

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



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FACULTY OF BUSINESS,
MANAGEMENT
AND ECONOMICS

ECONOMIC BAROMETER

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In 2023, the economic development in Latvia continued to be affected by the geopolitical situation and uncertainty, high prices and rising bank interest rates, negatively affecting private consumption and exports. Estimates show that in 2023 the GDP has decreased slightly. On the other hand, 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. Since the spring, the rapid rise in prices has started to subside, returning to the monthly price changes that were typical of the last years before the Covid-19 pandemic. Inflation will continue to decrease in 2024. Price dynamics will be influenced by various supply-side factors related to tax and tariff increases, as well as demand, as wages are expected to continue to rise. Despite the negative impact of the war in Ukraine on economic development, the labor market continues to recover from the negative effects of the Covid-19 pandemic. However, in 2023, the growth of new jobs and employment has become slower compared to 2022. The situation on the labor market will continue to improve in 2024, however, companies will increasingly face labor shortages. Unfavorable demographic processes narrow the labor supply and increase the risks of labor shortage.

Risks of a loss of competitiveness remain very high as the gap between labor costs and productivity growth has widened because of the pandemic crisis. Labor 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, strengthening energy security is one of the most important tasks. 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. In the 2nd half of 2022, compared to the corresponding period of 2021, the GDP decreased by 1.2%, due to the deterioration of the export-import balance and the decrease in the growth rates of private consumption and investment.

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. In the 3 quarters of 2023, GDP was 0.6% lower than in the corresponding period a year ago.

The leading indicator tool created by LV PEAK shows that the situation will not change significantly in the coming months. It

will continue to be affected by geopolitical uncertainty and low external demand (see infographic on page 11).

According to the consensus forecast of LV PEAK experts¹, overall, in 2023, GDP will decrease by 0.1%. On the other hand, growth could return in 2024 and GDP will increase by 1.8%, which will be promoted by the increase in EU-financed investments and faster growth of exports due to the improvement of external demand, as well as a gradual increase in private consumption.

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 solve the labor 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.

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

	2020	2021	2022	2023f	2024f
GDP (% change on previous year)	-3.5	6.7	3.4	-0.1	1.8
Unemployment (Unemployed persons % of economically active population, 15-74 years)	8.1	7.6	6.9	6.4	6.4
Gross Wages (Average gross wages, % change to previous year)	6.2	11.8	7.5	12.0	9.0
Inflation (Average annual inflation, %)	0.2	3.3	17.3	9.9	2.6

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

THE LABOR MARKET IS STABLE.

In 2023, despite the negative impact of the Ukrainian war on economic development, the Latvian labor market continued to recover from the negative consequences of the Covid-19 pandemic. However, in 2023, the growth of new jobs and employment has become slower compared to 2022.

The number of employees in the 3 quarters of 2023 increased by 1.6 thousand or by 0.2% compared to the corresponding period of 2022. This is still behind pre-Covid-19 crisis levels. The number of employees in the 3rd quarter of 2023 was 26.9 thousand or 2.9% less than in the 3rd quarter of 2019. Also, the number of economically active population and the level of population participation in the labor market in 2023 still lags the pre-pandemic period.

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 2023 was 6.5% or 0.4 percentage points lower than in the 3rd quarter of 2022. Unemployment rates are higher among young people, people with low skills and those living in rural areas.

The consensus forecast of LV PEAK experts shows that the unemployment rate could decrease to 6.4% in 2023, and its level could also be 6.4% in 2024.

THE LABOR MARKET WILL REMAIN TIGHT.

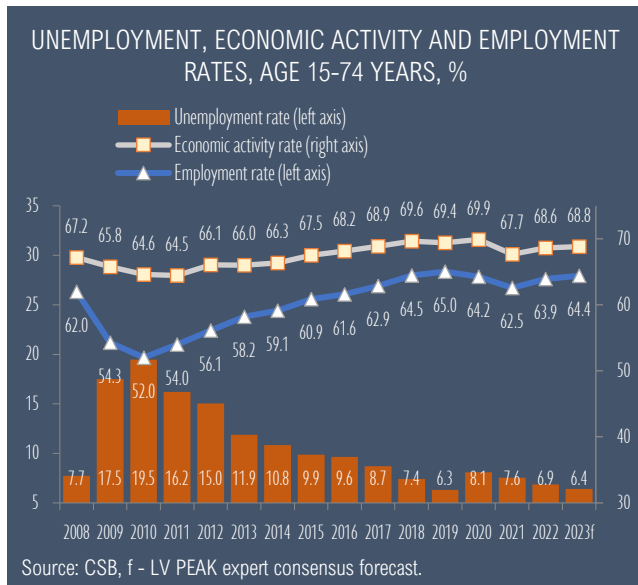
The lack of working hands is becoming more and more noticeable, as evidenced by the increase in the number of vacancies and the workload of jobs.

Unfavorable demographic processes narrow the labor supply and increase the risks of labor shortage. In the short term, Ukrainian refugees increase the labor supply.

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.

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.

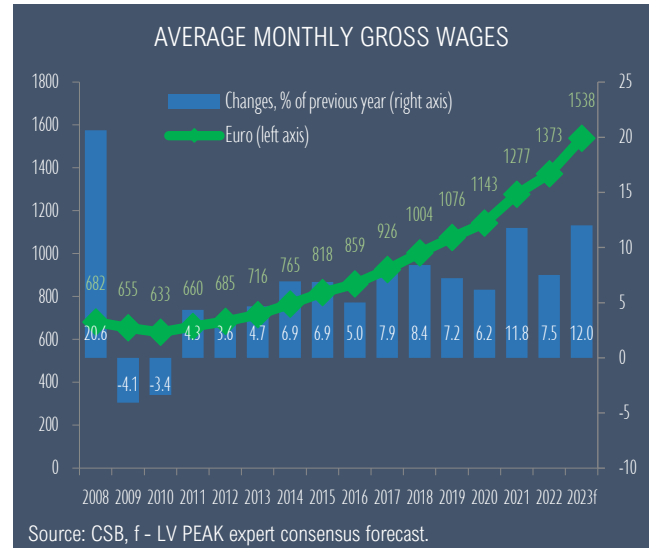
LABOR SHORTAGES AND A TIGHT LABOR MARKET ARE PROMOTING WAGE GROWTH.

