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In-depth review for Latvia

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European Commission

Latvia

In-Depth Review 2023



On the basis of this in-depth review for Latvia undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2023 Spring Package" (COM(2023) 600 final) that:

Latvia is not found to experience imbalances. Vulnerabilities relating to external borrowing and housing remain mild; risks to competitiveness are pertinent, but overall seem contained in the near future. The recent widening of the current account deficit was significant, but the deficit is expected to narrow substantially this year and further in 2024. Latvia's net international investment position, which improved markedly in the past decade, is expected to remain broadly stable. Nonetheless, inflation and wage pressures, if persistent, risk impairing Latvia's competitiveness, particularly as core inflation is well above the euro area average. While house price growth has been elevated recently, the house price overvaluation does not appear to be substantial. Moreover, house price growth slowed down in late 2022, mortgage lending has been weak, and household debt is limited and falling in terms of household income. Latvia faces key structural economic challenges related to declining labour supply, which has contributed to fast unit labour cost increases and risks impairing competitiveness over the medium term. The policy setting is overall favourable, although some additional efforts could help to address the risks from the identified vulnerabilities. Policies to safeguard competitiveness, including measures to increase the quality and quantity of labour supply, would be important in that respect. Shortening the construction permitting process would help supporting housing supply and improve the housing market situation.

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), Latvia was not subject to an in-depth review to assess its vulnerabilities. ([1]) The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken for Latvia this year, with a view to examine newly emerging vulnerabilities and their implications. ([2]) The Alert Mechanism Report found that concerns related to cost competitiveness and house price developments existed already before the COVID-19 pandemic and were increasing. Nominal unit labour costs were set to continue increasing driven by weakening productivity growth. Nominal house price growth had remained rapid and picked up more recently, leading to a slight overvaluation, although household debt was low. The surge in energy prices had spilled over to core inflation, which had been among the highest in the EU and contributed to a weakening of the current account.

In 2022, strong real growth at the beginning of the year, driven by the recovery from COVID-19 restrictions, was stopped by surging inflation in the second half of the year. Real GDP growth reached 2.8% in 2022, down from 4.3% in 2021. The start of the year was marked by surging private consumption, which had previously struggled to recover from COVID-19 related restrictions. However, the energy price surge, exacerbated by Russia's invasion of Ukraine, quickly eroded households' gains in real disposable income, putting a brake on consumption growth. Moreover, real investment growth struggled amid rapidly rising construction prices, partially caused by disruptions in metal and timber supply from Russia and Belarus. Inflation was initially driven by a surge in energy prices, but quickly spread to other price components. It peaked in September 2022, at 22.0%, averaging 17.2% for the entire 2022, and still standing at 15.0% in April 2023. Employment growth followed a similar path to GDP – strong growth in the first half and a slowdown in the second half the year, averaging 2.7% in 2022. Going forward, GDP growth is expected to slow to 1.4% in 2023, as inflation hampers consumption. In 2024, GDP growth is expected pick up to some 2.8% growth helped by the resumption of real wage growth and a pick-up in EU funded investments. ([3]) The forecast rests on the assumption of energy prices to broadly stabilise around their 2023-Q1 levels in 2023 and 2024. Given the exceptional volatility of energy prices in recent months, this assumption remains a key risk.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Latvia. Vulnerabilities related to housing, competitiveness, and external balances in Latvia are also discussed in horizontal thematic notes that that were recently published. ([4]) The MIP assessment matrix is published in the 2023 Country Report for Latvia. ([5])

([1]) European Commission (2022), European Semester Spring Package 2022, COM (2022) 600 final.

([2]) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

([3]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

([4]) European Commission (2023), Housing Market Developments: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 197. European Commission (2023), Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 198. European Commission (2023), External Sustainability Analysis: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 196.

([5]) European Commission (2023), Country Report Latvia 2023, SWD(2023) 614 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

Latvia has been selected for an in-depth review to assess risks related to deteriorating price competitiveness linked to the build-up of wage and price inflation differentials with its trading partners, strong house price growth as well as widening of the current account. House price growth in Latvia picked up significantly in 2021 and accelerated further to reach a 14% growth in 2022. While this follows a period of subdued house price growth, the review examines the reasons for the recent acceleration. Furthermore, while Latvia's net international investment position has constantly improved over the past decade, the current account widened significantly in 2021 and 2022 and warrants a closer look at the drivers of the break in pattern. Finally, Latvia experienced some of the highest inflation among the euro area member states, peaking at 22% in annual terms and being roughly twice as high as in the euro area. This inflation divergence raises concerns about Latvia's price competitiveness and comes in addition to a longer running trend of wage growth exceeding productivity growth. However, recent developments point to a slowing price and wage growth.

On 5 April 2023 the Commission published a horizontal thematic note on housing, which also covers Latvia. It showed that house prices almost doubled in nominal terms over the last decade, with almost half of this increase taking place over the last three years. However, since the global financial crisis, the increase in nominal prices had tracked incomes and although they have diverged recently, the price-to-income ratio remains some 40% below its peak reached during the height of the bubble 15 years ago. While the most recent acceleration in growth might have put house price growth out of line with income growth, overvaluation is assessed to be only limited. The note recognizes that most recent data point to a slowdown in house price growth and forecasts that it will continue to do so over the coming quarters due to rising interest rates. Furthermore, it accentuates that the recent house price growth in excess of income growth have likely been due to delayed or inelastic supply. Latvia's process for issuing building permits is lengthy and includes excessive red tape around building regulations. It adds that the rental market in Latvia is relatively small.

House prices reached two-digit growth over the past two years, exceeding income growth in 2022, but most recent data show signs of slowing. After having dipped during the height of the COVID-19 crisis, annual house price growth picked up in the second quarter of 2021. House price growth peaked in the first quarter of 2022 at 17.4%, and it has declined since then, recording a 9.1% annual growth in the last quarter of 2022. Monthly bank lending data for November 2022 show that interest rates on new mortgages had increased by 1.6 percentage points compared to the average prevailing during the first half of 2022, and lending growth slowed from around 7% during the first half of the year to 4.7% in November. Demand for housing and hence house price growth is expected to trend downwards this year and next as interest rates continue rising and real income growth remains subdued.

