

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 world economy continues to be negatively affected by the Russia's invasion of Ukraine. Global growth has moderated, and inflation has proved more resilient than initially expected. On the positive side, energy prices in early 2023 have been well below their 2022 peak. The labour market remains tight. At the same time, global supply chains have improved significantly. Policymakers face many challenges in containing inflation and restoring growth in a sustainable and inclusive manner.

Due to the geopolitical situation, Latvia's GDP grew by only 2.8% in 2022. However, this increase is higher than predicted at the start of the war due to strong private consumption and export growth. The negative impact of the war was felt in foreign trade data and supply chain disruptions. However, it was more manifested in the rise of inflation and production costs, due to the rapid growth of energy resource prices on world markets. GDP is expected to grow by 1.4% in 2023. Faster economic growth will be hindered by high inflation, which negatively affects private consumption, and geopolitical uncertainty. In 2024, growth will reach 3.1%, which will be promoted by the increase in EU-financed investments and the faster growth of exports due to the improvement in external demand. The situation on the labour market will continue to improve, however, companies will increasingly face labour shortages. Risks of a loss of competitiveness remain very high as the gap between productivity and labour costs has widened because of 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. Funding of credit institutions for companies should be promoted. Compared to the average level of the EU, the low level of lending is one of the main causes of Latvia's growth lag behind Lithuania and Estonia in the last decade. Also, strengthening energy security is one of the main tasks. 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.

THE GEOPOLITICAL SITUATION HAS A NEGATIVE INFLUENCE ON GROWTH.

The recovery of Latvia's economy from the Covid-19 pandemic crisis was interrupted by the war started by Russia in Ukraine. In contrast to 2021, when GDP grew by 4.3%, in 2022 GDP grew by only 2.8% due to the geopolitical situation. However, this growth was better than predicted at the start of the war due to strong private consumption and export growth. Gradual lifting of Covid-19 restrictions contributed to the development of several service industries. Unemployment continued to decrease. The negative impact of the war was felt in foreign trade data and supply chain disruptions. However, it was more manifested in the rise of inflation and production costs, due to the rapid growth of energy resource prices on world markets. At the same time, the warm winter and state support measures mitigated the effects of these price increases on the economy. In the 1st quarter of 2023, GDP increased by 0.8% compared to the corresponding period of the previous year. The leading

indicator tool created by LV PEAK shows that moderate growth will continue in the coming months, but it will still be affected by uncertainty and high inflation (see infographic on page 11).

According to the consensus forecast of LV PEAK experts¹, overall GDP will grow by 1.4% in 2023. But, in 2024, growth will reach 3.1%, which will be promoted by the growth of EU-financed investments and the faster growth of exports due to the improvement of external demand.

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 and the promotion of the innovative economy; to significantly reduce bureaucracy, the shadow economy and corruption; 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

	2020	2021	2022	2023 f	2024 f
GDP (% change on previous year)	-2.3	4.3	2.8	1.4	3.1
Unemployment (Unemployed persons % of economically active population, 15-74 years)	8.1	7.6	6.9	6.3	6.0
Gross Wages (Average gross wages, % change to previous year)	5.0	11.1	9.0	8.0	6.6
Inflation (Average annual inflation, %)	0.2	3.3	17.3	9.2	4.0

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

THE LABOR MARKET IS RECOVERING FAST.

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

The number of employees in 2022 increased by 22.2 thousand or 2.6% compared to 2021. However, it still lags pre-Covid-19 crisis levels. The number of employees in the 4th quarter of 2022 was 22.5 thousand or 2.5% less than in the 4th 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 2022 was 6.9%, or 0.7 percentage points lower than in 2021. However, the unemployment rate in 2022 was still 0.6 percentage points higher than before the pandemic. Unemployment rates are

higher for young people, people with low skills and those living in rural areas.

Also, the number of economically active population and the level of population participation in the labour market in 2022 still lagged the pre-pandemic period.

Similar trends in the labour market continued at the beginning of 2023. The consensus forecast of LV PEAK experts shows that unemployment will continue to decrease in 2023 and the average unemployment rate will be 6.3%, and in 2024 - 6.0%.

THE LABOUR MARKET WILL REMAIN TIGHT.

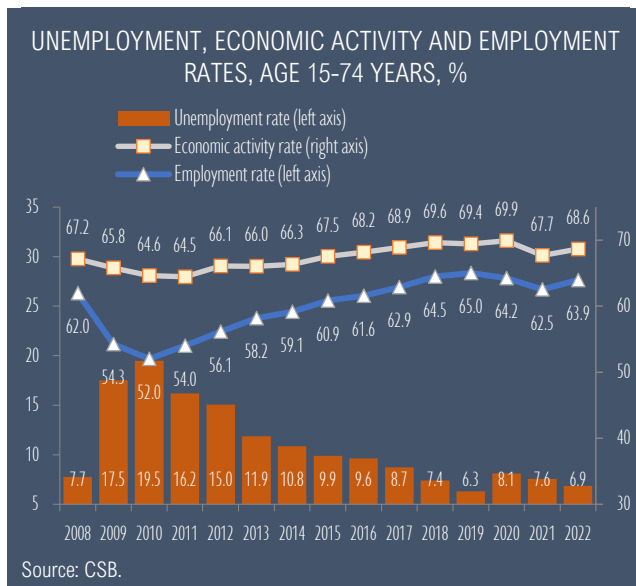
The lack of working hands is becoming more and more noticeable, as evidenced by the increase in the number of vacancies and the workload of jobs.

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.