The monthly average gross wage continues to increase rapidly. In the 3rd quarter of 2023, the average annual wage growth reached 11.8%, while the average gross wage increased to 1,549 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 has been 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 the 3rd quarter of 2023, taking inflation into account, the real net salary

increase compared to the corresponding period of the previous year was 5.7%.

The forecast of LV PEAK experts shows that despite the geopolitical tension, salaries will continue to grow in 2023 – by a total of 12%, and in 2024 – by 9.0%.

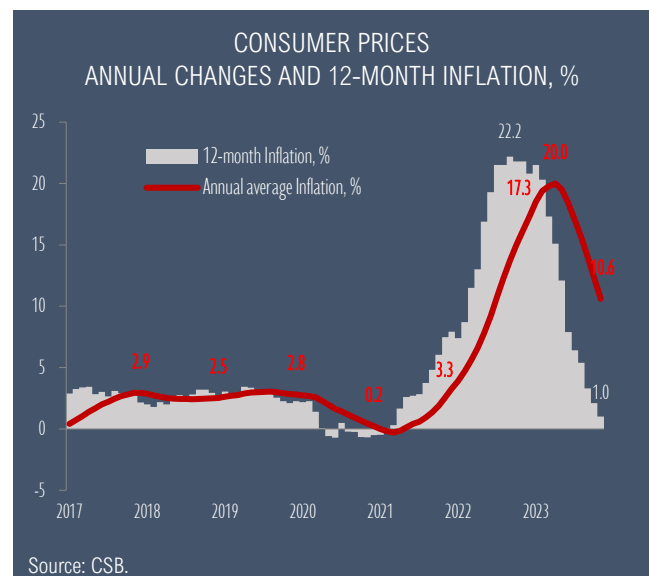
Graph 2. Wages continue to rise sharply.



THE RAPID RISE IN PRICES IS BEHIND.

During the Covid-19 pandemic, the average price level increased by only 0.2% in 2020. The adjustment of the economy to the conditions of the post pandemic happened very quickly - the supply did not keep up with the growing demand. In the second half of 2021, this had a significant impact on the rapid rise in prices in the world - especially for metal, wood, etc. intermediate consumption goods. The situation was further aggravated by the Russia's invasion of Ukraine in February 2022, which affected supply chains and resulted in a sharp increase in the prices of energy resources, food, and raw materials.

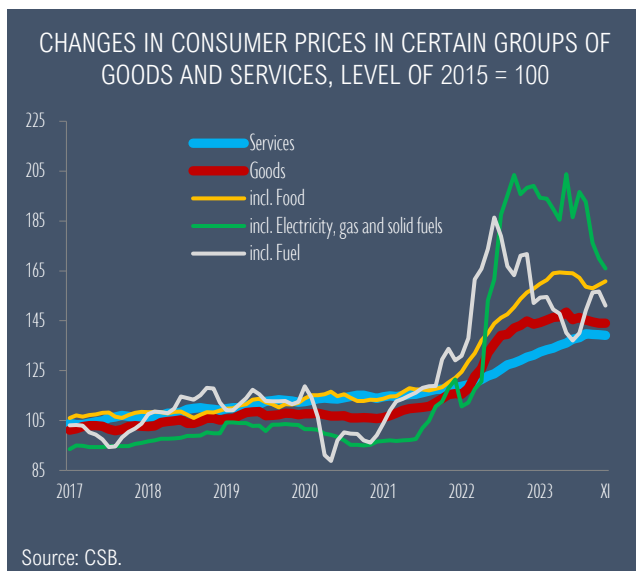
Graph 3. The rapid rise in prices is easing.



At the end of 2022, the 12-month inflation in Latvia reached 20.8%, 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 solid fuel, as well as fuel.

In the first two months of 2023, prices continued to grow relatively rapidly, especially for food items. Since the spring, the price increase has started to decrease, returning to the typical monthly price changes, as they were in the last years before the Covid-19 pandemic. In November 2023, the 12-month inflation was only 1%, and the annual average inflation was 10.6%. In November 2023, food prices were 2.8% higher than a year ago. During this time, there was a significant price drop for electricity, gas and solid fuel - by 16.3% and fuel - by 12%. In 2023, a relatively large price increase for services remained, which were 6.7% higher in November than in November 2022.

Graph 4. The prices of energy resources are decreasing.



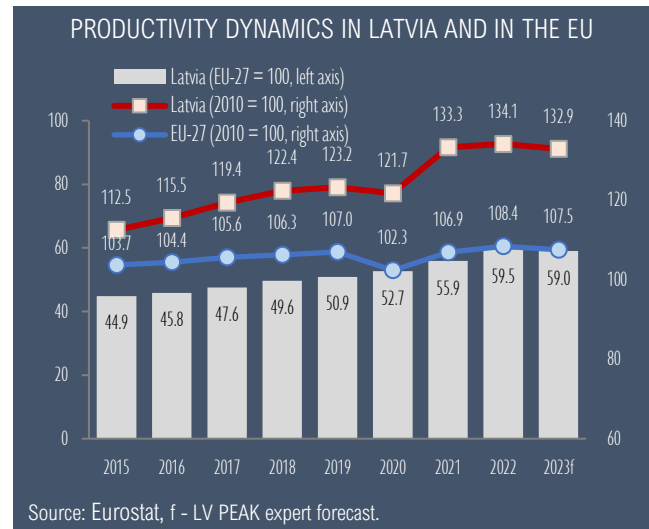
Inflation will continue to decrease in 2024. Price dynamics will be influenced by various supply-side factors related to tax and tariff increases, as well as demand, as wages are expected to continue to rise. LV PEAK predicts that in 2024 the average annual inflation could reach 2.6%.

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 increased by only 0.1%, but already in 2021, with the recovery of economic activities, the rate of productivity growth accelerated and was 9.5% higher than a year ago. However, in 2022, economic growth was extensive, and productivity was only 0.6% above the level of the previous year. In 2023,

productivity dynamics were weak - in three quarters it was 1% less than a year ago.

Graph 5. The productivity gap is narrowing.



The dynamics of productivity in Latvia has been fluctuating in the last ten years, but generally 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 59.5% (74.3% according to the purchasing power parity standard) of the average EU level.

LABOUR COSTS CONTINUE TO INCREASE.