Over the past decade, house price growth has been fairly rapid but has remained broadly in line with income growth. Since 2012 house prices have grown by 103% while income has

grown by 94%. This has led the price to income ratio to increase by 4.5% over the same period. However, in a historical perspective, it has remained below the average of the early 2000s and some 36% below its peak reached in 2007. The Commission's model estimates Latvian house prices to have been 6.6% overvalued in 2022. ([6]) At the same time, relative to rent, house prices have appreciated more significantly over recent years, implying an overvaluation of 49% in 2022. The latter is mostly due to stagnating rent prices, which have significantly lagged income growth. Thus, while this may signal a lack of efficiency of the rental market, it is not indicative of a housing market bubble.

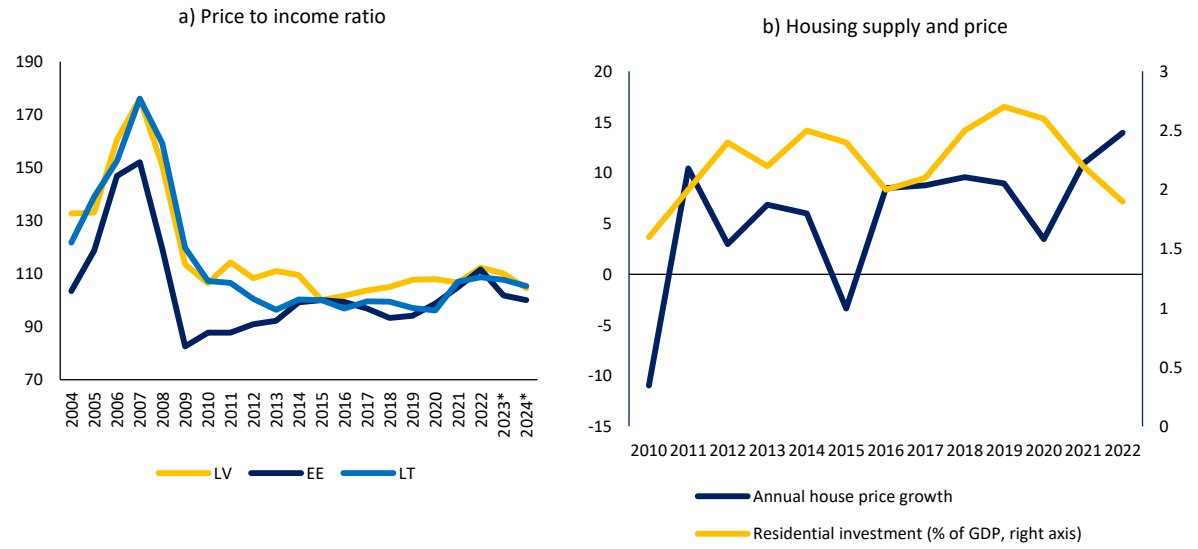
Mortgage lending growth has been weak over the past decade, dampening households' demand for housing, while supply has been restricted by labour shortages and a lengthy permitting process. Mortgage lending in Latvia has been weak since the global financial crisis. Lending growth was negative during the first half of the decade and then turned positive for the second half, while still remaining below the rate of growth of GDP. As a result, household debt declined from 50% of GDP in 2009 to below 20% of GDP in 2021. This dynamic suggests the demand impulse to housing market from credit has more likely been negative than positive. On the supply side, housing construction has been rather stable throughout the decade, hovering between 2 and 2.5% of GDP. However, the most recent house price rally has taken place in the context of falling investment in housing, which stood at 1.8% of GDP in 2022 (graph 2.1 b). Moreover, it remains considerably below Estonia's and Lithuania's investment levels, which in 2022 stood at 5.2% and 3.6% of GDP, respectively. The construction sector appears to suffer from increasing labour shortages – the job vacancy rate in the sector has been consistently above the economy's average. ([7]) Moreover, according to the Doing Business rating, getting a construction permit in Latvia takes longer than it does in either of its Baltic neighbours. ([8]) In 2020, Riga municipality introduced an accelerated permitting process for large-scale projects.

([6]) See "Housing Market Developments, Thematic Note to Support In-Depth Reviews", European Commission 2023, Institutional paper 197

([7]) In 2022, job vacancy rate in construction was 3.5% compared with 2.7% in the economy on average. Moreover, it has been consistently above the economy average since 2018. This is notable because in neighbouring Estonia and Lithuania it has been below the economy average.

([8]) Doing Business 2020, https://archive.doingbusiness.org/content/dam/doingBusiness/country/l/latvia/LVA.pdf

Graph 2.1: **Housing affordability and housing supply**



Source: Eurostat and European Commission services

An underdeveloped rental market drives people into buying, contributing somewhat to housing price growth. In Latvia, over 80% of households own their home and the majority of them has no mortgage. The rental market is relatively small and concentrated in Riga. The relatively small rental market limits housing options and likely contributes to driving people into buying a home instead of renting. As a result, over the past decade house price growth has exceeded rent price growth by some 60%. Moreover, until recently, poor protection of landlords' interests in the rental law meant little investment in rental housing, limiting rental options for modern dwellings. A new rental law was passed in 2021 aimed at addressing these issues. Finally, while rental regulation exists, it is poorly enforced and large parts of the rental market operate informally, adding to instability of living in a rental home, and hence decreasing its attractiveness.

On 5 April 2023 the Commission published a horizontal thematic note on external sector's sustainability, which covered Latvia. It found that Latvia's current account had experienced a significant deterioration since 2021. Most of the worsening in the balance of trade stemmed from the deteriorating balance of trade in goods, particularly energy. The trade balance was largely determined by the changes in trade volumes. Regarding the net lending/borrowing position, it declined strongly in 2021 and 2022, as the government increased its deficit and non-financial corporations turned into net borrowers.

