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# ECONOMIC DEVELOPMENT OF OF LATVIA

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All figures and data, unless indicated otherwise, have been obtained from the Central Statistical Bureau of the Republic of Latvia. The data of the European Union have been obtained from *Eurostat*. The data of the Bank of Latvia and the Financial and Capital Market Commission have been used in the description of balance of payments and the bank and monetary indicators of Latvia. The data of the Treasury have been used in the description of financial indicators.



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# OPENING STATEMENT

Experts of the Ministry of Economics have prepared the current 2022 *Report on the Economic Development of Latvia*. The report assesses the economic situation and forecasts the prospects of economic development.

We are facing an unprecedented time. Until very recently, we have been affected by the Covid-19 pandemic. While historically pandemics rustle through the world approximately once every hundred years, we were not ready for it. Both right and wrong decisions were made in a rush. The rules were changed frequently and without warning. It was a very difficult time for the economy, which we were able to go through economically only because of the ability of our exporters to adapt to the situation and the resilience of entrepreneurs.

When it seemed that we have adapted to the situation and we were going to be fine, the shock of the energy price crisis followed. Then immediately, there was Russia's brutal invasion and the war in Ukraine. It completely changed the situation in Europe in terms of energy, supply chains and outlets.

Despite the various difficulties and challenges, I would like to thank our entrepreneurs for their fighting spirit, their ability to adapt to external conditions, their ability to take risks and enter new markets. Statistical data show that exports can reach a value of 27 billion euro in 2022. This means that in 2022 we will have reached the export volume target for 2027 set in the *National Industrial Policy Guidelines*.

One of the priority development directions of the Ministry of Economics in the coming years will be economic security. It is because, at the Baltic level, our entrepreneurs deserve not only an excellent business environment and help in introducing innovation in the market but also stability.

According to the estimates of experts of the Ministry of Economics, in 2022, economic growth in Latvia will fall by at least 3 percentage points compared to the previous forecasts before the Russian invasion of Ukraine. However, growth will remain positive in 2022 and can reach 1-2% year-on-year.

In view of the rapid deterioration of the geopolitical situation, in 2022, the Ministry of Economics developed several support instruments to stabilise the economy as a whole and to support entrepreneurs who are subject to the *Law on Support for Overcoming the Economic Consequences Caused by Sanctions and Countermeasures Applied due to the Russian Military Aggression against Ukraine*. Support is provided both in the form of grants and in the form of financial instruments.

The support provided in the form of grants is focused on energy-intensive manufacturing companies. The importance of manufacturing to the economy is determined not only by its share in the gross domestic product, but also by the fact that it is closely related to other sectors of the economy. For example, the growth of food processing and woodworking creates demand for the necessary raw materials produced by agriculture and forestry.

Financial instruments – loans and guarantees – make it possible to provide immediate support for the provision of working capital and the stabilisation of liquidity. The conditions for obtaining loan support have been eased for the companies negatively affected by Russian military aggression against Ukraine, and the range of companies eligible for loans from the Development Finance Institution Altum has been extended. Guarantees have also been provided for export credit transactions on conditions favourable to equivalent entrepreneurs, as was the case during the spread of the Covid-19 crisis. Support in the form of financial instruments will be continued in 2023.

Extensive support for households is planned for partial compensation for the increase in energy prices during the heating season – partial compensation for the increase in prices for different fuel types, monthly benefits for the vulnerable population, taking into account their income, as well as more favourable calculation of the housing benefit in local governments. A number of support measures for businesses and other legal entities are also available. On 11 October 2022, the Cabinet of Ministers approved a programme providing for compensation to manufacturing businesses for the increase in electricity and natural gas costs, because it is the costs of energy sources used by manufacturing businesses that constitute a much more significant expenditure item compared to other sectors.

In order to mitigate the negative impact of Russian military aggression on the construction sector and to provide support to public commissioning parties in the effective management of construction contracts, the Ministry of Economics has developed *Guidelines for the Assessment of the Increase in the Cost of Construction Materials due to Russian Military Aggression in Ukraine for Making Amendments to the Public Construction Contracts in Force Regarding the Construction of Buildings* and *Guidelines for Indexation of the Price of a Construction Contract*. Meaningful management of public construction contracts is now essential to reduce the risk of losses in public infrastructure projects for performers of construction works due to being unable to meet their previously made commitments.

Over the next seven years, investments from the *Recovery and Resilience Facility* and the multiannual budget of the EU Structural Funds will provide significant support in fostering economic growth to boost productivity, innovation, digitisation, export and competitiveness of our entrepreneurs, channelling a total of 1.6 billion euro for this purpose.

In 2022, we have found the possibility of creating two new support instruments important for entrepreneurs. First, a national long-term mission-oriented research programme to create new products and address major societal challenges will be set up within the *Innovation Fund* or the *Industry Research Programme* initiative. Projects in line with two areas of the *Smart Specialisation Strategy* (RIS3) approved in Latvia, such as biomedicine, medical technologies, pharmacy, as well as photonics and smart materials, technologies and engineering systems are expected to be implemented within the programme.

Second, an *Investment Fund* (152 million euro) has been established which will make it possible for companies to invest in business expansion also during economic turbulence. Loans with a capital discount for large investment projects (starting from 10 million euro) are available in the *Investment Fund*. According to the Ministry of Economics, the activity of the *Investment Fund* will be a priority also in the coming years, because it serves as a good contribution from the state budget to Latvia's long-term growth.

Development of start-ups is an important chain link in the innovation system and promotes the change of the paradigm to modern and innovative economy. In recent years, the Ministry of Economics and the bodies subordinated to it have been actively working on the creation of uniform supply for the start-up ecosystem. In 2022, together with representatives of the start-up ecosystem, we have approved a strategy for the next three years defining the specific work to be done, both for new co-creation activities and for the entry of new players into the market and the development of access to capital. The Latvian start-up ecosystem has become more visible also in the international context. Every year several local events and festivals with international coverage bring together start-ups and their representatives.

21 Latvia's external economic representations abroad continue to work to support Latvian companies in increasing exports. Work is ongoing to expand the legal base, thus helping Latvian businesses to enter new markets. Entrepreneurs are also offered services of the Enterprise Europe Network – help in searching international partners, preparing market information, consulting on legislation and business aspects, access to finance, etc. It should be noted that the Investment and Development Agency of Latvia has developed a national platform for business development *business.gov.lv*, which contributes to the digitalisation of services and the development of e-services in general.

The vision of the Ministry of Economics is to create an excellent business environment and to move towards an innovative economic model. Therefore, for further improvement of the business environment, we have envisaged a more effective process of identifying and administering the necessary measures, by developing closer feedback with economic operators and by allowing for continuous follow-up to the progress made in the implementation of the measures. In progress towards an excellent business environment the *Consult First* initiative is implemented improving the mutual understanding and cooperation between entrepreneurs and supervisory authorities thus promoting the understanding fulfilment of requirements.

Provision of a fair competitive environment is also considered to be an essential element in promoting competitiveness. A pressing topic in the competition policy is still to foster equal and non-discriminating competition between public persons (for example, state or local government capital companies) and the private sector. In order to promote fair competition in the internal market for the benefit of the general public (including consumers), amendments have been made to the *Competition Law* by strengthening the Competition Council with the necessary guarantees of independence, resources and enforcement powers for the effective investigation and prevention of infringements of competition law, in particular in the application of Articles 101 and 102 of the *Treaty on the Functioning of the European Union*.

The Ministry of Economics continues to improve real estate development processes, paying particular attention to the quality of construction, reducing bureaucratic barriers, and promoting proportionality and transparency of processes. To improve the quality of construction, the technical requirements for structures have been reviewed and updated, and wider availability of standards has been ensured.

Prudent and meaningful deployment of electronic processes and the improvement of the functionality of the construction information system have made it possible to ensure that the restrictions introduced to mitigate the Covid-19 pandemic had a minimal impact on the development of the construction processes and on the development of the construction sector. The Ministry of Economics continues to improve the construction information system, a convenient platform for efficient management and operational supervision of structures, including residential houses, has been established. Over the last years, a number of complex measures have been implemented in cooperation with the construction industry contributing to a significant improvement in the competitiveness of the industry. The implementation of the measures provided in the building information modelling (BIM) roadmap continues with the main emphasis on the training of industry professionals and the improvement of construction study programmes.

A housing guarantee programme has been successfully implemented for several years, and an additional support programme named *Support* was created, which provides large families with the possibility of obtaining a non-repayable state subsidy for the acquisition or construction of housing. One of the priorities of the Ministry of Economics is support programmes that promote the construction of low-cost rental housing. A sustainable support model for the construction of affordable, high-quality and energy-efficient rental housing was developed in 2022.

The process of improving the legislation governing the mandatory electricity procurement (MP) system completed in 2022 reducing MP payments for electricity end-users. It should be noted that the Ministry of Economics has started work on amendments to the *Electricity Market Law* to determine at the level of the law that future MP costs are not to be covered by electricity end-users in Latvia.

Further diversification of natural gas supplies and measures necessary to reduce dependence on Russian natural gas imports shall be considered as important priorities for the future in the natural gas market, in particular, taking into account in particular amendments to the *Energy Law*, which came into force on 11 August 2022 and provides for a ban on Russian natural gas imports from 1 January 2023. Furthermore, it should be emphasised how important it is to continue work on provision of safe and accessible infrastructure that could significantly strengthen Latvia's energy independence. It should be noted that the situation in the Latvian energy sector is positively influenced by the opening of the Lithuanian-Polish natural gas supply system interconnection (GIPL) in May 2022, moreover, several other projects are expected to be implemented to improve the security of gas supply in the Baltic region and establish an efficient market.

The integration and synchronisation of power grids of Baltic countries with the European network to stop their dependence on Russian and Belarusian power supply systems and fully integrate them into the European Union electricity market remain one of the most important highlights in the electricity market. The synchronisation project is part of the overall EU integration process and is planned to be implemented until the end of 2025, however, since the beginning of 2022, active discussions have been taking place between the responsible ministries of the region and transmission system operators on the possibility of completing the project earlier.

At the same time, active work continues on the implementation of the *National Energy and Climate Plan 2021-2030*, which sets out the main action policies and measures to achieve the greenhouse gas (GHG) emission reduction targets, including the energy activity goal of promoting the use of RES and improving energy efficiency. Priorities for further action include further elaboration and updating of national legislation on energy efficiency and energy performance of buildings, also in the context of the forthcoming completion of the *Revision of the Energy Efficiency Directive Review* at EU level in 2023 and the entry into force of a new *Energy Efficiency Directive* and the *Energy Performance of Buildings Directive*.

In 2023, the Ministry of Economics has earmarked most of the funds in priority measures for strengthening energy security and independence so that households and entrepreneurs continue to feel safe about both the availability of thermal energy and the ability to pay utility bills. Just as important is the promotion of growth and access to finance for entrepreneurs and the contribution of science to the economy, housing affordability and improving energy efficiency – all of which are needed to build both our economic performance indicators and the well-being of our citizens.

To achieve the objectives set, the Ministry of Economics is actively creating a dialogue with entrepreneurs, non-governmental organisations, and other members of the community.

In this Report you will find information on the most important economic and social indicators of Latvia, development of industries and the external economic environment, the government's economic policy, and the main instruments of its implementation.

Not all the issues discussed in the Report were assessed by the Cabinet of Ministers, therefore, part of judgments on economic development of Latvia and suggestions for further action reflect only the opinion of the experts of the Ministry of Economics.

I would like to express my gratitude to the authors of the Report!

Ilze Indriksone,

Minister of Economics

December 2022

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# ABBREVIATIONS, MEASUREMENT UNITS AND SYMBOLS

## Saīsinājumi

| | |
|---|---|
| RES | Renewable Energy Source |
| NPP | Nuclear Power Plant |
| VUIS | Vulnerable User Information System |
| ALTUM | Joint Stock Company "Development Finance Institution Altum" |
| JSC | Joint Stock Company |
| USA | United States of America |
| FICIL | Foreign Investors Council in Latvia |
| FDI | Foreign Direct Investment |
| BIF | Baltic Innovation Fund |
| BIM | Building Information System |
| CIS | Construction Information System |
| AMR | Alert Mechanism Report |
| SCCB | State Construction Control Bureau of Latvia |
| CEF | Connecting Europe Facility of the European Commission |
| CSB | Central Statistical Bureau |
| EEA | European Economic Area |
| EIF | European Investment Fund |
| EC | European Commission |
| ERDF | European Regional Development Fund |
| MoE | Ministry of Economics |
| EU | European Union |
| EU-14 | European Union Member States before the enlargement in 2004 |
| EU-27 | European Union Member States after the withdrawal of the United Kingdom on 1 February 2020 |
| ESF | European Social Fund |
| OECD | Organisation for Economic Co-operation and Development |
| EU ETS | European Union Emissions Trading System |
| Eurostat | Statistical Office of the European Union |
| FCMC | Financial and Capital Market Commission |
| MoF | Ministry of Finance |
| GCI | Global Competitiveness Index |
| GWh | Gigawatt-Hour |
| HPP | Hydroelectric Power Plant |
| GDP | gross domestic product |
| ICT | information and communication technologies |
| IMI | Internal Market Information System |
| CF | Cohesion Fund |
| CP | Competition Council |
| TFEU | Treaty on Functioning of European Union |
| LIAA | Investment and Development Agency of Latvia |
| CM | Cabinet of Ministers |
| MIP | Macroeconomic Imbalances Procedure |
| SMM | Small and Medium-Sized Merchants |
| SME | small and medium-sized enterprises |
| MWh | Megawatt-Hour |
| NDP | National Development Plan of Latvia |
| NRP | National Reform Programme |
| NULC | Nominal Unit Labour Cost Index |
| NIIP | Net International Investment Position |
| CIS | Commonwealth of Independent States |
| OCTA | Mandatory Insurance of Civil Liability of Owners of Land Vehicles |
| MP | Mandatory Procurement |
| MPC | Mandatory Procurement Component |
| OPEC | Organization of the Petroleum Exporting Countries |
| EAAP | Extended Asset Acquisition Programme |
| R&D | research and development |
| CPI | Consumer Price Index |
| UGSF | Underground Gas Storage Facility |
| PJ | Petajoule |
| PPS | Purchasing Power Standard |
| CRPC | Consumer Rights Protection Centre |
| VAT | Value-Added Tax |
| REER | Real Effective Exchange Rate |
| RIS3 | National/regional research and innovation strategies for smart specialisation |
| ROA | Return On Assets |
| ROE | Return on Equity |
| GHG | Greenhouse Gases |
| LLC | Limited Liability Company |
| SOLVIT | EU Internal Market Problem Solving System |
| STEM | Science, Technology, Engineering and Mathematics |
| IMF | International Monetary Fund |
| LPP | Legal Protection Proceedings |
| HGP | Heat-Electric Generating Plant |
| MoJ | Ministry of Justice |
| TRIS | Technical Regulations Information System |
| CIT | Corporate Income Tax |
| ULC | Unit Labour Costs of Products |
| USD | US Dollar |
| MoEPRD | Ministry of Environmental Protection and Regional Development |
| SRS | State Revenue Service |
| SC | State Chancellery |
| SRDA | State Regional Development Agency |

## Country Abbreviations

| | | | |
|---|---|---|---|
| AT | Austria | IE | Ireland |
| BE | Belgium | IT | Italy |
| BG | Bulgaria | LT | Lithuania |
| CZ | Czech Republic | LU | Luxembourg |
| CY | Cyprus | LV | Latvia |
| DE | Germany | MT | Malta |
| DK | Denmark | NL | Netherlands |
| EE | Estonia | PL | Poland |
| EL | Greece | PT | Portugal |
| EU | European Union | RO | Romania |
| FI | Finland | SE | Sweden |
| FR | France | SI | Slovenia |
| HR | Croatia | SK | Slovakia |
| HU | Hungary | ES | Spain |

# PART I. ECONOMIC DEVELOPMENT TRENDS

## 1. ECONOMIC DEVELOPMENT TRENDS: OVERVIEW

**Stable economic growth in Latvia** with its rates exceeding the EU average **continued until the Covid-19 pandemic**. From 2013 to 2019, GDP grew by 2.9% per year on average.

**The Covid-19 pandemic has had a significant impact on economic development on a global scale and also in Latvia**. GDP shrank by 2.2% in Latvia in 2020. The extensive government and EU funds support measures, as well as the improvement of the epidemiological situation in 2021, contributed to the recovery of Latvia's economy, and GDP grew by 4.1%.

**On 24 February 2022, when Russia invaded Ukraine, the geopolitical situation and prospects for economic development deteriorated.** Energy and food prices have risen significantly, intensifying the inflation pressure at a time when the cost of living around the world had already skyrocketed as the world was recovering from the pandemic. The global economy is also affected by disruptions in raw material supply chains due to the war. In Q1 2022, the consequences of the war were not yet felt in full in Latvia. The economy grew 5.6% compared to Q1 2021. The rise is due to the low base in early 2021 and the gradual lifting of COVID-19 restrictions. However, GDP growth rates decreased to 2.9% year-on-year in Q2, while GDP decreased by 0.6% in Q3.

**Uncertainty and sharp price rises put a brake on the economy and in 2022 GDP as a whole could grow within 1-2%,** i.e. by at least 3 percentage points less than expected before the Russian invasion of Ukraine. High uncertainty affects consumption of the population, future plans of businesses, and foreign trade. The most difficult situation in the economy is expected in late 2022 and the first half of 2023. Growth could start in mid-2023, but overall growth is expected to be much more moderate in 2023 than in 2022.

Table 1.1

**Latvia: Key figures of economic development**

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022f | 2023f |
|---|---|---|---|---|---|---|---|---|
| Gross domestic product (at current prices, billion euro) | 25.4 | 27.0 | 29.2 | 30.7 | 30.3 | 33.7 | 39.4 | 42.6 |
| *changes as per cent* | | | | | | | | |
| Gross domestic product | 3.9 | 3.3 | 4.0 | 2.6 | -2.2 | 4.1 | 1.2 | 0.1 |
| Private consumption | 2.1 | 2.8 | 3.0 | 0.3 | -4.5 | 8.2 | 7.1 | 0.0 |
| Public consumption | 2.7 | 3.3 | 1.7 | 3.9 | 2.4 | 4.4 | 2.0 | 1.8 |
| Gross fixed capital formation | -2.0 | 11.4 | 11.7 | 6.9 | -2.6 | 2.9 | 0.3 | -0.4 |
| Export | 3.0 | 6.4 | 4.4 | 2.1 | -0.3 | 5.9 | 9.9 | 1.8 |
| Import | 1.6 | 8.6 | 6.3 | 3.1 | -0.3 | 15.3 | 10.4 | 1.6 |
| Consumer prices | 0.1 | 2.9 | 2.5 | 2.8 | 0.2 | 3.3 | 17.4 | 9.8 |
| *as a percentage in relation to the GDP, unless indicated otherwise* | | | | | | | | |
| General government sector balance | 0.02 | -0.8 | -0.8 | -0.6 | -4.3 | -7.0 | -3.3 | -0.7 |
| General government debt | 40.3 | 38.9 | 37.0 | 36.5 | 42.0 | 43.6 | 42.0 | 43.0 |
| Export-import balance | -1.7 | -0.7 | -0.7 | 1.0 | -3.4 | -5.5 | -4.8 | -4.4 |
| Changes in the number of the employed (15-74 years of age, % compared to the previous year) | -0.3 | 0.2 | 1.6 | 0.1 | -1.9 | -3.2 | 2.7 | -0.1 |
| Employment rate | 61.6 | 62.9 | 64.5 | 65.0 | 64.2 | 62.5 | 64.0 | 63.7 |
| Unemployment rate (unemployed, % of the economically active population, 15-74 years of age) | 9.6 | 8.7 | 7.4 | 6.3 | 8.1 | 7.6 | 7.0 | 6.7 |
| Average gross wage changes (% compared to the previous period) | 5.0 | 7.9 | 8.4 | 7.2 | 6.2 | 11.8 | 6.8 | 7.0 |

f – forecast

After recovering from the Covid-19 crisis, household consumption made a significant contribution to economic growth. Private consumption grew by 8.2% in 2021. Private consumption continues to grow in 2022 despite the significant rise in consumer prices. Private consumption increased by 9.9% in the three quarters of 2022 compared to the corresponding period of 2021. The increase is driven by the increase in average wages, the reduction in unemployment and the complete cancellation of the Covid-19 containment restrictions.

The support measures implemented by the government to mitigate the negative effects of Covid-19 and largely funded at the expense of increasing the state budget deficit maintained a positive increase in public consumption in 2020 and also in 2021. In 2022, public consumption continues to increase – by 1.6% year-on-year in the 3 quarters.

Investment growth is moderate. It declined by 2.6% in 2020 due to the Covid-19 crisis but gained 2.9% in 2021 thanks to an increase in investment in machinery and appliances, as well as intellectual property products. Despite the big uncertainty due to the geopolitical crisis, investment grew 1% year-on-year in the 3 quarters of 2022. Due to the rapid increase in costs, investment in buildings and structures fell 12.1%. At the same time, investment in machinery, equipment and vehicles increased by 11.6% and in intellectual property products – by 20%. Geopolitical tensions and rapid increases in costs are expected to hinder investments in the coming quarters, but they will be facilitated by the significant entry of EU funds into the Latvian economy.

Despite the Covid-19 crisis and geopolitical situation, net flows of FDI attracted to Latvia continue to increase. In 2021, FDI transactions increased significantly, reaching 2809 million euro (8.4% of GDP). In the first half of 2022, FDI transactions were almost 1.5 times smaller than a year ago. This was largely driven by negative flows of investment in companies' equity in response to EU sanctions against Russia. Foreign capital outflows were offset by non-resident investments in the form of reinvested profit and debt instruments. In the first half of 2022, the net FDI flows attracted to Latvia constituted 3.5% of GDP, while the FDI stock reached almost 22 billion euro, i.e., 60% of GDP, at the end of June 2022.

Exports of goods play an important role in ensuring growth. Exports of goods increased in both 2020 and 2021. They increased by 12.2% in 2021 compared to 2019. In 2021, exports of wood and wood products, mineral products and iron and steel goods had the largest positive impact on the increase. In the 3 quarters of 2022, exports of goods continued to grow – by 8.2% year-on-year.

After a significant drop in service exports after the Covid-19 pandemic began, they are recovering rapidly. In 2020, exports of services decreased by 15.9%. The fall was largely influenced by exports of aviation and tourism services affected by the Covid-19 restrictions, as well as by a drop in exports of transit services. In 2021, the situation stabilised, and overall exports of services increased by 7.3%. In the 3 quarters of 2022, exports of services increased by 22.4%, compared to the corresponding period of 2021, which was most significantly affected by the increase in exports of transport services, computer services.

Recovering from the Covid-19 crisis, the import of goods and services is also growing rapidly. In 2021, it grew by 15.3%, while in the 3 quarters of 2022 – by 12.2%.

From 2011 to 2021, a low current account deficit of the balance of payments was observed in Latvia, which indicates the external balance of the Latvian economy. External shocks have led to an increase in current account fluctuations. In the first half of 2022, the current account had a deficit of 8.6% of GDP. In the coming years, despite the geopolitical uncertainty, the current account is expected to be with a small deficit without compromising the external balance of the Latvian economy.

Development trends across sectors vary considerably. The Covid-19 pandemic has had a significant impact on economic development. Although GDP in 2021 slightly exceeded the pre-crisis level of 2019, the economic activity was seriously below this level in several sectors. Thus, accommodation and food service activities were 36.8%, arts, entertainment, and recreation services 32.5%, transportation and storage 12.2%, agriculture and forestry 11.2% and construction 16.3% lower than before the crisis. Meanwhile, the largest growth in this period was observed in the healthcare, public administration, and financial services sectors, as well as in the energy sector. Manufacturing also saw good growth.

With Covid-19 restrictions lifted, rapid growth rates are seen in 2022 in the sectors hit the hardest by the pandemic. In the 3 quarters year-on-year, the increase reached 56.7% in accommodation and food service activities and 29.3% in arts, entertainment, and recreation. There was also a rapid increase (+7.7%) in business services and in ICT (13.1%). The average growth rates of the economy were also exceeded by the largest producing sectors – in the 3 quarters year-on-year growth reached 4.3% in agriculture and forestry and 3.9% in manufacturing. It should be noted that in Q3 production volumes in manufacturing decreased by 1.6% due to the drop in the food industry, wood processing and chemical industry.

Some sectors saw a decline in the 3 quarters. The sanctions imposed by the EU have resulted in a decrease in the turnover of goods with Russian and Belarusian markets, resulting in a 23% decrease in the wholesale sector in Q3 compared to Q3 of the previous year. Overall, in the trade sector activity in the 3 quarters was 4.9% lower than in the corresponding period a year ago. The sharp increase in costs has led to a review of planned construction projects or an extension of their deadlines – construction volumes in the 3 quarters were 12.9% lower than a year ago. Due to the rapid price increase and decrease in consumption, the drop in the 3 quarters was also observed in the mining and energy sector (by 11.2%).

The Covid-19 pandemic has led to significant changes in the fiscal policy that has been implemented so far. In 2020, the general escape clause of the *Stability and Growth Pact* (SGP) was activated in the EU, enabling EU countries to increase their general government deficits in 2020-2022 to the extent necessary to mitigate the economic harm caused by the pandemic. Given the Russia-Ukraine war and all the related consequences, the general exception clause of the SGP will also remain in force in 2023. Due to the Covid-19 pandemic, the budget deficit in Latvia increased to 4.3% of GDP or 1.3 billion euro in 2020 and to 7.0% of GDP or 2.4 billion euro in 2021. The Covid-19 crisis is gradually ending, so support volumes are decreasing and the Saeima approved the 2022 budget with a deficit of 4.8% or 1.6 billion euro of GDP. However, the budget deficit could be higher due to the Ukrainian war – according to MoF estimates 7% of GDP. 2023 will begin with a temporary or technical state budget. The MoF has prepared a draft general government budget plan for 2023 with a budget deficit of 3.3% of GDP, without taking into account potential decisions to be taken by the new Saeima.

Despite the increase in the budget deficit in recent years, the general government debt level in Latvia is one of the lowest in the EU. The outbreak of Covid-19 caused the need to provide considerable amounts of funding to mitigate the impact caused by the Covid-19 crisis. Government debt increased to 43.6% of GDP or 14.7 billion euro in 2021. According to the MoF baseline scenario, government debt will be 42% of GDP in 2022. Since nominal GDP growth at high inflation is rapid, debt relative to GDP is expected to stabilise in the coming years.

The banking sector has been able to remain stable despite the economic turmoil caused by the Covid-19 pandemic. The banking sector is operating with profit. However, the development of crediting is still evaluated as weak – crediting of business is developing in an unevenly, while crediting of households has positive signs. Deposit volumes continue to rise. The negative effects of the Covid-19 crisis in the banking sector were mitigated by state support measures, but uncertainty remains relatively high in the banking sector.

The Covid-19 pandemic and subsequent restrictions had a significant impact on global demand, leading to a decline in prices. Latvia showed deflation in most months in 2020 and average annual inflation was only 0.2%. Global demand skyrocketed in 2021 as vaccination increased and Covid-19 restrictions eased, while supply (mainly due to supply chains) failed to adapt so quickly, leading to price rises for raw materials, energy, and food, especially in the second half of 2021.

In 2022, Russia's invasion of Ukraine and the subsequent sanctions resulted in an additional impact on the price increase, which led to a shortage of energy and production raw materials, which in turn increases the price level in the world. Latvia's inflation rate is one of the highest in the EU – in November it was 21.8%, while the average annual inflation was 16.2%. In the coming months, price changes will continue to exceed the level of seasonal fluctuations, however, overall price increases may no longer be as rapid as in previous months. The MoE forecasts that average annual inflation could reach 17.4% in 2022. In early 2023, inflation rates should start to decline.

The labour market is gradually recovering from the shock of the Covid-19 pandemic; however, the structural effects of the crisis persist. The number of employed and the employment rate are still significantly lower than in 2019. The number of employees in Q3 2022 was more than 18.3 thousand or 2% lower than in Q3 2019. The crisis has affected the economic activity of the population, which, along with demographic processes, is narrowing labour market supply and increases the risks of labour shortages. The share of long-term job seekers remains high, which, together with regional labour market disproportions, may pose structural unemployment risks in the coming years, as well as exacerbate the problem of the availability of labour force. In Q3 2022, 899.5 thousand people aged 15-74 years were employed. Compared to Q3 2021, the number of employed has increased by 2.6% or 22.6 thousand. The increase in the number of employed is still largely determined by the low base effect – the number of employed decreased significantly during the Covid-19 crisis and labour demand gradually increases as economic activities return to the economy.

The unemployment rate declining trend has persisted since mid-2020. The unemployment rate in Q3 2022 was 6.9%, down 0.3 percentage points from Q3 2021, respectively. Overall, 66.4 thousand people aged 15-74 were looking for a job in Q3 2022, which is 2.2% (1.5 thousand) less than in Q3 2021. The MoE forecasts that the number of employed in general could increase by an average of 2.6% in 2022 compared to 2021, while the unemployment rate will fall to an average of 7% per year.

In view of the escalation of the geopolitical situation, a wait-and-see situation will continue in the labour market in 2023. The resilience of Latvia's economy to external shocks has strengthened significantly in recent years, particularly in the financial sector, so a limited direct impact of sanctions and the narrowing of the export market on Latvia's labour market is expected. The labour market will continue to be supported by the recovery of sectors from the Covid-19 pandemic crisis, as well as the construction of public infrastructure facilities, as well as other types of public investment and economic recovery support measures.

The average monthly gross wage continues to increase rapidly. In Q3 2022, compared to the corresponding period in 2021, it increased by 6.3% – increasing to 1,384 euro per month. It should be noted that there has been a significant increase in wages in Latvia in previous years – the average increase in wages has been close to 7% per year over the last 5 years. However, in contrast to previous years, net wages observed in the first 3 quarters of 2022 have fallen in the face of rising consumer prices, suggesting a fall in the purchasing power of salaried employees. This trend is expected to continue in the short term, until the rapid increase in inflation decreases.

At the same time, positive pressure on wages will continue to be maintained both by the process of wage convergence closer to the wage level of the economically developed countries of the EU, and by the growing shortage of qualified labour – the narrowing of the labour market, which makes it necessary for entrepreneurs to think more actively not only about how to attract new specialists, but also how to keep the existing ones, including through a review of wage rates.

**Further economic development in the medium term depends on the situation in the external environment and progress in reforms.** The highest risk to the growth of Latvia is related to global economic development, in particular stopping of the expansion of the Covid-19 epidemic and the geopolitical situation. Further development of the EU's total economic space is similarly important. In the medium term, economic advantages of Latvia are mainly based on the achieved macroeconomic stability, as a result of which Latvia's credit ratings have improved, as well as on the efficiency of planned aid programmes of the EU funds and on the improvements in the business environment.

Benefits of the Latvian economic competitiveness are mainly based on technological factors, improvement of production efficiency, and innovation, to a lesser extent on cheap labour and low resource prices. In the medium term, Latvia's growth rates may reach a 4-5% increase per year. If the war in Ukraine and the COVID-19 pandemic endure, the pace of economic recovery might be slower.

# 2. GLOBAL ECONOMIC DEVELOPMENT

The **global** economy is facing growing challenges. The war started by Russia causes untold suffering and destruction in Ukraine and has significant global consequences. The war has been going on for more than ten months, but there is no evidence of any reduction in military intervention in the nearest time. This hinders growth and inflicts pressure on prices, particularly in food and energy prices in conditions when the cost of living around the world had already skyrocketed under the influence of the consequences of the Covid-19 pandemic. Overall, the labour market is still in a rather tense position, wage growth has been slower than inflation, as people's real incomes have fallen, even as governments have taken various steps to mitigate the impact of food and energy prices on households and businesses. The EC forecasts that global growth will reach 3.1% in 2022[1], while in 2023, with big uncertainty still in place, growth rates are expected to slow down to 2.5%.

Table 2.1

**GDP growth rate**
*changes compared to the previous year, as per cent*

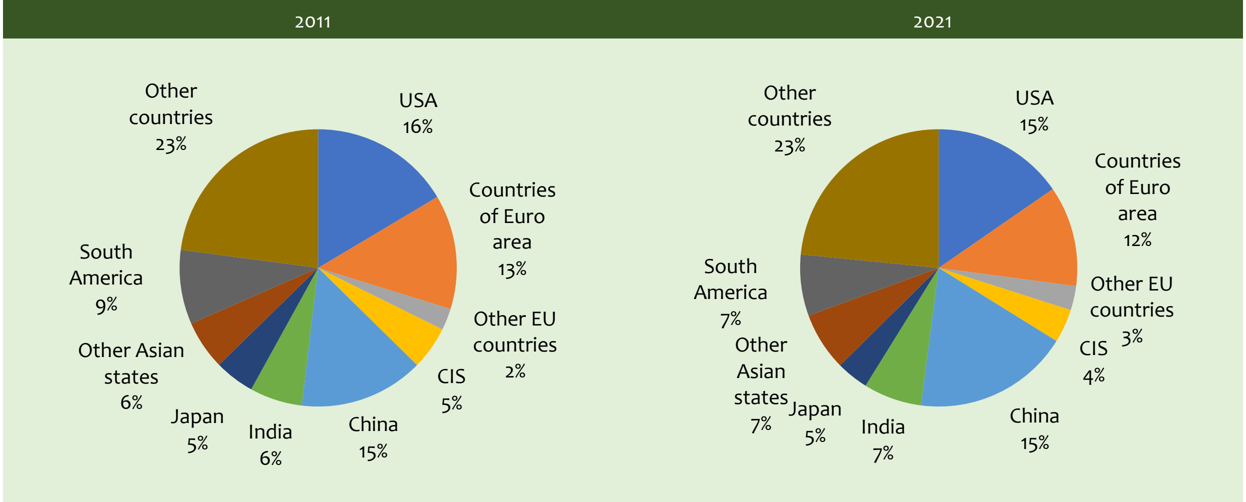
| | 2019 | 2020 | 2021 | 2022f | 2023f |
|---|---|---|---|---|---|
| **World,** including: | **2.8** | **-3.2** | **6.0** | **3.1** | **2.5** |
| USA | 2.3 | -2.8 | 5.9 | 1.8 | 0.7 |
| United Kingdom | 1.6 | -11.0 | 7.5 | 4.2 | -0.9 |
| EU, including: | 1.8 | -5.7 | 5.4 | 3.3 | 0.3 |
| Euro area | 1.6 | -6.1 | 5.3 | 3.2 | 0.3 |
| Japan | -0.4 | -4.6 | 1.7 | 1.7 | 1.6 |
| China | 6.0 | 2.2 | 8.1 | 3.4 | 4.5 |

Source: *EC – European Economic Forecast, Autumn 2022*
f – forecast

High inflation and tighter financing conditions are forecast to put a drag on **United States'** economic growth. Although this will have adverse consequences, the labour market is expected to remain resilient, with a moderate rise in unemployment. Monetary policy will be driven in an increasingly more restrictive direction in response to high inflation. The United States Federal Reserve System is raising interest rates at a faster pace than at other times in recent decades.

Figure 2.1

**Breakdown of the total global GDP by countries and groups of countries**
*by purchasing capacity parity, share in the global total, as per cent*




Source: *IMF*

[1] Unless other source is specified, the data in this chapter is taken from the edition *EC – European Economic Forecast, Autumn 2022* https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/autumn-2022-economic-forecast-eu-economy-turning-point_en

The first interest rate rise was introduced in March 2022 and the upper interest rate has risen from 0% to 4% in nine months. It is expected to continue growing until early 2023. At the same time, fiscal policy remains restrictive. The general government deficit is projected to fall from around 12% of GDP in 2021 to almost 6% in 2022. GDP is expected to have risen by 1.8% in 2022, while the growth rate will slow to 0.7% in 2023.

Table 2.2

**Main macroeconomic indicators of the EU member states**
*as per cent*

| | Real GDP | | | Inflation | | | Unemployment rate | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2021 | 2022f | 2023f | 2021 | 2022f | 2023f | 2021 | 2022f | 2023f |
| **European Union** | **5.4** | **3.3** | **0.3** | **2.9** | **9.3** | **7.0** | **7.0** | **6.2** | **6.5** |
| Austria | 4.6 | 4.6 | 0.3 | 2.8 | 8.7 | 6.7 | 6.2 | 5.0 | 5.2 |
| Belgium | 6.1 | 2.8 | 0.2 | 3.2 | 10.4 | 6.2 | 6.3 | 5.8 | 6.4 |
| Bulgaria | 7.6 | 3.1 | 1.1 | 2.8 | 12.8 | 7.4 | 5.3 | 5.2 | 5.2 |
| Czech Republic | 3.5 | 2.5 | 0.1 | 3.3 | 15.6 | 9.5 | 2.8 | 2.7 | 3.3 |
| Denmark | 4.9 | 3.0 | 0.0 | 1.9 | 7.9 | 3.7 | 5.1 | 4.5 | 5.5 |
| France | 6.8 | 2.6 | 0.4 | 2.1 | 5.8 | 4.4 | 7.9 | 7.7 | 8.1 |
| Greece | 8.4 | 6.0 | 1.0 | 0.6 | 10.0 | 6.0 | 14.7 | 12.6 | 12.6 |
| Croatia | 13.1 | 6.0 | 1.0 | 2.7 | 10.1 | 6.5 | 7.6 | 6.3 | 6.3 |
| Estonia | 8.0 | -0.1 | 0.7 | 4.5 | 19.3 | 6.6 | 6.2 | 6.1 | 6.6 |
| Italy | 6.7 | 3.8 | 0.3 | 1.9 | 8.7 | 6.6 | 9.5 | 8.3 | 8.7 |
| Ireland | 13.6 | 7.9 | 3.2 | 2.4 | 8.3 | 6.0 | 6.2 | 4.4 | 4.8 |
| Cyprus | 6.6 | 5.6 | 1.0 | 2.3 | 8.0 | 4.2 | 7.5 | 7.2 | 7.2 |
| Latvia | 4.1 | 1.9 | -0.3 | 3.2 | 16.9 | 8.3 | 7.6 | 7.1 | 8.1 |
| Lithuania | 6.0 | 2.5 | 0.5 | 4.6 | 18.9 | 9.1 | 7.1 | 6.0 | 7.1 |
| Luxembourg | 5.1 | 1.5 | 1.0 | 3.5 | 8.4 | 3.8 | 5.3 | 4.7 | 5.1 |
| Malta | 10.3 | 5.7 | 2.8 | 0.7 | 6.1 | 4.0 | 3.4 | 3.2 | 3.1 |
| Netherlands | 4.9 | 4.6 | 0.6 | 2.8 | 11.6 | 4.2 | 4.2 | 3.7 | 4.3 |
| Poland | 6.8 | 4.0 | 0.7 | 5.2 | 13.3 | 13.8 | 3.4 | 2.7 | 3.0 |
| Portugal | 5.5 | 6.6 | 0.7 | 0.9 | 8.0 | 5.8 | 6.6 | 5.9 | 5.9 |
| Romania | 5.1 | 5.8 | 1.8 | 4.1 | 11.8 | 10.2 | 5.6 | 5.4 | 5.8 |
| Slovakia | 3.0 | 1.9 | 0.5 | 2.8 | 11.8 | 13.9 | 6.8 | 6.3 | 6.4 |
| Slovenia | 8.2 | 6.2 | 0.8 | 2.0 | 9.2 | 6.5 | 4.8 | 4.1 | 4.3 |
| Finland | 3.0 | 2.3 | 0.2 | 2.1 | 7.2 | 4.3 | 7.7 | 7.0 | 7.2 |
| Spain | 5.5 | 4.5 | 1.0 | 3.0 | 8.5 | 4.8 | 14.8 | 12.7 | 12.7 |
| Hungary | 7.1 | 5.5 | 0.1 | 5.2 | 14.8 | 15.7 | 4.1 | 3.6 | 4.2 |
| Germany | 2.6 | 1.6 | -0.6 | 3.2 | 8.8 | 7.5 | 6.2 | 6.1 | 6.6 |
| Sweden | 5.1 | 2.9 | -0.6 | 2.7 | 8.1 | 6.6 | 8.8 | 7.2 | 7.6 |
| United Kingdom | 7.5 | 4.2 | -0.9 | 2.5 | 7.9 | 7.5 | 4.5 | 3.8 | 4.4 |

Source: EC – *European Economic Forecast, Autumn 2022*
f – forecast

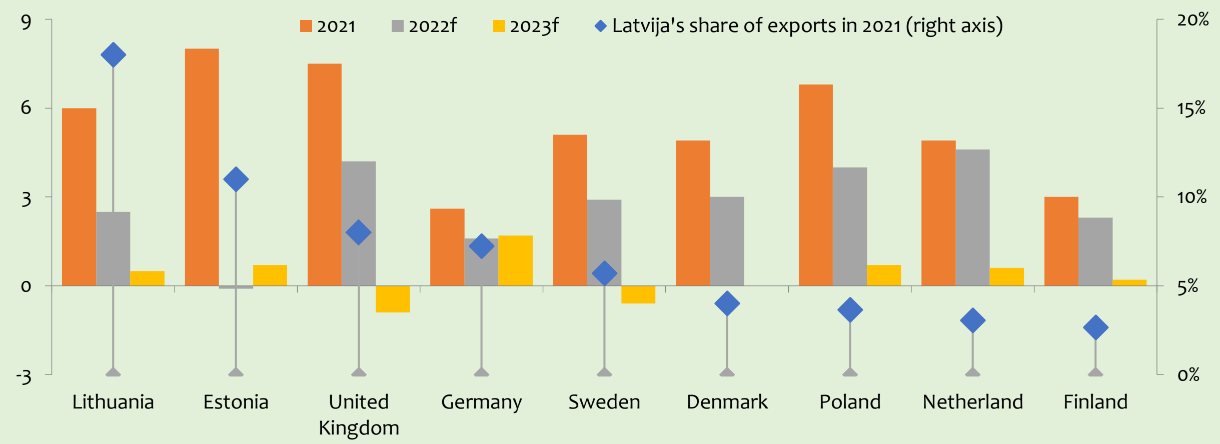
Estimates show that China's GDP will grow by 3.4% in 2022 and 4.5% in 2023. The growth outlook is still hindered by government policies on Covid-19 pandemic containment and an escalation of the crisis in the real estate sector. Sporadic Covid-19 outbreaks, followed by strict isolation, are expected to continue to create uncertainty and depress consumer and investment spending. The ability of burdened local governments to boost growth by increasing infrastructure spending in the future is likely to be constrained by high debt and lack of money. Structural risks to growth in China stem from debts of high-level companies and local governments, weak productivity growth and heavy reliance on investment as a key driver of growth.

In **Japan**, following moderate growth in 2021, with the continued spread of Covid-19 and the re-introduction of containment measures, GDP increase is expected to reach 1.7% in 2022. Similar growth rates (by 1.6%) are forecast also in 2023. The recovery of private consumption will continue as the situation in the labour market improves and government support reduces the negative impact of the increase in goods prices.

**India's** GDP is expected to grow by 6.9% in 2022. India's economy is forecast to be the second fastest growing economy among the G20, with GDP growing 6.0% also in 2023. Due to external uncertainty, macroeconomic stability should be pursued through monetary policies aimed at anchoring inflation expectations and fiscal policies aimed at controlling debt levels and optimising current and capital expenditures.

Figure 2.2

**Economic development of the main partner countries of Latvia**
*annual real GDP growth, as per cent*




Source: CSB, *EC – European Economic Forecast, Autumn 2022*
f – forecast

The **eurozone** economy is expected to grow 3.2% in 2022, while growth rates will slow to 0.3% in 2023.

According to projections, **Germany's** GDP grew by 1.6% in 2022. However, a 0.6% drop in economic growth is forecast for 2023. While supply chain problems are starting to ease, rapidly rising energy costs are having a negative impact on incomes and production growth. Given rising interest rates on loans, investment volumes are likely to shrink. Further loss of purchasing power at high inflation is expected to reduce private consumption, although some relief will come from political support. The government budget deficit is expected to remain elevated as pandemic-related spending is replaced by measures to mitigate the impact of high energy prices.

**Sweden's** economic growth is expected to be 2.9% in 2022, but it will slow down slightly in 2023 as high inflation and uncertainty will affect household consumption and investment, sending GDP down 0.6%. Forecasts suggest the pressure on wages will remain limited, in line with rising unemployment. Coupled with falling goods and transport prices and improved supply, this will contribute to lower inflation, contributing to a gradual recovery starting from the second half of 2023. The general government balance is also forecast to be in a small surplus.

The **United Kingdom's** GDP growth is projected to be 4.2% in 2022, while GDP is expected to fall 0.9% in 2023 due to worse trading conditions, higher interest rates and tighter fiscal policies. Only a slight recovery is expected in 2024. Risks have been heightened as recent political developments have added to insecurity and market volatility, which affects investor and consumer confidence.

The rate of economic growth in **CIS countries** will decline in 2023 as war and international sanctions continue to disrupt the Russian and Belarusian economies. While activity across the rest of the region should increase, the upturn will be constrained by increased inflation, higher interest rates and lower investment.

The economic impact of the war in **Ukraine** remains very uncertain and highly dependent on its duration. In June 2022, the Council of Europe granted Ukraine candidate status on the condition that the countries take several measures set out in the EC opinion based on a decision of the Council of Europe. The number of people leaving Ukraine for the EU because of the war is projected to reach 4.5 million by the end of 2022. Almost 2/3 of the persons reside in Poland, Germany, and the Czech Republic. The latest data show that around 20% of working-age people were in employment at the end of September and the employment rate is assumed to gradually rise to around 50% by the end of 2024 (i.e. around 30% of all those fleeing the war).

Baltic States are currently experiencing the fastest increase in prices, especially food and energy prices, among EU Member States.

Growth in Lithuania's economy is expected to be 2.5% in 2022, however, the growth rate will decrease in 2023, with GDP increasing by 0.5%. In 2022, relatively high general government revenues have managed to alleviate the budget deficit, but the projected increase in general government spending, due to measures to mitigate the economic and social impact of rising energy prices and aid to refugees from Ukraine, will bring a significantly higher budget deficit in 2023. However, it will decline again in 2024.

According to forecasts, Estonia's GDP decreased by 0.1% in 2022. In 2023, economic growth is expected to recover and reach 0.7%, mainly as the pressure of inflation decreases and investment recovers. In 2022, the labour market remained in a rather tense position, contributing to wage growth, which, though, has been more moderate than price growth, thus reducing real income.

# 3. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

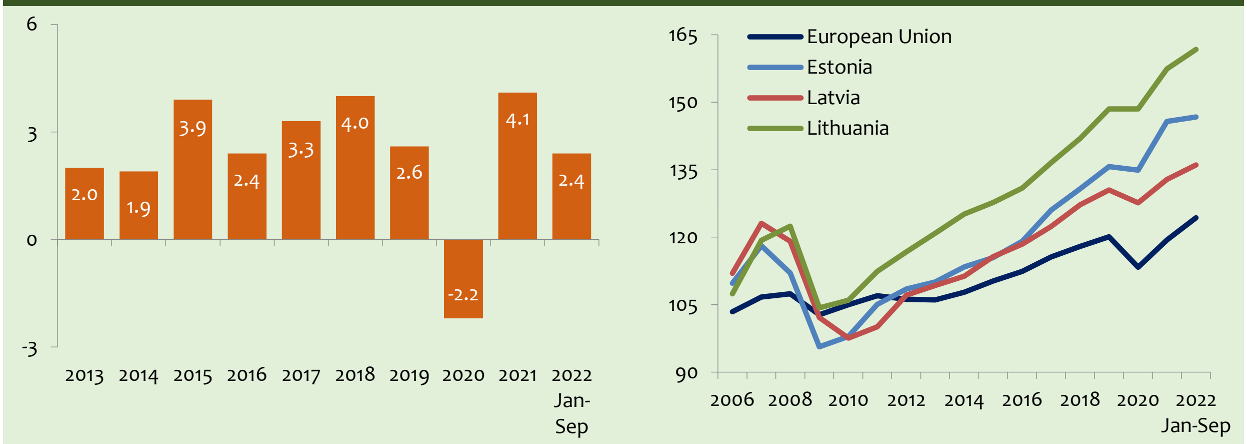
## 3.1. DYNAMICS AND STRUCTURE

From 2013 to 2019, GDP grew by 2.9% per year on average. In 2013-2014, slower GDP growth was influenced by trends in the external environment – slower growth in the EU, weaker economic situation in Russia. Even though the geopolitical situation in the region was tense, the Latvian economy grew more rapidly in 2015 due to the rapid increase in private consumption and export volumes. Growth was weaker in 2016 due to the drop in investments and delayed implementation of the EU's new structural funds programme.

Table 3.1

**Gross domestic product**

*changes compared to the corresponding period of the previous year, as per cent* | *2005 = 100*

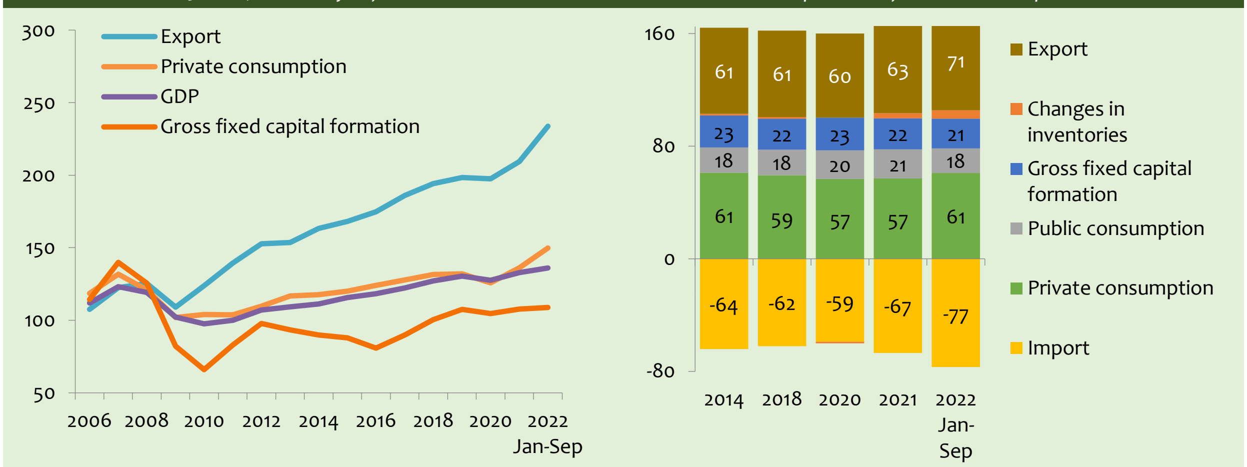



Growth became more rapid in 2017-2018 fostered by the improvement of the situation in the EU, the commencement of a new structural funds programme, increase in wages and employment. In this period, export, investments, private and public consumption were growing stably. The deceleration of economic development in 2019 was underpinned by both internal factors (the investments from EU funds have reached their maximum, developments in the financial sector, changes in port management), and external factors (revision of global trade relations, *Brexit*, slower growth in the EU countries).

Figure 3.2

**Gross domestic product by expenditure components**

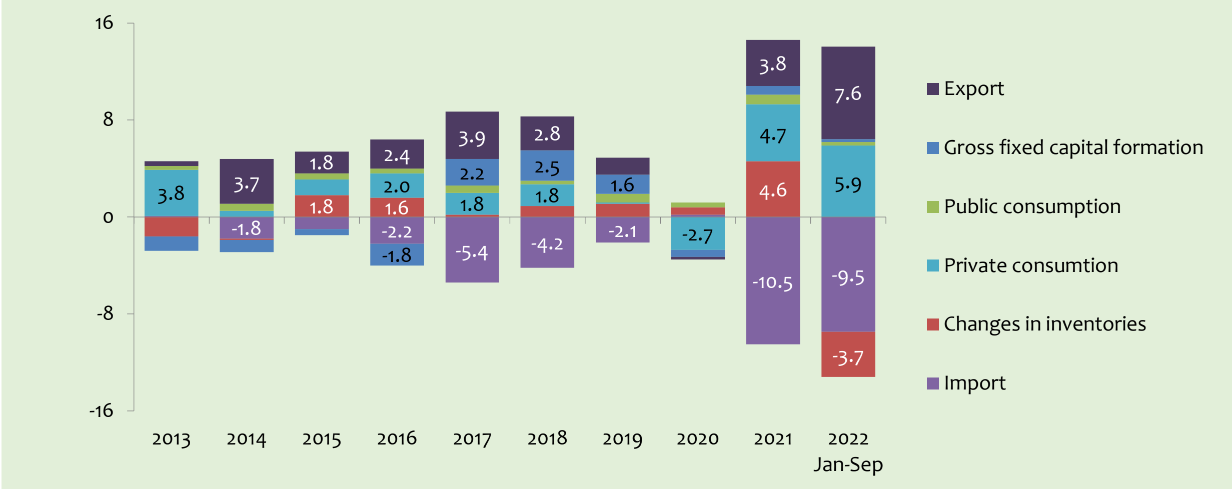
*2005 = 100, seasonally adjusted data* | *as per cent of GDP at current prices*



Economic development in 2020 was mainly dependent on the negative effects of the Covid-19 crisis. In 2020, GDP fell by 2.2%. It was the only GDP decline since the financial crisis. The fall in private consumption, which was affected by rising unemployment and shrinking incomes, had the biggest impact on the GDP reduction. Restrictions due to the Covid-19 pandemic on Latvian export markets and delays in raw material supply chains affected exports of goods and services. Investment volumes also reduced under the Covid-19 crisis conditions. Government consumption, on the other hand, continued to grow, mainly due to the government support measures to mitigate the negative effects of the Covid-19 pandemic.

Figure 3.3

**Contribution of expenditure components to Gross domestic product changes**
*as percentage points*




Economic development in 2021 was still affected by the Covid-19 pandemic and measures to restrict it, but rapid growth was observed in the economy in the middle of the year largely due to the base effect, and in 2021 GDP increased by a total of 4.1%. The increase in private consumption had the biggest impact, mainly due to the base effect. A favourable situation in Latvia's largest export markets contributed to a rapid increase in exports. Positive trends were observed in the area of investment, with governments still growing as support measures relating to the Covid-19 crisis continue to be implemented.

In the first half of 2022, economic development was affected by the low base in early 2021 and the gradual lifting of Covid-19 restrictions. Growth was very rapid in Q1, more moderate in Q2, and decreased in Q3 due to the high geopolitical uncertainty, the rapid rise in energy prices and the disruption of raw material supply chains caused by Russia's invasion of Ukraine. The biggest impact came from the increase in exports and private consumption. Despite the high uncertainty, there was also a slight increase in investment. Government consumption also continued to increase, but more moderately than in previous years.

In 2013-2021, comparing the Baltic States, faster growth was observed in Lithuania and Estonia, by 3.4% and 3.3% per year on average, while Latvia showed growth of 2.4%.

Table 3.1

**Gross domestic product by expenditure components**
*changes compared to the corresponding period of the previous year, as per cent*

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP** | **2.0** | **1.9** | **3.9** | **2.4** | **3.3** | **4.0** | **2.6** | **-2.2** | **4.1** | **2.4** |
| Private consumption | 6.5 | 0.7 | 2.1 | 3.4 | 3.0 | 3.0 | 0.2 | -4.6 | 8.2 | 10.0 |
| Public consumption | 1.7 | 3.5 | 2.7 | 2.3 | 3.3 | 1.7 | 3.9 | 2.4 | 4.4 | 1.6 |
| Gross fixed capital formation | -4.4 | -3.9 | -2.0 | -8.2 | 11.4 | 11.7 | 6.9 | -2.6 | 2.9 | 1.0 |
| Export | 0.7 | 6.2 | 3.0 | 4.0 | 6.4 | 4.4 | 2.1 | -0.3 | 5.9 | 11.7 |
| Import | -0.1 | 2.9 | 1.7 | 3.6 | 8.6 | 6.3 | 3.1 | -0.3 | 15.3 | 12.2 |

## 3.2. CONSUMPTION

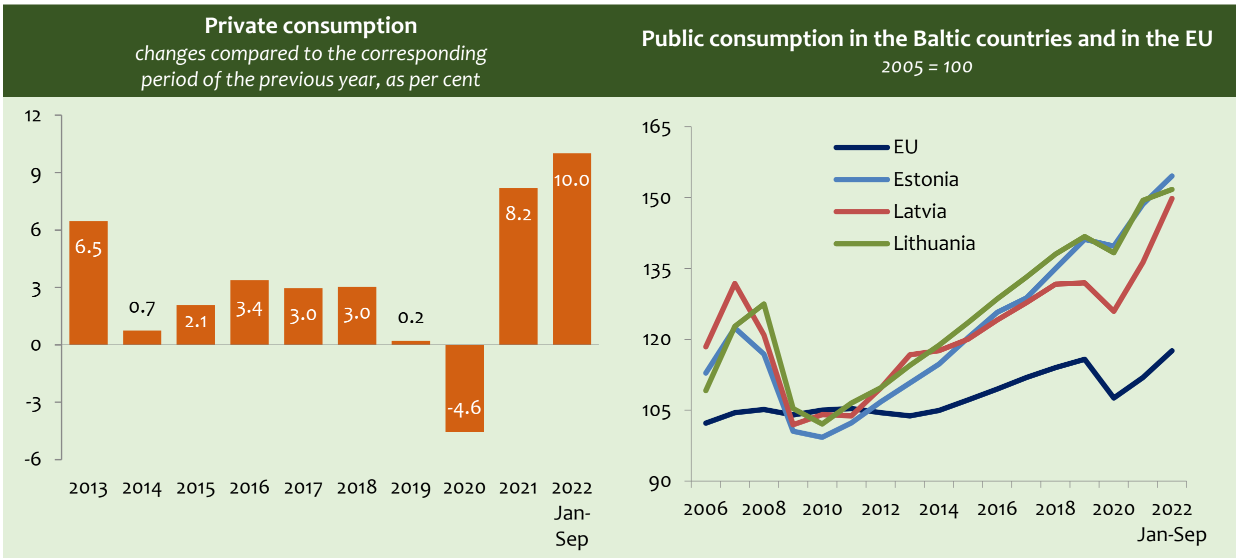
After a sharp rise in 2013, the increase in **private consumption** volumes, as well as overall economic growth, has been moderate since 2014. From 2014 to 2019, private consumption increased by an average of 2.1% annually. The increase was fostered by growth in wages, but the rise in employment was slow. In 2020, private consumption declined sharply due to the restrictions caused by the Covid-19 pandemic. The increase in unemployment and the drop in income caused by the Covid-19 crisis reduced private consumption by 4.6% during the year.

As economics recovered, a rapid increase in private consumption was observed in 2021 fostered by both the reduction of Covid-19 restrictions and the increase in average wages and government support measures.

Although there is a significant increase in consumer prices, in 2022 private consumption continues to grow very rapidly. The increase was driven by the increase in average wages, the reduction in unemployment and the complete cancellation of the Covid-19 containment restrictions. Overall, private consumption increased by 10% in the three quarters of 2022 compared to the corresponding period of 2021.

Since 2013, Latvia has been having the slowest increase in private consumption in comparison with other Baltic countries.

Figure 3.4




In the structure of household consumption, most of expenditure is on housing, expenditure on food is the second largest consumption group, while transport expenditure is the third priority. Within 10 years, the share of expenditure related to food, alcoholic beverages and tobacco, housing, transport, communications, restaurants, cafés and hotels has decreased in the structure of household consumption expenditure, while the share of expenditure related to clothing and footwear, housing equipment, health, recreation and culture, as well as education has increased.

As the economy was slowly adapting to the Covid-19 crisis in 2021, compared to the previous year, expenditure increased in all main consumption groups, except expenditure on alcoholic beverages and tobacco. The increase in expenditure on clothing and footwear, health and transport had the biggest effect. Health-related expenditure rose 22.2% during the rapid spreading of Covid-19. As government restrictions gradually eased, expenditure increased more in consumption groups such as clothing and footwear (by 24.5%), restaurants and hotels (by 19.6%), transport (by 9%), recreation and culture (by 7.3%). Because of the restrictions imposed by the government, meals were cooked more often at home, which increased spending on groceries by 1.6%. Household expenditure on housing increased by 1.3%, while expenditure on alcoholic beverages and tobacco fell by 1.3% compared to the year before.

In 2021, compared to 2011, household consumption expenditure increased in all groups of consumption expenditure. But spending on clothing and footwear, food and transport was the biggest consumer expenditure, which also led to an increase in overall costs.

**Consumer sentiment** generally improved between 2010 and 2019, despite being negative. The most optimistic sentiment level over the past five years had been reached in July 2019, when the rate was -1.4 points. Such an improvement in the sentiment has been largely fostered by rapid economic growth in recent years. Latvian consumers were generally more optimistic, and consumer confidence has been higher than the EU average since mid-2011. The confidence level was more pessimistic in 2017-2018, when Latvia's indicator slipped below the EU average. Pessimistic trends are again dominating after improving in 2019 and have been present since 2020.

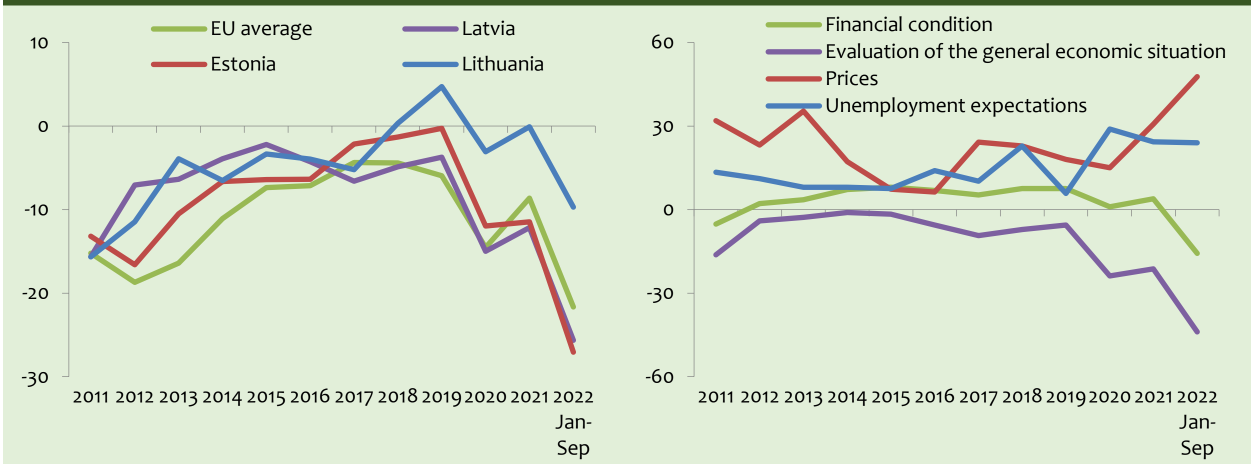
As a result of the Covid-19 pandemic, the consumer confidence indicator experienced a sharp decrease in 2020. Following the announcement of the emergency in the country, the lowest level of the indicator was reached in April and May 2020. As the epidemiological situation improved and restrictions eased, in 2021, consumer sentiment broadly improved, but in the second half of the year, optimism was tempered by growing uncertainty and concerns about the development of the spread of Covid-19, as well as price growth trends.

Figure 3.5

**Consumer confidence indicator***

*response balance, seasonally adjusted data*

Consumer confidence in the Baltic countries and in the EU | Consumer evaluation for the upcoming 12 months




* Consumer confidence indicator is calculated as the average of response balance to 4 questions – about the financial situation, the general economic situation, unemployment assessment and savings in the next 12 months

In 2022, consumer sentiment became much more pessimistic. Following Russia's invasion of Ukraine, the consumer confidence indicator is characterised by a marked downturn, and this trend was exacerbated by rising inflation. In the first half of 2022, the above factors led to a deterioration of all key items of the confidence indicator. The most pessimistic assessment of future prospects was reached in June 2022. The assessment of the financial situation and the general economic situation slipped to the lowest level since the financial crisis in 2009, while the level of inflation expectations reached the level of 2007 before the crisis. Meanwhile, large shocks in the labour market were not expected, and unemployment expectations remained at the level of the previous year. Consumer sentiment has started to improve in Q3, although future prospects are evaluated rather cautiously.

Consumers' assessment of the financial situation of the family in the future has largely stabilised since 2012 and was generally positive during the year. Optimism was growing on average since mid-2017, continuing until April 2020. While overall the financial prospects of families were viewed positively in 2020 and 2021, the specific figure deteriorated in those years. However, in 2022, following Russia's invasion of Ukraine, a sharp decline followed, and the indicator was negative during the year.

The assessment of the overall situation in the country, which has tended to improve since 2010, is essentially similar to the assessment of the financial situation of the family. A rapid increase has been observed until 2012, and in 2012 consumer confidence stabilised at the same time sticking to the ascending trend. The emergency announced in early 2020 drastically reduced consumer optimism. It continued to ease throughout the year and into 2021 as well. A particularly sharp decline was experienced in 2022. It should be noted that prospects of the country's economic situation are evaluated much more critically than the future of the financial condition of the family.

Unemployment expectations of consumers have been generally falling since 2010, although fluctuations were observed and stuck to the descending trend. However, since 2016 these expectations resumed growth reaching the highest level (24.3 points) by the end of 2016. Since the middle of 2017, unemployment expectations have been generally declining, which is largely related also to the overall decline in the unemployment rate and an increase in employment. Unfortunately, in 2020, unemployment expectations of consumers grew rapidly, reaching 63.1 points, the highest level in the last ten years, in April. Consumers then regained confidence in their job prospects, and unemployment expectations gradually reduced between 2021 and 2022.

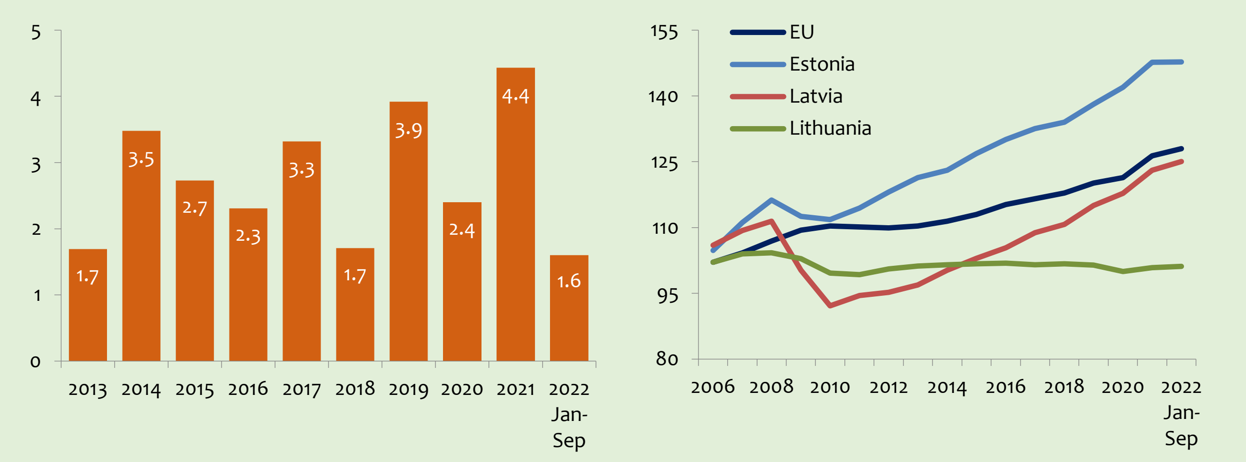
Inflation expectations rose sharply until April 2011. Since the middle of 2011, inflation expectations have been cyclical and, in this way, consumers responded to different changes, however, they have been generally declining. Since the middle of 2013, the drop has been very rapid reaching the level of -2.3 points in September 2016, the lowest since 2011. At the end of 2016, inflation expectations started to pick up again, a trend that persisted until mid-2017. Since the end of 2017, inflation expectations have moderately reduced, largely under the influence of a slower rise in prices and high inflation in the previous years. The Covid-19 pandemic did not significantly influence inflation expectations in 2020. Consumer concerns about price increases rose significantly in 2021, further boosted by Russia's invasion of Ukraine in 2022, and the highest rate of inflation expectations was reached in May and June.

The volume of public consumption or public services has grown at the fastest pace since 2014 as budget revenues increased. Overall, from 2014 to 2021, public consumption was growing by 3% per year on average.

Figure 3.6

**Public consumption**
*changes compared to the corresponding period of the previous year, as per cent*

**Changes in public consumption in the Baltic countries and in the EU**
*2005 = 100*




Budget expenditure has been growing rapidly in recent years to increase public defence capacity to provide financing for the national defence of 2% of GDP, but it is planned to gradually increase it to 2.5% of GDP by 2025. To promote sustainable and balanced country's economic development, deferred CIT for enterprise profits was introduced, the tax burden of the labour force was reduced and an increase of funding for defence, health, demography, and road maintenance was primarily ensured within the scope of the State budget possibilities.

The government support measures to mitigate the negative effects of the Covid-19 crisis are largely funded at the expense of increasing the state budget deficit maintained a positive increase in public consumption in 2020 and in 2021. In 2022, support measures implemented by the state to compensate for the rapid increase in energy prices for households and enterprises contributed to the increase in public consumption.

Since 2014, Latvia has been having the most rapid increase in public consumption in comparison with other Baltic countries.

## 3.3. INVESTMENT

Investment activities in the Latvian economy are fluctuating because they respond sensibly to geopolitical changes, programming periods of EU structural funds, external and internal shocks.

In the last three years before the Covid-19 pandemic (2017-2019) investment volumes increased by 10% per year on average. EU-funded public investment constituted a large share. Therefore, as the absorption of EU structural funds approaches its peak, the increase in investment activities is becoming increasingly more moderate.

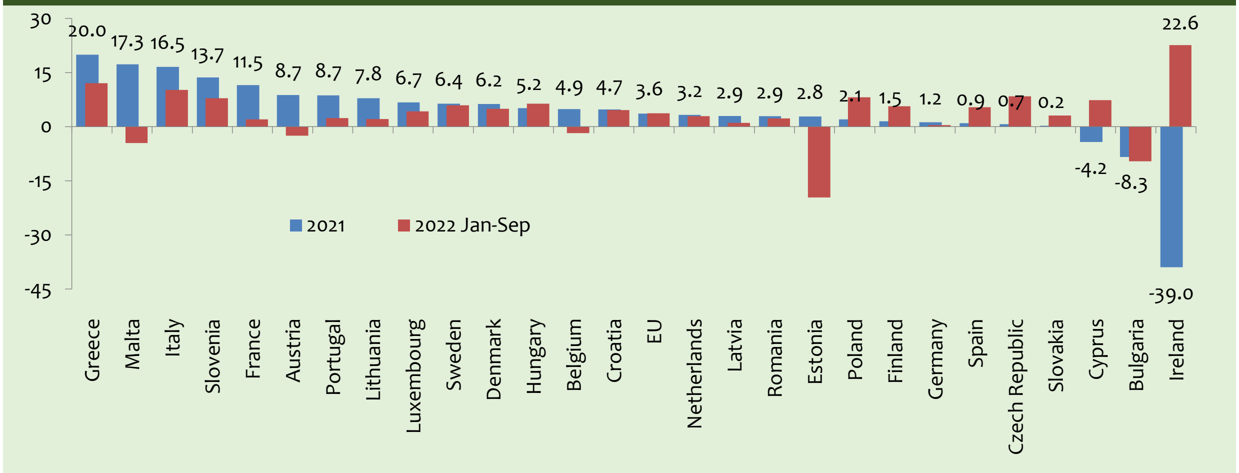
In 2020, investment activities reduced significantly due to the Covid-19 pandemic sensing the uncertainty about its combating possibilities soon.

In 2020, expenditure on fixed capital formation reduced by 2.6%, and this was the worst indicator in the Baltic States. When the economy had stabilised after the shock caused by the Covid pandemic, the investment volumes also increased. In 2021, expenditure on fixed capital formation was 2.9% higher than a year ago and amounted to 22.3% of GDP. The war in Ukraine exacerbated the situation and increased uncertainty, and this reflected in the dynamics of investment activities. In January-September 2022, investments in the Latvian economy were only 1% higher than a year ago.

Figure 3.7

**Changes in investment amounts in the EU countries**

*in 2021 and in January-September 2022, changes compared to the corresponding period of the previous year, as per cent*




In 2011-2021, investment grew annually on average by 4.6% and represented 22.6% of GDP, a lower level than before the global financial crisis.

The great uncertainty related to the geopolitical situation and the further development of the global economy, as well as the uncertainty regarding the course of the Russian war in Ukraine, may reduce the incentive for companies to invest.

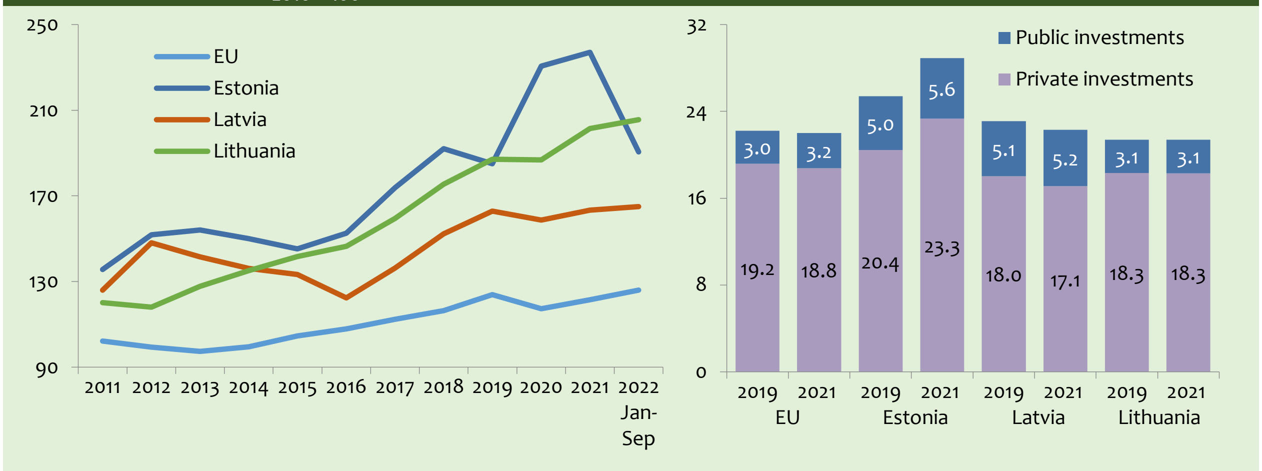
Figure 3.8

**Increase in Investments in the Baltic Countries and in the EU**

*2010 = 100*

**Investment level in the Baltic countries and in the EU**

*as % of GDP*




After the global financial crisis, private investment has been low for a long time. In the last three years before the Covid-19 pandemic (2017-2019), it grew on average by almost 8.5% annually and accounted for 17% of GDP. Measures to combat the Covid-19 pandemic limited overall economic activity and discouraged previously planned investments. In 2020, the private sector investment volume fell by 5.3%, compared to the previous year. However, in 2021, the volume of private investment increased again by almost 4.7% from a year earlier. In 2022, the positive dynamics of private investments persisted, and in the first half of the year, they grew by 6.8%, compared to the corresponding period of the previous year.

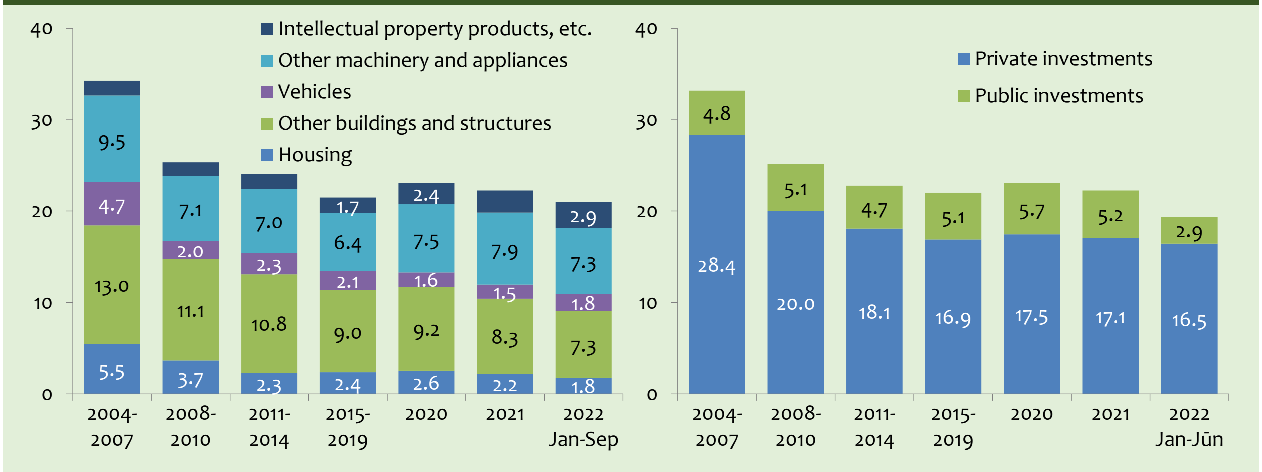
Although in recent years private investments have been growing, their level is lower than before the global financial crisis and also lower than in most EU countries, including Lithuania and Estonia. This is largely affected by weak lending, low demand and high uncertainty. The negative impact of these factors was significantly exacerbated by the crisis caused by Covid-19 and the Ukrainian war.

Lending remained at a very low level for a long time in Latvia. Despite comparatively low costs and growing demand, the credit portfolio does not increase. According to the data of the Bank of Latvia, in Q2 2022, the balance of loans to non-financial corporations and households accounted for 36% of GDP, which is well below the level before the crisis and one of the lowest in the EU. However, it should be noted that the adjusted annual growth rate of the domestic loan balance (excluding loans to the government) increased to 4.3% in July, and it was the highest level since the beginning of 2017. Moreover, analysts of the Bank of Latvia note that loans issued to companies are at high risk of interest rate hikes, which will be influenced by restrictive monetary policy measures implemented by the ECB to combat inflation.

Figure 3.9

**Investment by type of asset**
*as per cent of GDP*

**Level of public and private investments before and after the crisis**
*as per cent of GDP*




Public investments in Latvia are at a relatively high level and play an important role in the accumulation of fixed capital. It amounts to almost 1/5 of total investments in the Latvian national economy, and their dynamics are largely related to the cyclicity of absorption of EU structural funds. From 2017 to 2019, public investments were growing by 16% per year on average. As EU funding reached its maximum, in 2019 public investment volumes declined by 8%. Although we are experiencing the Covid-19 crisis, public investments increased by 9% in 2020. In 2021 and in the first six months of 2022 (at constant prices), they shrank and were 2.4% and 24% lower, respectively, than a year before.

Investments in construction assets constitute a large part of the total investment. These mainly are investments in buildings and structures, which account for almost half of the expenditure on gross fixed capital formation. Investments in buildings and structures in the three years before the Covid-19 crisis accounted for almost 45% of the expenditure on gross fixed capital formation. Due to the crisis, in 2020, investments in construction assets (at constant prices) decreased by 6.9%, but in 2021 they were 6.5% lower than a year before. In 2022, investments in these assets also continued to shrink and in January-September investments in engineering structures and buildings reduced by 12.1%, and investments in housing – by 11.6%, being largely influenced by the appreciation of construction costs.

Investments into machinery and appliances react sensibly to shocks, their recovery after the crisis is slower than in other assets. This is mainly due to weak lending, relatively high private debt and unfavourable market conditions, as well as low capacity utilisation. In 2017-2019, investments into machinery and appliances (without vehicles) did not exceed 40% of total investments and their dynamics were slower than in other assets. In 2020, investments in machinery and appliances generally remained at the level of the previous year. By contrast, in 2021, 12.9% more was invested in machinery and appliances than a year before. In January-September 2022, such investments kept growing and exceeded the level of the year before by 10.8%. The increase in investment was largely underpinned by investments in vehicles, as well as in information and communication technology equipment, which is necessary for remote work.

Investment in intellectual property assets represents around 7% of total investment. It is characterised by stability in the years of economic recession and growing dynamics are generally observed. It was particularly rapid in 2017-2019 – by an average of 10% annually. While investment growth rates became more moderate in the last two years (2020-2021), their levels are higher than before the Covid-19 pandemic. In January-September 2022, 20% more than a year ago was invested in intellectual property products.