Due to the decrease in economic activities, in 2020 labor costs also increased more slowly - by 4.3% (in 2019 - by 7.8%). Unit labor costs (ULC) also grew slightly slower - by 5.6%, which was determined by slow productivity growth.

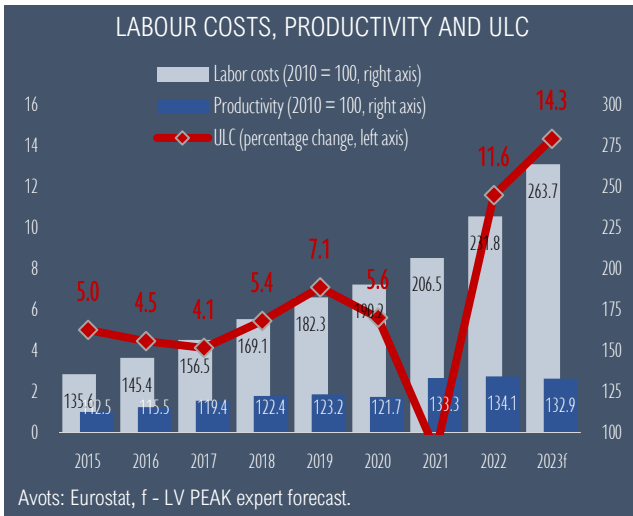
In 2021, labor costs continued to rise and were 8.5% higher than a year ago. Productivity growth (by 9.5%) reduced the pressure of labor costs on competitiveness and ULC decreased by almost 1%. The dynamics of labor costs in 2022 was even faster and with productivity remaining at the previous year's level, ULC increased by 11.6%. The dynamics of labor costs in the three quarters of 2023 was slightly more moderate than in 2022 due to a decrease in productivity, ULC increased by 13.8%. It should be noted that 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.

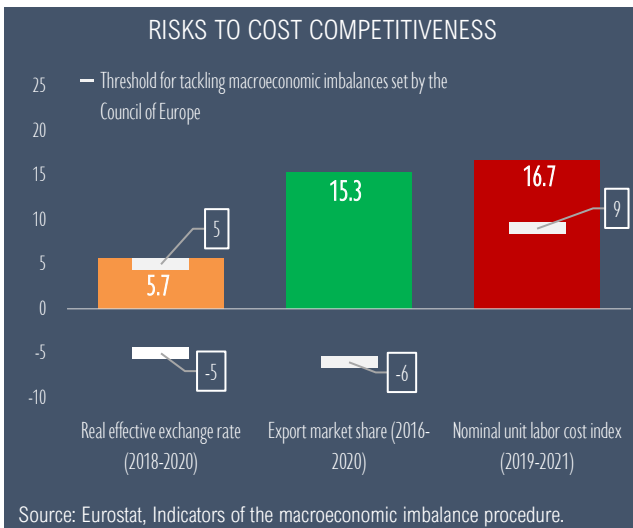
Risks of weakening cost competitiveness are growing, as evidenced by the increase in the real effective exchange rate (REER) and ULC. However, the long-term dynamics of Latvia's export market share is still positive. In five years (2018-2022),

it increased by 15.2%, including 3.6% in 2022. This was mainly determined by the increase in the market share of the export of goods - by 19.9%, while the increase in the market share of the export of services was more moderate - by 5.5%.

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 labor costs, which will continue to be quite rapid. The increase in labor costs is largely influenced by unfavourable demographic trends, growing demand and high competition in the EU's open labor markets.

In 2023, labor costs have significantly exceeded pre-pandemic levels, while productivity growth has been more moderate. 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.

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 4.6% in 2022, while general government debt decreased from 44.0% of GDP in 2021 to 41.0% in 2022. The Parliament of Latvia has approved the budget deficit for 2023 at 1.8 billion EUR or 4.2% of GDP. According to the assessment of the European Commission, in 2023 it is expected to amount to 3.2% of GDP. The budget for 2024 has been prepared 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.

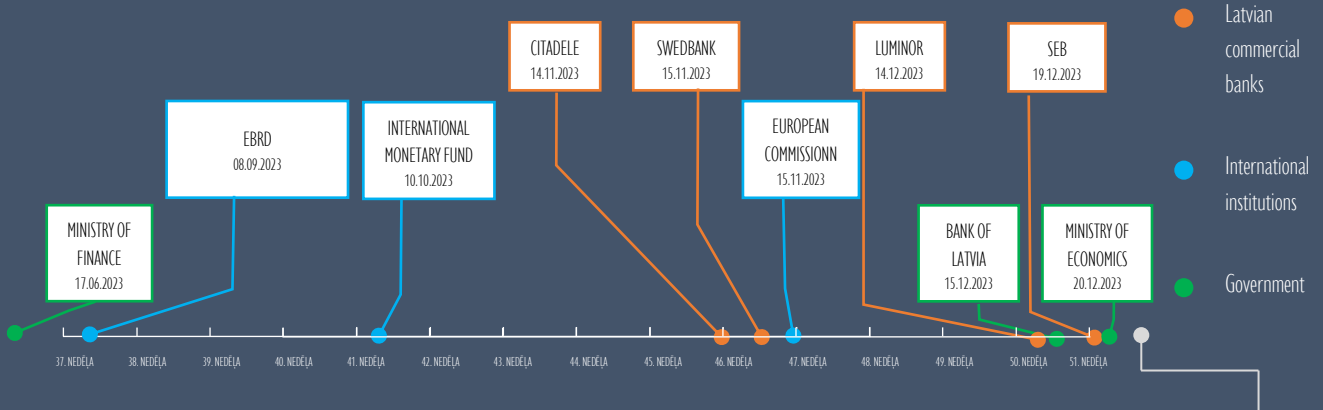
	2019	2020	2021	2022	2023f
Revenues, % of GDP	37.9	38.0	37.5	35.8	37.6
Expenditures, % of GDP	38.4	42.5	44.7	40.4	40.8
Balance, % of GDP	-0.5	-4.5	-7.2	-4.6	-3.2

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.