Since the global financial crisis, Latvia's current account deficit has remained broadly balanced, while its net international investment position (NIIP) has substantially improved. However, EU fund inflows through the capital account averaging around 2% of GDP meant that Latvia was a net lender during this time. From a sectoral perspective, corporations have been net lenders throughout this period and the government a net borrower, while households turned from net borrowers during 2012 to 2015 to net lenders from 2016 onwards. ([9]) As a result, Latvia's NIIP improved from -83.2% of GDP in 2010 to -27% of GDP in 2022. Taking out non-defaultable instruments from the NIIP balance puts Latvia in a positive net position of 16.3% of

([9]) Corporates turned into small net borrowers only in 2019 and 2021, while governments moved to a very small surplus only in 2016.

GDP. The steady improvement in the NIIP has been due to a combination of steadily growing domestic savings combined with weak credit growth and prudent fiscal policy.

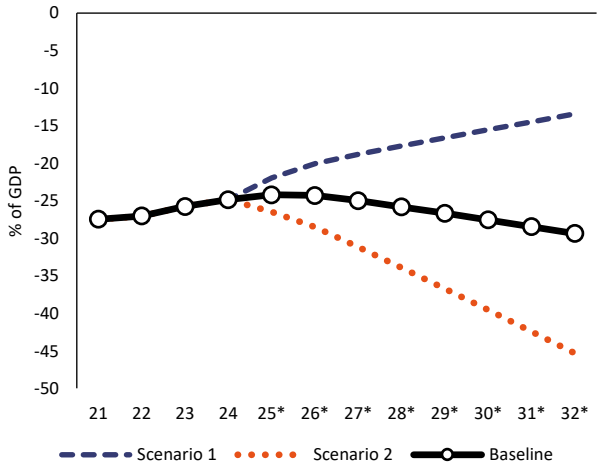
Over the past two years, Latvia's current account has markedly deteriorated, driven by rising energy prices and government borrowing. After having improved from -0.6% of GDP in 2019 to a surplus of 2.6% in 2020, the current account moved to a deficit of 4.2% in 2021, which deepened to 6.1% in 2022. Energy balance deterioration by 4.4% of GDP explains the lion's share of the current account worsening since 2019. The rest is mainly due to the deterioration in the balance of services and the decline in secondary income (composed primarily of expatriates' remittances). It should be noted that, although energy prices exerted a strong negative partial impact on the trade balance, the overall terms of trade movements were limited, as the changes in exports and imports deflators largely cancelled out. Thus, the worsening in the trade balance was driven mainly by the changes in trade volumes, rather than prices. Rising energy prices have brought households' savings to around zero and contributed to government borrowing. In 2021, government borrowing amounted to 7.1% of GDP and corporations' borrowing added another 2.4% of GDP, while households remained net lenders. In 2021, elevated government borrowing was mainly covid19-related – the measures included income support for households and businesses as well as an investment packaged aimed at fostering economic recovery. In 2022, government borrowing added up to 4.4% of GDP and remained the largest contributor to Latvia's net borrowing position. For the economy as a whole, net borrowing amounted to 2.9% of GDP in 2021 and to around 4.6% of GDP in 2022, significantly lower than the current account deficit thanks to a sizeable positive balance of the capital account, consisting primarily of EU fund inflows.

The current account is expected to return to balance once the budget deficit declines. In 2023 the current account balance is expected to remain at around -3.4% of GDP mainly explained by a still-elevated public deficit and increasing EU fund inflows, but also due to reduced household savings caused by the inflation surge. In 2024, the current account deficit is expected to narrow further; it is projected to normalise as the public deficit returns to the pre-pandemic level. Given the decade-long trend of weak bank lending, both households and corporations are expected to continue deleveraging or growing their liabilities no faster than the pace of income growth. As a result, the private sectors' net lending is expected to normalise to pre-pandemic levels over the medium term through reduced consumption or investment.

The NIIP is expected to worsen slightly going forward. Over the medium term, the NIIP is projected to decline mildly, reaching levels of around -29% of GDP by 2032, under the baseline assumptions (see graph 2.2). In order to assess the sensitivity of the baseline projections to different energy price assumptions, two alternative scenarios are simulated. Under the alternative assumptions of scenarios 1 and 2, the NIIP deviates from the baseline projection by around -16 pps. by 2032, i.e. comes close to -14% of GDP in the optimistic scenario and to around -45% of GDP in the pessimistic scenario. ([10]) Overall, as the recent increase in the current account deficit is expected to reverse in the following years, in part due to lower energy prices, and given Latvia's relatively strong NIIP, the risks of a substantial deterioration in external sustainability seem contained, even with a moderate current account deficit.

([10]) The optimistic scenario (scenario 1) illustrates a case of a more positive trade balance evolution amid lower energy prices than under the baseline. It assumes higher trade balances after 2024 by 2 pps. of GDP, higher real GDP growth in 2025 by 2 pps., as well as a lower inflation rate by 1 ppt. in 2025 than in the baseline scenario. The pessimistic scenario (scenario 2) simulates the impact of a corresponding adverse shock: it assumes the same timing and magnitude of deviations from the baseline as in scenario 1, but with the opposite sign.

Graph 2.2: **NIIP projections**



Source: European Commission servicews

On 5 April 2023 the Commission published a horizontal thematic note on competitiveness, which also covers Latvia. It showed that the recent surge in inflation had not only been driven by the increase in commodity prices, but also domestic-origin inflation, which contributed to consumer price increases more than in other euro area countries. The contribution of domestic-origin inflation to changes in export prices was also relatively strong in Latvia. From a national accounts income perspective, the estimated domestic contribution to consumer inflation essentially reflects rising compensation of employees (as reflected in unit labour costs) and profit margins (as reflected also in the notable rise in operating surplus in national accounts statistics). In effect, the corporate sector on aggregate managed to raise its revenues above the rise in input costs. Real effective exchange rates (REERs) based on core and HICP inflation likewise has been appreciating in recent years in Latvia. Nevertheless, recent research found that Latvia's REER had remained broadly in line with fundamentals and that non-price competitiveness had likely compensated for the loss in price competitiveness.