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

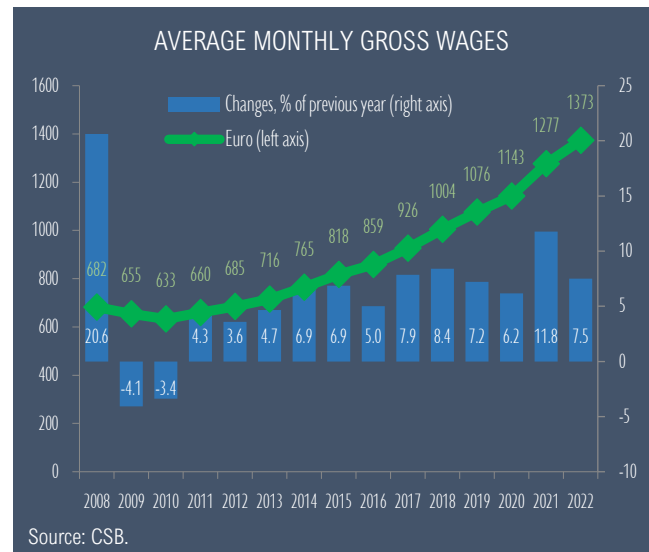
Seeing that the problem of labour shortage will worsen in the future, LV PEAK experts believe that it is necessary to strengthen the adult education system to ensure the transition of the workforce from unproductive areas to growing industries. The effectiveness of the adult education system will also 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 2022, compared to 2021, it increased by 7.5% - rising to 1,373 euros per month. 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 in 2022, considering the rise in consumer prices, decreased by an average of 8.7% compared

to 2021. 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 2023 - by 8%, and in 2024 - by 6.6%.

HIGH INFLATION GRADUALLY DECREASES.

During the Covid-19 pandemic in 2020, significantly limiting demand, prices also decreased. There was deflation in some months, but the average price level increased by only 0.2 percent in 2020.

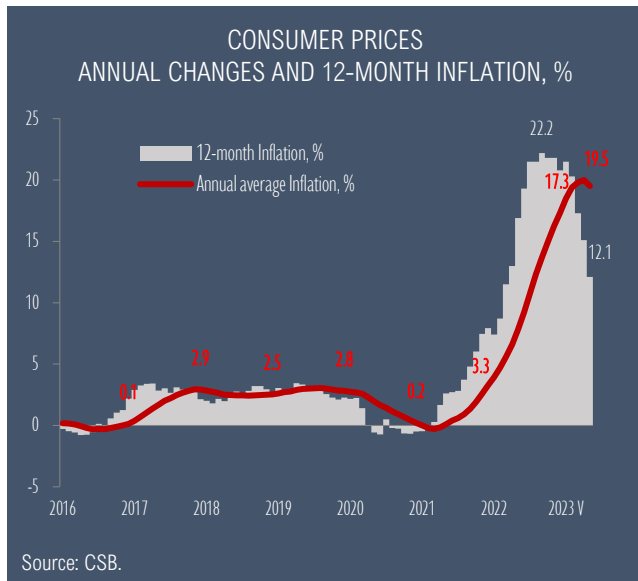
The economic adjustment after the pandemic conditions happened rapidly. The supply did not keep up with the growing demand, which determined a sharp increase in prices in the world in the second half of 2021 - especially for metal, wood, etc. intermediate consumption goods. Since the end of February 2022, the situation was worsened by Russia's war in Ukraine - 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 inflation in 2022 was the increase in the prices of food, electricity and fuel.

In the first two months of 2023, prices continued to grow relatively rapidly, especially for food products. On the other hand, in March and April, the price increase already started to return to the price changes characteristic of these months, which had been observed in the last years before the Covid-19 pandemic. In May the price changes were affected by the conclusion of state aid to compensate for the high prices of energy resources. From December last year to May 2023, the consumer price index for goods increased by 3.3% and for services by 3.7%. During this period, food prices increased by

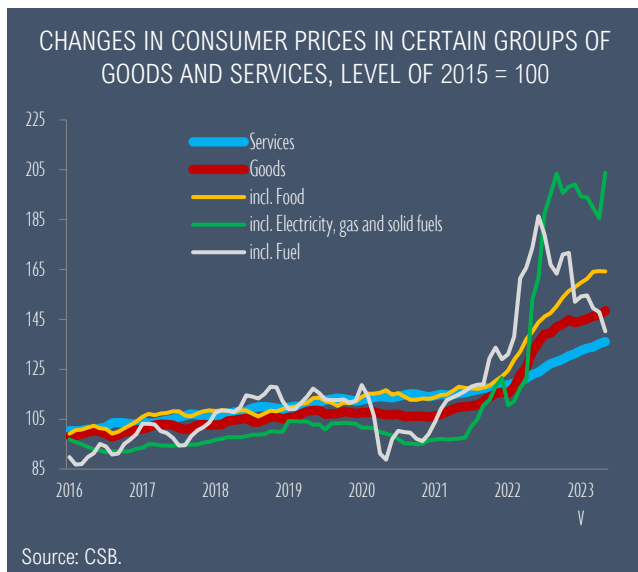
4% and prices for electricity, gas and solid fuel – by 2.4%. Prices for fuel decreased by 7.8%.

Graph 3. The sharp rise in prices is gradually easing



In May, compared to May 2022, consumer prices increased by 12.1% and the annual average inflation was 19.5%.

Graph 4. The prices of energy resources are decreasing



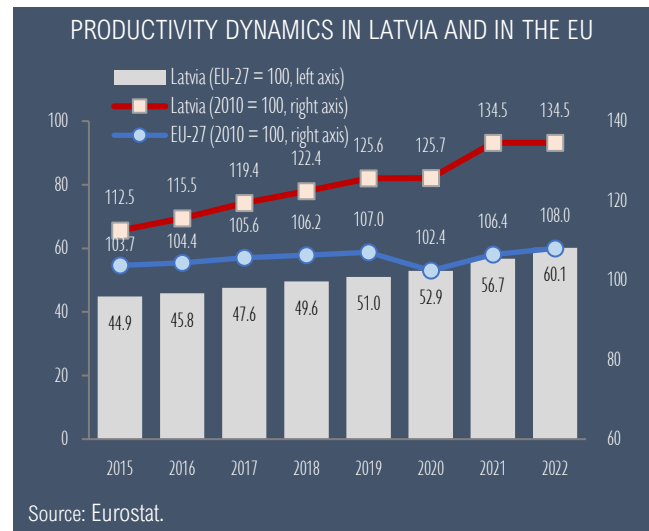
It is expected that the rapid rise in prices will continue to slow down gradually. However, the decline could be slightly more moderate than previously forecast. LV PEAK predicts that the average annual inflation will decrease to 9.2% in 2023 and to 4% in 2024.