Table 3.2

**Gross capital formation**
*annual average*

| | 1995-2007 | 2008-2010 | 2011-2019 | 2019 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|---|---|
| | | | | *actual increase* | | | |
| **GDP** | **7.4** | **-7.5** | **3.2** | **2.6** | **-2.2** | **4.1** | **2.4** |
| Gross capital formation | 18.1 | -25.3 | 7.0 | 10.1 | 0.0 | 18.0 | -10.0 |
| – gross fixed capital formation | 18.4 | -22.2 | 5.6 | 6.9 | -2.6 | 2.9 | 1.0 |
| | | | | *as per cent of GDP* | | | |
| Gross capital formation | 27.9 | 27.0 | 23.6 | 23.0 | 25.0 | 25.8 | 27.0 |
| – gross fixed capital formation | 25.2 | 25.1 | 22.5 | 23.1 | 23.2 | 22.3 | 21.0 |
| – changes in inventories | 2.6 | 1.8 | 1.1 | -0.1 | -1.2 | 3.5 | 6.0 |

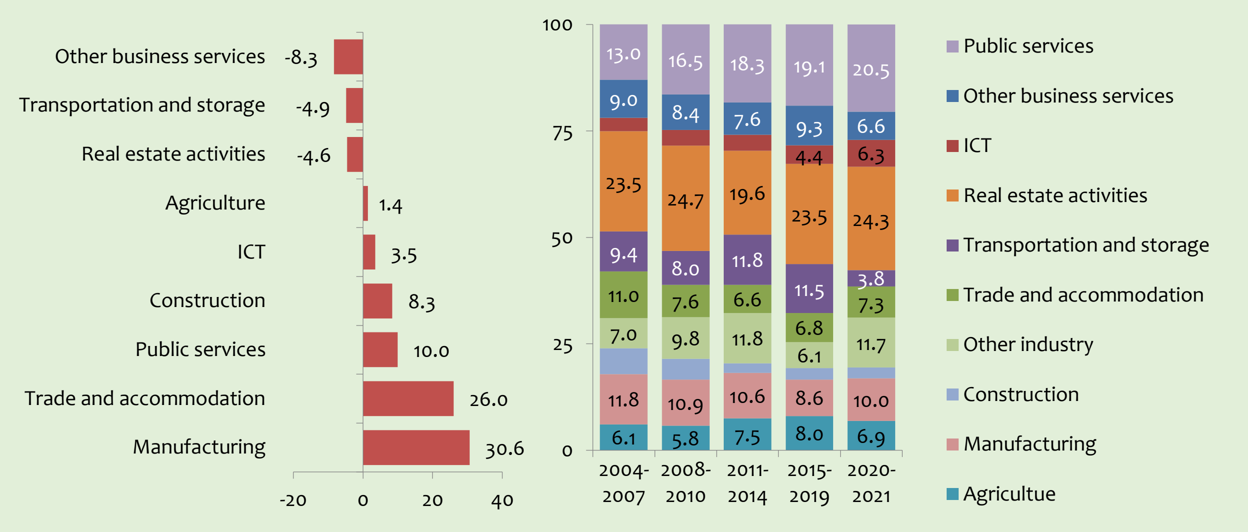
Investments in Latvia's economic sectors are unsustainable, and their volatility is affected by both the cyclicity of the absorption of EU structural funds and the adjustment of private sector investment plans in line with changes in market conditions.

In the five years (2015-2019) before the Covid-19 crisis the intensity of investment was moderate. Investment volumes increased more rapidly in services sectors – by an average of 5% annually, with the largest contribution extensive investment in real estate activities, public administration, as well as transportation and storage sectors. In goods sectors, investments increased slowly – by an average of 0.1% annually. Overall, the investment intensity in the services sectors has been close to historical indicators since 2011, while in manufacturing sectors it remains at a lower level.

Figure 3.10

**Gross capital expenditure by sectors**
*January-September 2022, changes compared to the corresponding period of the previous year, as per cent**

**Gross fixed capital formation by sectors**
*structure as per cent*




* calculated using quarterly data, at current prices

The crisis caused by the Covid-19 pandemic has affected the services sectors the most. In 2020, expenditure on fixed capital formation in the services sectors was 12.4% lower than a year ago. By 25% more than in 2019 was invested in the goods sectors, mainly due to the large volume of capital investment in the energy and communal services sectors. In 2021, investment in the goods sectors exceeded the level of the year before by almost 8%, while investment in the services sectors increased by only 0.9%. It should be noted that, disregarding the Covid-19 crisis, investment activity in some sectors is rather high. The increase in investment in both 2020 and 2021 was recorded in sectors such as agriculture, water supply, sewerage and waste management, construction. Investments increased significantly in capital investments in health, as well as information and communication services.

According to provisional data, in January-September 2022, overall capital investment in tangible assets in sectors of the Latvian economy increased by almost 6%, including by 8.2% in goods sectors and by 4.9% in services sectors, thus the goods sectors were growing at a faster rate. The largest increase in capital investment was recorded in manufacturing, trade and healthcare sectors – it accounts for almost half of the total capital investment in January-September of this year.

Surveys carried out by the European Investment Bank (EIB) show that in the field of investment Latvian entrepreneurs mark as the most significant long-term barriers to investment the shortage of skilled personnel and uncertainty regarding the future. These are also the two most frequently mentioned obstacles in EU Member States. Investments are also limited by high costs of energy sources and shortcomings in business regulation. The negative impact of the rise in energy prices caused by Russian military aggression may increase if the development or outlet prospects of the Latvian economy, its individual sectors or enterprises weaken.

The dynamics of investment will be further affected by the uncertainty in the international environment. EU funding, which is an important incentive for increasing investment levels, will have a positive impact on the investment dynamics. *Rail Baltica* and a number of other projects to be funded under the Recovery and Resilience Facility are expected to make a significant contribution to increasing investment activities. Increasing the loan portfolio, which has been low for a long time, also plays an important role. However, it should be noted that in the coming years investments will be significantly constrained both by the rapid rise in inflation and by lending becoming more expensive as the ECB implements restrictive monetary policy.

## 3.4. EXPORTS AND IMPORTS

Export has traditionally been one of the main factors of economic growth, and its dynamics are closely related to external demand and rates of development of economies of partner countries.

Figure 3.11


In 2014-2018, the development of exports was fostered by economic growth in EU countries and stable demand in other partner countries. In 2019, as economic growth rates of partner countries declined, the development of exports was more moderate.

2020 and 2021 will be marked in history as the time of crisis caused by Covid-19, which affected all economic indicators in all countries around the world, also in Latvia. As exports are directly dependent on external demand, this crisis had a significant impact on export volumes. In early 2020, export volumes increased, while in March a sharp decline in rates following the beginning of the pandemic was observed. In Q2 2020, export volumes were already significantly lower than a year before. In the second half of 2020, as external demand increased, exports started to grow moderately. In Q1 2021, export volumes were similar to a year ago, while in Q2 2021, as the external demand had grown considerably and partially due to the base effect, export volumes increased significantly. Growth continued also in the second half of the year.

In 2022, despite active hostilities taking place near the country's eastern border, the rapid growth of exports continues. In the first half of the year, export volumes were 11.3% higher than a year before and in Q3 they increased by another 2.3%.

The most important export markets for Latvia are EU countries, including Lithuania and Estonia. Exports to CIS countries, including Russia, keep getting smaller. It should be noted that Russian military aggression in Ukraine has a negative impact on the volume of trade deals with both Russia and Belarus. In the total structure, exports to other countries, to which the United Kingdom belongs since the first half of 2020, make up a slightly higher share than exports to CIS countries.

The main factors of development of imports of Latvian goods and services are increases in production volumes in manufacturing and in income available to households. Import volumes are growing considerably, as internal demand is growing. In 2020, as internal demand dropped considerably, import volumes slightly reduced compared to the previous year. In 2021, disparate trends were observed. In particular, in Q1 2021, a moderate increase in imports was observed. However, in Q2-Q4 2021, because of the increase in demand and the base effect, imports of goods and services were significantly higher than a year ago. Similar trends were preserved also in the three quarters of 2022.

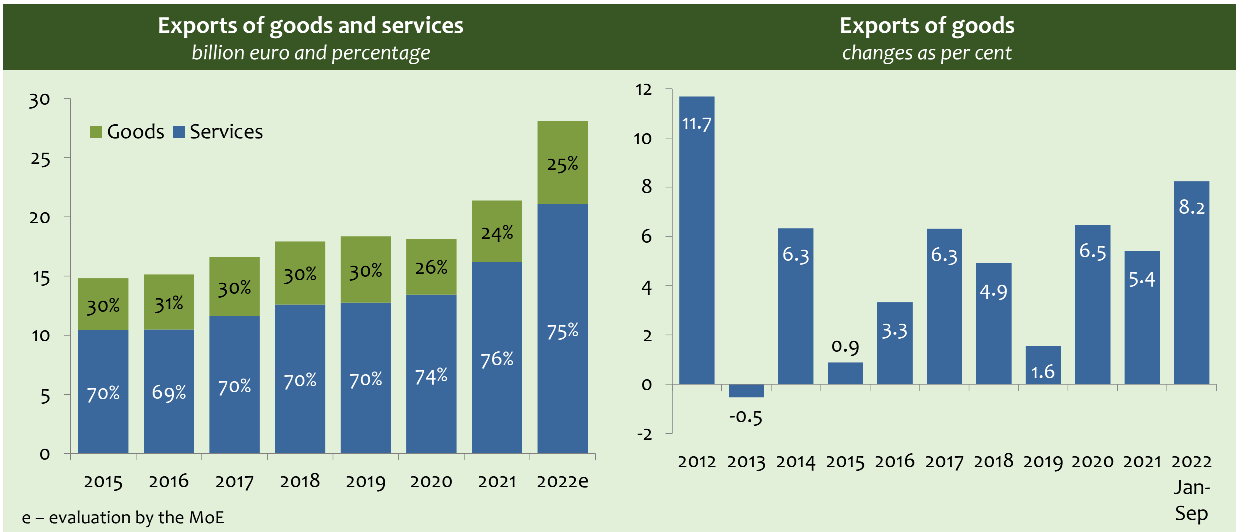
The export-import balance, after being clearly negative in 2012-2015, has been balanced since 2016. In 2020, when import volumes were declining more rapidly than export volumes, the indicator reached historically the highest level. An opposite picture is observed in 2021-2022.

Although demand in foreign markets is currently stable, the risks restricting the development of exports and related to the hostilities in Ukraine still exist.

## EXPORTS

More than two thirds of Latvian export are composed of exports of goods. Until 2019, this proportion has not significantly changed. However, in 2020, when the possibilities of exporting services were considerably restricted due to the Covid-19 crisis, the export structure in this period changed in favour to exports of goods. A similar proportion was preserved also in 2022.

Figure 3.12




In Latvia, exports of goods were developing dynamically from 2014 to 2018, except in 2015, when the volumes remained at the level of the previous year. In 2019, exports of goods increased more moderately due to falling external demand.

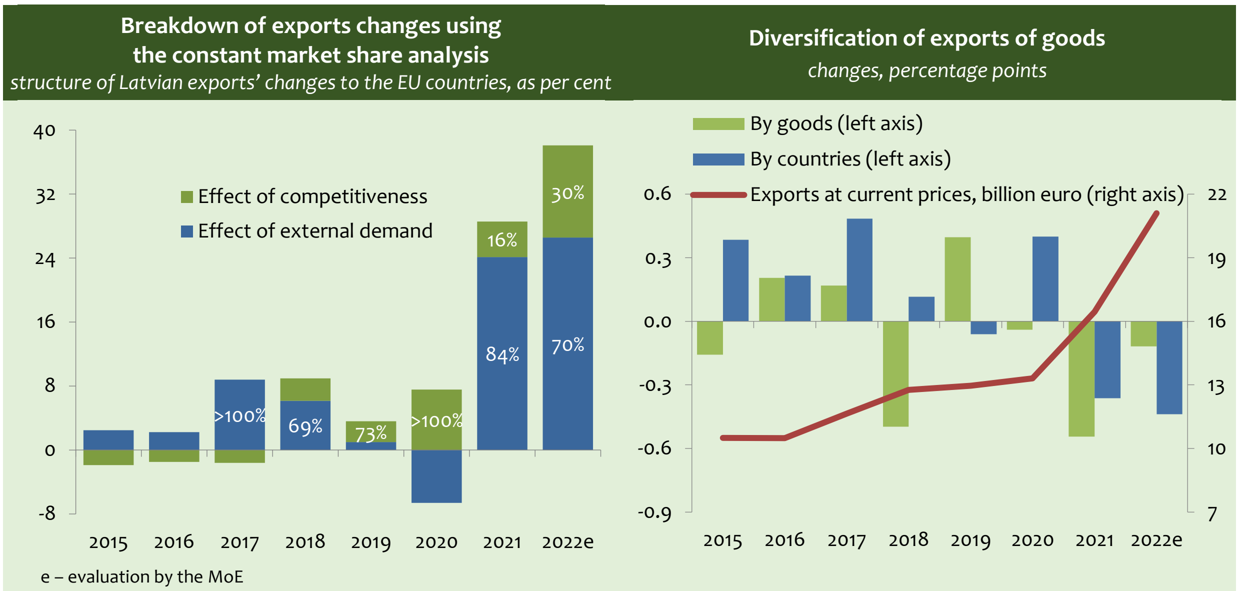
The first half of 2020 was not favourable to exports of goods as to the overall economic development. Export volumes during the crisis were lower than a year ago under the influence of Covid-19. However, rapid growth in exports of goods in the second half of the year, particularly in the last quarter of the year, allowed the year to be concluded with a very good growth. In 2021 and in the three quarters of 2022, exports of goods have continued to grow dynamically.

In 2017-2018, the development of exports of goods was positively influenced by changes in export prices. At current prices, exports increased on average by around 10% annually. Export prices declined slightly in 2019 as external demand declined. Similar trends were also observed in 2020. Starting from Q2 2021, the export unit value has been growing rapidly. It was

22% higher in the three quarters of 2022 than the year before. Export prices of wood and its products, metals, mineral products, agricultural products, as well as other goods increased rapidly.

In 2014-2018, the increase in exports of goods was driven by external demand, with a low or even negative role of competitiveness in export growth. In 2019, however, Latvia's exports to EU countries were driven by a more rapid increase in the competitiveness of Latvian companies. With external demand shrinking rapidly in 2020, the negative export development was partly compensated by the ability of entrepreneurs to compete in external markets. 2021-2022 were marked by a considerable increase in external demand, which largely drove the increase in exports. It should be noted that the effect of competitiveness also makes an increasingly positive contribution to export development.

Figure 3.13




As major groups of goods such as wood and wood products and agricultural and food products are growing more rapidly, the diversification rate of export goods is deteriorating, while faster development of relatively smaller export groups improves it. An improvement in the diversification indicator for goods was observed in 2015-2017. However, an opposite process was observed in 2018, when exports of wood and wood products grew considerably in response to the United Kingdom's anticipation of withdrawal from the EU, which had a negative effect on the diversification indicator for goods. The indicator improved in 2019 when this effect subsided. In 2020, the diversification of exports of goods by groups of goods did not change significantly. In 2021-2022, the value of the largest groups of export goods increased more rapidly, having a negative impact on the diversification rate of goods.

Table 3.3

**Exports of goods**
*as per cent, at current prices*

| | 2021 | | | 2022 Jan-Oct | | |
|---|---|---|---|---|---|---|
| | structure | changes | contribution to the changes | structure | changes | contribution to the changes |
| **Total** | **100** | **23.7** | **23.7** | **100** | **30.7** | **30.7** |
| Agricultural and food products | 18.3 | 2.7 | 0.6 | 19.3 | 39.6 | 7.2 |
| Mineral products | 6.3 | 92.5 | 3.8 | 12.1 | 184.0 | 10.2 |
| Chemical industry products | 12.2 | 33.0 | 3.7 | 11.8 | 28.5 | 3.4 |
| Light industry products | 3.2 | 14.5 | 0.5 | 2.9 | 16.5 | 0.5 |
| Wood and articles of wood | 19.1 | 43.5 | 7.2 | 18.0 | 19.0 | 3.8 |
| Metal and articles of metal | 10.0 | 49.6 | 4.1 | 7.2 | -4.9 | -0.5 |
| Machinery, mechanical and electrical appliances | 16.3 | 6.8 | 1.3 | 14.2 | 12.2 | 2.0 |
| Transport vehicles | 4.6 | 10.0 | 0.5 | 4.6 | 24.7 | 1.2 |
| Other goods | 9.9 | 19.2 | 2.0 | 9.9 | 29.2 | 2.9 |

Diversification of exports of goods by countries improved in 2015-2018 evidencing of entering new markets. In 2019, exports to the largest partner countries were growing more rapidly, thus worsening the diversification indicator. In 2020, however, the diversification of exports by countries improved. This was due to reductions in exports to several major partner countries, such as Russia, Lithuania, and Sweden. Accordingly, the share of goods exported to smaller partner countries in total exports increased. Similar trends were observed in the diversification of exports by countries in 2021-2022. The value of exports to the major trading partner countries as Lithuania, Estonia, Finland and Germany is growing more rapidly, having a negative effect on the country diversification indicator.

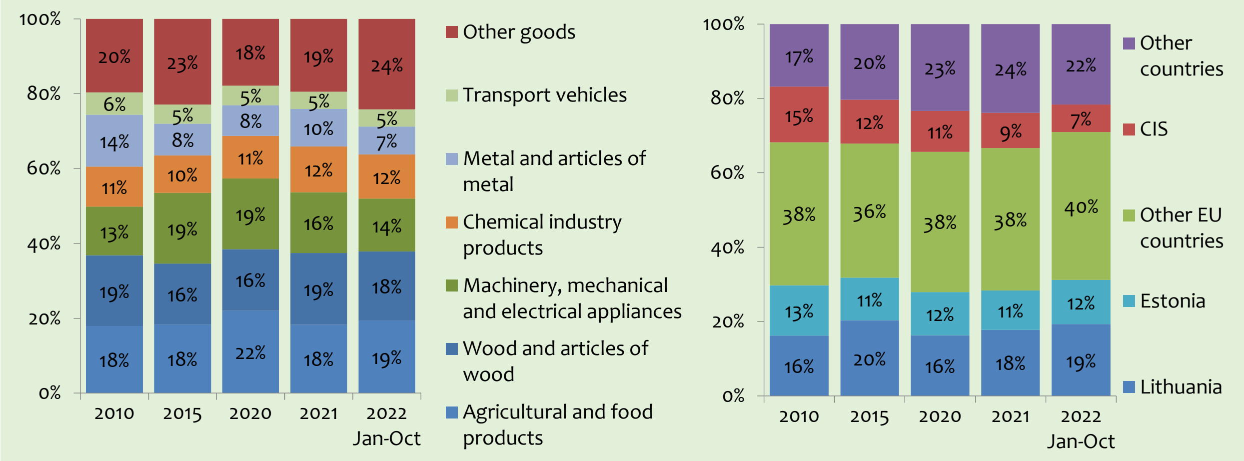
In 2021, exports of goods to the EU countries grew by 25.7%. A large part of the increase was due to the growth of exports of mineral products, wood and its products, and steel.

The exports to the EU countries also grew more rapidly in January-October 2022 – by 39.3%. Export growth was observed in almost all groups of goods, particularly as the export value of mineral products increased sharply. Exports of wood and its products, dairy products, crops, electrical appliances and equipment and mixed chemical products also increased significantly.

Figure 3.14

**Structure of exports of goods by groups of goods**
*as per cent*

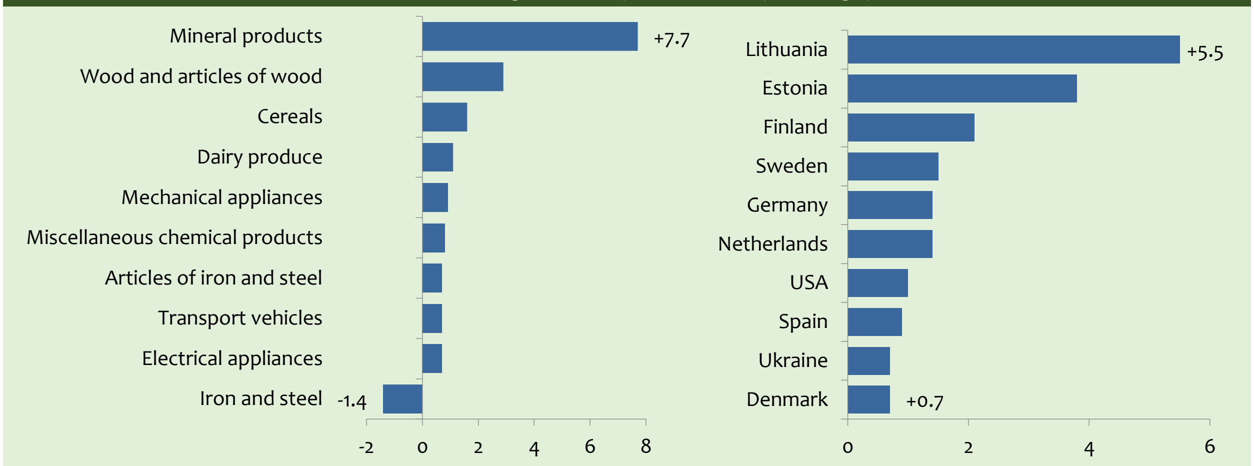
**Structure of exports of goods by groups of countries**
*as per cent*




In 2021, the number of exports of goods to the CIS countries grew by 5.7%. The value of exports of pharmaceutical products, machinery and appliances, as well as plastic articles increased more rapidly. On the other hand, exports of beverages, electrical appliances and equipment, as well as optical devices and equipment to CIS countries reduced.

Figure 3.15

**Groups of goods and countries with most effect on changes in exports**
*contribution to changes in January-October 2022, percentage points*



In January-October 2022, exports to CIS countries increased by 5.7%. The export group of pharmaceutical products, different plants, rubber and its products, as well as iron and steel products made the most significant contribution to their growth. The value of electrical appliances and equipment, as well as plastics and its products exported to CIS countries decreased during this period of time.

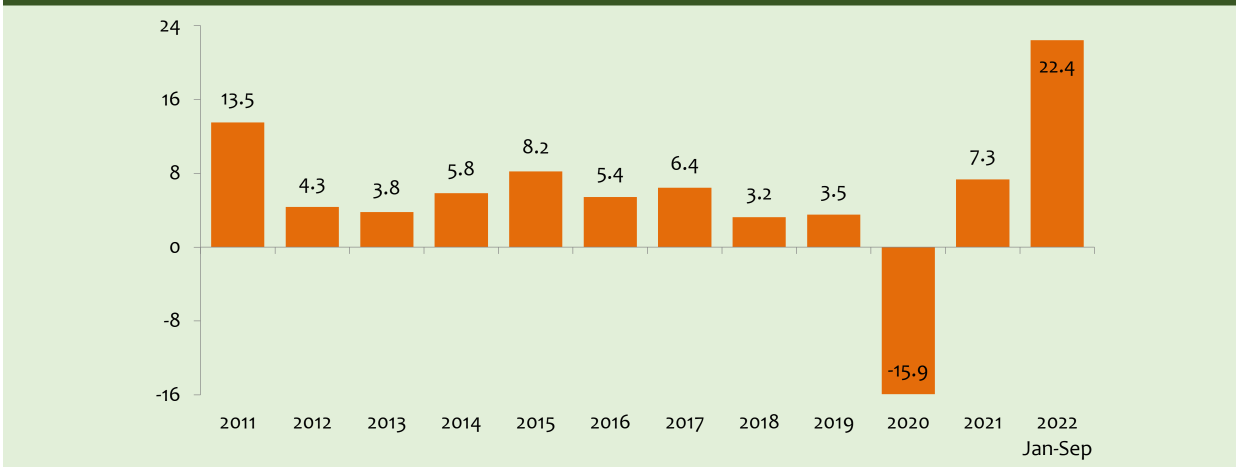
In 2021, exports of goods to other countries, excluding EU and CIS countries, grew by 26.5%. This was considerably influenced by the increase in exports of wood and wood products to the United Kingdom. In January-October 2022, exports to other countries continued to grow comparatively rapidly – by 17.1%. They were influenced significantly by exports of cereals to Angola and Saudi Arabia, as well as exports of mineral products to Ukraine.

In 2015-2016, **exports of services** grew more rapidly than exports of goods with the share of services making a larger contribution to the total increase in exports than the goods. The positive balance of exports of services in this period fully compensated the negative balance of exports of goods.

In 2017-2019, export rates of goods and services were similar.

Figure 3.16

**Exports of services**
*changes compared to the corresponding period of the previous year, as per cent*




In 2020, the growth of exports of services was greatly impacted by restrictions imposed on travelling, food services and other service activities due to the Covid-19 pandemic. In 2020, overall exports of services decreased considerably. The most rapid drop was observed from Q2 2020 to Q1 2021. Since Q2 2021, exports of services have resumed growth at a comparatively rapid pace due to the base effect.

Rapid growth rates of exports of services were also preserved in the three quarters of 2022. The increase in the value of exports of services exceeded 20% quarterly.

Until 2019, traditionally about 40% of the exports of services had consisted of income from transport services. The last few years have not been successful for the export of transport services. In 2019, the exports of services were similar to the previous year. In 2020, exports of services provided by all modes of transport declined significantly under the influence of Covid-19. The value of road transport export services declined moderately. In 2021, the development of exports of transport services was similar to the general trends in exports of services.

In the three quarters of 2022, exports of services by all modes of transport increased. Transport by air and road transport was growing more rapidly, while transport by rail and sea was growing moderately.

In 2021, income from foreign tourists fell slightly due to the Covid-19 crisis. But in the three quarters of 2022, it increased significantly, partly due to the base effect.

In the three quarters of 2022, exports of construction services declined, while exports of other services, in particular economic activity services, increased, contributing significantly to the overall increase in exports of services.

Until 2019, slightly less than 60% of total exports of Latvian services were related to EU countries; in 2020 and 2021, this share rose significantly – to 66% and 67%, respectively. In the three quarters of 2022, exports of services to EU countries were slightly lower.

Table 3.4

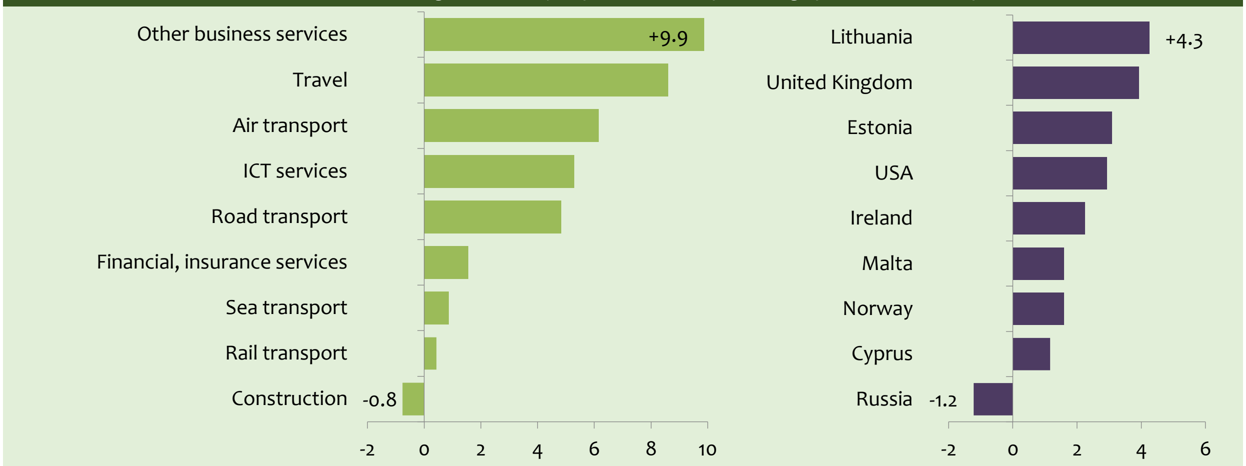
**Exports of services**
*as per cent, at current prices*

| | 2021 | | | January-September 2022 | | |
|---|---|---|---|---|---|---|
| | structure | changes | contribution to the changes | structure | changes | contribution to the changes |
| **Total** | **100** | **10.3** | **10.3** | **100** | **37.2** | **37.2** |
| Transport services, including: | 30.4 | 11.4 | 3.4 | 31.3 | 40.8 | 12.4 |
| – sea transport | 3.7 | -14.3 | -0.7 | 3.4 | 23.2 | 0.9 |
| – air transport | 4.4 | 63.8 | 1.9 | 7.2 | 164.5 | 6.2 |
| – rail transport | 2.9 | -6.3 | -0.2 | 2.4 | 15.4 | 0.4 |
| – road transport | 17.8 | 11.5 | 2.0 | 17.0 | 26.1 | 4.8 |
| – other transport services | 1.7 | 30.9 | 0.4 | 1.4 | 9.5 | 0.2 |
| Travel | 12.3 | -9.1 | -1.4 | 15.6 | 67.0 | 8.6 |
| Other services, including: | 57.4 | 15.1 | 8.3 | 53.1 | 28.6 | 16.2 |
| – construction services | 7.1 | 2.5 | 0.2 | 4.5 | -10.9 | -0.8 |
| – financial and insurance services | 3.6 | 29.0 | 0.9 | 3.5 | 46.7 | 1.5 |
| – ICT services | 18.5 | 12.4 | 2.3 | 17.5 | 28.3 | 5.3 |
| – other business services | 26.8 | 19.6 | 4.8 | 26.4 | 37.4 | 9.9 |
| – other services | 1.3 | 9.7 | 0.1 | 1.1 | 18.8 | 0.2 |

In 2021, exports of services to EU countries grew at a similar pace as total exports of services. In 2021, transport services (road and air transport) as well as economic activity and ECT services accounted for the largest share of exports of services to EU countries. In the three quarters of 2022, exports to the EU countries grew slightly more moderately than total exports of services – by 28.3%. Transport and travel services to EU countries, as well as the export value of economic activity and ICT services were growing more rapidly during this period.

Figure 3.17

**Services items and countries with most effect on changes in Latvian exports**
*contribution to the changes in January-September 2022, percentage points, at current prices*



## IMPORTS

In 2017-2020, the volume of imports of Latvian goods and services followed a downward trend – from 6.3% to -0.3%. Weak import growth in 2019-2020 was due to low domestic demand due to the Covid-19 pandemic. However, demand began to grow rapidly in 2021, with import growth rates at their fastest pace in recent years. Although they decreased slightly in the three quarters of 2022, they exceeded the level of the corresponding period of last year by 12.2%. Imports of both goods and services are growing rapidly.

In 2021, after the Covid-19 crisis, **imports of goods** at current prices increased by 28.8%. This was due to an increase in imports in all main groups of goods. The import value of mineral products, iron and steel, aircraft and its parts, wood and its products, and machinery and appliances increased more rapidly.

In January-September 2022, imports of goods at current prices were growing even more rapidly than a year before. The increase in the import value of mineral products secured a half of the whole increase. The import value of electrical appliances and equipment, land vehicles, different chemical products and machinery and appliances increased significantly.

Table 3.5

**Imports of goods**
*as per cent, at current prices*

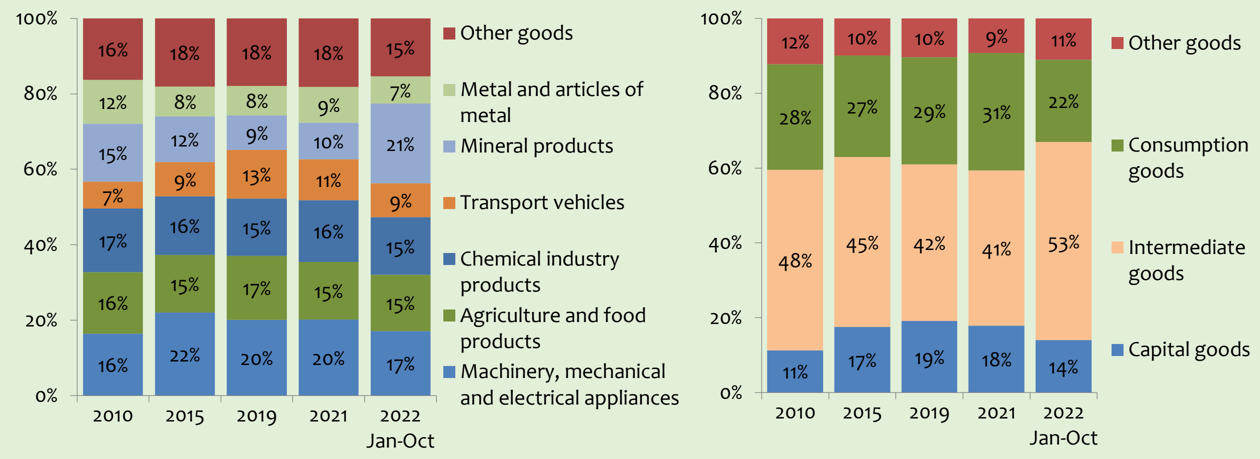
| | 2021 | | | 2022 Jan-Oct | | |
|---|---|---|---|---|---|---|
| | structure | changes | contribution to the changes | structure | changes | contribution to the changes |
| **Total** | **100** | **28.8** | **28.8** | **100** | **35.3** | **35.3** |
| Agricultural and food products | 15.2 | 4.5 | 0.8 | 14.9 | 34.7 | 5.2 |
| Mineral products | 9.7 | 88.2 | 5.8 | 21.2 | 201.0 | 19.1 |
| Chemical industry products | 16.4 | 28.2 | 4.6 | 15.3 | 28.6 | 4.6 |
| Light industry products | 4.4 | 11.6 | 0.6 | 3.9 | 20.0 | 0.9 |
| Wood and articles of wood | 4.8 | 60.0 | 2.3 | 3.6 | -1.6 | -0.1 |
| Metal and articles of metal | 9.5 | 55.8 | 4.4 | 7.2 | -1.1 | -0.1 |
| Machinery, mechanical and electrical appliances | 20.2 | 15.3 | 3.5 | 17.1 | 17.1 | 3.4 |
| Transport vehicles | 10.9 | 54.9 | 5.0 | 9.0 | 4.8 | 0.6 |
| Other goods | 9.0 | 17.7 | 1.7 | 7.8 | 20.1 | 1.8 |

In 2021, imports from EU countries at current prices were growing at a similar pace as total imports of goods – by 23.6%. In January-October 2022, however, imports of goods from EU countries increased more rapidly – by 47%. Similarly to total imports, the increase was significantly fostered by the increase in the import value of mineral products. The value of land vehicles, electrical appliances and equipment, fertilisers and other goods imported from EU countries increased as well.

Figure 3.18

**Structure of imports of goods by groups of goods**
*as per cent*

**Structure of imports of goods by the classification of broad economic categories**
*as per cent*



Imports from Russia and Belarus traditionally account for more than 95% of imports from CIS countries. Imports from CIS countries at current prices increased by 81.2% in 2021. This was mainly due to the increase in imports of mineral products, iron and steel, wood and its products. These three groups accounted for 4/5 of all import growth from CIS countries in 2021.

In January-September 2022, imports from CIS countries decreased by 2.6% directly due to the Russian war in Ukraine, moreover, due to sanctions, imports of many groups of goods from Russia and Belarus are declining. Mineral products are still mainly imported from CIS countries, but imports of animal and vegetable fats, feed and other agricultural and food products from CIS countries are also increasing.

In the group of other countries, except the EU and the CIS countries, imports in 2021 grew rapidly by 26.2% significantly affected by imports of aircraft and its parts from Canada. Also in January-October 2022, imports of goods from other countries continued to grow – by 10.2%. This indicator was affected by the increase in imports of electrical appliances and equipment from China.

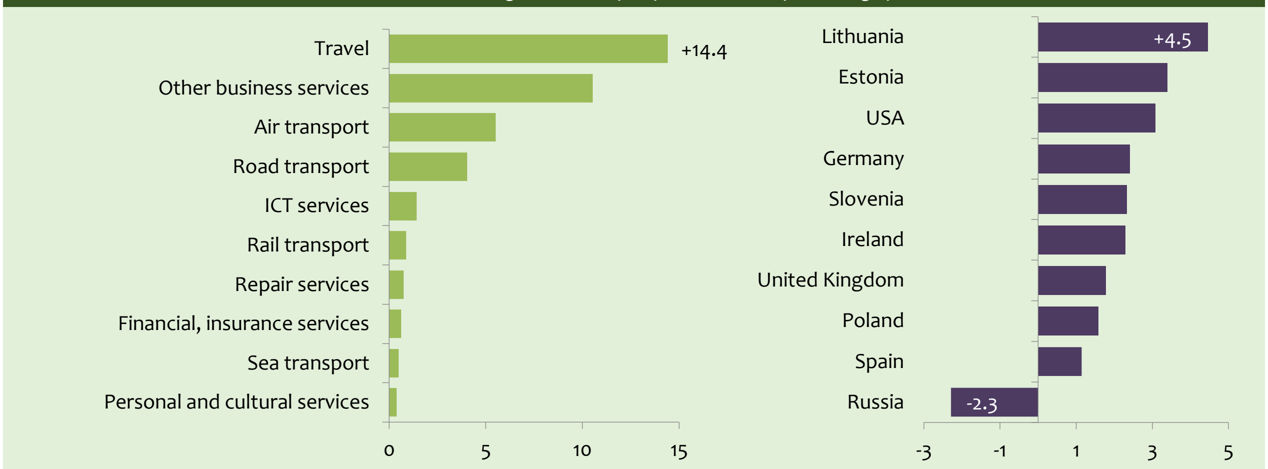
In the structure of imports of goods in terms of their end use, imports of capital goods increased until 2019. However, in 2021-2022, their share shrank slightly under the influence of the Covid-19 crisis. The share of intermediate goods in total imports decreased until 2019, mainly due to a decrease in the import value of fuel. However, in the three quarters of 2022, with fuel imports rising, the share of imports of intermediate goods was also increasing more rapidly.

In 2021, the growth of **imports of services** was comparatively rapid – by 24.9%. This was partially affected by the base effect. Imports of services related to brokering were growing more rapidly. Imports of transport services also increased considerably, while imports of financial services declined. In January-September 2022, imports of services continued to increase rapidly – by 24.4%. This was due to an increase in imports of all service items, in particular travel, transport and brokering services.

About two thirds of all services are provided to Latvia by EU countries. The share of imports from EU countries in the total imports of services keeps growing. The largest groups of imports of services are services related to brokering, travel, and transport.

Figure 3.19

**Services items and countries with most effect on changes in Latvian imports**
*contribution to changes in January-September 2022, percentage points*



# 4. CONTRIBUTION OF SECTORS

## 4.1. DYNAMICS AND STRUCTURE

In 2009-2010, as labour costs reduced, the competitiveness of Latvian producers improved, which served as a basis for an increase in export volumes and also the development of tradable sectors (agriculture, forestry and fishing, industry, as well as transport services). The structure of the economy has changed. In 2010, the share of these sectors reached 33.1% of total value added, but in 2021 – 28.7%. In 2021, compared to 2010, the share has increased in construction, business services and public services, but the share of other industry, transport, trade and accommodation reduced. The analysis of economy structures from another perspective shows that in 2021 producing sectors (agriculture, forestry and fishing, industry, and construction) accounted for 27.3%, but services sectors – for 72.7% of total value added. Compared to 2010, the share of producing sectors has increased everywhere, except other industry.

Since 2011, GDP has been growing by 2.6% per year on average.

Table 4.1

**Structure of the economy**
*by value added, as per cent*

| | 2000 | 2008 | 2010 | 2016 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|---|---|
| Agriculture, forestry and fishing | 5.0 | 3.3 | 4.6 | 3.7 | 5.0 | 4.6 | 6.3 |
| Manufacturing | 15.2 | 10.7 | 13.3 | 11.6 | 12.6 | 13.7 | 14.3 |
| Other industry | 4.2 | 3.4 | 4.8 | 4.2 | 3.4 | 3.5 | 4.0 |
| Construction | 7.0 | 10.2 | 4.9 | 5.3 | 6.3 | 5.5 | 4.8 |
| Trade, accommodation and food service activities | 15.6 | 16.0 | 17.7 | 16.6 | 16.1 | 16.6 | 16.7 |
| Transportation and storage | 11.9 | 9.3 | 10.4 | 9.1 | 6.7 | 6.9 | 7.2 |
| Other business services | 23.8 | 30.3 | 28.3 | 33.2 | 31.8 | 30.6 | 30.2 |
| Public services | 17.3 | 16.9 | 16.1 | 16.2 | 18.1 | 18.6 | 16.5 |
| **Total** | **100** | **100** | **100** | **100** | **100** | **100** | **100** |

In 2013-2016, due to a decline in cost competitiveness advantages gained during the financial crisis and geopolitical situation, exports slowed down, and growth of tradable sectors was slower. Growth continued in all sectors except construction. Domestic market-oriented sectors – trade and business services – have contributed the most to the growth. With the national budget expenditure growing, the volume of public services also increased.

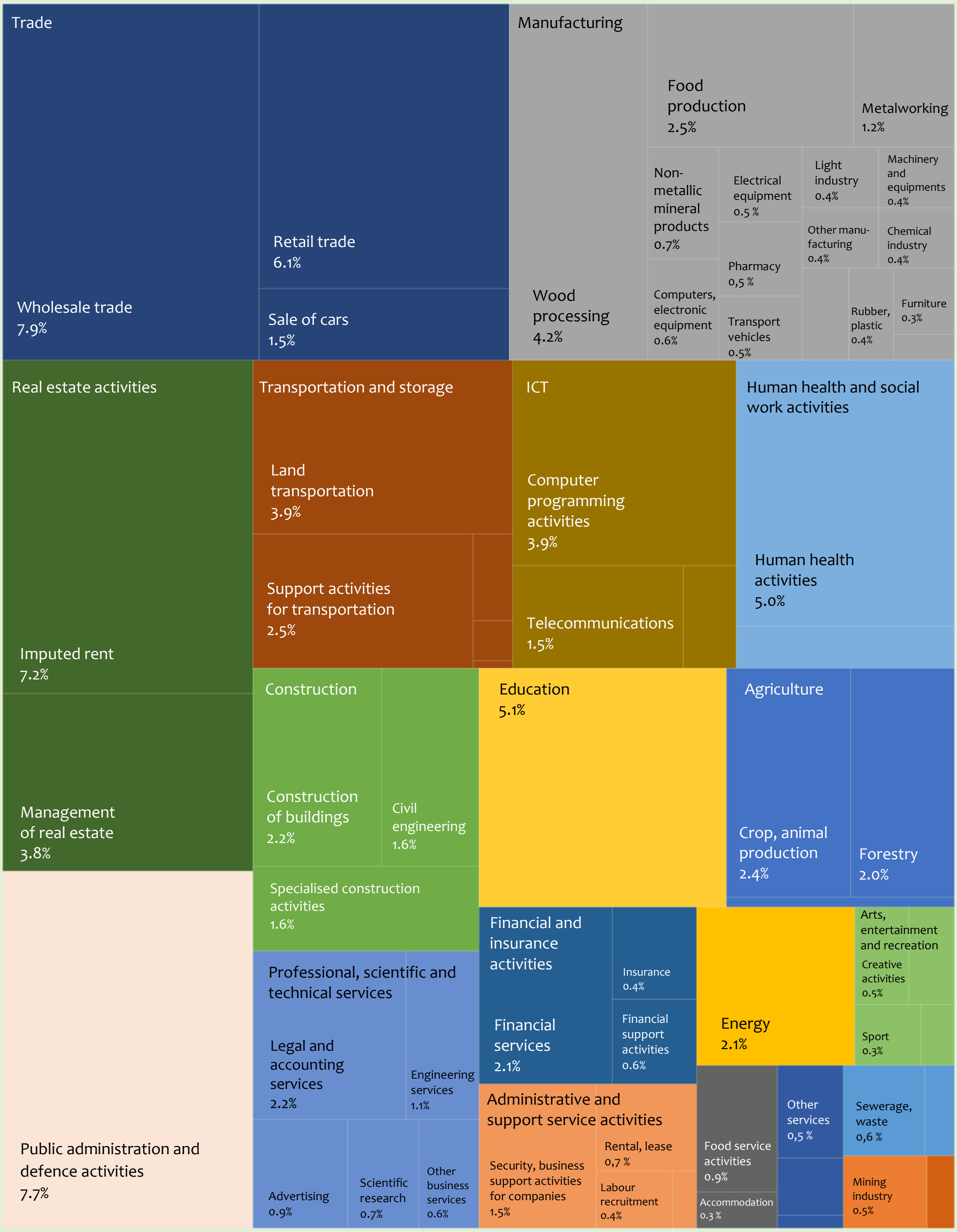
The acceleration of growth in 2017-2018 was fostered by the improvement of the situation in the external environment, more intensive absorption of EU Structural Funds and increase in employment and wages. Growth during this period was mostly affected by the main export sector – manufacturing, as well as in construction, which recovered from the fall in the previous period. Growth continued also in 2019, but economic growth has become more moderate. The increase in trade and public services had the biggest effect on growth.

The Covid-19 pandemic, which in Latvia started in March 2020, had a significant impact on economic development. Development trends across sectors varied considerably. The biggest decrease in volumes was in transportation and storage, and the drop in volumes in the accommodation and food service activities, arts, entertainment, and recreation, as well as construction, which were affected by the restrictions, also had a tangible impact. Meanwhile, volumes in industry, agriculture, and forestry, and in public services increased.

Sharp growth was observed in the economy in 2021. At beginning of the year, the Covid-19 pandemic continued to affect sectors with high levels of social contact, while sectors more focused on export of goods lived through the second wave of the Covid-19 crisis considerably more successfully. As extensive government and European Union funds support measures were taken and the epidemiological situation improved, economic activity in the most affected sectors gradually recovered. At the same time, there are several sectors that have already significantly exceeded pre-pandemic levels, such as part of manufacturing sub-sectors, health, information, and communication, etc.

Figure 4.1

**Value added structure**
*2021, as per cent**




* MoE assessment

At the beginning of 2022, the Latvian economy continued to recover, however, since the Russian invasion of Ukraine on 24 February 2022, the geopolitical situation and prospects for economic development deteriorated. Energy and food prices have risen significantly, intensifying the inflation pressure at a time when the cost of living around the world had already skyrocketed as the world was recovering from the pandemic. The global economy is also affected by disruptions in raw material supply chains due to the war. In Q1 2022, the consequences of the war were not yet felt in full in Latvia, the development was affected by the low base in early 2021 and the gradual lifting of Covid-19 restrictions. However, in Q2 GDP growth rates decreased year-on-year, while in Q3 a drop of GDP was observed. Overall, in the three quarters 2022, GDP has grown by 2.4%.

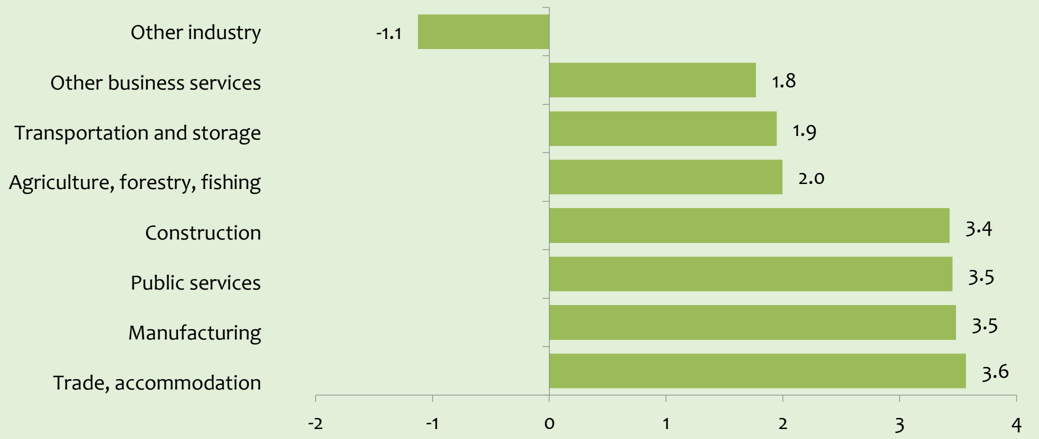
Table 4.2

**Development trends of sectors**
*compared to the corresponding period of the previous year, changes as per cent*

| | 2018 | 2019 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|
| **Gross domestic product** | 4.0 | 2.6 | -2.2 | 4.1 | 2.4 |
| Agriculture, forestry and fishing | -3.6 | 24.7 | 0.7 | -11.7 | 4.3 |
| Mining and quarrying | 9.1 | -5.2 | 8.3 | 5.0 | 2.5 |
| Manufacturing | 7.5 | 3.7 | 2.5 | 7.4 | 3.9 |
| Food industry | -2.9 | -0.7 | -1.7 | 1.3 | 2.0 |
| Light industry | -0.8 | -2.6 | -9.5 | 11.8 | 7.6 |
| Wood processing | 4.5 | 0.0 | 4.5 | 3.7 | -0.7 |
| Paper industry and publishing | -3.7 | 5.7 | 4.7 | 14.0 | 4.6 |
| Chemical industry | 7.0 | 3.9 | -1.8 | 14.8 | 8.7 |
| Manufacture of other non-metallic mineral products | 1.3 | -2.1 | -1.4 | 4.4 | 12.0 |
| Metalworking | 3.6 | 13.5 | -5.6 | 5.8 | 18.3 |
| Manufacture of electrical and optical equipment | 12.1 | 11.3 | 12.1 | 5.7 | -4.0 |
| Manufacture of machinery and equipment | 7.0 | -1.9 | -2.7 | 24.1 | -9.4 |
| Manufacture of transport vehicles | 7.3 | -7.7 | -15.3 | 17.7 | 21.5 |
| Other industries | -1.8 | 2.8 | -14.2 | 11.8 | 2.7 |
| Electricity, gas, steam and air conditioning supply | -38.8 | 2.6 | 27.7 | 3.1 | -15.7 |
| Construction | 12.4 | 1.3 | -7.2 | -9.8 | -12.9 |
| Construction of buildings | 25.6 | 7.8 | 0.9 | -10.5 | -10.7 |
| Civil structures | 11.6 | 1.0 | -1.5 | -5.0 | -14.3 |
| Trade | 3.9 | 6.2 | 1.4 | 8.0 | -4.9 |
| Retail trade | 3.8 | 2.3 | 1.5 | 2.5 | 4.9 |
| Transportation and storage | 3.8 | 3.5 | -20.2 | 9.9 | 1.7 |
| Transport of freight by railway | 12.5 | -15.8 | -42.3 | -9.5 | 8.4 |
| Freights transhipped in ports | 6.9 | -5.7 | -27.9 | -7.2 | 16.0 |
| Transport of freight by road | 12.8 | -3.8 | 2.6 | 7.8 | -1.8 |
| Accommodation and food service activities | 7.6 | -3.9 | -33.7 | -4.6 | 56.7 |
| Information and communication | 9.6 | 4.4 | 1.1 | 7.2 | 13.1 |
| Financial and insurance activities | -2.4 | -12.1 | -0.5 | 18.8 | 0.7 |
| Real estate activities | 2.3 | -3.6 | -1.1 | -1.7 | 1.4 |
| Other business services | 2.7 | 0.4 | 0.8 | 1.4 | 14.9 |
| Public administration and defence; compulsory social security | 2.7 | 3.4 | 2.8 | 2.8 | 1.9 |
| Education | 3.1 | 2.8 | 2.7 | 3.1 | 3.0 |
| Human health and social work activities | 9.3 | 9.6 | 4.3 | 25.2 | 3.3 |
| Arts, entertainment and recreation | 6.1 | 2.8 | -30.2 | -3.3 | 29.3 |

Figure 4.2

**Change in value added**
*2011–2021, annual average, as per cent*



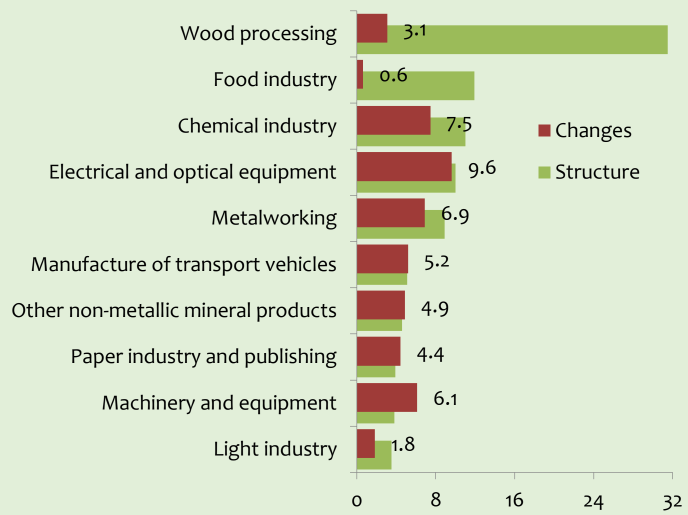

## 4.2. MANUFACTURING

Manufacturing contributes significantly to total economic growth. Manufacturing has been growing stably every year since 2015.

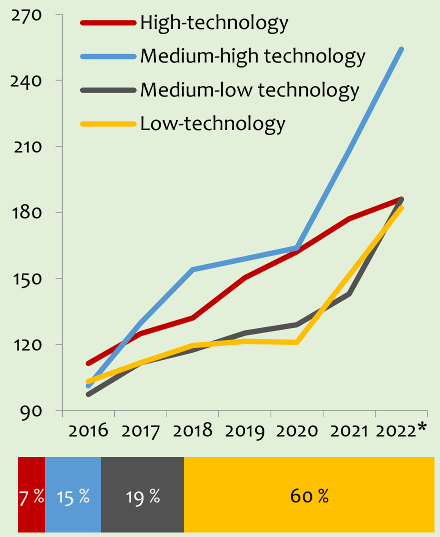
Wood processing, manufacture of basic metals, and manufacture of computer, electronic and optical products had the greatest positive contribution to the growth of manufacturing in 2015-2016. However, in 2015 manufacturing volumes of the food industry shrank, mostly because of the sanctions imposed by Russia on imports of certain food products.

Figure 4.3

**Growth of manufacturing since 2015**
*2022 in comparison with 2015*, annual average; structure in 2022*, changes as per cent*




**Manufacturing volumes index and structure by technology levels**
*2005 = 100, structure in 2022*, as per cent*




* estimation of MoE

2017, when production volumes increased by 8%, was one of the most successful years in the development of manufacturing. The development of food industry and manufacture of electrical and optical equipment was significant. Manufacturing continued to grow also in 2018 and 2019, yet at a slower rate than a year ago – by 2.7% and 2.1%, respectively. Wood processing, the largest sub-sector of manufacturing, made the largest contribution to total growth of the sector, while metalworking and manufacture of electrical and optical equipment contributed to the development markedly.

Table 4.3

**Structure of manufacturing and development trends of sectors in January-October 2022**
*as per cent*

| | Output structure | Structure of occupied posts* | Share of exports in the sales of the sector | Changes in production volumes |
|---|---|---|---|---|
| **Manufacturing – total** | **100** | **100** | **66.8** | **3.2** |
| Manufacture of food and beverages | 18.9 | 18.7 | 42.5 | 1.8 |
| Light industry | 2.8 | 7.9 | 85.3 | 5.9 |
| Wood processing | 30.7 | 20.4 | 68.1 | -0.9 |
| Paper industry and publishing | 3.7 | 4.5 | 70.1 | 3.1 |
| Chemical industry and related industries | 9.3 | 7.6 | 75.3 | 7.2 |
| Manufacture of other non-metallic mineral products | 5.8 | 5.3 | 53.0 | 10.3 |
| Manufacture of metals and metal articles | 9.3 | 11.1 | 65.3 | 15.2 |
| Manufacture of electrical and optical equipment | 7.6 | 5.7 | 87.5 | -1.3 |
| Manufacture of machinery and equipment | 2.8 | 3.2 | 91.6 | -9.3 |
| Manufacture of transport vehicles | 3.8 | 3.6 | 93.5 | 21.0 |
| Other manufacturing industries | 5.3 | 12.1 | 73.4 | 2.5 |

* Data on the first half of 2022

Year 2020 was full of challenges for manufacturing, similarly to the economy as a whole. Before the Covid-19 crisis, in January-March 2020, manufacturing volumes decreased by 3.6% – mainly in due to the drop in volumes in wood processing and the chemical industry and the base effect. In April-May 2020, as the Covid-19 crisis hit, manufacturing volumes declined by 10.4%, which mainly provided for a reduction in the sector's annual volumes over the year. Meanwhile, in the second half of the year increasingly more sub-sectors showed positive growth, and manufacturing volumes in this year were only 0.9% lower than the year before.

In 2021, manufacturing developed dynamically. It can partially be attributed to the base effect. In Q1 of 2021, manufacturing volumes increased more moderately In Q2 of 2021, volumes rose particularly rapidly, reaching a total growth of 7.5% during the year. Increases in manufacturing volumes during this period were observed in all main manufacturing sub-sectors. Similarly, to a year ago, wood processing made the largest contribution to the development of the sector. Volumes of the chemical industry, manufacture of electrical and optical equipment and other sub-sectors also increased significantly.

In 2022, growth of manufacturing continued. In the first half of the year, more rapid growth rates were observed fostered by an increase in manufacturing volumes of metalworking and chemical industry. In Q3, production volumes in manufacturing were slightly lower than the year before. Overall, growth of manufacturing in the three quarters of the year was fostered by an increase in production volumes of metalworking, chemical industry, manufacture of vehicles and other non-metallic mineral products.

In recent years, as producer prices have been rising, stable growth was observed also in turnover of manufacturing – both products sold in the domestic market and exported products. Turnover in manufacturing increased particularly rapidly in 2021, fostered by sales of products in the domestic market and exported products.

In 2022, the turnover of manufacturing continues to grow rapidly. In January-October, sales of products increased similarly in the domestic market (22%) and in the export market (by 18.9%). The turnover of woodworking, food industry, chemical industry and metalworking sub-sectors has increased the most.

Every year, as usual, around 2/3 of all products are exported. Over the last five years, the share of exported products has increased by more than 2 percentage points. The sub-sectors with the share of exports in sales above 85% are manufacture of vehicles, manufacture of machinery and appliances, manufacture of electrical and optical equipment and light industry. Traditionally, most of the food industry's products are sold in the domestic market.

About 2/3 of products produced in manufacturing are sold in markets of the EU countries. Sales in markets of other countries increased when the United Kingdom withdrew from the EU in 2020. The share of sales to CIS countries amounts 9%.

The number of occupied posts in manufacturing increased moderately in 2016-2017; however, it decreased in 2019-2020, reflecting changes in production volumes showing a relative increase in productivity.

In 2021, the number of occupied posts in manufacturing increased by 4.5%, representing the largest increase since 2005. This was largely influenced by the rise in the number of occupied posts in wood processing, the chemical industry, and manufacture of vehicles. Meanwhile, a decline in occupied posts is observed in the food industry.

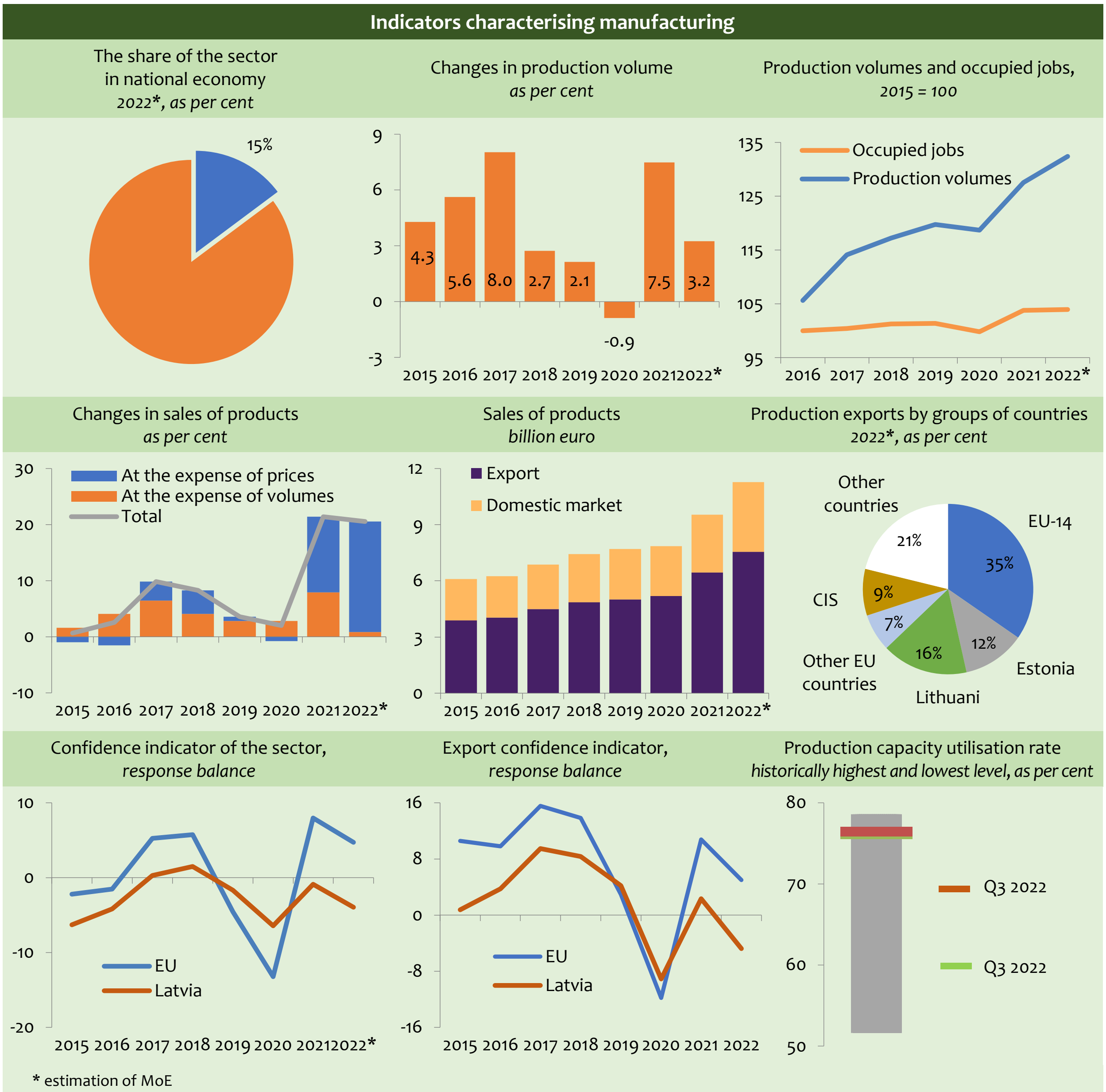
In the first half of 2022, the number of occupied posts was slightly lower than a year before. It is still mainly affected by lower number of jobs in the food industry, while the number of jobs in manufacture of electrical and optical equipment, metalworking and manufacture of vehicles was growing more rapidly.

In recent years, the confidence indicator of manufacturing has been volatile. It slightly improved in 2018, while declining in 2019. Meanwhile, in 2020, confidence in manufacturing had a highly negative trend. Confidence of manufacturers deteriorated particularly rapidly under the influence of the Covid-19 pandemic – in April-June 2020. The decline in confidence was observed in all sub-sectors of the manufacturing industry. The indicator improved in 2021; however, it was still slightly below zero. A similar trend was preserved also in 2022. In September, a lower indicator is observed in the food industry, woodworking and manufacture of paper, as well as printing.

The export confidence indicator was strongly positive until 2018. In 2019, producers looked at export prospects more cautiously; however, still with a positive sign. The opposite trend was observed during the Covid-19 crisis, particularly in Q2 and Q3 2020, as future prospects of exports were assessed as very negative. In 2021, as Covid-19 restrictions reduced, the assessment of export opportunities by entrepreneurs improved considerably, i.e., it was highly positive. Meanwhile, in Q3 2022, the assessment was more cautious – the indicator was highly negative. The vehicles sub-sector and manufacture of electrical and optical equipment, where export opportunities were assessed with a positive sign, were an exception.

Until 2019, production capacity levels in manufacturing have had a growing trend, and in 2019 they exceeded 76%. The adjustments were introduced by the Covid-19 crisis, when manufacturing capacity levels in Q2 2020 decreased to the level of 2012, i.e. 68.1%. After the crisis, this indicator resumed growth exceeding 77% at the end of 2021. In Q3 2022, the capacity utilization rate remained comparatively high – 76.4%.

Figure 4.4


Indicators characterising manufacturing
The share of the sector in national economy
2022*, as per cent
15%
Changes in production volume
as per cent
9
6
3
0
-3
4.3
5.6
8.0
2.7
2.1
-0.9
7.5
3.2
2015 2016 2017 2018 2019 2020 2021 2022*
Production volumes and occupied jobs,
2015 = 100
135
125
115
105
95
Occupied jobs
Production volumes
2016 2017 2018 2019 2020 2021 2022*
Changes in sales of products
as per cent
30
20
10
0
-10
At the expense of prices
At the expense of volumes
Total
2015 2016 2017 2018 2019 2020 2021 2022*
Sales of products
billion euro
12
9
6
3
0
Export
Domestic market
2015 2016 2017 2018 2019 2020 2021 2022*
Production exports by groups of countries
2022*, as per cent
Other countries
EU-14
CIS
Other EU countries
Lithuani
Estonia
21%
35%
9%
7%
16%
12%
Confidence indicator of the sector,
response balance
10
0
-10
-20
EU
Latvia
2015 2016 2017 2018 2019 2020 2021 2022*
Export confidence indicator,
response balance
16
8
0
-8
-16
EU
Latvia
2015 2016 2017 2018 2019 2020 2021 2022
Production capacity utilisation rate
historically highest and lowest level, as per cent
80
70
60
50
Q3 2022
Q3 2022
* estimation of MoE

**Manufacture of food and beverages** is the second largest manufacturing sub-sector in Latvia in terms of both the output and the number of occupied posts. Although it sells most of its products on the domestic market (58%), its export sales have gradually increased in recent years. CIS countries are an important market for the sector's products.

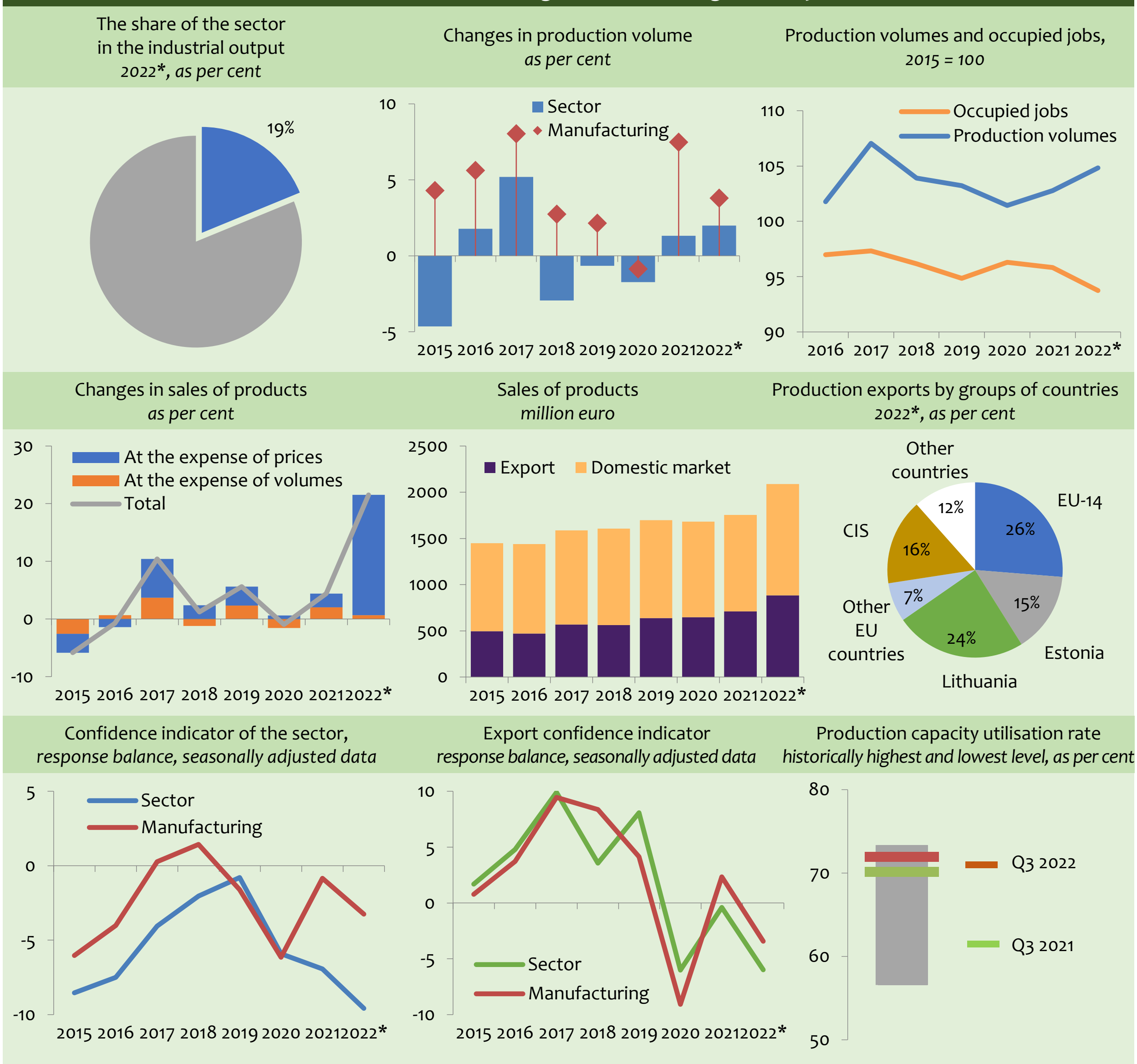
In 2020, manufacture of both food and beverages declined. By contrast, in 2021 and in January-October 2022, production volumes of food slightly declined, while production volumes of beverages were growing stably.

As producer prices of food products increased, in 2021, the turnover of the sector increased as well. Volumes of products sold in the domestic market grew more moderately, while volumes of exported products – more rapidly. In January-October 2022, sales of the sub-sector increased rapidly.

After an increase in 2020, in 2021, the number of occupied posts in the food industry slightly declined. A small drop was also observed in the first half of 2022. Since 2015, the confidence indicator has been clearly negative, it was above the general confidence level of manufacturing only in 2019. Similar trends in industry confidence remain also in 2022. The production capacity utilisation rate in the food industry is slightly lower than in manufacturing on average.

Figure 4.5

**Indicators characterising food and beverage industry**



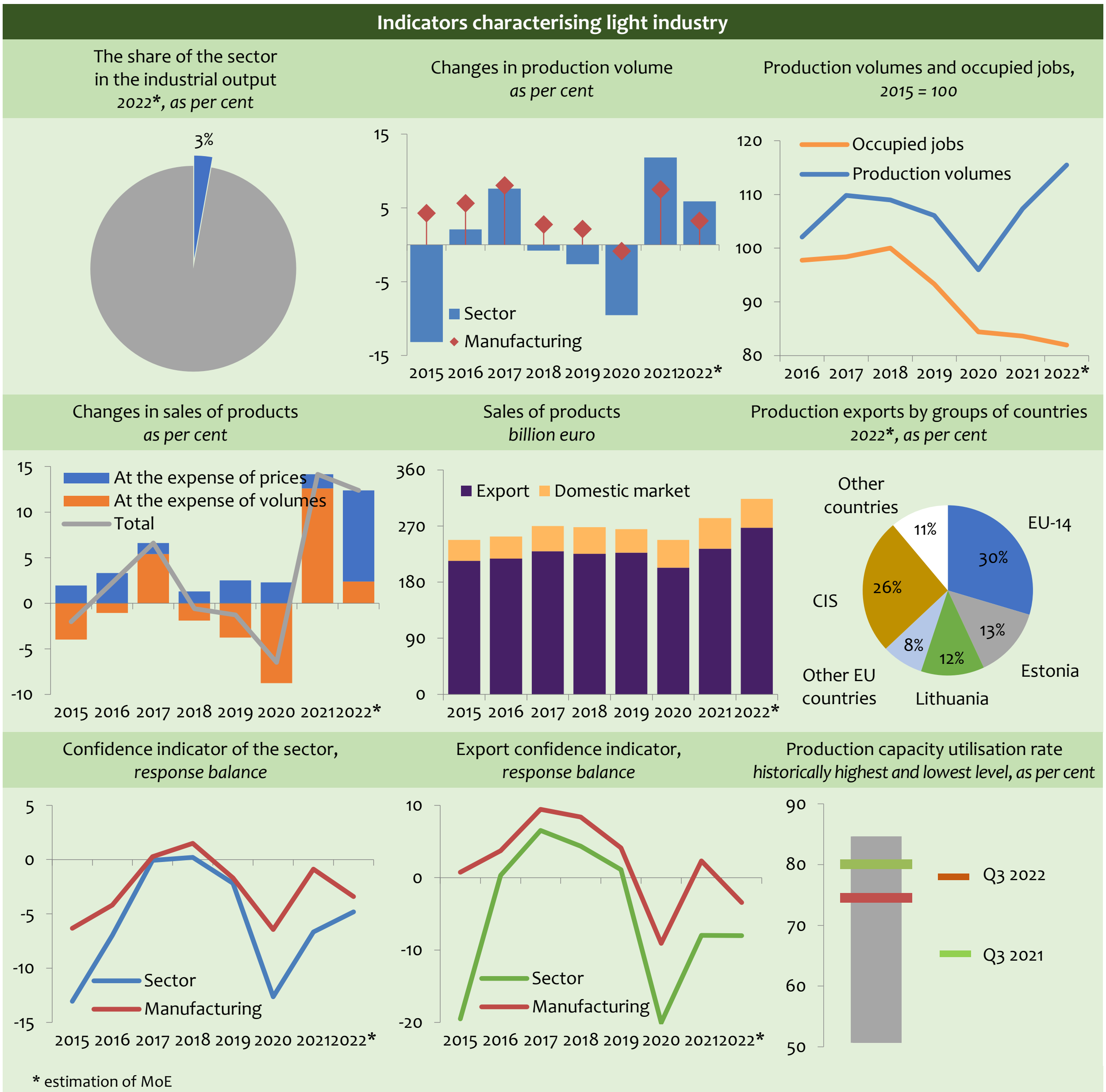

* estimation of MoE

**Light industry** is considerably affected by global trends, and in conditions of the open EU labour market the sector cannot rely on advantages of cheap labour force, for example, like East Asia does. In 2018-2019, production volumes of the sector slightly shrank under the effect of the reduction of volumes of manufacture of wearing apparel. As with other sub-sectors, production volumes in the light industry decreased significantly in 2020; however, the volumes resumed growth in 2021, already exceeding the pre-crisis level of 2019. Highly positive sub-sector development trends remain positive also in 2022.

In 2020, sales volumes of the sub-sector decreased by 6.5%, as sales of exported products declined; however, in 2021 and in January-October 2022, they increased by 14.1% and 10.8%, respectively.

In 2020, the number of occupied posts in the sector declined by 4 thousand; in 2021, it slightly increased, but in the first half of 2022 slightly declined again. The confidence indicator has remained negative over the last three years, yet with a positive trend. Until 2019, the capacity utilisation rate of the sector has been one of the highest in manufacturing, exceeding 80%. In Q3 2022, it slipped slightly below 75%. Taking into account the large share of exports in sales of the sector, its development is closely related to changes in demand and competitiveness in the external markets.

Figure 4.6



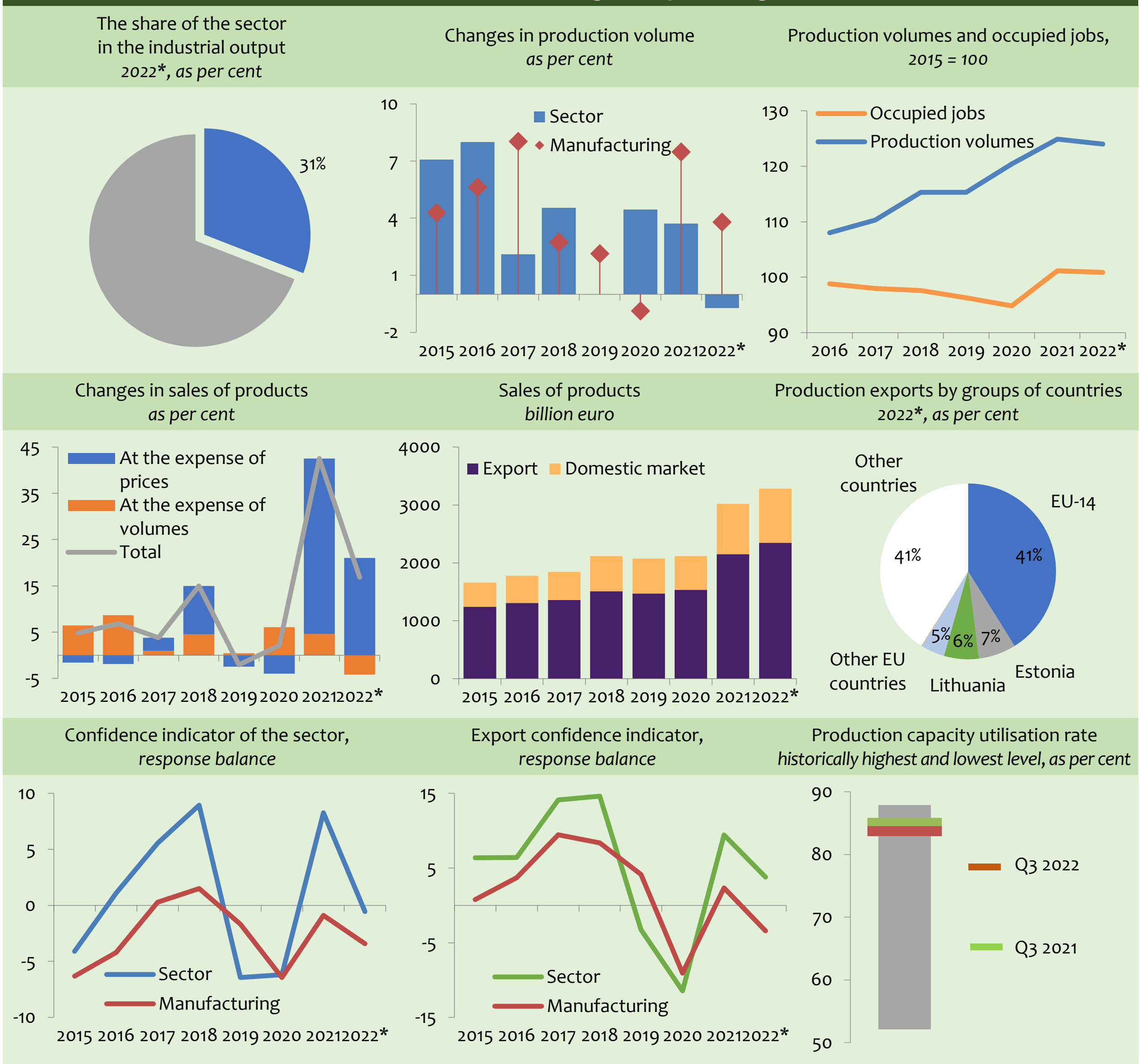
**Wood processing** is the largest manufacturing sector of Latvia. It accounts for more than 30% of the total manufacturing output. Recent years have been successful for woodworking, in particular 2020, when growth of the sector exceeded average manufacturing rates. In January-October 2022, woodworking production volumes were similar to those a year ago.

Woodworking is also mainly export-oriented – in January-October 2022, more than two-thirds of the production of the sector were exported. EU countries have traditionally been the export market of this sector. In 2019, turnover growth rates were significantly slower due to the withdrawal of the United Kingdom from the EU. At the end of 2020, the sector's turnover increased sharply as producer prices were growing. In January-October 2022, the sector's output sales have increased by 16.9%.

The number of occupied posts in the sub-sector declined until 2020 but increased significantly in 2021. However, the number of occupied jobs slightly shrank in the first half of 2022. In 2021, the confidence indicator of the sector was considerably below the average level in manufacturing, but in Q3 2022 it is still highly negative. Future export opportunities of the sub-sector are also evaluated cautiously. Although the sector's capacity utilisation rate is slightly lower than in 2021. However, it remains significantly higher than the average in manufacturing.