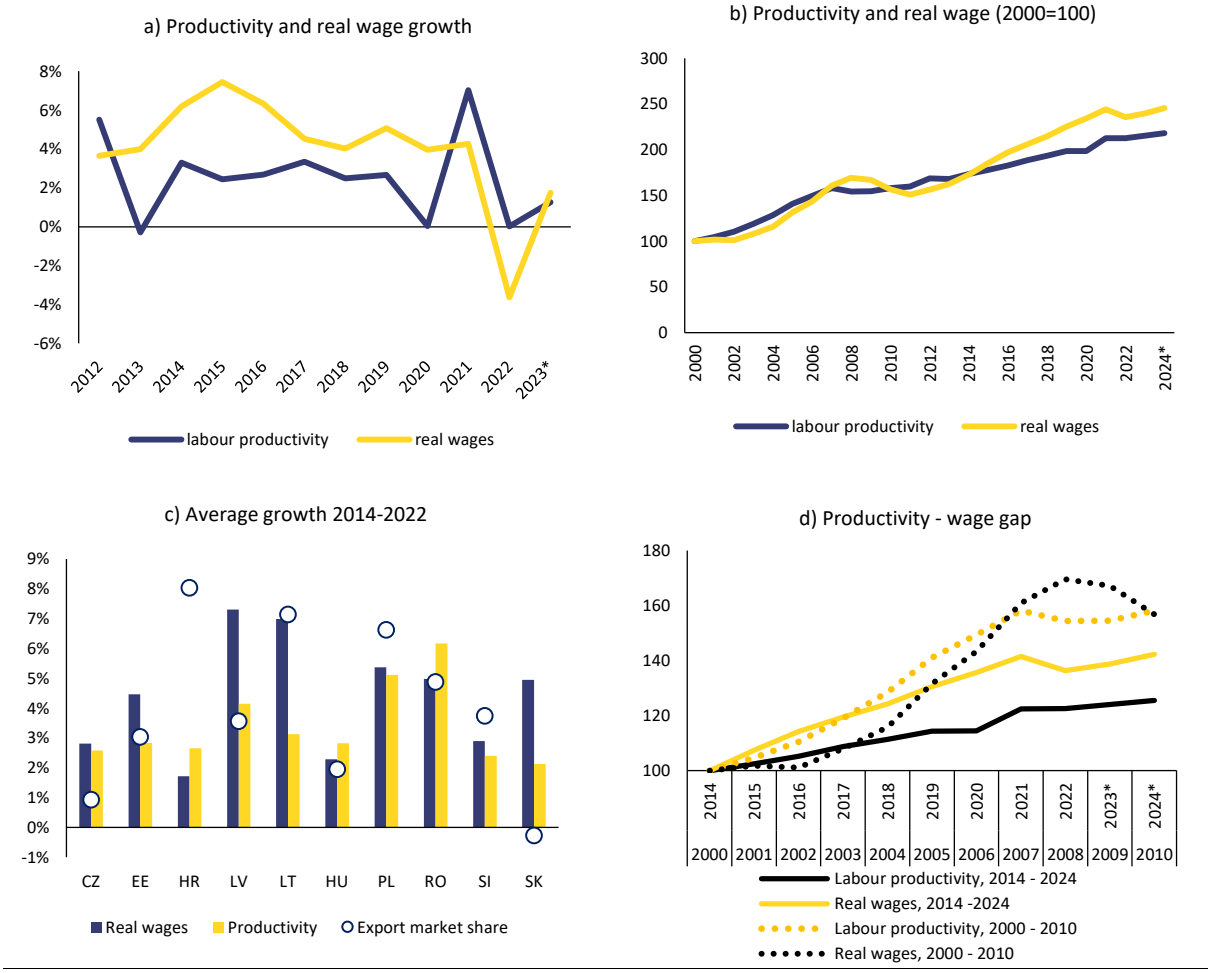
Latvia's wage growth has consistently exceeded that of its trade partners, but inflation remained largely contained up until 2022. Rapid wage growth has translated in high unit labour cost growth, which has been consistently above the EU average (7.5% vs 2.7% over the 2019-2022 period). Moreover, the unit labour cost-based measure of Latvia's real exchange rate has appreciated by 28% since 2015. This is about the same as in Estonia and somewhat lower than in Lithuania. However, inflation-based real exchange rate changes have been more contained – from 2015 until 2021, HICP-based REER had appreciated only by 3.4%. However, the recent inflation surge led to a further 6.6% appreciation in 2022 alone. While the wage and price appreciation appear to be driven by different phenomena (wage growth driven by falling labour supply and prices driven by energy price shock), the combination of the two increases the risk of being priced out of the export markets. Difficulty to increase exports would translate into slower pace of income convergence and hence risks undermining one of Latvia's key economic goals.

Over the past decade, real wage growth in Latvia has consistently exceeded productivity growth, raising concern about the country's cost competitiveness. In 2022, the accumulated gap between real wage and productivity growth since 2014 ([11]) amounted to some 14%, which was only slightly less than the 15% gap accumulated at the peak of 2008 over the

([11]) 2014 is chosen as a benchmark year because, in a long-term comparison, the ratio of real wages to productivity returned to its level of the year 2000 following a strong appreciation and depreciation during the 2004–2008 housing boom.

previous eight years (graph 2.3 d). This raises questions about the causes and possible effects of this development, as well as about the sustainability of the trend. While real wage growth tends to follow productivity growth, it has consistently exceeded it throughout most of the previous decade (graph 2.3). Compared to that of its peers, Latvia's productivity growth has been among the better performing (behind only Poland and Romania), but its real wage growth has been even higher. ([12]) Hence, the issue more likely lies with the labour market rather than Latvia's productivity performance.