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 7% higher than a year ago. In 2022, however, economic growth was extensive, and productivity remained at the previous year's level.

Graph 5. The productivity gap is narrowing



The dynamics of productivity in Latvia in the last ten years has been almost 3.5 times faster than the EU average, which ensured productivity convergence closer to the EU average level. However, the productivity gap remained wide. The GDP per employed person in actual prices in the Latvian national economy in 2022 was only 60.1% (75.8 according to PPS) of the average EU level.

LABOUR COSTS CONTINUE TO INCREASE.

Due to the decrease in economic activities, in 2020 labour costs also increased more slowly - by 5% (in 2019 - by 7.8%). On the other hand, unit labour costs (ULC) grew slightly slower - by 4.9%, which was determined by the slow growth of productivity.

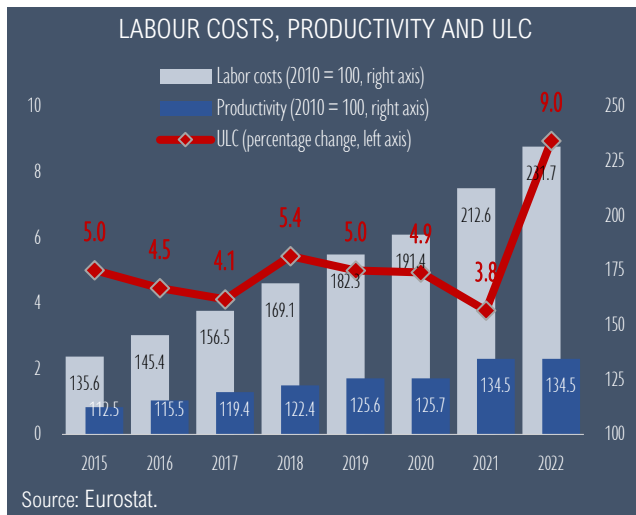
In 2021, labour costs continued to rise and were 11% higher than a year ago. The increase in productivity (by 7.0%) reduced the pressure of rising labour costs on competitiveness. ULC growth in 2021 was more moderate than a year ago (increased by 3.8%). The dynamics of labour costs in 2022 was slightly more moderate than in 2021, however, with productivity remaining at the level of the previous year, ULC increased by 9%. A rapid increase in nominal ULC in 2022 was observed in all Baltic countries (Lithuania – by 14% and Estonia – by 14.8%).

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

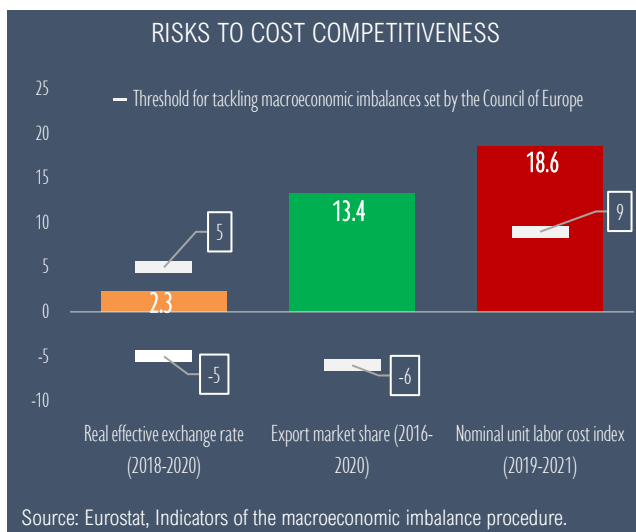
Risks of a weakening of cost competitiveness are growing, as evidenced by the increase in the real effective exchange rate (REER) and ULC. In 2021, Latvia's export share in world

markets decreased by 1.8%. However, the long-term dynamics of Latvia's export market share is still positive. In five years (2017-2021), it grew by 13.4%. This was mainly determined by the increase in the market share of the export of goods - by 19.2%, while the increase in the market share of the export of services was quite moderate - by 1.8 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 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.

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 AND THE WAR IN UKRAINE HAS CAUSED SIGNIFICANT CHANGES IN THE FISCAL POLICY IMPLEMENTED SO FAR.

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 SGP will also be valid in 2023.

A high level of deficit in the years 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 7.1% of GDP in 2021 to 4.4% in 2022, while general government debt decreased from 43.7% of GDP in 2021 to 40.8% in 2022. The Parliament of Latvia has approved the budget deficit for 2023 at 1.8 billion. EUR or 4.2% 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

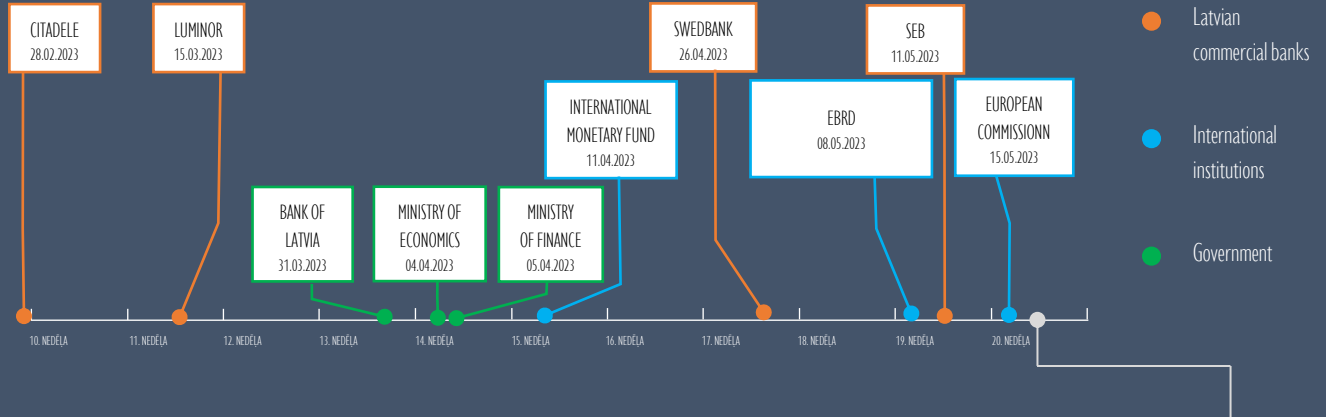
	2019	2020	2021	2022	2023f
Revenues, % of GDP	37,7	37,9	37,1	35,8	36,3
Expenditures, % of GDP	38,3	42,3	44,2	40,2	40,1
Balance, % of GDP	-0,6	-4,4	-7,1	-4,4	-3,8