Figure 4.7

**Indicators characterising wood processing**




* estimation of MoE

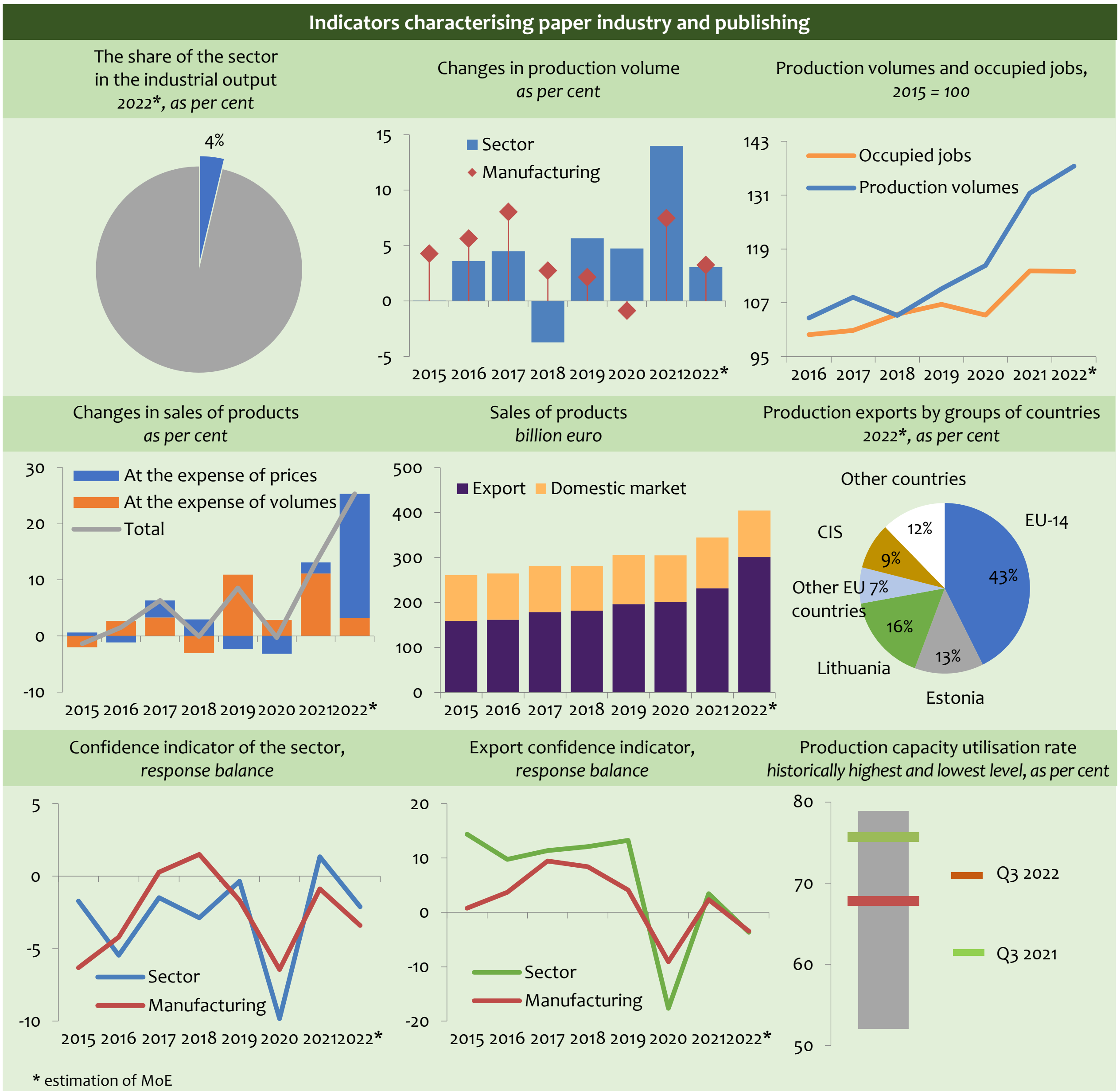
The **paper industry and publishing** are gradually reorienting from the domestic to export markets. In 2021 and in January-October 2022, it exported 67.2% and 70.1 of the production, respectively.

Recently, production volumes in the sector have been growing stably. Also, in 2021 its growth was much more rapid than the average rates in manufacturing. Production volumes continued to grow also in January-October 2022. Printing output is growing more rapidly, while manufacture of articles of paper is declining.

The turnover of the sector has been growing in recent years. Larger growth of sales in the sector was observed in January-October 2022 facilitated by an increase in exported products and products sold on the domestic market. The EU countries are the main outlet for the products of the sector.

After the decline in 2020, the number of occupied posts slightly increased in 2021. However, in the first half of 2022, the number of occupied posts was by slightly lower than a year before. In recent years, the confidence indicator of the sector has been negative, particularly in 2020. In 2021 and at the beginning of 2022, with growth rates in the sector increasing, confidence was positive for the first time since 2007. However, starting from Q2, the confidence indicator has been negative again. In Q3 2022, export opportunities in the sector are evaluated with a minus sign, similarly, to manufacturing in general. The capacity utilisation rate in the paper industry and publishing is slightly below the average level in manufacturing.

Figure 4.8



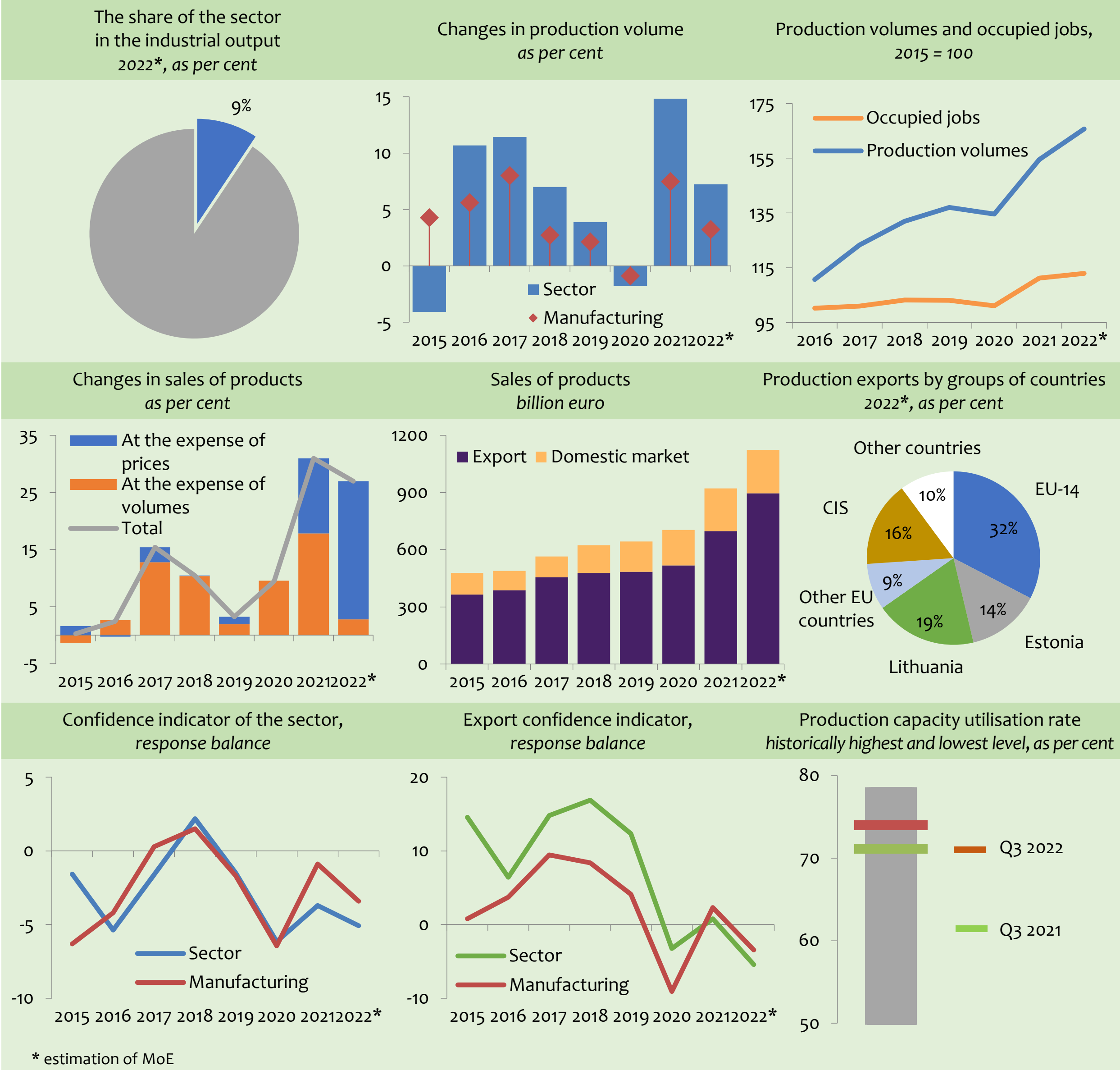
2016-2018 were successful for the **chemical industry**, which can be attributed to the overall improvement of the economic situation in trading partner countries as considerable part of chemical industry products are exported. In 2019, growth rates of the chemical industry slightly slowed down. Following the small decrease in volumes in 2020, rapid growth was observed in 2021 and also in January-October 2022.

Sales volumes of the sector are also growing rapidly. In 2020, when the sector's volumes declined slightly, its sales increased by 9.5%. Noticeable growth of sales in the domestic and export markets continued also in 2021 and January-October 2022.

The number of occupied posts in the chemical industry slightly declined in 2020 but increased in 2021. In the first half of 2022, the number of occupied posts was similar to that a year ago. The confidence of the sub-sector remained negative both in 2021 and in 2022. Export opportunities in 2022 are also evaluated cautiously. In 2022, the capacity utilisation rate of the sub-sector is similar to the average rate in manufacturing.

Figure 4.9

**Indicators characterising chemical industry**



**Manufacture of other non-metallic mineral products** is closely related to the demand of the construction sector. As the demand for products declined, in 2018, growth of the sub-sector became more moderate. In 2019-2020, manufacturing volumes of non-metallic mineral products declined slightly. In 2021, manufacture of other non-metallic mineral products showed slightly slower growth than manufacturing on average, while in January-October 2022 it was one of the most rapidly growing sub-sectors.

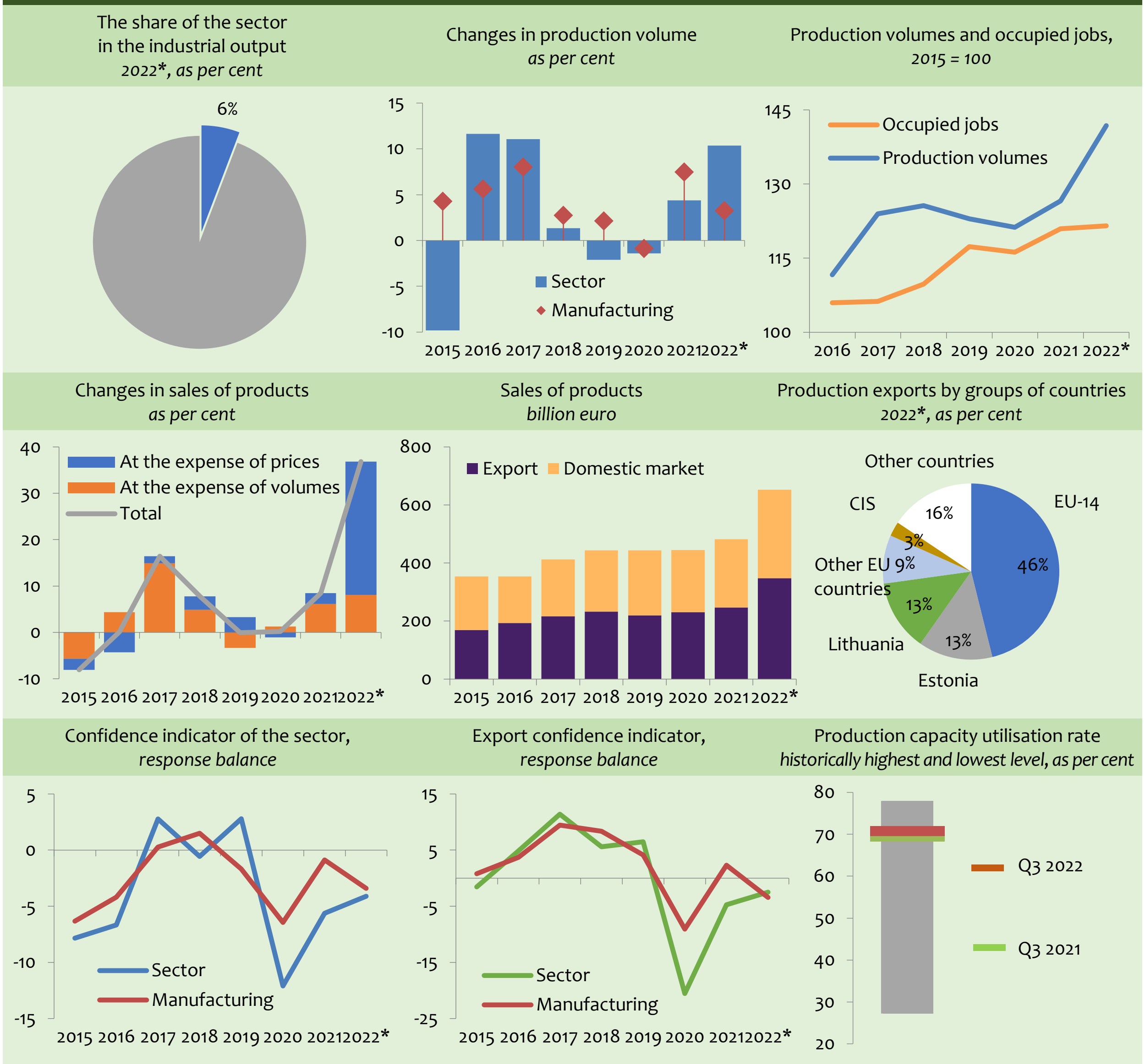
Similarly, to growth in production, sales volumes of other non-metallic mineral products increase as well. In January-October 2022, sales of products in export markets and in the domestic market show good indicators – an increase by 53% and 47%, respectively.

In 2019, the increase in the number of occupied posts in the sector was rather dynamic – by 7%, but in 2020 this indicator slightly declined. In 2021 and in the first half of 2022, minor growth in the number of occupied posts in manufacture of other non-metallic mineral products was observed.

In 2020 and at the beginning of 2021, the confidence indicator of the sector was negative. After a positive sentiment in the second half of 2021, in September 2022, the confidence level approached the general level in the sector. Similar trends are observed in the assessment of export opportunities. Meanwhile, in the last two years, the capacity utilisation rate in the sub-sector has tended to grow.

Figure 4.10

**Indicators characterising manufacture of other non-metallic mineral products**




* estimation of MoE

In recent years, achievements in the **metalworking** sub-sector have been significant in the total growth of manufacturing. In 2021, growth is observed again, following the small decline in production volumes in 2020. In January-October 2022, however, metalworking was one of the most rapidly growing sub-sectors in manufacturing.

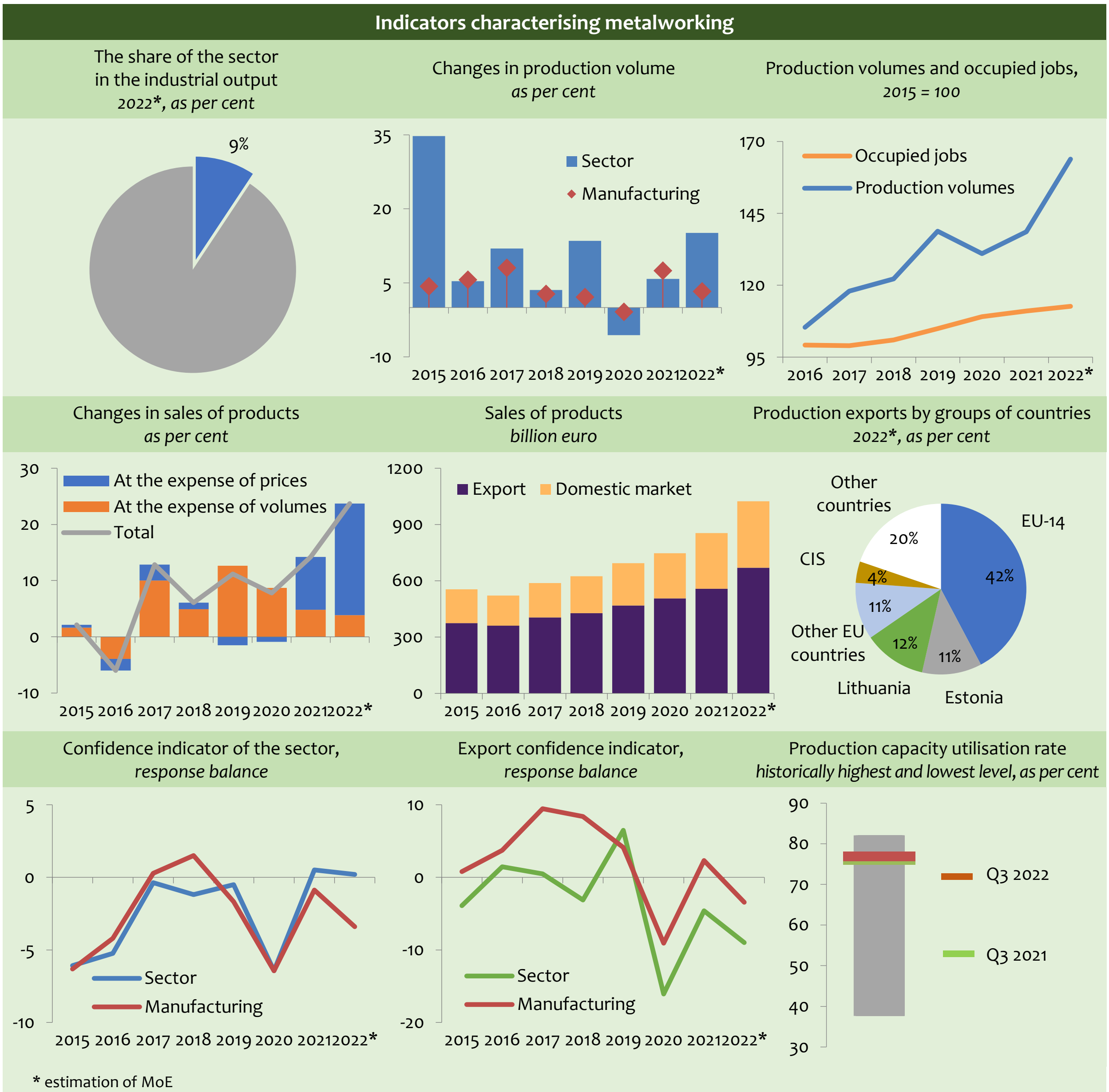
Large part of the products produced by metalworking are exported, which means that manufacture of basic metals and articles thereof is significantly affected also by competitiveness of the EU steel manufacturing sector on the global market, which has not been good in recent years. The EU has traditionally been the main market for the products.

Sales volumes of the sector increase considerably every year. In 2021, volumes of products sold on the domestic market increased more, but in January-October 2022 they increased equally rapidly with export volumes.

Since 2017, the number of occupied posts in metalworking has been growing. In 2020, the increase was more rapid, in 2021 –moderate. The comparatively rapid growth of the number of occupied posts continued also in the first half of 2022.

In the last two years, the confidence indicator of the metalworking sub-sector fluctuated every month, however, it was more often positive than negative. It should be taken into account that confidence of this sub-sector is one of the most positively assessed in manufacturing. In the first half of 2022, future export opportunities are evaluated cautiously. Capacity utilisation in the metalworking sub-sector remains above the average in manufacturing.

Figure 4.11



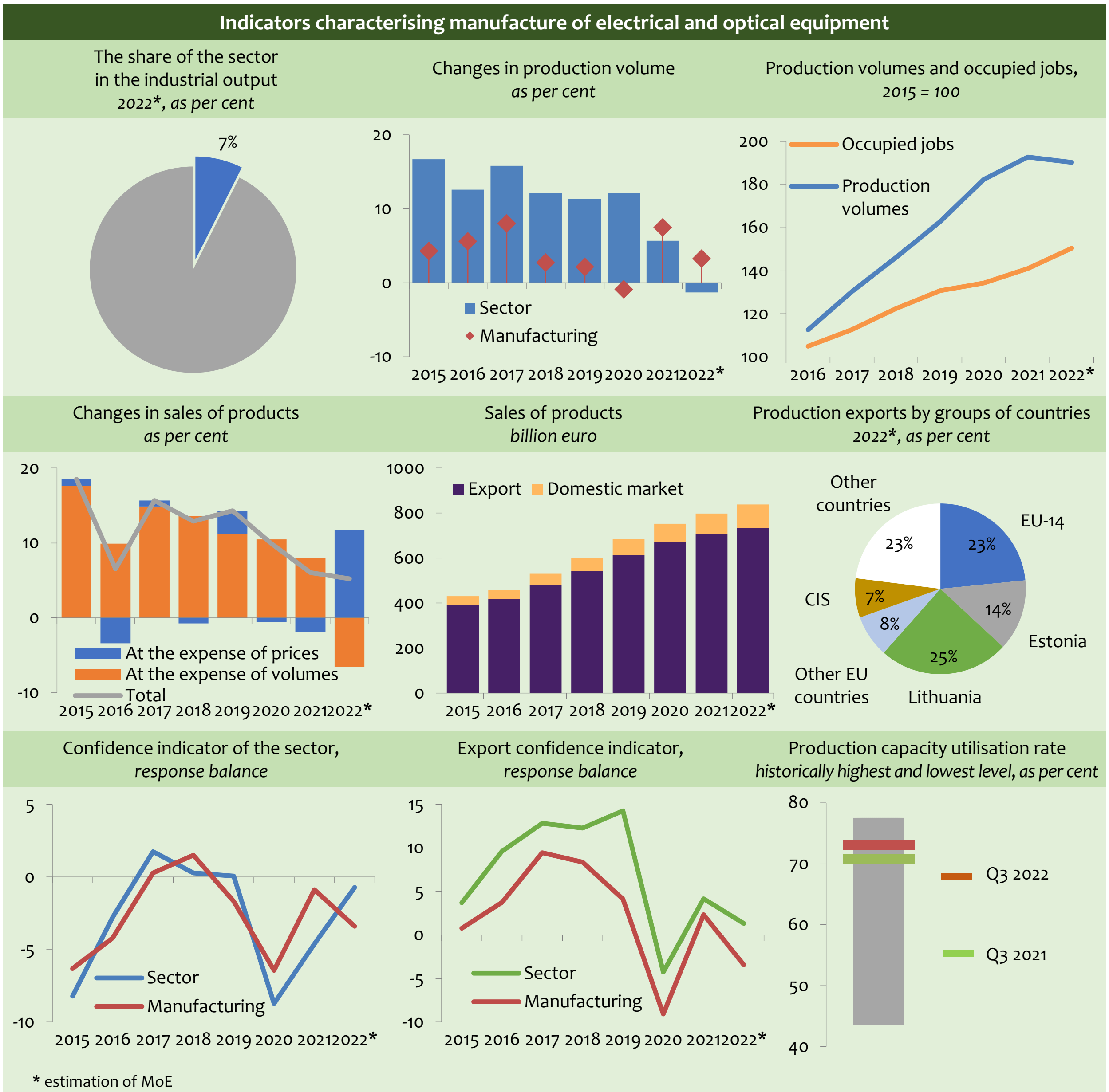
From 2010 to 2020, **manufacture of electrical and optical equipment** was the most rapidly growing manufacturing sub-sector. Every year during this period, its growth rates were considerably higher than in manufacturing on average. In 2021, production volumes of the sector continued to grow, yet slightly slower than in manufacturing on average. By contrast, in January-October 2022 production volumes of the sub-sector lagged behind the level of the previous year.

Although producer prices fluctuate, sales volumes of the sector are growing firmly. The development of the sector is closely related to external demand, almost 90% of the production is exported. In recent years, the increase in sales volumes has been more rapid in the domestic market and moderate in the export market.

Although most of the sector's growth is ensured by a rise in productivity, the increase in the number of occupied posts has also been developing dynamically in recent years. In 2019-2020, the number of occupied posts in the sub-sector was growing more rapidly, but in 2021 – moderately. However, in the first half of 2022, the increase in the number of occupied posts was the highest in manufacturing.

In recent years, the confidence indicator of manufacture of electrical and optical equipment has improved and has been mainly positive. Export opportunities are also evaluated positively. As the output of the sector is growing, the capacity utilisation rate gradually increases.

Figure 4.12



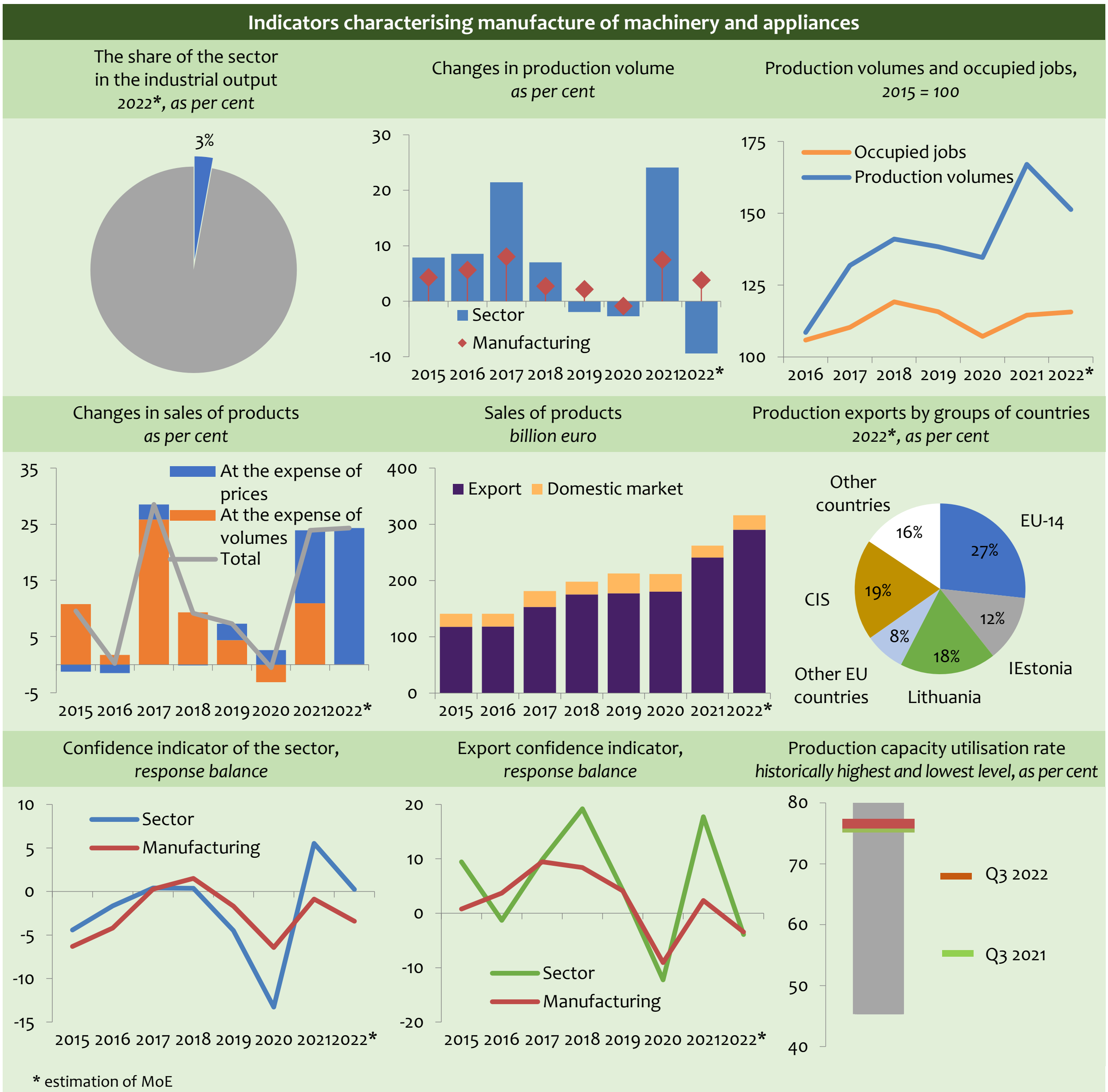
In 2015-2018, growth rates in **manufacture of machinery and equipment** were considerably more dynamic than the average in manufacturing. In 2017, rapid growth was observed. In 2019, as external demand declined under the influence of the Covid-19 crisis, in 2020, growth rates of the sub-sector were negative, but in 2021 they were the highest in manufacturing. By contrast, in January-October 2022 production volumes of the sub-sector lagged behind the level of the previous year, partially attributed to the base effect.

Similarly, to other manufacturing sub-sectors, in recent years, growth in sales volumes of machinery and appliances has been more rapid than output. In 2021, the increase in turnover of all sub-sectors was secured by sales of products in export markets, while the turnover in the domestic market shrank. It should be noted that almost 90% of the production of the sector is exported. In January-October 2022, sales volumes in the domestic and export market were growing equally rapidly.

In the recent years, the number of occupied posts in the sector has been fluctuating. After a minor increase in 2021, it slightly reduced again in the first half of 2022.

In the last two years, confidence of the sector has been evaluated mainly positively. There is a similar sentiment in the assessment of export opportunities. In the last two years, the capacity utilisation rate has been comparatively high, slightly above the average level in manufacturing.

Figure 4.13



**Manufacture of vehicles** is evidently focused on external markets – more than 90% of products of the sector are exported. Since the sector largely depends on new orders, it is characterised by considerable fluctuations in production volumes.

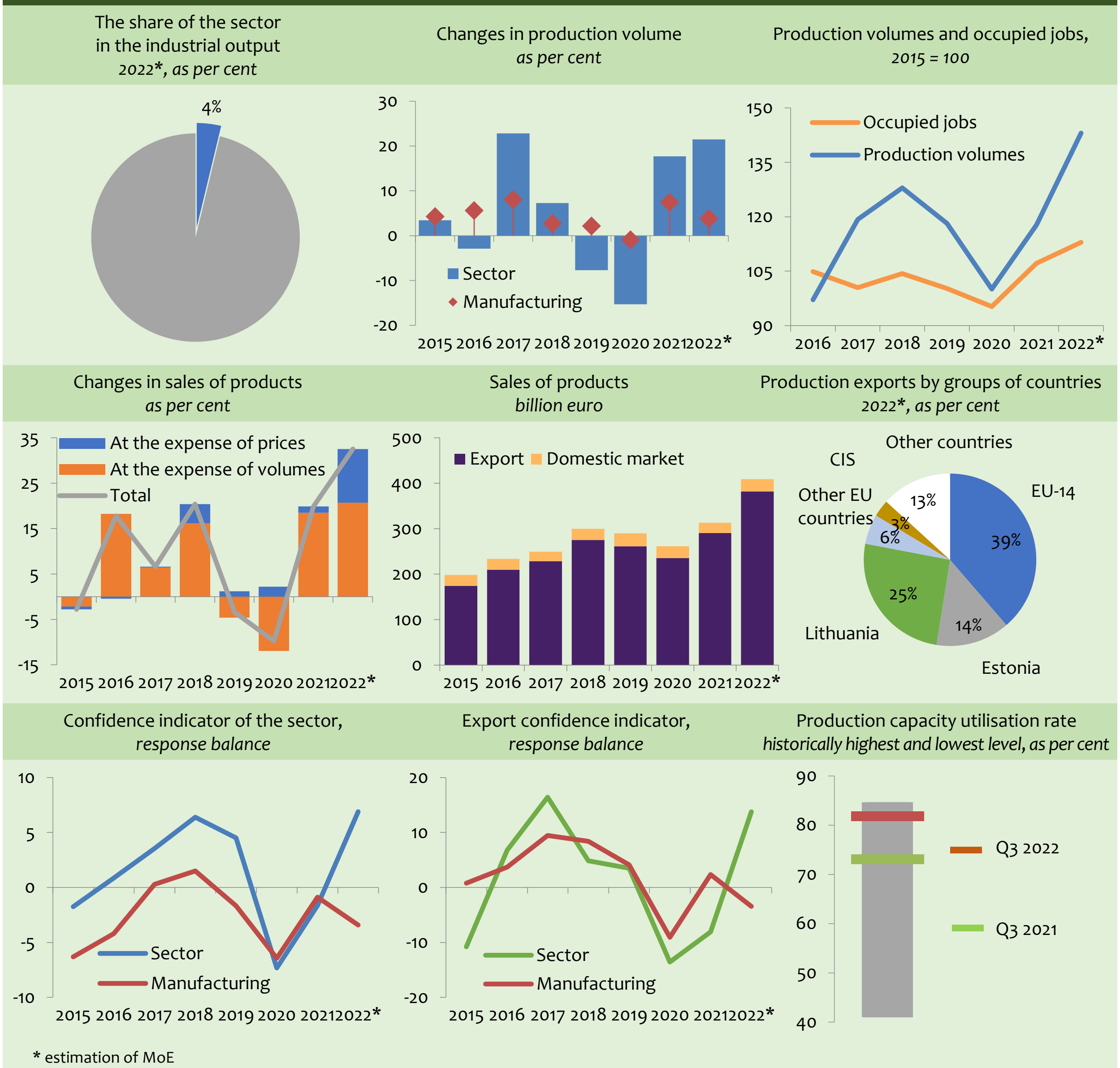
Comparatively rapid growth of the sub-sector was observed in 2017-2018, as external demand increased. It was considerably affected by the increase in production volumes of cars, trailers, and semi-trailers. However, in 2019, production volumes declined. Year 2020 was not successful for the sector. It was affected by the general situation in the European automotive sector, including the Latvian companies, which mainly produce spare parts. Similarly, to other sub-sectors, in 2021, there was a rapid increase in manufacture of vehicles, and in January-October 2022, growth rates of this sub-sector were the most rapid in manufacturing.

In the last two years, sales volumes in manufacture of vehicles have been developing dynamically. It has been mainly secured by an increase in sales volumes in exports.

The number of occupied posts in manufacture of vehicles declined slightly in 2019-2020; nevertheless, in 2021 and in the first half of 2022, it increased. The confidence indicator in 2022 is one of the best in the sector. In recent months, export opportunities have been evaluated cautiously. The capacity utilisation rate in 2022 is also above the average in manufacturing.

Figure 4.14

**Indicators characterising manufacture of transport vehicles**



## 4.3. OTHER INDUSTRY

Electricity and gas supply dominate in the structure of other industry (mining and quarrying; electricity, gas, steam, and air conditioning supply; water supply, sewerage, waste management and remediation activities). After a drop in 2017-2019, the share of other industry in total value added has resumed growth since 2020. The dynamics in production volumes in electricity and gas supply sectors are related to weather, as amounts of electricity and heat produced depend on it.

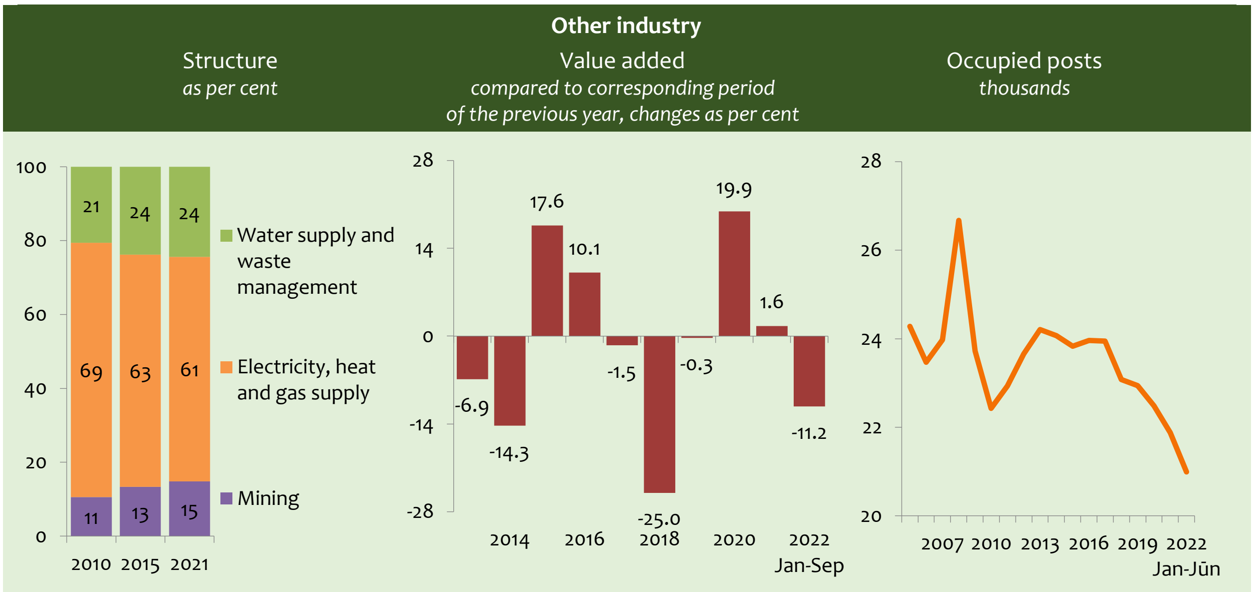
In 2015-2016, after a drop in production volumes in the previous years, a rapid increase was observed in other industry. However, volumes reduced in 2017-2019, in 2018 in particular. The dynamics of volumes in these years were dependent on weather and corresponding amounts of electricity and heat consumed. However, in 2020, other industry experienced a rapid increase in production volumes again, driven by an increase in electricity and natural gas supply, as their consumption increased under the conditions of the Covid-19 pandemic.

In 2021, production volumes in other industry sectors increased very moderately. Due to the cold weather, at the beginning of the year the supply of natural gas and electricity increased, while at the end of the year the amount of electricity produced in cogeneration plants and gas supplies decreased significantly, as consumption decreased due to the rise in energy prices.

In the three quarters of 2022, volumes of other industry sectors showed a sharp decline, compared to the corresponding period of the previous year. Volumes decreased significantly in electricity, gas, steam, and air conditioning supply due to the disruption of natural gas supplies from Russia, moreover, natural gas consumption reduced due to the increase in price. Favourable weather conditions, on the other hand, contributed to the growth of mining and quarrying.

In recent years, the number of occupied posts in mining has been growing, while in other industry it has been declining rapidly.

Figure 4.15

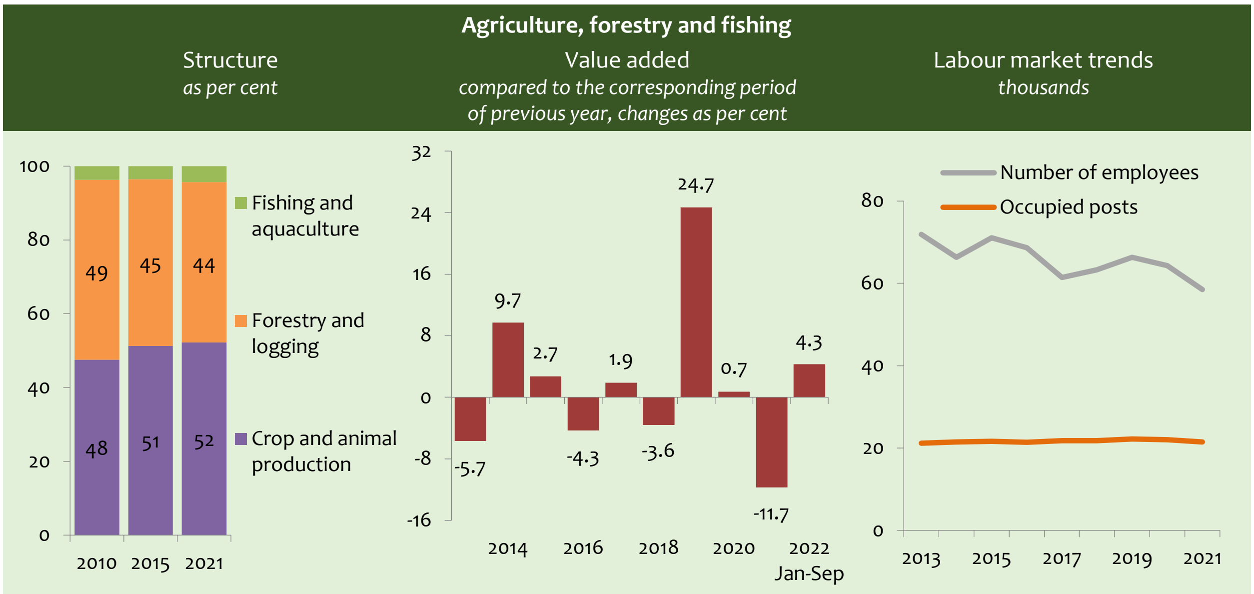



## 4.4. AGRICULTURE, FORESTRY AND FISHING

Agriculture and forestry dominate in the structure of agriculture, forestry, and fishing. The activity of the industry is closely related to weather conditions; therefore, its growth is generally volatile. After the increase in 2017-2020 the share of the sector in the total value added reduced in 2021 due to the decrease in crop production.

In 2014-2015, despite Russia's embargo on food imports, there was rapid growth in agriculture and forestry fostered by good harvest of crops. In 2016 and 2018, the volume of the sector decreased due to a fall in crop production, while in 2017 the sector showed some growth due to a rise in forestry volumes. In 2019, very rapid growth was observed, which was attributed to an increase in crop production – that year Latvia had the highest total crop harvest in its history.

Figure 4.16




In 2020, volumes of the sectors slightly increased. A rapid increase in production volumes was observed in crop production – for the second consecutive year the crop harvest was excellent, while production volumes in forestry reduced rapidly – both volumes of cut wood and forest renewal volumes. In 2020, the timber market in Europe was affected by the consequences of insect infestations, *Brexit,* and the Covid-19 pandemic.

In 2021, a considerable drop in sectors was observed – the highest during one year so far. It was caused by a drastic reduction in production volumes in crop production, mainly attributed to the reduction in the total crop harvest by 14.4% compared to the previous year. Weather in the summer of 2021 had a considerable influence on the entire harvest of agricultural crops, especially the harvest of spring crops, which was the lowest in the last 11 years.

In 2021, animal production volumes increased slightly. The number of farmed live cattle, sheep and goats at farms reduced, while an increase was observed in the number of pigs, horses, and poultry. At the same time, the number of exported livestock compared to the previous year remained unchanged, but the number of exported live pigs declined. In 2021, both volumes of meat, milk and egg production increased.

In view of the rapid increase in global prices of food, in 2021, prices of agricultural products rapidly increased also in Latvia. The average purchase price of grain increased considerably – to 192.88 euro per ton, i.e. by 16.9%. Average purchase prices increased also in animal production; the purchase price of pork was the exception. It reduced by 11.9% reaching the lowest level in the last four years. The largest increase in the purchase price was for mutton and beef. The average purchase price of fresh milk increased to 318.01 euro per ton or by 13.2%, reaching historically the highest price in Latvia.

In 2021, the total volume of production reduced in forestry as well. Volumes of cut wood decreased by 1%, but forest renewal volumes increased by 3%. In 2021, the average purchase price for logs (of both coniferous and deciduous trees) in Latvia continue to grow. The increase in the average purchase price was affected by growing demand for timber, which was mainly related to Covid-19 restriction measures: the population invested more in construction and repair of housing, as travel and recreation opportunities reduced. Total volumes of production also reduced due to supply problems and the rapid increase in energy prices.

In the three quarters of 2022, production volumes increased in all sectors. The most rapid increase was observed in crop production, forestry, and logging, while production volumes in animal production and fishing increased moderately.

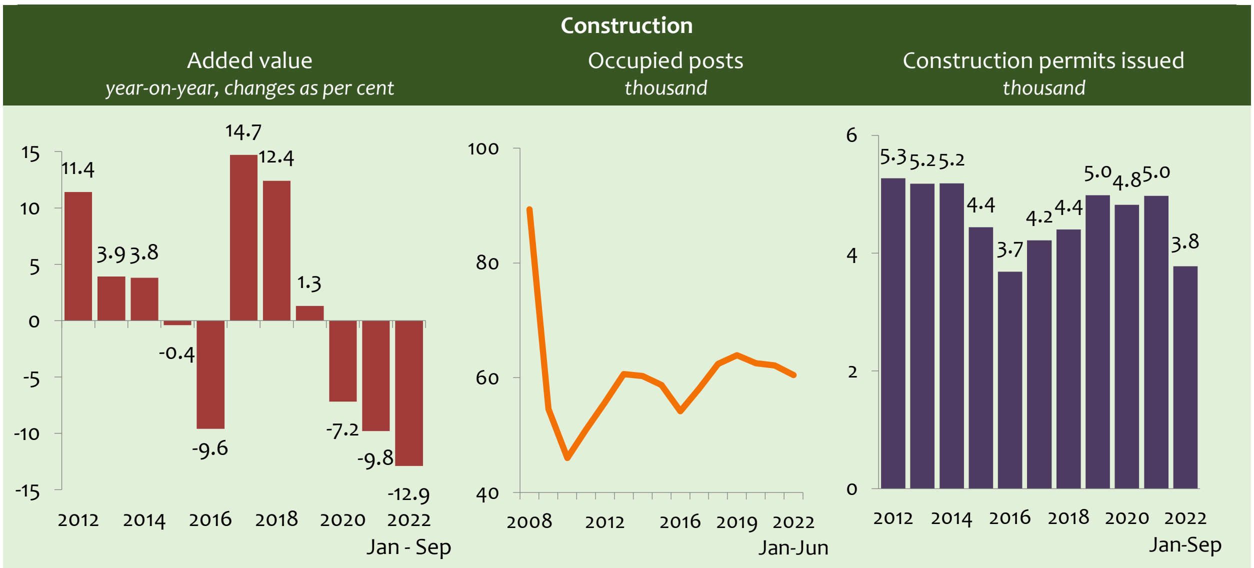
In recent years, the number of the employed and occupied posts has been growing slowly before the pandemic, but in 2020, under the influence of Covid-19, the number of jobs shrank in agriculture and forestry, but increased in fishing. In 2021 and in the first half of 2022, the number of occupied posts reduced in all sectors.

## 4.5. CONSTRUCTION

Growth of construction is largely subject to cyclical fluctuations. In 2000-2007 the sector developed rather rapidly. Signs of overheating have been observed in the last years during the period. The annual average output increased by 14.4% and the average increase in 2006-2007 was even 25.3%. The construction was actively attracting employees in the period before the crisis. In 2005-2007, the number of occupied posts increased by almost 30 thousand reaching 91.7 thousand. Construction costs increased gradually until 2005. In 2006-2008, construction costs virtually exploded, labour costs increased 2.6 times, but costs of maintenance and operation of machinery and mechanisms almost doubled.

Production volumes dramatically declined during the crisis; industry output shrank more than twice in the period from 2008 to 2010. During the economic recession, the number of persons employed in the sector was significantly adjusted and reduced almost twice. The reduction also affected construction costs (mostly labour costs). It should be noted that they remained at a higher level than before the overheating.

Figure 4.17



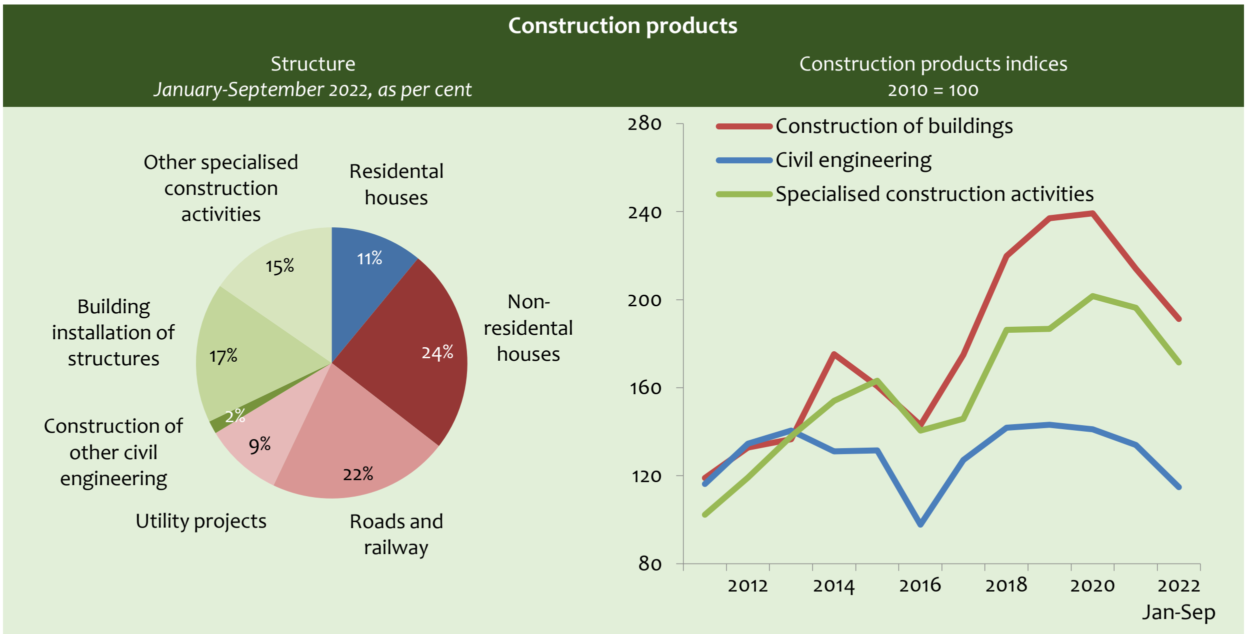

The demand for services of the sector resumed growth in 2011. During the period until 2019, the construction development rates were steeper than economic development rates. Average growth was 7.1% annually. The recovery of the construction sector was largely driven by public procurement and more active absorption of EU structural funds. Along with the increase in internal demand, the development of the sector was positively affected by the ability to reorient to external markets during the crisis. For example, in 2011, the volume of construction products outside Latvia exceeded the indicator of 2008 more than five times. The increase in construction activities also reflected in the increase in the number of granted building permits.

It should be noted that during the transitional period of the EU Structural Funds, construction output decreased by 4.2% annually in 2014-2016 as a result of a reduction in investment in construction. Construction activities shrank in all groups, most rapidly in the group of civil engineering. Negative trends also contributed to the reduction in the number of granted building permits in this period. In the next years since 2017, the sector's development driver was the increase in intensity of implementation of projects of EU structural funds after a transition period, as well as the inflow of private investments for construction of large construction objects.

As economic activity increased, the number of the employed started to evenly increase in 2011. A reduction was observed in 2015 and 2016, when outputs of construction products reduced. In 2019, the number of the employed exceeded 60 thousand and was higher than in 2010; however, increase rates were considerably slower than the increase in outputs. This means that the sector was largely developing at the account of the increase in productivity. Construction costs increased uniformly during this period, with a more rapid increase between 2017 and 2019. Labour costs and costs of maintenance and operation of machinery and mechanisms made the biggest pressure, while the costs materials remained almost unchanged.

The Covid-19 pandemic had a general negative influence on the sector, and in 2020-2021 average development indicators were negative. Unlike other sectors, in 2020, the construction sector was not subject to strict restrictions. Construction production volumes continued to increase, although in some quarters of the year the decline in private investment caused by the economic downturn has led to a downturn. In 2021, however, the sector experienced a bigger drop in demand due to the global rise in construction costs, in particular prices of timber and metal. In 2020-2021, the Covid-19 crisis caused a slight drop in the number of jobs in construction. Although the increase in labour costs had a greater impact during this period, since 2021, the cost of building materials has also had a significant impact on the level of sector's costs.

Figure 4.18




In 2022, recession in the construction sector continues, with negative development indicators in all quarters. In the three quarters of 2022, construction production volumes year-on-year are by 12.5% lower than in the three quarters of 2021. It can be seen that the increase of construction costs is increasingly negatively affecting the dynamics of activities of the sector. Rising prices are hinder both existing construction projects and the commencement of new ones. In the three quarters of 2022, construction output decreased in all sub-groups of construction. The rate of decrease is fairly even in all sub-groups, but the smallest decrease is observed in construction of buildings, while the biggest decrease is in civil engineering.

**Box 4.1**

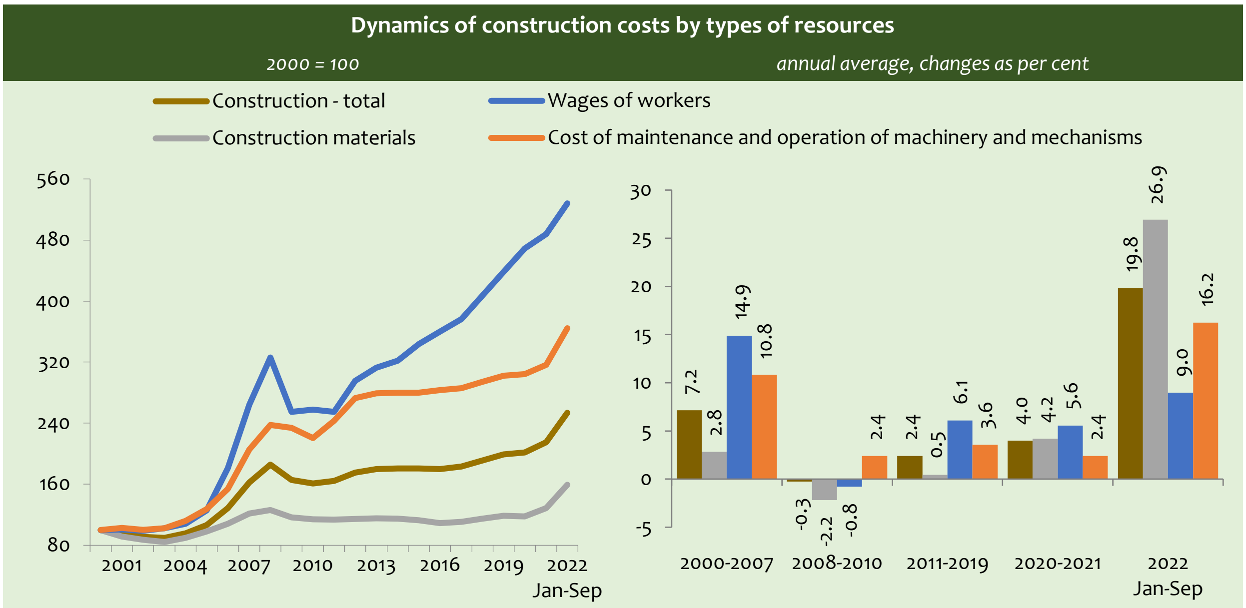
**Circumstances affecting construction costs**

Russia's military aggression had an immediate negative impact on the construction sector – in March 2022, several construction products, and raw materials important to the sector became unavailable.

- Due to both active hostilities and sanctions introduced as a result of them in March 2022, certain groups of construction products became unavailable on the Latvian market. Materials such as steel, wood, concrete, and bitumen, which were historically imported from war-affected countries in large quantities, are the biggest problem. Iron, steel, and their products were mainly imported from Russia, and wood and timber products as well as charcoal – from Belarus and Ukraine.
- A rapid increase in prices is observed in almost all groups of construction products, prices of individual construction products rose several times.
- The increase in fuel and energy prices increased the cost of certain types of construction work. A sharp increase in prices was observed in several groups of construction products.

The decrease in activity also affects demand for labour force – the number of jobs in construction has decreased. The dynamics of construction costs shows that construction materials have become the main driver of the increase in construction costs during this period.

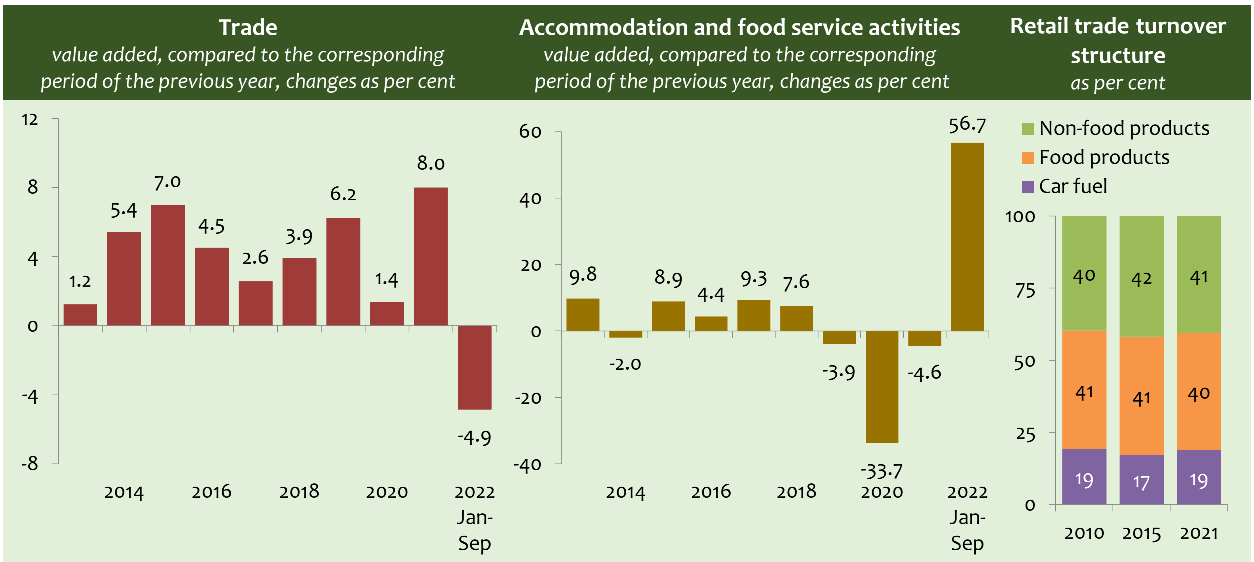
Figure 4.19




## 4.6. TRADE, ACCOMMODATION AND FOOD SERVICE ACTIVITIES

Trade dominates in **trade, accommodation, and food service activities** – about 90%. Volumes of services provided in the sectors have been generally growing rapidly since 2014. The trade sector was positively influenced by an increase in private consumption and retail turnover. Furthermore, accommodation and food service activities were positively affected by the development of the tourism sector.

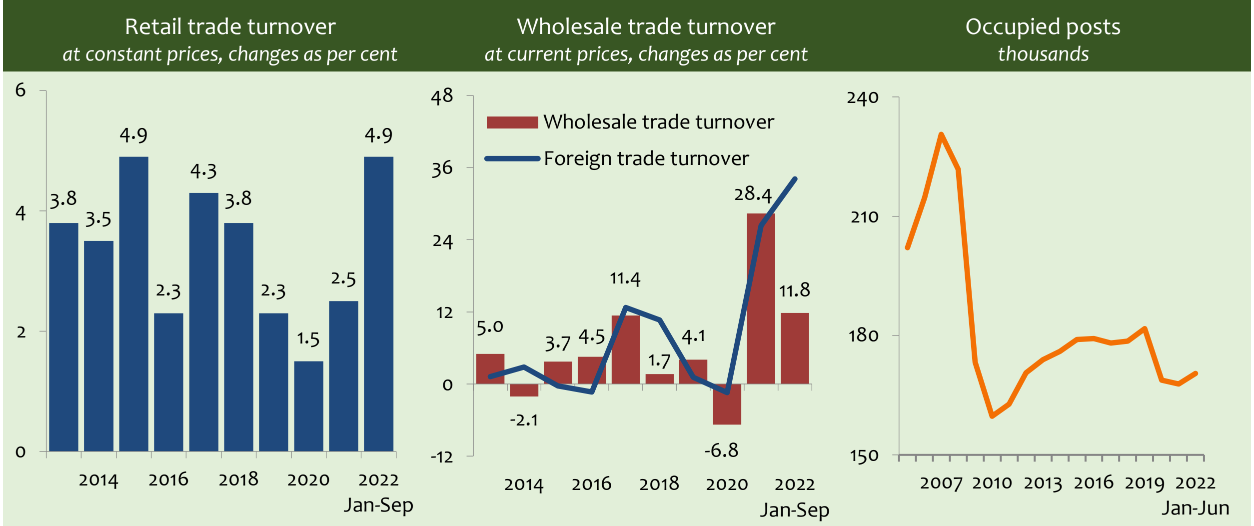
Figure 4.20




Between 2013 and 2019, services in trade increased every year and overall growth was rapid – on average by 4.4% per year. In general, accommodation and food service activities also experienced a sharp increase in volumes in this period – an average annual increase of 4.7%, but in some years, there was a drop in service volumes. The increase in wages and improvements in the labour market ensured growth of retail turnover, which increased by 3.6% per year on average. The dynamics of the total retail trade turnover were mostly affected by the increase in non-food retail trade volumes, the turnover increased sharply for automotive fuel, while retail volumes increased somewhat slower in the group of food products. The dynamics of the retail sector were affected by external trade activities.

Figure 4.21

**Key indicators of the trade sector**




In 2020, the volume of services provided in trade, accommodation and food services activities generally reduced. The trade sector was negatively affected by the decline in private consumption, rising unemployment and falling incomes caused by the Covid-19 crisis. Retail turnover increased very moderately, wholesale turnover shrank rapidly, but the strict virus containment measures had a particularly negative effect on accommodation and food service activities.

In 2021, the volume of services provided in trade, accommodation and food services activities grew rapidly again. The trade sector was positively influenced by the easement of the restrictions caused by the Covid-19 pandemic. It grew by 8% in 2021. The rise in retail trade turnover in 2021 was steeper than in 2020 and grew by 2.5%. Retail trade of non-food products increased by 3.2%, retail trade of fuel by 6%, while trade of food remained almost unchanged. The wholesale trade turnover at current prices grew by 28.4%. In 2021, the volumes of accommodation and food service activities generally shrank by 4.6% due to the sharp decline in Q1.

In 2022, trade was negatively affected by the decrease in turnover of goods with Russian and Belarusian markets due to sanctions imposed in the EU, which resulted in a sharp decrease in wholesale trade volumes (at constant prices). Overall, trade volumes decreased by 4.9%. However, in the three quarters of 2022, retail trade turnover increased very rapidly – by 4.9%, which is explained by the rapid increase at the beginning of the year when Covid-19 containment restrictions were lifted, but from the middle of the year retail trade turnover is growing slower due to high prices. Turnover of non-food retail trade rose the fastest – by 9.3%, turnover of food rose more moderately – by 2.4%, while turnover of fuel decreased by 0.9%. In the three quarters of 2022, growth of accommodation and food service activities was very rapid. Its volume increased by 56.7%, but the recovery of this sector from the deep downturn in the two previous years should be considered.

The largest share of occupied posts is in trade, but it has shrunk in recent years with jobs growing faster in the accommodation and food services activities sector. In 2021, under the influence of Covid-19 the decline in the number of jobs in accommodation and food service activities continued, while an increase was observed in trade. By contrast, in the first half of 2022, the number of jobs increased in accommodation and food service activities and declined in trade.

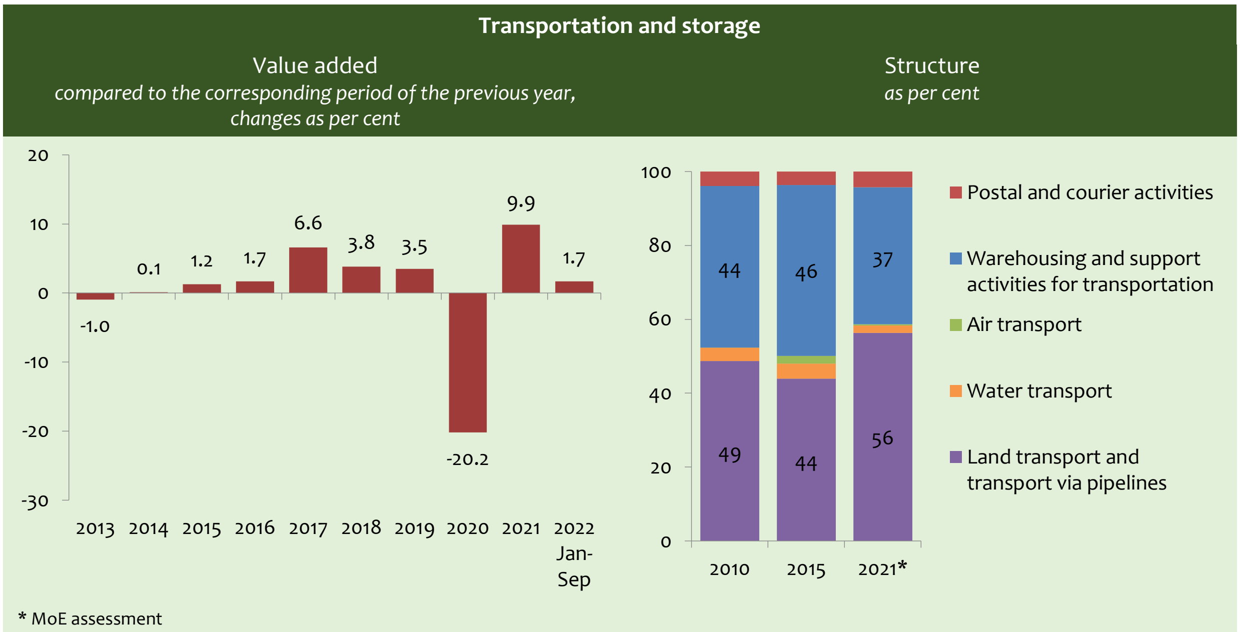
## 4.7. TRANSPORTATION AND STORAGE

**Transportation and storage** are closely related to international transportation, including volumes of freight transported by railway, as well as through ports.

From 2013 to 2016, a small increase was observed – by an average of 0.5% annually. This indicator was still affected by the decline in transit freight transport, mainly due to the Russian transport policy and growing competition. Since the end of

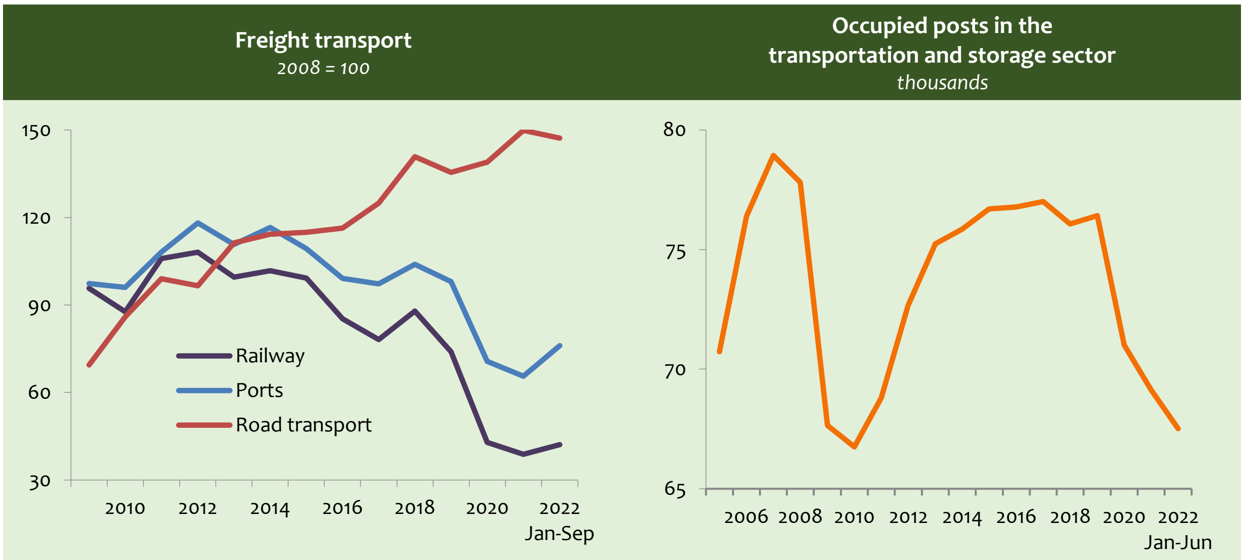
1990s, Russia has been forwarding the goals to develop its own transportation infrastructure to be independent from transit countries. In 2017-2019, increases in sector's volumes were the most rapid – an average of 4.6% annually. Although the volume of transit freights by railway and in ports declined, growth of the sector was fostered by the increase in freight transport by road, as well as the increase in the number of passengers in the airport and seaports. However, in 2020, volumes of the sector reduced sharply due to the movement restrictions caused by the Covid-19 crisis, having a significant impact on aviation, land transport and railway operations.

Figure 4.22




Also, in Q1 2021, the sector's volumes continued to decline, but as the epidemiological situation improved and the restrictions introduced were removed, in Q2 the sector's volumes increased again. In 2021, overall, the sector's volumes increased by 9.9%, a drop in transported freight volumes was seen in railways and ports, while road freight volumes increased rapidly. An increase was observed in both inland and international freight volumes. In 2021, passenger transport continued to reduce under the influence of Covid-19 – by 46.5% in ports and by 16.6% in inland transport. Although an increase by 17% was observed in air transport, the number of passengers still considerably lagged behind the indicators of 2019 before the Covid-19 crisis.

Figure 4.23



In three quarters of 2022, volumes of the sector continued to increase. A rapid increase in volumes of transported freight was seen in railways and ports, while road freight volumes slightly declined, due to a rapid drop in international freight volumes. In the three quarters of 2022, passenger transport rose noticeably as the flow resumed after Covid-19 restrictions were lifted. In land transport, passenger numbers increased by 24.1%, the increase in ports was 61.5%, while in air transport passenger numbers were almost three times higher compared to the corresponding period of 2021.

The biggest share of occupied posts in transportation and storage is in land transport, transport via pipeline, and support activities for transportation. In 2020, the Covid-19 crisis has led to a decline in the number of occupied posts in all transportation and storage sub-sectors, with the most rapid decline observed in air and water transport. The number of occupied posts also declined in 2021 – in all transportation and storage sectors, except postal and courier activities and air transport. The steepest drop in the number of jobs was in water transport. However, in the first half of 2022, the number of occupied posts declined in all sub-sectors, except air and water transport, which showed a very rapid increase.

## 4.8. BUSINESS SERVICES

Real estate activities dominated in the structure of business services (information and communication, financial and insurance activities, real estate activities, professional, scientific, and technical activities and administrative and support service activities, arts, entertainment, and recreation).

In 2014-2018, volumes of business services increased moderately – by an average of 1.8% annually. They increased in all main business services sectors, with the exception of financial and insurance activities, which was largely attributed to the decline in the volume of non-resident business in Latvia, and the consolidation of banks. In 2019, service sectors volumes declined, driven by a drop in volumes in real estate activities and financial and insurance activities. In 2020, under the influence of the Covid-19 crisis volumes of business services reduced rapidly in all sectors, except professional, scientific, and technical activities. Volumes in arts, entertainment and recreation fell particularly rapidly due to stringent measures to contain the Covid-19 pandemic.

In 2021, volumes of business services rose as they recovered from the Covid-19 crisis. The biggest impact was from the increase in service volumes in financial and insurance activities, as revenue from commissions, financial instrument transactions and insurance activities increased. The increase in information and communication services also had a significant impact. The biggest diminishing effect came from the decrease of volumes of arts, entertainment, and recreation, which was influenced by the decrease in gambling and betting activities and creative and artistic activities.

In the three quarters of 2022, volumes of business services showed a rapid increase, compared to the corresponding period of 2021. Volumes of services increased in all sectors. The biggest impact was from the increase in professional, scientific, and technical activities, administrative and support service activities, information and communication, and arts, entertainment and recreation.

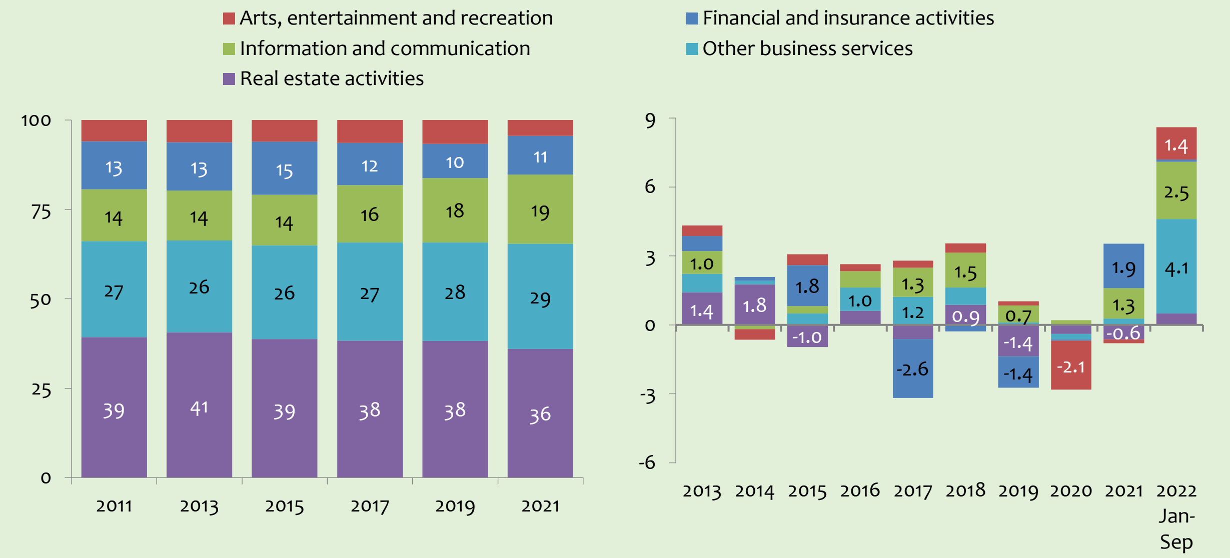
The largest share of occupied posts in business services was in professional, scientific, and technical activities, administrative and support service activities, and information and communication. After the decline in the number of jobs in all sectors in 2020, in 2021, the number of jobs increased only in information and communication and in professional, scientific and technical activities. In the first half of 2022, the number of jobs increased only in financial and insurance activities and administrative and support service activities.

Figure 4.24

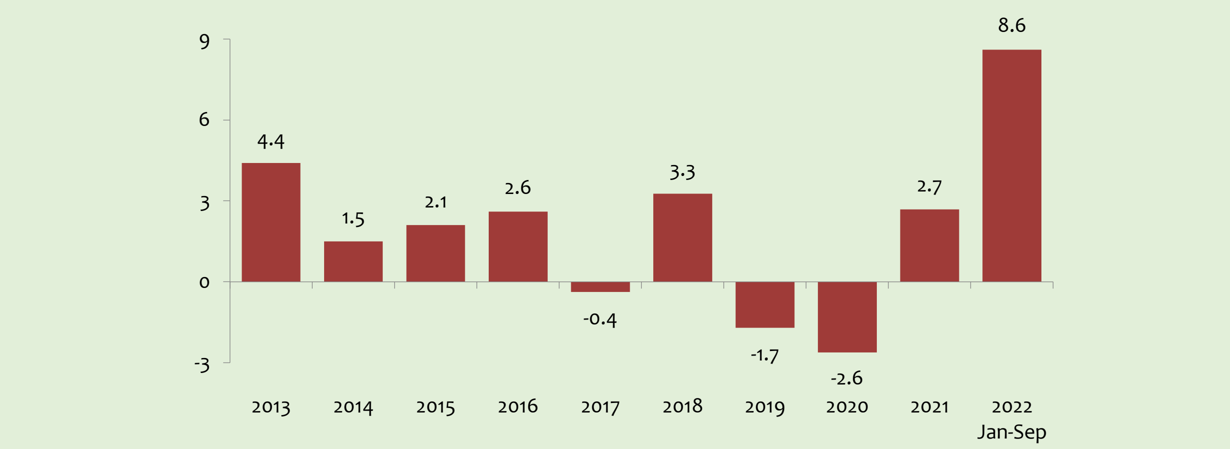
**Business services**

Structure
*as per cent*

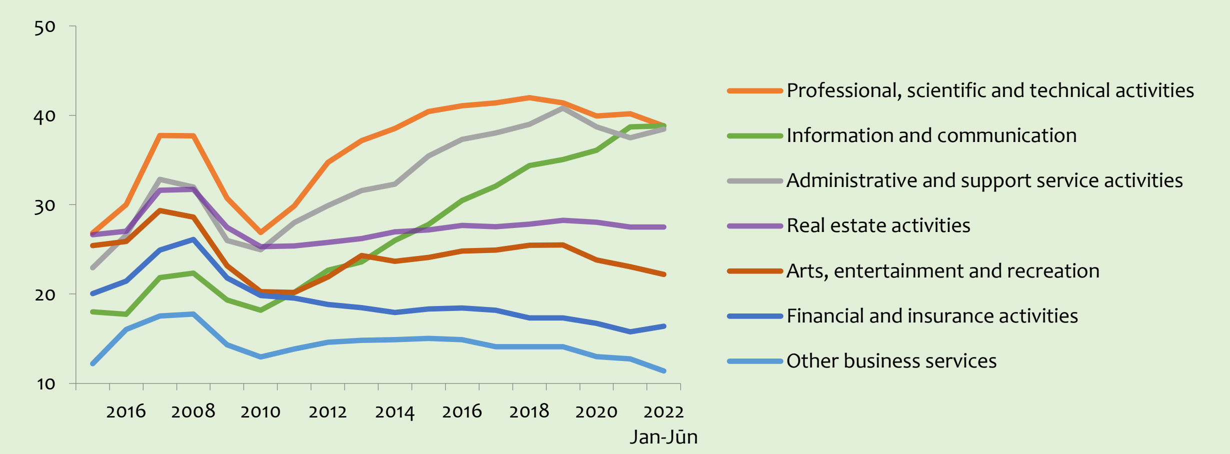
Contribution to growth
*percentage points*




Value added
*compared to the corresponding period of the previous year, changes as per cent*




Occupied posts
*thousands*

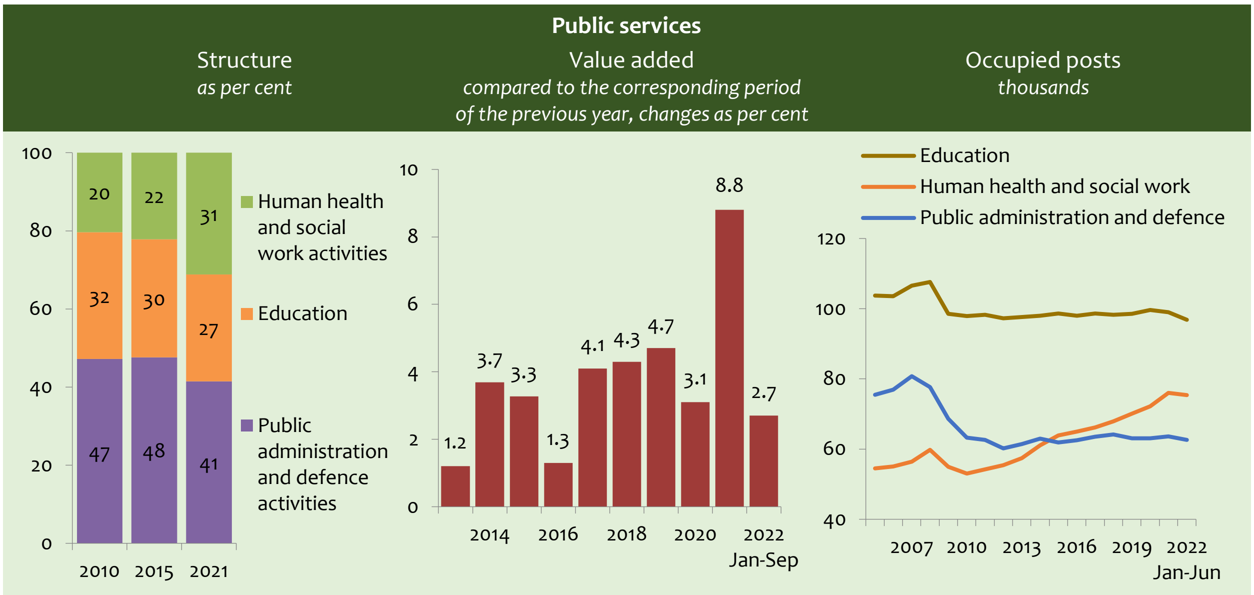


## 4.9. PUBLIC SERVICES

Public administration and defence activities dominate in the structure of **public services** (public administration and defence activities, education, health, and social work activities). With the government expenditure increasing, a steady growth has been observed in the public services sectors since 2014. It was slower in 2016, when only public administration and defence activities had a stable rise in volumes. Overall, in 2014-2020, volumes of public services increased by 3.5% per year on average. The most rapid increase was observed in health and the slowest – in public administration and defence activities.

In 2021, total volumes of services showed a rapid increase caused, like in 2020, by the increase in human health and social work activities (by 25.2%) under the influence of the Covid-19 pandemic. Volumes of public administration and defence activities increased by 2.8%, but volumes of education by 3.1%. Consumption on the increase of defence capabilities of the state, health and education has increased considerably in recent years.

Figure 4.25




In the three quarters of 2022, total volumes of services also continued to increase. Similarly, to the previous years, this process was more rapid in human health and social work activities – by 3.3%, while volumes of public administration and defence activities increased by 1.9%, but volumes of education by 3%.

Education has the highest share of occupied posts, while public administration and health have an equal share. In recent years, the fastest growth of jobs was observed in health. In 2021, a rapid increase in the number of jobs was also observed in health. The number of occupied posts also increased in public administration but reduced in education. In the first half of 2022, the number of jobs reduced in all sectors. Education showed the steepest drop.

# 5. ECONOMIC DEVELOPMENT FORECASTS

## ECONOMIC DEVELOPMENT IN 2023[1]

The geopolitical situation and prospects for economic development have deteriorated due to Russian aggression. Energy and food prices have risen significantly, intensifying the inflation pressure at a time when the cost of living around the world had already skyrocketed as the world was recovering from the Covid-19 pandemic. Struggling with booming inflation, the European Central Bank is raising interest rates, which in turn puts a break on economic growth. Due to the war, the economy is also affected by disruptions in raw material supply chains. Consumer prices growth rates outpace wage growth, negatively impacting the purchasing power of the households. As a result, the high uncertainty and rapid price increases have slowed down the development of the Latvian economy. In 2022, GDP is generally expected to grow by 1% to 2%.