Graph 2.3: **Productivity and wages**



Source: Eurostat and European Commission services

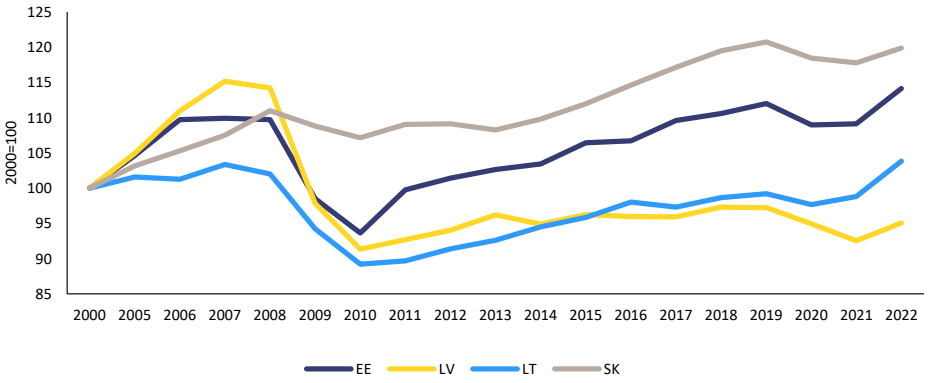
Labour market tightness is due to falling labour supply, skills and regional mismatches. In a stark comparison to the period prior to the global financial crisis, a gap between real wages and real productivity growth has opened in the absence of a major demand stimulus – the private sector has been considerably deleveraging, while public debt has remained broadly stable before the one-off increase during the pandemic. Unlike during the 2004–2008 period, when employment increased by some 15%, employment has remained broadly unchanged since 2012. The economic context of the elevated wage growth suggests that it is driven by supply rather than demand.

([12]) The choice of the base year may affect the results. However, the same broad picture emerges if the same variables are compared over the past 5 or 10 years.

Latvia's labour force has declined by 0.8% annually on average over the past decade and the rate of decline is expected to accelerate to 1.8% over the coming decade. ([13]) Moreover, despite the high wage growth, the unemployment rate did not fall below 6.1% during the previous decade, which is notably higher than for its peers. ([14]) This points to difficulties in matching willing workers with jobs, either due to their inadequate skills or limited internal labour mobility as evidenced by high regional disparities in the unemployment rate.

As wage setting in Latvia is firm level-based and automatic wage indexation rarely used suggest that the risk of a wage-price spiral is unlikely. Collective bargaining predominantly takes place at the company level, with a low degree of coordination and automatic wage indexation is rare, thus structural linkages between inflation and wages are weak. In the second and third quarters of 2022, annual wage growth was slowing, while inflation was climbing. Wage growth picked up slightly in the last quarter of 2022; however, at 10%, it remained significantly below the 20% inflation rate.

Graph 2.4: **Employment index, (2000=100)**



Source: Eurostat and European Commission services

The energy price surge has hit Latvia's economy harder than most other EU countries, putting additional strain on its competitiveness. The energy price shock resulting from Russia's invasion of Ukraine, affected Latvia more severely than most other EU countries. This was due to Latvia's high reliance on natural gas for electricity generation and heating, as well as comparatively low prices it paid for natural gas before the price surge. Its energy inflation averaged 48.8% in 2022 compared with 36.9% in the euro area, however the difference in energy price inflation reached some 20 pps. in the second half of 2022. The monthly energy price inflation peaked in July 2022 at 70%, significantly above the around 40% energy inflation peak in the EU and euro area. Furthermore, with energy products comprising a larger share of Latvia's consumption basket, its impact on consumer price inflation was larger than in other countries ([15]). Finally, a higher energy price inflation meant a higher inflation in other prices as the energy price

([13]) European Commission, 2021, https://economy-finance.ec.europa.eu/document/download/9acc3a53-b2dc-42e1-94cd-de5130b07f2c_en?filename=new_country_fiches_ar2021.xlsx

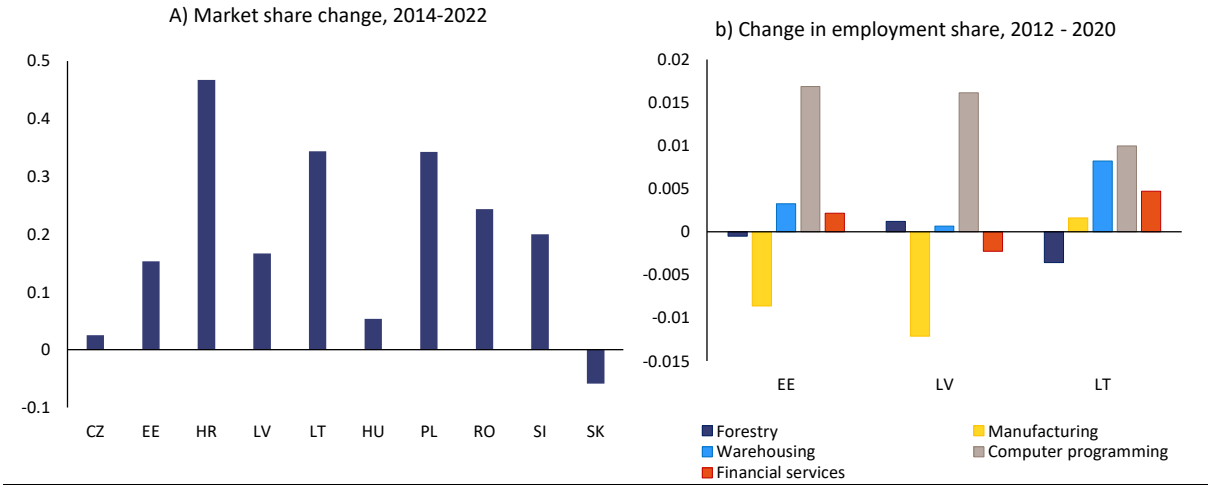
([14]) Estonia's unemployment rate dropped to 4.1% in Q3 2019, Lithuania's to 5.6% in Q2 2019, and Latvia's to 6.1% in Q4 2019.