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

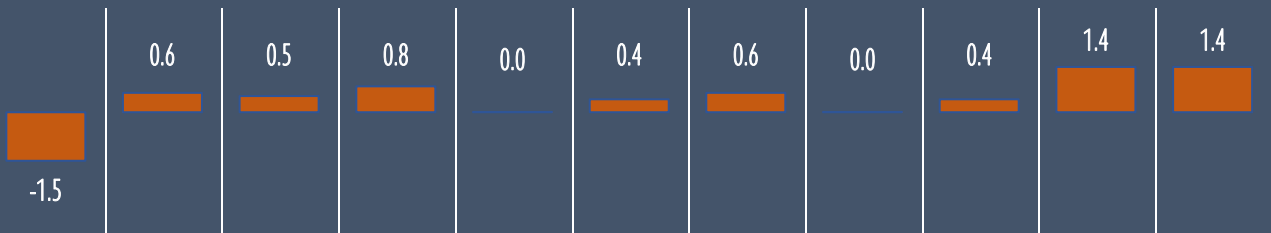
INFOGRAPHIC

FORECASTS OF LATVIAN AND INTERNATIONAL INSTITUTIONS – ECONOMIC ACTIVITIES WILL GROW FASTER THAN PREVIOUSLY FORECASTED, INFLATION WILL DECREASE SLOWER, UNCERTAINTY REMAINS

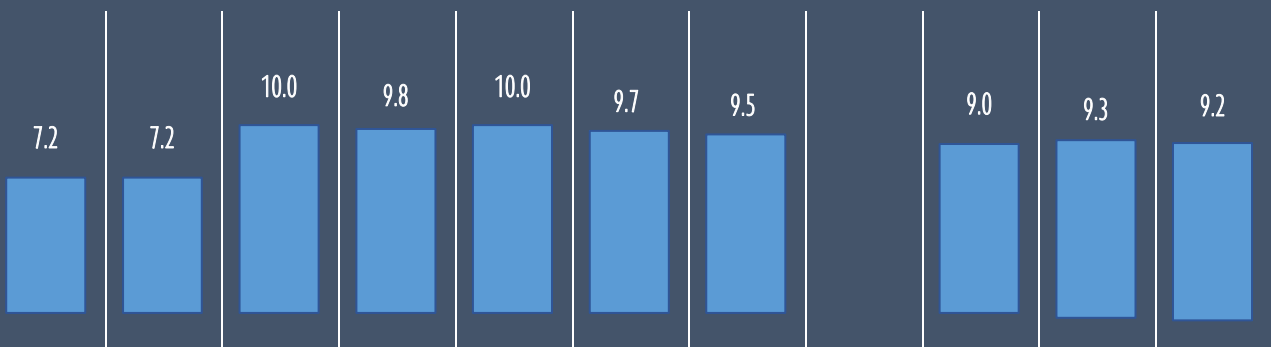


CITADELE	LUMINOR	BANK OF LATVIA	MINISTRY OF ECONOMICS	MINISTRY OF FINANCE	IMF	SWEDBANK	ERAB	SEB	EUROPEAN COMMISSION	LV PEAK EXPERT CONSENSUS FORECAST
Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	Source: →	15.05.2023.

GDP FORECASTS 2023, Growth rate, %



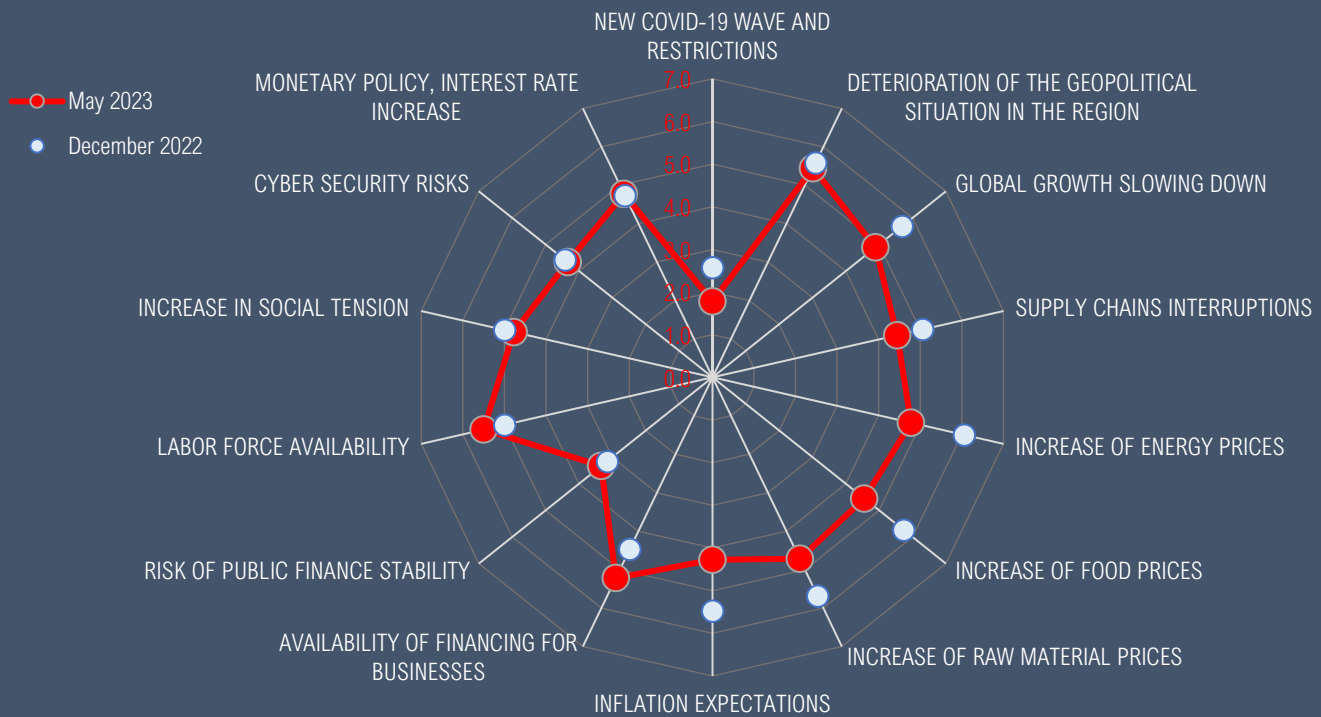
INFLATION FORECASTS 2023, Annual prices changes, %