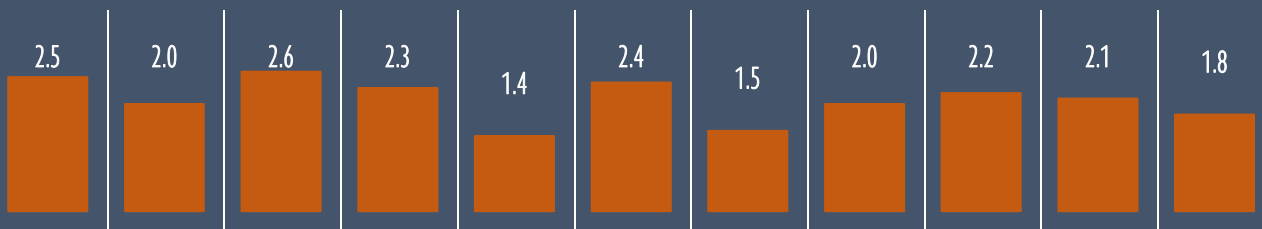
INFOGRAPHIC

FORECASTS OF LATVIA AND INTERNATIONAL INSTITUTIONS – THE ECONOMY WILL RECOVER IN 2024, INFLATION WILL CONTINUE TO DECREASE

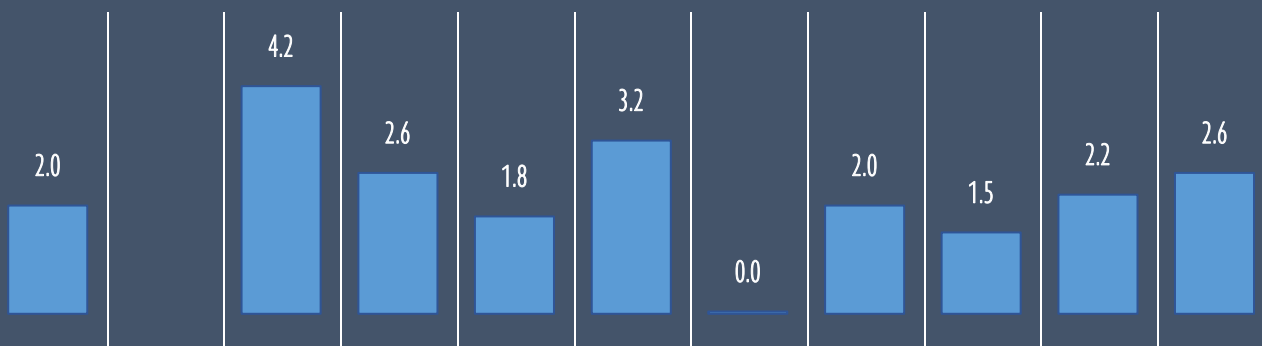


MINISTRY OF FINANCE	EBRD	IMF	CITADELE	SWEDBANK	EUROPEAN COMMISSION	LUMINOR	BANK OF LATVIA	