([15]) In 2022, energy prices constituted 16.2% of the HICP basket in Latvia, the highest weight in the EU and significantly higher than the EU average of 11.3% or the euro area average of 10.9%.([16]) The overall inflation excluding energy prices in Latvia increased from 2.0% in 2021 to 11.7% in 2022. Euro area's respective inflation was 1.5% in 2021 and 5.2% in 2022. In the first quarter of 2023, the inflation excluding energy was 15.4% in Latvia and 7.7% in euro area.

increases affected producers of other goods and services. ([16]) Besides the energy price shock, the supply of metal and timber products as well as fertiliser – products previously imported from Russia and Belarus – was disrupted, leading to a surge in the prices of these products and rising costs in agriculture and manufacturing, in particular. While finding new supply routes should normalise the prices of these materials, the loss of supply that was closest to home is likely to leave Latvia paying permanently higher prices for these products. On the positive side, Latvia's export price growth has kept pace with import prices, leaving terms of trade almost unchanged in 2022. However, the gains in export prices are also likely due to cyclical reasons (e.g. lumber and grain prices play a particularly important role in Latvia's exports) and may prove to be temporary. All in all, these developments raise additional concerns about Latvia's price competitiveness besides wages.

Evidence of actual impairment of competitiveness is mixed, as Latvia's export market shares continued to grow, but not as fast as those of some of its peers. From 2014 to 2022, Latvia's export market shares increased by 17%, which is notably lower than the best performers, whose shares increased by 30% and above, but well above the worst performing who saw their export market shares stagnate or even decline (see graph 2.5.a). It is worth noting, however, that the export market performance cannot be explained solely by the wage-productivity gap. Looking at sectoral dynamics reveals that, among Latvia's key exporting sectors, the share of employment of manufacturing, warehousing and financial services has declined. While warehousing and financial services face a secular decline caused by the loss of transit and non-resident bank business, respectively, the declining employment share of manufacturing may be indicative of the sector's difficulty to compete in the domestic labour market.

Graph 2.5: **Market share and employment**



Source: Eurostat and European Commission services

In the near term, the wage-productivity gap is set to narrow, but wage pressures are expected to resume as growth picks up. According to the Commission's Spring forecast, the wage-productivity gap narrowed in 2022 and will continue to do so in 2023 as economic growth slows and pressure in the labour market abates. However, the underlying problem stemming from population ageing is set to shape the labour market over the long term, and hence wage pressures

([16]) The overall inflation excluding energy prices in Latvia increased from 2.0% in 2021 to 11.7% in 2022. Euro area's respective inflation was 1.5% in 2021 and 5.2% in 2022. In the first quarter of 2023, the inflation excluding energy was 15.4% in Latvia and 7.7% in euro area.

will return over medium term The persistent labour market tightness risks hampering Latvia's potential growth through higher labour costs and skills and labour shortages.

While inflation is set to slow, it remains unclear whether the recent shock will leave Latvia with a permanent increase in relative prices. Inflation is forecast to slow to 9.3% in 2023 and to 1.7% in 2024. Compared with EU and euro area average inflation, projected inflation is still higher in Latvia in 2023 and only somewhat lower in 2024 pointing to continued inflation differentials. Over 2014 to 2019, Latvia's inflation exceeded the EU average by 3.8 pp, while over 2019 to 2024 it is forecast to exceed it by 13.3 pp. With energy prices normalising, it is expected that some of the increase in Latvia's relative prices would unwound over the coming years. However, there is a risk that the Europe's energy price shock and the secondary shock on other prices will have permanently increased Latvia price level and thus hurt its price competitiveness vis a vis its peers. In that case, the risk for Latvia is lower potential growth and slower convergence.

Assessment of MIP relevant policies

The efficiency of the housing market could be improved by facilitating housing supply. Weak household lending and only mild house price overvaluation do not warrant a major intervention of macroprudential policy. In fact, weak lending is arguably holding back investments, including in housing, which is a prerequisite for increased labour mobility, as well as for productive capacity more generally. The state guarantee programme for housing introduced in 2014 helped boost lending somewhat, however, its impact has been limited as evidenced by still falling private debt. However, lending and/or guarantee programmes tailored for regions outside of Riga metropolitan area, where bank financing both for development and purchase is difficult to come by due to poor liquidity of collateral, could be helpful for boosting both housing demand and supply. Moreover, Latvia could improve the efficiency of the housing market by shortening the construction permitting process, which is considerably longer than in neighbouring Estonia and Lithuania. Additionally, it is advisable to monitor the impact on the rental market of a new rental law in 2021, which aims to facilitate investments in rental properties. Finally, the housing supply would likely benefit from better access to skilled labour, the lack of which is the key structural problem fuelling Latvia's wage growth.

Apart from the housing guarantee programme, which supports mortgage lending to some extent, government policy has relatively little direct impact on either savings or investment of the private sector. Notwithstanding the limitation to lending, Latvia's demographic prospects are likely another important factor behind subdued investments, particularly in housing. Given these dynamics, it is highly unlikely that the private sector would borrow from the rest of the world any time soon. Even if investment rates do pick up, they could make use of excess domestic savings before turning to external financing. These trends are also visible in the banking sector's balance sheet with high capitalisation and liquidity ratios and a loan-to-deposit ratio safely below one and declining. However, despite government's limited role in private sector borrowing, fiscal policy has a direct material impact on the current account through EU fund inflows and government borrowing.

Government policies in response to the energy price surge cushioned the impact on consumers, yet preserved the pricing signal, therefore maintaining incentives to cut back on energy consumption. The support measures ended in April 2023; should they need to be reinstated for the next heating season in the event of a renewed rise in energy prices, it would be important to preserve the price signal in order to limit the deterioration in the current account created by the government borrowing.