INFOGRAPHIC

MAIN RISKS TO ECONOMIC GROWTH IN THE SHORT TERM – INFLATION PRESSURE IS DECREASING, AVAILABILITY OF LABOR AND FINANCIAL RESOURCES FOR INVESTMENTS ARE IMPORTANT FOR 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 availability of labor, the deterioration of the geopolitical situation in the region, the availability of financial resources for companies, the slowdown in global economic growth, and the prices of energy resources.



LABOR FORCE AVAILABILITY



INCREASE OF RAW MATERIAL PRICES

DETERIORATION OF THE
GEOPOLITICAL SITUATION IN
THE REGION

INCREASE OF FOOD PRICES

AVAILABILITY OF FINANCING
FOR BUSINESSESSUPPLY CHAINS
INTERRUPTIONSGLOBAL GROWTH SLOWING
DOWN

CYBER SECURITY RISKS



INCREASE OF ENERGY PRICES



INFLATION EXPECTATIONS



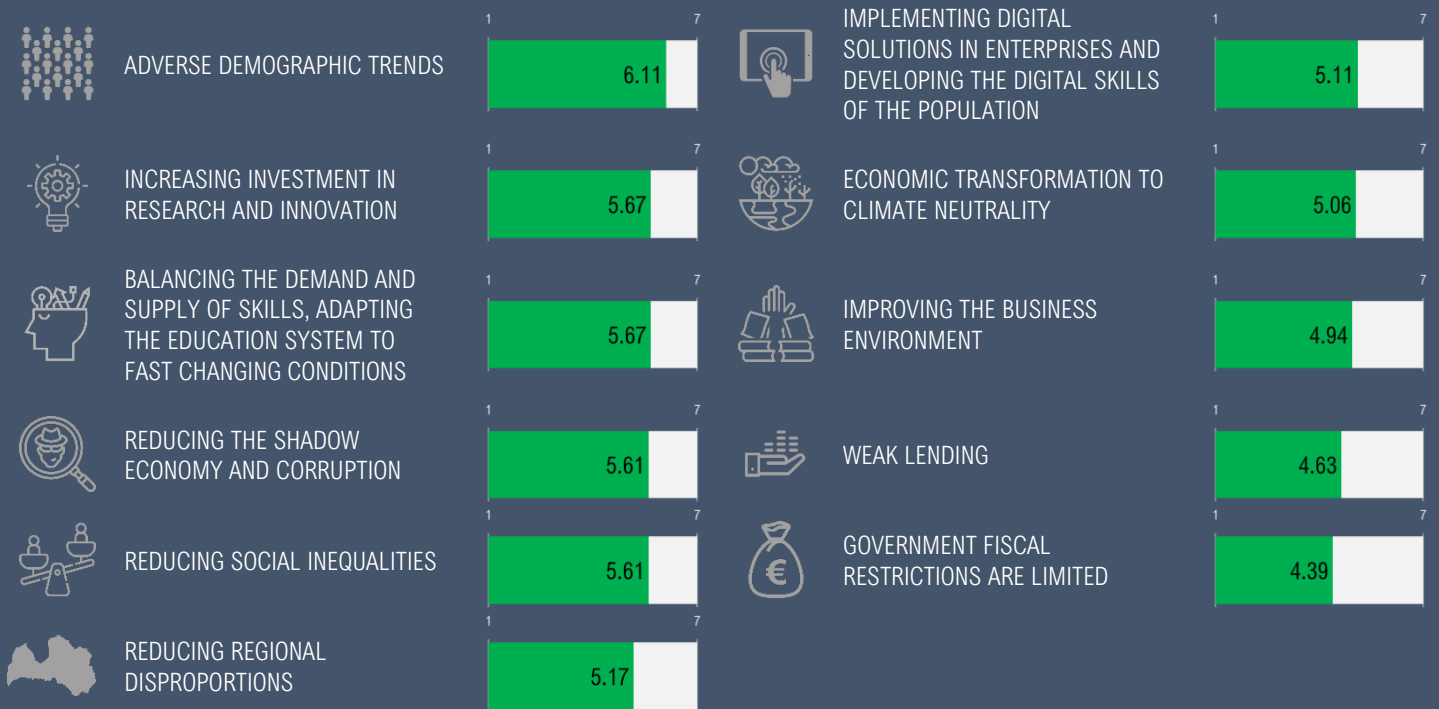
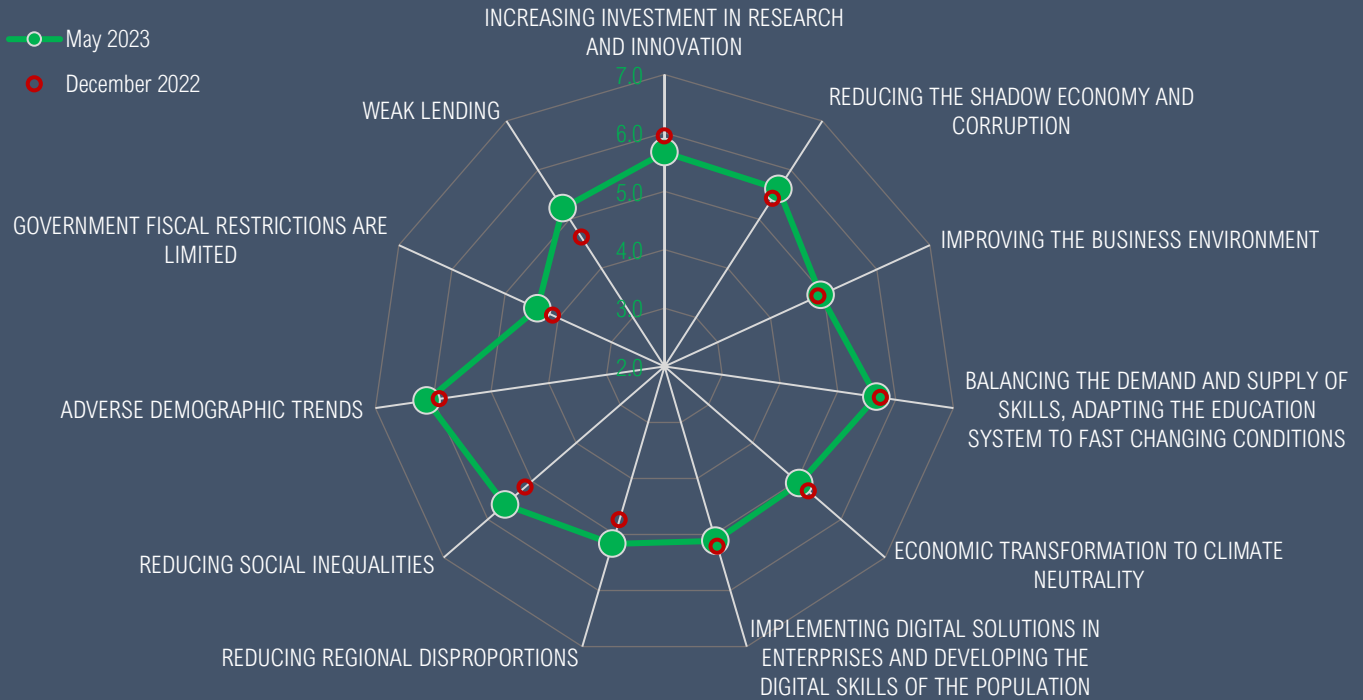
INCREASE IN SOCIAL TENSION