The most difficult situation in the economy is expected in late 2022 and the first months of the next year. Growth could return in mid-2023, but in 2023 GDP will generally remain close to the volumes of 2022 – an increase by only 0.1% provided that the existing geopolitical situation does not deteriorate significantly.

In the first quarters of 2022, private consumption was growing sharply, yet it was largely driven by the base effect and the lifting of the restrictions imposed during the Covid-19 crisis. Meanwhile, the rapid rise in prices, including particularly high energy prices during the heating season 2022/2023, is slowing down the household consumption. Overall, in 2023, in terms of volumes, private consumption is expected to remain at the level of 2022.

The rapid increase in costs in the coming quarters will continue to negatively affect investments in buildings, which make up a large share of investments. Some construction plans are being postponed due to high prices, while construction projects already underway have become much more expensive. In the second half of 2023, public funding could contribute to positive investment trends – the launch of the new programming period of EU funds and the implementation of measures of *Latvia's Recovery and Resilience Facility Plan*. However, overall investment volumes in 2023 could be lower than in 2022.

Despite the problems in global supply chains and rising prices of resources, Latvian producers maintain their competitiveness, and in the second half of 2022, the increase in export volumes remains relatively rapid. Export volumes of goods and services are also forecast to continue to grow in 2023, yet at slower rates than in the previous two years.

In 2022 a sharp rise was in import volumes. This was largely due to the relatively rapid economic growth in the first half of the year, as well as the high uncertainty surrounding Russia's war in Ukraine and sanctions imposed by the EU, which resulted in increased stockpiling of goods by many companies. Given that in 2023 domestic demand will be weak and stockpiling has already reached very high levels, in 2023 import dynamics are forecast to be moderate.

In 2023 development trends across sectors will be very moderate. In the coming months, the situation in the construction sector will remain difficult, as the current increase in prices will continue to affect construction costs, while the geopolitical situation and uncertainty will affect private investments. In the first half of 2023, the downturn in construction will continue due to high costs. The situation in the sector could stabilise in the middle of the year, but overall, a 2.7% drop is expected in 2023, compared to 2022.

In 2023, a slight decrease in volumes is likely to be observed in manufacturing. In the coming quarters, the sector will continue to be affected by the hostilities in Ukraine, resulting in further disruption of the supply chains of raw materials. The competitiveness of companies will be influenced by high prices for raw materials, including energy sources. Businesses linked to the markets of the countries involved in the conflict will face difficulties and will have to keep looking for new supply opportunities and new markets. Domestic market-oriented industry sectors will be influenced by the purchasing power of the households.

The retail trade will also keep being affected by high price levels. The population will spend more on goods of first necessity (food and housing payments), thus postponing the purchase of non-food products, including larger purchases. The negative impact on retail trade turnover will be partly reduced by state support to the population in covering heating costs during the heating season. The slowdown in external trade dynamics will affect the wholesale sector. Overall, in 2023, volumes of services in the trade sector are expected to shrink within 1%.

In 2023, transportation and storage sectors are expected to grow very slightly (by 0.9%). No reason to anticipate significant improvements in transit freight flows can be stated. On the other hand, sector development will be positively affected by the recovery of the aviation sector from the fall caused by the Covid-19 crisis. In 2023, volumes of land transport sector services could be close to the levels of 2022.

[1] The latest forecasts of the IMF and EC were used by the MoE to analyse external markets and evaluate the global economic development trends when making forecasts about the economic development (see Chapter 2).

Relatively better growth rates in 2023 are expected in services sectors. Growth in public services sectors is projected to reach 1.5%. For commercial services, on the other hand, growth of 1.6% is projected for 2023. The rise will mainly be driven by further growth in IT sectors. The accommodation and food service activities, as well as arts, entertainment and recreation, will also have a positive contribution, as they will continue to recover from the impact of the Covid-19 crisis.

## DEVELOPMENT PROSPECTS FOR 2024-2028

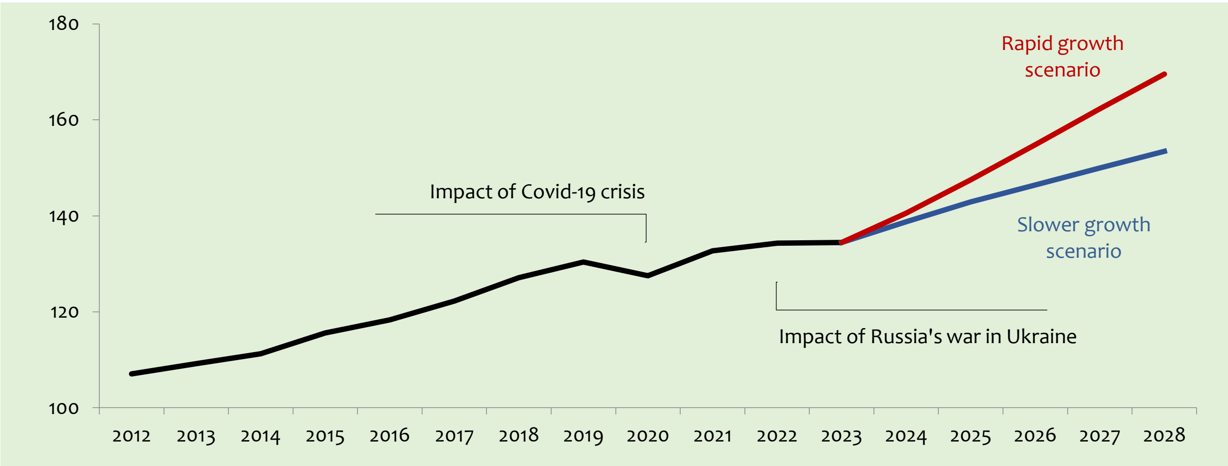
Scenarios of slower and more rapid or target growth are developed for the medium term until 2028. Basic assumptions of the scenarios are based on different trends of global economic development over the medium term, the efficiency of the structural policy implemented by Latvia and the ability successfully overcome the consequences of the Russian war in Ukraine – supply chain restrictions and high inflation, in particular for foods products and energy sources.

The slower growth scenario assumes that the process of economic transformation is slow, and the transition to a higher value-added economy will be gradual. Coping with the shock of high inflation, the economy will return to the average growth rates of the previous decade, which, in the medium term between 2024 and 2028, could reach 2.7% per year. During this period, slightly more rapid growth rates of exports, investments and private consumption are forecast, which may exceed 3% per year.

Figure 5.1

**Forecast of Latvian GDP**

*2011 = 100*




Competitiveness is crucial for more rapid growth of the Latvian economy. However, it is not possible to change the growth trajectory of Latvia without structural changes and increasing productivity. One of the main challenges in the rapid growth scenario is to create new competitive advantages, which is related to investments in human capital, technologies, innovation and research, digitisation. The creation of new competitive advantages is an important condition for the extension of export outlet markets and growth in export volumes, which should become the main growth driver. Latvia's competitiveness in external and domestic markets will depend on its ability to close the productivity gap with the technologically developed countries. The increase in productivity is based not only on technological novelty, improvement of production process management, but also on reallocation of existing resources to produce products with higher value added, i.e. structural transformation of the national economy. In this scenario, from 2024 to 2028 GDP growth rates can on average reach 4.8% annually.

The medium-term scenario of more rapid growth foresees a more rapid increase in investments, which promotes the introduction of the latest technologies, the development of new products and services, the wider use of digital solutions, and the efficiency improvement of processes. In the rapid growth scenario, private investments will also play a vital role stimulating an increase in crediting, the development of the capital market and the use of financial instruments.

Solutions to the labour shortage problem are also the most important factor in ensuring more rapid growth. Investments in human capital are very important. It is critical to provide the growing and productive sectors with the labour force needed for growth, which means reviewing existing adult education programmes and encouraging labour overflows from less productive sectors to productive sectors.

Table 5.1

| Forecast of Latvian GDP by expenditure items *changes as per cent* | | | | | | |
|---|---|---|---|---|---|---|
| | Fact | | | Forecast | | |
| | 2019 | 2020 | 2021 | 2022 | 2023 | 2023-2027 annual average |
| **Gross domestic product** | **2.6** | **-2.2** | **4.1** | **1.2** | **0.1** | **2.7 .. 4.8** |
| Private consumption | 0.2 | -4.6 | 8.2 | 7.1 | 0.0 | 3.0 .. 5.2 |
| Public consumption | 3.9 | 2.4 | 4.4 | 2.0 | 1.8 | 2.2 .. 2.4 |
| Gross fixed capital formation | 6.9 | -2.6 | 2.9 | 0.3 | -0.4 | 3.6 .. 5.5 |
| Export | 2.1 | -0.3 | 5.9 | 9.9 | 1.8 | 3.1 .. 5.6 |
| Import | 3.1 | -0.3 | 15.3 | 10.4 | 1.6 | 3.2 .. 5.4 |

The rapid growth scenario envisages that exports and manufacturing retain a relatively rapid growth rate in the medium term, based on both the increase in competitiveness of Latvian producers and growing external demand. More rapid development is expected in high and medium-high technology sectors. Medium term exports would have to grow faster than the rest of the economy.

Table 5.2

| Forecast of Latvian GDP by sectors *changes as per cent* | | | | | | |
|---|---|---|---|---|---|---|
| | Fact | | | Forecast | | |
| | 2019 | 2020 | 2021 | 2022 | 2023 | 2023-2027 annual average |
| **Gross domestic product** | **2.6** | **-2.2** | **4.1** | **1.2** | **0.1** | **2.7 .. 4.8** |
| Agriculture, forestry | 24.7 | 0.7 | -11.7 | 4.7 | 1.6 | 2.2 .. 3.0 |
| Manufacturing | 3.7 | 2.5 | 7.4 | 2.8 | -1.9 | 2.9 .. 5.4 |
| Other industry | 0.0 | 17.9 | 1.6 | -10.0 | -5.0 | 2.0 .. 3.8 |
| Construction | 1.3 | -7.2 | -9.8 | -17.1 | -2.7 | 3.8 .. 7.2 |
| Trade, accommodation | 5.0 | -2.4 | 7.1 | 1.3 | -1.0 | 2.9 .. 5.4 |
| Transportation and storage | 3.5 | -20.2 | 9.9 | 2.9 | 0.9 | 2.7 .. 5.4 |
| Other business services | -1.7 | -2.6 | 2.9 | 6.7 | 1.6 | 2.8 .. 5.0 |
| Public services | 4.6 | 3.1 | 8.4 | 2.0 | 1.5 | 2.0 .. 2.9 |

In the medium term, rapid growth rates are anticipated in construction. On the one hand, it will be ensured by public investment and the implementation of large investment projects (*Rail Baltica*). On the other hand, growing industries and the need for new industrial buildings will create a demand.

In the target scenario, rapid development is expected in information and communication technology services. This is related to the increasingly growing demand for digitalisation of production and services processes, as well as global ICT sector development trends. The availability of qualified labour force will affect it as well.

# 6. ECONOMIC STABILITY AND COMPETITIVENESS

## 6.1. PRICES

### CONSUMER PRICES

After the deflation caused by the financial crisis, consumer prices started to grow again in 2011. External factors and global price fluctuations for crude oil and food started to affect the total price level increasingly more seriously. Price increases were also driven by internal factors, such as increased excise taxes on fuel, alcoholic beverages and tobacco products, fluctuations in administrative prices and increased private consumption. In 2013-2016, consumer price growth was very moderate, but it was rapid in 2017-2019. In contrast, in 2020, a drop in consumer prices was observed, their level was significantly affected by the decline in demand due to the Covid-19 crisis.

Figure 6.1

**Consumer prices**

Annual average changes
*as per cent*


Changes by months, *as per cent*

| | | *compared to previous month* | *Compared to corresponding month of the previous year* | *Annual average* |
|---|---|---|---|---|
| 2021 | July | 0.4 | 2.8 | 0.6 |
| | August | 0.4 | 3.7 | 0.9 |
| | September | 1.1 | 4.8 | 1.3 |
| | October | 1.1 | 6.0 | 1.9 |
| | November | 1.1 | 7.5 | 2.6 |
| | December | 0.4 | 7.9 | 3.3 |
| 2022 | January | 0.0 | 7.4 | 3.9 |
| | February | 1.6 | 8.7 | 4.7 |
| | March | 3.3 | 11.5 | 5.6 |
| | April | 2.2 | 13.0 | 6.6 |
| | May | 4.0 | 16.9 | 7.8 |
| | June | 2.4 | 19.3 | 9.2 |
| | July | 2.2 | 21.5 | 10.8 |
| | August | 0.4 | 21.5 | 12.3 |
| | September | 1.6 | 22.2 | 13.7 |
| | October | 0.8 | 21.8 | 15.0 |
| | November | 1.1 | 21.8 | 16.2 |

In 2021, a rapid increase in consumer prices was observed, as the economy was recovering from the Covid-19 crisis. Consumer prices increased by 7.9% in December 2021, compared to December 2020, but annual average inflation was 3.3%. Consumption prices increased in all the main groups of goods and services. The rise in energy and food prices had the biggest effect, which was driven by the sharp increase in global prices. It was in turn driven by weaker supplies from major producing countries and a sharp rise in global demand. The rise in prices of services, mainly out-patient, catering, recreational and cultural services, had a significant impact in 2021. Prices of alcoholic beverages and tobacco products increased due to the increase in the excise tax rate. The increase in prices of clothing and footwear has been the most rapid since 1999, which is attributed to the increase in demand due to the easement of measures limiting the spread of Covid-19.

In January-November 2022, prices were rising very rapidly. Consumer prices rose by 21.4% in November 2022 compared to December 2021, showing the steepest rise since 1994 in January-November. This was underpinned by the increase in global energy and food prices exacerbated by the Russia's invasion of Ukraine and the subsequent sanctions, which caused a deficit of energy, food and raw materials for manufacturing. It should be noted that this has a downstream impact on prices of industrial goods and services. Compared with November of the previous year, consumer prices rose by 21.8%. The average annual inflation in November was 16.2%.

We will focus on the main factors affecting prices in Latvia in 2022.

- The increase in prices of food due to the increase in global prices of these goods had the largest impact on the total increase in prices in January-November 2022. Prices of food and non-alcoholic beverages have increased by 27.6% in the eleventh months increasing the total level of consumer prices by 7 percentage points. Prices of all food products increased with the biggest increasing effect coming from the increase in prices of bread and cereals, milk, cheese, and eggs, as well as meat and meat products. Local changes in food prices are largely determined by global price fluctuations. Since mid-2020, global food prices have been rising rapidly, driven by a sharp rise in import demand, delays in processing and transportation due to the shortage of labour force caused by Covid-19 and rising crude oil prices. The situation was worsened by Russia's invasion of Ukraine in February, raising concerns about future global food supplies, as both Ukraine and Russia are important suppliers of agricultural products. In the first months of the year, global food prices rose sharply, with the food price index hitting a new all-time high in March. In January-November, the most rapid price increase was recorded for cereals and dairy products, more moderate for meat, while the prices of vegetable oils and sugar decreased. Global food prices have been gradually decreasing since April, so their overall growth in January-November was very moderate – by 1.5%. However, due to the rapid rise of previous years, prices still remained high. The price drop since April was driven by weak demand and a strong US dollar, as well as uncertainty in the market about the future direction of demand due to sharp inflation and an economic slowdown. In November 2022, compared to December 2019, global food prices increased by 34.3%. The increase in prices of food in Latvia during this period was 38.3%.
- The overall price level increased by 6.4 percentage points due to the rise in prices of energy sources related to housing – electricity, gas, solid fuel and heating energy. The support measures introduced by the government to compensate for the rapid increase in energy prices from 1 January to 30 April of this year and from 1 October to 30 April of the following year (for natural gas already from 1 July) were important, partly compensating households for payments for electricity, natural gas and heating energy and thus slowing down even faster price increases in this group of energy sources. The practically constant increase in heating energy prices up to 74.9% had the most significant impact in January-November, which is attributed to the increase in prices of natural gas and wood chips. As prices of wood products used for heating rose rapidly in the market, the increase in prices of solid fuels was significant, reaching 109.3% in January-November with the most rapid rise in April-July. Natural gas tariffs were increased on January 1 and July 1 and in the eleven months the prices of natural gas increased by 133.7% in total. This process was influenced by a sharp rise in natural gas prices on the stock exchange since autumn 2021. In 2022, prices continued to rise, largely due to Russia's invasion of Ukraine and subsequent sanctions, when several countries terminated or restricted Russian gas imports. Gas supplies were also terminated at Russia's initiative. The price increase for electricity – by 20.4% in eleven months – had a smaller impact. This indicator was significantly affected by the state support, both by compensating payments for distribution and transmission services at the beginning of the year, by cancelling the mandatory procurement component (MPC) from September 1, and partly by compensating the price for households for the first 100 kWh from October 1. In May-August, the price of electricity increased very rapidly in response to the increase of global natural gas prices, the unfavourable weather conditions for electricity production in Europe and the capacity restrictions of cross sections of the electricity transmission system between Latvia and other connection countries. This combination of circumstances led to a sharp increase in electricity prices on the stock exchange. Price increases were also influenced by the increase from September 1 of prices for *Latvenergo* customers using fixed tariff payments.
- Prices of services rose by 10.5%, which increased the overall level of consumer prices by 2.7 percentage points. The biggest impact came from the increase in the prices of catering services and out-patient services, mainly dental and specialised medical services, as well as for recreational and cultural services (including recreational and sporting events, television subscription fees, cinema, theatre, concert visits), housing-related services (water supply, sewerage services, waste removal), as well as maintenance and repair of personal vehicles.
- Fuel prices in Latvia grew by 33.1% in January-November, thus increasing the overall level of consumer prices by 2.2 percentage points. Fuel prices rose particularly sharply in the first half of the year, as following the fall in the last months of the previous year, global growth of crude oil prices in the first months of this year was very rapid. The Brent crude oil price reached 130 US dollars per barrel, mostly influenced by the invasion by Russia, an oil-producing country, of Ukraine and the response of other countries: The US ban on Russian energy imports, the UK's announcement on abandonment of Russian crude oil imports by the end of the year, as well as discussions among EU Member States about imposing an embargo on Russian crude oil imports. Since April, global crude oil prices have fallen, showing an increase only in May and June, while even in mid-September the *Brent* crude oil prices slipped to 82 US dollars per barrel. It was the lowest price since January, mainly due to a strong US dollar and concerns about falling demand for crude oil – it was forecast in relation to a possible economic recession following decisions by central banks to raise interest rates to combat rising inflation, as well as Covid-19 restrictions in China and plans by several countries to market crude oil from

emergency reserves. In October, global oil prices rose again, as OPEC+, the Organization of the Petroleum Exporting Countries, made the decision to drastically cut crude oil extraction from November to curb falling prices caused by fears of falling demand for crude oil. Thus, at the end of October, the *Brent* crude oil price rose to 96 US dollars per barrel. However, after a sharp rise in October, crude oil prices gradually reduced in November and slid to 77 US dollars per barrel in the first weeks of December, the lowest level since December of the previous year. It was sparked by concerns about insufficient demand for crude oil as growth slowed across key economies. Overall, in November 2022, compared to December 2021, global prices of crude oil rose by 21%.

The annual average inflation in 2022 will reach 17.4%. Changes in prices are also expected to exceed the level of seasonal fluctuations in the coming months, as the heating season continues. In 2023, consumer prices will stabilise. The main impact on price changes will continue to be linked to the rise in global prices for energy and food, and their downstream impact on prices of industrial goods and services will be observed. Taking into account the insecure geopolitical situation and the base effect, annual average inflation in 2023 can reach 9.8%, with the increase in 12-month prices by 2% (December on December).

Figure 6.2

**Goods and services with most effect on changes in consumer prices**
*contribution to 11-month changes in November 2022, percentage points*

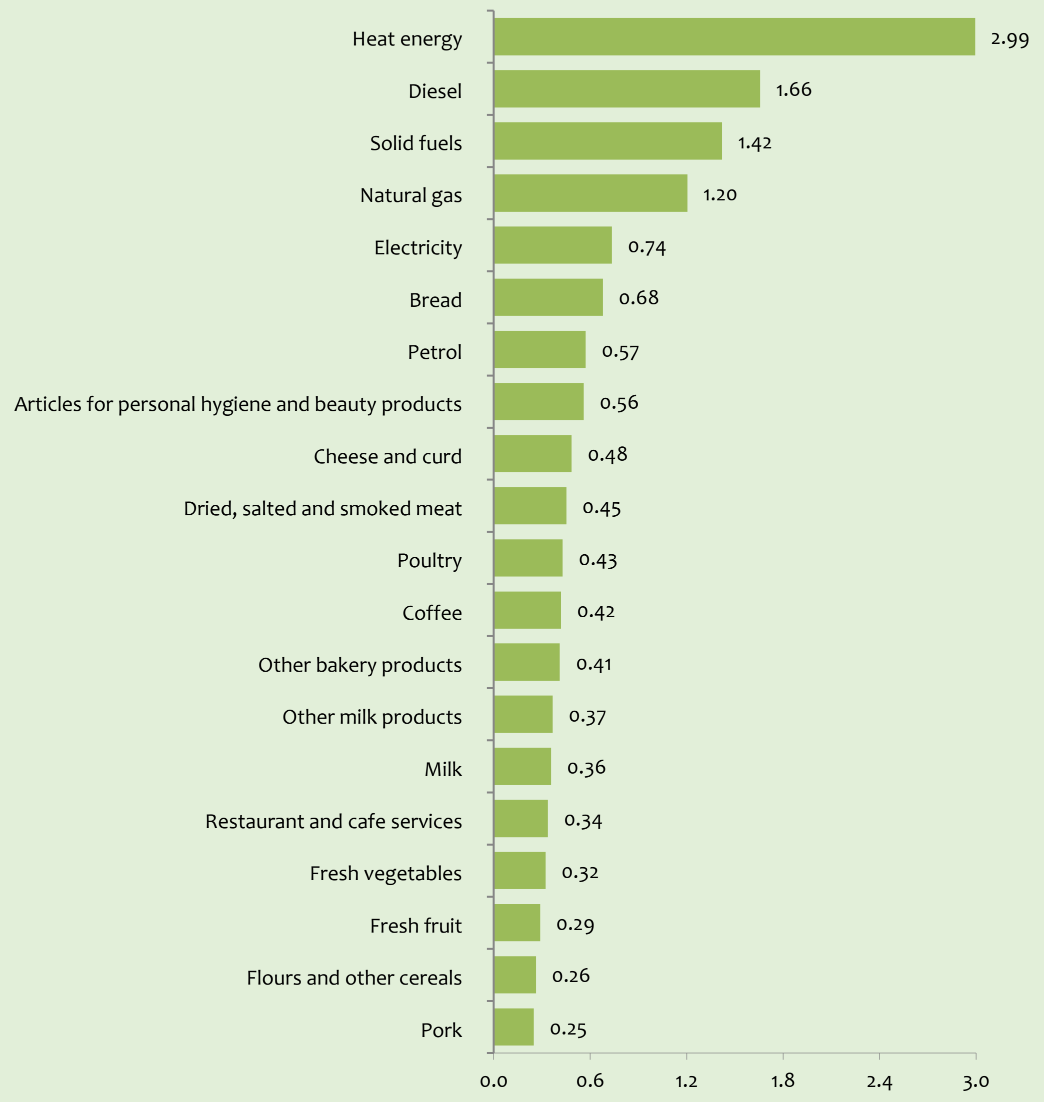


Figure 6.3

**Consumer price index by groups and subgroups**
*by months, December of the previous year = 100*

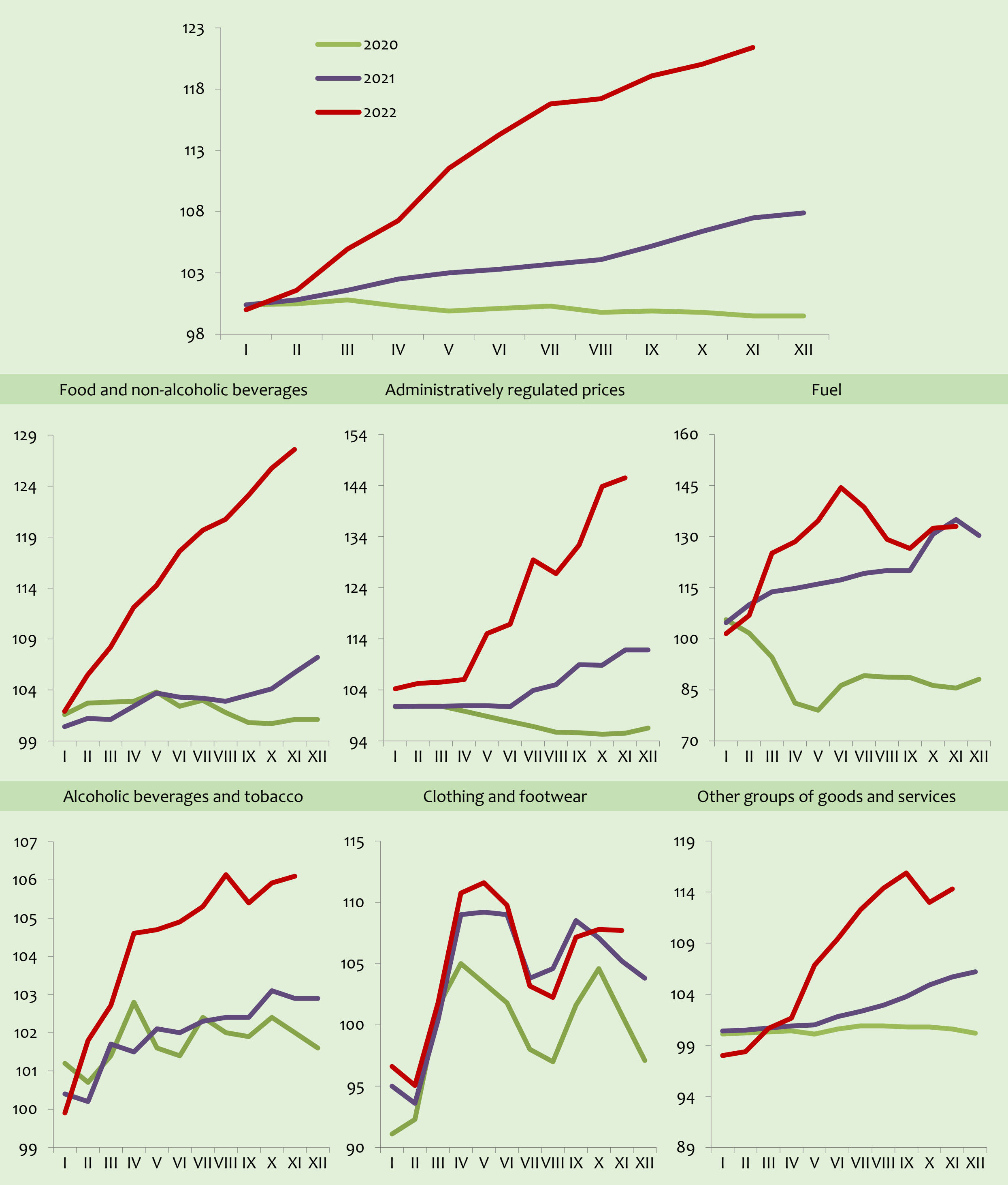
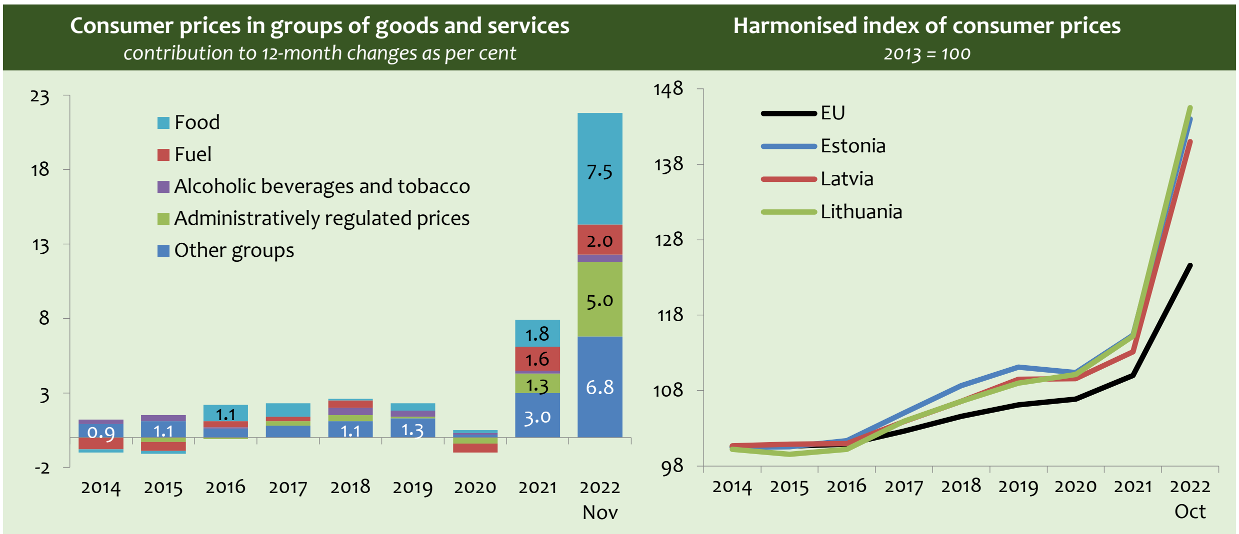


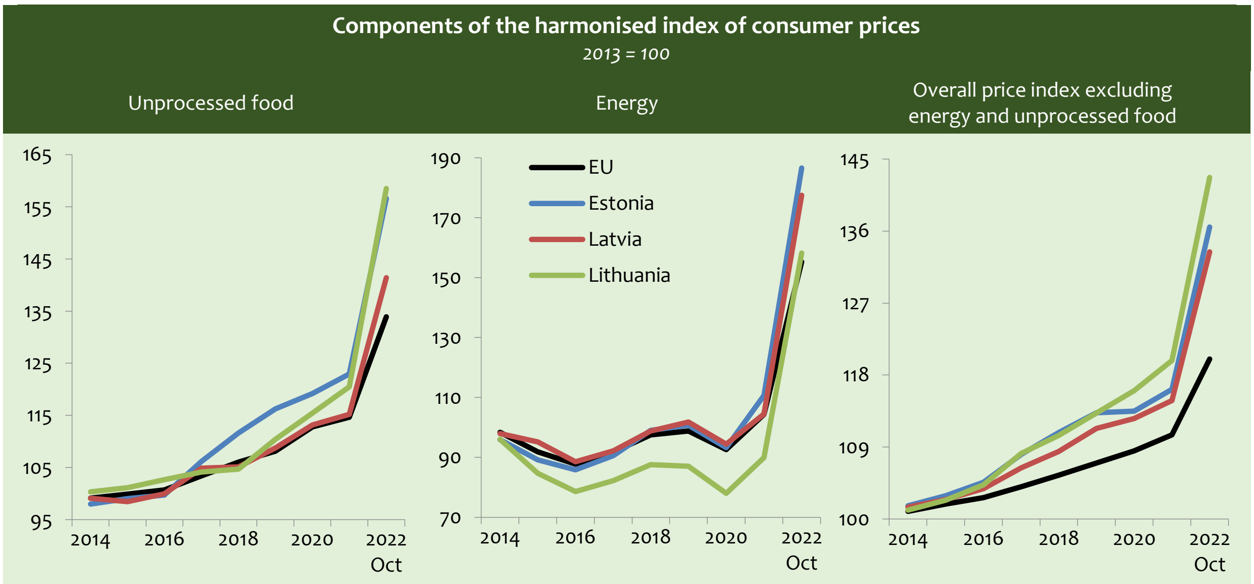
Figure 6.4




In the EU, following a very moderate increase in prices in 2014-2016 driven by relatively weak economic growth, as well as by the drop in global prices for food and crude oil, a very sharp rise in prices was seen in 2017-2019 as economic activities increased. On the other hand, in 2020, Covid-19 reduced consumer prices. The biggest diminishing effect came from the fall in prices of energy sources and non-food products caused by the decline in demand due to the Covid-19 pandemic. The rise in prices of services had an increasing effect as well as the rise in food prices due to a sharp rise in global food prices in the second half of the year.

With economic activity increasing and countries starting large-scale vaccination against Covid-19, consumer prices increased sharply in 2021. In 2021, annual average inflation in the EU was 2.9%. Prices increased in all the main consumption groups. The rise in energy prices had the biggest effect, which was driven by the sharp increase in global prices of crude oil and natural gas. A considerable increasing impact came from the increase in prices of services, among them the most in out-patient, catering services and package recreational services. Food prices also continued growing significantly, as the rapid increase in global food prices continued, in particular in the first half of the year. In 2022, Russia's invasion of Ukraine and protest sanctions, which resulted in a shortage of energy and production raw materials, have added to the impact on price growth all over the world. In October 2022, annual average inflation in the EU was 8.3%. Prices increased in all the main consumption groups.

Figure 6.5



When comparing the Baltic countries, in 2021, the highest annual average inflation was in Lithuania, slightly lower inflation was in Estonia, while inflation in Latvia was the lowest. The increase in energy prices has the biggest impact in all the three countries (the highest in Estonia and the lowest in Latvia). The increase in prices of services also had a big impact in Lithuania and Estonia. Meanwhile, the increase in food prices in all the countries had the lowest impact – it was slightly higher in Latvia and Lithuania than in Estonia.

It should be noted that since 2014 Latvia has been having the lowest core inflation among the Baltic countries, because the increase in private consumption in Latvia is slower than in the two other countries and the increase in prices of services is slower as well. Prices of alcoholic beverages and tobacco in Latvia also increased slower, while the equalisation of the excise tax with the EU level in Estonia and Lithuania is more rapid. Prices of transport and communication increased in Latvia more rapidly.

In 2022, the Baltic countries showed the most rapid price increases in the EU. In October 2022, the highest annual average inflation was in Estonia – 18%. In Lithuania, average annual inflation was 17.1%, while in Latvia it was 15%. The biggest impact came from the increase in energy and food prices. Energy prices rose most rapidly in Estonia and food prices – in Latvia. The lowest increase for energy was in Latvia and for food – in Estonia. The increase in prices of services in Latvia had a lower impact than in Lithuania and Estonia.

In October 2022, compared to October 2021, the price level grew by 11.5% in the EU countries, and by 10.6% in the Euro Area. The highest inflation in October 2022 was in Estonia, Lithuania, Hungary and in Latvia, while the lowest – in France and Spain.

Figure 6.6

**Changes in the harmonised index of consumer prices in the EU member states**
*12-month inflation, as per cent*


## PRODUCER PRICES

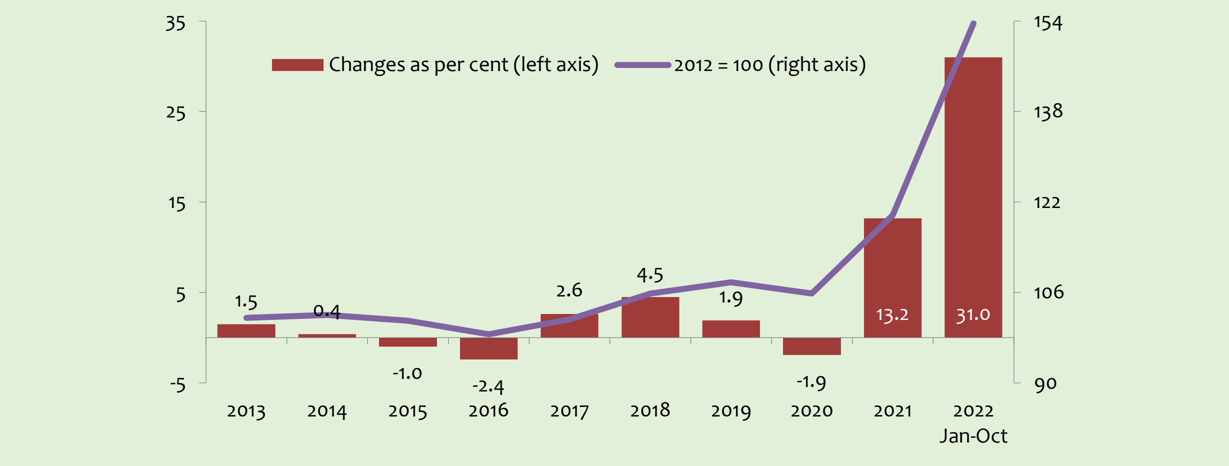
After a drop in 2015-2016 producer prices showed a considerable increase in 2017-2018, and it slowed down in 2019. In 2020, producer prices reduced under the influence of Covid-19 in all major industry sectors (mining and quarrying, manufacturing, electricity, gas, steam and air conditioning supply, and water supply, sewerage, waste management and remediation activities). The decline in producer prices of electricity, gas, steam, and air conditioning supply had the biggest effect.

In 2021, producer prices increased rapidly, reflecting the rapid growth of prices of energy sources and other raw materials in the world. In 2021, the producer prices of products sold on the domestic market increased by 12.6%, while the producer prices of exported products – by 13.7%. Producer prices increased in all major industrial sectors, and manufacturing had the biggest effect on the increase in producer prices.

In 2022, a very rapid rise continued in this price group due to the energy crisis, which was exacerbated by Russia's invasion of Ukraine and subsequent sanctions against Russia and Belarus, as well as the limited export of Ukrainian goods under conditions of war, which caused shortages of both energy sources and raw materials. In January– October 2022, producer prices in the industry increased by 31% compared to the relevant period of the previous year. Prices of products sold on the domestic market grew by 47.7%, while prices of exported products – by 17.1%. Producer prices increased in all industrial sectors. Electricity, gas, steam, and air conditioning supply had the biggest effect on the increase in producer prices.

Figure 6.7

**Producer prices**




A similar trend has been observed in producer prices in manufacturing since 2013. Following the rapid increase in 2017-2018, in 2019, producer prices in manufacturing experienced very moderate increases related to slower growth in the EU and a slight drop in prices of energy sources and raw materials. Although 2020 was marked by the Covid-19 pandemic and a rapid drop in energy prices, producer prices in manufacturing reduced just slightly during this period, while they increased sharply again in 2021. In 2021, the increase in producer prices in manufacturing was more rapid for exported products – by 13.6% and increased by 10.3% for the products sold on the domestic market. Furthermore, in January-October 2022, compared to the corresponding period of the previous year, producer prices in manufacturing were growing more rapidly for the products sold on the domestic market than for exported products – by 24.9% and 16.8%, respectively.

Slightly more than 60% of the manufacturing production is exported; therefore, the overall producer price dynamics of the industry are largely affected by the fluctuations in producer prices of production for exports. The prices of production for exports, in their turn, are mainly determined by the price dynamics of the Latvian key export goods, including timber, metal products, and food, in global markets. It should be noted that a rapid increase was observed in global prices of energy sources and raw materials in 2021 under the influence of the energy crisis, which continued also in the first half of 2022. However, in the second half of the year global prices of energy and raw materials reduced, and this could slightly slow down the rate of increase of producer prices. However, price will still be significantly affected by limited supplies of raw materials related to the sanctions against Russia and Belarus after the invasion of Ukraine. However, the growth rates of prices of products sold on the domestic market will not decrease, mainly due to high prices of energy sources and raw materials both in the world and on the domestic market, for example, for unprocessed food, timber, etc. At the same time, the dynamics of producer prices for products sold on the domestic market will be affected by growth rates, which could slow down in the second half of the year.

When viewed by sector, the most significant increase in producer prices in manufacturing in 2021 was in wood processing. It was the most rapid increase in prices in the whole sector. Wood processing was largely affected by the increase in prices of exported products. It should be noted that average procurement prices for logs increased sharply in the first half of 2021 following a fall of prices in the previous years. The increase in producer prices in manufacture of chemicals, metalworking, manufacture of food and manufacture of finished metal products had the biggest effect in manufacturing, while prices decreased in the manufacture of computer, electronic and optical products and in publishing.

Wood processing also saw the most significant increase in producer prices in January-October 2022. The increase in producer prices in manufacture of food products of products sold in the domestic market and prices of exported products also had a similar impact in wood processing. The increase in producer prices of food products also had a big impact. It should be noted that global food prices increased rapidly from mid-2020 to March 2022, when, despite the effects of the Covid-19 pandemic, high demand persisted. In 2022, prices in manufacture of food products were mostly affected by the high prices of products sold on the domestic market. In January-October 2022, manufacture of other non-metallic mineral products, finished metal products and chemicals also saw a considerable increase in producer prices in manufacturing.

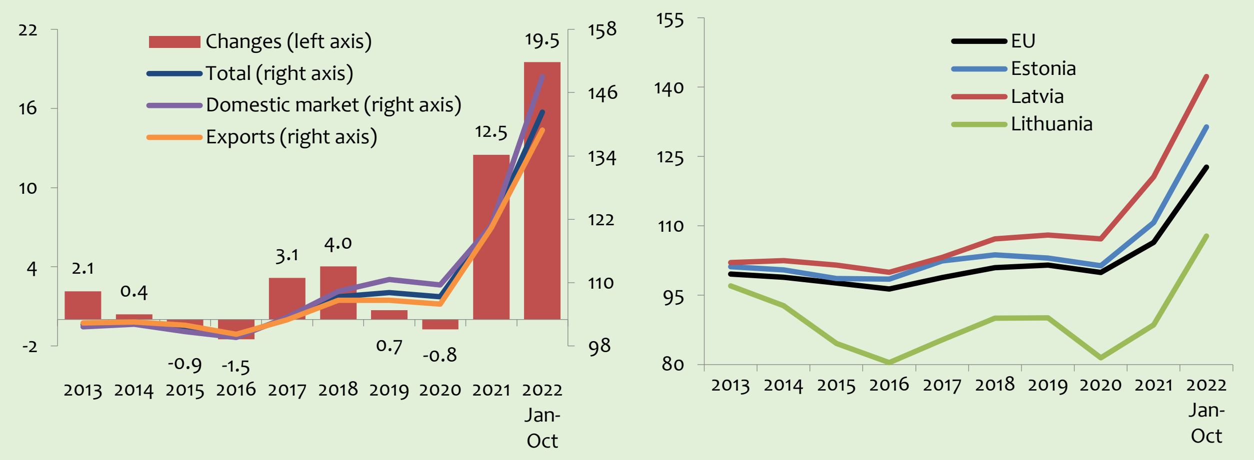
Following a fall in 2013-2016, in 2017-2018, **producer prices in the EU** saw a sharp increase, with the steepest rise in producer prices in manufacturing since 2011, both in the EU as a whole and in all three Baltic countries. The rise of producer prices slowed down in 2019 mainly due to the drop in world energy prices and slowdown of global economic growth. The fluctuations in supply and demand of energy sources and raw materials due to the Covid-19 pandemic affected the fall in producer prices in 2020. Producer prices in the EU increased very rapidly in 2021, with the economy recovering and significantly growing demand for raw materials and energy sources. This continued also in 2022, when the crisis of energy prices and supplies was enhanced by the Russian invasion of Ukraine. When comparing the EU countries, producer prices in manufacturing in January-October 2022, compared to the respective period of the previous year, increased most rapidly in Greece, Luxembourg, Finland and the Netherlands, while the increase was the slowest in Ireland and Malta.

When comparing the Baltic countries, producer prices in manufacturing in January-October 2022, compared to the respective period of the previous year, increased rapidly in all the three countries: by 23.2% in Lithuania, by 20.1% in Estonia and by 19.5% in Latvia.

Figure 6.8

**Producer prices in manufacturing**

*changes as per cent – left axis, 2012 = 100 – right axis* *2012 = 100*



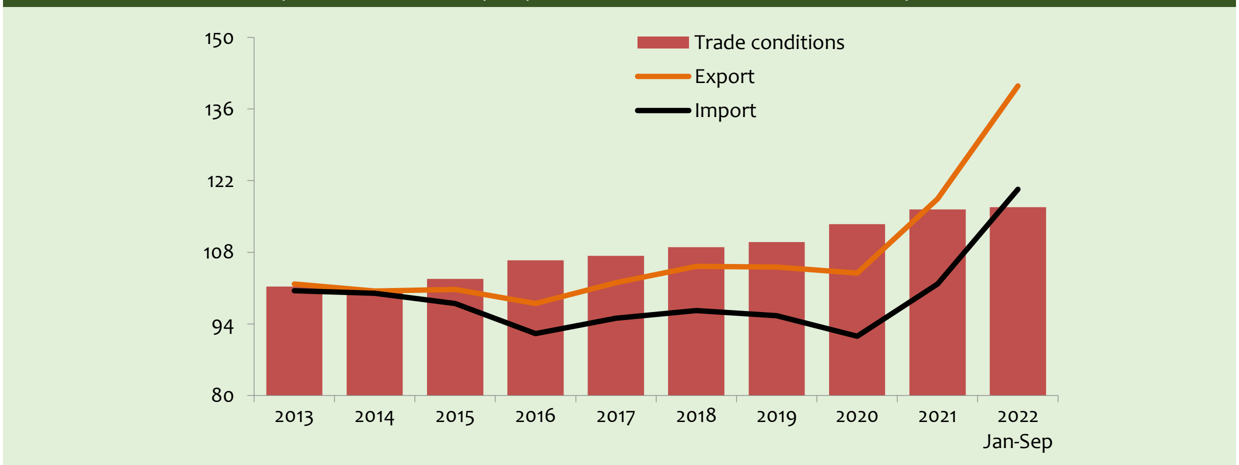

## FOREIGN TRADE UNIT VALUE INDICES

Trade conditions have been improving rapidly since 2016. In 2016-2019, the biggest impact on the export unit value and import price came from the fluctuations of prices of wood and its products, as well as coke and refined petroleum products. In 2020, trade conditions continued to improve with the import price index declining more rapidly than the export unit value. In 2020, the export unit value was mostly affected by the drop in the unit value of wood and products of wood, while the import price – by the drop in value of coke and refined petroleum products.

Figure 6.9

**Export unit value and import price indices and trade conditions**

*export unit values and import price indices 2012 = 100; trade conditions as per cent*



In 2021, trade conditions still improved, and the unit value index for exported goods exceeded the price index for imported goods already by almost 17 percentage points. In 2021, the export unit value increased by 13.9%, but the import price index – by 11.2%. The export unit value index was most affected by the increase in the unit value of wood and wood products, base metals and agricultural products, while the import price index was most affected by the increase in value of base metals, coke and refined petroleum products, chemical substances and chemical products, as well as wood and wood products, and by the fall in unit value of computers, electronic and optical devices.

In January-September 2022, the unit value of exported goods grew by 21.9%, while of imported goods – by 21.5% compared to the relevant period of the year before. The unit value index for exported goods exceeded the price index for imported goods by almost 21 percentage points. The total export unit value index was most affected by the increase in the unit value of mining of valuable minerals, wood and wood products, food products, agricultural products, coke and refined petroleum products, chemical substances, and chemical products, as well as base metals. The total import price index was most affected by the increase in prices of coke and refined petroleum products, base metals, chemical substances and chemical products, food products, as well as wood and wood products.

## 6.2. BALANCE OF PAYMENTS

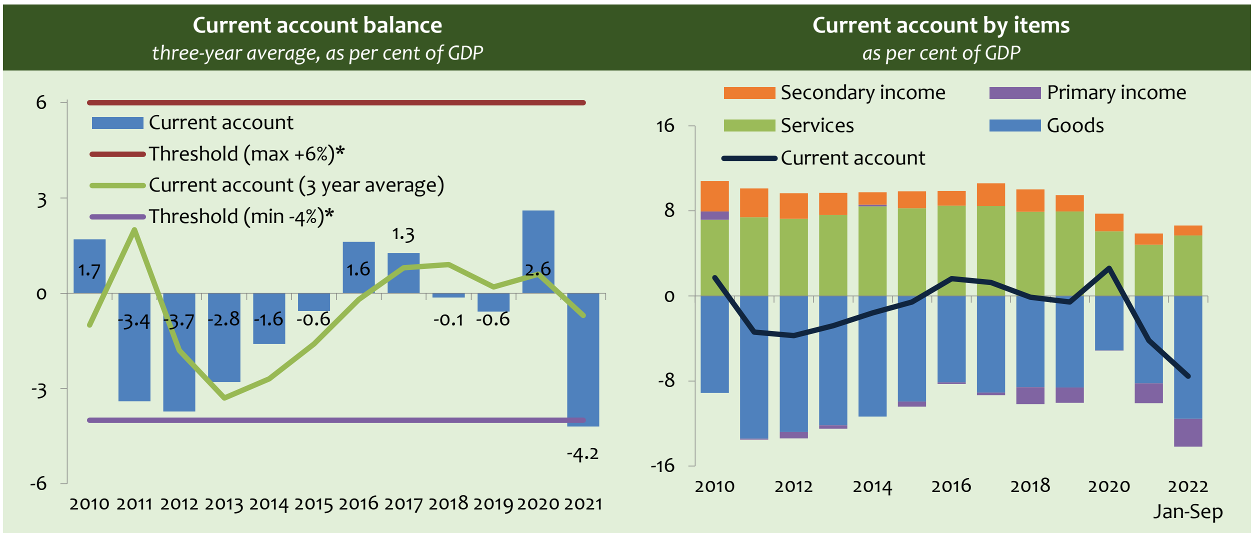
### CURRENT ACCOUNT

The Latvian current account of the balance of payments reacts sensitively to changes in the external environment. Since 2020, external shocks have led to an increase in current account fluctuations.

Before the Covid-19 pandemic (2015 – 2019), the current account balance was positive – 0.3% of GDP. Its fluctuations were moderate, yet the general trend was turned downwards – from surplus of 1.6% of GDP in 2016 to deficit of 0.6% of GDP in 2019. Since 2010, the current account does not exceed the indicative thresholds set in the EU Alert Mechanism and is evaluated as sustainable.

In 2020, the condition of current account was determined by the shock caused by the Covid-19 pandemic. The restrictions introduced to combat the pandemic had an uneven impact on cross-border flows of goods, services and income, which reflected in significant adjustments to the current account. Current account balance improved under the conditions of the rapid decline in global trade reaching a surplus of 2.6% of GDP in 2020. With economic activity and domestic demand increasing, in 2021, current account balance was negative – 4.2% of GDP. In 2022, the current account balance continued to deteriorate. In January-September 2022, its deficit increased to 7.2% of GDP, significantly affected by the changes in the geopolitical environment after the Russian invasion of Ukraine.

Figure 6.10




* Indicative threshold established in the EU alert mechanism

The state of the current account is mainly determined by changes in the balance of goods and services, and in smaller scope by net flows of primary income and secondary income.

Weakening of external trade flows has been observed in recent years. Economic shock was its main reason. It was first caused by the Covid-19 pandemic, then Russian invasion of Ukraine, which enhanced the uncertainty of the external environment.

In the last five years before the Covid-19 pandemic (2015-2019) the external trade deficit was 8.9% of GDP on average. The Covid-19 pandemic containment measures had a strong impact on trade intensity. In 2020, imports of goods shrank due to weak demand. The drop in imports along with stable goods export dynamics reduced the deficit of the external trade balance from 8.6% of GDP in 2019 to 5.1% of GDP in 2020. In 2021, the export value of goods was 20.5% higher than a year ago, but the import value increase slightly more rapidly than export value – by almost 26.5%, and the trade deficit reached 8.2% of GDP.

Also, in the nine months of 2022, export dynamics were more moderate than import dynamics, compared to the corresponding period of 2021. High prices of energy sources and the need to change their sources of supply due to the Ukrainian war significantly increased the import value. As exports continued to grow at a slower pace than imports and the price increase had a greater impact on the prices of imported products, the trade deficit increased to 11.6% of GDP.

Table 6.1

**Balance of payments of Latvia**
*as per cent of GDP*

| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|---|
| **Current account** | **1.3** | **-0.1** | **-0.6** | **2.6** | **-4.2** | **-7.6** |
| Trade balance | -9.1 | -8.6 | -8.6 | -5.1 | -8.2 | -11.6 |
| *Export* | 43.1 | 43.2 | 41.6 | 44.4 | 48.1 | 53.4 |
| *Import* | 52.2 | 51.8 | 50.2 | 49.4 | 56.3 | 65.0 |
| Balance of services | 8.4 | 7.9 | 7.9 | 6.1 | 4.8 | 5.7 |
| Primary income | -0.3 | -1.6 | -1.5 | 0.0 | -1.8 | -2.6 |
| Secondary income | 2.1 | 2.1 | 1.5 | 1.7 | 1.1 | 0.9 |
| **Capital account** | 1.0 | 1.7 | 1.5 | 1.7 | 1.4 | 0.9 |
| **Financial account** | 2.2 | 2.3 | 1.2 | 6.1 | -1.0 | -3.2 |
| Direct investment | -2.0 | -2.2 | -3.0 | -2.1 | -2.5 | -4.4 |
| *Assets* | 1.9 | -0.9 | 0.3 | 0.6 | 6.9 | -0.7 |
| *Liabilities* | 3.8 | 1.3 | 3.3 | 2.7 | 9.4 | 3.7 |
| Portfolio investment* | 6.6 | -4.3 | -1.7 | 13.1 | -0.8 | 5.7 |
| *Assets* | 5.9 | -3.7 | 1.0 | 10.3 | 0.6 | 3.9 |
| *Liabilities* | -0.7 | 0.5 | 2.7 | -2.8 | 1.4 | -1.8 |
| Other investment | -5.8 | 9.2 | 6.2 | -6.3 | 1.9 | -2.9 |
| *Assets* | 1.0 | -1.4 | 0.1 | -0.3 | 0.8 | 5.5 |
| *Liabilities* | 6.7 | -10.7 | -6.1 | 6.0 | -1.1 | 8.5 |
| Reserve assets | 3.3 | -0.4 | -0.3 | 1.5 | 0.4 | -1.5 |
| **Deviation** | 0.0 | 0.7 | 0.3 | 1.8 | 1.9 | 3.5 |

* Portfolio investment and financial derivatives

The balance of services is positive in Latvia. In 2015-2019, the surplus of the balance of services was 8.2% of GDP on average. Although the growth rates of imports of services remained comparatively high, imports in absolute terms amounted only to half of exports of services thus ensuring a stable surplus in the balance of services.

The shock related to the Covid-19 pandemic had a stronger impact on cross-border trade of services rather than trade of goods. In 2020, cross-border flows of services decreased considerably. Movement restrictions and cautious attitude of the population to leisure and business trips affected the drop in the value of trips and air and road transport services. Total exports of services decreased slightly more rapidly than imports, thus the surplus of the balance of services decreased from 7.9% of GDP in 2019 to 6.1% of GDP in 2020. Although the partial cancellation of the pandemic restrictions contributed to an increase in exports and imports of services, in 2021 the surplus of the balance services continued to shrink, reaching 4.8% of GDP.

In the nine months of 2022, imports of services at current prices were 35% higher than a year ago, while exports increased by 37% and the surplus of the balance of services increased to 5.7% of GDP (4.7% of GDP in the nine months of 2021).

The primary income balance in the last five years (2015-2019) has been negative – 0.8% of GDP per year on average with relatively small fluctuations mainly underpinned by changes in non-residents' investment income and inflow of EU funds. As the income earned by foreign investors in Latvia declined under the influence of the crisis; in 2020, the primary income balance was in balance. Meanwhile, in 2021, its deficit increased to 1.8% of GDP, driven by an increase in direct foreign investment income. In nine months of 2022, the primary income balance deficit was 2.8% of GDP, being slightly lower than a year ago.

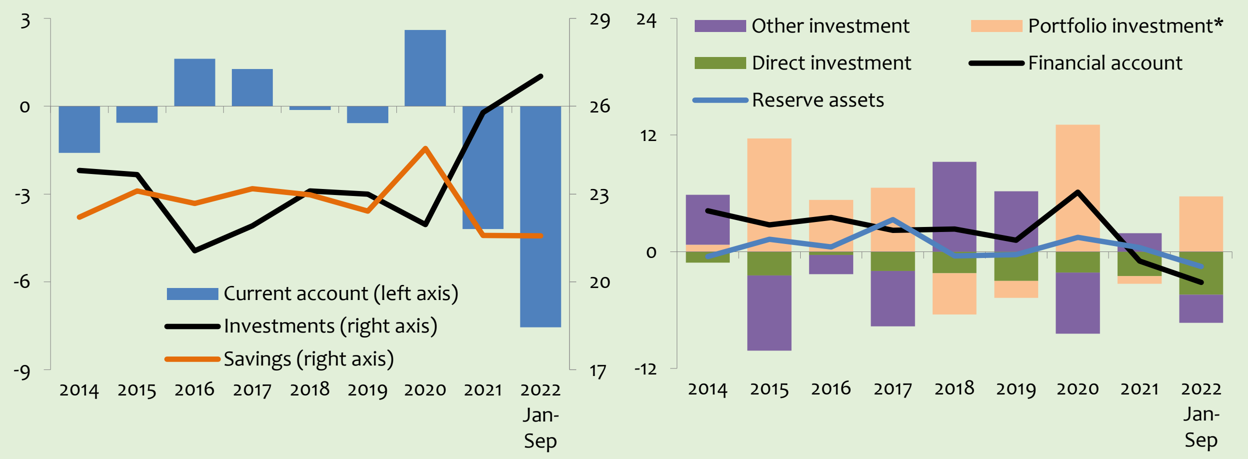
The condition of the secondary income and capital account is significantly affected by flows of EU funds, as well as Latvia's contributions to the EU budget. The secondary income balance in Latvia is positive and in the period from 2015 to 2019 it was 1.8% of GDP on average. External shocks have not significantly affected the condition of this account. In 2020 and 2021, the secondary income account had a surplus – 1.7% and 1.1% of GDP, respectively. Also, in the nine months of 2022, the secondary income account balance is positive – 0.9% of GDP.

The inflow of EU structural funds dominates in the capital account. Since 2015, the average capital account surplus has been 1.6%, including 1.4% of GDP in 2021. The positive balance of capital account in the nine months of 2022 is slightly lower than a year ago, reaching 1% of GDP. Changes in capital account surplus are mainly related to changes in EU funds uptake activities.

Figure 6.11

**Deficit, investment and savings of the current account**
*as per cent of GDP*

**Financial account broken down by investment types**
*as per cent of GDP*




* Portfolio investment and financial derivatives

The condition of the current account balance until 2019 proved that savings and domestic investments were balanced. In 2020, the current account surplus was determined by an increase of *forced* savings and a decrease in investments. On the other hand, since 2021, the increase in current account deficit has been mainly affected by the decline in the level of savings, while investment activities were growing.

## CROSS-BORDER FINANCIAL FLOWS

In recent years, the status of the financial account balance has been determined by financial sector stabilisation measures, restructuring of debts of the public sector, measures of the Bank of Latvia within the scope of an extended asset acquisition programme (EAAP), as well as the implementation of restrictive monetary policy by the European Central Bank for combating inflation.

From 2015 to 2019, external assets generally increased more than liabilities, and the financial account balance (assets less liabilities) was positive – 2.4% of GDP on average. In 2020, the positive financial account balance increased to 6.2% of GDP compared to 2019, which was significantly affected by the increase in assets of the Bank of Latvia and credit institutions in the form of portfolio investments. In 2021 and also in the nine months of 2022, financial account assets grew more modestly than liabilities, which determined the negative financial account balance of 1.0% and 3.2% of GDP, respectively.

The **foreign gross debt of Latvia has slightly increased**. This was determined by the participation of the Bank of Latvia in Eurosystem monetary policy operations. The external liabilities of the private sector (financial institutions and non-financial corporations) also increased. According to Latvia's international investment balance data, at the end of September 2022 gross external debt was almost 101.5% of GDP, including the government's gross external debt amounted to 9,611 million euro (25% of GDP).

The status of the balance of payment accounts in the near future will be determined by the impact of the sanctions imposed against Russia and the impact of other geopolitical factors on cross-border flows.

## 6.3. FOREIGN DIRECT INVESTMENT

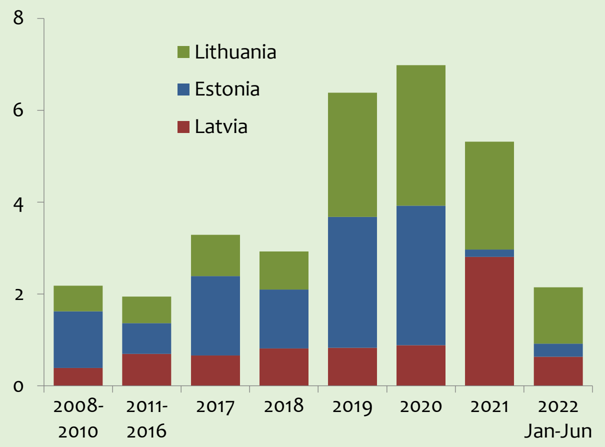
Intensity of FDI is moderate in almost all countries of the world. This is underpinned by both growing geopolitical risks, political uncertainty, and structural changes in FDI models under the influence of the economic industrial revolution (including digitalisation).

The Covid-19 containment restrictions were also a significant obstacle to cross-border investment flows. The hindered the implementation of commenced and pre-planned investment projects on a global scale. Thus, in 2020 FDI flows reduced to one trillion US dollars reaching the lowest level in the last decade. As the situation improved, in 2021, global FDI flows increased rapidly and were by 64% higher than in 2020. However, the global environment of international business and international investments has changed drastically in 2022. The war in Ukraine exacerbated the situation in food and energy markets and increased the uncertainty caused by geopolitical development, which will probably have negative pressure on global FDI flows soon.

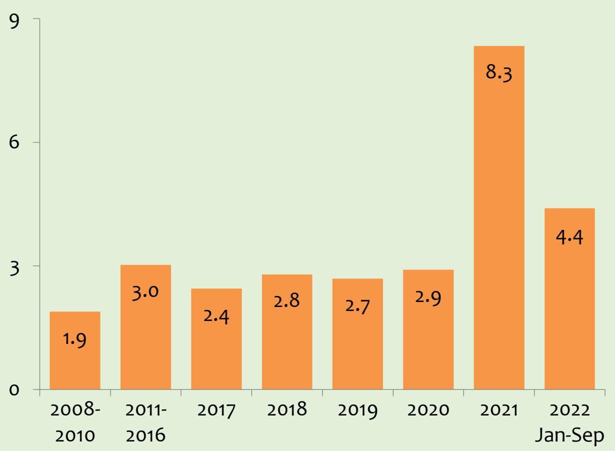
Intensity of FDI flows in EU countries remains moderate. In 2021, compared to 2020, the amount of FDI attracted was nearly 35% smaller than in 2020. Cross-border flows of direct investments in the Baltic countries in 2021 were also more moderate than in 2020. This was affected by a smaller volume of FDI entering the Estonian and Lithuanian economy than a year ago, while volumes entering the Latvian economy increased. In the first half of 2022, the Baltic States together attracted FDI of almost 2.2 billion euro (3.3% of GDP), which is only half of the volume of the previous year. The Lithuanian economy had the highest volume of FDI transactions (57.3% of total FDI). The share of Estonia and Lithuania in total FDI transactions amounted to 29.6% and 13.1%, respectively.

Figure 6.12

**Inflow of foreign direct investment in the Baltic Countries**
*flows, billion euro*




**Foreign direct investment in Latvia**
*received on average over the period, as per cent of GDP*



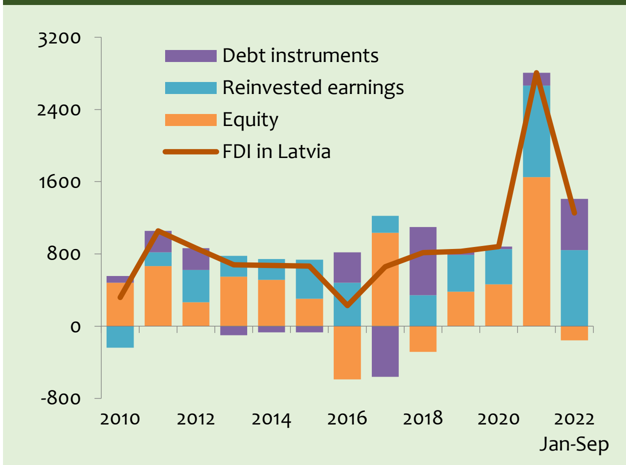

The impact of shock caused by Covid-19 and the global financial crisis on FDI attraction in Latvia differed drastically. In the years of financial crisis (2008-2010), FDI flows declined almost by half and for a long time remained at a lower level than in the years of rapid growth (2004-2007). In recent years (2017-2020), FDI flows in the Latvian economy fluctuated within

2.4 to 2.9% of GDP on average annually. It should be noted that the intensity of FDI flows attracted to Latvia has not decreased in the years of the Covid-19 crisis. In 2021, net FDI flows attracted to Latvia amounted to 2809 million euro, i.e., by 1929 million euro more than a year before. This was due to the extensive investments of the Swedish company *Swedbank AB* in the equity capital of companies registered in Latvia. The amount of FDI attracted to the Latvian economy as a result of this transaction reached 8.3% of GDP.

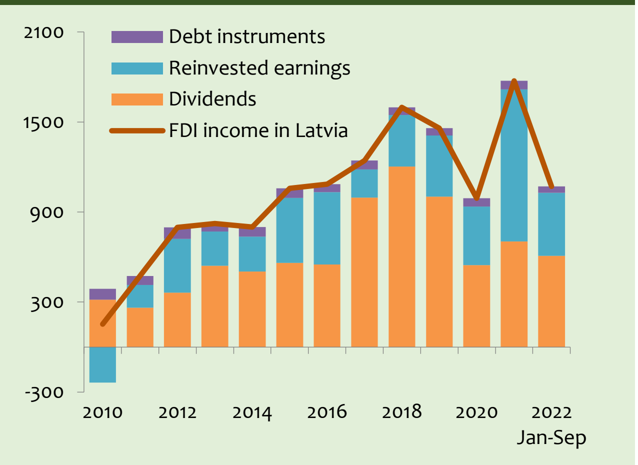
FDI transactions in the nine months of 2022 were almost by 1.5 times lower than a year before and constituted 4.4% of GDP. This was largely driven by negative flows of investment in companies' equity in response to EU sanctions against Russia. Foreign capital outflows were offset by non-resident investments in the form of reinvested profit and debt instruments.

Figure 6.13

**Foreign direct investment in Latvia**
*received, million euro*




**Foreign direct investment income**
*million euro*

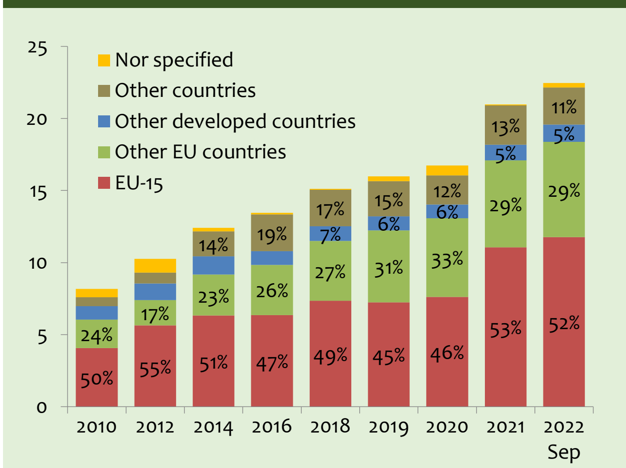



The long-term income of foreign direct investors has a positive dynamic, reflecting the high profitability of FDI in Latvia. After peaking in 2018 (5.4% of GDP), FDI income in Latvia decreased slightly in 2019, as economic growth slowed down. In response to the outbreaks of Covid-19 and its containment restrictions, FDI income continued to decline in 2020, however, in 2021, they already almost doubled compared to the level of the previous year. In the nine months of 2022, compared to the corresponding period of the previous year, income of foreign investors increased. Most of it constituted paid dividends, while reinvested profit remained at the level of the previous year.

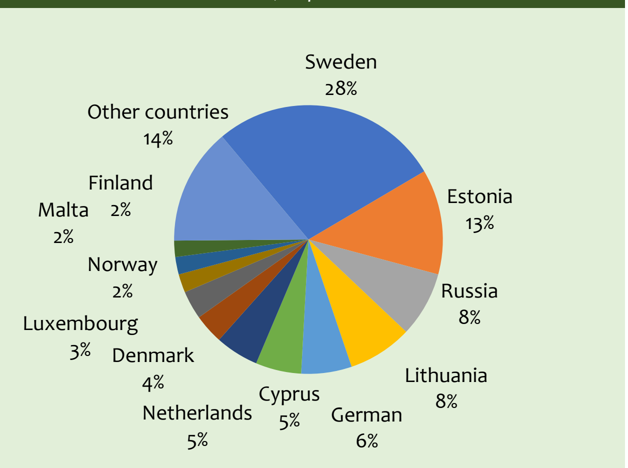
Figure 6.14

**Foreign direct investment accrued in Latvia at the end of September 2022**

by groups of countries
*million euro*




FDI by countries
*accrued, as per cent*



The amount of FDI accrued in the Latvian economy is growing year on year. The amount of FDI accrued at the end of September 2022 reached 22.4 billion euro (59.5% of GDP). It grew by 5.8%, compared to the end of 2021, mainly underpinned by the increase in investment in manufacturing and trade.

The geopolitical structure of FDI accrued is relatively stable. Investments of businesses from the EU countries dominate, amounting to 76.2% of the total FDI accrued in the Latvian economy at the end of September 2022.

Sweden is the largest investor in the economy of Latvia. The initiatives of its businessmen reached almost 27.6% of total accrued FDI (16.5% at the end of 2020). Investments of businesses from Estonia, Russia, the Netherlands, Cyprus, Lithuania and Germany are also extensive.

The introduction of sanctions against Russian affected investments of its businesses in the Latvian economy. At the end of September 2022, direct accrued investments of Russia were almost 4.6% lower than at the end of the previous year. However, it should be noted that Russia is still the third largest investing country in the economy of Latvia by accrued FDI.

Investments of Lithuanian and Estonian businesses make almost one fifth of accrued FDI in Latvia. Activities of Latvian businessmen in the Baltic neighbouring countries are, on the contrary, much more moderate.

Most of FDI is attracted in service sectors. At the end of September 2022, the accrued FDI in the services sector constituted 79% of the accrued FDI in the economy of Latvia. It grew by 40%, compared to the end of 2019, mainly underpinned by extensive investments in professional, scientific, and technical activities. The total amount of FDI accrued in this part of the sector at the end of September 2022 increased to 20.6%. (1.7% – at the end of 2019). Almost 56% of accrued FDI in service sectors are investments in financial intermediation, real estate, and trade activities. Investment dynamics in these sectors are generally positive (except financial intermediation).

At the end of September 2022, the accrued FDI in manufacturing of goods amounted to 20.7%. Almost 12% of total accrued FDI were invested in manufacturing and mainly concentrate in traditional sectors. Only one fifth of accrued FDI in manufacturing were invested in high-technology and medium-high technology sectors evidencing of low attractiveness of these activities for foreign capital. Since the end 2019, the amount of accrued FDI in manufacturing has increased by 40.2%. Although the FDI attraction dynamics are positive, the volume of FDI accrued in manufacturing in Latvia is still smaller than in Lithuania and Estonia.

Table 6.2

**FDI by sectors**
*balances at the end of the period*

| | *million euro* | | | *structure, as per cent* | | |
|---|---|---|---|---|---|---|
| | 2011 | 2021 | 2022 Sep | 2011 | 2021 | 2022 Sep |
| Agriculture | 263 | 796 | 847 | 2.8 | 3.7 | 4.1 |
| Manufacturing | 1 113 | 2320 | 2 632 | 11.9 | 10.9 | 12.9 |
| Other industry | 386 | 852 | 749 | 4.1 | 4.0 | 4.3 |
| Construction | 482 | 386 | 432 | 5.2 | 1.8 | 2.2 |
| Trade and accommodation | 1 329 | 3 138 | 3 570 | 14.3 | 14.8 | 18.4 |
| Transportation and storage | 400 | 736 | 755 | 4.3 | 3.5 | 4.2 |
| Financial intermediation | 2 534 | 3 293 | 3 381 | 27.2 | 15.5 | 23.5 |
| Real estate activities | 1 109 | 3 124 | 3 290 | 11.9 | 14.7 | 15.6 |
| Other services | 688 | 5 645 | 5 785 | 7.4 | 26.6 | 9.2 |
| Unclassified activity | 1 019 | 939 | 1 020 | 10.9 | 4.4 | 5.4 |
| **Total** | **9 323** | **21 229** | **22 461** | **100** | **100** | **100** |

Overall, it should be noted that the intensity of FDI flows follows the trends of previous years and the amount of FDI flows attracted in 2023 might be at the level of the previous year or slightly above that level. This will be influenced not only by internal factors, such as active FDI attraction policy, but also by global trends in cross-border investment flows. According to the estimates of the United Nations Conference on Trade and Development (UNCTAD), an increase in global FDI flows in 2023 will be driven largely by strong investment support from governments.

Investment and Development Agency of Latvia (LIAA) plays a major role in the attraction of foreign investment in Latvia. The strategy of the LIAA for attracting investment is oriented towards qualitative servicing of incoming investment projects and active operation in attracting investment projects through addressing potential investors.

The process of improvement of the FDI attraction policy is ongoing in close cooperation with the Foreign Investors' Council in Latvia (FICIL). The surveys of foreign investors in Latvia conducted by FICIL make it an important contribution to the improvement of the investment environment. (For details about FDI attraction policy see Chapter 11.3)

## 6.4. MONETARY INDICATORS

The banking sector has managed to maintain its stability after the economic shock caused by the Covid-19 pandemic and is working with profit. The development of crediting is still evaluated as weak – crediting of business is developing in an irregular way, while crediting of households has positive signs. Deposit volumes continue to rise. The negative effects of the Covid-19 pandemic in the banking sector were mitigated by state support measures, albeit uncertainty remains relatively high also in the banking sector.

In accordance with the information from FCMC, bank profitability is improving. A sharp increase in profitability was observed the banking sector after a significant drop in 2020. In 2021, profit of the banking sector increased, exceeding the indicator of the year before by 94%. This was largely driven by both the low base effect and the increase in economic activity as restrictions related to the Covid-19 pandemic were eased. Also, in 2022, the banking sector was operating with profit, but its growth rates declined. In the first half of this year, profit reached 132.5 million euro, which is by 9.4% less than the year before. The decline in the profit increase rate was mainly underpinned by the increase in expenditure on savings, which were 4.7 higher than in the first half of the previous year. Overall, 13 banks and three branches of EU banks are operating in Latvia. The capitalization level of the banking sector remained high. In Q2 2022, the average capital adequacy ratio of the banking sector reached 24.25% (25.08% – in Q1 2021). The return on assets (ROA) and the return on equity (ROE) of the banking sector were 1.03% and 8.55%, respectively, lower than a year before.

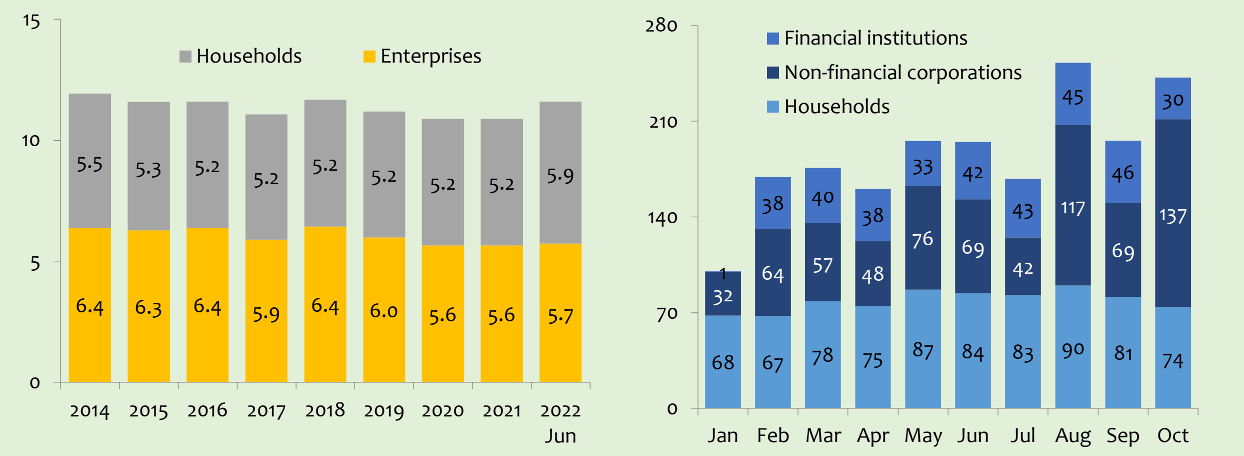
The increase in the assets of Latvian banks has been seen since Q3 of 2018. Although several credit institutions ceased operations, bank assets also increased in 2022 and amounted to 26.3 billion euro in Q2, which was 4% or 1.02 billion more than a year ago. The share of non-bank credits in total assets increased and amounted to 56.6%, while the share of debt securities was 12.1% or 3 percentage points lower than the year before.

Although the volume of issued loans is gradually growing, the development of crediting is still generally evaluated as weak. According to the FCMC data, outstanding amounts of loans to non-banks increased by 7.4% at the end of Q2 2022 compared to the corresponding period of the year before, including the domestic crediting portfolio increased by 6.8% mainly determined by the increase in loans issued to households.

Figure 6.15

**Credit portfolio of households and non-financial corporations**
*at the end of the period, billion euro*

**New loans granted to residents by category of borrowers**
*2022, million euro*



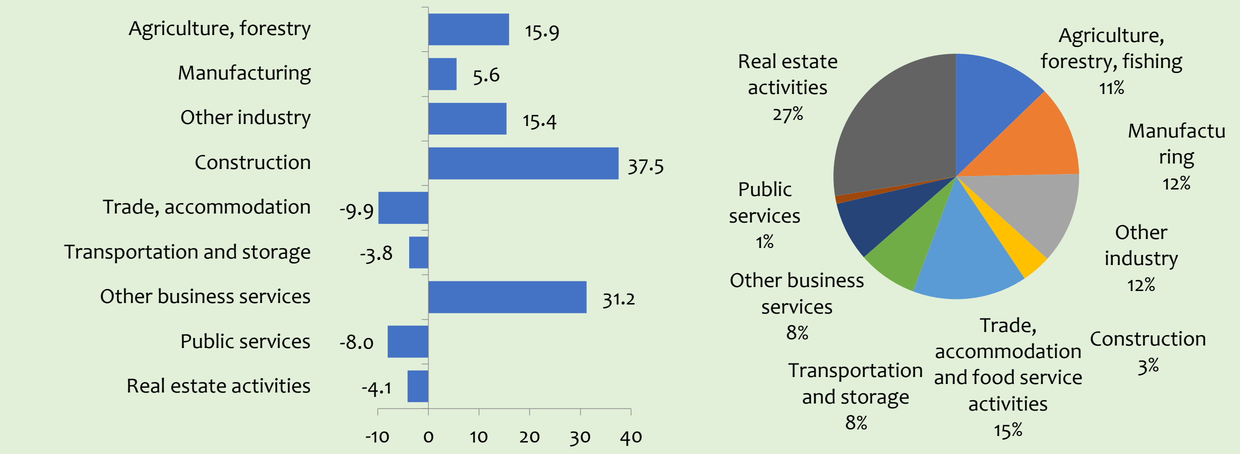

Source: FCMC, Credit Register

The overall dynamics of the credit portfolio of households are positive. Most of the loans granted to households are loans for house purchase, reconstruction and repair. The impact of the consequences of the Covid-19 pandemic on crediting of households was smaller than on crediting of business.