Investments in skills and health could help increase labour supply, which faces a structural decline due to ageing. Declining labour supply is one of the key drivers of above-productivity wage growth Therefore, policies related to labour and skills supply are relevant for addressing the medium to long term wage cost appreciation. There are limited policy options to mitigate the impact of population ageing. Yet, while Latvia will have to contend with stagnant or declining labour supply, investments in areas that help increase participation or improve the quality of the labour force are of particular importance. With shortages of specialists of both medium and high skill and low participation rates in adult learning, there is ample room for productive investment in skills which would help improve the employment opportunities of the low-skilled and alleviate the broader labour supply problem. Equally, the comparatively poor health of the Latvian population (see Latvia 2023 Country Report, section 3) contributes to absenteeism and limits the potential of the population around retirement age. Finally, since Latvia's rather restrictive policy has largely prohibited significant addition to the labour supply through immigration, it presents another avenue that could be explored to address the issue of labour supply.

Conclusion

In Latvia, vulnerabilities related to housing and external borrowing remain mild, however risks to competitiveness remain pertinent, albeit contained in the near term. Whilst Latvia has experienced elevated house price growth recently, the housing price level over a longer perspective does not appear excessive. A negative impulse from lending suggests the emergence of a price bubble in housing is unlikely. Furthermore, the recent widening of the current account deficit is expected to be temporary. Latvia's net international investment position, which improved markedly in the past decade, is expected to remain broadly stable this year and next. Overall, given the absence of significant capital inflows to the private sector and hence the lack of demand stimulus, it is unlikely that Latvia would face a threat to its external stability. Having said that, its key structural economic challenges are related to declining labour supply, which might impair Latvia's competitiveness over the medium term. If this risk materialises, it would result in gradually falling behind its peers in catching up with the average EU income level and hence undermining one of its key economic objectives.

The policy setting is overall favourable considering the identified vulnerabilities, although labour market and skills policies could help address wage cost appreciation. Government policies in response to the energy price surge cushioned the impact on consumers, yet preserved the pricing signal, therefore maintaining incentives to cut back on energy consumption. While the risk of a sudden economic disturbance stemming from the domestic market and policy developments is low, particular attention to pursuing policies that increase the quality and quantity of labour supply is warranted. Since the key driver of wage growth above productivity growth is the declining labour supply, policies that aim to improve the quality and quantity of Latvia's labour supply could help mitigate the challenges stemming from the population ageing. In particular, ramping up spending on skills, healthcare and labour mobility would help address these challenges. Moreover, Latvia could take measures to attract foreign workers with specific skills. Supporting housing supply, shortening the construction permitting process, and better access to skilled labour would improve the efficiency of the labour market.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Latvia, in line with Regulation 1176/2011. ([17])

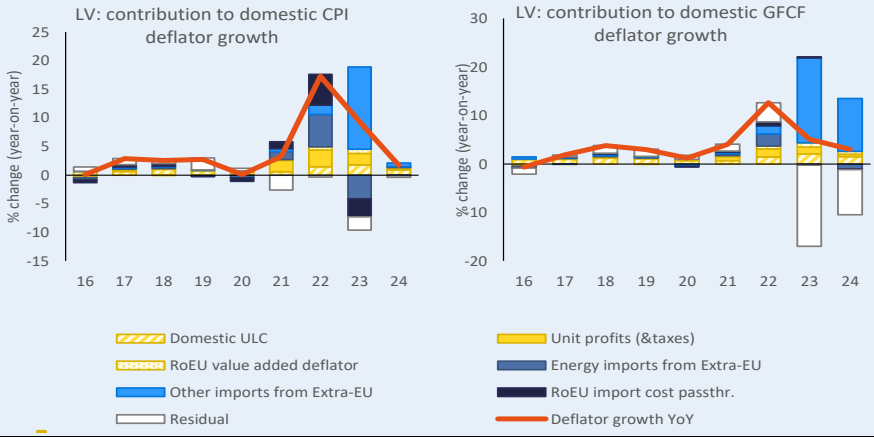
([17]) European Commission (2023), European Semester Spring Package 2022, COM (2023) 600 final.

Box 1: Inflation exposures and cross-border pass-through

This box sheds light on the sources of inflation in Latvia and spill-overs from EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Latvia surged. Moreover, wages and profits also picked up across the EU, which further added to price pressures in Latvia. Using input-output data, domestic inflation can be Broken down into contributions from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from import costs of Latvia's EU partners ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([18])

Data suggests that much of inflation in Latvia in 2022 reflected surging import prices, and non-energy imports are projected to keep inflation elevated in 2023. In 2022, energy prices were a key driver of consumer and investment inflation (see Graph 2.6). However, the contribution from inflation passed through EU partners was also sizeable, particularly to consumer inflation. The contribution from domestic value-added inflation, which covers wages and profits, was signifiacnt in 2022 and is expected to remain high in 2023. This reflects increases in both, unit profits and unit labour cost. The impact of energy inflation is set to decrease consumer inflation this year, as prices of energy commodities have fallen. In addition, inflation passed through EU partners is also projected to slow inflation this year. By contrast, non-energy imports from outside the EU are expected to keep both consumer and investment inflation elevated. Spill-overs from value-added inflation in other EU countries are set to remain marginal.

Graph 2.6: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

([18]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, combined with Eurostat input-output data. HICP is taken as the measure of the price of private consumption, including non-residents. Changes in import prices and value-added deflators are assumed to affect demand prices with a delay of 1 and 5 months for consumption and investment inflation, respectively. For further methodological details, see explanations in the 2023 in-depth review for Czechia, p. 16.