SEB	MINISTRY OF ECONOMICS	LV PEAK EXPERT CONSENSUS FORECAST
Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	Source: ➔	22.12.2023.

GDP FORECASTS 2024, Growth rate, %



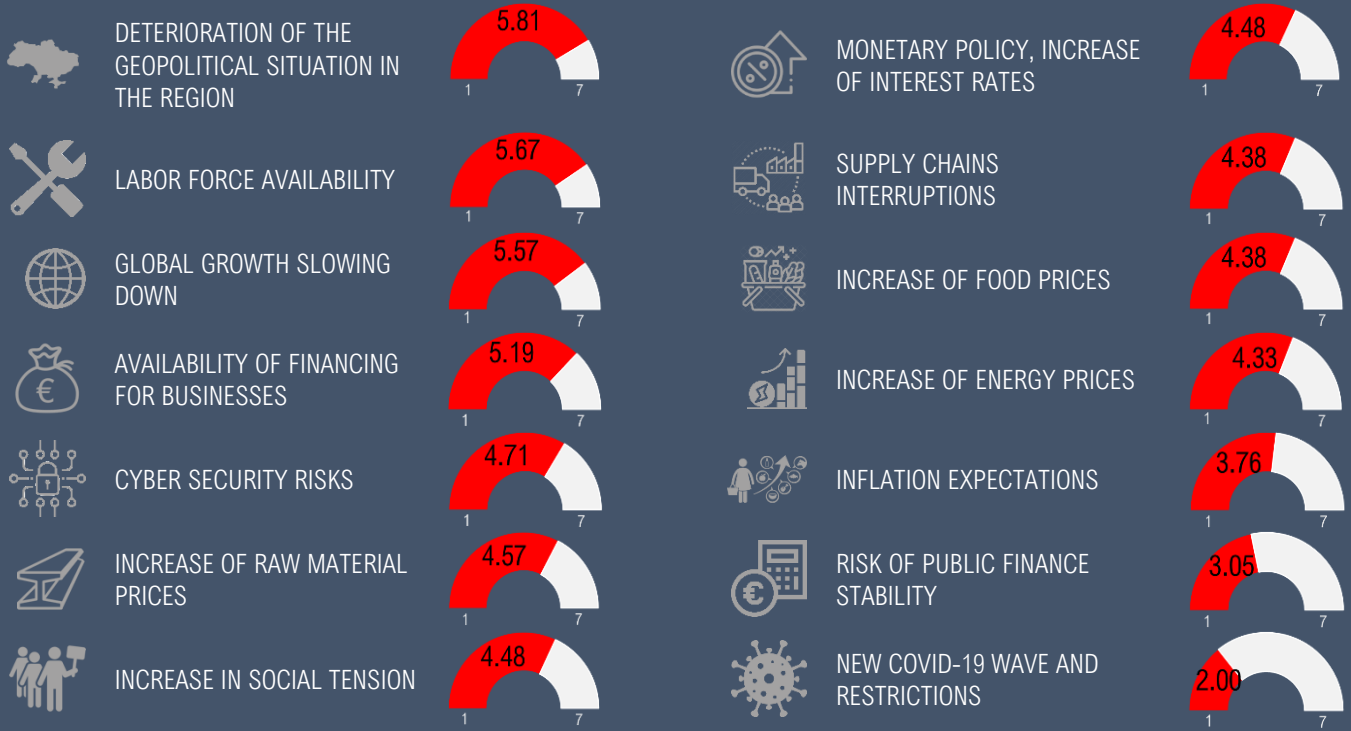
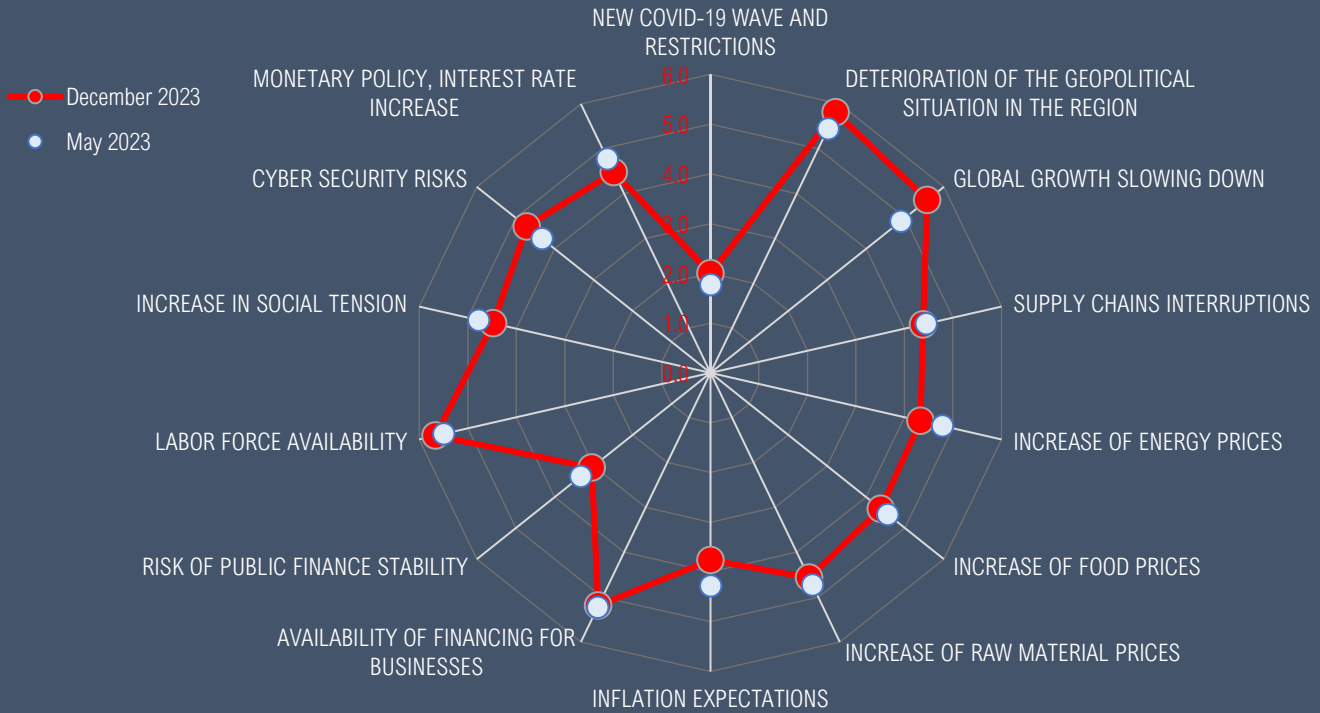
INFLATION FORECASTS 2023, Annual prices changes, %