Figure 6.16

**Loans for domestic non-financial corporations by sectors of economy**

*changes, at the end of Q2 2022, compared to late Q2 2020, as per cent* — *structure, at the end of Q2 2022, as per cent*



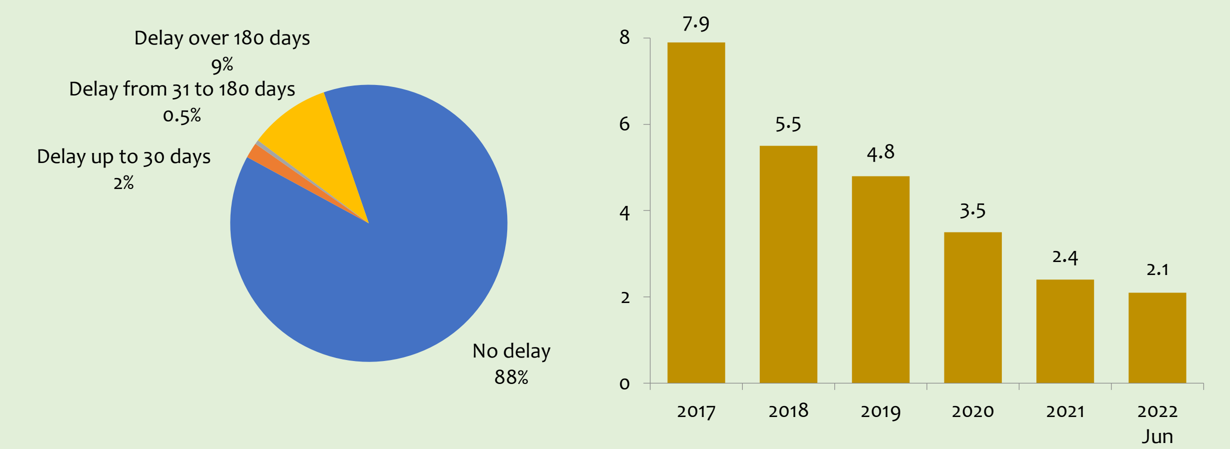

Source: FCMC

Crediting of business is still developing slowly and unevenly. The ability of entrepreneurs to borrow has reduced in the sectors most affected by the pandemic (accommodation and food service activities, as well as transportation and storage). This, in turn, had a negative effect on the volume of investments. Overcoming of the crisis caused by the pandemic and the improvement of the economic situation also had a positive impact on the crediting dynamics of enterprises. In accordance with FCMC data, the number of balances of credits issued to non-financial corporations increased by 3.8% in Q2 2022 compared to the corresponding period of the previous year. Still, there are also enterprises, which do not qualify for credits, because they are operating in the shadow economy.

Figure 6.17

**Statistics of overdue payment days**
*by liability balance share, as per cent*

**Share of non-performing loans in the portfolio of domestic non-bank customers**
*as per cent*




Source: Credit Register, FCMC

Sectors like real estate activities (1/3 of loans) and trade (12.3% of loans), are most credited sectors in the economy. In 2022, crediting increased more rapidly in IC services, construction, as well as administrative and support service activities. It should be noted that almost 2.8% of loans granted to domestic non-financial corporations are non-performing loans (3.1%

at the end of 2021). Companies in accommodation and food service activities get a relatively higher share of these loans (9.4% of total loans). Although the share of non-performing loans gradually reduced, it is important not to postpone resolution of financial problems of companies.

**New crediting** is developing moderately. Loans amounting to 242.2 million euro were newly issued in October 2022. Compared to 2021, the volume of newly issued loans to microenterprises almost doubled. Loans to households for purchasing of consumption goods increased by 54% and for house purchase – by 7.4%. Given the uncertainty of the economic situation, the population is generally cautious in creating new credit obligations and are more inclined to making savings than to taking on new financial obligations.

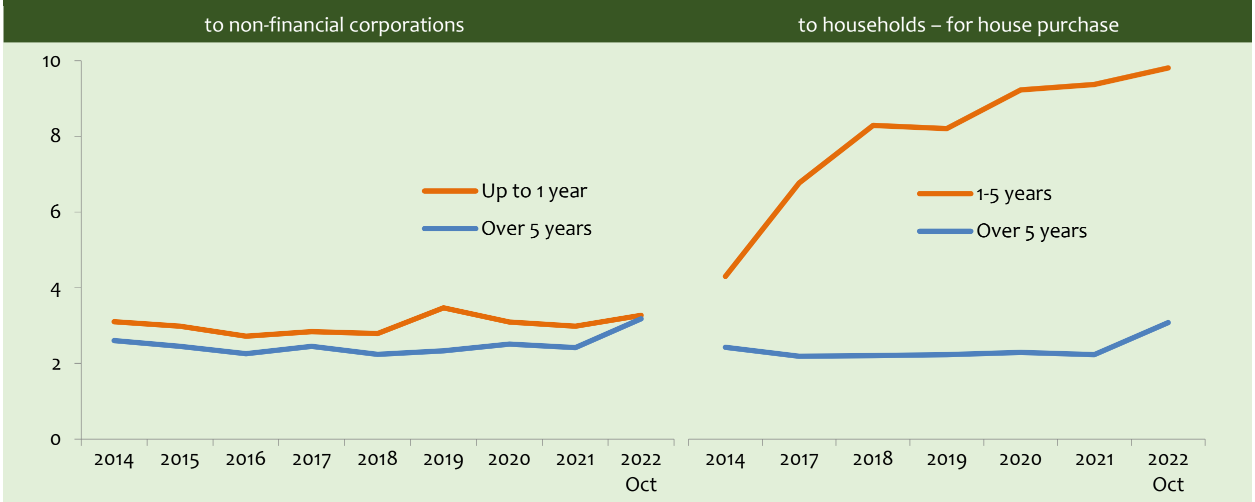
The development of crediting of business is uneven. According to the Credit Register, loans amounting to 137.3 million euro were newly issued to resident non-financial corporations in October 2022. Almost 75% of these loans have been issued to microenterprises and 1/4 to large enterprises. Most new loans have been issued for trade, financial and insurance activities and electricity, gas, steam, and air conditioning supply.

Before the pandemic, the **quality of credit portfolio** had been gradually improving since 2011, mainly due to improvement of the economic situation and writing off bad debts. The quality of the credit portfolio remained high also during the pandemic. The situation was improved by the credit moratorium and other solutions offered by banks implemented for the support of borrowers and therefore they helped entrepreneurs and households to overcome short-term liquidity problems. Statistical data of the Credit Register (as of September 2022) show that the amount of liabilities with overdue payments in the total credit portfolio of banks was 11.7%. Most of them (9.5%) were linked to a delay longer than 180 days. Given the high uncertainty caused by geopolitical developments in the region and in the world, the quality of the credit portfolio is expected to deteriorate.

In recent years, long-term **interest rates** (on outstanding amounts) for credits granted to non-financial corporations have been growing moderately and in October 2022 amounted to 3.18% (2.46% in October 2021). Short-term interest rates (up to 1 year) for non-financial corporations increased slightly slower (by 0.35 percentage points) and in October amounted to 3.27%. Similar trends were observed in the dynamics of interest rates of credits granted to households. This October, long-term interest rates (on outstanding amounts) for credits granted to households for house purchase amounted to 3.01% (2.32% in October 2021). Short-term interest rates (1-5 years) increased from 9.43% in September 2021 to 9.81%, which is one of the highest indicators in the last 10 years. The credit rate hike was driven by the European Central Bank's policy to combat inflation, as well as the uncertainty surrounding Russia's war in Ukraine, which contributed to a slight increase in the credit risk premium for long-term credits to businesses and households. Experts of the Bank of Latvia note that credits granted in 2023 are also subject to a high risk that interest rates will grow.

Figure 6.18

**Weighted average interest (outstanding amounts) rates on loans granted in euro in credit institutions**
*at the end of the period, as per cent*




Source: Bank of Latvia

A more rapid increase in **deposit volumes** started in Q2 2020, which coincides with the onset of the Covid-19 crisis, when the population was more cautious in its spending and was more inclined to make savings because of uncertainty of future economic developments. Formation of savings was also boosted by the limited opportunities to spend due to the restrictions on trade in the country. Since 2021, deposit increase rates have increase significantly along with the increase in spendings of the population. At the end of the first half of 2022, deposits amounted to 21.5 billion euro.

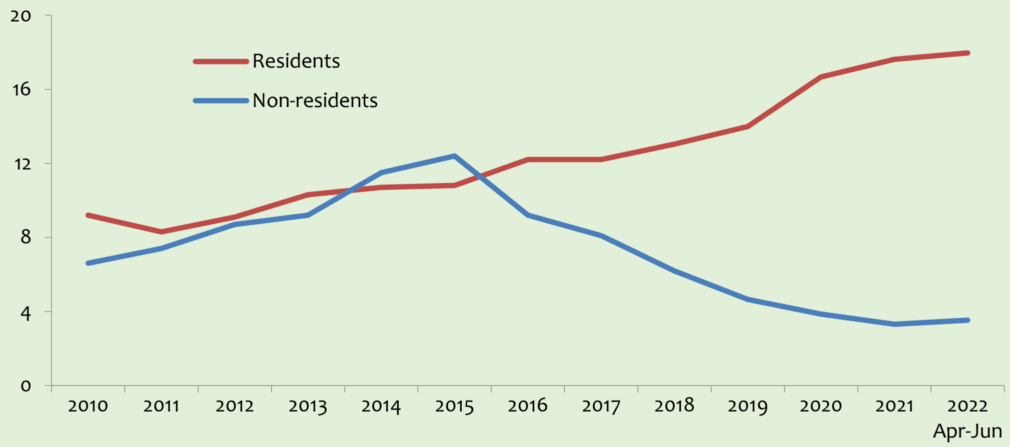
The structure of the national economy has changed in the long-term. The share of deposits of non-residents has shrunk from 53% in Q2 2015 to 16.4% in Q2 2022. The balance of deposits of non-residents in Q2 2022 amounted to 3.5 billion euro, which is 0.4% less than a year before, including deposits of non-residents of non-EU countries reduced by 11.4%. Higher requirements in relation to liquidity and capital adequacy are set for the banks working with non-resident deposits. Small commercial institutions mainly work with money of non-residents in Latvia.

The balance of non-resident deposits retains a positive increase, yet the dynamics are becoming increasingly more moderate. They increased by 5.7% in 2021, compared to 2020, but in Q2 2022 exceeded the level of the previous year only by 1.6 – they amounted to 18 billion euro.

Overall, in the financial sector, as in other sectors, further development of the situation will depend on stabilisation of the economic situation in the region and in the world in general and the effectiveness of the policy measured implemented by the European Central Bank to combat inflation. Like in several economic sectors, in the banking sector, there is also high uncertainty and increased risks to the resilience of financial stability.

Figure 6.19

**Non-bank deposits at banks**
*billion euro*




Source: FCMC

## 6.5. FISCAL POLICY AND PUBLIC DEBT

The Covid-19 pandemic has led to significant changes in the policy that has been implemented so far, which is based on meeting the structural deficit target, i.e., -0.5% of GDP. In 2020, the general escape clause of the *Stability and Growth Pact* (SGP) was activated in the EU, enabling EU countries to increase their general government deficits in 2020-2022 to the extent necessary to mitigate the economic harm caused by the pandemic. Given the Russia-Ukraine war and all the related consequences, the general exception clause of the SGP will also remain in force in 2023, which actually means that fiscal (budgetary) numeric conditions are not in force in EU Member States and EU Member States should observe recommendations of the EU Council.

Table 6.3

**General government budget**

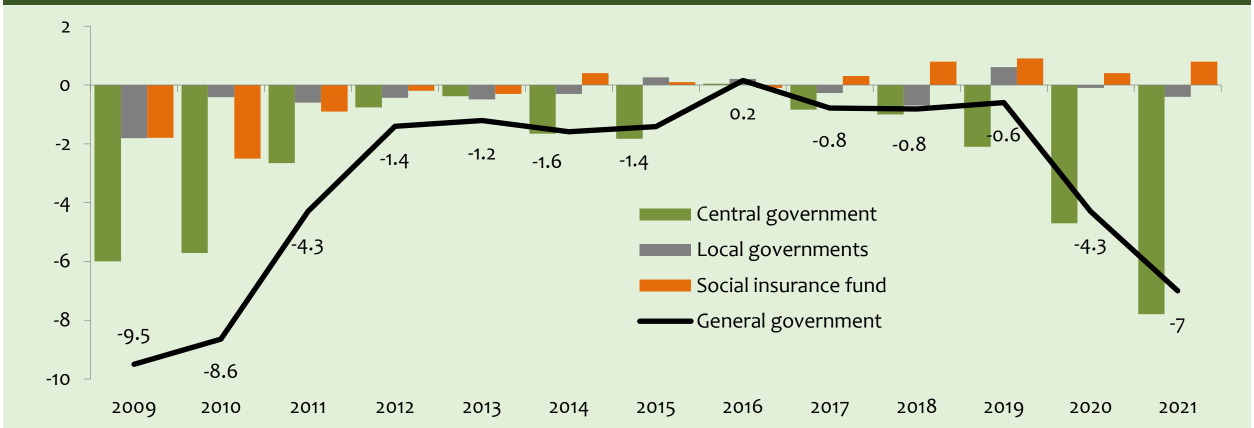
| | *billion euro* | | | | | *as per cent of GDP* | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Revenue | 10.2 | 11.2 | 11.5 | 11.5 | 12.5 | 37.9 | 38.5 | 37.6 | 37.8 | 37.0 |
| Expenditure | 10.4 | 11.5 | 11.7 | 12.7 | 14.8 | 38.7 | 39.4 | 38.2 | 42.2 | 44.0 |
| Balance | -0.21 | -0.24 | -0.17 | -1.32 | -2.35 | -0.8 | -0.8 | -0.6 | -4.3 | -7.0 |

The EU Council's country-specific recommendations for Latvia 2022 specify: *In 2023, ensure that the growth of nationally financed current expenditure is in line with an overall neutral policy stance, taking into account continued temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. Stand ready to adjust current spending to the evolving situation. Expand public investment for the green and digital transition and for energy security, including by making use of the RRF, RePowerEU and other EU funds. For the period beyond 2023, pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions. Broaden taxation of property and capital and strengthen the adequacy of healthcare and social protection to reduce inequality.*

Due to the Covid-19 pandemic, the budget deficit in Latvia increased to 4.3% of GDP or 1.3 billion euro in 2020 and to 7% of GDP or 2.4 billion euro in 2021 (see Table 6.3). The Saeima approved the budget for 2022 with a deficit of 4.8% of GDP or 1.6 billion euro. However, the budget deficit could be higher due to the Ukrainian war. According to the MoF assessments, it could reach 7% of GDP in 2022.

Figure 6.20

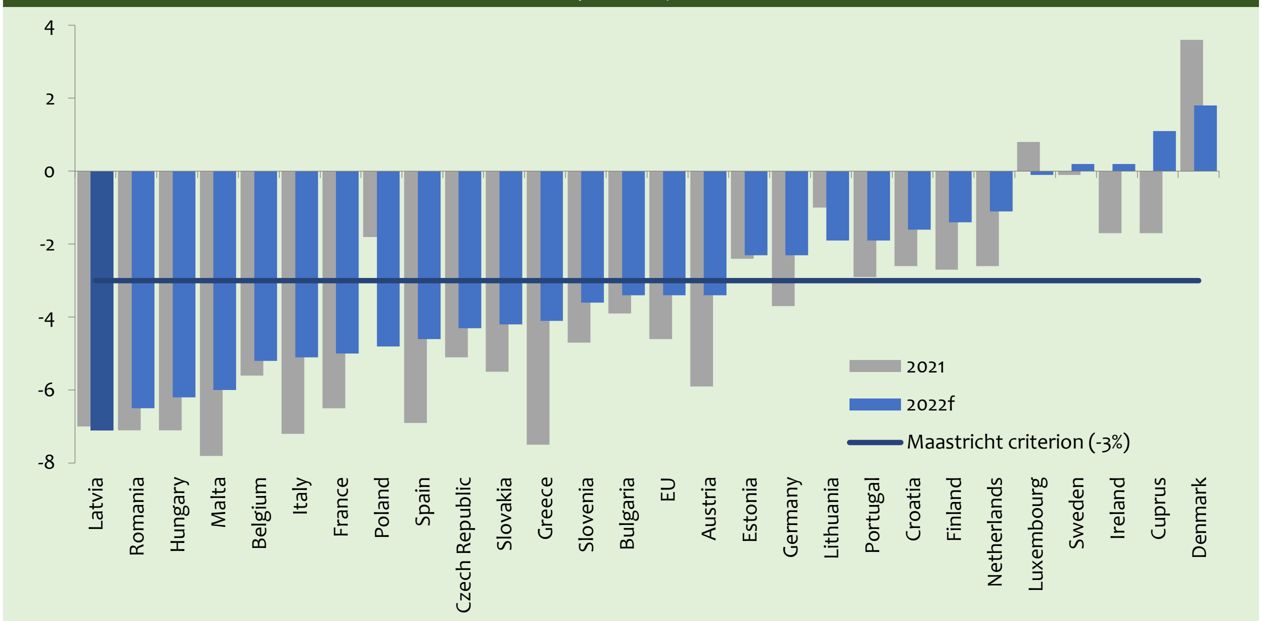
**General government budget balance by sub-sectors**
*as per cent of GDP*




In 2020 and 2021, the budget deficit was in central government and local government budgets. There was a surplus in the Social Insurance Fund (see Figure 6.20).

Figure 6.21

**General government budget balance in the EU member States in 2021 and 2022**
*as per cent of GDP*




f – forecasts of the EC

According to Figure 6.21, in 2021, the Latvian budget balance to GDP showed one of the highest deficits among the EU countries. In 2021, the general budget deficit of EU countries amounted to 4.6% of GDP. It was the highest in Malta, Greece, Italy, Hungary, Romania, and Latvia (7% or more in all of them). The deficit exceeded the Maastricht criterion (3% of GDP) in 15 EU Member States. The budget has a surplus in two EU Member States – Denmark and Luxembourg.

In accordance with the EC's forecasts in autumn 2022, in 2022, the average level of budget deficit in the EU is expected to be 3.4% of GDP, while in 2023 – 3.6%. The highest budget deficit in 2022, which may exceed 6% of GDP, is expected in Latvia, Romania, Hungary, and Malta.

The 2023 budget will be adopted by the new Saeima. 2023 will begin with a temporary or technical state budget. The MoF has prepared a draft general government budget plan for 2023, based on the updated macroeconomic development scenario and updated fiscal forecasts. It was drafted using an unchanged policy scenario, namely, taking into account the fiscal impact of all the adopted decisions, but disregarding any potential decisions adopted by the next CM in the process of drafting the budget for 2023. The estimated budget deficit approved by CM in the middle of October 2022 is: in 2023 – 3.3% of GDP, in 2024 – 0.7% of GDP and in 2025 – 0.2% of GDP.

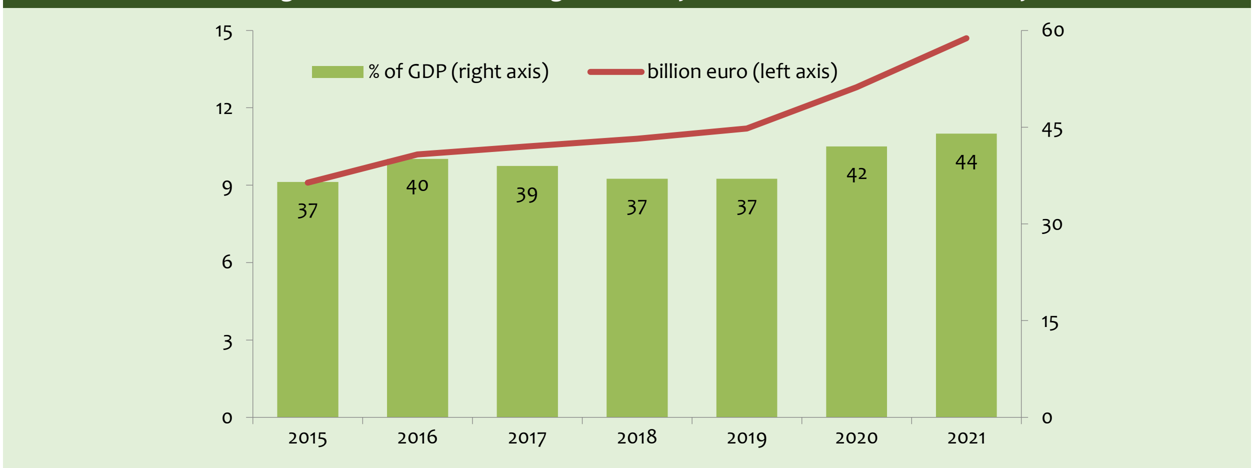
Figure 6.22

**General government budget balance in the EU member States in 2021 and 2022**
*as per cent of GDP*


The general government debt in Latvia is still one of the lowest in the EU (see Figure 6.22).

Figure 6.23

**General government consolidated gross debt by nominal value at the end of the year**



The average level of public debt in the EU in 2021 was 87.9% of GDP (in 2020 – 89.8% of GDP). In 2021, across 14 EU member states, the public debt exceeded the Maastricht criterion, which is 60% of GDP. The highest public debt to GDP in 2021 was in Greece, Italy, Portugal, Spain and France, where it exceeded 110% of GDP. The lowest general government debt to GDP was registered in Estonia, Bulgaria, and Luxembourg. As indicated by the EC forecasts for autumn 2022, the average level of public debt in the EU will slightly reduce to 86% of GDP in 2022 and to 84.9% in 2023.

Similarly to other EU Member States, in Latvia, the outbreak of Covid-19 caused the need to provide considerable amounts of funding to mitigate the impact caused by the pandemic crisis. The government debt increased to 42.0% of GDP or 12.7 billion euro in 2020 and continued to increase to 43.6% of GDP or 14.7 billion euro in 2021 (see Table 6.23).

According to provisional data of the Treasury, in Q3 2022, central government debt amounted to 40.8% of estimated GDP. Since nominal GDP growth at high inflation is rapid, debt relative to GDP is expected to stabilise in the coming years.

In accordance with the MoF assessment, at the end of 2022 the general government debt level is expected to amount about 42% of GDP. In the next two years, the general government debt level will stabilise at around 42% to 43% of GDP with a minor decreasing trend starting from 2025.

By implementing timely borrowing measures according to the medium-term strategy and by continuing implementation of a sustainable fiscal policy, it is possible to refinance the currently undertaken debt liabilities of the central government under favourable conditions in terms of interest rates and maturity, and to achieve a decrease and stabilisation of the level of the general government debt at a sustainable level in a long-term perspective, thus convincingly complying with the criteria concerning the amount of general government debt specified in the *Maastricht Treaty*.

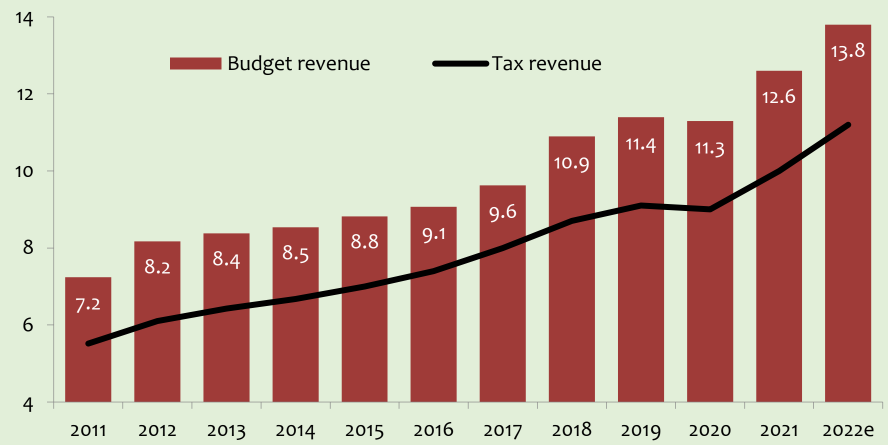
## 6.6. BUDGET REVENUE AND EXPENDITURE

### BUDGET REVENUE[1]

Since 2011, as the economic situation has improved after the economic crisis, the budget revenues have increased. From 2010 to 2021, consolidated general budget revenue increased 1.9 times. In 2021, budget revenues amounted to 12.6 billion euro or for 1.3 billion euro more than in 2020. The budget revenue growing trend will continue also in 2022, and in the three quarters of 2022 they exceeded the indicator of the previous year by 9.8%.

Figure 6.24

**General government consolidated budget revenues**
*billion euro*




e – evaluation by the MoE

[1] The official data of monthly reports of the Treasury was used in this chapter.

Tax revenue is the main revenue item and constitutes approximately 4/5 of all budget revenue. A stable increase in this revenue was observed in 2011-2019. In 2020, there was a small reduction in tax revenue due to the Covid-19 pandemic, however, an increase is observed again in 2021.

In recent years **employment taxes** account for approximately a half of all tax revenues. After the fall caused by the Covid-19 pandemic in 2020, employment tax revenue in 2021-2022 continued to increase.

In 2012-2019, personal income tax revenue increased, primarily affected by the improvement of the situation in the labour market. After the fall in 2020, positive dynamics resumed in 2021. In the three quarters of 2022, the personal income tax revenue kept growing and in this period exceeded 29.6% of the indicator of the first three quarters of 2021. The introduction of tax incentives continued in 2022, for example, the general non-taxable minimum and the non-taxable minimum for pensioners increased. In the three quarters of 2022, revenues from mandatory state social insurance contributions increased as well with the increase rate of 24.7%, compared to the corresponding period of the previous year.

Table 6.4

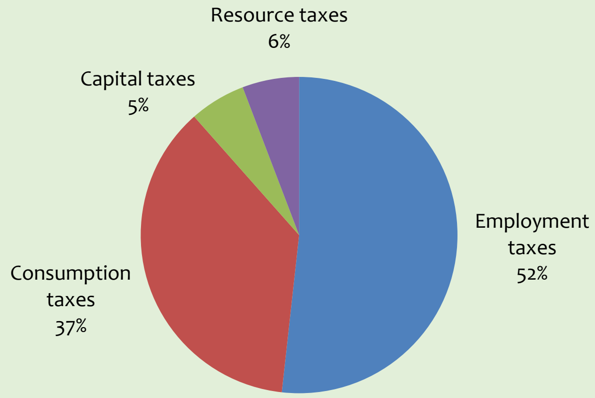
**Budget revenue**
*as per cent of GDP*

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 Jan-Sep |
|---|---|---|---|---|---|---|---|
| **General government consolidated budget revenues** | **35.7** | **35.7** | **37.3** | **37.2** | **37.4** | **37.3** | **36.1** |
| **I Tax revenues** | **29.2** | **29.7** | **29.7** | **29.5** | **29.7** | **29.8** | **29.4** |
| *1. Indirect taxes* | 11.5 | 11.6 | 12.1 | 12.3 | 12.1 | 11.7 | 12.1 |
| – value-added tax | 8.0 | 8.1 | 8.4 | 8.6 | 8.4 | 8.2 | 8.8 |
| – excise tax | 3.4 | 3.4 | 3.5 | 3.5 | 3.5 | 3.3 | 3.0 |
| – customs duty | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| *2. Income taxes and property taxes* | 8.5 | 8.7 | 7.7 | 7.2 | 7.4 | 7.2 | 7.5 |
| – corporate income tax | 1.7 | 1.6 | 1.0 | 0.1 | 0.7 | 0.8 | 1.0 |
| – personal income tax | 6.0 | 6.3 | 5.9 | 6.3 | 6.0 | 5.7 | 5.8 |
| – real estate tax | 0.9 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 |
| *3. Social insurance contributions* | 8.4 | 8.6 | 9.1 | 9.4 | 9.6 | 9.3 | 9.6 |
| *4. Other taxes* | 0.8 | 0.8 | 0.7 | 0.6 | 0.6 | 1.6 | 0.2 |
| **II Other revenues** | **6.5** | **6.0** | **7.6** | **7.7** | **7.7** | **7.6** | **6.7** |

**Consumption tax** revenues constitute approximately 1/3 of all tax revenues. In recent years, consumption tax revenue has increased due to the rise in private consumption and, consequently, the increase in retail turnover. In the three quarters of 2022, compared to the three quarters of 2021, the increase in consumption tax revenue was 17.1%.

Figure 6.25

**General government consolidated budget tax revenues by tax groups**
*January-September 2022, as per cent*



In 2022, the increase of excise duty on tobacco products and non-alcoholic sweetened beverages continued. From 1 July 2022, the excise duty on wine, fermented beverages and intermediate products was reduced for a certain quantity produced. In 2022, the value added tax rate for books and press publications reduced from 12% to 5%.

In 2010-2019, value added tax revenue increased. After the fall in 2020, the increase resumed the following year. In the three quarters of 2022, the growth rate was 19.2% compared to the corresponding period of 2021. A similar trend is observed in the area of the consumption part of the excise tax revenue, but with a slower growth rate.

**Capital tax** revenues increased until 2017. The reduction in 2018 and 2019 was underpinned by the changes made within the tax reform in the field of corporate income tax. In 2020, capital tax revenues resumed growth. In the three quarters of 2022, revenues from corporate income tax and real estate tax are higher than in the three quarters of 2021 – 24.8% and 3%, respectively.

Since 2010, **resources tax** revenue has been growing. Growth trends are observed in revenue from natural resource tax and excise tax on petroleum products and natural gas. In the three quarters of 2022, resource tax revenue exceeded the indicator of the first three quarters of 2021 by 5.3%.

## BUDGET EXPENDITURE

Since 2011, after an extensive cutting down of expenditure during the economic crisis, the **general government consolidated budget expenditure** has gradually increased (barring 2016, when general government budget expenditure slightly declined). They increased by 15.6% and amounted to 14.4 million euro in 2021. The increase continued also in 2022. In its three quarters, general government consolidated budget expenditure amounted to 10.6 billion euro, so it increased by 4.8%. The dynamics of budget expenditure items was underpinned by the channelling of funds for Covid-19 support measures, compensation of energy prices, as well as to support Ukraine.

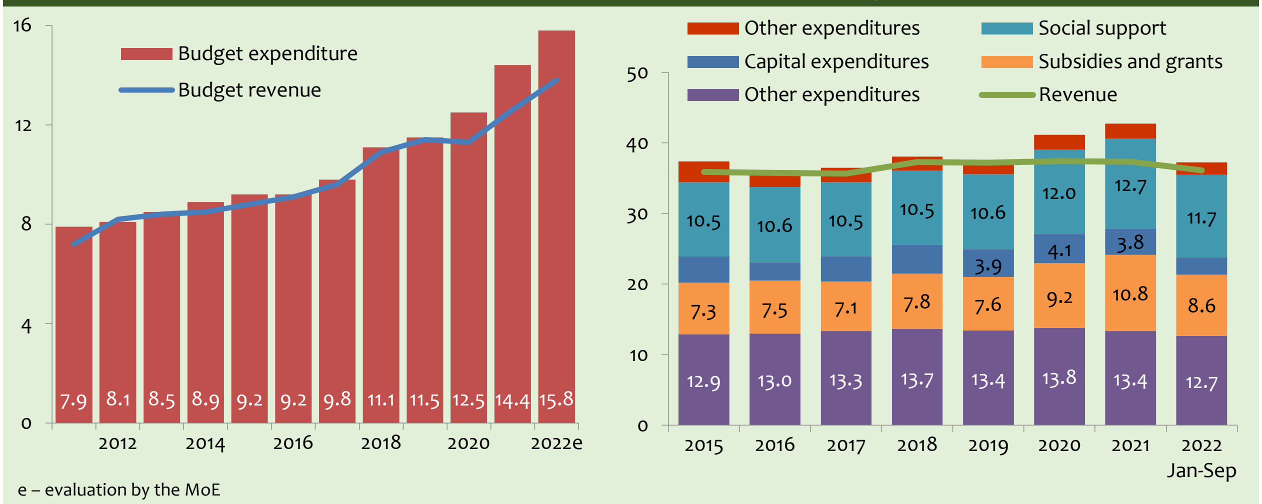
Since 2016, **expenditure on subsidies and grants** has been growing. In the three quarters of 2022, the upward trend continues, and the increase is 24%.

The **capital expenditure** growth trend has been observed since 2017. In the three quarters of 2022, this trend changed, and capital expenditure decreased by 4.6% compared to the corresponding period of 2021.

Figure 6.26

**General government consolidated budget expenditure**

*billion euro* *as per cent of GDP*

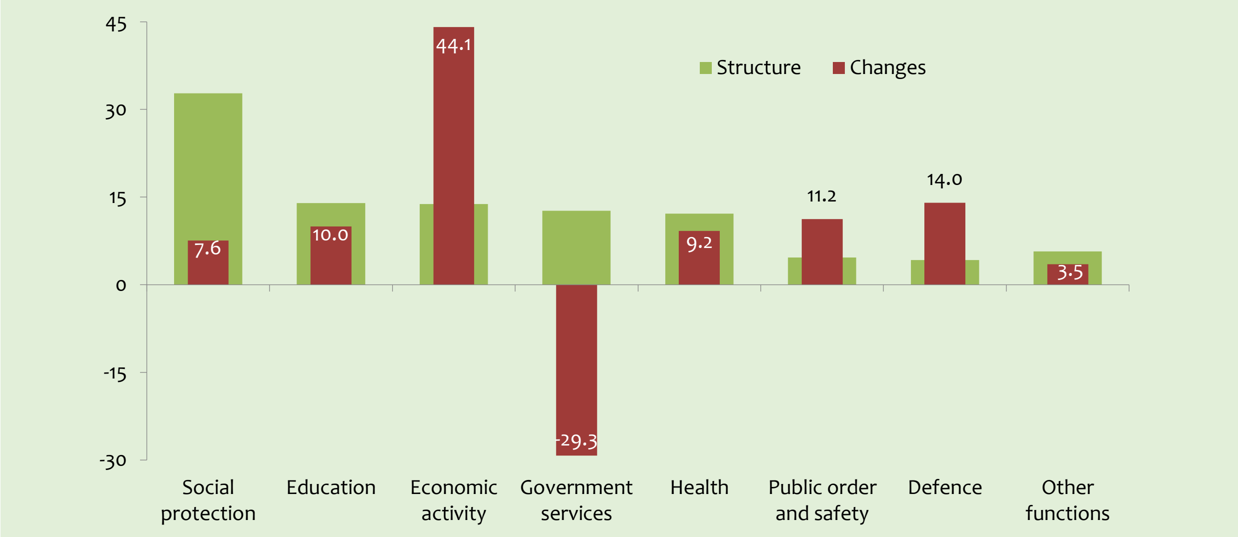



Since 2011, **current expenditure** has been growing. It was 16.3% higher in the three quarters of 2022 than in the three quarters of the previous year.

Changes have been introduced in the budget expenditure structure by functional categories in relation to Covid-19 support measures, Russia's invasion of Ukraine and compensation for energy prices. The largest expenditure growth rate in the three quarters of 2022 is in areas such as economic activity, defence, as well as public order and safety.

Figure 6.27

**General government consolidated budget expenditure by function in January-September 2022**
*as per cent*




## 6.7. PRODUCTIVITY AND COMPETITIVENESS

### PRODUCTIVITY

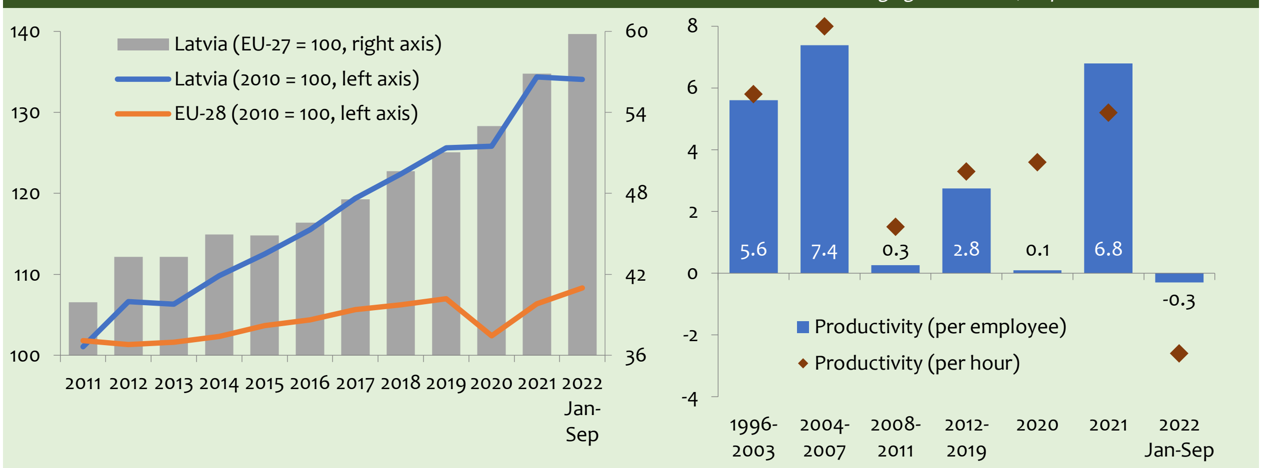
Latvian economic growth is supported by the increase in productivity. However, productivity rates tend to decrease in the long term, while the increase in labour costs remain persistently high.

The most rapid increase in productivity was observed before 2008, after Latvia acceded to the EU, which became a significant incentive for the inflow of foreign investments. From 2004 to 2007, productivity increased by 7.4% per year (EU average – 1.4%). Furthermore, the global financial crisis had a negative impact on productivity. In the first two years of economic recession (2008-2009), it declined by 2.3%, which was still rather insignificant compared to the drop in GDP (by 17%) mainly due to the strong adjustments in the labour market. Although the effects of the crisis have not been long and positive productivity dynamics have been observed since 2010, they are still half slower than the average in 1996-2007.

Figure 6.28

**Productivity in Latvia and in the EU**

**Productivity dynamics**
*annual average growth rates, as per cent*



Productivity has been growing by 14.3% per year in the last five years (2015-2019) before the Covid-19 pandemic, i.e., almost three times more rapidly than in the EU on average. Transportation and storage, manufacturing, and trade have made the largest contribution to total productivity growth in the national economy. Dynamics were positive also in other sectors, except financial intermediation, where productivity was at a 18% lower level in 2019 compared to 2014.

Since 2020, the productivity dynamics were determined by adjustments in product and labour markets in response to the measures to contain Covid-19. In 2020, productivity remained at the level of the previous year, while in 2021, as the restrictions reduced and economic activities resumed, productivity increased by 6.8% and GDP per employed in the Latvian economy reached 56.9% (almost 75% according to PPS) of the EU average. Since 2016, the productivity gap between the EU average and Latvia (according to PPS) reduced by almost 11 percentage points.

The impact of the Covid-19 crisis on productivity remains uncertain. Measured by the number of people employed, in 2020, productivity grew by just 0.1%, but by the number of hours worked, it has increased by 3.6%, slightly lower than the average over the past decade. Clearly different fluctuations in productivity rates in the first year of the Covid-19 pandemic were largely affected by state support, mainly in the form of subsidised wage schemes, which contributed to the preservation of jobs, while the number of hours worked reduced.

In 2021, productivity (per employee) in the Latvian economy was at a 6.8% higher level than in the period concerned a year ago, but hourly productivity – 5.2% higher. This was mainly driven by a sharp increase in productivity in services sectors, including trade, transport services and financial intermediation.

In the nine months of 2022, productivity (per employee) in the Latvian economy was at a 0.3% lower level than in the period concerned a year ago. It was mostly affected by the decrease in productivity in the trade and construction sectors.

In the short term, productivity fluctuations lead to changes in product, labour and capital markets as businesses respond to external and internal shocks (such as Covid-19 pandemic, energy crisis, etc.) and their containment and stabilisation of the economy. The impact of these measures on long-term productivity trends will largely determine change in business models and consumer behaviour. In recent years, there have been significant changes in labour and product markets, the degree of digitisation increases (e-services, remote work, etc.). However, great uncertainty regarding the stability of these changes and their impact on long-term productivity trends remains. Structural changes in Latvian economy towards higher value-added activities and knowledge-intensive industries will also greatly determine the positive dynamics of productivity.

## COST AND PRICE COMPETITIVENESS

Latvia is in one of the leading positions by productivity growth rates among the EU Member States, yet wages have been growing faster than productivity, thus weakening competitiveness of Latvian entrepreneurs in the field of costs. The increase in nominal unit labour costs (ULC)[1] also evidences of the growing risks of losses in cost competitiveness.

Statistical data shows that in years of high economic growth the gap between productivity and labour costs is widening, while in recession it is getting lower. The growth rates of workers' wages in 2004-2007 were almost five times higher than those of productivity dynamics indicators, which also had a reflection in a rapid increase in ULC. Although the serious adjustments to product and labour markets created by the global financial crisis in 2009-2011 bridged the gap between the increase in productivity and labour costs, the ULC growth also has resumed after the economy recovered.

Particularly strong dynamics of nominal ULC was observed in the last years before the Covid-19 pandemic. In 2019, compared to 2015, ULC rose 15.4%, driven by a nearly threefold faster increase in labour costs compared to productivity growth. Before 2019 the increase in labour costs was affected both by wage convergence processes in the EU labour market and more tense situation in the Latvian labour market due to the increase in labour shortage.

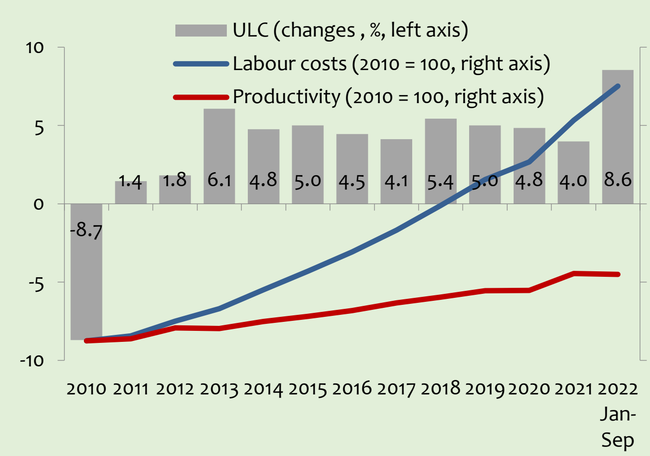
ULC continued to grow also in the years of the Covid-19 pandemic. Due to the decline in economic activity, labour costs increased more slowly in 2020 than a year ago – by 5% (by 7.8% in 2019). Despite a more moderate increase in labour costs, it did not compensate for the slow increase in productivity (by 0.1%) and ULC increased by 4.8%. In 2021, labour costs kept growing rapidly and exceeded the level of the year before by 11%. This did not put significant pressure on labour unit labour costs, because productivity increased at the same time, and ULC increased by only 4%. By contrast, in the nine months of 2022, labour costs grew almost five times more rapidly than productivity, boosting nominal ULC by 8.6%.

Sharp growth of nominal ULC is observed in all the Baltic countries. In 2021, compared to 2018, nominal ULC increased by 14.5% in Latvia, by 10.7% in Estonia and by 19.2% in Lithuania, which is much faster than in the EU on average (6.5%). The threshold (9%) set for this indicator in the *EU Alert Mechanism* (MIP) for countries of the Baltic countries has been exceeded (for details see Chapter 6.8).

[1] ULC is a relationship between labour costs and productivity. If productivity is growing faster than the wages, then ULC is decreasing, which is an indication that competitiveness of state costs increases, and the other way around.

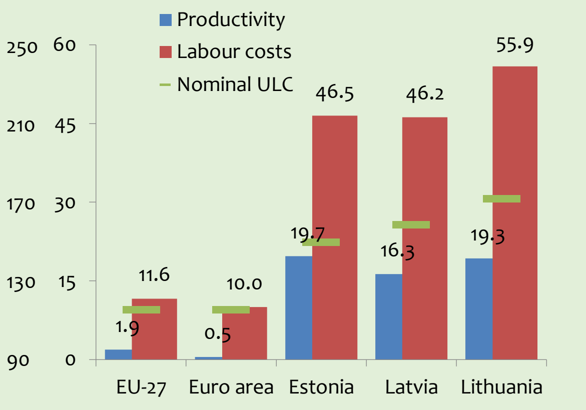
Figure 6.29

**ULC, productivity and labour costs**




**ULC, productivity and labour costs in the Baltic countries and in the EU**

*2021, compared to 2016, as per cent*

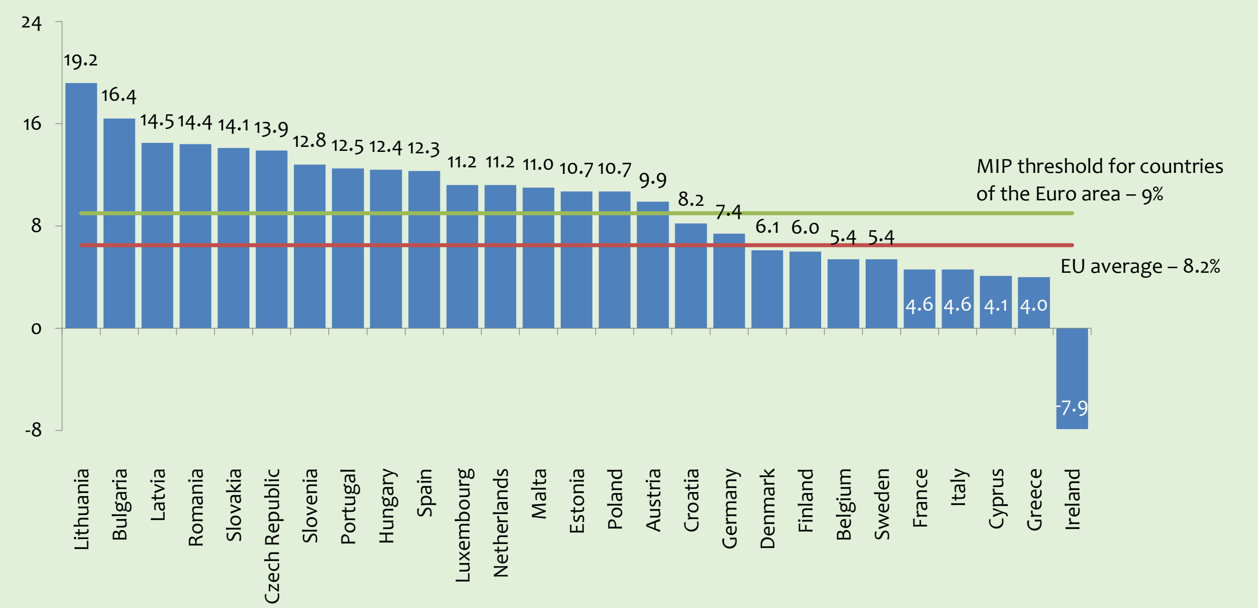



Cost competitiveness reduction risks are observed in both manufacturing and services sectors. The dynamics of labour costs in the last five years (2015-2019) before the Covid-19 pandemic in both mentioned groups of sectors were very similar – they increased by almost 7.1% and 7.8% on average every year, respectively. However, productivity in manufacturing sectors increased almost one and a half times more rapidly than in the services sectors – by 3.7% and 2.2%, respectively. Therefore, also the nominal ULC increase in manufacturing sectors was more moderate.

Figure 6.30

**Nominal ULC in EU countries**

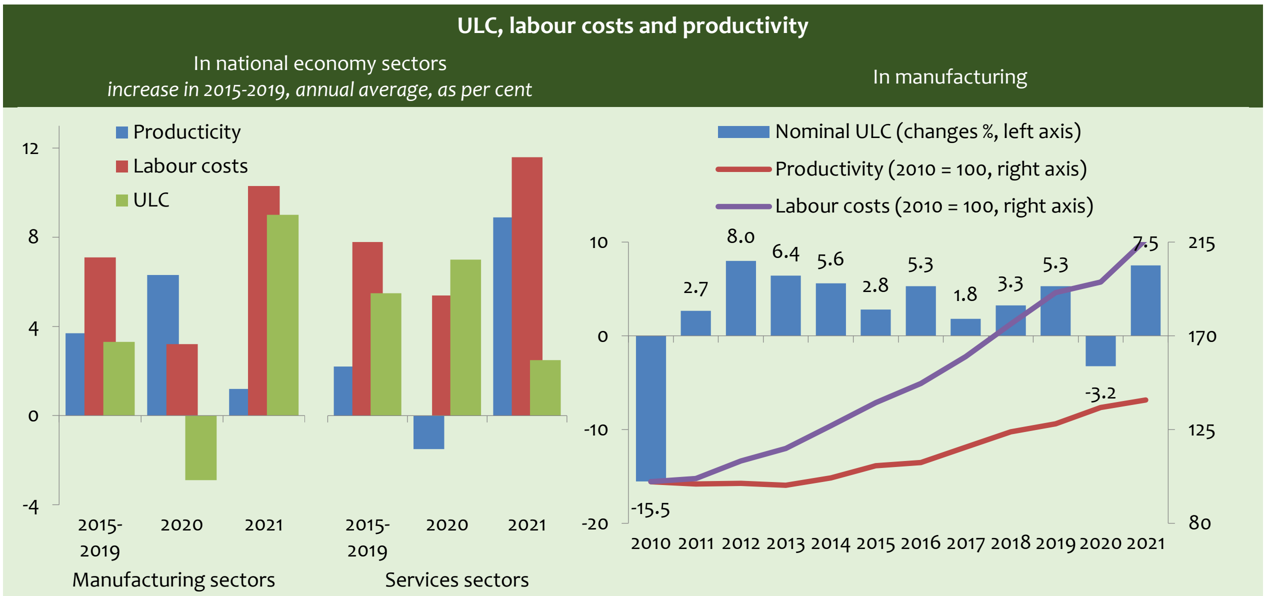
*changes as per cent, over three years (2021, compared to 2018)*




The shock related to the Covid-19 pandemic has a stronger impact on the products market than the labour market. In two years (2020-2021), labour costs in manufacturing and services sectors increased by 13.8% and 17.6%, respectively. Although productivity in goods manufacturing sectors increased in 2020 and 2021, it was unable to compensate for the increase in labour costs, and ULC increased by 5.8%. The largest increase in nominal ULC in the two years was observed in the field of information and communication, and in the construction sector. In financial services, unit labour costs of products were at a lower level than in 2019, mainly due to the decrease in the number of employees.

In manufacturing the gap between the rise in productivity and labour costs is slightly more moderate than in the economy overall. However, annual changes in nominal ULC are rather volatile; to a large extent they are affected by factors on the goods market, while labour costs show stable upward dynamics. Labour costs in manufacturing were growing two times faster than productivity in the last five years before the Covid-19 pandemic (2015-2019).

Figure 6.31

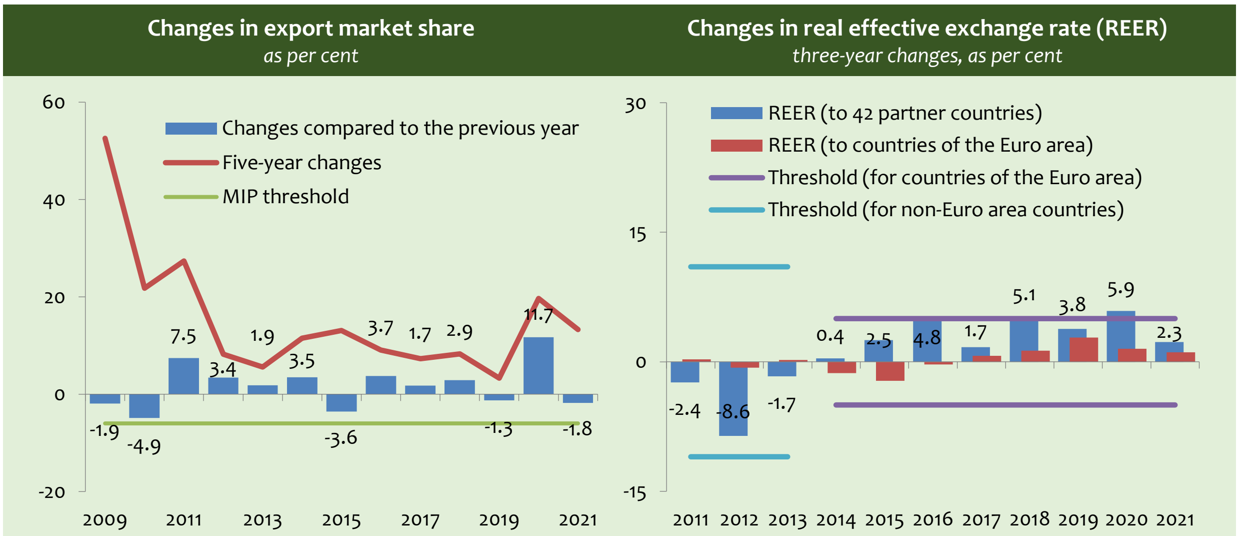



In 2020, both productivity and labour costs have increased by 6.1% and 2.6%, respectively, thus decreasing nominal unit labour costs of products by 3.2%. It evidences that under the influence of the measures to restrict the Covid-19 pandemic the changes in the number of the employees were stronger than the decline in manufacturing volumes. Nevertheless, labour costs in companies in manufacturing sectors to continues to increase.

In 2021, the dynamics of productivity and labour costs in manufacturing remained positive. Compared to the previous year, productivity in the sector increased by 2.7%, but labour costs increased much more rapidly – by 10.4%. As the gap between the growth rates of productivity and labour costs is expanding, nominal ULC is growing more rapidly as well – by 7.5%, getting close to the trends of the crisis caused before the pandemic.

The labour costs dynamics in Latvian manufacturing significantly exceeds EU average labour costs and nominal ULC growth rates. Considering that the EU countries are our main trade partners, such trends reduce the competitiveness of Latvian producers in the field of costs.

Figure 6.32



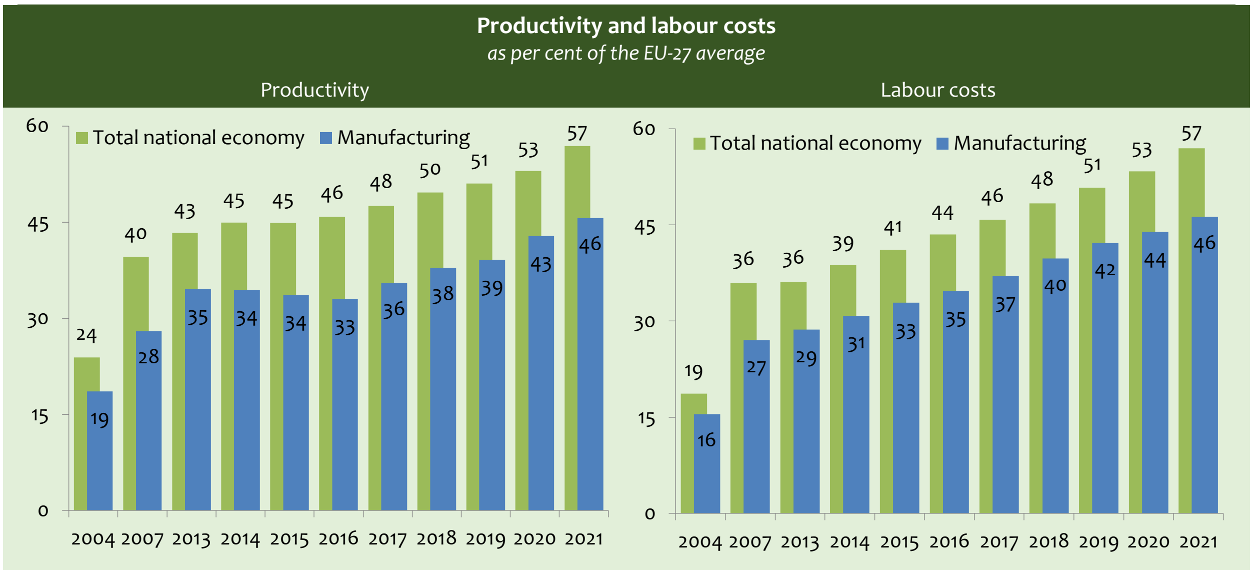
Although trends in cost competitiveness indicators are negative, the long-term dynamics of the Latvia's export market share are improving. In the last five years (2017-2021), the Latvia's export market share in world markets increased by 11.8%, largely affected by the positive changes in the goods export market. In five years (2017-2021), the share of Latvia in the goods export market grew by 19.7%. Export market share in the world has reduced – by 5.2% over five years. This was mainly underpinned by the negative dynamics of the market share since 2019 due to the pandemic containment measures.

The real effective exchange rate (REER) is growing. The consumer price index (CPI) based REER to 42 trade partner countries has increased 2.3% in the last three years (2018-2021), which is more than the threshold set by MIP. However, it should be noted that the increase in the export share along with the rapid increase in labour costs implies that the increase in wages is compensated in prices only partially.

In the long term, the increase in labour costs, which is not compensated by a corresponding rise in productivity, may have a negative impact competitiveness and reduce the share of company's profits, which entrepreneurs will be forced to adjust to keep price competitiveness in external markets.

Labour costs in Latvia are among the lowest in the EU Member States. In 2021, labour costs per employed in the Latvian economy were almost 57% of the EU average, whereas in the manufacturing industry – 46.3%. Compared to 2016, in 2021, the labour cost gap decreased by 14 percentage points (in manufacturing – by 11.6 percentage points), while in terms of productivity in the economy it fell by a total of 10 percentage points (by 12.6 percentage points in manufacturing). This means that the wage convergence process in the economy is generally more rapid than productivity convergence, but the productivity convergence rate in manufacturing has been the most rapid in recent years.

Figure 6.33




The increase in productivity is the main factor determining competitiveness. Although Latvia's export share in world markets is growing, the risks of decline in competitiveness remain elevated. The gap between productivity and labour costs increased as a result of the crisis caused by the Covid-19 pandemic. The data of 2021 evidence that as the economic activity has resumed, the dynamics of labour costs are becoming more rapid than productivity dynamics, increasing cost competitiveness reduction risks even more. Therefore, strengthening of Latvia's competitiveness will largely depend on the ability to reduce the productivity gap with the EU Member States. Structural changes in Latvian economy continuing progress towards higher value-added activities and knowledge-intensive industries will also greatly determine the stability of productivity increase.

## 6.8. ALERT MECHANISM

According to the economic and fiscal policy surveillance rules adopted in 2011, a **macroeconomic imbalance procedure** (MIP) was created in the EU in addition to the existing excessive budget deficit procedure. The procedure aims to identify imbalances that hinder the uniform development of Member State economies and to spur the right policy responses. The implementation of the MIP is embedded in the European Semester of economic policy coordination (see Chapter 8.1) so as to ensure consistency with the analyses and recommendations made under other economic surveillance tools.

On 22 November 2022, the EC published the ***Alert Mechanism Report***[1] (AMR) for 2023, which identifies the countries with excessive imbalances – Cyprus, France, Germany, Greece, Italy, the Netherlands, Portugal, Romania, Spain and Sweden. In-depth reviews were prescribed for the countries. Meanwhile, in-depth analysis in individual areas will be performed for the countries, which could be subject to individual macroeconomic imbalance risks – Czechia, Estonia, Hungary, Latvia, Lithuania, Luxembourg and Slovakia.

The scoreboard reading for Latvia shows that in 2021 four indicators were beyond their indicative thresholds, namely nominal unit labour cost (NULC) index, real house price index, change in activity rate and change in youth unemployment (see Table 6.5).

Table 6.5

**List of indicators of the macroeconomic imbalance procedure for Latvia**

| | Thresholds | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|
| External imbalances and competitiveness | | | | | | | | | |
| Current account balance (% of GDP, 3-year average) | -4%/6% | -2.7 | -1.6 | -0.2 | 0.8 | 0.9 | 0.2 | 0.6 | -0.7 |
| Net international investment position (% of GDP) | -35% | -64.1 | -60.1 | -54.3 | -51.5 | -45.4 | -40.3 | -34.1 | -27.4 |
| Real effective exchange rate – 42 trading partners, HICP deflator (3-year % change) | ±5%* & ±11% | 0.4 | 2.5 | 4.8 | 1.7 | 5.1 | 3.8 | 5.9 | 2.3 |
| Export market share – % of world exports (5-year % change) | -6 % | 11.5 | 13.1 | 9.2 | 7.3 | 8.4 | 3.3 | 19.7 | 13.4 |
| Nominal unit labour cost index (3-year % change) | 9%* & 12% | 13.2 | 16.7 | 14.9 | 14.2 | 14.7 | 15.2 | 16.1 | 14.5 |
| Internal imbalances | | | | | | | | | |
| Deflated house prices (% y-o-y change) | 6% | 4.7 | -2.8 | 7.2 | 5.3 | 6.4 | 5.8 | 2.7 | 7.3 |
| Private sector credit flow (as % of GDP, consolidated) | 14% | -4.6 | -0.8 | 2.5 | 2.8 | -0.2 | 1.1 | -1.9 | 0.9 |
| Private sector debt (as % of GDP, consolidated) | 133% | 82.2 | 78.3 | 78.3 | 75.7 | 69.8 | 66.2 | 64.7 | 58.0 |
| General government sector debt (as % of GDP) | 60% | 41.6 | 37.0 | 40.3 | 38.9 | 37.0 | 36.5 | 42.0 | 43.6 |
| Unemployment rate (3-year average, %) | 10% | 12.6 | 10.9 | 10.2 | 9.4 | 8.6 | 7.5 | 7.3 | 7.3 |
| Total financial sector liabilities (% y-o-y change) | 16.5% | 10.9 | 13.3 | 4.7 | 6.2 | -3.5 | 4.6 | 10.8 | 13.2 |
| Employment indicators | | | | | | | | | |
| Activity rate – % of total population aged 15-64 (3-year change, percentage points) | -0.2 percentage points | 1.8 | 1.4 | 2.4 | 2.5 | 1.9 | 1.1 | 1.1 | -1.8 |
| Long-term unemployment rate – % of economically active population aged 15-74 (3-year change, percentage points) | 0.5 percentage points | -4.7 | -3.7 | -1.9 | -1.5 | -1.5 | -1.7 | -1.2 | -1.1 |
| Youth unemployment rate – % of economically active population aged 15-24 (3-year change, percentage points) | 2 percentage points | -11.4 | -12.2 | -5.7 | -2.6 | -4.1 | -4.8 | -2.1 | 2.6 |

* for countries of the Euro area
Note: highlighted number exceed the limits of thresholds set in the alert mechanism.
Source: *MIP Scoreboard, Eurostat*

[1] https://ec.europa.eu/info/publications/2023-european-semester-alert-mechanism-report_en

It is noted in AMR that real GDP growth in Latvia is forecast at 1.9% in 2022 and -0.3% in 2023.

External sustainability risks are limited despite the worsening outlook. The current account turned negative in 2021, reaching -4.2%, and is forecast to deteriorate further in 2022, mainly due to rising costs of energy imports. The government deficit widened significantly during the Covid-19 crisis, having reached 7% in 2021, and is forecast to remain at about this level in 2022 before narrowing in 2023. However, the net international investment position (NIIP) continued improving and reached -27.4% of GDP in 2021.

Cost competitiveness concerns existed already before the Covid-19 pandemic and remain pertinent. Nominal unit labour cost growth decelerated to 4% in 2021 but is forecast to pick up again strongly in 2022 and remain high in 2023. The high inflation may put additional pressure on wage growth and the worsening economic outlook is expected to reduce productivity growth. While inflation has been particularly high, the HICP-based real effective exchange rate appreciated marginally in 2021, and year-on-year also appreciated by August 2022.

High house price growth continues being of concern. Nominal house price growth stood at 10.9% in 2021 and accelerated significantly in the first half of 2022. Nominal year-on-year house price growth was at 16.5% in the second quarter of 2022. This acceleration follows a decade where house price growth remained broadly in step with wage growth. In 2021, house prices were estimated to be 10% overvalued. Mortgage lending is moderate and household debt low and decreasing.

The banking sector is sound and well capitalised. Profitability improved in 2021 above the EU average and the non-performing loans ratio declined by more than 2 percentage points to 2.1%. The private sector debt has continued declining.

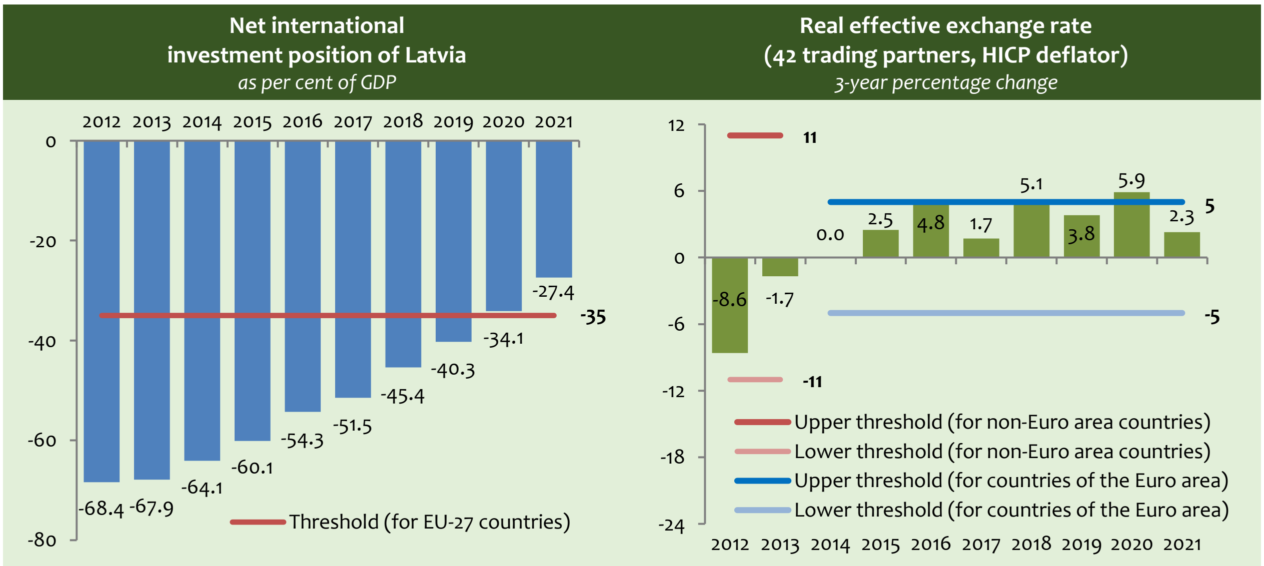
The labour market deteriorated during the Covid-19 crisis and has not fully recovered. The unemployment rate decreased to 7.6% in 2021 and is forecast to decrease in 2022 before increasing again in 2023. The activity rate fell significantly in 2021 breaking an almost decade long trend of improvement, but it is forecast to start increasing again in 2022. Youth unemployment has failed to improve after the increase in 2020.

Indicators of the macroeconomic imbalance procedure (both on the primary list and on the auxiliary list) have been selected to better and faster warn about each potential macroeconomic imbalance, as well as help to characterise the processes ongoing in the economy.

External imbalances and competitiveness are characterised by current account balance, net international investment position, real effective exchange rate, export market share and nominal unit labour cost index.

The 3-year average current account balance of Latvia does not surpass the thresholds. From 2017 to 2020, including, it was positive. The countries, where the 3-year average current account balance in 2021 surpassed the upper threshold, were the Denmark, Germany and the Netherlands, and the lower threshold was surpassed in Cyprus, Romania, Greece and Ireland.

Figure 6.34




Source: *Eurostat*

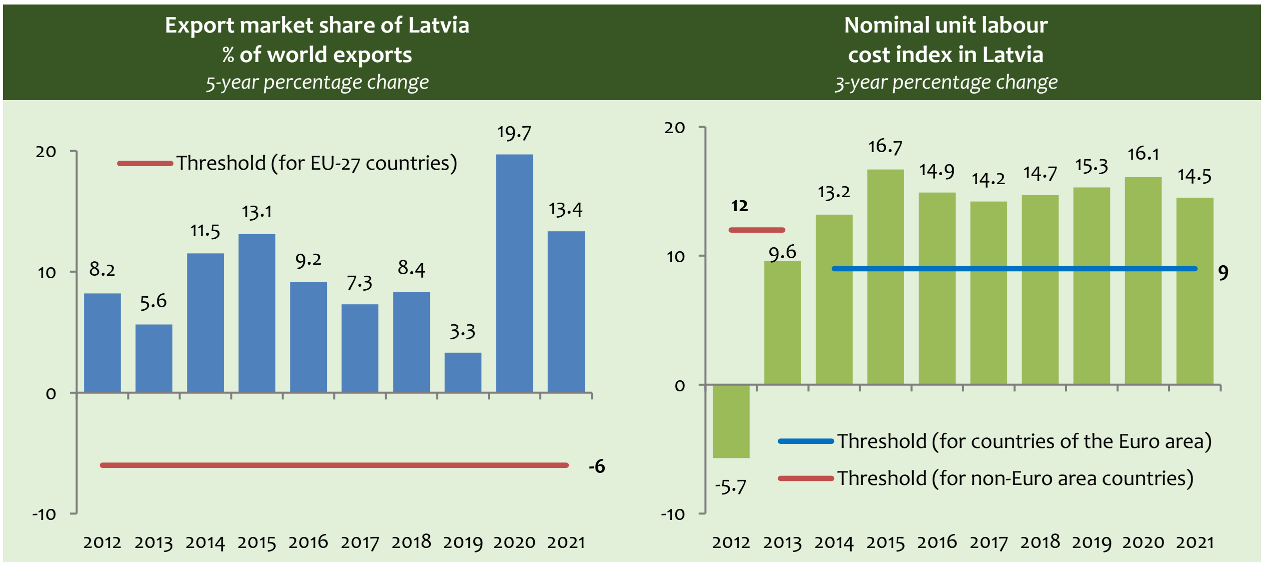
Since 2020, the net international investment position of Latvia no longer surpasses the threshold (see Figure 6.34). Meanwhile, in 2021, 10 of EU-27 countries surpassed the NIIP threshold, moreover, in three of them, this indicator was lower than -100% of GDP (Greece, Ireland and Cyprus). FDI is considered the safest means of raising foreign capital included in NIIP. In 2021, FDI constituted 40.5% of the total attracted foreign capital in Latvia.

Until 2020, Latvia surpassed the real effective exchange rate 3-year change neither before nor after its accession to the Euro area. However, in 2020 it surpassed the upper threshold, and as data of the previous years were updated, it was stated that the upper threshold was surpassed also in 2018 (see Figure 6.34). Out of EU-27 countries, real effective exchange rate 3-year changes did not surpass the threshold in any of the countries in 2021.

In 2021, the share of the Latvian export market slightly shrank, however, along with the rapid increase in 2020, the export market share 5 year % changes indicator improved remained high (see Figure 6.35). Meanwhile, this indicator in Italy, Spain and France was -6% below the threshold.

Since the accession of Latvia to the Euro area in 2014, the nominal unit labour cost index exceeds the threshold set for Euro area countries (see Figure 6.35). 10 Euro area and 4 non-Euro area EU-27 countries exceeded this threshold in 2021.

Figure 6.35




Source: *Eurostat*

Internal imbalances are characterised by deflated house prices, private sector, private sector debt, general government debt, unemployment rate and financial sector liabilities together.

After 2010, the house price index of Latvia exceeded the threshold in 2013, 2016, 2018 and 2021 (see Figure 6.36). Out of EU-27 countries, Czech Republic, Luxembourg, Netherlands, Lithuania, Estonia, Hungary, Austria, Denmark, Germany, Sweden, Portugal, Slovenia, and Greece exceeded the house price index threshold in 2021.

The private sector credit flow of Latvia has not exceeded the threshold since 2010. In 2021, out of EU-27 countries, this indicator exceeded this threshold only in Luxembourg and Sweden.

The private sector debt approached the threshold in Latvia only in 2010. After 2010, the private sector debt continues to decrease. In 2021, this indicator exceeded this threshold only in 11 out of EU-27 countries.

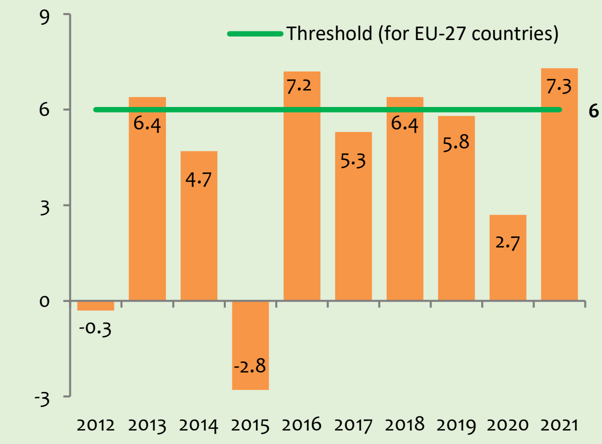
The general government debt of Latvia reached its highest level (47.3% of GDP) in 2010, however, it did not exceed the threshold. Then government debt reduced to 36.5% with small variations in 2019 and has increased again since 2020 (see Figure 6.36). In 2021, this indicator exceeded the threshold in 14 EU-27 countries.

The increase in total financial sector liabilities in Latvia has never exceeded the set 16.5% threshold. Out of EU-27 countries the total financial sector liabilities increase threshold in 2021 was surpassed by Lithuania, Slovakia, Ireland and Estonia.

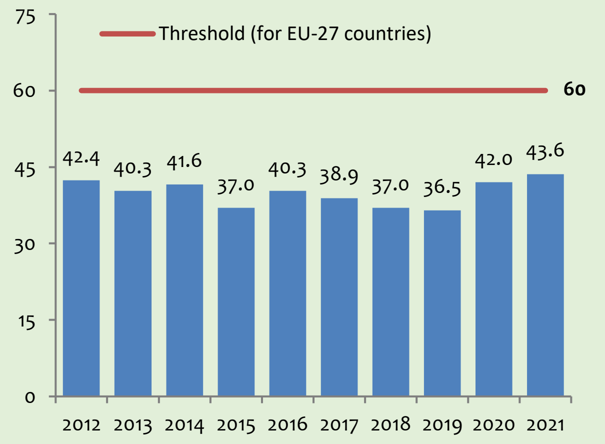
The list of MIP indicators includes indicators characterising employment such as changes in the level of economically active population, changes in the long-term unemployment rate, and changes in the youth unemployment rate. Youth unemployment is also characterised by an auxiliary indicator – youths not in employment, education or training.

Figure 6.36

**House price index in Latvia**
*1-year percentage change, deflated*




**General government debt of Latvia**
*as per cent of GDP*



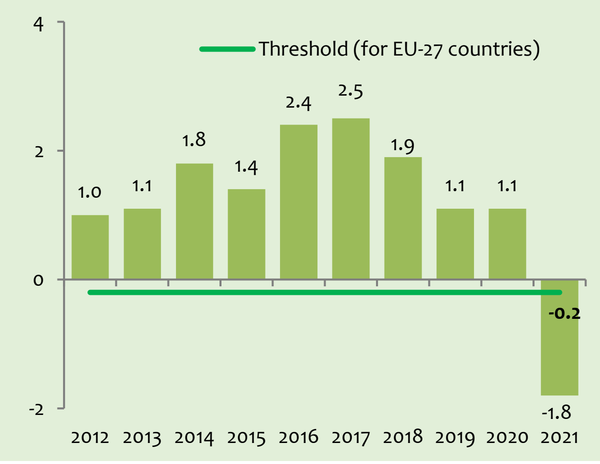

Source: *Eurostat*

Three-year changes in percentage points in the economically active population level in Latvia have exceeded the threshold since 2012, but in 2021, exceeded the threshold under the influence of the Covid-19 crisis (see Figure 6.37). In 2021, out of EU-27 countries this indicator surpassed the threshold also in Italy, Greece and Estonia.

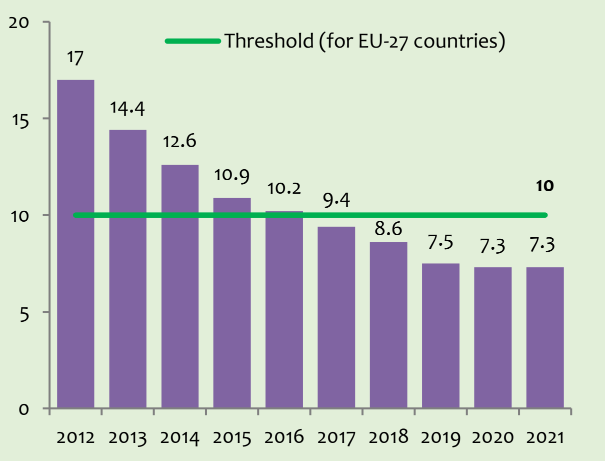
The three-year average unemployment rate in Latvia exceeded 10% from 2010 to 2016. It was the highest in 2011, but then reduced. It was 7.3% in 2021 (see Figure 6.37). In 2021, out of EU-27 countries the 3-year average unemployment rate exceeded the 10% threshold only in Greece and Spain.

Figure 6.37

**Changes in economic activity rate of working age population in Latvia**
as per cent of population aged 15-64
*(3-year change, percentage points)*



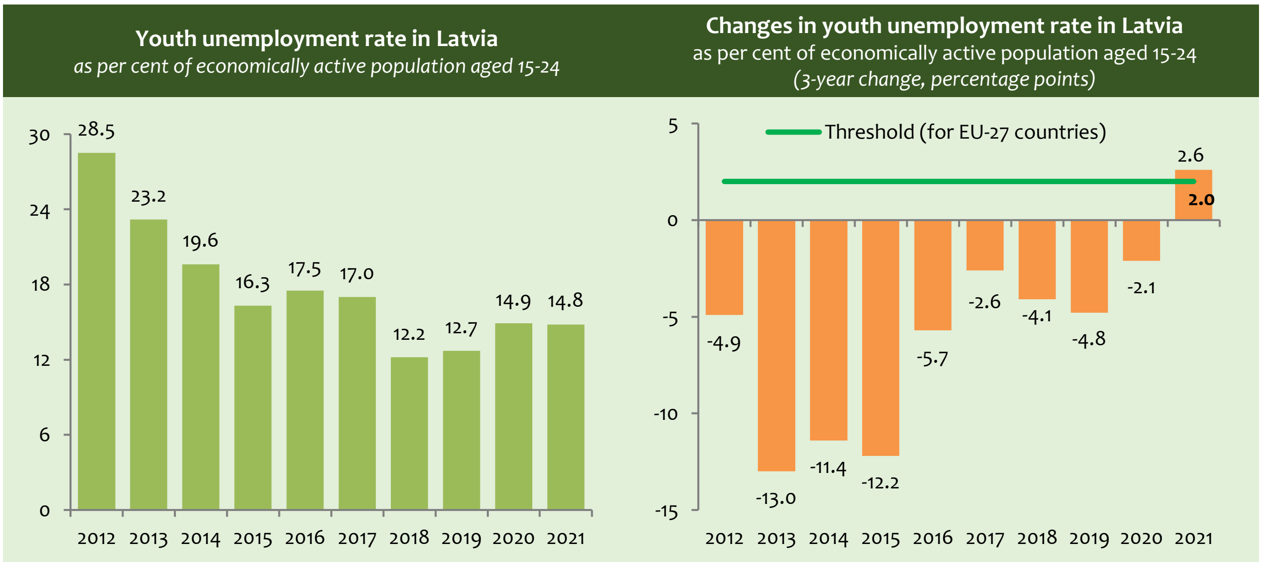

**Unemployment rate in Latvia**
*3-year average, as per cent*




After 2012, 3-year average long-term unemployment indicator in Latvia never exceeded the set threshold, because long-term unemployment continued to decrease, although no longer so rapidly in recent years (see Table 6.5). In 2021, out of EU-27 countries, 3-year average long-term unemployment indicator exceeded this threshold only in Lithuania.

If we look at annual changes, they show that youth unemployment reduced rather rapidly, while after 2015 there were years, when youth unemployment increased again (see Figure 6.38). In 2021, the change in youth unemployment rate exceeded the threshold under the influence of the Covid-19 crisis (see Figure 6.38). In nine EU-27 countries, change in the youth unemployment rate exceeded the threshold in 2021. In 2021, 8.6% of youths aged 15-24 in Latvia were not in employment, education or training.

Figure 6.38




Source: *Eurostat*

## 6.9. LATVIA IN INTERNATIONAL RATINGS

### INDICES

The indices created by the United Nations (UN), the World Bank group, the World Economic Forum and other organisations characterise Latvia as a country, which carries out many reforms to improve its competitiveness improving the business environment, human resources, ICT infrastructure and other areas, at the same time ensuring also free press and without endangering other countries of the world in a military way.

The indices below have been arranged starting from the highest place reached (see Figure 6.39), but their descriptions are broken down into main thematic groups. Many indices are published once in two years, while the preparation of other indices was delayed by the Covid-19 pandemic.

Comprehensive indices

In 2019, in the ***Global Competitiveness Index*** (GCI 4.0) of the World Economic Forum Latvia occupied the 41st place (Estonia – 31st place, Lithuania – 39th place) among 141 countries of the world. The index is composed of 12 pillars characterising the business environment, human capital, market (products, labour, financial) and innovation ecosystem. Taking into account the growing impact of digitalisation on the development of competitiveness, the GCI methodology was changed, and the index was renamed into GCI 4.0. In 2020, the preparation of the index was skipped because of the difficulties in collecting data due to the Covid-19 pandemic, and therefore a special edition was issued and was devoted to the ability of 37 countries to overcome the Covid-19 crisis. Latvia was not included in this list. The index was not prepared also in 2021.

