

## Summary

- 1.** The current wave of Covid-19 infection is increasing in Latvia and other countries around the world, which will affect both Latvia's economic growth and fiscal position this year. Although the Omicron type specifics and the high level of vaccination among the population result that the illness is most often mild, so healthcare systems of different countries, including Latvia, at least currently are not overloaded. But the situation remains unstable and can change rapidly. The level of economic restrictions is not high, so the economic growth is upheld to a lesser extent compared to 2020-2021. However, there is a growing risk that companies could face labor shortages due to the massive Covid-19 cases among their employees. The uncertainty remains high, and the economic consequences are difficult to predict due to the pandemic.
- 2.** According to the CSB, the real seasonally adjusted GDP grew by 5.1% GDP in the third quarter of 2021 compared to the third quarter of 2020; however, the growth was only 0.6% compared to the second quarter of 2021. Investment (6.8%) and household consumption (4.4%) had the largest positive impact on the GDP structure in the third quarter. Overall, economic growth reached 5% after three quarters of 2021, exceeding the 2019 growth rate by 2 percentage points over the same period.
- 3.** According to the CSB data, the annual inflation in 2021 reached 3.3%. However, its volatility has been high - 2021 started with 0.1% deflation in the first quarter and ended with 7.1% inflation in the fourth quarter. In December 2021, compared to December 2020, the average consumer price level increased by 7.9%, which was the fastest price increase since March 2009. In November and December, price increases in Latvia were the third largest in the EU but lower than in Lithuania and Estonia<sup>1</sup>.
- 4.** Inflation has become a significant problem, and there is no evidence that it will start declining in the nearest future. Price expectations of entrepreneurs and consumers, futures prices for energy sources, producer prices, etc. factors suggest that inflation will only grow. The rise in energy prices is already having a painful effect on consumers, which could lead to a significant economic slowdown, a fall in the purchasing power of the population and a decline in the competitiveness of energy-intensive industries. The government should try to avoid stimulation of price increase in the construction sector, where rising inflation is already significant. Possibly even by cancelling projects, as the Council has already advised to the government in its previous Monitoring Report<sup>2</sup>, if the planned costs are too high.
- 5.** The high level of energy prices is still one of the main factors holding back the economy and causing inflation both in Latvia and in many other developed countries around the world. Unfortunately, energy futures indicate that energy prices are likely to be steadily high and that there is little probability of energy prices declining in the nearest future. The state should develop a proactive policy for living in high energy price conditions. The economic policy mechanism must include a social and business competitiveness aspects, so that the poorest groups of society are protected, and companies or energy-intensive industries do not lose their competitiveness on the international market. In essence, today the country is facing two crises at the same time - epidemiological and energy, which requires government action.

<sup>1</sup> Eurostat data: <https://ec.europa.eu/eurostat/documents/2995521/14083883/2-07012022-AP-EN.pdf/49039c42-31ea-3513-8307-eece31d6b25a>, viewed 19/01/2022

<sup>2</sup> Available: <https://www.fdp.gov.lv/lv/media/3300/download>, viewed 19/01/2022

- 6.** The business sentiment at the end of 2021 can be described as pessimistic. Confidence indicators decreased in retail (-1.2%), service providing (-0.7%), construction (-13.3%) and manufacturing (-1.7%). Consumer sentiment also remains negative (-7.1%); however, it has improved by 6 percentage points compared to November.
- 7.** The registered unemployment rate increased by 0.3 percentage points in December 2021 and reached 6.7% compared to November. The average registered unemployment rate in 2021 was 7.2%, which is in line with the five-year average unemployment rate. As of July 2021, the registered unemployment rate has started to fall below the five-year average. In addition, in almost all sectors, entrepreneurs cite labor shortages as a constraint on activity. Unemployment expectations for consumers are pessimistic, while employment expectations in industry and construction suggest the opposite. Employment expectations are pessimistic in the services sector and volatile in the retail sector, where the situation is highly dependent on the development of Covid-19 and the corresponding constraints.
- 8.** Overall, the positive trend in tax and SSC collection which started in April 2021 continued in November and December as well. In November, 10% more taxes and SSCs were collected compared to the same month a year ago, and the respective increase in December was 17%, despite the wide spread of Covid in those months. Rising inflation also plays a role in the relatively good tax collection trends.
- 9.** The government began paying working capital grants and downtime allowances in mid-December accepted by the government in November to compensate the damage caused by lockdown period. The support period for entrepreneurs was extended until the end of February, but the program is relatively targeted: it contains criteria that companies must meet and is limited to certain sectors that have been most affected by Covid-19.
- 10.** At the beginning of January, the government has increased the amount of funds for unforeseen events by 300 million euros, which will be used to finance the support mechanisms and unfortunately will increase this year's budget deficit. Coalition parties have agreed on new support mechanisms of 260 million euros to offset the rise in energy prices. Thus, it will require to increase financing of Funds for Unforeseen Events program which will inevitably lead to higher budget deficit.
- 11.** Latvia already has one of the highest inflation rates in the EU and increasing the budget deficit further will stimulate price increases. Consequently, a certain vicious circle is formed: disproportionate government support to cope with the effects of inflation leads to faster price increases.
- 12.** The draft budgetary plan of Latvia for 2022<sup>3</sup> projects that the budget deficit will be 4.8% of GDP this year, which will result in a general government debt of 51.7% of GDP at the end of the year. However, there is already a high probability that these projections will not be met due to the spread of Covid-19, which would require additional support measures and more rapid increase in the deficit and debt.
- 13.** The government is currently working in very difficult circumstances and is facing strong pressure from different interest groups that demands state support. The Council calls on the government to avoid general economic warm-up measures that do not have a long-term positive impact on economic potential, as well as to balance the need for state aid with fiscal responsibility.

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<sup>3</sup> Draft budgetary plan for 2022. Available: <https://www.fm.gov.lv/lv/media/8874/download>, Viewed 20/01/2022