RISK OF PUBLIC FINANCE
STABILITYMONETARY POLICY, INCREASE
OF INTEREST RATESNEW COVID-19 WAVE AND
RESTRICTIONS

INFOGRAPHIC

MAIN MEDIUM-TERM CHALLENGES FOR GROWTH – 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 unfavorable demographic trends, increasing investment in research and innovation, balancing the demand and supply of skills, adapting the education system to rapidly changing conditions, reducing the shadow economy and corruption, reducing social inequality of the population.

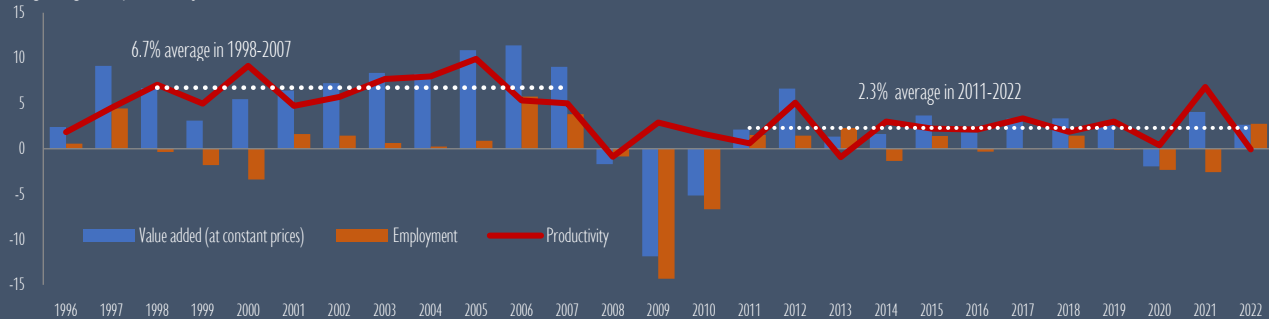


INFOGRAPHIC

PRODUCTIVITY IN LATVIA

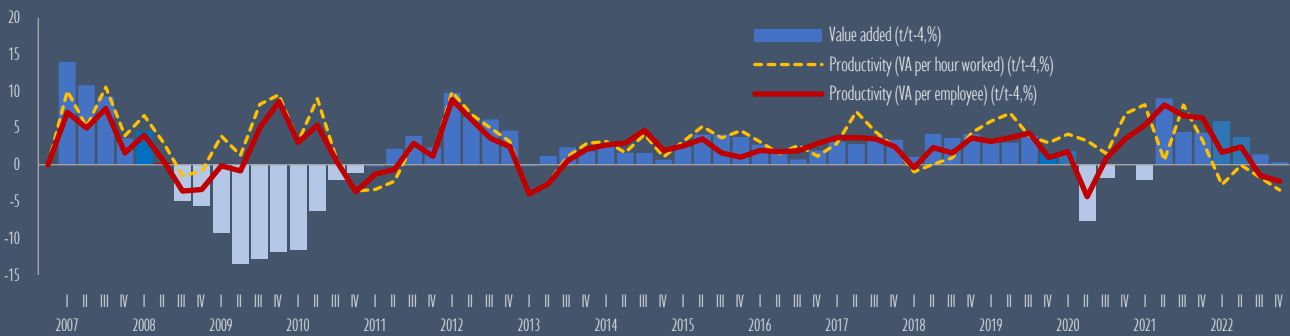
GROWTH RATES OF VALUE ADDED, EMPLOYMENT AND PRODUCTIVITY

changes against previous year, %



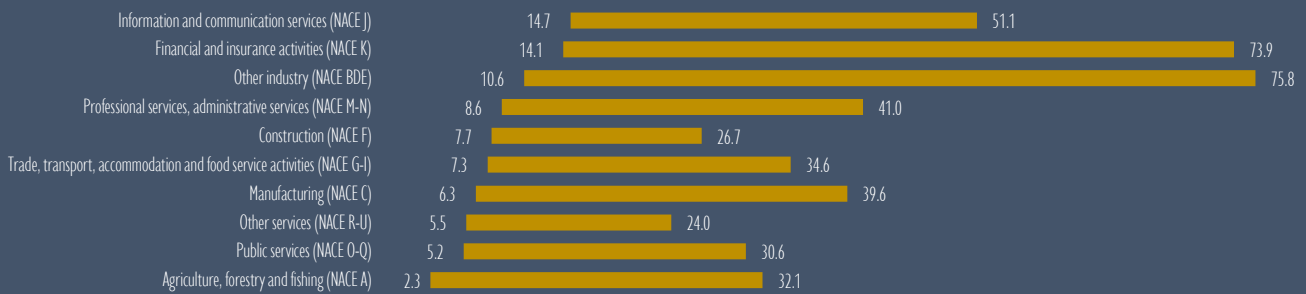
DYNAMICS OF LATVIA'S VALUE ADDED, NUMBER OF EMPLOYEES AND HOURS WORKED

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



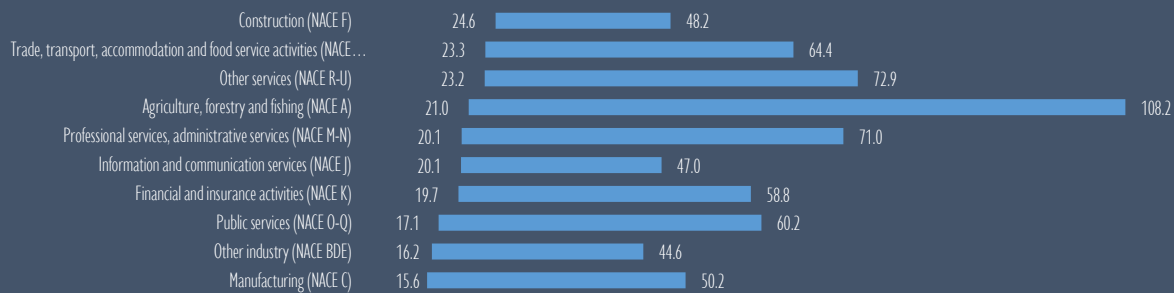
PRODUCTIVITY OF INDUSTRIES IN LATVIA 2000-2022