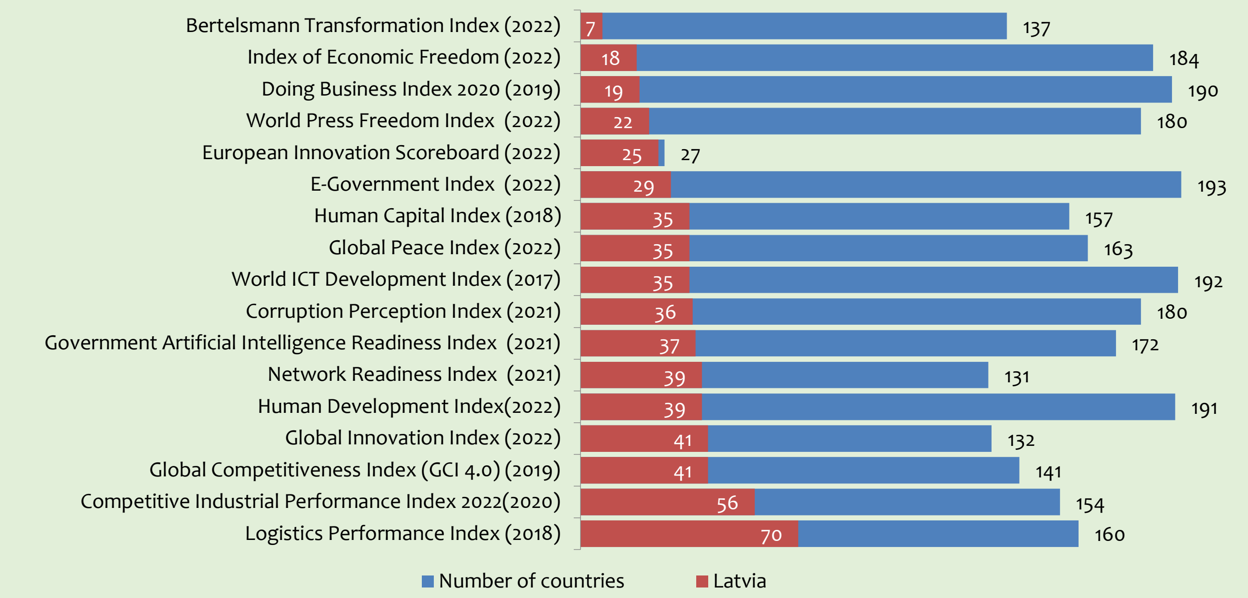
In the ***World Competitiveness Ranking 2022*** published annually by the International Institute for Management Development (IMD) Latvia was ranked 35th (Estonia – 22nd, Lithuania – 29th) among 63 countries of the world moving three positions up compared to 2021. Progress during the year was fostered by government stability, increase in investments to the economy, increase in exports and increase in investments of businesses in research and development. Progress was hindered by the increase in energy prices, which has caused high inflation of consumer prices, and employment indicators deteriorated as well.

In the ***Human Development Index 2022*** created by the UN Development Programme in 2022, which summarises the data of 2021 and includes life expectancy, literacy, education level, GDP per capita and other indicators, Latvia was ranked 39th (Estonia – 31st, Lithuania – 35th) among 191 countries of the world moving two positions down compared to 2020.

Figure 6.39

**Latvia's Position in the Most Popular International Ratings in 2022**

*position according to the year of the latest publication; number of countries in the index*




Source: *Bertelsmann Stiftung's Transformation Index, Bertelsmann Stiftung; Index of Economic Freedom 2022, The Heritage Foundation; Doing Business 2020: Sustaining the Pace of Reforms, International Bank for Reconstruction and Development, The World Bank; 2022 World Press Freedom Index, Reporters Without Borders; European Innovation Scoreboard 2022, European Commission; United Nations E-Government Survey 2022, United Nations; World Development Report 2019: The Changing Nature of Work, International Bank for Reconstruction and Development, The World Bank; Global Peace Index 2022: Measuring Peace in a Complex World, Institute for Economics and Peace; Measuring the Information Society Report 2017, International Telecommunication Union; Corruption Perceptions Index 2021, Transparency International; Government Artificial Intelligence Readiness Index 2021, Oxford Insights, International Development Research Centre; The Network Readiness Index 2021: Shaping the Global Recovery, Portulans Institute; Human Development Report 2021/2022, United Nations Development Programme; The Global Innovation Index 2022: What is the future of innovation driven growth?, World Intellectual Property Organization; The Global Competitiveness Report 2019, World Economic Forum; Competitive Industrial Performance Index 2022, United Nations Industrial Development Organization; Logistics Performance Index 2018, International Bank for Reconstruction and Development, The World Bank.*

Indices characterising institutional environment

In the ***Transformation Index 2022*** created by *Bertelsmann Stiftung*, which evaluates the quality of democracy, market economy and political governance Latvia is placed 7th among 137 countries of the world (Estonia – 2nd, Lithuania – 4th) having improved its performance by one position compared to 2020.

In the ***Corruption Perceptions Index 2021*** created by the International anti-corruption organisation *Transparency International*, Latvia was ranked 36th (Estonia – 13th, Lithuania – 34th) among 180 countries of the world moving six up positions compared to 2020.

In the ***2022 World Press Freedom Index*** created by the international press and freedom of expression organisation *Reporters Without Borders*, Latvia was ranked 22nd (Estonia – 4th, Lithuania – 9th) among 180 countries, and this indicator is the same as in 2021.

In the ***Global Peace Index 2022*** created by the Institute for Economics and Peace, Latvia was ranked 35th (Estonia – 33rd, Lithuania – 37th) among 163 countries of the world having moved four positions down compared to 2021.

Indices characterising ICT development

In the ***Global ICT Development Index 2017*** created by the International Telecommunications Union, which provides comprehensive information on the assessment of the condition of the ICT market, including infrastructure development (mobile and fixed) and government policy, Latvia was ranked 35th (Estonia – 17th place, Lithuania – 41st) among 192 countries of the world. This index is no longer determined in the latest publications.

In the ***E-Government Survey 2022*** created by the UN Department of Economic and Social Affairs, which analyses the progress of using e-government, Latvia was ranked 29th (Estonia – 8th, Lithuania – 24th) among 193 countries of the world moving 20 positions up compared to 2020.

In the *Government Artificial Intelligence Readiness Index 2021* by Oxford Insights and the International Development Research Centre, Latvia was ranked 37th (Estonia – 21st, Lithuania – 30th) among 172 countries moving one position down compared to 2020.

In the *Network Readiness Index 2022* created by the Portulans Institute, which analyses digital transformation by four pillars (technology development, human capital, governance, and economic and social effects), Latvia was ranked 39th (Estonia – 22nd, Lithuania – 33rd) among 131 countries of the world moving three positions down compared to 2021.

In the *Digital Economy and Society Index (DESI) 2022* by the EC, Latvia is 17th (Estonia – 9th, Lithuania – 14th) among EU-27 countries. Since 2021, the DESI index has been structured into four key areas: 1) human capital characterised by the level of digital and software skills and the number of ICT specialists; 2) connectivity characterised by the prevalence and use of different speed and access networks; 3) integration of digital technology characterised by the ability of the company to use digital technologies like cloud services, big data, artificial intelligence, as well as prevalence of e-commerce; 4) digital public services characterised by the use of public services and open data. The performance of Baltic countries in the DESI index by areas varies (see Table 6.6).

Table 6.6

**Performance of Baltic countries in Digital Economy and Society Index (DESI) 2022***

| | 1. Human capital | | 2. Connectivity | | 3. Integration of digital technology | | 4. Digital public services | | DESI index Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *Place* | *Result* | *Place* | *Result* | *Place* | *Result* | *Place* | *Result* | *Place* | *Result* |
| **EU-27** | - | **45.7** | - | **59.9** | - | **36.1** | - | **67.3** | - | **52.3** |
| Estonia | 8 | 53.9 | 26 | 44.4 | 15 | 36.5 | 1 | 91.2 | **9** | **56.5** |
| Latvia | 18 | 44.1 | 20 | 50.1 | 23 | 25.8 | 11 | 78.8 | **17** | **49.7** |
| Lithuania | 20 | 42.5 | 23 | 49.4 | 13 | 37.2 | 10 | 81.8 | **14** | **52.7** |

* The results were converted to the scale 0-100, where 100 is the best result
Source: *European Commission, Digital Economy and Society Index (DESI) 2022*

Indices characterising business environment

In 2019 *Doing Business 2020* by the World Bank Group, which compared the business environment of 190 countries, Latvia was placed in the 19th place (Estonia – 18th, Lithuania – 11th). This was a high evaluation because Latvia was the 4th among EU countries. Unfortunately, the issuing of the index has been permanently suspended because the data integrity audit revealed that many countries provided false information.

In the *2022 Index of Economic Freedom* created by the Heritage Foundation, which consists of four pillar characterising rule of law, government size, regulatory efficiency and open market, Latvia was ranked 18th as mostly free economy (Estonia – 7th as free economy, Lithuania – 17th as mostly free economy) among 184 countries moving 12 positions up compared to 2021.

In *Competitive Industrial Performance Index 2022* created by the UN Industrial Development Organization, which is based on the data of 2020 and analyses the ability of industrial enterprises of countries to produce and export by transforming them competitively and structurally, Latvia was placed 56th (Estonia – 50th place, Lithuania – 38th) among 154 countries of the world.

In the *Logistics Performance Index 2018* created by the World Bank group, which evaluates how effectively delivery chains connect enterprises to markets or logistical activities, Latvia was placed 70th (Estonia – 36th place, Lithuania – 54th) among 160 countries of the world. On average, in the period from 2012 to 2018 Latvia occupied the 55th place in this index (Estonia – 36th, Lithuania – 43rd).

Indices characterising innovation environment

In the *Global Innovation Index 2022* created by the World Intellectual Property Organisation Latvia was ranked 41st (Estonia – 18th, Lithuania – 39th) among 132 countries of the world moving three positions down compared to 2021. The following indicators were noted as strengths of Latvia: pupil-teacher ratio in secondary education, tertiary enrolment, ICT use, environmental performance, females employed w/advanced degrees, gross domestic expenditure on research and development financed by abroad, high-tech exports, cultural and creative services exports, national feature films, printing and other media, creative goods exports.

In the *European Innovation Scoreboard 2022* created by the European Commission Latvia is placed 25th among EU-27 (Estonia – 12th place, Lithuania – 19th place) and is included in the group of *moderate innovators*. It is noted in the report that the overall business environment is favourable and the innovation potential is high, but there are no large companies to invest in research and development.

In the ***Human Capital Index 2018*** created by the World Bank group, which measures productivity of employees of the next generation to complete education and full health standard, Latvia occupied the 35th place (Estonia – 29th, Lithuania – – 37th) among 157 countries.

## CREDIT RATINGS

The credit rating of a country is the evaluation of its creditworthiness, which is an essential indicator for potential creditors and investors. The higher it is, the more beneficial terms of borrowing of financial resources are, which allows to reduce service costs of the state debt. The credit rating reflects the condition of economy and governance of a country.

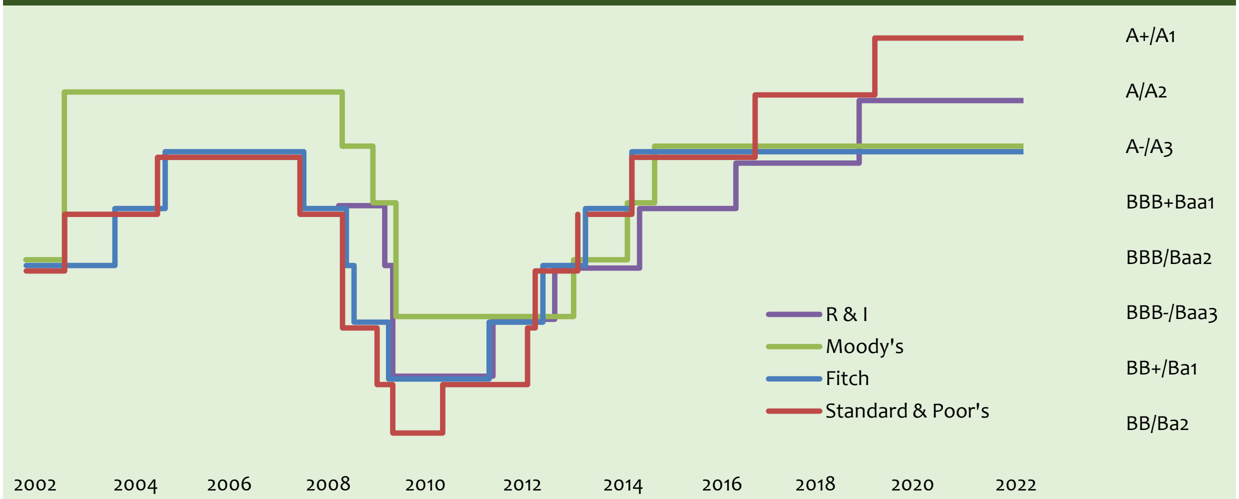
The credit rating of Latvia is determined by the following international rating agencies: *Moody's Investors Service*, *Fitch Ratings* and *S&P Global Ratings*, as well as the Japanese rating agency *R&I*.

According to the assessment of credit rating agencies, Latvia holds a stable position in group A of the credit rating, which is evaluated as low risk class.

In February 2020, the international rating agency *S&P Global Ratings* increased the credit rating of Latvia from *A* to *A+,* which is historically the highest credit rating set for Latvia. The agency confirmed in its assessment made in June 2022 that Latvia still corresponds to *A+* level with a stable outlook. However, in its latest assessment made in December 2022, this agency downgraded the outlook from stable to negative justifying it by the impact of the protracted Russian hostilities in Ukraine and high inflation on the Latvian economy. Other rating agencies have not changed their rating of Latvia since Covid-19 (see Figure 6.40).

Figure 6.40

**Credit ratings for Latvia for long-term liabilities**




Source: *State Treasury*

The assessment of the agencies is based on conclusions that the measures reducing Latvia's energy dependence on Russia, participation in NATO and EU, moderate public debt level and overall effective state economic policymaking are sufficient to maintain its high credit rating.

Russia's war in Ukraine affects Latvia's export and import performance, but inflation reduces purchasing power of consumers, which has a negative impact on economic growth in 2022. However, the agencies note the ability of Latvian national economy to adapt quickly to external shocks and believe that Latvian companies will be able to divert most exports to other markets, as well as reduce imports from Russian and Belarusian markets soon, thus limiting the risk of long-term negative effects of the military conflict on Latvian economy. However, lasting Russian hostilities in Ukraine may increase the risks of growth and competitiveness of Latvia as a small and open economy, as well as direct and indirect costs for the economy and state budget.

Although the level of public debt has increased, it is still relatively low and debt service costs are evaluated as moderate. The main obstacles for increasing the credit rating still are low population income levels and long-term demographic challenges. According to *Moody's Investors Service*, international ratings agency, anew factor that may limit further positive developments in the ratings is relatively high debts of state-owned enterprises.

The credit rating of Baltic countries is determined by the following international rating agencies: *Moody's Investors Service*, *Fitch Ratings* and *S&P Global Ratings.* Estonia has the highest credit rating among the Baltic countries, but credit ratings of Latvia and Lithuania are similar.

Table 6.7

**Credit ratings for the Baltic countries for long-term liabilities in 2022**

| | Moody's Investors Service | S&P Global Ratings | Fitch Ratings |
|---|---|---|---|
| Estonia | A1/Stable | AA-/Negative | AA-/Negative |
| Lithuania | A2/Stable | A+/Negative | A/Stable |
| Latvia | A3/Stable | A+/Negative | A-/Stable |

Source: *Moody's Investors Service*, *S&P Global Ratings*, *Fitch Ratings*

The credit rating of Estonia is one to two levels higher than the credit rating of Latvia and Lithuania. In 2022, all three international rating agencies kept Estonia's credit rating at the existing level. Only the assessment of the outlook has been changed. In March, *S&P Global Ratings* downgraded the outlook from positive to stable, assessing the potential consequences of Russia's aggression against Ukraine, and predicted that the Estonian economy would enter recession as well as inflationary pressures on households and businesses would rise. In December, this credit rating agency downgraded the outlook from stable to negative, justifying it by the impact of the protracted Russian hostilities in Ukraine and high inflation on the Estonian economy. In August, *Fitch Ratings* downgraded its outlook from stable to negative, believing there had been a shift away from strict fiscal governance, public debt-to-GDP continued to grow and Russia's war in Ukraine was affecting Estonia's economic growth.

For Lithuania, neither rating agency changed its credit rating in 2022, but the outlook was downgraded by *S&P Global Ratings* from stable to negative in December. The agencies' assessment noted effective economic policy making, EU and euro area membership, economic resilience and flexibility, flexibility of export sectors, institutional strength, moderate government debt and low interest payments as factors strengthening the credit rating. Russia's war in Ukraine and its effect on rising inflation, demographic problems and low GDP per capita compared to countries with a similar credit rating were noted as factors negatively affecting the credit rating.

# 7. LABOUR MARKET

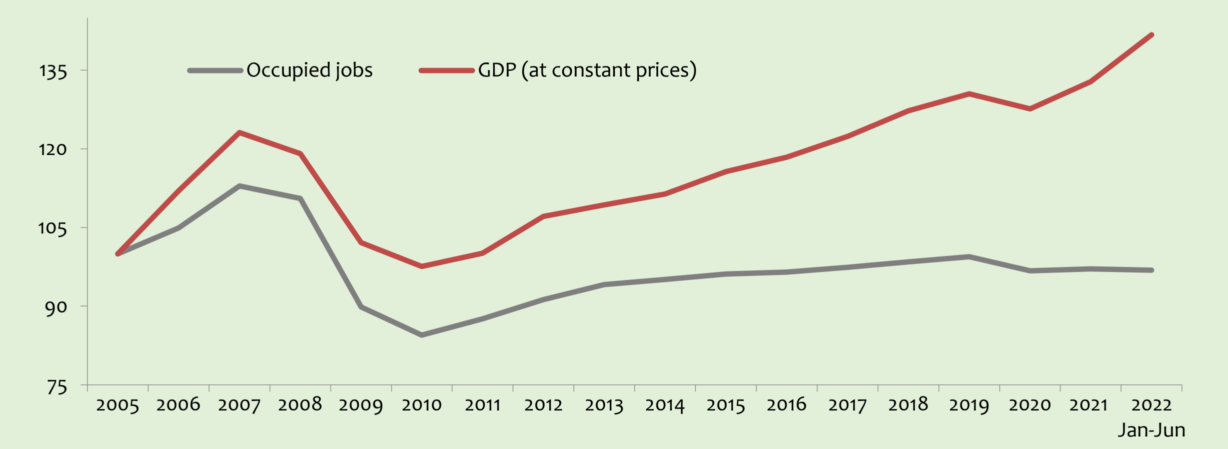
## 7.1. EMPLOYMENT AND UNEMPLOYMENT

Along with the increase in economic activity, since April 2021 the employment growth has resumed as well as the unemployment continues to fall. At the same time, as labour demand grows, the shortage of workers is becoming more sensitive. This is evidenced both by the return of unemployment indicators to pre-crisis (2019) levels and by the increase in vacancies and workplace load. The Covid-19 crisis as a whole has had a negative impact on the economic activity of the population, which, along with demographic processes, is narrowing labour market supply and increases the risks of labour shortages.

However, while the employment rate is growing, overall demand for labour force remains limited and there is still a slight decrease in the number of occupied posts. As pressure from the labour supply side increases, both in terms of access to human resources and in terms of remuneration, it is increasingly difficult for employers to create new jobs and attract employees.

Figure 7.1

**GDP and occupied jobs**
**2005 = 100**




* From 2021, data of the SRS are used to calculate occupied jobs, and this has caused a break in time series

In the three quarters of 2022, the number of employees increased by 20.8 thousand or 2.4%, compared to the corresponding period of 2021, while in Q3 it was 22.6 thousand or 2.6% higher than a year ago. Overall, the increase in the number of employees in the first three quarters of the year has been the most rapid since 2013.

The increase in the number of employees is still largely driven by the low-base effect. It should be noted that in 2021 the number of employees reached the lowest level since 2011 (in 2021 864 thousand people were employed), however, as economic activities in the national economy recover, demand for labour force is gradually growing as well.

Despite the sharp increase in employment, the number of employees is still behind the mark of 2019 (level before the Covid-19 crisis). The number of employees in Q3 was more than 18.3 thousand or 2% lower than in Q3 2019.

In Q3 2022, 899.5 thousand residents aged 15-74 were employed. These were 64.6% of the total population aged 15-74 in private households. During the year, the employment rate of the population has increased by 1.1 percentage points but is still 1 percentage point behind the level of Q3 2019.

As employment of the population increases, unemployment rates continue to fall. The unemployment rate in Q3 2022 decreased by 6.9%, down 0.3 percentage points from Q3 2021 (7.2%). 66.4 thousand people aged 15-74 were looking for a job in Q3 which is 2.2% (1.5 thousand) less than in Q3 2021.

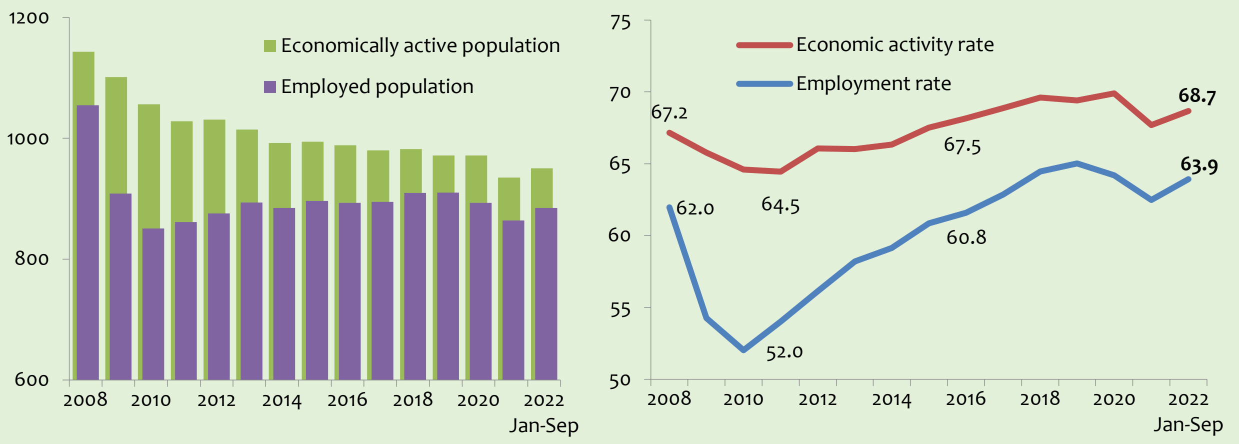
Although in the three quarters of 2022 the situation in the Latvian labour market has improved considerably, overall improvements are slower than in neighbouring countries. In Q3, the unemployment rate in Latvia was 4.9 percentage points lower than in Estonia (69.5%) and by 2.7 percentage points lower than in Lithuania (67.3%). Similarly, the unemployment rate in Latvia in Q3 remained 1.3 percentage points higher than in Estonia (5.6%) and by 1.2 percentage points higher than in Lithuania (5.7%).

Figure 7.2

**Employment and economic activity of the population**

Employed and economically active population *aged 15-74, thousands*

Employment and participation rate *aged 15-74, as per cent of economically active population*




* As of 2014, changes have been made to the labour force survey methodology. The quarterly average number of people living in private households (previously – population at the beginning of the year) is used to generalize the quarterly data

As the epidemiological situation stabilises and with the recovery of labour market activity, participation of the population in the labour market has also increased. The economic activity rate of the population in Q3 2022 increased to 69.4%, up 0.9 percentage points from Q3 2021.

Considering the increase in economic activity of the population, the number of economically active population has also increased in Q3 2022. In Q3 2022, compared to the corresponding period of the previous year, the number of economically active population aged 15-74 increased by 21.1 thousand (by 2.2%) – to 965.9 thousand. It should be noted that in addition to the increase in economic activity of the population, the dynamics of the economically active population in Q2 and Q3 2022 were also positively influenced by the growth of the working age population. In Q3 2022, the population aged 15-74 increased by approximately 12.6 thousand, compared to Q3 2021.

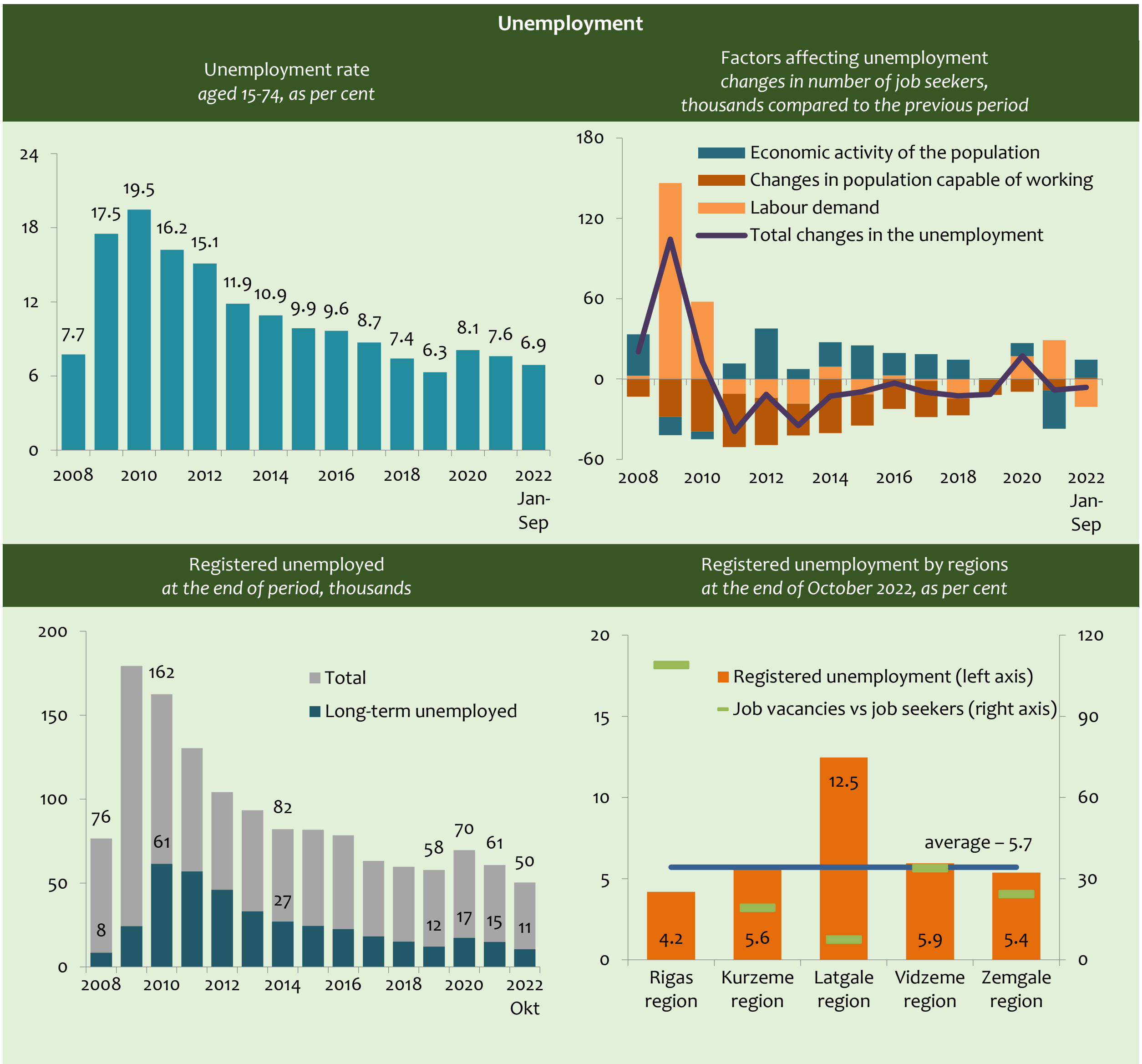
At the same time, the number of economically active population is still lagging behind the level of 2019, which is affected both by a lower number of working-age population compared to 2019, as well as by a lower participation rate of the population in the labour market, which in general continues to maintain negative pressure on the supply side of the labour market. As labour demand increases, the shortage of skilled labour is becoming increasingly pressing, especially in the most rapidly growing sectors.

Positive trends are also observed in the dynamics of the long-term unemployed. Both the number of long-term unemployed and their share in the total number of job seekers is gradually decreasing. The number of long-term unemployed registered during the year has decreased by more than 30% or approximately 4.6 thousand, which is a general indication of a more pronounced decrease of labour stock. At the end of October 2022, approximately 10.5 thousand registered job seekers or about 21% of all registered unemployed were unemployed for more than one year.

Despite the decline in unemployment, there is still a high risk that some of the unemployed may have problems finding jobs that match their skills in the coming years, since complete recovery in the sectors directly affected by the Covid-19 crisis might be long, but in sectors where job opportunities can potentially be developed, skills previously acquired will not necessarily be required. It should be noted that high long-term unemployment can cause an increase in structural unemployment, namely, the longer these people are unemployed, the greater the risk of losing skills and abilities, and the more difficult it is to adapt to new labour market needs.

It should be noted that the Covid-19 crisis has generally accelerated structural changes in labour demand accelerating automation of workplaces in labour-intensive industries – mainly reducing the demand for low and medium qualification workforce without processional skills and increasing the share of jobs requiring higher qualification, in particular in information and communication services. Therefore, labour force upskilling and reskilling measures provide a significant support to overcoming structural changes in the labour market.

Figure 7.3




Similarly, structural problems may be exacerbated by regional differences in the labour market, which may hinder the recovery of the labour market in the future. Although the regional disproportions in the labour market have slightly levelled during the crisis, the unemployment rate in Latgale region more than twice as high as the average in the country and almost 3 times higher than in the Riga Region, which together with the low geographical mobility of the labour force, increases the risk of structural unemployment.

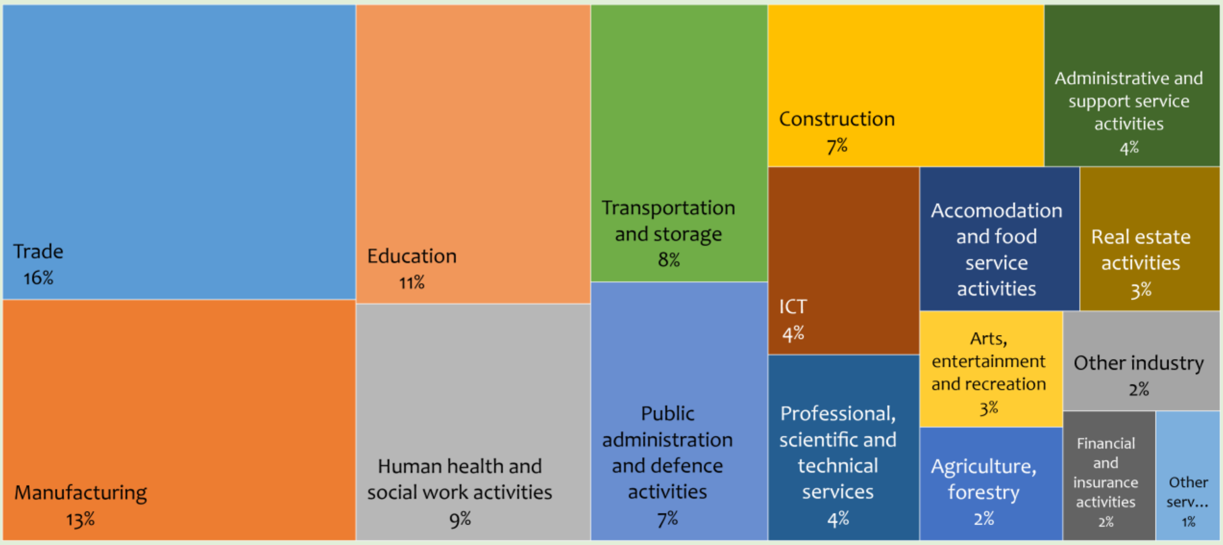
Despite the increase in employment, at the end of Q2 2022, the number of occupied posts increased reaching 893.5 thousand – a reduction by 17.9 thousand posts or by 2%, compared to the corresponding period of 2021.

At the same time, the number of occupied posts where employees have their main job has increased, the average number of employees in normal working time units has increased as well, which is a general indication of a tendency for part-time jobs and the number of employees employed in several workplaces at the same time to decrease. Consequently, although the total number of occupied posts is decreasing, the number of employees, considering the increase in 1 workplace labour force capacity, continues to grow.

The number of posts occupied with employees in their main job increased by 15.5 thousand or 2.5% in Q2, compared to Q2 2021, reaching a total of 625 thousand jobs. However, in the corresponding period the average number of employees in normal working time units has increased by more than 22 thousand or 3.1%, and in Q2 2022 the total number of employees reached 742.6 thousand.

Figure 7.4

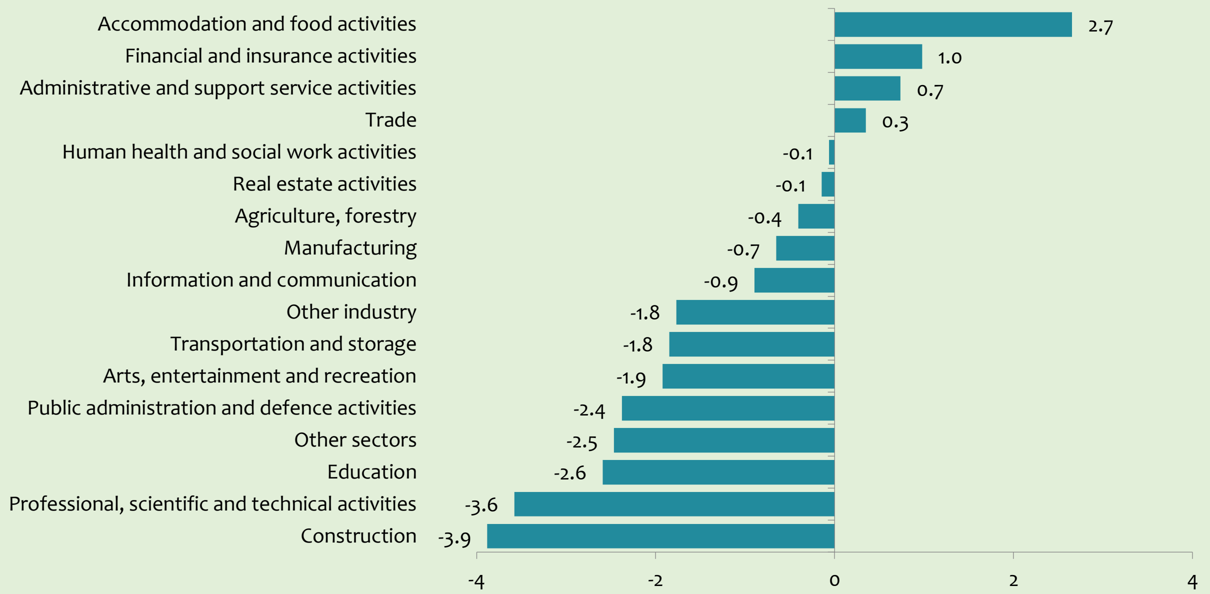
**Occupied jobs by sectors**
*structure at the end of June 2022, as per cent*




In Q2 2022, the most significant increase in the number of occupied posts was observed in sectors most affected by the Covid-19 crisis – accommodation and food service activities, administrative and support service activities, as well as trade. There has also been a significant increase in occupied posts in financial services. However, despite the gradual recovery of those sectors, the number of occupied posts in them is still significantly lower than it was before the Covid-19 crisis in 2019. For example, the number of occupied posts in accommodation and food service activities in Q2 2022 was still by 17% or approximately 2.7 thousand less than in Q2 2019.

Figure 7.5

**Changes in the number of occupied jobs in economic sectors***
*Q2 2022 to Q 2 2021, thousands*




* From Q1 2021, data of the SRS are used to calculate occupied jobs, and this has caused a break in time series; GDP growth versus the first six months of the previous year

Taking into account the decrease of construction volumes, the most significant decrease in the number of occupied posts in Q2 of the year was observed in the construction sector, as well as in the sectors related thereto. Overall, the number of occupied posts in construction decreased by 3.9 thousand or 5.9% year on year, where about half of the total decrease was due to the decrease of jobs in specialised construction activities.

Similarly, a significant decrease in the number of occupied posts is observed in professional and scientific technical services – a decrease by 3.6 thousand jobs or 8.5% compared to Q2 2021. More than 2/5 of the total reduction in occupied jobs in the sector were driven by job cuts in advertising and market research and almost 1/5 – in architectural and engineering services.

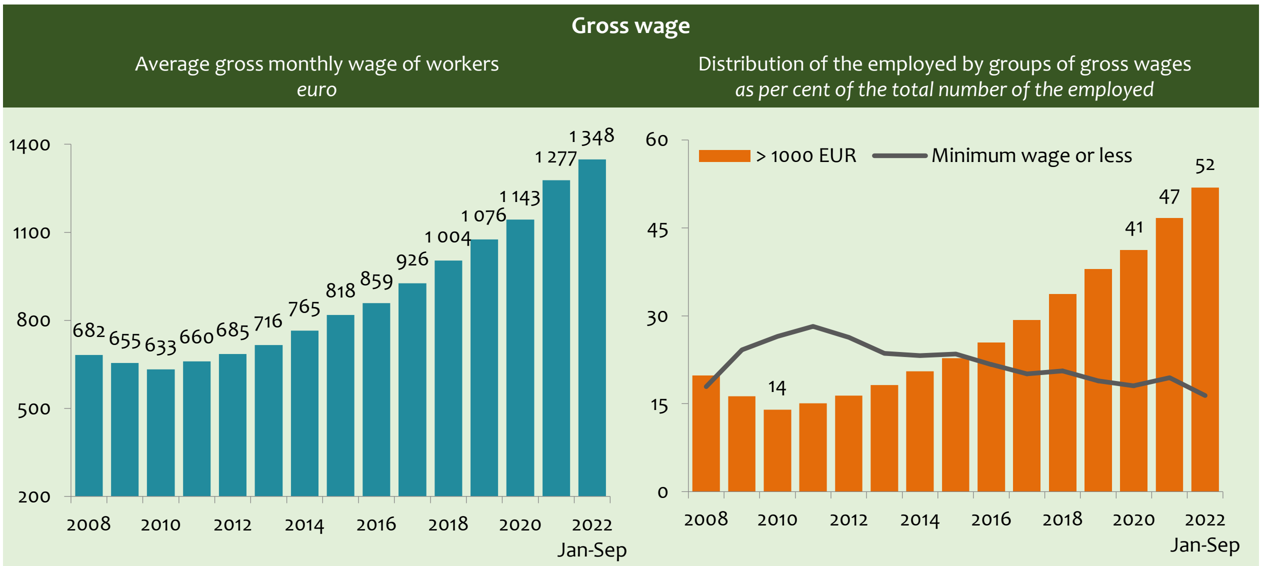
Overall, in the past 10 years (between Q2 2012 and Q2 2022) the total number of occupied jobs increased by 53.3 thousand or 6.3%. The largest increase in jobs was observed in human health and social work activities (by 20.5 thousand), information and communication (by 16.5 thousand) and administrative and support service activities (by 9 thousand). Meanwhile, the biggest job cuts were observed in the retail sector, as well as transportation and storage services.

## 7.2. WAGES

Considering the return of activities to the labour market after the Covid-19 pandemic, as well as the increasing pressure on the labour market supply side, the average wages continue to rise at a rapid pace. In Q3 2022, the average annual increase in wages reached 6.3%, while the average gross wage increased to 1,384 euro. It should be noted that already in 2021, the average gross wage increase reached almost 12%, being the fastest wage increase in the last 13 years, thus the total wage increase over the last 2 years amounts to 27.8, whereas compared to the pre-Covid-19 period (Q3 2019), the average wage has increased by more than 1/4.

The increase in average wages in 2021 was significantly affected by an increase in the minimum wage rate by 16.3% – from 430 euro in 2020 to 500 euro, as well as a reduction in the share of lower-paid jobs, for example, job cuts in sectors like accommodation and food service activities, transport services, as well as administrative and support service activities. Meanwhile, wage growth in 2022 continues largely to be driven by both acute shortage of workers and rising inflationary pressures. It should be noted that due to inflation, a decrease in real wages in Latvia has been observed for the first time since 2011. In the first three quarters of 2022, real wage decreased by an average of 7.7% compared to the corresponding period of 2021 a year earlier, while in Q3 real wages decreased by 12.9%.

Figure 7.6




It should be noted that stable wage growth has persisted in Latvia since the end of 2010, moreover, in the last five years the average annual growth rate of gross wages has been close to the 8%. A positive pressure on wages keeps coming from the wage convergence process closer to the wages levels of the EU's economically developed countries as well as from the growing shortage of skilled labour – shrinking of the labour market, which makes it necessary for entrepreneurs not only to think more actively about how to attract new professionals, but also how to keep existing ones, including through a review of wage rates.

Wage growth in previous years partly ensured labour productivity growth – real labour productivity per employee in 2021 was approximately 34% higher than in 2010. At the same time, the average wage growth in previous years has significantly exceeded the increase in labour productivity, thus negatively impacting the competitiveness of Latvian enterprises. Between 2010 and 2021, real wages have grown by an average 5.1% per year, while real labour productivity alone has increased by an average of 2.7% per year.

In the three quarters of 2022, wages have increased in both the private and public sectors. Compared to the corresponding period of 2021, the average gross wage in the public sector increased by 6.5% (to an average of 1,346 euro) and by 7.4% in the private sector (to an average of 1,352 euro). In Q3 2021, the average gross wage by an average of 6.6% for those working in the public sector increased (to 1,372 euro) and by 6.1% – for those working in the private sector (to 1,393 euro).

Since 2010, wages have increased in both the private and public sector. At the same time, wage growth in the private sector has been on average more rapid in the previous years, partially affected by a more significant increase in labour demand – in 2011-2021, the number of occupied posts grew by 23.2% in the private sector and only by 0.7% in the public sector.

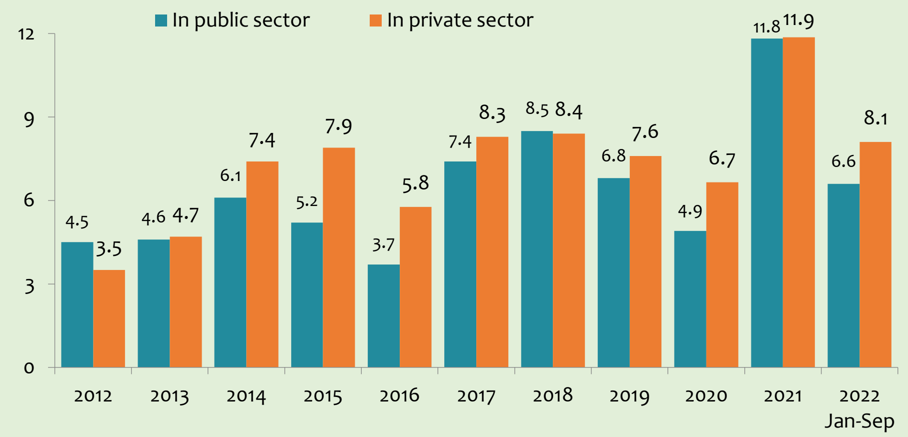
Along with the average wage increase, positive trends are also observed in the remuneration structure – on the one hand, the proportion of recipients of the minimum wage continues to decrease, but on the other hand, the share of employees who receive a wage above 1,000 year per month increases. In the three quarters of 2022, more than half (about 52%) of all employees had gross remuneration exceeding 1,000 euro, while the share of employed receiving the minimal wage or less has reduced to 16.4%.

Between 2010 and 2022 the share of employed receiving the minimal wage or less has reduced by approximately 10 percentage points, while the share of employed receiving more than 1,000 euro has increased by almost 38 percentage points during this period.

Figure 7.7

**Wages in the private and public sector**

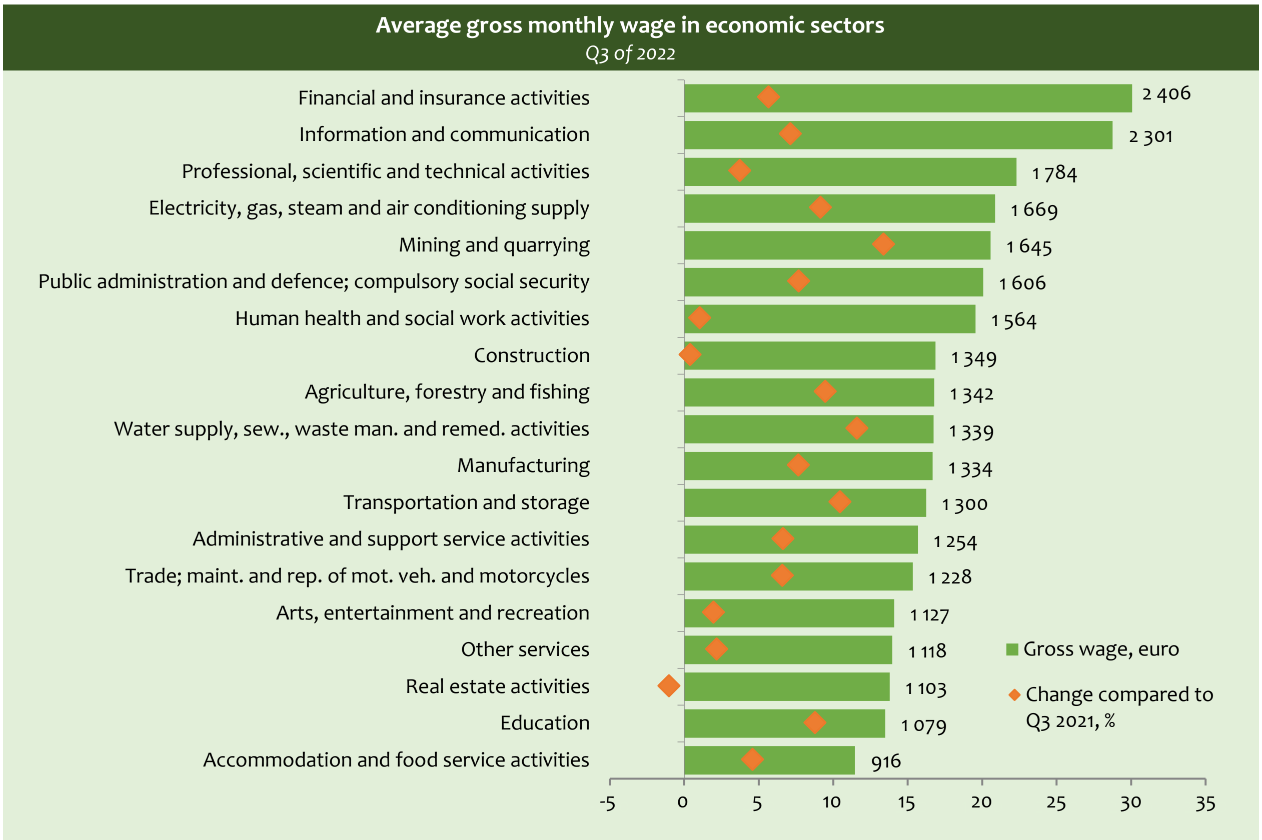
*changes as per cent compared to the previous year*




In Q3 2022, the increase in wages was observed in almost all sectors of the economy, except real estate activities. The most significant annual wage increase (in Q3 2022, compared to Q3 2021) was in mining and quarrying – by 13.5%, water supply and waste management – by 11.7%, as well as in transport and storage services – by 10.6%. However, a decrease in average remuneration during the period considered was observed in real estate activities. The overall wage level has grown slowly in construction – growth in Q3 by about 0.5%, compared to the corresponding period of the previous year.

The highest wage level in Q3 2022 remained in financial services – the average monthly gross wage was 2,406 euro, while the lowest wage was in accommodation and food service activities – on average 916 euro per month.

Figure 7.8




## 7.3. LABOUR MARKET FORECASTS

The labour market forecasts until 2030 are prepared in accordance with the medium-term economic growth forecasts (see Chapter 5).

Along with the economic recovery after the Covid-19 pandemic, the overall situation in the labour market has stabilised as well and employment growth has resumed, and unemployment continues to decrease. At the same time, the Covid-19 crisis has left visible *tracks* in the labour market, the number of employees and employment rates are still not back to the level of 2019. Similarly, the number of economically active population and the participation rates in the labour market are still lagging behind the levels of the pre-pandemic period, which, along with demographic processes, is narrowing labour supply and increases the risks of labour shortages.

The most significant effects of the Covid-19 pandemic continue to be seen in those sectors that were most directly involved in the implementation of the pandemic containment measures. Sectors such as accommodation and food services, transport services and the arts, entertainment and recreation sector remain significantly below their pre-crisis employment levels and are not expected to recover to their pre-crisis levels in the coming years.

At the same time the Covid-19 crisis has also brought many positive changes. It has visibly affected changing public habits, creating new opportunities and needs in the labour market. The use of different ICT solutions in everyday life has increased significantly, providing the necessary infrastructure for remote work, education, shopping, supplies of goods and other processes. Much more extensive remote work opportunities have also shown during the crisis (about 1/5 of employees worked remotely in 2021), which can have a generally positive impact on the employee productivity (the ability to plan and organise the work process more effectively, combine jobs, etc.) and also reduce the costs for the employee/individual and company, for example, the transport costs of the employee from/to the workplace, the cost of maintaining on-site workplaces, etc. Many of these processes open up a new development stage, and part of them are expected to be preserved in the future.

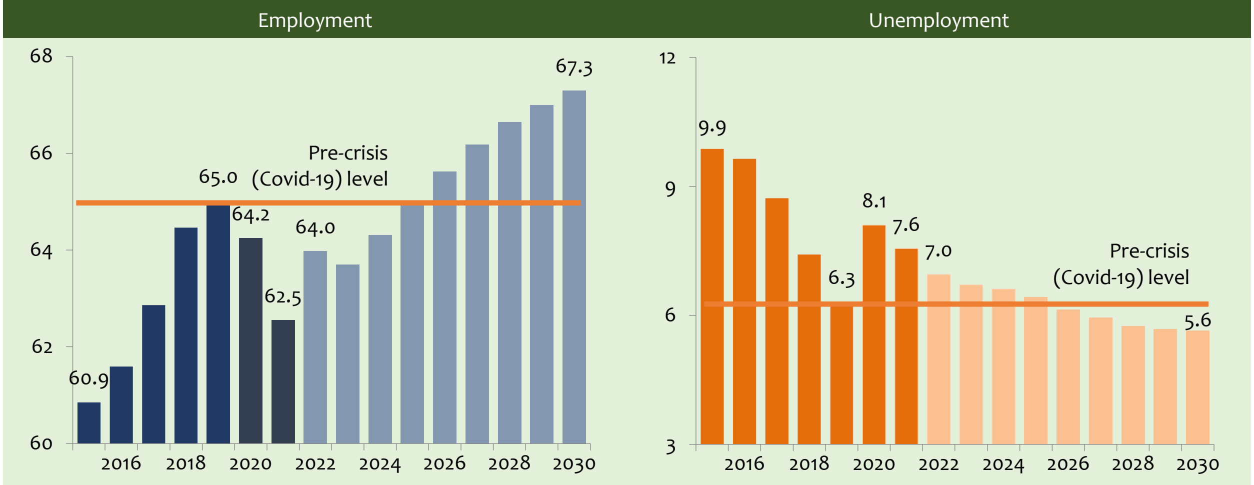
Given the escalating geopolitical situation, the overall situation in the Latvian labour market is expected to remain cautious until 2024. The number of the employed is expected to generally increase by 2.7% or 23 thousand in 2022, compared to 2021, but the unemployment rate will reduce to 7%, mainly due to the low base effect in 2021. Considering slower economic growth, in 2023 the number of the employed could reduce by 0.1% on average or by about 1.3 thousand – up to an average of 886 thousand, while unemployment might reduce to 6.7% (63.7 thousand job seekers). Overall, in 2022, compared to 2021, the employment rate in age cohort 15-74 could increase by 1.4 percentage points – to an average of 64%. In 2023 the employment rate could reduce to 63.7% on average.

Overall, relative employment and unemployment indicators could return to the levels before the Covid-19 crisis (2019) around mid-2025, however, the number of employees in absolute terms is likely to remain below pre-crisis levels in the coming years, considering both the demographic processes (less working age population in the labour market) and the need for higher labour efficiency – economic growth will be based more on labour productivity growth.

Considering the demographic trends, unemployment will generally keep shrinking both in the medium and long term and will be close to the natural level (within 5-6%). The highest unemployment risks are expected among the population with a low level of education and without professional skills/professional qualification.

Figure 7.9

**Employment and unemployment rate**
*as per cent*




Available labour resources will continue to shrink in the coming years, and the problem of labour shortages could become more pronounced. The decline in labour stocks will be largely determined by the reduction in the number of the population capable of working, as well as ageing of existing labour force and leaving of the labour market.

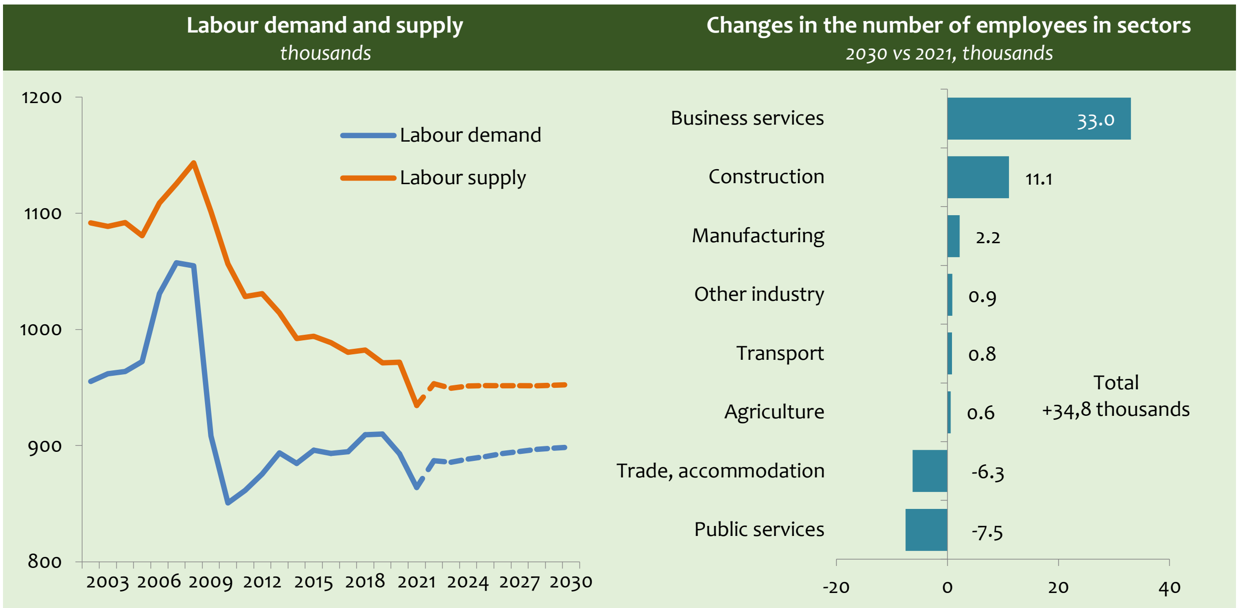
It should be noted that the Covid-19 pandemic crisis has had a negative impact on participation of the population in the labour market, which altogether also reduced the number of workers available in the labour market. In 2021, the economic activity rate of the population was 1.7 percentage points lower than before the crisis in 2019, the lowest indicator since 2015. Although labour market participation is starting to pick up again, it is still below its 2019 level and could only fully return to pre-crisis levels around 2025. Given the growing labour shortages and the overall expansion of employment opportunities in the labour market, the participation rate is expected to increase further in the medium to long term. By 2030, the participation rate for the 15-74 age group as a whole could increase by 3.7 percentage points compared to 2021 to 71.3%.

Although economic activity is expected to increase, the overall labour supply is likely to remain below 2019 levels until 2030. Demographic factors, such as an ageing population and a declining working-age population, will have a major impact on this trend. Although the population in private households aged 15-74 has slightly increased in 2022, the medium- and long-term trend is still downwards, due to a strong ageing trend. According to demographic forecasts of the Ministry of Economics the Latvian population might decrease by almost 96 thousand by 2030, compared to 2022. The most significant reduction will be observed among people in working age. The population aged 15-64 is expected to fall by nearly 84 thousand or more than 7% by 2030, which will also have a negative impact on the overall labour supply.

Since the economic activity of the population is increasing, overall the economically active population is expected to grow by almost 2% or 18 thousand by 2030, compared to 2021. However, it will still be about 19 thousand less than in 2019.

Given the trend towards an ageing workforce, the main job opportunities in the coming years will come from replacement demand. According to the MoE projections, almost 2/3 of all vacancies between 2022 and 2030 could be due to replacement demand.

Figure 7.10




By 2030, labour demand is expected to increase in all sectors except trade and public services.

The most significant increase in labour demand until 2030 is expected in the commercial services sector, in particular in information and communication industry and in professional, scientific and technical activities. Overall, the number of employed in commercial services sector might increase by 33 thousand by 2030, compared to 2021.

A significant increase in labour demand until 2027 is expected in the construction sector, which will be mainly ensured by the implementation of major investment projects such as *Rail Baltica*, the construction of the National Concert Hall in Riga. Overall, the number of employed in construction might increase by more than 11 thousand by 2030, compared to 2021.

An increase in the number of employees in the coming years might also be observed in manufacturing. However, the employment increase in manufacturing and in other traditional tradable sectors will remain sluggish, as the growth of those sectors will mainly depend on the productivity increase, which plays a decisive role in ensuring competitiveness. Considering that, the employment in manufacturing might not return to the levels of 2019 in the medium term. Overall, the number of employed in manufacturing might increase by about 2% or 2.2 thousand by 2030, compared to 2021.

In the coming years, the employment could also gradually increase in transport services, but it should be noted that the structure of the sector has changed significantly during the crisis (a significant drop in labour demand in passenger transport by air and water and rail), therefore the number of employed in the sector might not return the level of 2019 by 2030.

Given the impact of the crisis and job automation trends, overall, the employment could continue to decline in the retail segment in the coming years along with the broader entry of self-service cash register systems as well as other automated trading solutions in the sector. The number of employed in trade is expected to reduce by 9.2% or by about 12 thousand by 2030, compared to 2021.

So far, the most significant drop in labour demand has been in accommodation and food service activities. Labour demand is expected to gradually increase starting from 2022, however, considering the slower economic growth rate, the number of employees in the coming years is not estimated to return to the level of 2019.

The most considerable employment decline in the coming years is also expected in public sector, however, the development of certain public services may be different. The most significant reduction is expected in public administration and education, considering both the planned reduction in the number of staff working in public administration and the continued optimisation of the school network. Overall, by 2030 the number of employed in public administration might decrease by 5.3 thousand, while in education – by 4.6 thousand, compared to 2021. At the same time, the number of employees could continue to grow in human health and social work activities. In 2030 the number of employed in human health and social work activities could be by 2.3 thousand higher than in 2021.

# 7.4. EMPLOYMENT POLICY

During the Covid-19 crisis, from mid-March 2020 to April 2022, state support measures were important for the businesses and the population as they limited the negative effect of the crisis. Support mechanisms such as downtime allowance and wage subsidy helped companies to save jobs during the periods of state of emergency and protected people from complete loss of income, which was particularly important in the sectors directly affected by the crisis. At the same time, it should be noted that the role of digital technologies increased due to the Covid-19 pandemic, which changed the habits of both businesses and the population and expanded remote work opportunities.

Since 24 February 2022, as the war in Ukraine continues, Ukrainian civilians – war refugees – have been arriving in Latvia. One of the types of support that helps them to enter the Latvian labour market as soon as possible is the facilitation of the procedures by which Ukrainian nationals acquire the right to employment in Latvia. In order to employ a Ukrainian citizen, the employer does not have to register a vacancy at the SEA, nor does it have to ensure remuneration at least in the amount of the average monthly gross wage of employees in Latvia, as it is in the case of employment of citizens of other third countries. Refugees from Ukraine also have simplified requirements for the official language proficiency – it is possible to work without knowledge of Latvian if it does not interfere with the performance of job duties. When entering into legal employment relationships or registering as a self-employed person, Ukrainian civilians are entitled to a one-off employment or self-employment start-up benefit of 500 euro.

Rapid and effective integration of war refugees into employment can provide them not only with income and social protection in the territory of Latvia, but also partially address the growing labour shortage problem here. However, it should be noted that as the situation in Ukraine stabilises, some refugees will want to return home, or, given the small size of Latvian labour market, move further to countries with more employment opportunities. Consequently, the positive effect of the influx of refugees on the dynamics of labour supply in Latvia may not be sustainable in the long term.

## LABOUR MARKET CHALLENGES AND POLICY DIRECTIONS

Long-term major challenges for Latvia's labour market and the economy, taking into account negative demographic trends, are related to the ageing of the workforce and labour (relevant qualification) shortage (for information on labour market forecasts see Chapter 7.3).

It should be taken into account that the demographic situation in Latvia is mainly affected by economic migration of the population, and substantial improvements in the Latvian labour market are necessary to change migration flows. Measures to foster birth rates are also very important. However, changes in demographic trends may have a tangible effect only in the long-term, therefore, measures to foster labour force availability through education supply, active labour market measures (promoting economic activity of the population), sound labour force migration policy, which includes support for remigration are important in the medium and short term. At the same time, it should be emphasised that sustainability of economic growth of Latvia cannot be related to the attraction of cheap labour force from third countries.

Labour market mismatches aggravate pronounced regional differences. New jobs mainly appear in more economically active regions and larger cities, while less developed regions, in particular Latgale, have the biggest number of job seekers. The regional disparities impede a balanced development of the labour market. Meanwhile, the regional equalization of the labour market is hampered by the low regional mobility of labour force, i.e., the ability to rapidly change their place of work and residence.

To promote employment, policy directions are planned and implemented in relation to both labour supply and labour demand. The key elements of the employment policy of Latvia:

- supporting the labour demand – stimulation of economic activities and entrepreneurship, including reduction of the labour taxes, the fight against undeclared employment, indirect and direct support measures for businesses ensured by the government, measures to reduce administrative barriers, business incubators, etc. (see Chapters 9-11);
- strengthening the labour supply – increasing the competitiveness of the unemployed and people at risk of unemployment in the labour market, including skills development according to the labour market needs, lifelong learning measures, advice for starting a business, etc.;
- facilitating the process of aligning the labour supply and demand, including the improvement of the education system, involvement of employers' organizations in the improvement of the quality of education, forecasting the compliance of the labour market supply with the labour market demand, educating the labour market participants, including pupils and students, on labour market and career issues.

**Social dialogue** is an important element in the implementation of the employment policy. Employers' Confederation of Latvia and Free Trade Union Confederation of Latvia are involved in the provision of the social dialogue at national, regional, and sectoral level. Employment partnership involves other cooperation partners, for example, local governments of Latvia and the Latvian Association of Local and Regional Governments.

In order to foster changes in the labour market providing specialists required for economics, thus, contributing to growing economy, the **Employment Board** composed of three ministers (of economics, education and science and welfare) that was created in 2016 continues work. The goal of this Board is to coordinate inter-ministerial cooperation in planning, implementation, and monitoring of labour market reforms, thereby reducing the disproportions in the Latvian labour market. The Employment Board has paid special attention to the matters of investment in human capital and the development of skills of labour force (in particular, low qualified labour force). In 2021 and 2022, the Board continued its previous activities, coordinating actions to promote employment and skills development in society, particularly addressing the problem of skilled labour shortages, which are quite pronounced in the sectors less affected by the Covid-19 crisis and growing. The Board studied the medium- and long-term labour market forecasts updated by the MoE and discussed the measures implemented by the ministries to reduce expected disproportions in the labour market, as well as examined matters regarding the improvement of the quality of education in general secondary and vocational secondary education and planned changes in the mastering of exact and natural sciences subjects in general education. The Board supported the proposal prepared by MoE and MoW for the pilot project *Future Skills Initiative*, which provides support to the population in mastering digital and other skills demanded in the labour market on international open online courses platforms. Ministers also agreed to continue monitoring graduates of education institutions. Information on career (employment and income) of graduates of higher education and vocational education institutions is useful not only for policy makers and educational institutions, but also for young people to make more informed and targeted choices for future careers – the choice of occupation and study direction. The idea of the *STEAM Lyceum* project, a virtual classroom designed to help improve the knowledge of secondary school students in mathematics, chemistry, and physics, proposed by the Ministry of Education and Science was also supported, while increasing the interest of future students in these subjects. The initiators of the *STEAM Lyceum* idea are the telecommunication operator *LMT*, Employers' Confederation of Latvia and Riga Technical University. It was proposed to increase the number of people with STEM education. The State President also expressed support for the idea.

Under the conditions of the Covid-19 pandemic, human capital development matters came to the fore to ensure the growth of Latvia's national economy. The medium-term objective is the creation of a functional adult education system for reducing the share of persons with low education, to enable continuous development of skills, abilities and competences and changing the socio-economic paradigm – the introduction of the concept of lifelong learning. Strengthening human capital and lifelong learning are among Latvia's development priorities in the *National Industrial Policy Guidelines for 2021-2027*.

## ADULT EDUCATION

In 2021, 8.6% of 25–64-year-olds were involved in adult education activities, while in the Nordic countries this rate was three and even four times higher. Although participation of adults in learning has increased recently (by 2.0 percentage points compared to 2020), it is still below the EU average. It should be noted that the involvement of people in adult education in Latvia has not changed significantly over the last 10 years. The purpose of the policy is to reach the involvement of at least 12% of adults in adult education by 2027.

Taking into account that changes in formal education give a tangible effect in the long-term, adult education plays an important role in reducing labour market disproportions. Providing the sectors relatively less affected by the Covid-19 crisis and export-capable sectors and companies with the necessary human resources would contribute to the recovery and transformation of Latvia's economy. Within the framework of Covid-19 crisis overcoming support mechanisms, the availability of training for citizens and businesses has been extended.

Since 2017, the employed have the possibility to increase their professional competence and competitiveness by applying for studies within adult education ESF project *Improvement of Professional Competence of Employed Persons* implemented by the State Education Development Agency. Since the launch of the project, training has been carried out in seven application rounds, as well as in one remote training round, which was announced in addition in summer 2020 to mitigate the negative effects of the Covid-19 crisis. In August 2022, the 8$^{th}$ application round for training concluded, which primarily intended to involve employed with a low level of education into an education programme.

More than 80 thousand workers had started training by October 2022, including 8.2 thousand employed persons in the remote training round. 67.2 thousand people have already completed some education programme. In total, more than 87 thousand employed persons are expected to be involved in the project by the end of 2023. To reduce participation barriers and to extend training opportunities, the possibility for one person to learn twice within the project was introduced, the person's co-payment was reduced to 5% (previously 10%) of the tuition fee of vocational continuing education programmes, as well as support for travel expenses to the place of training of 30 euro per month is available. The employed person, who have been granted the status of a low-income or poor person, are provided support for regional mobility, as well as training for them is free of charge.

The MoE has developed a state support programme to train employees of companies and improve their skills upon request of employees for introduction of technological and non-technological innovations:

– *Support for employed learning (technology learning)*. The aim of this measure is to provide the enterprises with labour force holding the relevant qualification, thus contributing to an increase in productivity and development and putting into production of new or improved products and technologies. Two project selection rounds are planned. The total planned ERDF funding is 18 million euro, agreements have been concluded for 14.7 million euro. In spring 2016, ten projects of the first selection round implemented by the 10 largest sectoral associations were approved. These associations represent manufacturing subsectors, the ICT sector and accommodation and food service activities sector. In spring 2020, five projects of the second selection round implemented by industry associations representing a manufacturing subsector, the ICT sector and international business services centres sector were approved (training has started). By October 2021, 15.6 thousand non-unique persons employed with 875 enterprises have been trained within both rounds. The period of implementation of the first and the second round is until 31 December 2023. In November 2020, CM supported an extension of training by including in-depth training to promote digital transformation of enterprises, to improve business and digital skills. Additional *REACT-EU* funding of 14.7 million euro is available for the implementation of the training programme. By the end of 2023, it is planned to provide training support to at least 2 thousand employees from 350 enterprises (total indicator of technological and non-technological training programmes).

  *Support for ICT and non-technology learning, as well as learning aimed at attracting investors (non-technology learning)*. The measure is developed with the aim to promote the productivity and work efficiency of self-employed persons, as well as enterprises, by raising the employees' qualifications and skills in ICT areas, to provide enterprises with employees holding the relevant qualification, promoting introduction of non-technological innovations (products, processes, marketing or organisation) in merchants, as well as to provide support for learning thereby attracting investments. The total planned ERDF funding is 6.9 million euro. Three projects implemented by the Latvian Chamber of Commerce and Industry, Latvian Information and Communications Technology Association and Investment and LIAA, the were approved in 2016 and should be implemented by the end of 2023. By October 2021, 6.8 thousand non-unique persons employed in 563 enterprises have been trained. On 1 December 2020, CM decided on additional *REACT-EU* funding of 5 million euro for high-level training (for top and middle-level managers) and the adoption of good practices, as well as new support measures for the training of investor employees. The support is intended for companies in the sectors with high potential in Latvia and relevant to the smart specialisation strategy in order to boost their competitiveness in international markets. The planned deadline for implementation of the measure is 31 December 2023. There are plans to support the training of at least 900 employees from 240 businesses.

For the programming period 2021-2027, MoE has developed an investment plan for the improvement of digital skills of employees of companies. Entrepreneurs will have access to support in the form of grants with intensity of up to 70% of total training costs. The total planned investment is 30 million euro, including *Recovery and Resilience Facility* funding of 20 million euro and ERDF funding of 10 million euro. At least 3,000 entrepreneurs are expected to be supported as part of the investment from *Recovery and Resilience Facility* funding by 2027, while at least 1273 entrepreneurs are expected to be supported from ERDF funding by the end of 2029. Funding for businesses will be available for:

– Massive Open Online Courses Online, which will offer non-formal education, regardless of geographical location; online training courses are planned on topics such as UX/UI fundamentals, e-commerce, data analysis and visualization, database development and maintenance, programming, development of business intelligence systems provided by European digital innovation centres;

– improvement of high-level digital skills in a specialised training organised by the European Digital Innovation Centres on topics such as cyber security, artificial intelligence and high-performance computing;

– improvement of the digital skills of employees in key areas for their undertakings; support will primarily be provided in areas such as storage of information on the internet, use of websites/social portals, software configuration, online sales, image, video and audio processing, preparation of presentations, basic programming skills provided with support of sectoral associations.

17.9 thousand people in total were involved in professional training, reskilling and upskilling activities for the unemployed and job seekers organised by the State Employment Agency (SEA) in 2020, 12.8 thousand persons in 2021 and 7.8 thousand persons in the nine months of 2022. To encourage unemployed to go to educational institutions to acquire the skills required in the labour market, the SEA offers regional mobility support within the framework of training measures. At the end of 2021, the target group for the training activities implemented by SEA was extended – in future, individuals at risk of unemployment will be able to participate in them, in particular elderly employed persons, employed persons with disabilities or low level of education.

SEA continues to offer unemployed, job seekers and employees at risk of unemployment the opportunity to acquire digital and other skills demanded in the labour market on the international open online course platforms *Coursera, EdX*, *FutureLearn*, compensating training expenses up to 500 euro. SEA also offers the population the opportunity to apply for free training supported by *Google* to acquire digital skills demanded in the labour market, while within the framework of cooperation between MoE and *Google* it is also offered to improve digital skills for representatives of small- and medium-sized enterprises (see Box 7.1).

**Box 7.1**

**MoE's cooperation with *Google***

Considering the significance of international companies in the innovation ecosystem, on 13 April 2022, the technology company *Google*, MoE and LIAA representatives signed a memorandum of cooperation. As part of this, a free of charge *Grow with Google* training programme was launched, with 4,500 representatives of small- and medium-sized enterprises (including diaspora) already trained in October 2022, expanding their knowledge and skills in areas such as e-commerce, exports, digital marketing and technology integration into business.

Latvian Chamber of Commerce and Industry, Employers' Confederation of Latvia and other sectoral associations participated in the development of the training programme and involvement of entrepreneurs. In cooperation with local partners – the digital marketing training centre *Digital Journey* and e-commerce growth support platform *eCOMHUB* – the purpose of *Grow with Google* is to help Latvian small- and medium-sized enterprises to improve their mastering and use of digital skills, as well as foster full use of advantages of digital opportunities by the Latvian population.

During training, participants can acquire state-of-the-art skills for business development in the digital environment, learning how to use digital platforms to expand business, find new export markets and types, reach new customers online. In addition, considering the current situation, the programme will also offer training on cyber security, helping people familiarise themselves with the most common online security threats and practical ways to protect company data, devices, and websites. Training is appropriate for all employees of small and medium-sized enterprises who wish to improve their digital skills; this will also contribute to the development of the Latvian economy. The study conducted by Connected Commerce Council shows that during the pandemic the small enterprises in Europe, which used digital skills skilfully, were able to create a *digital safety net* reaching 80% better sales and 60% higher revenues.

## ACTIVE EMPLOYMENT MEASURES

The national policy in the field of unemployment reduction and support for the unemployed, job seeker and persons subject to risk of unemployment is implemented by the SEA. Active and preventive labour market measures foster economic activity and competitiveness of the population in the labour market.

The most important measures implemented by the SEA:

- training measures – vocational training, reskilling and upskilling, on-the-job training, acquisition of non-formal education, competitiveness improvement measures (basic competences);
- employment measures – measures for the most vulnerable groups of unemployed (subsidised jobs), temporary paid public works, measures to facilitate the start-up of business activities or self-employment, summer employment of pupils;
- job search support measures and consultations – profiling of the unemployed and drawing up an individual job search plan, career planning consultations, informative days;
- other support measures – activation measures for the long-term unemployed, also persons with addictions, support for regional mobility (getting to work or training), etc.

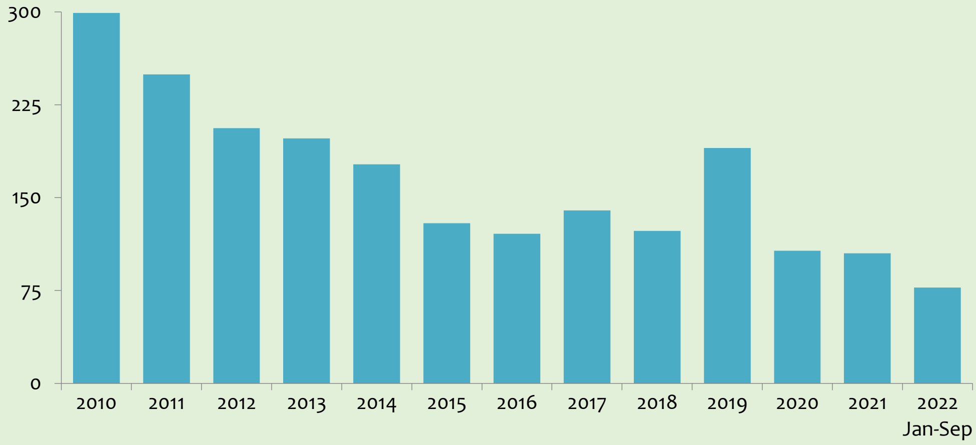
In August 2021, the CM approved *Social Protection and Labour Market Policy Guidelines for 2021-2027*. One of action lines of the guidelines is to promote the establishment of an inclusive labour market and to take care of the quality of existing jobs, thus supporting long-term participation in the labour market. Plans until 2027:

- to achieve 80% employment rate of the population in age group between 20 and 64;
- to achieve 50% employment rate among persons with disabilities in age group between 20 and 64;
- to reduce the share a long-term registered unemployed to 15%.

The improvement and development of active labour market measures is planned in such a way as to help all residents capable of working to get included in the labour market. However, like in previous years, increased attention is paid to more disadvantaged population groups and groups at higher risk of unemployment (long-term unemployed, youth neither in employment, nor in education or training, pre-retirement people, disabled people, persons with low skills and skills not corresponding to the labour marker, etc.), for whom it is most difficult to include into the labour market and who need more targeted support to promote their economic activity. The development of an inclusive labour market involves the provision of timely and tailor-made support to improve employment or self-employment prospects, support for the transition from economic inactivity to employment or between different professions and sectors, the development of high-quality and secure workplaces, the prevention of the risk of poverty of the employed, the creation of opportunities for reskilling and education throughout the working life.

Figure 7.11

**Involvement* in active labour market measures**
*thousands*




- one person may be involved in several activities. In 2019, the methodology was changed, indicating participations. The data are not comparable to the previous periods.

Source: *SEA*

Since 2010 the involvement in active labour market measures has reduced. Although the number of unemployed increased under the influence of the Covid-19 crisis in 2020, participation in active labour market measures did not increase, partly due to the measures to restrict the spread of Covid-19 – on-site activities implemented by SEA were temporarily suspended. However, unemployment was significantly tempered by the support measures implemented by the government, including downtime allowances and support for wage subsidies, which mitigated the effects of the Covid-19 crisis. In 2021, 64.5 thousand unique persons participating in 105.2 thousand activities (number of participation) were involved in active employment measures and received support. The funding for active labour market measures reduced from 91.1 million euro in 2010 to 27.5 million euro in 2021. During the nine months of 2022, 58.7 thousand persons were involved in the SEA active labour market measures participating in 77.3 thousand activities (participations), and the funding available for the implementation of the measures was 17.1 million euro.

The services and measures provided by the SEA are constantly reviewed and improved to improve their efficiency and adapt them to the current situation in the Latvian economy and labour market. During the pandemic, following national Covid-19 containment restrictions, several SEA services and measures have been offered remotely and the availability of training programmes in the electronic environment has been developed. Existing employment support measures were extended, and new ones were introduced to cope with the Covid-19 crisis – the period of participation in paid temporary public works was extended to six months, and the scope of the potential participating unemployed has been extended; a new wage subsidy support measure was introduced providing financial support to employers for recruitment of new employees from the unemployed, etc.

When assessing labour market demand and economic forecasts, the training supply of SEA is reviewed on a regular basis. In 2022, a one-unit cost methodology has been introduced in SEA settlements for training of SEA customers (payment only for persons who have received a qualification certificate), moreover, monitoring and quality control has been strengthened in cooperation with the State Education Quality Service, focusing on the performers of training programmes and the content aspects of programmes.

Since March 2022, SEA has also been providing support to Ukrainian civilians – war refugees who have left Ukraine and want to find work in Latvia. By December 2022, SEA has registered more than 16 thousand Ukrainian civilians and more than 10 thousand applications for employment start-up benefit have been received.

## INTERNAL LABOUR MOBILITY

The availability of labour force in regions with higher economic activity is delayed by the lack of high-quality housing corresponding to the paying capacity of the population. Within the scope of a cooperation project with OECD, proposals for effective support instruments for ensuring availability of housing in Latvia were developed in 2020. MoE has drafted a support programme for the construction of low rent paid housing in Latvian regions, and *Recovery and Resilience Facility* funding of 42.9 million euro is available for that. Moreover, through the EC's technical support instrument, MoE has also launched an additional cooperation project with the OECD in order to further explore foreign practices and the possibilities of introducing a long-term housing affordability fund – a revolving fund in Latvia, the necessary legal framework, financing options; and the fund management model. The project will last until spring 2023.

The attraction of qualified labour force to regions is also promoted by state support for purchasing housing for highly qualified specialists (aged up to 35 and having higher or vocational education), which is available from March 2018. Young specialists having constant income but having no sufficient savings to make the first instalment, can receive a guarantee for purchasing or construction of housing amounting to 20% of the loan amount, which does not exceed 50 thousand euro. Over 4,300 guarantees have been granted to young specialists by May 2022 and the total amount of allocated guarantees is 35 million euro (for more detailed information on the activities see Chapter 14 on the housing policy).

Regional mobility support is also available within the scope of active employment measures. In order to address regional unemployment challenges and promote the acceptance of job offers outside the declared place of residence, persons employed by employers can receive financial compensation to cover expenses of transport or rental of a dwelling in the first four months after starting the new legal employment relationship. In 2021, regional mobility support for getting to work was granted by the SEA to 213 persons. In 2022, regional mobility support for employers has also been introduced, if, in establishing employment legal relationships with an unemployed person living further away, the employer ensures the trip of the employee from the place of residence to the place of work and back or accommodation near the place of work.

## SMART IMMIGRATION

The shortage of highly qualified specialists, which is currently experienced by several companies, particularly in knowledge and technology intensive sectors, is hindering Latvia's economic growth, growth in business productivity and attraction of investments, therefore also the creation of well-paid jobs. The reduction of shortage of highly qualified labour force is set as one of priorities of the MoE. The aim of the smart migration policy is to promote the attraction of highly qualified professionals from third countries. It should be emphasised that activities to promote smart immigration do not focus on cancellation or facilitation of immigration of labour force from third countries in total but focus on the improvement of the process for the Latvian employer to be able to attract qualified employees as soon as possible.

In order to ensure development of the ICT sector and satisfy the demand of other sectors for ICT specialists, trilateral cooperation between state authorities, leading ICT companies and representatives from higher education institutions has been established in a targeted manner. A joint ICT education platform called *Baltic IT Society* or *BITS.education* has been created. The platform collects ICT education programmes to promote the preparation in Latvia of new ICT professionals, who are ready for the international market, and creates digital campaigns to attract students from foreign countries.