INFOGRAPHIC

MAIN RISKS TO ECONOMIC GROWTH IN THE SHORT TERM – EXTERNAL ENVIRONMENT, LABOR AVAILABILITY AND FINANCIAL RESOURCES FOR INVESTMENTS

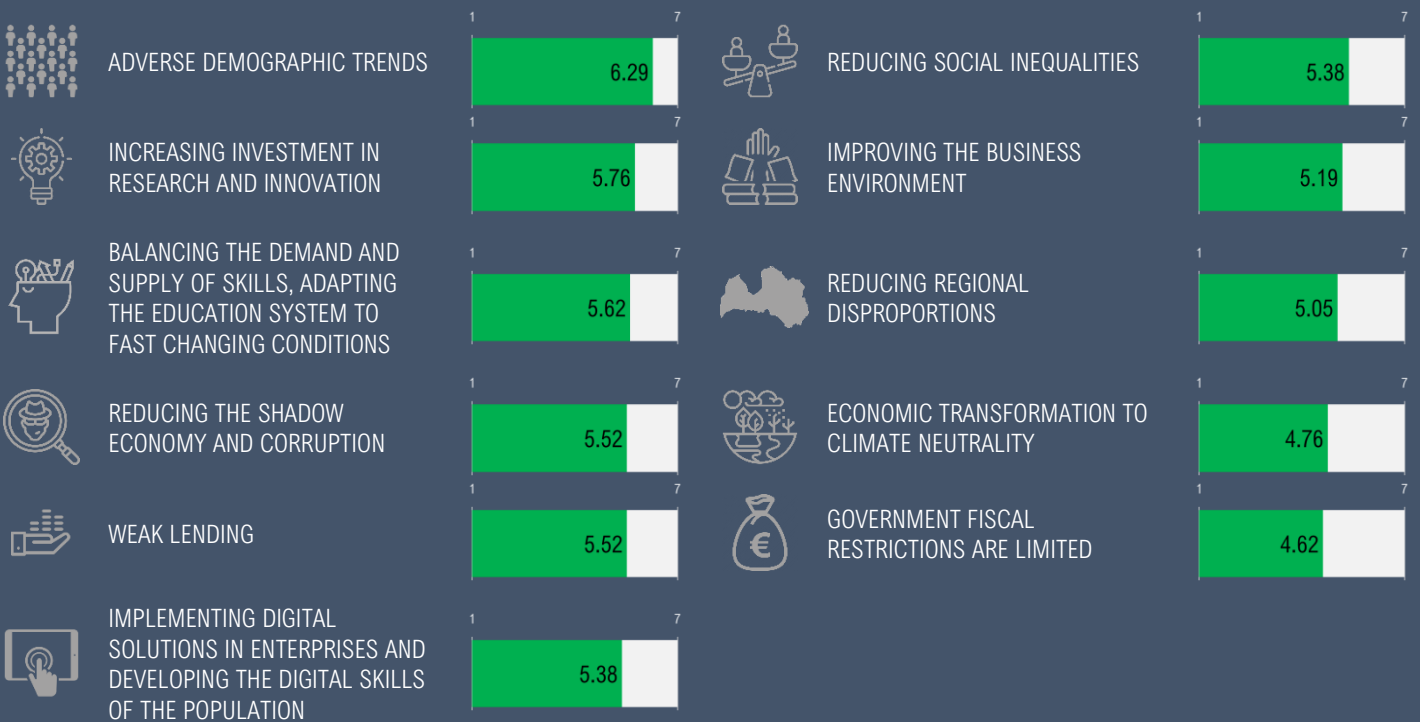
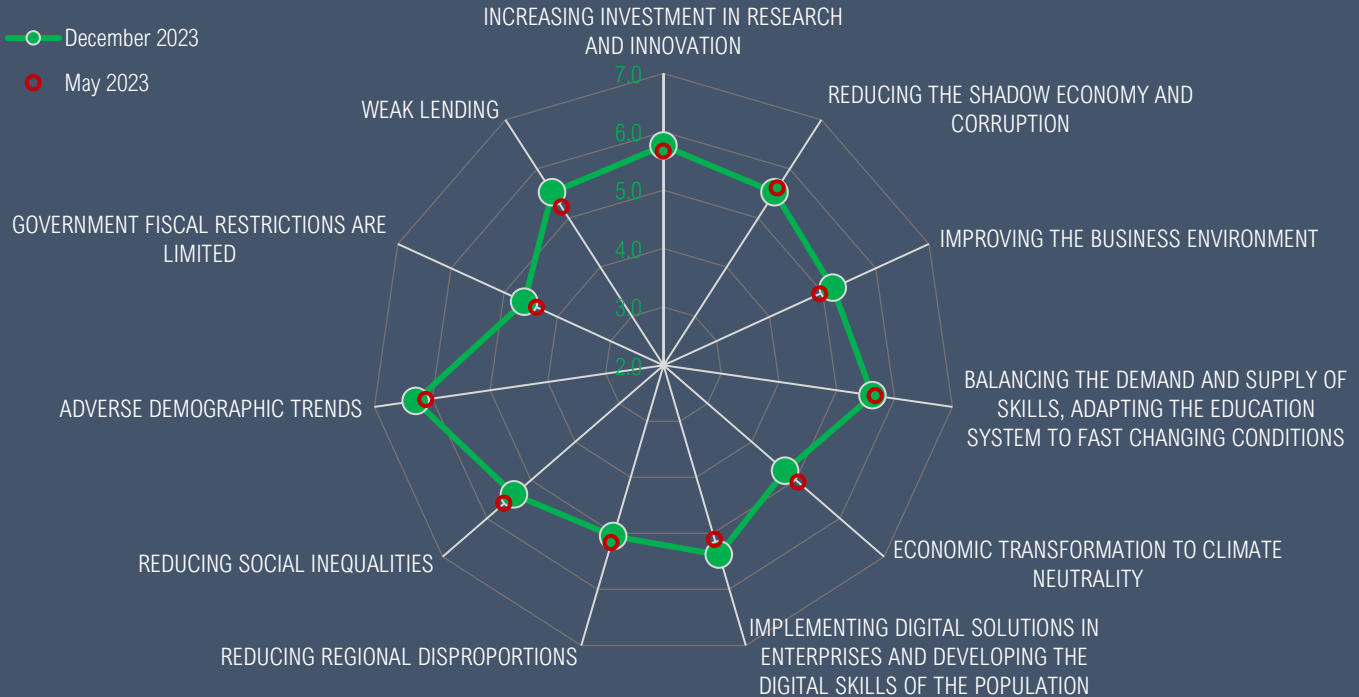
The LV PEAK expert survey asked to assess the potential risks to short-term economic growth on a scale from 1 (very low risk) to 7 (very high risk). The main risks identified are the deterioration of the geopolitical situation in the region, the availability of labor, the slowdown in global economic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



INFOGRAPHIC

MAIN MEDIUM-TERM CHALLENGES FOR GROWTH – DEMOGRAPHIC TRENDS, INVESTMENTS IN RESEARCH, DEVELOPMENT AND 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 investments 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.