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



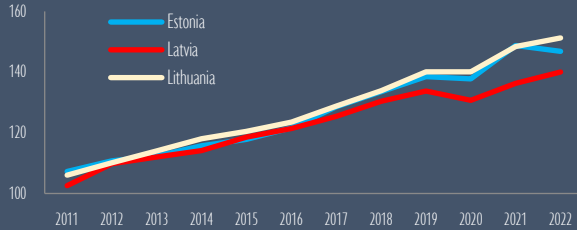
Source: Eurostat

INFOGRAPHIC

COMPARISON OF THE BALTIC STATES

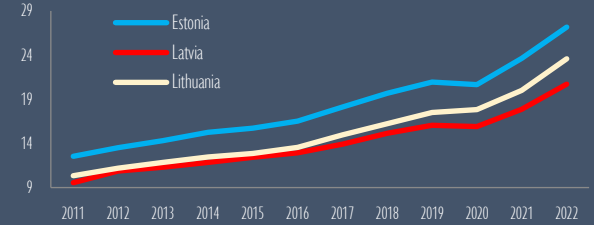
GROSS DOMESTIC PRODUCT

Growth at constant prices, 2010 = 100



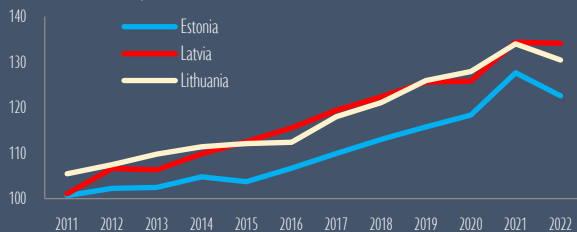
GROSS DOMESTIC PRODUCT PER CAPITA

At current prices, thousand EUR



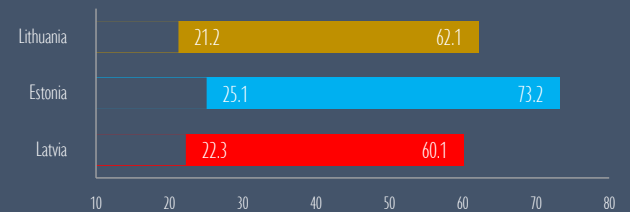
PRODUCTIVITY

Growth at constant prices, 2010=100



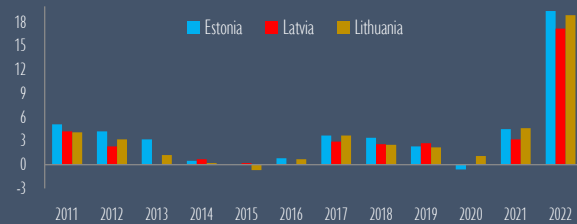
CONVERGENCE OF PRODUCTIVITY

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



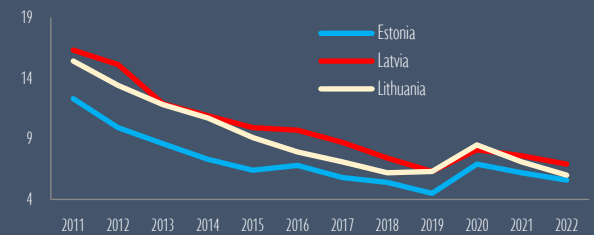
INFLATION

Harmonized index of consumer prices, annual average changes, %



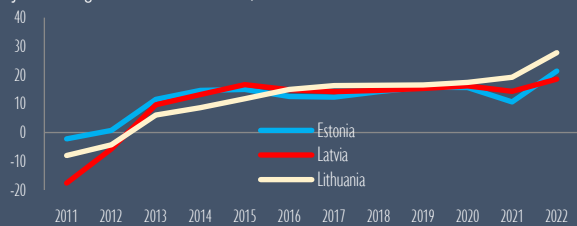
UNEMPLOYMENT

Unemployment rate in age group 15-74, %



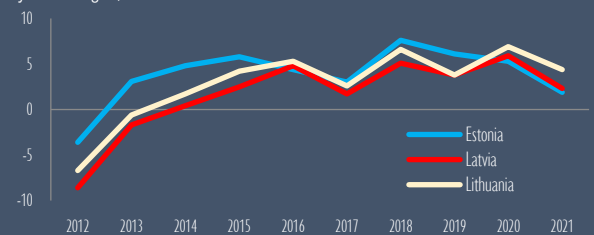
NOMINAL ULC

3-year changes in unit labor costs, %



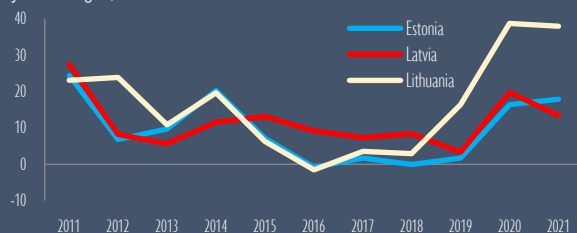
REAL EFFECTIVE EXCHANGE RATE

3-year changes, %