## REMIGRATION

One of solutions for the reduction of labour shortage in Latvia is to foster the return of the population who have left. The availability of well-paid job offers is an important factor in promotion of remigration. However, the matters related to social guarantees, taxes, work environment and cultures, reintegration support measures, in particular the availability of kindergartens and schools and other matters are equally important. At the same time, it is necessary to create and maintain a closer link with those who have left and to ensure the availability of latest information on job and life opportunities in Latvia. Specific support measures for those wishing to return, as well as for the maintenance of links and cooperation with the diaspora, are set out in the *Diaspora Law*, which entered into force in 2019.

A targeted remigration support measure is a network of five regional remigration coordinators created by MoEPRD, providing one regional coordinator in each planning region. Potential remigrants have the possibility to receive a free of charge consultation and support of the regional coordinator in resolution of matters of particular importance for them, which are related to their return to the specific region in Latvia. Within four years, a system has been established and strengthened to help people returning to Latvia. 3,151 people or 1,165 families returned to Latvia from March 2018 to April 2022 with the support of the coordinators. In 2022, due to both the war in Ukraine and the rise in global prices, the resettlement to Latvia has subsided.

The SEA and the LIAA are also taking measures to address potential remigrants by providing information and advice, participating in events organised by the diaspora, etc. To develop the human capital of Latvia and to exploit the experience accumulated by the diaspora, measures have been taken, inter alia, to encourage the involvement of the diaspora in promoting exports, investment attraction and knowledge and technology transfer (see Box 7.2).

**Box 7.2**

**Activities of MoE and LIAA in 2022, which facilitated the involvement of the diaspora in the development of the Latvian economy**

**Pre-incubation and incubation support programmes**. Interest in participation in LIAA incubation and pre-incubation programmes among representatives of the diaspora has increased. The LIAA has received 80 applications from compatriots in 25 countries. These participants also include people who, after successfully developing a business idea, move to Latvia to be closer to the implementation of the business. When diaspora participants join the incubator community with their experience, knowledge of international markets and ideas acquired in their home country, they also benefit the programme participants living in Latvia.

**Economic representations of the LIAA.** In April 2022, the LIAA opened two new economic representations – in Boston (USA) and Toronto (Canada). Representatives of the diaspora have been chosen as heads of missions, thus also promoting involvement of diaspora professionals in economic cooperation with Latvia.

**Activities for the transfer of knowledge and world experience to Latvia.** Engagement of diaspora professionals in deep-tech, RIS3 areas and other business promotion activities continues actively. The LIAA cooperates with the association *Economic Cooperation and Investment for Latvia* or the community *#esiLV*, which brings together entrepreneurs, scientists, international organisations, and creative industry professionals residing abroad. The involvement of diaspora professionals in the commercialisation of scientific discoveries provides new opportunities to contribute together to the economic development of Latvia. For example, on 13 and 14 October 2022, an international *Precision Medicine Networking Forum* organised by MoE and LIAA was held at Rīga Stradiņš University, in which a representative of the diaspora participated as an expert.

In order to connect professional nationals living abroad and companies in Latvia, by fostering Latvian employers to get actively involved in promotion of remigration, private investments have also started, for example, the *Latvija strādā* movement launched in 2018 at the initiative of the mobile communication operator *Tele2*, the work and information portal *YourMove.lv* has been created, etc.

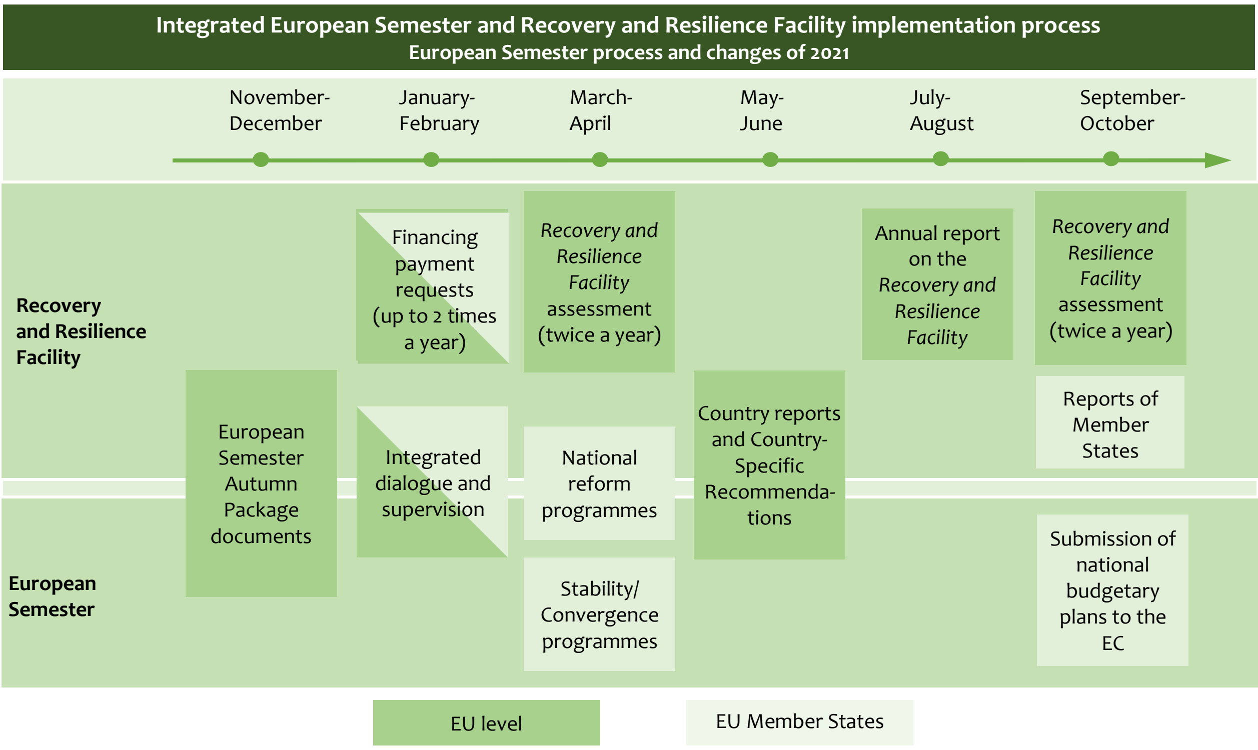
# PART II. ECONOMIC POLICY PRIORITIES

## 8. INTEGRATION OF LATVIA IN THE EU ECONOMIC AND STRUCTURAL POLICIES

### 8.1. EUROPEAN SEMESTER

On 12 January 2010, the EC published its *Annual Growth Survey* offering to launch a new economic policy surveillance and coordination mechanism in the EU – the European Semester. Since 2011, the European Semester starts every year in November, when the EC publishes the key documents (the so-called *European Semester Autumn Package*), the evaluation of which starts the European Semester of the next year, and those are: the *Annual Sustainable Growth Survey*, *the Alert Mechanism Report*, the *Draft Joint Employment Report*, the *Proposal for EU Council's Recommendations to the Euro Area* and other documents. In these documents the EC evaluates the economic situation across the EU and offers economic policy priorities for the next year. These documents are the basis for further discussions between EU Member States and the EC at different meetings of the EU Council.

Figure 8.1




The EC reports on each EU Member State (Country Reports), which are published every year in spring, are another important element of the European Semester. In these reports, the EC offers a detailed analysis of each EU Member State, its economic situation, main challenges and ongoing reforms.

**Box 8.1**

**EC proposal for EU Council's *Recommendations on the Economic Policy of the Euro Area***

According to the EC's proposal for EU Council's *Recommendations on the Economic Policy of the Euro Area* (published on 22 November 2022), euro area Member States in the period 2023 –2024 are urged to:

1. Continue to use and coordinate national fiscal policies across Member States to effectively underpin a sustainable and inclusive recovery. Maintain a moderately supportive fiscal stance in 2022 across the euro area, taking into account national budgets and the funding provided by the *Recovery and Resilience Facility.* Gradually pivot fiscal measures towards investments that promote a sustainable and inclusive recovery, consistent with the green and digital transitions, paying particular attention to the quality of budgetary measures. Keep fiscal policy agile in order to be able to react if pandemic risks re-emerge. Differentiate fiscal policies taking into account the state of the recovery, fiscal sustainability and the need to reduce economic, social and territorial divergences. Once economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment;
2. Promote policies that tackle aggressive tax planning, tax evasion and tax avoidance to ensure fair and efficient tax systems. Work to limit harmful tax competition including through the implementation of the global consensus-based solution to address the tax challenges arising from the digitalisation and globalisation of the economy. Lower the tax wedge on labour and promote a shift-from labour taxation towards taxes that are less distortive. Transition from emergency to recovery measures in labour markets by ensuring effective active labour market policies: (i) supporting job transitions, in particular towards the green and digital economy, (ii) combining measures tackling skills shortages, strengthening upskilling and re-skilling, providing targeted hiring incentives and (iii) enhancing the capacity of public employment services to address labour market mismatches. Strengthen inclusive quality education and training systems. Promote labour market integration of vulnerable groups, in particular young people and women, ensure adequate working conditions and address labour market segmentation, develop and adapt where needed social protection systems to address challenges emerging after the Covid-19 crisis. Ensure the effective involvement of social partners in policy making, strengthen social dialogue and collective bargaining. Ensure sharing of, and convergence towards, good practices in labour market and social policies that increase economic and social resilience;
3. Monitor the effectiveness of policy support packages for companies, focus on a more targeted support for the solvency of viable firms that have come under stress during the pandemic, and make greater use of equity-type instruments. Take actions to increase the capacity of insolvency frameworks to deal effectively and timely with bankruptcy and debt restructuring, maximize the preservation of value and promote an efficient allocation of capital and cross-border investments. Make progress in deepening the Capital Market Union, including by swiftly agreeing on the Commission legislative proposals to support the financing of the economy and to enhance investments opportunities for firms and individuals and remove cross-border barriers to investments in the single market;
4. Continue to strengthen national institutional frameworks and pursue reforms to address bottlenecks to investment and reallocation of capital, and ensure the efficient and timely use of Union funds. Reduce the administrative burden for firms and improve the business environment. Strengthen the effectiveness and digitalisation of public administration. Improve public financial management, including through green budgeting and effective public investment management frameworks, and make use of spending reviews to improve the composition of public finances, in particular quality of public investments, investment in people and skills, and to better focus public expenditure on recovery and resilience needs;
5. Ensure macro-financial stability, and maintain the credit channels to the economy, continuing to address non-performing loans through, amongst others, monitoring asset quality, timely and pro-active engagement with distressed debtors (in particular viable ones) and the further development of secondary markets for non-performing loans. Continue to work on completing the Banking Union, through a step-wise and time-bound work plan, and on strengthening the international role of the euro. Continue to support exploratory work on the possible introduction of a digital euro.

Further steps in deepening the Economic and Monetary Union (EMU) should take into account the lessons learnt from the design and implementation of the Union's comprehensive economic policy response to the Covid-19 crisis, including the RRF and the economic governance review. Progress in deepening the EMU should be continued in full respect of the Union's single market and in an open and transparent manner towards non-euro area Member States.

Meanwhile, at national level in accordance with the European Semester process every year EU Member States should draft and by mid-April submit to the EC national programmes (the *National Reform Programme*, *Stability Programme* or *Convergence Programme*). After both documents have been submitted, the EC prepares its assessment and at the end of May makes proposals for EU Council's Country-Specific Recommendations, which are discussed at different EU Council meetings and are approved at the European Council meeting in June.

With the establishment of the EU *Recovery and Resilience Facility* (see Chapter 8.2), which was integrated into the European Semester process, EU Member States should report twice a year to the EC on the implementation of the National Recovery and Resilience Plans, the achievement of their milestones and targets, etc. In addition, National Reform Programmes should contain references to the National Recovery and Resilience Plans as both processes are integrated. In Country Reports, the EC also evaluates progress in the implementation of the National Recovery and Resilience Plans (see Figure 8.1).

Following the European Semester process, on 22 November 2022 the EC published the *European Semester Autumn Package*: the *2023 Annual Sustainable Growth Survey* (see Box 8.2), the *2023 Alert Mechanism Report* (see Chapter 6.8), the *Draft Joint Employment Report*, the *Proposal for EU Council's Recommendations to the Euro Ar*ea (see Box 8.1) and other documents.

**Box 8.2**

***2023 Annual Sustainable Growth Survey***

In its *2023 Annual Sustainable Growth Survey*, the EC emphasises that Europe was generally able to recover from the Covid-19 pandemic due to different support measures. Now Europe is facing new challenges caused by Russia's invasion of Ukraine. This led to a sharp increase in energy and food prices, a decrease in household disposable income, an unstable external environment, a narrowing of funding and investment opportunities. In view of these challenges, economic and social policy coordination must continue at EU level, moving jointly towards long-term objectives. To overcome the energy crisis, it is necessary to combine efforts at the level of EU Member States and the EU, including through the opportunities offered by EU funding. Therefore, the integration of the Recovery and Resilience Facility (see Chapter 8.2) into the European Semester process is a very important element that will help to overcome existing challenges and strengthen the economy.

The *2023 Annual Sustainable Growth Survey* outlines the EC proposal relating to the short-term economic policy mainly to mitigate the shock and negative impacts of the energy crisis and to keep up efforts to support sustainable and inclusive growth and increase resilience of the economy in the medium term, while maintaining flexibility to tackle new challenges. In light of this, the EC believes the **four priority dimensions** defined in the previous years are still relevant, however, economic and social policy needs to be adapted to the new challenges.

- **Fairness**: in the short-term it is important to respond to steep increases in energy prices and support households and companies in crisis. In the medium term, effective training, skills development and labour market policies are important to help workers adapt to the new circumstances relating to the transition to the green and digital economy.
- **Productivity**: problems related to global value chain disruptions and support required by the companies negatively affected by the current energy crisis are topical in the short term. The functioning of the EU Single Market, investments in skills, digitalisation, research and development are important in the medium term.
- **Environmental sustainability**: support to households and reducing energy demand, as well as the development of renewable energy are topical in the short term. Progress towards European Green Deal, the achievement of the Fit for 55 targets and the establishment of a circular economy, including accelerating transition to clean energy sources and better functioning of energy markets are important in the medium term.
- **Macroeconomic stability**: in the short term, fiscal sustainability in combination with investment is important to facilitate the transition to the green and digital economy, maintain crediting and macro-financial stability, as well as restrict inflation. In the medium term, sustainable public finances and investments in the green and digital economy, as well as economic and social resilience, are topical.

The *National Reform Programme of Latvia for the implementation of the Europe 2020* strategy (hereinafter – NRP of Latvia) was approved by the CM on 26 April 2011 together with the *Convergence Programme of Latvia 2011-2014*. Both programmes were submitted to the EC on 29 April 2011. Since then, every year Latvia drafts and submits to the EC Progress Reports on the implementation of the NRP of Latvia.

According to the European Semester's process and timeline, the CM approved the eleventh ***Progress Report on the Implementation of the NRP of Latvia*** (hereinafter – Progress Report) and *Latvia's Stability Programme for 2022-2025* on 12 April 2022. Both documents were submitted to the EC on 15 April 2022.

**Box 8.3**

**2022 Country Report – Latvia**

According to the *2022 Country Report on Latvia* the Latvian economy has weathered well the Covid-19 crisis. Latvia's macroeconomic fundamentals remain sound despite the significant increase in public debt in the wake of the Covid-19 pandemic. Although its income level remains below the EU average, Latvia continues on a solid convergence path. Ensuring an inclusive and socially fair economic recovery remains a challenge in Latvia. Growth has not been fully inclusive as income inequality is among the highest in the EU, regional disparities persist, and poverty risks remain significant.

Reducing energy consumption in transport and buildings, boosting renewable energy capacity, delivering on the circular economy and improving protection of biodiversity are Latvia's key environmental and climate policy challenges. While Latvia is performing well in terms of connectivity and digital public services, the shortage of digital skills hampers the digital transformation.

Further challenges for the development of Latvian economy are related to the war in Ukraine, rapid decline in trade volumes with Russia and Belarus, as well as the spike in energy prices and supply chain disruptions that are spurring high inflation. The EC evaluates positively the ability of the Latvian government to respond to the Russia's war in Ukraine and adapt to its consequences by approving and introducing support measures for households and companies.

The *2022 Country Report on Latvia* also reflects the EC' opinion on the *Latvia's Recovery and Resilience Facility Plan* and its key measures.

The *Progress Report on the Implementation of the NRP of Latvia* contains an updated medium-term macroeconomic scenario described in the NRP of Latvia, evaluates the progress of Latvia in addressing the recommendations issued by the EU Council in 2019-2021, provides information on the implementation of the *Latvia's Recovery and Resilience Plan* and characterises the progress of Latvia in the achievement of objectives of the UN sustainable development goals. The *Progress Report* shows that the implementation of all the EU Council Recommendations is ongoing, the targets set in the *Latvia's Recovery and Resilience Plan* for Q1 2022 have been fulfilled and Latvia is generally moving towards the achievement of the UN sustainable development goals.

**Box 8.4**

**The EU Council's Country-Specific Recommendations for Latvia 2022**

The following recommendations are made for Latvia for 2022-2023:

- in 2023, ensure that the growth of nationally-financed current expenditure is in line with an overall neutral policy stance, taking into account continued temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. Stand ready to adjust current spending to the evolving situation. Expand public investment for the green and digital transition and for energy security, including by making use of the RRF, *RePowerEU* and other EU funds. Pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions. Broaden taxation, including of property and capital, and strengthen the adequacy of healthcare and social protection to reduce inequality;
- Proceed with the implementation of its recovery and resilience plan, in line with the milestones and targets included in the Council Implementing Decision of 13 July 2021. Submit the 2021-2027 cohesion policy programming documents with a view to finalising their negotiations with the Commission and subsequently starting their implementation;
- Improve access to finance for small and medium-sized enterprises through public lending and guarantee schemes aimed at facilitating investments of strategic importance, in particular the green transition and regional development;
- Reduce overall reliance on fossil fuels and diversify imports of fossil fuels by accelerating the deployment of renewables, ensuring sufficient interconnection capacity, diversifying energy supplies and routes and reducing overall energy consumption through ambitious energy efficiency measures.

When evaluating the national programmes submitted by the EU Member States and their implementation, on 23 May 2022 the EC published Country Reports, including about Latvia (see Box 8.3), and proposals for EU Council's Country-Specific Recommendations for the EU Member States, which were approved by the European Council on 17 June 2022 after discussions at different EU Council's meetings (see Box 8.4). The European Semester of 2022 has been completed with the approval of these recommendations by the European Council.

The measures planned by the government for the fulfilment of EU Council's Country-Specific Recommendations are included in the government's action plan. EU Council's Country-Specific Recommendations for Latvia are considered to be a significant element when setting national economic policy priorities, formulating necessary reforms and policy activities, as well as successfully implementing the *National Reform Programme of Latvia*, the *Latvia's Recovery and Resilience Facility Plan* and *Stability Programme of Latvia*.

It should be noted that the *National Reform Programme of Latvia*, the *Latvia's Recovery and Resilience Facility Plan* and the *Stability Programme of Latvia* are being implemented in close cooperation with the European Commission. The progress on the implementation of the above-mentioned programmes is being regularly discussed in the bilateral meetings between Latvia and the EC. The MoE will continue monitoring the progress in implementation of measures reflected in the NRP of Latvia and EU Council's Country-Specific Recommendations, and the information on the progress in the implementation of these measures will be included in the *Progress Report on the Implementation of the National Reform Programme of Latvia for 2023*, which will have to be submitted to the EC by 15 April 2023 together with the *Stability Programme of Latvia.*

## 8.2. USE OF EU FUNDING FOR ECONOMIC DEVELOPMENT

### GENERAL DESCRIPTION OF THE 2014-2020 PROGRAMMING PERIOD

In accordance with the EU Council decision on the EU's multiannual financial framework for 2014-2020 Latvia has received 4.4 billion euro for the implementation of Cohesion Policy targets using EU funds (ERDF, ESF and CF). This means that in this period Latvia is the fourth largest net beneficiary among all other EU Member States and will receive about 3 thousand euro per capita from the EU budget in the 2014-2020 period. Therefore, Latvia currently receives from the EU budget four times more than contributes into it. According to the assessments of the MoF, the contribution of EU funds to Latvia's GDP in 2020 was 1.2 percentage points.

Until 29 November 2021, a total of 2152 EU funds investment projects have been implemented for the total amount of 4.1 billion euro or 87% of the available funding. The actually disbursed support of EU funds is 2.9 billion euro – 61% of the 4.4 billion euro available in the 2014–2020 programming period. 396 million euro or 97% of the estimated amount were paid out in the nine months of 2021. Thus, the forecast of 544.2 billion euro for 2021 has been fulfilled by 73%.

Table 8.1

**Progress of the implementation of activities in competence of the MoE**
*as of 14 November 2022*

| | Support programme | EU funds funding (allocation) *million euro* | Scope of paying *million euro* | *as per cent of allocation* |
|---|---|---|---|---|
| 1.2.1.1. | Competence centres | 63.2 | 59.20 | 74.00 |
| 1.2.1.2. | Technology transfer system | 30.0 | 22.20 | 74.00 |
| 1.2.1.4. | Introduction of new products | 45.1 | 39.53 | 87.65 |
| 1.2.2.1. | Employee training | 22.5 | 22.42 | 99.60 |
| 1.2.2.2. | Motivation for innovation | 4.8 | 4.30 | 89.60 |
| 1.2.2.3. | ICT and non-technological training | 11.16 | 11.15 | 99.96 |
| 3.1.1.1. | Loan guarantees | 58.9 | 46.70 | 79.29 |
| 3.1.1.2. | Mezzanine loans | 7.0 | 6.90 | 98.57 |
| 3.1.1.3. | Support for attracting financing for small and medium-sized enterprises in the capital markets | 1.0 | 0.58 | 57.50 |
| 3.1.1.4. | Microcredits and start loans | 15.0 | 14.90 | 99.30 |
| 3.1.1.5. | Production premises | 43.0 | 39.80 | 92.50 |
| 3.1.1.6. | Business incubators | 31.7 | 23.20 | 73.10 |
| 3.1.2.1. | Venture capital | 29.2 | 26.20 | 89.73 |
| 3.1.2.2. | Technology accelerator | 16.0 | 16.00 | 100.00 |
| 3.2.1.1. | Cluster programme | 6.7 | 6.69 | 99.40 |
| 3.2.1.2. | International competitiveness | 80.5 | 56.30 | 69.90 |
| 4.1.1. | Energy efficiency of manufacturing enterprises | 23.7 | 13.80 | 58.00 |
| 4.2.1.1. | Energy efficiency of multi-apartment buildings | 141.5 | 88.60 | 62.60 |
| 4.2.1.2. | Energy efficiency of public buildings | 93.4 | 55.90 | 59.90 |
| 4.3.1. | Energy efficiency of district heating | 49.6 | 40.50 | 81.60 |
| **Total** | | **741.4** | **482.90** | **65.10** |

To ensure successful operation of regional business incubators until the end of the programme (31 December 2023), on 19 July 2022 the CM decided to divert the financing of 1 million euro from SO 13.1.6: recovery measures in the economic sector (measure 1.2.2.1 *Support for the training of employees*). The additional funding granted will provide grants and non-financial support for the development of businesses.

To ensure continuation of the *International Competition Promotion Programme* until 31 August 2023 by granting support for various export promotion activities, including participation in trade missions and international exhibitions, at the meeting of 19 July 2022 the CM decided to redistribute 4.5 million euro from SO 13.1.6: recovery measures in the economic sector (measure 1.2.2.1 *Support for the training of employees*). Additional funding is directed to those sectors that are expected to play a crucial role in the stability of Latvia's economic recovery. For example, support for organizing events and visits abroad.

The opportunity to receive EU funds co-financing for the issue of shares has caused the greatest interest among entrepreneurs. The ERDF funding available for the measure is 1 million euro, private co-financing – at least 1 million euro. Four project selection rounds have been announced for this activity so far. In total, contracts with seven businesses for the total amount of 1.4 million euro have been concluded in four selection rounds.

## GENERAL DESCRIPTION OF THE 2021-2027 PROGRAMMING PERIOD

On 2 May 2018, the EC published the communication *A Modern Budget for a Union that Protects, Empowers and Defends*[1]. It marked the EC's vision of the new EU's multiannual financial framework for 2021-2027 (this communication is reflected in detail in the *Report on the Economic Development of Latvia for 2019*). The communication from the EC of 2 May 2018 served as a basis for discussions between EU Member States and the EC on the new multiannual EU budget for 2021-2027.

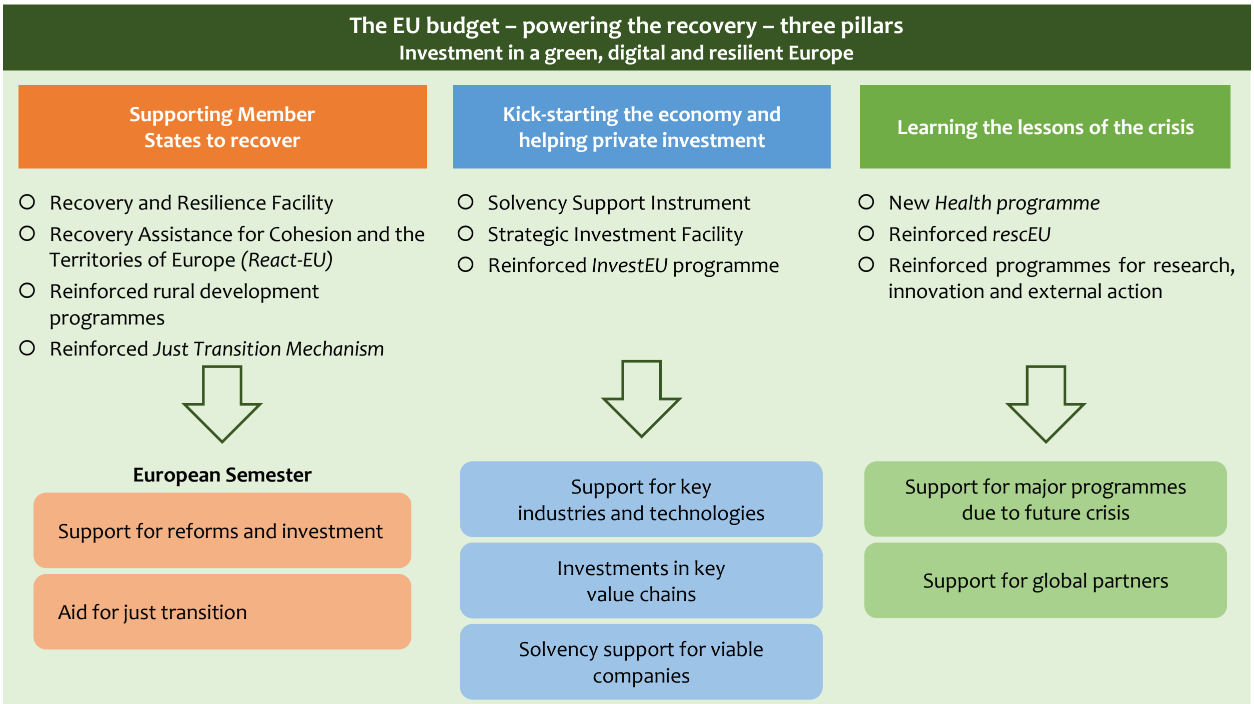
[1] https://eur-lex.europa.eu/resource.html?uri=cellar:c2bc7dbd-4fc3-11e8-be1d-01aa75ed71a1.0007.02/DOC_1&format=PDF

However, considering the Covid-19 pandemic and the crisis caused by it, the EC was urged to present a revised EU multiannual financial framework for 2021-2027.

On 27 May 2020, the EC presented a revised proposal for the EU multiannual financial framework for 2021– 2027 by publishing a communication ***The EU budget powering the recovery plan for Europe***[1]. The EU's long-term priorities to boost the green and digital transitions have been integrated in the new proposal for the EU multiannual financial framework. These horizontal priorities are embedded into all instruments and programmes of the EU multiannual financial framework. The reviewed EU budget proposal is based on three pillars:

- tools to support EU Member State efforts to recover, repair and emerge stronger from the crisis;
- measures to boost private investment and support viable companies;
- the reinforcement of key EU programmes to draw the lessons from the crisis and make the EU single market stronger and more resilient (see Figure 8.2).

Figure 8.2




Source: EC

In order to foster a more rapid recovery of the EU and EU Member States from the current Covid-19 crisis (pillar 1 of the EU budget), the EC offered to create a new ***European Recovery Instrument (Next Generation EU)***. This supplements the budget with new funding from financial markets and is a one-off emergency instrument, put in place for 2021 – 2024, which can be used by EU Member States exclusively for economic recovery measures.

In the context of the *European Recovery Instrument (Next Generation EU)* it is important to mention the new ***Recovery and Resilience Facility (RRF)***, which will be closely linked to the European Semester and National Reform Programmes of EU Member States (see Chapter 8.1). The aim of the facility will be to support investments and reforms essential to a lasting economic recovery, to improve the economic and social resilience of EU Member States, and to support the green and digital transitions.

The facility comes with a proposed budget of 560 billion euro to help fund EU Member States' Recovery and Resilience Plans. It is equipped with a grant facility worth up to 310 billion euro and will be able to make up to 250 billion euro in loans.

For EU Member States to be able to qualify for the funding from the *Recovery and Resilience Facility*, they have to draft a National Recovery and Resilience Plan, which is part of National Reform Programmes. The EC urged EU Member States to take into account the EU Council's Country-Specific Recommendations to EU Member States made in 2019 and 2020 when preparing their National Recovery and Resilience Plans and planning funding for the necessary investments and reforms. In

[1] https://eur-lex.europa.eu/resource.html?uri=cellar:4524c01c-a0e6-11ea-9d2d-01aa75ed71a1.0006.02/DOC_1&format=PDF

order to ensure efficient and effective use of funding, specific milestones and targets to be reached are set for each EU Member State within Recovery and Resilience Plans. The funding to EU Member States is allocated in instalments. EU Member States will be able to receive the next portion of the funding, if they fulfil the set milestones and targets within the set time limits.

Cohesion policy plays its essential role in supporting a balanced and sustainable recovery through a new *REACT-EU* initiative. Its aim is to tackle the most pressing economic and social needs and adjustments to the future cohesion programmes to make them more flexible and fully aligned with economic recovery priorities.

The *European Agricultural Fund* for Rural Development helps farmers and rural areas to deliver the green transition and support investments and reforms essential to the achievement of environmental targets.

The EC has significantly strengthened *Just Transition Mechanism* aiming to help EU Member States accelerate the transition to a green economy and in doing so boost their economies.

As part of the Pillar 2 of the EU budget, the EC proposed to strengthen the *Europe's flagship investment programme (InvestEU)* to mobilise private investments in strategic projects across the EU. As part of this, the Commission proposed to create a new *Strategic Investment Facility* to invest in key value chains crucial for Europe's future resilience and strategic autonomy. Considering the impact of the Covid-19 crisis on the financial condition of viable companies, the Commission also proposed a new *Solvency Support Instrument* to provide urgent support to companies and help them overcome the difficulties.

The Pillar 3 of the EU budget provides for the strengthening of the EU's capacity to respond to potential crises in the future. In this context the Commission proposed to create a new *EU4Health* programme to strengthen health security and prepare for future health crises. *RescEU* or the *Union's Civil Protection Mechanism*, was expanded and reinforced to equip the Union to prepare for and respond to future crises. The flagship programme *Horizon Europe* was also reinforced to fund vital research in health, resilience and the green and digital transitions. Other EU programmes, including its external instruments, were strengthened to align the future EU financial framework fully with economic recovery needs. Special instruments were also reinforced to make the EU budget more flexible and responsive to the new challenges.

The total funding of the EU multiannual financial framework for 2021-2027 offered by the Commission is 1,850 billion euro, which is historically the highest amount so far, of which 1,100 billion euro came from the EU multiannual financial framework, 750 billion euro came from the new *European Recovery Instrument* (*Next Generation EU)* and 540 billion euro came from the *Support to Mitigate Unemployment Risks in an Emergency (SURE)/European Stability Mechanism (ESM)*.

**Box 8.5**

**EU funds support in 2021-2027**

The EC has distributed legislative proposals on EU support for regional development and cohesion, as well as investment in human resources, social cohesion and values. These proposals were the beginning of discussions between Member States on the implementation conditions for the allocation of EU Structural Funds – the ERDF, the CF and the ESF (hereinafter – EU Funds) – among Member States and support programmes.

The MoE, as the authority responsible for the EU funds, is planning support for the sectors within its competence in line with the national priorities identified in the NDP 2021-2027.

The total investment planned by the MoE is 951.3 million euro and covers priorities such as digital transformation, productivity, social inequality, and climate and energy efficiency.

The programme includes measures to:

- ensure the transformation of the economy to the production of products and services with higher added value;
- promote digital skills of entrepreneurs and promote the digital transformation of entrepreneurship (digitalisation of processes);
- promote a more climate-friendly and energy-efficient business;
- provide support for the introduction of more energy-efficient measures for both households (residential buildings) and the public sector (public buildings).

Indicative financing of EU funds for the MoE activities for:

- digital transformation – 44 million euro, including support for digitalisation for the development of new products and services – 21.15 million euro, development of digital skills (training) – 10 million euro, EDIC and digital maturity test – 8 million euro and digitisation of financial instruments – 5 million euro;
- productivity – 367.3 million euro, including support for development of SME business – 101.2 million euro, financial instruments for SMEs – 164.4 million euro, support for research and innovation in the development of new products – 51.7 million euro, financial instruments for research and innovation – 50 million euro;
- reducing inequalities – 83 million euro, including access to social housing – 60.9 million euro and improving accessibility of the environment – 21.75 million euro;
- climate and energy efficiency – 457 million euro, including support for energy efficiency in residential buildings – 163.1 million euro, energy efficiency in public buildings – 104.4 million euro, heating and cooling – 56.5 million euro, RES in business 43.5 million euro, promotion of the use of RES in production – 23.49 million euro, promotion of biomethane production – 21.75 million euro, *greening of business – 44.06 million euro.*

Figure 8.3

**EU's investments in Latvia in 2021-2027**

**10.44 billion euro in total**

**Cohesion and values**
**6,630 million euro**

***React-EU***
**272 million euro**

**Common Agricultural Policy – direct payments and rural development**
**3,413 million euro**

**European Maritime and Fisheries Fund**
**134.9 million euro**

**Cohesion Policy Funds**

**ERDF, CF, ESF+**
**4,240 million euro**

Comprehensive investment in accordance with NDP2027

**Just Transition Fund**

**192 million euro**

Investments for the economic diversification of the areas most heavily affected by climate change

**Recovery and Resilience Facility**

**1,820 million euro**

Investments to mitigate the effects of the long-term Covid-19 pandemic in the economy, transition to the green and digital economy

**Transfers**

**European Territorial Cooperation**
**49.76 million euro**

Connecting Europe Facility (CEF)
320.18 million euro

Source: MoF

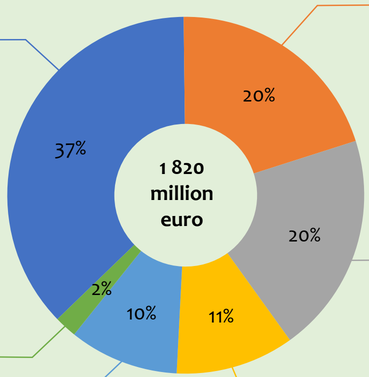
The *National Development Plan of Latvia* is the main document in the country, in accordance with which EU funds are being planned and EU funds programmes are implemented. On 2 July 2020, the Saeima approved the *National Development Plan of Latvia for 2021-2027* (hereinafter – NDP2027). The strategic goals of the NDP2027 are productivity and income, social trust, equal opportunities and regional development. Each strategic goal has its priorities, each priority has dependent action lines and indicative funding.

Figure 8.4

**Investments and action lines of the Latvia's Recovery and Resilience Facility Plan**

**Climate – 676.2 million euro**

- Improvement of the Riga Metropolitan area transport system
- Energy efficiency of private and public buildings
- Use of renewable energy sources
- Strengthening of the disaster management system




**Reduction of inequality – 370 million euro**

- Improvement of the road network
- Development of industrial parks and territories in regions
- Construction of low rent housing
- Social inclusion
- Improvement of infrastructure of education institutions

**Digital transformation – 365.2 million euro**

- Digital transformation of public services
- Digital transformation and innovation of companies
- Development of digital skills
- Infrastructure – 5G network in the *Via Baltica* corridor

**Rule of law – 37 million euro**

- Reduction of shadow economy
- Increase of transparency and competition in the field of public procurement
- Strengthening of analytics and development of data management in the field of tax administration and customs

**Health – 181.5 million euro**

- Development of medical education system
- Improving the efficiency of healthcare services
- Readiness of medical institutions to epidemiological crises
- Methodological management of the oncology sector

**Economic transformation – 196 million euro**

- Innovation and raising private funding in research
- Creation of a state support instruments for the development of innovation clusters
- Ensuring a change in the governance model of higher education institutions

Source: MoF, EC

In order to start using the EU funding and implementing the support programmes funded by EU funds, the *Partnership Agreement for EU investment funds programming period 2021-2027* and the EU *Cohesion Policy Programme 2021-2027* were approved by the CM in the autumn of 2022. The programme states the political objectives, priorities and specific support objectives and the planned actions to be supported within its framework, the amount of financing and corresponding national co-financing, as well as the target indicators. Information about the planned EU investments in Latvia in 2021-2027 is reflected in the Figure 8.3 and in the Box 8.3.

The ***Latvia's Recovery and Resilience Facility Plan*** (hereinafter – Latvia's RRF Plan) is another important document in acquiring EU funding in Latvia in the context of the European *Recovery and Resilience Facility*. The Latvia's RRF Plan was submitted for review to the EC on 30 April 2021, and was approved on 22 June 2021. Then followed the evaluation of Latvia's RRF Plan at the EU Council, where it was approved on 13 July 2021. Main six lines of the Latvia's RRF Plan (see Figure 8.4):

1) climate change and environmental sustainability (676.2 million euro or 37% of total available funding);
2) digital transformation (365.2 million euro or 20% of total available funding);
3) reducing inequalities (370 million euro or 20% of total available funding);
4) health (181.5 million euro or 10% of total available funding);
5) economic transformation and productivity reform (196 million euro or 11% of total available funding);
6) rule of law (37 million euro or 2% of total available funding).

The Latvia's RRF Plan includes investment projects and reforms that will contribute to a faster economic recovery from the current Covid-19 crisis. The plan is closely linked to the European Semester process, the implementation of the EU Council's *Country-Specific Recommendations for Latvia* and the NRP of Latvia (see Chapter 8.1). Financing from the *Recovery Fund* will be available until 31 August 2026.

Latvia has fulfilled all the nine milestones defined in the Latvia's RRF Plan (see Figure 8.5) and in June 2022 it submitted its first payment request for 231 million euro, which the EC supported on 7 October 2022.

Figure 8.5

**Progress in fulfilment of milestones by Latvia**

| 9 milestones have been fulfilled | 214 milestones in total | | | | |
|---|---|---|---|---|---|
| Q2 2022<br>9 milestones<br>**231 million euro** | Q2 2023<br>49 milestones<br>**503 million euro** | Q2 2024<br>35 milestones<br>**419 million euro** | Q2 2025<br>40 milestones<br>**293 million euro** | Q2 2026<br>22 milestones<br>**168 million euro** | Q3 2026<br>59 milestones<br>**212 million euro** |

| Area | Reform/investment | Milestones to be fulfilled |
|---|---|---|
| **Digital transformation** | Reducing the digital gap for socially vulnerable students and in educational institutions<br>Development of broadband infrastructure | Entry into force of legal regulation for the organisation and implementation of remote studies<br>Acceptance of a single model for the development of the *last mile*<br>Adoption of technical requirements for connected and automated driving |
| **Reduction of inequality** | Creation of a financing fund for the construction of low-rent housing<br>Improvement and equipment of infrastructure of education institutions<br>Availability of social and employment services to support the minimum income reform | Entry into force of the law balancing the rights of tenants and landlords<br>Qualitative and quantitative criteria determining the number of pupils per class have been defined<br>Adoption of a strategic framework for developing a minimum income support system |
| **Rule of law** | Modernisation of identification of money laundering, investigation of economic crimes and court proceedings<br>Improving the competition environment<br>Increasing information technology and analytical capacity of the Procurement Monitoring Bureau | Entry into force of amendments to the Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing<br>Entry into force of the legal regulation on the improvement of the competition environment and mitigation of corruptions risks in public procurement<br>Adoption of criteria for determining risky market sectors, customers and purchases |

Source: MoF

# 8.3. EU SINGLE MARKET

In 2023, the EU Single Market turns 30. It unites 30 countries (27 EU Member States and 3 countries of the EEA, i.e. Norway, Iceland and Liechtenstein) having over 500 million consumers. The EU Single Market as we see it today is the result of continued work. By coordinating decisions gradually, step-by-step the requirements have been harmonized and closer integration has been achieved – unified principles and rules for economic operators have been developed, border control has been cancelled, consumers have been provided with a wider range of goods and services, new jobs were created, freedom for citizens to live, work and study in other Member States has been provided, a possibility was found to introduce a single currency, and those are not the only benefits. However, the EU Single Market is still being improved.

On 30 March 2022, the EC published a *Proposal for **Ecodesign for Sustainable Products Regulation***, which will supersede the currently applicable directive. Its main objective is to improve environmental sustainability of products throughout their life cycle and to ensure a single framework for EU regulation. The new proposal foresees that in future it will also apply to the products with circularity potential not only the energy-related ones, thus covering the broadest range of products possible. It provides not only for new requirements for sustainability of products relating to durability, reusability, upgradability and reparability, energy and resource efficiency, recycled content and recycling, carbon and environmental footprints, but also for a digital product passport, which will be a source of information for consumers on environmental impact of products.

To reduce shortcomings in goods and services delivery chains and promote a more resilient EU Single Market in crisis situation, on 19 September 2022 the EC proposed the EU ***Single Market Emergency Instrument*** package. The intention of this instrument is to restrict Member States in adopting bans related to the EU internal trade in emergency situation in the EU, such as the Covid-19 crisis or the impact after the Russia's invasion of Ukraine. The proposal has been transferred to the EU Council and the EU Parliament for evaluation.

On 4 October 2022, the European Parliament reached an agreement in the final vote that, from the end of 2024, all new portable devices placed on the EU market (mobile phones, tablets, digital cameras, hand-held video game consoles, headsets, headphones, portable speakers, readers, keyboards, mice, portable navigation systems, wireless headsets) should be equipped with a **single charging standard** so that consumers can charge their devices with a single (USB Type-C) charger, regardless of the brand of the device. In addition, the charging speed of the devices with any compatible charger should be the same. This has been unduly delayed by manufacturers so far. Devices and their chargers are expected to be sold separately in the future to reduce the number of unnecessarily purchased and unused chargers and electronic waste.

The EU ***Digital Markets Act*** came into force on 1 November 2022, which will help end unfair practices where companies act as gatekeepers in the online platform economy. The aim of the act is to prevent unfair conditions being imposed on businesses and end-users, thereby ensuring the openness of digital services. For example, online platforms will need to ensure that end-users can easily opt out of core platform services or stop software installing by default, provide advertising performance data and pricing information, allow developers to use alternative payment systems in the app and allow end-users to download alternative app stores. Alongside the EU ***Digital Services Act*** was adopted, which will impose new obligations on online platforms to combat illegal and harmful content, including accessibility to goods and services, and to strengthen the protection of interests of users and the public which will come into force in 2024.

To ensure better governance of the EU Single Market, an electronic **Single Market Centre**[1] is available on the MoE website providing essential information on different EU information and assistance services. The main purpose of the Single Market Centre is to help entrepreneurs to use all the advantages related to the EU Single Market and to provide practical assistance when the freedom of provision of goods and services is limited.

The MoE supervises and coordinates the freedom of provision of goods and services and the right to do business in Latvia as provided for by Articles 34-36 and 49-62 of the TFEU. Within the scope of its competence is also identification of legal provisions which may hinder the use of freedoms of the EU Single Market, including the evaluation of draft laws and regulations.

The **technical regulations notification** is a preventive, unified and transparent monitoring tool to evaluate and prevent the inclusion of such requirements into laws and regulations, which might create barriers for free circulation of goods, as well as information society services. Not only responsible authorities of EU Member States, but any economic operator can participate in the process and provide comments and objections regarding draft laws prepared by any Member State, which might potentially affect product export or cross-border information society services. The draft technical regulations notified by Member States are freely available in the database of the *Technical Regulations Information System* (TRIS)[2], where information on drafts is available also in Latvian. If an economic operator has any objections to draft technical regulations of other countries which might potentially or actually affect sales of its product in the market of a specific EU country, the

[1] https://www.em.gov.lv/lv/vienota-tirgus-centrs
[2] http://ec.europa.eu/growth/tools-databases/tris/lv/search

economic operator has the right to submit its objections to the responsible ministry which is competent to coordinate the respective policy area in Latvia.

To ensure administrative cooperation between EEA's national public authorities, the EC has introduced an *Internal Market Information System* (IMI). The IMI system allows to contact responsible authorities of the EEA countries at national, regional and local level in a fast and effective way. Using the IMI system, authorities of Member States can verify the information indicated in applications of legal entities and individuals, authenticity of documents issued in other Member States and clarify other issues according to respective EU laws and regulations. Hence, the applicant is free from bureaucratic barriers in the resolution of different cross-border issues in the EU Single Market. MoE is the national coordinator of the IMI system in Latvia. Every year, IMI operating areas are extended and adapted to the needs of national regulatory authorities, for example, in 2022, a Mobility Package was included in the IMI system, which included road transport shipment declaration, modules for the conditions of establishment and the social rules. A weapons refusal module was also introduced, which makes it possible to register information on refusals to issue a permit for purchasing and storing weapons. From January to October 2022 Latvia processed 198 information requests within the IMI system: 133 in the professional qualifications area, 64 in the posting of workers and 1 in the patients' rights.

*SOLVIT* Centre – an alternative EU Single Market problem solution network, created by the EC and the Member States, has been operating in Latvia since 2004. Its task is to find a fast and practical solution of the EU Single Market's problems caused by administrative decisions of public authorities in case of incorrect application of EU law. In situations, when a resident or a businessman is harmed by wrongful decisions taken by responsible authorities of Member States, the *SOLVIT* Centre operates as a free pre-trial problem-solving tool. There are *SOLVIT* Centres in each EEA Member State. From January to October 2022 the Latvian *SOLVIT* Centre received 13 complaints on problems of Latvian citizens in other EU countries and 9 complaints on problems of EU citizens in Latvia. In this period, all complaints were resolved within the defined time – not more than 10 weeks. To submit a complaint to the *SOLVIT* Centre, the case must meet the following criteria: 1) the decision has been taken by a public authority; 2) the public authority is located in another Member State (cross-border element); 3) norms arising from the EU law (regulations, directives, etc.) have been violated. Most frequently the Latvian *SOLVIT* Centre receives complaints of individuals related to social benefits and issues of residence permits, while complaints of businesses are related to restrictions on freedom of provision of goods and services, repayment of value added tax and recognition of professional qualifications.

# 9. IMPROVEMENT OF THE BUSINESS ENVIRONMENT

Different measures for improvement of the business environment in Latvia have been implemented since 1999. The MoE, with the participation of a wide range of sectoral ministries and organisations representing entrepreneurs, prepares the *Action Plan for Improvement of the Business Environment* (hereinafter – the Business Plan), which is updated and submitted for approval to the government every other year. The Business Plan is a business policy making tool, which shapes the business policy by hearing and solving the problems identified by businesses. Almost 600 measures for improvement of the business environment have been introduced so far, while implementing the Business Plan.

In 2022, MoE continued efforts to implement the *Business Plan 2019-2022* and began developing the new plan together with its partners – the Latvian Chamber of Commerce and Industry, Employers' Confederation of Latvia and Foreign Investors' Council. The purpose of the new plan is to create an attractive business environment with accessible and understandable services for entrepreneurs in conformity with the conceptual changes proposed by the CM on 7 September 2021 in the development and implementation of the Business Plan, which would make it more efficient and targeted (see Box 9.1).

**Box 9.1**

**Development of a new *Action Plan for Improvement of the Business Environment***

To improve the regulatory enactments regulating entrepreneurship and the services provided by the state administration promoting the competitiveness of the Latvian business environment within the framework of the new Business Plan, the MoE will define specific measures according to the following actions lines of the plan:

- data collection and re-use;
- improvement of construction processes and related requirements;
- improvement of local government planning;
- reduction of business costs;
- improvement of customs procedures;
- reduction of administrative burden on economic operators in relation to the regulatory requirements for anti-money laundering and combatting terrorism and proliferation financing.

Discussions between the parties concerned on the listed lines of action will continue in order to reach agreements on specific measures and the result indicators to be achieved, and to coordinate the planned measures with the responsible national regulatory authorities and to direct them for approval to CM.

In 2022, work was continued on promoting economic activity of businesses and the population and creating an attractive business environment, focusing on the second chance for individuals and legal persons, taking into account the recommendations contained in the IMF *Evaluation of the insolvency framework* in Latvia and the EU *Directive on restructuring and insolvency*. The insolvency regulations are improved for the implementation of these recommendations and the requirements of the Directive.

## DIGITALISATION OF THE BUSINESS ENVIRONMENT

One of the priorities in creating an excellent business environment is to promote digitisation – the use of digital solutions in business and public services, to improve the competences of public authorities in the field of digitisation and to provide the necessary infrastructure for the development of digitisation.

Modern digital technologies (broadband, big data, data centres, cloud services, artificial intelligence, etc.) create unprecedented opportunities for improvement of different processes and procedures, development of new products and services, and process analysis and optimisation. At the moment, however, Latvian companies are significantly lagging behind in the use of digital technologies, entrepreneurs lack digital skills and the necessary knowledge, skills and proper tools for transformation (such as productivity tools for digital trade, online cross-border trade, etc.) compared with OECD member states.

Industry associations recognise that ICT solutions and services are too expensive. Many entrepreneurs lack skills and experience, as well as information on the benefits of digitisation in business. Given that most of companies in Latvia are small and medium-sized enterprises, it is necessary to stimulate SMEs to use advanced technologies and new innovative business methods, thus implementing digital transformation in enterprises and promoting their competitiveness.

The *Digital Economy and Society Index* (DESI) of 2022 ranks Latvia the 17$^{th}$ among 27 countries. Latvia's level of digital development is broadly in line with the EU average. In terms of connectivity, Latvia is only 20$^{th}$ among the 27 EU countries, but still stands out (ranks 4$^{th}$) in very high capacity networks (VHCN) coverage (91% compared to 70% on average in the EU). Latvia continues to work towards better connectivity – facilitating the rapid deployment of 5G and, in line with EU targets, achieving coverage in all urban areas by 2025 and in all populated areas by 2030. In terms of digital public services, Latvia is 11$^{th}$ and its results in most categories are better than the EU average, for example, 8$^{th}$ in the category *Digital public services for businesses*. However, Latvia lags behind in several aspects: internet use (18$^{th}$ place), human capital (18$^{th}$ place), integration of digital technology (23$^{rd}$ place). Progress has been fostered by improvements in the connectivity aspect (the coverage of high-speed broadband networks and their deployment level is relatively high) and in digital public services (the opening of the Latvia's Open Data portal and an approach based on different life situations adopted for the purposes of provision of public services).

Improving citizens' digital skills is a prerequisite for creating inclusive labour markets, and for increasing the productivity of the companies that currently enjoy very little digital benefits. Regions still have untapped potential for broadband-optic internet connectivity, which would provide reliable and fast digital infrastructure for businesses, as well as remote job opportunities for employees. Despite the good availability of basic infrastructure in regional centres, the provision of electronic communications services to citizens in regions is not possible until the *last mile* connection and adequate service provision policy are provided.

Promoting the digitisation of the business environment requires the introduction of productive and competitive digital solutions, the development of high-value digital products and services and integration into international markets and supply chains. The development of entrepreneurs' digital skills (at workforce and management level) should be encouraged, as this is the factor that enhances business efficiency.

## SINGLE INFORMATIVE PORTAL WWW.LATVIJA.LV

In order to facilitate the full functioning of the EU Single Market and the provision of cross-border services, the information and services necessary for business activities should be easily accessible and available on the national websites of the EU Member States. In Latvia, such information is available electronically in one place on the portal of Government Services *www.latvija.lv*. Since 2006, the portal has also performed the functions of an electronic point of single contact for services set out in the *Directive on services in the internal market* (Directive 2006/123/EC), i.e. provides together detailed information on public services related to business in the field of services and the possibility to electronically fulfil the necessary administrative requirements for the provision of services in Latvia. Since 2020, the portal performs the function of a point of single contact for goods – it provides information on the mutual recognition of products, general and technical product rules, remedies and market surveillance authorities in the non-regulated product areas in Latvia.

The main principles of operation of the portal *www.latvija.lv* are defined in the *Information Society Development Guidelines for 2014-2020*, and the legal regulation is stipulated in several CM regulations. In cooperation with MoEPRD, work continues on the introduction and implementation of *Regulation (EU) 2018/1724 of the European Parliament and of the Council of 2 October 2018 establishing a single digital gateway to provide access to information, to procedures and to assistance and problem-solving services and amending Regulation (EU) No 1024/2012.*

As the digital modernisation of public administration continues, particularly as regards digital access to services provided by public administration, MoEPRD in cooperation with MoE and other public authorities have started the transformation of the portal to enable the population and companies to easily and conveniently find necessary information and receive public services. The new design of www.latvija.lv is planned to be gradually introduced in 2023. Since the entry into force of the *Single Digital Gateway Regulation* (EU) 2018/1724 in December 2018, this information has been gradually collected and transferred to the EU portal *Your Europe* (*www.youreurope.eu*) to provide information and services to the population and businesses on cross-border activities in all EU Member States in a transparent way in one place.

# 10. INNOVATION AND NEW TECHNOLOGIES

An important precondition for transition to innovative economy is strengthening of the Latvian innovation system by eliminating its deficiencies and facilitating mutual cooperation between all subjects of the innovation system – businesses, science and education, as well as financial and legislative systems.

The ***European Innovation Scoreboard 2022*** has appreciated Latvia's achievements in several innovation indicators. Since the previous reporting year, the number of public-private co-publications has increased by an average of almost 40%, the mobility of human resources in science and technology between jobs has increased by almost 33%, the number of international co-publications has increased by almost 18%, while venture capital expenditure – by 16%. It is assessed positively that the net foreign direct investment inflow exceeds the EU average 1.5 times and the turnover share of small and medium-sized enterprises – by 35%. The share of in-house companies that have developed and introduced a new product on the market in the Latvian economy structure is 7 percentage points higher compared to the EU average.

In the *European Innovation Scoreboard*, Latvia is ranked 25th among EU Member States, i.e. in the group of Emerging Innovators. Currently, this group includes countries below at least 70% of the EU average. Compared to the previous year, in the report of 2022 Latvia's indicators significantly increased in three dimensions of innovation: the linkages between sectors, finance and support, and environmental sustainability. Compared to EU indicators, Latvia has a proportionally large share of the population with tertiary education (126.3% of the EU average), very good results in the number of trade mark applications per billion GDP (101.4% of the EU average) and also in the share of people with above basic overall digital skills (90.9% of the EU average). Latvia has the lowest indicators in government support for business research and development (5.2% of the EU average), research and development expenditure in the business sector (11.5% of the EU average), innovation expenditures per employee (12.2% of the EU average) and most cited publications (22.9% of the EU average).

In 2022, Latvia ranks 41st among 132 countries in the ***Global Innovation Index***. It was 38th in 2021. In order to measure the increase in output of innovative and internationally competitive products, Latvia's assessment in the subcategory of knowledge and technology outputs is of essence – it shows that Latvia was 44th among 132 countries in 2022, 45th among 132 countries in 2021 and 36th among 131 countries in 2020.

**Box 10.1**

**Proportion of innovative businesses**

Between 2018 and 2020, an average of 32.5% of all Latvian companies were innovative, which is 0.4 percentage points more than in the previous period (2016-2018), however this indicator is lagging behind the average in the EU countries (2018: EU-27 – 50%). The turnover of innovative companies in the total turnover of companies increased by 0.9 percentage points over this period reaching 60.6%, indicating that demand for the products of innovative companies or services has slightly increased. Overall, the share of innovative companies has been exceeding 30% of the total number of companies since 2016. The current trends have also been positively influenced by public intervention in the form of various actions, including information campaigns, support programmes, regulatory frameworks and improvements in the business environment.

In the report *Innovation Development Trends and Proposals to Promote Innovation during the Economic Crisis* drafted within the project *Economic, Political and Legal Framework for preserving the potential of the Latvian National Economy and Promoting the Growth of Competitiveness in the Wake of the Crisis Caused by the Pandemic* (reCOVery-LV) of the national research programme *For Mitigation of Covid-19 Consequences*, the researchers have concluded that during the period 2019-2020 63% of the companies surveyed in course of preparation of the report (37 companies from all regions of Latvia) have introduced at least one product or business process innovation, or have carried out an innovative activity that is still ongoing. The result of such an alternative survey, although based on a small sample, shows that more targeted work on raising awareness of businesses may lead to a larger number of innovative companies appearing in statistics.

## INVESTMENT IN RESEARCH AND DEVELOPMENT

Total expenses of Latvia on research and development (R&D) in 2021 amounted to 232 million euro or 0.71% of GDP. Compared to 2020, they increased by 11.6%, and investments of businesses in R&D activities increased by 19.1%. It is likely that such results were achieved due to the measures implemented for promotion of innovation in state-owned enterprises as well as measures to promote innovation in SMEs. Overall, the financing of R&D by businesses amounted to 66.83 million euro in 2021 or 28.7% of total R&D funding in the Latvian economy. However, this indicator significantly lags behind the achievements of EU Member States, where businesses provide more than half of total investments in R&D (2020: EU-27 – 65.8%; Latvia – 30.9%). Low activity and capacity of Latvian businesses in R&D is largely affected by the existing economy and business structure – low share of high and medium high-tech businesses in the Latvian economy.

The total amount of investments in R&D is affected by investments from all sectors, but it should be noted that large state-owned enterprises (SOEs) have a significant influence. SOE's assets account for 13.29% (2019) of the assets of all capital companies. Approximately half of them are formed by three state-owned enterprises. There is a discrepancy between the national targets in promoting R&D in SOEs and the existing regulation, the shortcomings of which create obstacles to holders of capital shares or board of directors in setting R&D targets in SOEs, and thus delay the achievement of the R&D target value set by the state. Differences in the regulatory framework in Latvia from trends in other countries show that SOEs play a key role in achieving the country's R&D targets.

## IMPLEMENTATION OF THE INNOVATION GOVERNANCE REFORM

In 2022, the creation of the innovation institutional governance and *Smart Specialisation Strategy* (RIS3) governance model continued. The reform provides for the involvement of the LIAA in the coordination of RIS3 areas, leading the work of the five RIS3 management groups to this end and envisaging a long-term strategy and action plan for each RIS3 areas. Similarly, within the framework of the reform for the approximation of innovation and research policies, including the supervision of RIS3, an Innovation and Research Governance Council (IRGC) has been established, where the Minister of Economics, Minister of Education and Science, as well as officials of the LIAA and Latvian Council of Science cooperate. The first IRGC working meeting took place in September 2022.

In 2022, the functions of the Latvian Research and Innovation Strategic Council headed by the Prime Minister were reviewed in order to ensure that this Council decides only on strategically crucial matters of R&D, innovation policy and RIS3.

At the end of 2022, a cooperation project between the LIAA and the OECD on the development of a methodology for working with innovation ecosystems was completed, defining new systems, working with existing ones, and defining the role of LIAA in the development of ecosystems.

## CREATING INNOVATION DEMAND IN THE PUBLIC SECTOR

The public sector may play a crucial role in fostering innovation and research activities forming demand for innovation. Europe is increasingly using innovation public procurement for this purpose. For example, EU Member States spend an average of 19% of GPS on public procurement, while Latvia only 17% of GDP.

By developing the innovation procurement culture, it is possible to promote innovative procurements of goods and services and improve public services, and also to create a market for innovative solutions. To foster innovation procurement MoE continued the implementation of *iBuy*, an *Interreg Europe* project, also in 2022. Publicly available guidelines have been developed within the project telling how to conduct innovative procurement and also providing practical examples and tips. At the same time, a broader use of innovation procurement is delayed by the lack of practical examples, therefore the public sector would have to involve in the implementation of specific pilot projects in innovation procurement.

## NATIONAL RESEARCH PROGRAMME *INNOVATION FUND – SECTORAL RESEARCH PROGRAMME*

On 26 April 2022, the CM approved the national research programme *Innovation Fund – sectoral research programme* (hereinafter – Programme) developed by the MoE, within the framework of which it is planned to channel up to 12 million euro to research organisations for the implementation of innovative, commercial studies between 2022 and 2024. The aim of the programme is to promote scientific research and technology transfer, development of innovative and commercialisable products and technologies, in line with industry demand in two RIS3 areas: *Biomedicine, medical technologies, pharmacy* and *Photonics, smart materials, technologies and engineering systems*.

The programme sets the following tasks:

- In the RIS3 area *Biomedicine, medical technologies, pharmacy* – improving the availability of therapy for increased survival and capacity to work through the development of technologies for the manufacture of medicinal products, their transport vehicles and vaccines, the reprofiling of therapeutic moieties and the detection and development of new medicinal products, as well as the identification of new biomarkers and the development of precision medical solutions;
- In the RIS3 area *Photonics, smart materials, technologies and engineering systems* – development of smart optics and materials, microfluidics, microelectronics and sensors, robotics and Internet of Things solutions for the future.

Overall, the programme will receive funding for one project at a time in each of the two selected RIS3 areas. The time period for the implementation of one project is 24 months, the results of the projects should be demonstrated by the end of 2024.

## SPACE INDUSTRY

Aware that the global space industry is developing rapidly and that the Latvian space industry has inherited large and high value-added infrastructure (instruments, radio telescopes, equipment, etc.), as well as modern Latvian scientific achievements and unique innovations, Latvia is competitive in the international space industry.

Currently, the Latvian space ecosystem is maintained by the status of an Associate Member of the European Space Agency (since 2020), the EU Space Programme, EC innovation support programmes, as well as bilateral international cooperation projects and national support instruments. The potential of the Latvian space industry is, however, not fully exploited. The hindering factors are the shortage of human resources and limited access to infrastructure maintenance and modernisation financing opportunities.

The space industry of Latvia (as well as other countries) face the challenge of commercialisation of science (i.e. science is more advanced than the space industry). Therefore, discussions have begun with the European Space Agency regarding Latvia's possible participation in the platform of Business Incubation Centres of the European Space Agency. MoE, in close cooperation with other institutions, is actively raising awareness of the Latvian space industry, related industries and the general public about national, European and global level space industry opportunities and promoting active participation in them. Special attention was paid to internationalisation, as international cooperation in the space industry is the basis for effective commercialisation and technological development.

The MoE and the LIAA have organised a number of space-themed events to position Latvia as an active player in the global space industry and provide valuable networking opportunities, and they also provided the necessary support for the Latvian space industry to be represented at major industry conferences and exhibitions across the world (e.g. the International Astronautical Congress), as well as in committees of international organisations such as the European Space Agency, the European Union Agency for the Space Programme (EUSPA), the United Nations, etc., thus facilitating both the launch of new bilateral cooperation projects and the visibility of Latvia within and outside the EU.

## UNIFORM COUNTRY IMAGE CONCEPT

A new uniform country image concept *Latvia – country with a mission* has been developed since 2021. To introduce the Latvia's country image and its values, the mission approach has been selected, which is a long-term cooperation model that foresees cooperation among the public sector, industry, academia and the general public. The mission approach means defining the challenge and finding a solution by choosing an intersectoral path.

The first mission is *Sea 2030*. With this mission, we advocate the restoration of a resource important for the region, the Baltic Sea, creating the conditions and tools to prevent death of the sea in the long term, as the Baltic Sea is one of the most polluted and threatened seas in the world. The mission aims to find solutions and instruments to restore the Baltic Sea environment in the long term at the same time promoting global innovation and development in various related industries. Within the framework of the *Sea 2030* mission, the importance of the water theme was emphasised at various international events, both in Latvia and abroad: At the *Three Sea Initiative Business Forum*, the business forum *Deep Tech Atelier* (discussion *Space and Sea synergy: life support and data sharing – for the benefit of both*), the business opportunities forum *Icebreakers* (informing business beginners about the long-term goals and opportunities of the image of the Latvian state), the business forum organised by *Riga Fashion Week* (sustainable fashion, sea and innovation). A contract has been entered into with the developer of the visual image of *missionLatvia* and *Mission Sea*.

The LIAA has started developing the website latvia.eu and other tools needed to develop and strengthen the country's image. The procurement for the study on international recognition of Latvia in 10 target countries is ongoing in order to develop and implement the national strategy of Latvia on the basis of the data collected in the study. Digital proactive investment campaigns have been organised in the countries of external economic representations in order to promote Latvia's visibility and identify potential investors.

Latvia's preparations for participation in the exhibition *Expo 2025 Osaka*, Japan have begun. On 15 September 2022, there was a visit to Osaka by the Minister of Economics and other country's senior officials, which included a meeting with the organizers of *Expo 2025 Osaka* and discussions on Latvia's participation in the exhibition.

## ESTABLISHMENT OF A KNOWLEDGE TRANSFER SYSTEM SUPPORTING INNOVATION

The LIAA, which at the same time ensures functions of a Single Technology Transfer Centre, is a central element, and a mediator in the ecosystem of innovations in Latvia, which fosters cooperation between research organisations and industries along with competence centres. The LIAA also develops the awareness and development of technology transfer in public research organisations, improves their industrial property management policy, promotes the takeover of international knowledge and skills for the organisation of technology transfer processes and ensures introduction of a commercialisation fund and innovation vouchers support instruments. A knowledge transfer system supporting innovations in the 2014-2020 programming period of EU funds was implemented within the framework of activity 1.2.1.2 *Support for Improvement of Technology Transfer System* of the Specific Objective 1.2.1 *To increase investments of private sector in R&D* of the Operational Programme *Growth and Employment*. The knowledge and technology transfer system needs to be improved to develop cooperation skills of the research and business sector, foster a closer link of scientific activity with the demand from the business sector, satisfying the needs of companies for new technologies and innovative solutions.

The *Technology Transfer Programme* provides an opportunity to commercialise or convert into new products and services the results of research funded from public resources, and the private sector will thus ensure further development and introduction into market of the research results. Moreover, the purpose of the *Technology Transfer Programme* is to help Latvia achieve RIS3 goals, foster commercialisation of state-funded research results available to research organisations in Latvia and abroad, as well as promote innovation activities in small and medium-sized enterprises, including in start-ups through technology transfer. Thus, companies get support for new or substantially improved product or technology development.

By now, the *Technology Transfer Programme* helped to support 104 projects for commercialisation ideas, conclude 288 agreements (282 have been performed, but 6 were annulled or terminated) for support to start-ups in participation in exhibitions and visits to potential investors, as well as conclude 357 innovation voucher agreements (192 have been performed, 116 are still ongoing, but 49 were annulled or terminated). It is planned to continue programme activities to foster operations of economic operators and research organisations until 2023. Then R&D activities are expected to receive support within the scope the funding of the next EU funds programming period.

## CREATION OF START-UPS

Development of start-ups is an important chain link in the innovation system and promotes the change of the paradigm ensuring modern and innovative economy. Over the last years, the MoE and the bodies subordinated to it have been actively working on the creation of uniform supply for the start-up ecosystem. The Latvian start-up ecosystem has become more visible also in the international context. Every year several local events and festivals with international coverage bring together start-ups and their representatives.

Since 3 September 2020, when the Saeima adopted amendments to the *Law on Aid for Activities of the Start-up Companies*, which provides for the facilitation of the qualification requirements for start-ups and the mitigation of the limitations set out in the programme, the number of supported start-ups had grown rapidly. Aid for 153 start-ups was approved since the launch of the programme easing the attraction of highly qualified employees using a fixed payment and personal income tax discount. These amendments provide for the possibility of qualifying for support also for start-ups which, in order to receive a venture capital investment, founded a related company abroad.

Considering that some start-ups may have a business idea development process of more than five years, the amendments have increased the allowed time since registration in the Commercial Register (as one of the qualification criteria). The requirements applicable to employees are intended to be reduced, i.e. a start-up company will be required to have 50% of employees with a master’s or doctoral degree rather than 70%, and the restrictions on employment with other economic operators were lifted (to facilitate the attraction of highly skilled employees). It is also intended to support not only autonomous businesses, but also those whose shareholders own other businesses, to extend the support period from 12 months (in the current version of the law) to 24 months and to lift the requirement to terminate employment relations in other enterprises before the start-up company has received a decision granting aid, as well as to allow start-ups to re-apply for participation in the aid programme, including cases where no early stage venture capital investment has been made.

On 25 February 2021, amendments to CM Regulations No. 74 of 7 February 2017 *Procedures for the Submission of Applications of Aid Programmes for Start-up Companies and Administration Thereof* and amendments to CM Regulations No. 30 of 17 January 2017 *By-Laws of the Commission for Evaluation of Start-up Activities* were approved, which include the requirements fixed in the amendments to the *Law On Aid for the Activities of Start-up Companies* adopted by the Saeima. In addition, on 17 September 2020 the Saeima adopted amendments to the *Law on Personal Income Tax* and the *Commercial Law* to introduce a competitive regulation for options over shares. Therefore, the current commercial law regulation in Latvia provides for the possibility to grant share purchase rights not only to joint-stock companies, but also to start-ups or other fast-growing companies operating, for example, in the field of ICT, whose chosen commercial form is a limited liability company. Thus, it has been achieved that the right to purchase capital shares as an incentive for employees is used to a wider extent.

On 9 August 2022, amendments to CM Regulations No.74 of 7 February 2017 *Procedures for the Submission of Applications of Aid Programmes for Start-up Companies and Administration Thereof* were approved, the purpose of which is to ensure quality supervision of implementation of the support programme and to reduce the admirative burden in the process of evaluation of applications, when the employment of applicants’ employees with other employers needs to be checked in accordance with the *Law On Aid for the Activities of Start-up Companies*.

In order to promote a favourable environment for the development of start-ups, the MoE, the LIAA and ALTUM, together with organisations representing the interests of Latvian start-ups, i.e. the *TechChill* foundation, the non-profit organization *Latvian Private and Venture Capital Association*, the non-profit non-government organization *Latvian Startup Association*, Riga Technical University, the *TechHub* foundation, the association *Latvian Business Angel Network*, agreed on a joint *Strategy for the Development of the New Enterprise Ecosystem 2022-2025* approved on 7 September 2022, and signed a *Memorandum of Cooperation*.

In accordance with the *Law on the State Budget for 2022*, in accordance with the proposals included in the summary of proposals of the Saeima Budget and Financial (Tax) Commission, which support reallocation of financing, cooperation agreements were concluded in February 2022 with the *Latvian Startup Association*, the association *Latvian Business Angel Network*, the *TechChill* and *TechHub Riga* foundations regarding implementation of measures promoting the start-up ecosystem until 1 December 2022.

## NORWEGIAN FINANCIAL INSTRUMENT

In 2022, the implementation of the Norwegian Financial Mechanism 2014-2020 programme *Business Development, Innovation and Small and Medium-sized Enterprises* (hereinafter referred to as NFM Programme) continued. The funding available for the implementation of the NFM Programme is 14.7 million euros. The allocation of the Norwegian Financial Mechanism is 12.5 million euros, but co-financing of the Latvian state is 2.2 million euros. This funding will be channelled to SMEs, as well as to the developers of innovative business ideas for the development of new products and technologies, as well as the modernisation or purchase of production equipment.

The NFM Programme aims to promote the creation of higher value-added products and services in three areas: *green* innovation, welfare technologies and information and communication technologies. The NFM Programme has received a total of 116 applications and supported the implementation of 45 projects. At the same time, the LIAA Technology Business Centre (hereinafter – TBC) opened in 2021 continued functioning. It is part of the NFM Programme and exists in cooperation with TBC partners – University of Latvia, Riga Technical University, Rīga Stradiņš University. It aims to promote the development of technology-intensive business ideas. Considering the high demand, support for the entrepreneurship and innovation programme is likely to increase during the next NFM period, also by developing synergies with the NFM programmes of other sectoral ministries and by selecting focused topics such as the use of space technologies and the development of the STEAM (Science, Technology, Engineering, Arts and Math) competences as a central element.

## BUSINESS INCUBATORS

The following activities of the business incubator programme started in 2016 – activity 3.1.1.6 *Regional business incubators and creative industries incubator* of specific objective 3.1.1 *To foster creation and development of SMEs, in particular in manufacturing and in RIS3 priority sectors* and activity 13.1.1.4 *Recovery measures in the economic sector – Regional business incubators and creative industries incubator* of specific objective 13.1.1 *Recovery measures in the economic sector* of the Operational Programme *Growth and Employment*.

The aim of the measures is to support the establishment of new viable and competitive economic operators in the regions of Latvia by providing final beneficiaries with the necessary advice, training, measures regarding general business matters, also mentor support, environment (working space), and grant arrangements for covering the operational costs of economic operators. Pre-incubation support and incubation support can be received within the measures.

Throughout Latvia there are 11 regional business incubators and 9 support units, as well as a Creative Industries Incubator in Riga specialising in providing support to creative industries. By 14 November 2022, 634 businesses received grants, 1,037 businesses received non-financial support, while employment growth in supported companies is 2,292.32 full-time equivalents. The number of pre-incubation beneficiaries receiving non-financial support is 2,676.

## COMPETENCE CENTRE PROGRAMME

One of the most important tasks is to build understanding of companies about research, development and innovation as drivers of growing productivity and competitiveness of companies. The purpose of activity 1.2.1.1 *Support for Development of New Products and Technologies within the Competence Centres* of specific objective 1.2.1 *To increase investments of private sector in R&D* of the Operational Programme *Growth and Employment* (activity 1.2.1.1) is to increase competitiveness of economic operators by promoting cooperation between the research sector and the industrial sector when implementing projects developing new products and technologies and introducing them in production. The main challenges of activity 1.2.1.1 are to ensure the achievement of investment results and active involvement of beneficiaries of funding in the creation of international and intersectoral platforms. 10 competence centres received support as a result of selection of projects within the *Competence Centre Programme*. The total funding of the programme is 78.7 million euro, incl. ERDF of 63.2 million euro, by raising private sector funding for research and development of at least 49 million euro.

191 research projects were approved within the second round, of which 174 were completed. 149 performers of economic activities received support by 31 December 2018. 492 new jobs, incl. those employing scientific employees in the public sector, were created within the scope of the *Competence Centre Programme*. 175 persons with a master's and doctoral degree are involved in the implementation of research projects. 238 scientific articles were published in journals indexed in international databases (*Scopus, Web of Science*). The raised private sector funding was 24.5 million euro.

As at November 2022, more than 230 research projects have been approved within the scope of the fourth round, including more than 96 intersectoral research projects. The co-funding of companies involved in R&D projects as at November 2022 was 34.2 million euro. 167 performers of economic activities received support within the scope of the fourth round. The programme provides a perfect opportunity to study good innovation practices. The contributions received from ERDF have increased the number of innovations, productivity, export capability and other indicators, which considerably increase general competitiveness of industries.

In the future, digital transformation of companies, investment in research and development of new products or technologies will play an increasingly important role in increasing competitiveness. It will be particularly important to produce export capable products with commercialisation potential.

## DEVELOPMENT OF STRATEGIC ECOSYSTEMS

In order to increase the potential of Latvian scientists and the potential of companies to get included the leading European innovation platforms and attract public investments in the next programming period, proactive actions are necessary to determine strategic competitiveness factors and strengthen the local cooperation model (triple helix). The multiannual financial framework of the EU after 2020, which marks further EU policy and investment directions, sets research and science as one of the main priorities. Taking into account the funding attraction conditions and investment priorities set by the EC, MoE delegated LIAA the implementation of pilot projects in three development areas – biomedicine, smart cities and smart materials.

A market research framework has been developed for mapping of Latvia's innovation environment, potential new value chains with a focus on those that have an analytically proven high potential to successfully integrate into international value chains.

In 2022, a cooperation project with the OECD on the development of a methodology for working with innovation ecosystems continues – defining new ones, working with existing ones, defining the role of LIAA in the development of ecosystems.

As part of the pilot project of the photonics and smart materials ecosystem, agreement has been reached on LIAA's support in the application for the *Horizon Europe* project (*Innovation Hubs*) as a provisionally associated partner, several high-level visits abroad with strategically important partners have been made, agreement has been reached with *Photonics Sweden* on the organisation of the Association's annual industry event in Latvia and it is planned to extend this event to include other Nordic photonics and smart materials ecosystems.

A *Biobank Law* and a *Health and Social Data Secondary Use Law* are being developed within the framework of the biomedical ecosystem. A road map has been created in the project of the Children's Clinical University, the activities to be performed have been clarified, the attraction of potential partners has been evaluated, bilateral meetings have been held with Latvian start-ups.

At the same time, work on ICT solutions – 5G, mobility, data cloud solutions and infrastructure, microelectronics – is ongoing.

# 11. PROMOTING PRODUCTIVE INVESTMENTS AND EXPORTS

## 11.1. PROMOTION OF ACCESS TO FINANCE

The purpose of implementation of financial instruments is to reduce market failures and to promote the creation of new economic operators and growth of existing ones, ensuring access to funding to make possible the implementation of prospective and viable business projects for those economic operators, who due to insufficient security, history of economic activity, credit history, net income flow or the amount of current credit obligations were unable to attract funding from participants of the financial market (commercial banks, private investors) for the implementation of business projects in the necessary amount.

The ERDF funding for financial instruments intended in the 2014-2020 programming period of EU funds amounts to 101 million euro. In addition, ALTUM should attract indicatively its funding or use the repaid funding of funds (for direct microcrediting, for support in starting economic activity and mezzanine loans) of 68 million euro, as well as external funding of indicatively 36.15 million euro (for ensuring venture capital and acceleration services) should be attracted.

To ensure continued availability of funding to SMEs, it is planned to continue state aid programmes in the form of financial instruments in the new EU funds programming period 2021-2027, providing loans to business starters and guarantees, as well as facilitating the availability of venture capital instruments, while ensuring that these programmes and activities planned by *InvestEU* complement each other.

### SUPPORT PROGRAMMES FOR MITIGATION OF THE CONSEQUENCES OF THE COVID-19 PANDEMIC

In spring 2020, the challenges posed by the spread of the Covid-19 virus and related restrictions adopted by the government led to the development of additional state support programmes. The programmes for mitigation of the consequences of the virus and providing funding for the implementation of investment projects by adapting or transforming their current business model.

Until February 2022, entrepreneurs could receive wage subsidy support to compensate remuneration of part-time workers. 18.4 million euro were paid in wage subsidies from 1 October 2021 to February 2022.

Entrepreneurs could also receive support to compensate a decline in working capital flows. 66.6 million euro were paid to 8,175 companies as a compensation for a decline in working capital flows from 1 October 2021 to February 2022.

On 9 November 2021, a state support programme for shopping and sports centres, cultural, recreation and entertainment places was approved. The support was provided in the form of grants and was one-time support for the period from 11 October to 15 October 2021 for owners of shopping centres, and for the period from 1 October to 31 December 2021 for owners, legal possessors and lessees of sports centres, cultural, recreation or entertainment places for sports centres, cultural, recreation or entertainment places owned, managed and leased by them. They were used to cover operational costs (payments related to the use of the building and premises, including payments for electricity, water, heat, real estate rental, liability payments, also credit payments, and outsourcing costs) from 1 October 2021 to 30 June 2022. The support programme funding was 50 million euro. A total of 125 companies have been supported with 8.338 million euro.

To ensure access to finance for large investment projects for economic recovery after the crisis caused by Covid-19, on 6 July 2021, the CM approved Regulations No. 503 *Regulations regarding Loans with Capital Discount for Investment Projects for Merchants for Promotion of Competitiveness* (hereinafter – Investment Fund), approving the state budget of 152 million euro. The objective of the Investment Fund is to stimulate an influx of new investments to expand entrepreneurship by stimulating entrepreneurs to make new investments and thus create a value-added chain throughout the economy. The application for the new support programme for large investment projects started in 2022. The programme is planned for development projects of large and medium-sized enterprises in Latvia from 10 million euro. When achieving the objectives of the project and fulfilling certain criteria, a company can qualify for a loan with a capital discount of 30% or repayment the portion of the loan granted by ALTUM. In the first selection round of the loan programme, the LIAA has approved 14 large investment projects, while in the closed round 7 projects have been approved for further evaluation of the request of funding from ALTUM.

