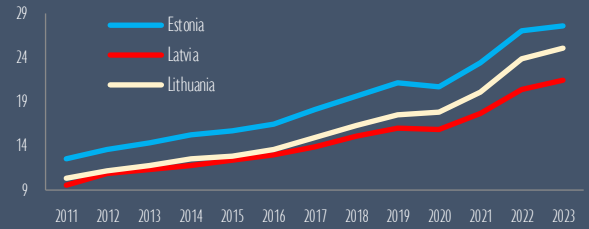
INFOGRAPHIC

COMPARISON OF THE BALTIC STATES

GROSS DOMESTIC PRODUCT
Growth at constant prices, 2010 = 100

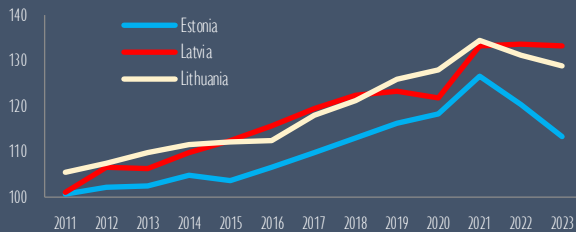


GROSS DOMESTIC PRODUCT PER CAPITA
At current prices, thousand EUR



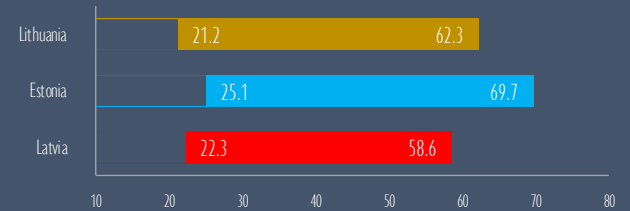
PRODUCTIVITY

Growth at constant prices, 2010=100



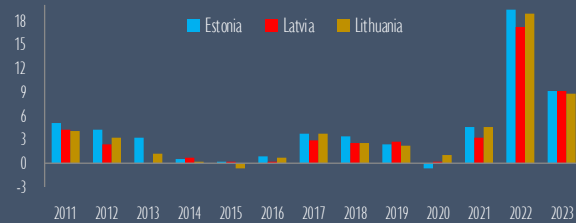
CONVERGENCE OF PRODUCTIVITY

From 2000 to 2022, at current prices, EU = 100



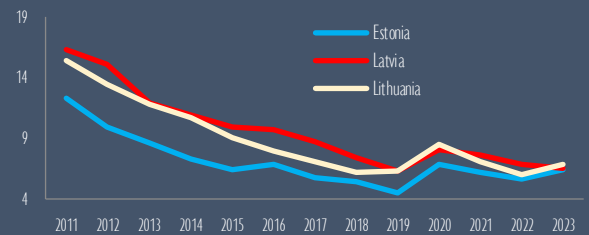
INFLATION

Harmonized index of consumer prices, annual average changes, %



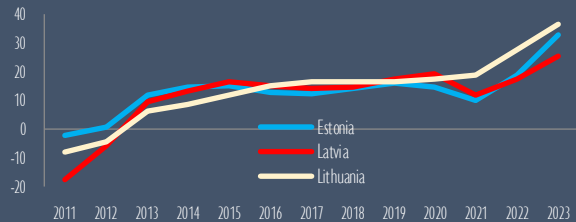
Unemployment

Unemployment rate in age group 15-74, %



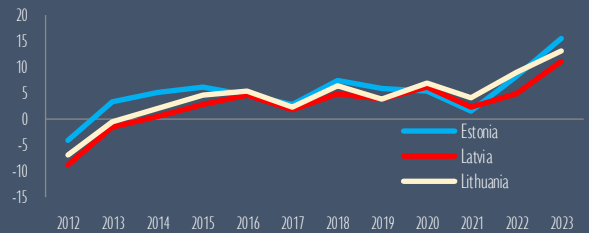
NOMINAL ULC

3-year changes in unit labor costs, %



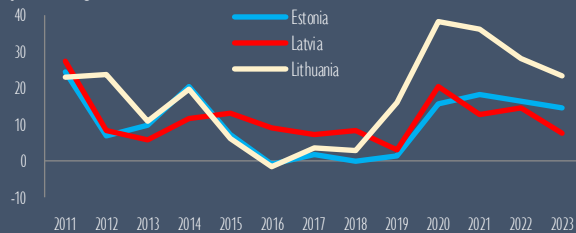
REAL EFFECTIVE EXCHANGE RATE

3-year changes, %



EXPORT MARKET SHARES

5-year changes, %



EXPORT PER CAPITA

At current prices, thousand EUR