Table 2.1:**Selected economic and financial indicators (Part 1), Latvia**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Real GDP	9.9	-2.7	2.9	2.6	-2.3	4.3	2.8	1.4	2.8
Potential growth (1)	7.3	-0.3	2.1	3.5	2.6	3.0	1.7	1.9	2.1
Contribution to GDP growth:									
Domestic demand	13.5	-5.0	2.4	2.4	-2.8	6.2	5.4	2.4	2.8
Inventories	1.0	-1.0	0.4	0.8	0.5	3.5	-0.6	-1.2	-0.1
Net exports	-4.8	2.8	0.1	-0.6	0.0	-5.4	-2.0	0.5	0.4
Contribution to potential GDP growth (1)									
Total Labour (hours)	-0.2	-1.8	-0.5	0.0	-0.5	0.3	-0.2	0.1	0.1
Capital accumulation	3.5	1.3	0.8	1.1	0.8	0.9	0.8	0.8	0.9
Total factor productivity	4.0	0.2	1.9	2.4	2.2	1.9	1.0	1.0	1.1
Output gap (2)	4.9	-5.2	1.2	2.1	-2.8	-1.6	-0.5	-1.0	-0.3
Unemployment rate	9.4	15.3	9.8	6.3	8.1	7.6	6.9	6.8	6.5
Harmonised index of consumer prices (HICP)	6.5	4.6	1.1	2.7	0.1	3.2	17.2	9.3	1.7
GDP deflator	11.0	2.1	2.8	2.6	1.0	6.5	13.1	8.9	2.7
External position									
Current account balance (% of GDP), balance of payments	-14.6	-2.0	-0.4	-0.6	2.6	-4.2	-6.4	-3.7	-2.9
Trade balance (% of GDP), balance of payments	-16.1	-5.3	-1.7	-0.7	1.0	-3.4	-5.8	.	.
Primary income balance (% of GDP)	-2.0	0.8	-0.4	-1.4	0.0	-1.8	-1.7	.	.
Secondary income balance (% of GDP)	3.5	2.5	1.8	1.5	1.7	1.1	1.1	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.8	-0.6	-0.7	-0.4	-0.4	-0.5	-0.5	-0.5	-0.6
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-3.6	-2.5	-3.9	-3.9	-4.0	-3.4	-3.1	-2.9	-2.8
Capital account balance (% of GDP)	1.2	2.2	2.0	1.5	1.7	1.4	1.1	.	.
Net international investment position (% of GDP)	-56.1	-77.0	-57.2	-40.3	-34.2	-27.5	-27.0	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-27.1	-37.9	-10.0	5.8	14.1	19.0	16.3	.	.
Net FDI flows (% of GDP)	-4.5	-2.6	-1.6	-3.0	-2.1	-2.5	-3.3	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	13.4	0.2	6.3	5.0	4.9	3.8	9.0	9.4	4.1
Nominal compensation per employee	21.8	1.5	7.4	7.8	5.0	11.1	9.0	10.8	5.3
Labour productivity (real, hours worked)	8.0	2.5	2.6	4.6	3.5	5.4	-2.0	0.8	0.6
Real effective exchange rate (ULC)	7.2	-1.8	4.2	2.5	0.7	2.7	4.1	3.1	0.5
Real effective exchange rate (HICP)	1.3	1.9	0.4	0.8	0.4	0.2	6.4	.	.
Export performance vs. advanced countries (% change over 5 years)	102.7	49.7	11.3	1.6	20.4	18.5	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	87.7	115.8	79.2	66.2	64.8	58.1	52.2	.	.
Household debt, consolidated (% of GDP)	29.2	42.3	24.4	20.2	20.3	19.4	17.7	.	.
Household debt, fundamental benchmark (% of GDP) (6)	7.3	10.7	13.3	16.1	18.2	18.2	18.2	.	.
Household debt, prudential threshold (% of GDP) (6)	106.7	91.7	103.3	74.3	51.6	45.4	50.3	.	.
Non-financial corporate debt, consolidated (% of GDP)	58.5	73.5	54.7	46.0	44.5	38.7	34.6	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	37.7	46.5	60.0	63.4	70.1	68.9	67.9	.	.
Corporate debt, prudential threshold (% of GDP) (6)	132.3	110.5	127.8	90.3	71.6	65.0	73.4	.	.
Private credit flow, consolidated (% of GDP)	23.8	-2.2	-0.1	1.1	-1.9	0.9	2.7e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-8.4	5.1	3.6	-0.6	2.5	-2.1	-1.9	2.0	1.4
Households, net lending (+) or net borrowing (-) (% of GDP)	-4.3	0.8	-0.9	2.1	6.1	6.3	1.4	0.3	0.6
Net savings rate of households (% of net disposable income)	-7.7	-2.4	-6.1	0.3	6.3	5.9	.	.	.

(e) estimate based on ECB quarterly data

(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.

(2) Deviation of actual output from potential output as % of potential GDP.

(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.

(4) This benchmark is defined as the average current account required to halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. Calculations make use of Commission's T+10 projections.

(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.

(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.

Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

Table 2.2:**Selected economic and financial indicators**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Housing market									
House price index, nominal	27.0	-8.5	6.0	9.0	3.5	10.9	14.0	.	.
House price index, deflated	16.9	-11.3	4.5	5.8	2.7	7.2	-0.2	.	.
Overvaluation gap (%) (7)	13.2	0.6	-6.4	3.0	5.6	9.6	11.8	.	.
Price-to-income overvaluation gap (%) (8)	24.3	-2.5	-13.6	-11.4	-11.3	-12.4	-7.7	.	.
Residential investment (% of GDP)	3.9	2.9	2.3	2.7	2.6	2.2	1.9	.	.
Government debt									
General government balance (% of GDP)	-0.9	-5.6	-1.0	-0.6	-4.4	-7.1	-4.4	-3.8	-2.7
General government gross debt (% of GDP)	11.8	38.1	39.2	36.5	42.0	43.7	40.8	39.7	40.5
Banking sector									
Return on equity (%)	.	-15.3	10.9	7.0	1.0	9.1	.	.	.
Common Equity Tier 1 ratio	.	10.2	14.4	19.9	21.5	18.9	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	.	9.9	5.5	3.5	3.6	1.7	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	6.7	3.9	4.6	2.1	1.6	.	.
Cost of borrowing for corporations (%)	.	.	3.1	3.4	3.2	3.0	5.0	.	.
Cost of borrowing for households for house purchase (%)	.	.	2.8	2.6	2.5	2.3	4.3	.	.

(1) (7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2022-04-28, where available; European Commission for forecast figures (Spring forecast 2022)