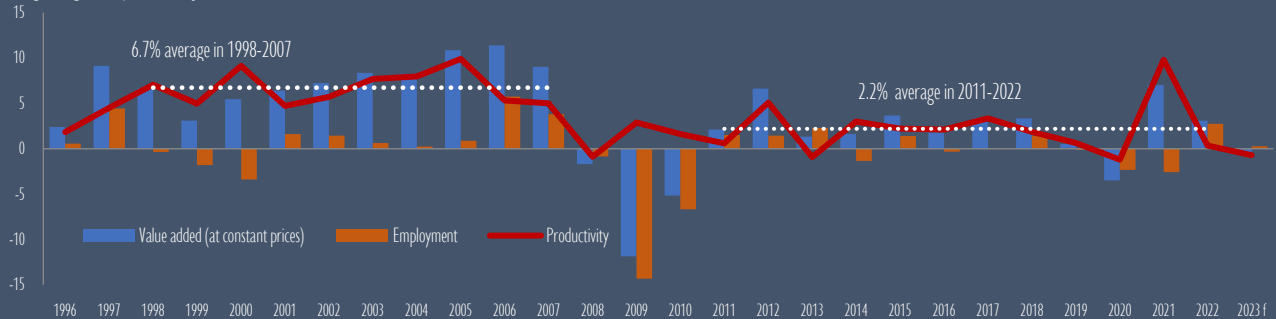


INFOGRAPHIC

PRODUCTIVITY IN LATVIA

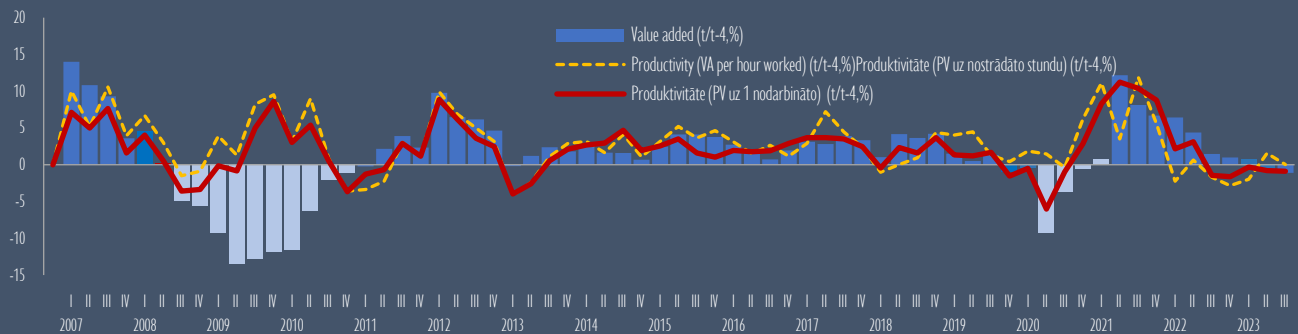
GROWTH RATES OF VALUE ADDED, EMPLOYMENT AND PRODUCTIVITY

changes against previous year, %



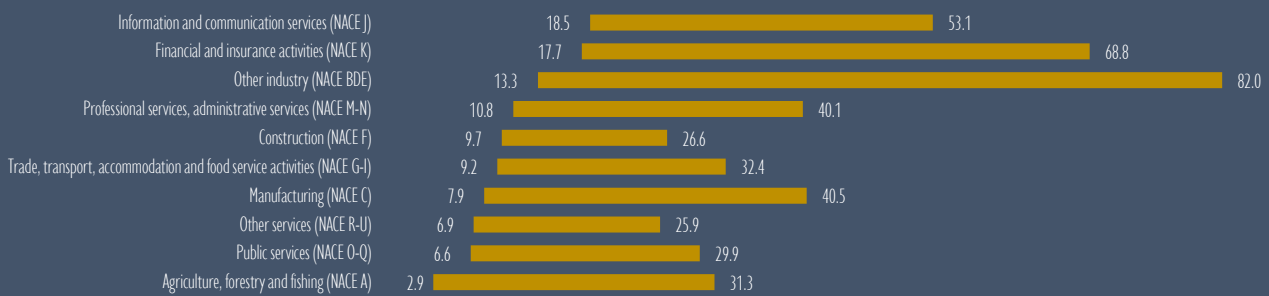
DYNAMICS OF LATVIA'S VALUE ADDED, NUMBER OF EMPLOYEES AND HOURS WORKED

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



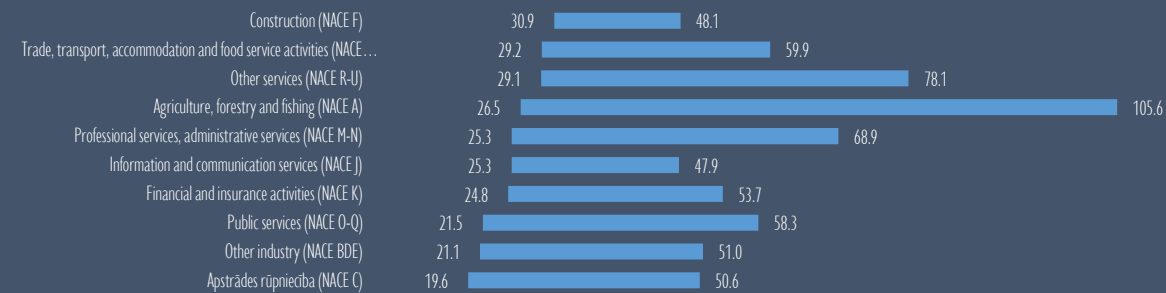
PRODUCTIVITY OF INDUSTRIES IN LATVIA 2000-2022

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



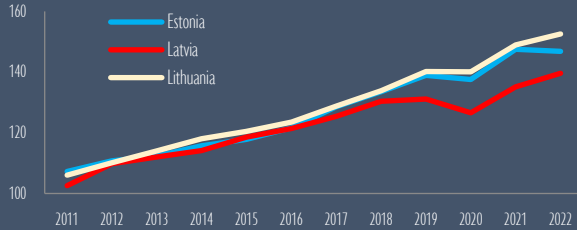
Source: Eurostat

INFOGRAPHIC

COMPARISON OF THE BALTIC STATES

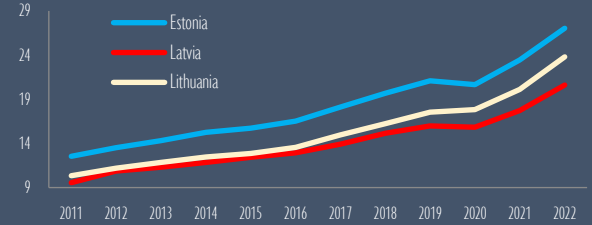
GROSS DOMESTIC PRODUCT

Growth at constant prices, 2010 = 100



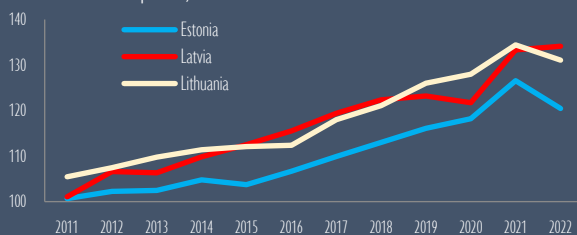
GROSS DOMESTIC PRODUCT PER CAPITA

At current prices, thousand EUR



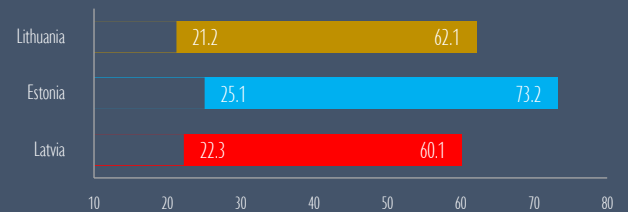