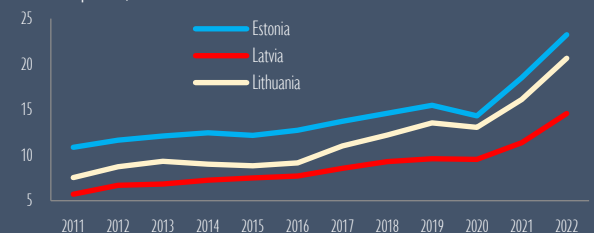
EXPORT MARKET SHARES

5-year changes, %



EXPORTS PER CAPITA

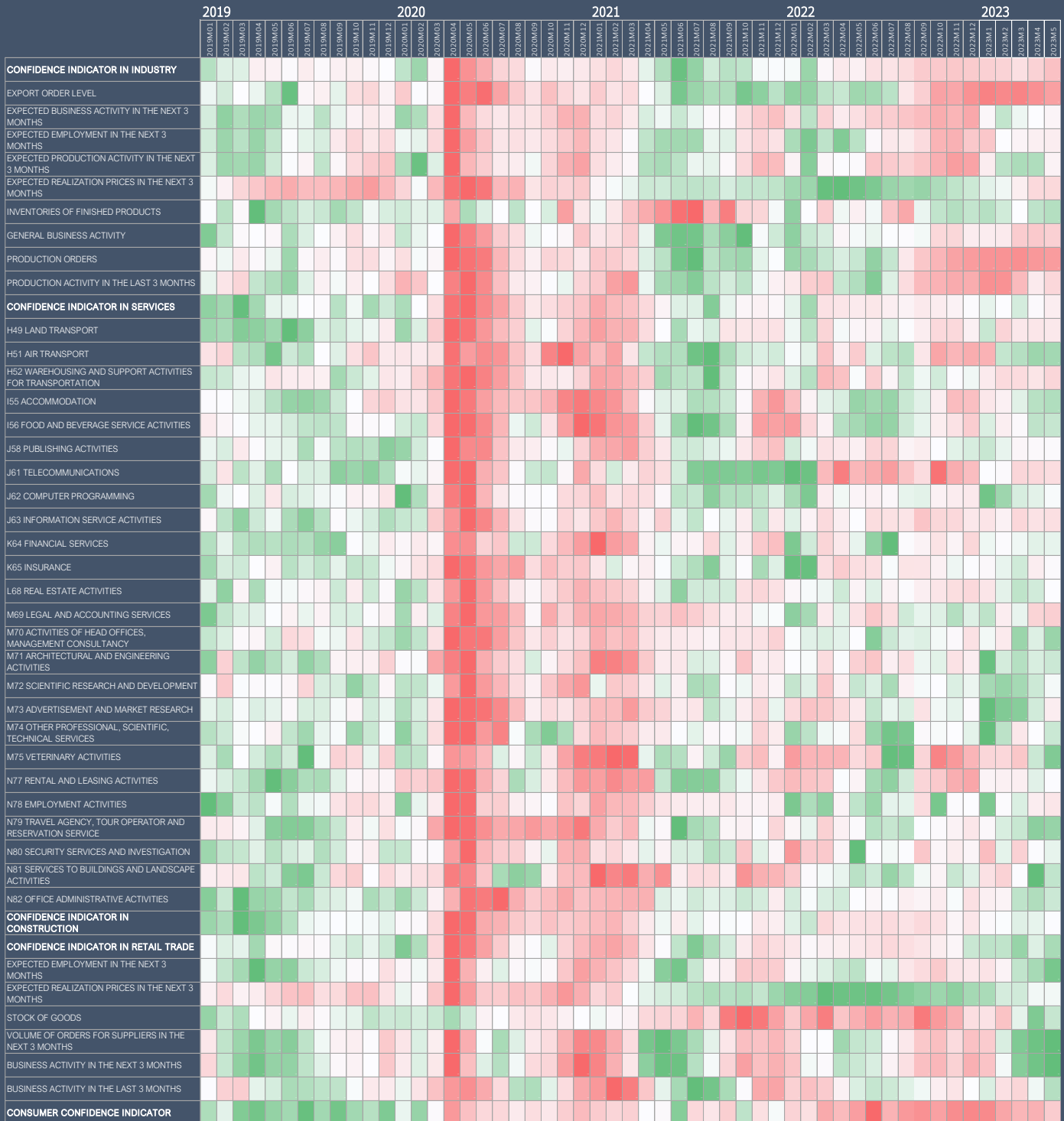
At current prices, thousand EUR



Source: Eurostat.

INFOGRAPHIC LEADING INDICATORS

In the fall of 2022, LV PEAK, commissioned by the Ministry of Economy, conducted a study - "Creation of a tool for leading indicators, incl. use of open data, etc. alternative solutions for real-time economic monitoring". One of the data visualization tools is a heat map, which uses business cycle indicators in the manufacturing industry, construction, service sectors and retail trade, as well as includes the citizens' confidence index and data from the Bank of Latvia on the amount of cash in circulation. In the heatmap, the relative values of each indicator over time are colored in a range from red (lowest level) to green (highest level).



Source: LV PEAK <https://www.lvpeak.lv/zinatniskie-projekti/pasakumu-sistemosana-investiciju-un-produktivitatesma/>