PRODUCTIVITY

Growth at constant prices, 2010=100



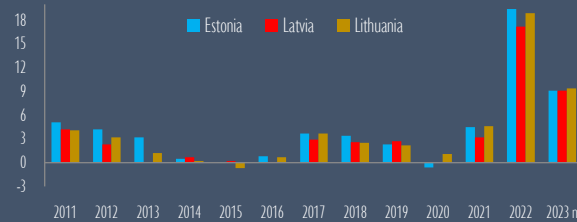
CONVERGENCE OF PRODUCTIVITY

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



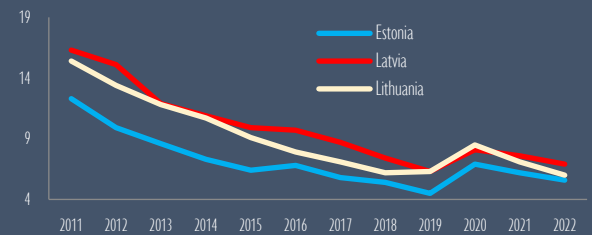
INFLATION

Harmonized index of consumer prices, annual average changes, %



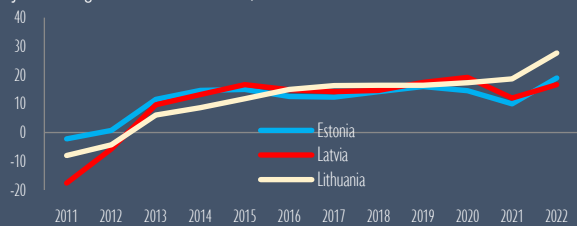
UNEMPLOYMENT

Unemployment rate in age group 15-74, %



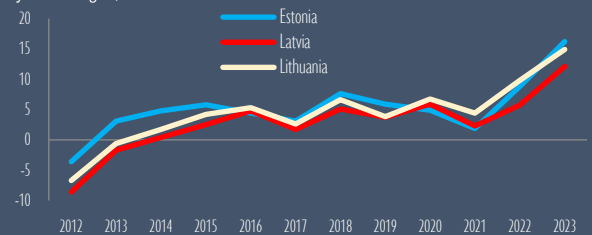
NOMINAL ULC

3-year changes in unit labor costs, %



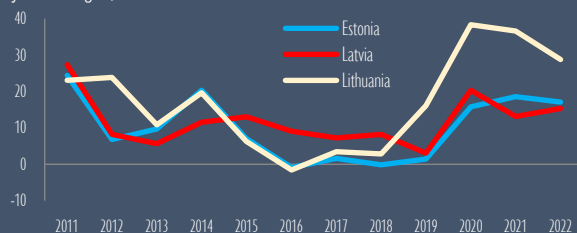
REAL EFFECTIVE EXCHANGE RATE

3-year changes, %



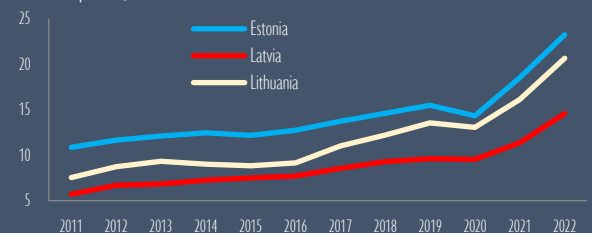
EXPORT MARKET SHARES

5-year changes, %



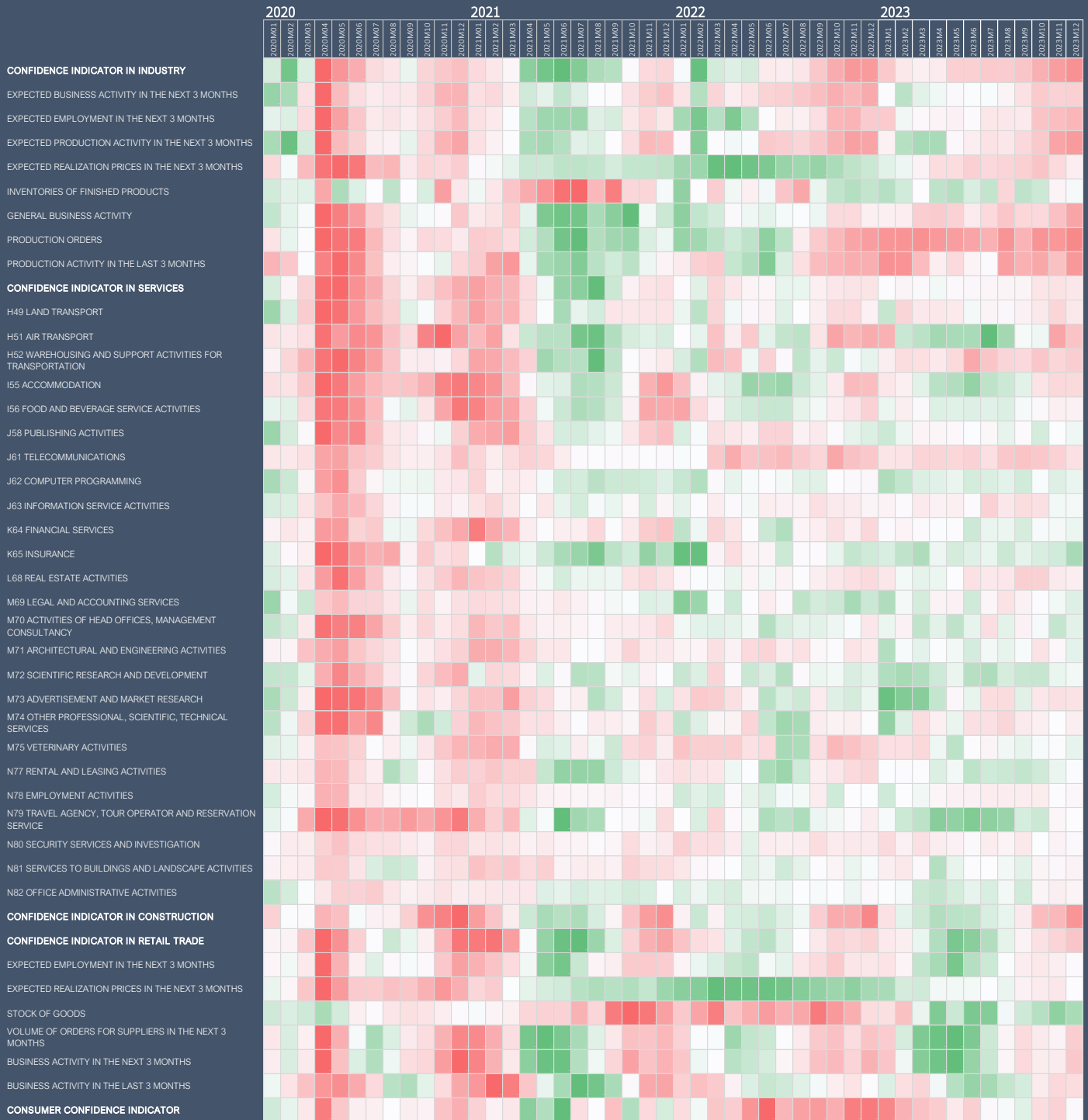
EXPORTS PER CAPITA

At current prices, thousand EUR



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).



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