Companies that had objective difficulties making loan payments to banks due to the spread of Covid-19 have access to a guarantee allowing the commercial bank to defer payment of the principal amount, in accordance with CM Regulations

No. 150 of 19 March 2020 *Regulations Regarding Guarantees for the Enterprises whose Activity has been Affected by the Spread of Covid-19* (credit guarantees) and CM Regulations No. 537 of 5 September 2017 *Regulations regarding Portfolio Guarantees for Promoting Crediting of Small (Micro), Small and Medium-Sized Economic Operators – Legal Persons*. Public funding of 50 million euro has been channelled for that support. Total amount of guarantees issued – 42.1 million euro, total amount of loans guaranteed – 110 million, total number go guarantee transactions – 247.

Support in the form of export credit guarantees has been extended, in accordance with CM Regulations No. 866 of 20 December 2016 *Regulations for Issuance of Short-Term Export Credit Guarantees to Merchants and Corresponding Cooperative Companies Providing Agricultural Services* to provide support to exporting enterprises, which face growing risks in trade transactions due to the negative impact of Covid-19. Until 30 June 2021, export credit guarantees were also available to companies of all sizes and without any deferred payment deadline restrictions. The declared volume of transactions (transactions that have already taken place) is 91.8 million euro, the number of declarations is 830.

## SUPPORT TO MITIGATE THE CONSEQUENCES OF RUSSIAN MILITARY AGGRESSION

The military aggression of the Russian Federation against Ukraine has caused significant economic and financial turmoil, particularly in commodity markets, as oil, gas, wheat, fertilizer and seed prices have skyrocketed. The scope of economic impact of the aggression is very unclear and will depend on the duration of the war and political reactions. However, there is no doubt that global growth will be significantly hampered and inflationary pressures will rise. To mitigate the impact of war and the resulting consequences of market reorientation, access to raw materials and the creation of new supply chains, the LIAA is carrying out important work in advising entrepreneurs on current crisis solutions and potential support tools is carried out by the LIAA. It acts as a single point of contact for market reorientation, also looking for options to replace exports and imports.

In a situation where economic operators are experiencing the effects of the Russia-Ukraine war, such as supply chain disruptions, market shock, uncertainty, inflation, etc., the MoE has developed solutions to overcome the crisis and stabilise the market by offering various financial instrument programmes:

- At the CM meeting of 14 June 2022, a loan programme with a financing of 21.5 million euro was approved to reduce the economic consequences of the Russian military aggression against Ukraine. The beneficiaries are small- (micro), medium-sized and large enterprises which are able to demonstrate that they need the loan to mitigate the negative impact on economic activity of economic operators and that the performer of economic activity is economically viable;
- At the CM meeting of 21 June 2022, a guarantee programme with a financing of 12.5 million euro was approved to reduce the economic consequences of the Russian military aggression against Ukraine. The beneficiaries are small (micro), medium-sized and large enterprises capable to demonstrate that they need the guarantee to mitigate the negative impact on economic activity of economic operators and that the performer of economic activity is economically viable;
- At the meeting of 11 October 2022, the CM approved a programme providing for compensation to manufacturing businesses for the increase in electricity and natural gas costs, due to the consequences of Russian military aggression during the period from 1 February 2022 to 31 December 2022. The total planned support funding is 50 million euro.

## PORTFOLIO GUARANTEES

On 12 September 2017, a state aid programme, portfolio guarantees, was approved. It provides entrepreneurs with the opportunity to receive investment and working capital loans and financial leasing with a term of 1 to 10 years and in the amount of up to 250 thousand euro. The aid programme is implemented by ALTUM, which in the process of open selection has selected and concluded agreements with six credit institutions, which are now able to grant loans within the scope of available funding with a state guarantee to companies without direct involvement of ALTUM. 11.2 million euro of repaid public funding are available for issuing of the guarantees. Since the start of the programme from 2018 to 30 September 2022, 855 guarantees in the amount of 35.57 million euro have been issued within its framework providing financial services to companies in the amount of 44.47 million euro.

## ACCELERATION FUNDS

The acceleration programme during the 2014-2020 programming period of EU funds is part of activity 3.1.2.2 *Technology accelerator* of the Specific Objective 3.1.2 *To increase the number of start-ups* of the Operational Programme *Growth and Employment*. Support to economic operators is provided in the form of quasi-equity investments or equity investments. The acceleration programme is implemented by ALTUM, which performed a selection and concluded agreements with three financial intermediaries (fund managers) within a public procurement process. Each financial intermediary manages one pre-seed investment fund and one seed money investment fund. The public funding available for implementing the activity is 16.62 million euro.

From the beginning of 2022 to 30 September 2022, 15 new agreements were concluded and ERDF funding of 602 thousand euro was paid. By 30 September 2022, a total of 135 agreements for 5.4 million euro have been concluded.

## SEED CAPITAL, INITIAL CAPITAL AND GROWTH CAPITAL FUNDS

Continuing the experience of the 2007-2013 programming period of EU structural funds and the CF and considering market development trends, several venture capital instruments are offered, which are available within the programme 3.1.2.1 *Venture capital* of the Specific Objective 3.1.2 *To increase the number of start-ups* of the Operational Programme *Growth and Employment*. Economic operators can receive support in the form of quasi-equity investments or equity investments. The programme is implemented by ALTUM, which performed a selection and concluded agreements with three financial intermediaries (fund managers) within a public procurement process. One of them manages a seed capital fund and an initial capital fund, and two financial intermediaries manage one growth capital fund each. Funding amounting to a total of 93 million euro is available for the activity.

From the beginning of 2022 to 30 September 2022, five new agreements were concluded and ERDF funding of 2.6 million euro was paid. By 30 September 2022, a total of 25 agreements for 19.6 million euro have been concluded.

New draft CM regulations were prepared, which include a 5$^{th}$ generation opportunity capital model. The approval of the programme by the CM is expected in Q1 2023.

## MICROCREDITING

The Start Loan Programme in the 2014-2020 programming period of EU funds is implemented within the framework of the programme 3.1.1.4 *Microcrediting and loans to starters* of the Specific Objective 3.1.1 *To foster creation and development of SMEs, in particular in manufacturing and in RIS3 priority sectors* of the Operational Programme *Growth and Employment*. Starters can receive loans in the form of direct financial instruments. The Start Loan Programme is an important type of state aid for companies at an early stage.

Since June 2016 start loans can also be received within the scope of the current programming period for the implementation of viable business projects – for investments and working capital. The loans are issued to economic operators, which are registered in the Commercial Register, are not older than five years (of their establishment), and the maximum loan amount is 150 thousand euro. Start loans are an important instrument for starters of business, as they provide access to funding required for the implementation of prospective and viable business projects to those economic operators, who due to insufficient security, history of economic activity, credit history, net income flow or the amount of current credit obligations are unable to attract funding from participants of the financial market (commercial banks, private investors) in the necessary amount.

515 start loans for a 14.4 million euro and 170 microloans for 2.5 million euro have been issued by 30 September 2022.

## LOAN GUARANTEE PROGRAMMES

Loan guarantee support activities for starting business and development in situations, when own funds of the company are not a sufficient to attract the necessary funding from commercial banks or the company is classified as too risky.

ERDF funding of 49.8 million euro for the support of small and medium-sized enterprises and 3.51 million euro of repaid funding of the previous EU funds periods for the support of large enterprises is available in the support programme from the 2014-2020 programming period of the EU funds.

The programme has been functioning since June 2016 and by 30 September 2022 980 guarantees amounting to 245.9 million euro were issued, guaranteeing financial services for at least 400 million euro, which evidences of constantly high demand for such financial instruments.

## PARALLEL LOANS

The Parallel Loan Programme is implemented in the 2014-2020 programming period of EU funds within the framework of the programme 3.1.1.2 *Mezzanine loans* of the Specific Objective 3.1.1 *To foster creation and development of SMEs, in particular in manufacturing and in RIS3 priority sectors* of the Operational Programme *Growth and Employment*, which is planned to be implemented in the form of direct financial instruments.

The availability of parallel loans makes it possible to receive funding for those economic operators, which are unable to receive funding from commercial banks in the necessary amount for the implementation of viable investment projects due to financial indicators not meeting crediting policies of commercial banks (for example, the ratio of undertaken obligations to net income, insufficient equity). The parallel loan instrument allows resolving the problem of security and insufficient cash flow, as well as to some extent it resolves situations, when a commercial bank has reached the maximum accepted risk level for the specific customer or transaction and is unable to fund the transaction in full.

First, using a parallel loan, the bank keeps the first pledge right on the transaction security, thus distributing exposition, banks can improve the security/loan ratio and reduce estimated losses.

Second, ALTUM may postpone part of the principal loan amount to the loan maturity, which is a way of relieving customer's cash flow and supporting higher risk projects.

Third, at present, it is possible to create a transaction structure in such a way that a bank loan is repaid before repayment of the parallel loan to ALTUM starts, therefore the part of the loan from ALTUM can be considered technically subordinated.

These opportunities make the use of the product more understandable from the point of view of credit policy of commercial banks. Furthermore, for a customer or entrepreneur a parallel loan means a way to reduce participation of the customer itself, which is rather difficult to accumulate for companies. The programme has been functioning since July 2016, and 21 parallel loans for 11.4 million euro have been issued by 30 September 2022.

## EXPORT CREDIT GUARANTEES

The MoE continues the export support measures initiated in the previous years. Financial instrument programmes provided significant support for export facilitation. They made it possible to obtain a short-term export credit guarantee of ALTUM. From the beginning of the current export credit guarantee programme in 2017 until 31 December 2022, export credit guarantees have been issued in the amount of 35.8 million euro (declared export amount – around 163 million euro) and 159 companies have been supported (unique). Since April 2020, exporters of goods and services affected by the Covid-19 crisis have access to the program to deal with the consequences of the crisis, regardless of the size of the company and the country of export.

## SME LOANS

In the SME loan programme, since the end of 2021, activity 3.1.1.7 *Loans for the development of micro, small and medium-sized economic operators* and activity 13.1.1.1. *Loans to promote the development of micro, small and medium-sized economic operators* provide financing for loans for the sustainability of enterprises in the amount of 16 million euro. By 30 September 2022, 15 loans in the amount of 12.8 million euro have been issued.

# 11.2. SUPPORTING ACCESS TO FOREIGN MARKETS

To strengthen and extend economic, industrial, scientific, and technical cooperation, at the same time creating favourable conditions for cooperation between economic operators, Latvia has concluded and maintains agreements on economic cooperation with the United Arab Emirates, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Kuwait, China, Moldova, Turkey, Turkmenistan, Tajikistan, Ukraine, Uzbekistan.

Intergovernmental Commissions or Joint Committees have been established to implement these agreements. The agenda of their meetings includes issues of bilateral economic cooperation, which are important for contracting countries at the level of governments and businesses in various areas: industry, tourism, transport, pharmacy, agriculture, financial services, communication, professional training, investment attraction, technology and innovation. In 2022, the second meeting of the Joint Economic Committee between Latvia and United Arab Emirates was held in Dubai, and the eighth meeting of the

Intergovernmental Commission between Latvia and Azerbaijan was held in Riga. To continue intergovernmental dialogue, a series of meetings and visits were held looking into the possibilities of extending Latvia's cooperation with Lithuania, Estonia, Poland, United States, United Arab Emirates, Japan, Vietnam, Ukraine, and other countries.

In 2022, based on a CM decision, the previously concluded agreements on economic cooperation with Russia and Belarus were suspended in response to hostilities in Ukraine conducted by Russia and backed by Belarus and in view of sanctions imposed against Russia and Belarus.

## LATVIA'S FOREIGN ECONOMIC REPRESENTATIONS

LIAA representations operate in several countries of the world to solve economic issues and support Latvian businesses. They organise national stands at international trade shows abroad, organise trade missions, provide advice on foreign markets and organise meetings with potential business partners.

In 2022, Latvia's foreign economic representation worked in Brussels, the United States, the United Arab Emirates, Austria, Denmark, South Korea, France, Italy, Japan, Russia, Beijing, the United Kingdom, the Netherlands, Norway, Finland, Ukraine, Germany, and Sweden. Considering the current global and geopolitical challenges, representations will also be opened in Australia, Switzerland and Israel, while representations in Russia have suspended their operations.

In the nine months of 2022, LIAA provided 1,269 consultations on external markets to Latvian companies; 430 export projects and requests have been identified and transferred to companies, including 39 RIS3 areas.

LIAA also offers economic operators the services of the *Enterprise Europe Network* (EEN) – assistance in searching for international partners, preparation of market information, consultations on legislation and business aspects, consultations on access to finance (*Horizon 2020, Erasmus, Creative Europe, Interreg*, etc.), and other consultations. EEN successfully complements the services provided by the LIAA – providing advice to economic operators regardless of the industry, access to information in 69 countries around the world and specific resources developed by the EC.

During the nine months of 2022, 741 consultations were provided; 13 trainings and information activities were organised (also remotely) within the framework of the EEN project involving 956 participants; 18 *B2B* (*business-to-business*) events, with participation of 143 economic operators from Latvia were co-organised. After these activities, statements about 34 cooperation agreements concluded between Latvian and foreign commercial companies or their organisations have been received.

During the nine months of 2022, LIAA organised participation in 23 national stands (160 participants), 82 contracts or letters of intent on new export markets were concluded, 14 trade missions (contact fairs) were organised abroad (120 participants), 27 contracts or letters of intent were concluded.

## NATIONAL PLATFORM FOR BUSINESS DEVELOPMENT

To improve the awareness of potential and existing economic operators of business developments, enhance LIAA's customer service processes, and simplify obtaining information and communication, LIAA has developed a national platform for business development *business.gov.lv*, which will contribute to the digitisation of services and the development of e-services.

The platform *business.gov.lv* has been set up as a web-based customer self-service platform for the acquisition of personalised information and communication, where an economic operator can create its profile, indicating industries of interest, topics and other criteria for receiving personalised information, has the possibility to apply electronically to the services provided by LIAA, including the possibility to submit forms, payment requests and other documents electronically. The platform provides in one place information about industry news, news abroad, and different events addressed to economic operators. The creation of the content of the portal is supported by the sectoral ministries, the CSB, ALTUM, the Latvian Chamber of Commerce and Industry, the Bank of Latvia and other commercial banks and institutions.

In the nine months of 2022, more than 3,800 natural persons registered as users and more than 670 profiles of companies were created on the platform *business.gov.lv*. During this period, the platform provided application to more than 20 LIAA services and received more than 3,000 service application.

## EXPORT MARKETING ACTIVITIES

Against the backdrop of the Covid-19 pandemic and geopolitical turmoil, companies' interest in finding new markets has grown more than ever, and as a result, companies' motivation to use state and other support tools more effectively has also risen.

The total financing for the programme 3.2.1.2 and the related project *Promotion of international competitiveness* of specific objective 3.2.1 *Increasing the share of exports of high value-added products and services* of the Operational Programme *Growth and Employment* has significantly increased – to 64.8 million euro. Moreover, the support available to the merchant or final beneficiary has been increased – 40 thousand euro per calendar year. In the nine months of 2022, 718 payment requests have been received for the total amount of 4.55 million euro. Support to target groups in the amount of 2.46 million euro has been disbursed from the project. In the nine months of 2022, support was provided to assess the conformity of 82 production facilities and products of the project target group (30 unique grant recipients), and 818 times support was provided for participation in both on-site and digital exhibitions, conferences, seminars, contact fairs, trade missions or visits of senior Latvian public officials, as well as participation in international digital industry platforms, adaptation of products or services to foreign markets, brand or product/service publicity in foreign specialised industry media (both printed and digital), telemarketing services and participation in international industry associations (1,056 unique grant recipients). Considering that project funding in the form of grants will also be available in 2023 to help merchants implement diversified export promotion activities, special attention will be paid to the targeted use of financing.

Each year a competition *Export and Innovation Award* is organised to honour Latvian merchants who have achieved good results in the production of new and exportable products and in the implementation of innovations. In 2022, the tender regulations have been amended, moving to a more data-based approach: CSB data on exports, turnover, value added created, profitability, number of employees and investments in research of companies will be evaluated. In 2022, companies will get awards in five categories: *Export Leader*, *Export Newcomer*, *Innovation Champion*, *Export Champion* and *Most Exportable New Tourism Product*. Traditionally, the company award ceremony takes place at the end of the year.

## *EXPO 2020 DUBAI*

From 1 October 2021 to 31 March 2022, an international exhibition *Expo 2020 Dubai* took place in Dubai (United Arab Emirates) during which approximately 73 thousand interested persons visited the Latvian pavilion (general exhibition). Latvia's participation in this exhibition opened a wide range of opportunities for Latvian companies to explore the Persian Gulf countries, establish contacts and present Latvian products and innovations on the global market. 443 Latvian companies participated in events organised by Latvia or placed their exhibition in the Latvian pavilion. A total of 29 thematic events took place, such as the Pharmaceutical Business Forum in the Latvian pavilion and the Latvian Space Industry Business Forum with over 1,000 participants. As part of the exhibition, 13 trade missions were organised in eight different sectors, where 137 companies had 589 meetings with potential business partners. In total, more than 3,000 business contacts have been obtained and at least 33 contracts have been entered into during the events. The following sectors of the economy dominated in business activities: construction and innovative construction materials, ICT, pharmacy, food industry, as well as transportation and logistics.

In January 2022, the CM conceptually supported Latvia's participation in the next *Expo 2025* exhibition, which will take place in Osaka, Japan.

## SUPPORT TO WELCOME FOREIGN COMPANIES IN LATVIA

On 15 March 2022, the CM approved a new support programme for the production of foreign films in Latvia – *Procedure by which state budget co-financing is granted for the production of foreign films in Latvia*. The total annual state funding of the support programme until 2024 constitutes 850 million euro. The amount of co-financing available for one project is 20% of the total amount of eligible expenditure indicated in the co-financing agreement, while for eligible remuneration cost items the amount of co-financing is 30%.

To be able to grant national co-financing for the production of foreign films, twice a calendar year the LIAA organises an open competition for the selection of project applications. Eight project applications were received in the first selection round of 2022, of which two highest score recipients (total co-financing – 778 thousand euro) were supported, while the rest were placed on the reserve list. Six project applications were received in the second selection round, requesting the necessary co-financing in the amount of 1.895 million euro. On 27 September 2022, the CM approved an increase in appropriations in the amount of 2.097 million euro to ensure state budget co-financing for the production of foreign films in Latvia, thus supporting the projects submitted in both the first and second selection rounds, which were on the reserve list.

# 11.3. POLICY FOR ATTRACTION OF FOREIGN INVESTMENT

The LIAA plays a significant role in the attraction of foreign investment in Latvia. The strategy of the LIAA for attraction of investment is oriented towards qualitative servicing of incoming investment projects and active operation in attracting investment projects by addressing potential investors. Attraction and promotion of FDI is broken down into four main processes such as strategy and planning (creation of the national investment policy, setting of goals, investment promotion structure, positioning of competitiveness, targeted analysis of sectors), promotion of interest (marketing and addressing of companies), servicing (project management) and provision of investment services (post-service and improvement, monitoring of services).

In the coming years, LIAA will promote greater attraction of investment in RIS3 areas, purposefully promoting the growth of foreign direct investment in knowledge-intensive sectors with high added value.

In early 2022, all of Europe and its economy were shocked by the Russian Federation's invasion in the Ukraine and the start of a new war, which has had a particularly negative impact on foreign investment flows throughout the Baltic States region. On a global scale, an extensive restructuring of supply chains has been taking place in order to reduce any kind of resources dependency on the Russian Federation. As a result, considerable opportunities have opened at European level and substantial investments were devoted to them. However, Latvia, like other Baltic States, is considered as a very risky region for investment from the point of view of large foreign investors. This can be seen in significantly reduced investor activity in the region, as well as in dialogues with investors and partners.

**Box 11.1**

**Policy for Attraction of Direct Foreign Investment**

The export promotion and foreign investment attraction policy is enshrined in the *National Industrial Policy Guidelines for 2021-2027*.

FDI attraction policy is aimed at raising the competitiveness of Latvia as an attractive investment environment, considering the most important aspects for investors: macroeconomic indicators of states, the business environment – simplicity of bureaucratic procedures and the stability of tax policy, availability of an appropriately qualified labour force, market potential, accessibility of the necessary infrastructure, available support instruments and incentives.

It is important to attract foreign investment in sectors which ensure changes of the economy structure in favour of external demand-oriented sectors, especially those that are defined as medium-high and high technology sectors. The priority in the FDI attraction process must be geographically closest neighbouring countries where Latvia is recognized and no extensive additional resources have to be invested for informative activities; also it has to be oriented towards economically stable and developed countries where the development potential and needs of economy sectors are appropriate for Latvian perspective cooperation opportunities; and countries with globally largest investment outflows – USA, France, Germany, United Kingdom of Northern Ireland and Great Britain, Japan, China, India.

The process of improvement of the FDI attraction policy has been taking place in close cooperation with the Foreign Investors' Council in Latvia (FICIL). On 8 and 9 September 2022, the twenty-sixth high level meeting between the Latvian government and the FICIL was held. This year, government representatives and investors discussed about such topics as fair competition, availability of labour force, energy independence and public governance reforms.

In 2022, the war results in a new activity of Western-origin capital investors, assessing their possibilities of closing their companies and representations in the Russian Federation and transferring them with all employees to the nearest neighbouring EU countries. Latvia has been considered as a potential destination by several international companies, envisaging the possibility to relocate their offices with several thousand employees, but the process of negotiations has been slow due to the high workload of state security and related institutions.

The mitigation of the effects of the Covid-19 pandemic and the promotion of energy independence through the establishment of an appropriate legal framework and the improvement of existing legislation exert influence on the work of the LIAA as it reduces the need for the state to resolve the implementation of domestic and foreign investment projects of national importance in the *POLARIS* process. However, the *POLARIS* process is expected to be reactivated as the country's economy recovers and significant foreign and local investment flows in.

In 2022, a major focus at national level is on green energy and energy independence. This is confirmed by several previous rounds of negotiations with global leaders in the field of renewable energy resources regarding a possible flow of investments to Latvia both directly and through downstream services, which would promote not only production of energy, but also develop production and provision of the necessary infrastructure.

Investment flow activity has also been increased by the *Large investment loan with a capital discount programme*, which provides a capital discount of up to 10 million euro for strong and large investment projects. Such increased activity has confirmed the willingness of several foreign investors to continue investing in large projects in Latvia and is considered as a major success story in increasing the flow of foreign investments.

To contribute to the faster recovery of the Latvian economy from the Covid-19 crisis and to the improvement of the economic situation by accelerating attraction of investment and increasing Latvia's competitiveness, in February 2021, the CM approved a MoE's and LIAA's offer to create a *green channel* to accelerate the bureaucracy and administrative processes for high value-added investment projects. The *green channel* is designed for investment projects in priority industries covering RIS3, international business services centres, as well as construction, transportation and logistics if the implementation of these ideas is linked to priority industries. It is an opportunity for the companies registered in Latvia, which are planning to implement investment projects and meet the set criteria (size of investments, number of jobs created, volume of exports and investments in R&D), to receive public administration services provided in the field of construction, spatial planning or migration in an accelerated manner, reducing the waiting time approximately two times.

The draft law *Innovative Business and Priority Investment Support Law* is currently being developed to create a legal framework for business support in priority sectors, as well as to introduce innovation zones and *regulatory sandboxes*.

# 12. ENERGY POLICY

## 12.1. ENERGY MARKET AND INFRASTRUCTURE

The main priority of the energy policy of Latvia, which is set out in the informative report *Long-Term Energy Strategy of Latvia 2030 – Competitive Energy for the Society* (*Energy Strategy 2030*) approved at the CM meeting of 28 May 2013, is to ensure positive effect of the energy sector on the Latvian national economy at the same time aspiring for the security of energy supply, competitiveness and sustainability:

- security of energy supply – access of energy consumers to stable energy supplies and a developed infrastructure;
- competitiveness – a market-principle based energy sector, which ensures further development of the national economy, its competitiveness in the region and globally;
- sustainable energy – reduced dependence on energy imports, promotion of new, efficient technologies for the use of renewable energy, and energy efficiency improvement measures have been carried out.

The development of both gas and electricity infrastructure, as well as diversification of supply routes and sources, is important for Latvia at the national and regional level, keeping in mind the importance of reduction of energy dependence and long-term decarbonisation goals. Considering the consequences caused by the Covid-19 pandemic and the Russia's invasion of Ukraine, including rising energy prices, particular attention in 2022 was paid to the development of various support mechanisms that would help households and enterprises during the energy crisis and strengthen energy independence.

### ELECTRICITY MARKET

The electricity market has been fully liberalised since 1 January 2015, which means that households, as well as legal electricity consumers are free to choose the trader by mutually agreeing on the (unregulated) electricity price. According to the electricity trade register of the Public Utilities Commission (hereinafter referred to as the Regulator), 45 traders were registered for sale of electricity in November 2022.

The Latvian bidding area of *Nord Pool* electricity exchange started its operation on 3 June 2013. Currently, *Nord Pool* bidding areas are opened in all three Baltic States; and electricity trade is carried out in a uniform and consistent manner throughout the Baltic Sea region. Market participants of the *Nord Pool* Latvian open electricity bidding area may submit their quotes for transactions that will take place the following day (day-ahead market) or intraday market. The difference of an intraday electricity market from a day-ahead market is that the price offers are submitted for transactions that will take place on the current day, after the *Nord Pool* day-ahead electricity trading stock exchange *ELSPOT* trading session results are published. The existence of both markets not only ensures greater liquidity of the Latvian electricity market, but also a more efficient utilisation of network transfer capability, and transparent and reliable energy price for the market participants.

In 2021, the average electricity price at the *Nord Pool* exchange in the Latvian region was 88.78 euro/MWh. The price increased by 160.73% compared to 2020 due to the recovery of the economy from the crisis caused by the Covid-19 pandemic, as well as changes in the geopolitical situation that contributed to the increase in energy prices. In the first 10 months of 2022, the average electricity price at *Nord Pool* exchange was 222.06 euro/MWh. The rise in electricity prices in 2022 was mainly influenced by an unstable situation in the fossil energy market and sub-optimal weather conditions, while the situation in 2021 was affected by several adverse conditions: a multiple increase in gas prices and $CO_2$ emission allowances, lower electricity production in wind power plants in Europe, a smaller inflow of water into reservoirs in Scandinavia, which reduced the amount of electricity produced by hydropower plants, which had to be replaced by fossil sources. Data from the electricity market review of transmission system operator JSC *Augstsprieguma tīkls* for 2021 show that 5.6 TWh of electricity were produced in Latvia, which is 1.8% more than a year ago, while Latvian electricity consumption increased by 3.5%, reaching 7.3 TWh a year. In 2021, 75.9% of consumption in Latvia was covered by local generation, resulting in a shortage of 1.7 TWh, and the missing amount was imported from neighbouring countries.

In fulfilment of *Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC*, Latvia has separated the electricity distribution and transmission functions from the electricity trade and production company. As of 1 July 2007, functions of the electricity distribution system operator are performed by JSC *Sadales tīkls*, independent subsidiary of JSC *Latvenergo* (MoE is the holder of capital shares). In Latvia, the Regulator has issued 10 licenses in total to distribution system operators, however, JSC *Sadales tīkls* provides 99% of services in the territory of the state.

On 1 January 2012, JSC *Augstsprieguma tīkls* started operating outside the *Latvenergo Group* as an independent transmission system operator, all capital shares of which are held by MoF. Until 2020, JSC *Augstsprieguma tīkls* rented transmission system assets from JSC *Latvijas elektriskie tīkli*, subsidiary of *Latvenergo*, but in June 2020, as a result of reorganisation of JSC *Augstsprieguma tīkls* and JSC *Latvijas elektriskie tīkli*, JSC *Augstsprieguma tīkls* took over ownership of transmission system assets – poles, lines, high-voltage substations, related real estates and other. JSC *Augstsprieguma tīkls* is the only transmission system operator in Latvia and is operating in conditions of natural monopoly.

On 27 November 2019, the Regulator approved the new tariffs of the distribution system services of JSC *Sadales tīkls* for the period from 1 January 2020 and until 2024 (inclusive). However, considering the consequences of the Russia's invasion of Ukraine, JSC *Sadales tīkls* prepared and submitted a new draft tariff to the Regulator for evaluation. The new tariff is expected to enter into force on 1 July 2023. In the draft tariff, more than 2/3 (69%) of the increase in costs comes from the increase in the transmission tariff by 102% and the costs of electricity necessary for ensuring electricity transmission technological consumption technological (increase from 16 to 69 million euro per year), which the electricity distribution system operator purchases at the market price. Inflation has also led to an increase in the prices of resources necessary for the operation of the company – wood, metal, fuel, logistics services, etc. It should be added that from 1 September 2022, one of the tariff items, i.e. the mandatory procurement component, is 100% reimbursed from the state budget for all electricity consumers.

One of the most important topics in the electricity market still is **integration and synchronisation of electricity networks of the Baltic States with the European network** (hereinafter referred to as the synchronisation project). The development of the synchronisation project has been ongoing since 2007, when Prime Ministers of the Baltic countries proposed the idea to investigate into such an opportunity. It is at the top of the EU energy policy agenda, and it is one of priority projects not only at the level of the Baltic countries, but also at the EU level, because it improves functioning of the EU's internal energy market and facilitates the achievement of goals of the Energy Union by constructing additional electricity interconnections. The synchronisation project is part of the overall EU integration process and is planned to be implemented by the end of 2025, however, since the beginning of 2022, active discussions have been taking place between the responsible ministries and transmission system operators of the region within the *Baltic Energy Market Interconnection Plan* (BEMIP) on the possibility of completing the project earlier.

By implementing the synchronisation project, energy systems of Baltic countries will start functioning in a synchronous mode with the Continental European network, at the same time disconnecting from the IPS/UPS (Russian and Belorussian energy system) network. Internal electricity trade between Russia, Belarus and other CIS countries, which jointly with the Baltic countries form BRELL (abbreviation of *Belarus, Russia, Estonia, Latvia, Lithuania*), as well as fluctuations of their power system modes and accidents technically affect and strain the electricity transmission network of the Baltic states by limiting the ability of the Baltic States to fully implement the EU legal framework in the electricity market, particularly in relation to the calculation and planning of capacity, overload management, and network balancing. Several studies and due diligence have been conducted for the synchronisation project to be as successful as possible, identifying all technical and economic considerations, as well as finding the most cost-effective solution. The project aims to reconstruct and improve internal infrastructure of each Baltic country, as well as to construct a new *Harmony link* submarine direct current cable between Lithuania and Poland.

The EC's *Connecting Europe Facility* (CEF) co-finances 75% of total eligible costs of the project, the remaining funding is provided by transmission system operators of Baltic countries – JSC *Elering*, JSC *Augstsprieguma tīkls* and *Litgrid AB*. The CEF funding approved for the synchronisation project in January 2019 amounts to 323 million euro. The total costs of measures of the first phase of the synchronisation project of the Baltic countries is 430.39 million euro, of which 75% or 322.79 million euro will be covered from the CEF funding, while other costs will be covered by electricity transmission system operators of Baltic countries. Co-funding of 57.75 million euro was granted to Latvia for costs of the first phase of the synchronisation project. In May 2020, the transmission system operators of the Baltic States applied for co-financing for the second phase of synchronisation project, which was approved in the EC on 1 October 2020. The Baltic States will receive 719 million euro co-financing for the 2$^{nd}$ phase of synchronisation project, securing a significant portion of functions for all the infrastructure works necessary in the 2$^{nd}$ phase. The request for additional CEF funding of 178 million euro for the implementation of the second phase was submitted to the EC in October 2021. It should be added that according to the forecasts of JSC *Augstsprieguma tīkls*, project costs may increase by 15-20% in certain stages due to the consequences caused by the Russia's invasion of Ukraine. At the same time, it should be noted that in August 2021 one of the most important stages of the synchronisation project in Latvia – Estonia-Latvia third interconnection or 330 kV electricity transmission line from *Riga TEC-2* to the Estonian border – was successfully completed.

Another vital matter is **electricity trade with third countries**. On 25 August 2020, the Latvian government decided that considering the current developments in Belarus and the consequent risks to the compliance with international nuclear security standards at Astravets Nuclear Power Plant (NPP), it is necessary to stop trading electricity with Belarus, if Astravets NPP becomes operational. Therefore, electricity trade with Belarus ceased in November 2020. Meanwhile, the electricity trade with Russia ceased in February 2022, when Russia's invasion of Ukraine began, and currently cooperation is only taking place for the purposes of maintaining the IPS/UPS network without performing commercial activities.

Sufficient electricity transmission interconnections are one of the most important preconditions for optimal functioning of the electricity market. The Latvian electricity market, just like the energy market of the Baltics, currently is connected to the common European energy market with two sea cables connecting the Estonian and Finnish power systems *Estlink I*, with the transmission capacity of 350 MW, and the *Estlink II*, with the transmission capacity of 650 MW. Transmission capacity of both interconnection links is sufficient for aligning electricity prices in the *Nord Pool* Estonian and Finnish bidding areas. Although these interconnections improve the situation in ensuring the integration of Estonian and Finnish power systems and liquidity of the Estonian and Finnish bidding areas, they do not reduce the risk of overload in the Latvian-Estonian cross-section. Although of a highly seasonal nature, such overloads are characterized by a negative impact on the dynamics of electricity prices in the *Nord Pool* Latvian and Lithuanian bidding areas. In addition, the overload on *Estlink II* in the direction from Finland to Estonia could lead to additional load on the Latvian-Estonian cross-section, thus increasing the risk of overload or line outage. In order to improve the interconnection capacity, Lithuanian-Polish interconnection *LitPol Link* stage 1 with transmission capacity of 500 MW started its operation at the end of 2015. It has been supplemented by the Lithuania-Sweden interconnection *NordBalt* with transmission capacity of 700 MW.

Part of the *NordBalt* project is the 330 kV transmission line project *Kurzemes loks* implemented in the western region of Latvia, which started in 2010 and has been implemented in three stages (construction of a 330 kV cable between *Riga TEC-1* substation and *Imanta* substation in 2013, construction of Grobiņa-Ventspils electricity transmission line in 2014 and Ventspils-Tume-Imanta 330 kV electricity transmission line in 2019) creating, in total, a 330 km long 330 kV electricity transmission line. It increases the availability of capacity and power supply safety in Kurzeme, as well as a potential to connect the generation capacity from renewable energy sources to the network at least in the amount of 800 MW. The costs of the third stage of *Kurzemes loks* amounting to 55.1 million euro were covered by CEF.

In the coming years, the development of electricity transmission infrastructure is among priorities, which will promote closer integration of Latvia into the regional electricity market, as well as strengthen operational efficiency and interoperability of infrastructure.

Commissioning of the above-mentioned third Estonian-Latvian interconnection is also strategically important, allowing to eliminate the existing transmission network overload and increasing the available transmission capacity of the Latvian-Estonian interconnection. Within the project, a 176 km long 330 kV high-voltage electricity transmission line from *Riga TEC-2* 330 kV substation to the Estonian-Latvian border was built. Total costs of the third Estonian-Latvian interconnection were approximately 170 million euro, but total project costs in the territory of Latvia amount to 79 million euro. In November 2014, EU co-funding of 65% was granted for the construction of the third Estonian-Latvian interconnection from CEF funds (112 million euro).

In order to implement the requirements defined in *Regulation (EU) No 347/2013 of the European Parliament and of the Council of 17 April 2013 on guidelines for trans-European energy infrastructure and repealing Decision No 1364/2006/EC and amending Regulations (EC) No 713/2009, (EC) No 714/2009 and (EC) No 715/2009* (hereinafter referred to as Regulation No 347/2013), EC, using the delegated acts procedure, the EU's lists of projects of common interest are adopted. Regulation No 347/2013 provides that the projects included in the list of projects of common interest not only may qualify for the support of the EU co-funding, but also benefit from fast and efficient permitting procedures, while respecting the environmental assessment and protection standards. In Q4 2021, the EC included the synchronisation project and the Latvia-Sweden electricity interconnection through Gotland (*LaSGo Link*) in the fifth list of Projects of Common Interest.

Continuation of the synchronisation project by implementing the second phase of the project has an important priority in the coming years, which has currently received partial CEF co-financing. At the same time, attracting the CEF funding (CEF has 5.84 billion euro for energy) in the current support period (2021-2027) is very important not only in the context of the synchronisation project, but also for cross-border cooperation projects in the field of renewable energy to create favourable conditions for an increase in the country's internal generation volumes.

Since 2015, when the electricity market has fully opened, in order to fulfil the recommendations included in EU laws and regulation with regard to reducing the risk of poverty for vulnerable energy consumers, a certain group of electricity consumers has access to the vulnerable consumer trading service. Vulnerable consumer (about 170 thousand families/persons in Latvia) is a poor or a low-income household (person), a large family or a family (person), which takes care of a disabled child, or a person with disability group I, which uses electricity in their household for their own needs (final consumption). Until August 2021, the vulnerable consumer trading service could be received only by those vulnerable consumers, who concluded an electricity trade agreement with the only service provider (since 2015 – JSC *Latvenergo*), and the vulnerable consumer had to apply for this service manually.

However, in accordance with amendments to the *Electricity Market Law* and CM Regulations No. 345 of 1 June 2021 *Regulations Regarding the Trade Service of a Protected Customer*, since 1 September 2021, the service can be provided by any electricity trader, and compliance with the status of a vulnerable consumer be checked by the vulnerable consumer data information system ALDIS, the controller of which is the SCCB. Each electricity trader providing the service will have a link to ALDIS so that after data exchange once a month the system reduces an electricity bill for those of customers, which qualify for the status of a vulnerable consumer. The service is funded from the funds allocated for this purpose in the state budget funds. The regulation that entered into force on 1 September 2021 provided that a poor or a low-income household (person), a family (person), which takes care of a disabled child, or a person with disability group I or its guardian receives a 5 euro support for electricity settlements. Large families receive a support of 10 euro. However, considering the rapid increase in electricity prices in 2021, the regulation was immediately amended and from 1 November 2021 to 30 April 2023 the support to the above-mentioned groups of protected consumers was increased by 10 euro (15 and 20 euro depending on the group of protected consumers).

## NATURAL GAS MARKET

Since April 2017, the natural gas market has been fully liberalised, aiming to create an effectively functioning and integrated EU energy market, ensuring high flexibility of the system, competition among companies, competitive prices, and strengthening energy security. In order to promote the development of competition and independence of operators of the transmission and distribution system, and at the same time following the amendments to the *Energy Law* adopted on 11 February 2016, the historical natural gas monopoly JSC *Latvijas Gāze* had to separate its natural gas transmission and storage infrastructure from the natural gas trading and distribution functions, meaning that legally separated natural gas transmission and storage system operator JSC *Conexus Baltic Grid* and distribution system operator JSC *GASO* were created. A gradual opening of the market has been planned for household consumers – they reserve the right not to use the opportunity of becoming a market participant to freely choose a natural gas trader. By using the right not to become a market participant, household consumers still retain the consumer status and the possibility to buy natural gas according to the tariffs set by the regulator, rather than the market price.

The total natural gas consumption in 2021 was 12.702 TWh. It is noteworthy that in ten years (2011-2020), the share of natural gas has reduced by 8.7 percentage points and amounted to 20.6% in 2020. A decline is observed in natural gas consumption in Latvia in 2022 – it reduced by 32% in Q1 and Q2 year-on-year. The decline in consumption was mainly affected by weather and unexpectedly high prices of natural gas.

The drop in natural gas consumption was also accompanied by the drop in the volume of imported natural gas, which could be largely linked to the use of alternative fuel resources and facilitating energy efficiency measures. Despite the drop in its share, natural gas remains important in the Latvia's total structure of consumption of energy sources. Most of natural gas is used for generation of electricity and heat in boiler houses and cogeneration stations. In 2021, combined heat and power plants generated 1.9 TWh of electricity using natural gas, which constituted 34.3% of the total electricity output during the year.

One of the most significant processes in the natural gas sector is the establishment of a **single regional natural gas market of the Baltic States and Finland**. The establishment of a single natural gas market of Latvia, Estonia and Finland on 1 January 2020 is considered to be an event unique for Europe and historical for the Latvian natural gas sector. This is the result of long-term cooperation that was rich in challenges and was performed by regulatory authorities, natural gas transmission system operators and ministries responsible for the energy sector of the Baltic countries and Finland.

On 17 September 2019, CM supported amendments to the *Energy Law*, which prevents obstacles in the creation of a single natural gas market and operation of Latvia in a single input– output tariff system together with Finland and Estonia. Amendments to the law were supported in Saeima on 17 October 2019.

At present, a single gas transmission tariff zone is functioning in Finland, Estonia and Latvia. The single natural gas market is functioning with two balancing zones – the combined Latvian and Estonian balancing zone and Finland. A single ICT platform is developed in parallel, which will simplify operations of every natural gas trader in the single market zone.

The process of integration of the regional gas market started in December 2015 at a political level, when the Prime Ministers of the Baltic States approved an action plan for the development of the regional gas market and invited Finland to participate. The results show that all the participants involved in natural gas supply have gained significant benefits – the choice of supplier has substantially increased for natural gas consumers, promoting competition among gas traders and simplifying access to alternative gas sources. In turn, the establishment of the single Estonian-Latvian balancing zone has a positive impact on the functioning of the market, reducing the bureaucratic burden and ensuring a convenient and transparent balancing process. With the opening of the natural gas market and the integration of the regional market, the role of Inčukalns underground gas storage facility has expanded, improving competition, supply flexibility and security of gas supply in the region.

The initial participants of the single market area are Finland, Estonia and Latvia, but there are plans to develop it to provide benefits to all participants of this market, including consumers, and urge other European Union Member States to join it.

In addition, it should be emphasised that the Estonia-Finland interconnector (*Balticconnector*) project was completed in 2019 and has been commercially used since 1 January 2020. This interconnector connects the Finnish natural gas transmission system with the natural gas transmission system of Baltic countries. It consists of a land pipeline section, a submarine pipeline section and two compressor stations.

Further diversification of natural gas supplies and reduction of dependence on Russian natural gas imports should be considered one of the most important priorities for the future in the natural gas market, in particular, taking into account amendments to the *Energy Law*, which came into force on 11 August 2022 and imply a ban on Russian natural gas imports from 1 January 2023. It is also important to emphasise how important it is to continue ensuring safe and accessible infrastructure that could significantly strengthen Latvia's energy independence. It should be noted that the situation in the Latvian energy sector is positively influenced by the opening of the Lithuanian-Polish natural gas supply system interconnection GIPL in May 2022, moreover, several other projects are expected to be implemented, improving the security of gas supply in the Baltic region and establishing an efficient market (see Box 12.1).

The Latvian-Lithuanian interconnector and the modernisation of the Inčukalns underground gas storage facility mentioned in Box 12.1 are included in the fifth Union list of Projects of Common Interest as nationally and regionally important gas supply projects.

The natural gas market will also be significantly affected by the synchronisation project of electricity networks of the Baltic countries with the network of Continental Europe, because connection to the European network envisages that Latvian electricity producers will have to provide generating capacities themselves, and natural gas will play an important role in guaranteeing stable energy supplies.

**Box 12.1**

**Projects for Improvement of Security of Natural Gas Supply and Creation of an Effective Market in the Baltic Region**

**Latvian-Lithuanian interconnector's modernisation project**

At present, there are already flows in both directions in the Latvian-Lithuanian interconnector. In 2021, JSC *Conexus Baltic Grid* in cooperation with the Lithuanian natural gas transmission system operator *AB Amber Grid* presented the results of a study, which was conducted using EU funding. The study included the cost-benefit analysis for the interconnection capacity project and identified optimal interconnection capacities, taking into account other gas interconnection projects implemented in the region (*Balticconnector* and *GIPL*) and potential gas flows. At the Lithuanian side, it is planned to modernise the Kiemenai gas measuring station and the Panevezys compressor station, while at the Latvian side, it is planned to modernise high-pressure pipelines to be able to increase working pressure of the system to 50 bar. By making respective investments, the interconnection capacity would increase to approximately 130 GWh/d in the Latvian direction and to 119 GWh/d in the Lithuanian direction. The planned investments are 10.3 million euro, of which 4.7 million euro would be attributable to the territory of Lithuania. Regulators are also provisioning to raise EU co-funding. If financial and other aspects resolve as planned, project might be fully implemented by 2023.

**Modernisation of the Inčukalns underground gas storage facility (UGSF)**

Latvia hosts an important strategic site and the only natural gas storage facility in the entire Baltic region – the Inčukalns underground gas storage facility (UGSF), which is managed by the natural gas storage operator JSC *Conexus Baltic Grid*, ensuring regional gas supply stability and strengthening energy security of the region, as well as providing market participants with an opportunity to store natural gas in a strategically advantageous place. This modern main natural gas transmission system connects the Latvian natural gas market with Lithuania, Estonia and Russia. The total volume of UGSF is 4.3 billion $m^3$, which includes the active natural gas volume of approximately 2.3 billion $m^3$, and therefore fully secures natural gas demand even in the coldest winter months. The Inčukalns UGSF modernisation project is included in the list of projects of common interest, and in early 2019 the EC allocated 50% co-funding for it (the total project investments amount to 88 million euro) from CEF funding. The project intends to improve technical infrastructure of UGSF, operational flexibility of the storage facility and safety of operation of equipment.

Cyber security is among challenges in the natural gas sector that become increasingly more pressing annually. JSC *Conexus Baltic Grid* in cooperation with JSC *Augstsprieguma tīkls* has applied for EU support in the EC programme, so that both system operators jointly establish a cyber security operations centre for the energy industry in the Baltic region. The purpose of the project is to use joint resources and knowledge in the management of cyber security incidents. Since the infrastructure of energy companies is interdependent, cooperation in response to incidents and exchange of information may significantly improve cyber security of the entire industry. It should be added that cooperation between electricity transmission system operators of Baltic Countries and partner countries within the framework of the *Partnership for Transatlantic Energy Cooperation* (P-TECC) format is also important in the field of cybersecurity of the energy sector.

# 12.2. PROMOTING ENERGY EFFICIENCY

In the *Energy Sector Development Guidelines 2016-2020*, the Latvian government set energy efficiency targets to be reached by 2020:

- total indicative national energy efficiency — the primary energy savings in 2020 — 0.67 Mtoe (28 PJ), which correspond to the total primary energy consumption of not more than 225 PJ;
- annual saving of 1.5% for energy supplied to end consumers – final energy savings in 2020 — 0.213 Mtoe (8.9 PJ) and the final energy saving accumulated from 2014 to 2020 – 0.85 Mtoe (9897 GWh);
- annual renovation of 3% of the state-owned building area (maximum estimates – 678.5 thousand $m^2$).

The main task of energy efficiency improvement measures is to limit increase in consumption of primary energy resources and final energy consumption and to reduce overall energy consumption. The total primary energy consumption in Latvia was 183.5 PJ in 2020, 192.9 PJ in 2021, while final energy consumption was 165.5 PJ in 2020 and 174.6 PJ in 2021. Thus, Latvia exceeded its primary energy consumption target for 2020 by 20.7% and its final energy consumption target for 2020 by 13.7%.

From 2014-2020 energy efficiency improvement measures contributed to 10,469.1 GWh in cumulative final energy savings which constituted 105.8% of the mandatory cumulative target 9,896 GWh. Thus, Latvia also exceeded its mandatory cumulative final energy consumption target.

Final energy savings were achieved by means of financial support programmes to improve energy efficiency of residential, public and industrial buildings, as well as public lighting. Energy Efficiency Obligation Scheme and energy efficiency measures implemented by enterprises (as a result of mandatory energy auditing) were of high importance in achieving abovementioned national energy efficiency targets. Energy efficiency improvements in enterprises is important element in facilitating EU competitiveness, therefore, since 2015 all large enterprises in the EU are obliged to conduct regular energy audits.

The *Energy Efficiency Law* provides that large companies and companies with annual electricity consumption above 500 MWh (two calendar years in a row) every four years conduct energy audit or introduce and maintain a certified energy management system, obliging them to implement energy efficiency measures with the highest energy saving potential or economic return.

According to the latest data, these requirements generally apply to 276 large enterprises and 1,086 large electricity consumers. Energy audits help enterprises to assess potential improvements of buildings, introduce energy efficient lighting, as well as production equipment and transport. Efficient energy use will enable companies to save costs while contributing to the achievement of energy efficiency targets set for Latvia.

In 2018, when Directive (EU) 2018/2001 of the European Parliament and of the Council amending Directive 2012/27/EU on energy efficiency was approved, the EU member states agreed to improve energy efficiency by 32.5% by 2030. Therefore, each Member State shall be involved in achieving this target, and to comply with a horizontal principle *energy efficiency first* in national development planning. This principle is included in the *National Energy and Climate Plan 2030*.

**Box 12.2**

**Improvement of Legislation**

In 2022, the Saeima adopted Amendments to the *Energy Efficiency Law*, which entered into force on 2 August 2022.

On 4 October 2022, the CM adopted CM Regulations No. 622 *Amendments to Regulations of the Cabinet of Ministers No. 876 Regulations for the Supply and Use of Heating* of 21 October 2008, and on 18 October 2022 – CM Regulations No. 660 *Energy Efficiency Monitoring Regulations*, thus updating current regulation and finalising work on the transposition of provisions of Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 into national law.

In addition, draft provisions of energy resources information system were developed in 2022 to supervise the performance of energy efficiency measures, as well as draft provisions of updated Energy Efficiency Obligation Scheme were developed. Taking into consideration that from 1 January 2020 maintenance of the energy efficiency monitoring system is transferred to the SCCB, it is expected that collection and calculations of energy savings in the energy efficiency monitoring system will improve substantially.

At the same time future priorities include further elaboration and update of national legislation on energy efficiency, considering forthcoming completion of the *Review of the Energy Efficiency Directive* at the EU level in 2023, entry into force of the new directive, and the update of the *National Energy and Climate Plan*, where energy efficiency is significant in future development of the economy.

By approving the *Latvia's National Energy and Climate Plan 2021-2030* by CM Order No. 46 of 4 February 2020, the Latvian government set energy efficiency targets to be reached by 2030:

- total indicative national energy efficiency – total primary energy consumption not more than 165 – 170 PJ and final energy consumption not more than 145 – 149 PJ;
- annual final energy consumption saving of 0.8% – final energy saving of 1.76 Mtoe (20,472.02 GWh) accumulated in 2021 – 2030;
- annual renovation of 3% of the state-owned building area (maximum estimates – 500 thousand m$^2$).

## 12.3. ENERGY FROM RENEWABLE SOURCES

In the *Energy Sector Development Guidelines 2016-2020*, the Latvian government has set renewable energy targets for 2020: to achieve a 40% share of RES in the gross final energy consumption and a 10% share of renewable energy in the transport sector final consumption.

**Box 12.3**

**Improving the Regulatory Framework**

In the field of legislation, the process of improving the legislation governing mandatory electricity procurement (MPC) system completed in 2022. Following the legislative authorization granted in the amendments to the *Electricity Market Law* adopted by the Saeima in 2020, on 8 March 2022, the CM adopted the amendments (prepared by the MoE) to CM Regulations No. 560 of 2 September 2020 *Regulations on Electricity Production Using Renewable Energy Sources, as well as Pricing Procedure and Supervision* and CM Regulations No. 561 *Regulations on Electricity Generation, Supervision and Pricing when Producing Electricity in Cogeneration*. Amendments, on the basis of the conditions included in the *Electricity Market Law*, determined the principle of the single technological cycle of power plants, improved the mechanism for the prevention of overcompensation, updating also the principles for calculation of the internal rate of return (IRR) of power plants, and also supplemented the procedure for recovery of unduly or illegally received state aid. The adoption of these amendments completed the process of adjusting the MPC system, which included both the improvement of the regulatory base and the strengthening of the supervision and control of support recipients.

The work to promote self-consumption of electricity continues paying special attention to the improvement of the electricity net accounting system. The net system, which has been functioning in Latvia from 2014, is available to the electricity producers, which produce electricity for self-consumption using RES, for example, by solar panels or wind turbines. The net system provides the possibility to transfer the excessive electricity produced to the electrical network and use it again, when necessary. On 14 July 2022, the Saeima adopted amendments to the *Electricity Market Law* developed by the MoE, which includes amendments for the expansion of the current net system. In fulfilling the mandate specified in the law, the MoE developed draft amendments to CM Regulations No. 50 *Regulations Regarding the Trade and Use of Electricity* of 21 January 2014, subordinate to the law. The amendments to that legislation provide for complementing the current net system, which takes into account only the amount of electricity produced, transferred to the network and received from the network, by creating a new net accounting system which will also take into account the value of electricity produced, transferred to the network and received from the network. As the new net accounting system is based more on market principles, it will provide more opportunities for electricity producers to take advantage of electricity generated for their own consumption, for example, system users will be able to take advantage of the so-called remote self-consumption option – using electricity produced at one user facility at another facility of the same user, and the power capacity threshold permitted in the system will be raised. Along with these amendments, the net accounting system will also be open to legal persons, thus enabling merchants to use the electricity produced by them more efficiently to reduce the burden of total energy costs.

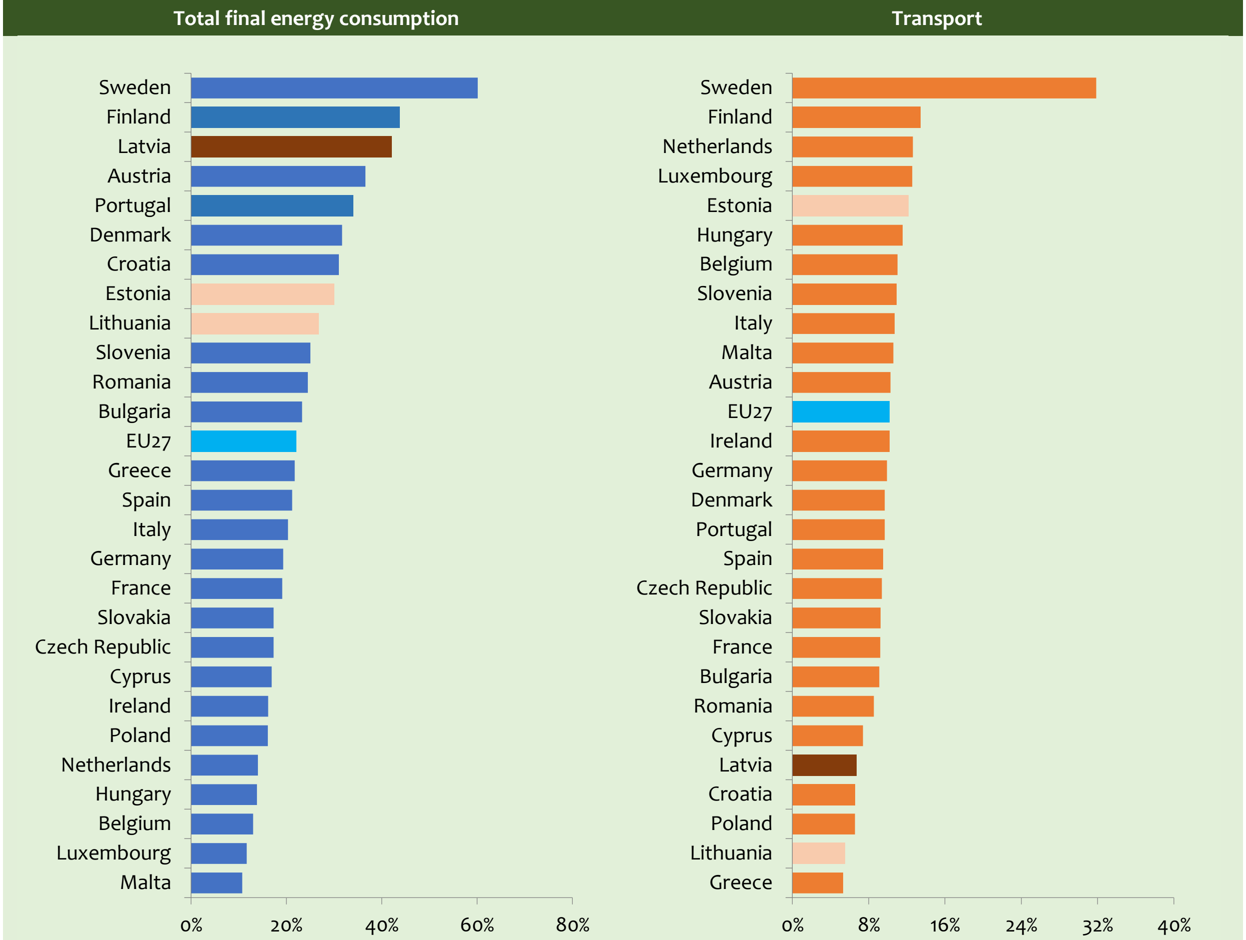
In 2022, amendments to the *Energy Law* and the *Electricity Market Law* were adopted to introduce in the Latvian legislation the conditions for the establishment and operation of energy communities and renewable energy communities in Latvia, thereby promoting the generation and use of renewable energy also within the energy communities, and guarantees of origin for biomethane (for biogas produced from RES and purified to the quality of methane). In 2022, amendments to the *Energy Law* were also developed and forwarded providing basic conditions for the implementation of joint renewable energy projects, incl. intergovernmental, the stability of support schemes, as well as recalculations of statistical exceedances of renewable energy.

A new draft *Transport Energy Law* was submitted for approval to the CM in 2022, which will impose on fuel suppliers the renewable transport energy implementation obligation and the obligation to reduce the intensity of life cycle greenhouse gas emissions of the transport energy sold, which fuel suppliers will be able to ensure by increasing the share of renewable transport energy in total transport energy sold or by selling such transport energy types as electricity, hydrogen or biomethane. The draft law will also impose an obligation on public transport used in state cities and on the transport used by the municipalities of state cities. This will ensure compliance with Latvia's binding renewable energy target for the transport sector, at the same time significantly reducing greenhouse gas emissions and emissions of air pollutants.

Latvia has the third highest share of renewable energy in the final energy consumption in the EU: It was 42.1% in 2020 (the EU average is 22.1%), therefore Latvia has exceeded the target set for 2020 – 40%. Furthermore, in the transport sector the share of renewable energy reached 6.7% in 2020, which is significantly lower than the EU average (10.2%) and significantly lower than the EU target of 10% set for 2020 (see Figure 12.1).

Figure 12.1

**Renewable energy share in EU Member States in 2020**
*% of final energy consumption*




Source: *Eurostat*

Renewable energy in Latvia (including renewable heat and renewable electricity) reached 19,342 GWh in 2020 and 20,397 GWh in 2021. The main type of renewable energy in Latvia is solid biomass (firewood, wood residues, woodchips, briquettes, pellets) and hydroenergy. The share of solid biomass in the total renewable energy was 77.4% in 2020, and 78.4% in 2021, while the share of electricity generated from hydroenergy in the total renewable energy volume was 13.5% in 2020 and 13.3% in 2021.

In Latvia, the share of renewable electricity in the total amount of produced electricity was 63.8% in 2020, and 63.6% in 2021, while the share of renewable heat (incl. in district heating and the use of fuels in final energy consumption) in total heat supply was 57.1% in 2020 and 57.4% – in 2021. While final energy consumption increased in 2021 compared to 2020, the share of renewable energy has not changed significantly as renewable energy consumption contributed more to the growth of final energy consumption than fossil energy consumption.

By approving the *Latvia's National Energy and Climate Plan 2021-2030* in 2020, the Latvian government has set more ambitious renewable energy targets to be reached by 2030:

- indicative renewable energy share in electricity – >60% (calculated using the *Eurostat* method);
- indicative renewable energy share in heat supply and cooling – 57.6%;

- renewable energy share in transport – 7% (can be reached only using advanced biofuel and renewable energy);
- share of advanced biofuels and biogas in the final energy consumption in transport – 1.75%.

## SUPPORT FOR IMPROVING ENERGY EFFICIENCY AND PRODUCTION OF RENEWABLE ENERGY

Support to generation of electricity using RES in Latvia is provided in the form of a mandatory electricity procurement or as a payment for the electrical capacity installed at power plant. The costs of mandatory procurement are covered using the mandatory procurement component (hereinafter – MPC) applying it to electricity consumers. In 2022, the average MPC rate was 7.55 euro/MWh.

In response to the significant increase in energy prices caused by external conditions in 2021 and 2022, the MoE developed and proposed solutions for the CM to reduce MPC payments for electricity end consumers. On 27 January 2022, the Saeima adopted the *Law on Measures to Reduce an Extraordinary Increase in Energy Prices* developed by the MoE and the Ministry of Welfare, which provided for a series of support measures for natural and legal persons to reduce the negative impact of the increase in energy prices. According to the Law, from 1 January to 30 April 2022, 100% of MPC payments of electricity consumers were covered from the state budget, so these costs were not included in the electricity bills during that period. On 30 August 2022, the CM examined the conceptual report *Package measures to address the problem of the mandatory procurement component and the development of the electricity market* developed by the MoE, supporting the solution offered in the report to apply the average MPC rate compensation from 1 September 2022, reducing it to 0.00 euro/MWh. The abovementioned average MPC rate compensation applies to both households and legal persons, thus comprehensively reducing the negative impact of the increase in energy costs and promoting international competitiveness of Latvian businesses, also energy intensive manufacturing enterprises. At the same time, by the CM Order No. 584 of 6 September 2022 *Package measures to address the problem of the mandatory procurement component and the development of the electricity market* the MoE started working on amendments to the *Electricity Market Law* to determine at the level of the law that future MPC costs are not to be covered by electricity end consumers in Latvia.

Several programmes supervised by the MoE are currently being implemented to support energy efficiency projects (see Box 12.4).

**Box 12.4**

**Support Programmes for Improvement of Energy Efficiency (Conditions as at 1 November 2022)**

**Energy efficiency programme for multi-apartment houses:**

- 826 projects requesting ERDF funding of 169 million euro were submitted to ALTUM;
- 523 positive decisions on granting of grants were taken;
- the implementation of 349 projects has completed, 150 projects are still being implemented, incl. at the construction stage;
- 120 ALTUM loans for 21.7 million euro were issued;
- 290 guarantees for 58.8 million euro were granted.

Average indicators of projects:

- the average energy consumption reduction in homes – 41%;
- the annual average energy consumption for a renewed house – 56 kWh/ m$^2$.

Annual energy saving in submitted projects:

- annual consumed heating energy reduction– 55.75 MWh/ m$^2$;
- annual $CO_2$ reduction – 26.6 thousand tons.

**Energy efficiency programme for private houses:**

- 711 projects requesting funding of 3.1 million euro were approved by ALTUM;
- the implementation of the projects will increase the energy efficiency class of the private house at least to class C and reduced heating consumption at least by 20%.

**Energy efficiency programme for public buildings:**

- 131 project applications requesting ERDF funding of 88.3 million euro were received;
- the implementation of 87 projects requesting ERDF funding of 51.2 million euro has been completed;
- the total area of state-owned buildings, which will be renewed within projects – 112,583 m$^2$;
- the annual average energy consumption of the buildings after a year of implementation of the project – 110 kWh/ m$^2$.

**Box 12.4 continued**

**Energy efficiency programme for production buildings:**

- 73 agreements for CF funding of 20.20 million euro were concluded;
- the implementation of 39 projects for CF funding of 9.61 million euro has been completed.

Indicators to be achieved within the approved projects:

- annual energy savings – 169.6 GWh;
- installed capacity of renewable energy sources (heating boilers + solar collectors) – 9.5 MW;
- annual $CO_2$ reduction – 22.5 thousand tons.

**Energy efficiency programme for the district heating system:**

- projects were approved and 158 agreements for CF funding of 93.79 million euro were concluded;
- the implementation of 74 projects for CF funding of 26.10 million euro has been completed.

Indicators to be achieved within the approved projects:

- additional capacity of renewable energy sources – 219.31 MW;
- reconstructed production capacity– 217.82 MW;
- reconstructed heating networks – 61.86 km;
- annual reduction in heating energy losses in reconstructed heating networks – 47.75 GWh;
- annual $CO_2$ reduction – 163.03 thousand tons.

## 12.4. REDUCING GREENHOUSE GAS EMISSIONS

Over the last decades, climate has changed faster than ever in the history of instrument meteorological observations, and in the 21$^{st}$ century the temperature is expected to increase even more drastically having a bigger effect on the society in general and different industries and national economy sectors. Individual policies in national economy sectors are implemented to reduce GHG in Latvia – promotion of use of RES, improvement of energy efficiency, promotion of electromobility, measures to reduce the use of fossil fuels, etc. (see Box 12.5).

**Box 12.5**

**Reducing GHG Emissions in Latvia**

Taking into account Latvia's participation in the EU, Latvia's political goals in terms of climate are linked to the EU climate policy goals, as well as the international climate policy – the *UN Framework Convention on Climate Change* and its *Kyoto Protocol* and the *Paris Agreement*.

EU GHG emission reduction target has been set within the EU, and it is broken down into two parts – the activities included in EU Emissions Trading System (hereinafter referred to as EU ETS) and the activities not included in EU Emissions Trading System (hereinafter referred to as non-ETS). Common targets set by the EU:

- ETS operators should jointly reduce the amount of GHG emissions by 21% until 2020 and by 43% by 2030 (in comparison with the amount of GHG emissions of EU ETS operators in 2005);
- the total amount of non-ETS GHG emission within the EU should reduce by 10% by 2020 and by 30% by 2030 (in comparison with the amount of GHG emissions of non-ETS operators in 2005).

The fulfilment of the **EU ETS target** is the responsibility of the EC. In order to perform this task, conditions for the operation of ETS and the responsibilities of ETS operators have been approved by EU legislation. Measures for reduction of the amount of GHG emissions of ETS operators are set in a harmonised way in the EU Emissions Trading System Directive. The development and implementation of ETS measures is ensured by the EC jointly with EU Member States. The Latvia's largest energy and industrial companies are also EU ETS operators.

The **non-ETS GHG emissions reduction target** fulfilment obligations should be undertaken by each EU Member State, including Latvia. For the period from 2013 to 2020 the target of each EU Member State and the corresponding conditions are set in the so-called Decision 406/2009/EC, and for the period from 2021 to 2030 – with Regulation 2018/84. In the period from 2013 to 2020 Latvia is allowed to increase its non-ETS GHG emissions by no more than 17%. However, in the period from 2021 to 2030 Latvia should reduce its non-ETS GHG emissions by 6%, compared to 2005. The target for the entire period is divided into binding annual targets.

According to the 2022 GHG inventory for 1990–2020[1] (*2022 GHG inventory*) and an approximate GHG inventory for 2021[2], total GHG emissions of Latvia from 1990 to 2020 and 2021 have reduced by 59.6% and 58.7% respectively, while in the period from 2005 to 2019 (see Figure 12.2) and 2021 total GHG emissions of Latvia decreased by 4.5% and 2.3% respectively. Total GHG emissions of Latvia were 10,597.7 kt of $CO_2$ eq. in 2020 and approximately 10,694.1 kt of $CO_2$ eq. in 2021.

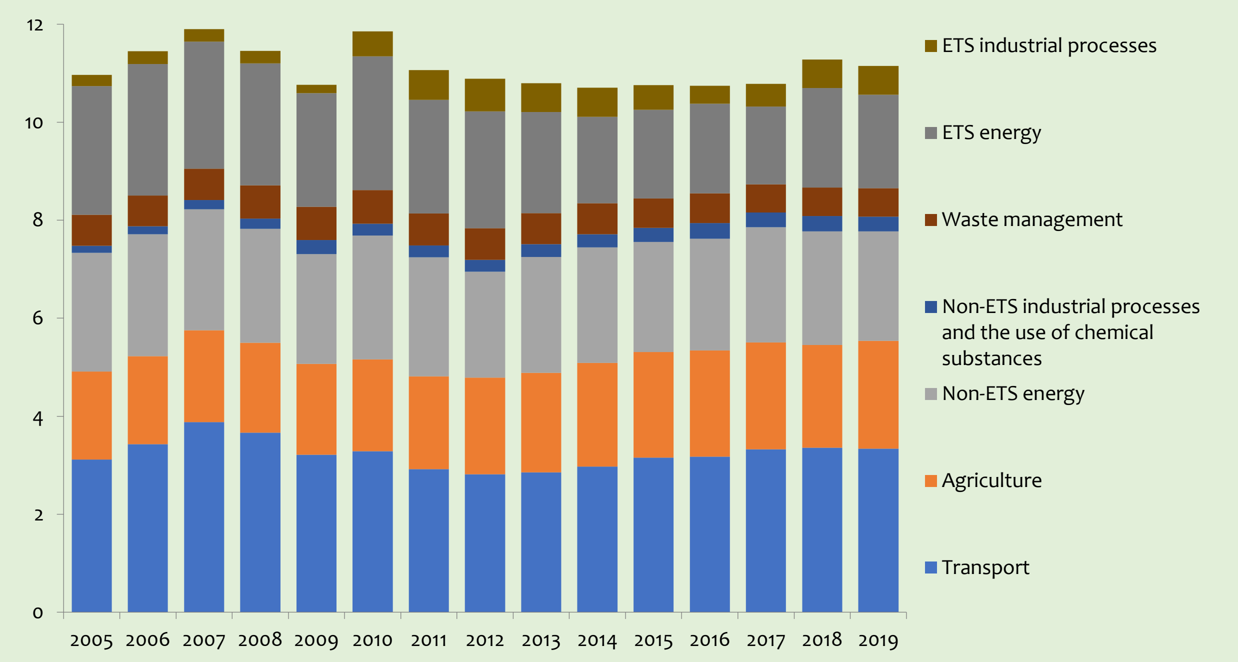
In 2020, non-ETS GHG emissions dominated in the total amount of GHG emissions of Latvia with 80.7%[3]. The estimated share of GHG emissions from non-ETS activities in the total amount of GHG emissions of Latvia in 2021 was similar — 80.7%. GHG emissions generated by Latvian ETS operators amounted to 2022 kt $CO_2$ eqv. in 2020, and 2065.4 kt $CO_2$ eqv.in 2021 or 19.3 % of Latvia's total GHG emissions.

The development of GHG emissions from non-ETS activities suggests an increase of emissions by 4.2% from 2005 to 2020 and by 6.6% from 2005 to 2021. Overall, until 2020 Latvia was within the annual targets set for non-ETS activities in Decision No 406/2009/EC[4]. Latvian ETS operators had reduced their GHG emissions by 29.2% before 2020, in comparison with 2005, exceeding the Latvian national ETS GHG emissions reduction target for 2020 – minus 21% compared to 2005.

Figure 12.2

**GHG emission trends from non-ETS and ETS activities from 2005 to 2021[5]**

*million kt of $CO_2$ eq.*




In 2020, the biggest source of GHG emissions was energy (35.2% of total GHG emission excluding land use, land use change and forestry sector) followed by transport (29.7%) and agriculture (21.5%), the rest was industrial processes and product use, and waste management. In 2020, total emissions of the energy sector (including transport) reduced by 65.2% in comparison with 1990 and by 16.7% in comparison with 2005.

On 28 February 2020, the *Latvian strategy for reaching climate neutrality by 2050* was approved at the CM meeting, which sets the Latvia's climate neutrality goal for 2050 and necessary action lines for the achievement of this goal.

[1] https://unfccc.int/ghg-inventories-annex-i-parties/2022
[2] https://reportnet.europa.eu/public/dataflow/610
[3] The non-ETS activities subject to Decision 406/2009/EC, the calculation of GHG emissions has been carried out using the defined EC formula – total GHG emissions minus amount of $CO_2$ emissions verified by EU ETS operators minus local aviation $CO_2$ emissions.
[4] https://eur-lex.europa.eu/legal-content/LV/TXT/PDF/?uri=CELEX:32009D0406&from=EN
[5] The data of 2021 are the data of approximated GHG inventory (excluding total approximate $CO_2$ equivalent emissions and removals from land use, land use changes and forestry in accordance with Article 17 of Commission Implementing Regulation 749/2014), which were calculated, taking into account the initial statistical data, and which have not been verified or approved by experts of the EC and the Secretariat of the *UN Framework Convention on Climate Change*. In this section, the approximated GHG inventory data for 2021 for 2018 are included for approximate description of the situation in 2018.

# 13. CONSTRUCTION POLICY

The construction industry was planning that 2022 would be a year of stabilization after two years impacted by the Covid-19 pandemic, when the industry was working under severe turbulence. However, on 24 February 2022, the military aggression against Ukraine launched by Russia had a significant and lasting negative impact on the sector, leading to a sharp and unpredictable rise in the prices of construction products and the unavailability of certain construction products.

In order to reduce risks in public infrastructure development projects, the MoE prepared an informative report *On the situation in the construction sector in relation to Russian aggression in Ukraine and necessary solutions in public investment projects* (reviewed at the CM meeting of 5 April 2022). It was stated that Russian military aggression in Ukraine was a circumstance that was the reason for substantial amendments to public construction contracts, including increases in contract prices.

To provide support to public commissioning parties in the effective management of construction contracts, the MoE has developed *Guidelines for the Assessment of the Increase in the Cost of Construction Materials due to Russian Military Aggression in Ukraine for Making Amendments to the Public Construction Contracts in Force Regarding the Construction of Buildings*[1].

The MoE also developed *Guidelines for Indexation of the Price of a Construction Contract*, which contains recommendations for contractual legal indexation of the contract price of construction works[2]. Indexing the contract price is an effective tool for risk management in construction contracts where the risk is linked to fluctuations in labour costs and resource prices. The inclusion of rules on indexation of prices of construction contracts will make it possible for commissioning parties to adapt flexibly to fluctuations in the construction market.

On 15 November 2022, the CM reviewed a repeated informative report *On the development of the situation in relation to availability of raw materials and construction products and rapid price increase in the Latvian construction sector*. It describes in more detail the increase in construction costs, paying attention to the need for commissioning parties and contractors of construction to agree to cover the increase in costs or other solutions to successfully complete the initiated construction projects.

The MoE closely follows global development trends, as well as their impact on the Latvian economy, as well as the planned investment volumes in order to identify in a timely manner the risks of cyclicality and to prevent the unbalanced development of the construction sector and a potential *overheating* (see Box 13.1).

**Box 13.1**

**On expected changes in costs of labour force and construction materials in the construction sector and their impact on the economy**

Every year, the MoE commissions the study on expected changes in costs of labour force and construction materials in the construction sector and their impact on the economy (see https://www.em.gov.lv/lv/buvniecibas-nozare-attistiba-strategija-un-petijumi).

The study includes an assessment and analysis of the factors affecting the costs of labour and construction materials, making an assessment of shares of both direct and indirect impact indicators, including measures to combat the shadow economy, lending, availability of funding and labour, this year also the Russian military aggression in Ukraine and the impact of the Covid-19 pandemic.

The last study was conducted from May to July 2022. Researchers and experts used the information available at the time. However, in the light of the latest statistical data on construction output, it has to be concluded that such high instability in the sector makes it impossible to make accurate forecasts. The study predicts that construction output is generally expected to fall in 2022. The decline could exceed 10% compared to 2021. So the forecasts calculated by the researchers for the construction output (the researchers calculated that a 1.1% increase in construction output is expected in 2022 compared to 2021) are too inaccurate and would not be useful in planning the volume of construction industry and in deciding whether to continue existing construction concepts or to start new ones.

While improving the construction regulation, the MoE continues the completion of the implementation of the initiated construction policy initiatives, as well as the transfer of the *good practices* recognised in the sector to the regulatory framework. This will improve transparency in the implementation of the construction process now and in the future. Particular attention is paid to changes in sectoral standards and to ensuring consistency with the technical regulation included in the construction standards (see Box 13.2).

[1] https://www.em.gov.lv/lv/vadlinijas-buvmaterialu-izmaksu-sadardzinajuma-novertesanai-sakara-ar-krievijas-militaro-agresiju-ukraina-grozijumu-veiksanai-speka-esosajos-publiskajos-buvdarbu-ligumos-attieciba-uz-eku-buvniecibu
[2] https://www.em.gov.lv/lv/vadlinijas-buvdarbu-liguma-cenas-indeksacijai

**Box 13.2**

**Significant legislative initiatives in 2022**

- CM Regulations No. 419 of 7 July 2022 *Regulations on Mandatory Provisions for Public Procurement Contracts for Construction Works and Their Content* prescribe a uniform procedure for acceptance-transfer of public construction works, settlement and contract performance guarantee. They will apply to public construction procurements announced from 1 January 2023, including joint design and construction work procurements, to which the *Public Procurement Law* and the *Law on the Procurement of Public Service Providers* apply. These Regulations will have to be applied to a public construction contract, which provides for construction of new structures of the second or third group, reconstruction, renewal or restoration of structures, placement of structures, burying of engineering networks or demolition of structures in the territory of Latvia, but will not apply to public construction contracts for all types of construction works in diplomatic and consular representations of the Republic of Latvia abroad or to structures which have the status of a property of national interest.
- On 1 July 2022, Section 14.[1] of the *Construction Law* on the principle of silent approval and consent in the construction process came into force. Along with this Section of the *Construction Law*, 9 amendments to construction regulations came into force, specifying in detail all the cases in which the principle of silent approval will be applied. At present, the principle of silent approval is already applied to the explanatory note for changing the use of a first, second or third group building or group of premises without reconstruction. With effect from 1 July 2023, it is planned to extend this principle also to other explanatory notes and decisions of the National Cultural Heritage Administration during the administrative process of construction and coordinations of the authors of technical regulations for crossing of municipal streets or civil engineering networks of local significance or works in the protection zone of such objects.
- Amendments to Latvian Construction Standard LBN 221-15 *Internal Water Pipeline and Sewerage of Buildings* and Latvian Construction Standard LBN 222-15 *Water Supply Structures* transpose legal provisions arising from *Directive (EU) 2020/2184 of the European Parliament and of the Council of 16 December 2020 on the quality of water intended for human consumption*.
- Amendments to Latvian Construction Standard LBN 261-15 *Internal Wiring of Buildings* update the technical regulation is related to the mandatory requirements for ensuring electromobility (for example, requirements for the construction of electrical cable channel infrastructure in the event of renovation or reconstruction of non-residential buildings).

Work continues on:

- Draft *Law on Mandatory Insurance of Civil Liability in Construction*, which will include regulation for enforcing the strict liability of the construction initiator, ensuring meaningful protection of third parties in the construction process;
- amendments to the *Construction Law* on the liability of a consulting engineer of the International Federation of Consulting Engineers (*Fédération Internationale des Ingénieurs-Conseils — FIDIC*) in the construction process, as well as on combining of the speciality of construction management and supervision, additional access rights of construction specialists to the information in the CIS and additional rights for persons to see data regarding immovable property and its ownership in the CIS;
- amendments to CM Regulations No. 500 of 19 August 2014 *General Construction Regulations* to define a uniform regulation applicable to the stages of a building design, as well as to update the regulation for engineering survey and construction expert examination;
- amendments to 7 Latvian construction standards to harmonise the current technical requirements with the new standards, to eliminate the shortcomings detected in the regulatory framework and to introduce new requirements in cooperation with non-governmental organisations of the sector.

## DIGITALISATION THE CONSTRUCTION SECTOR

The work on digitalisation of the construction sector continues. In 2022, the implementation of the ERDF project *Construction process and information system development* (round 2) continued. The aim of round 2 of the project is to increase the efficiency of the construction process, the productivity of the sector and to promote the use of information and communication technologies in the management of the construction process and the lifecycle of the building. This will improve the availability of public administration services and ensure the re-use of the data available to the state. At the same time, the administrative burden, the costs associated with the organisation of the construction process and the time needed to prepare the documentation will be reduced. The process of submitting and coordinating a construction concept and a building design, the construction monitoring process, the process of supervision of operation of structures, the process of managing the energy performance of buildings, the process of registration of construction waste, as well as notification and information of those involved in the construction process have been improved.

In 2022, the following was improved in the CIS: the building operation supervision process (structure operation file, house file, *Register of Residential House Administrators*, technical survey report, determination of the operational risk of a structure, attachment of a decision of the State Fire and Rescue Service and a work assignment for the construction board), the process of managing the energy performance of buildings (creation, selection and display of an energy certificate), the process of submitting and coordinating a construction concept and a building design (visual solution, notification process, principle of silent approval, BIM), construction supervision process (construction log, construction waste accounting), notification and information (public portal, mobile application, notifications), and integration into other systems (Immovable Property State Cadastre Information System (data monitoring), Waste Transportation Accounting System, Amelioration Cadastre Information System, Information System of the Register of Natural Persons (data on foreigners), Open Data Portal, interface with administrator information systems, etc.).

The MoE continues the measures provided for in the building information modelling (BIM) roadmap. The implementation of BIM in Latvia is essential to improve productivity of companies in the construction sector on a local and international scale, as well as to increase quality of construction, shorten the time of implementation of construction and to reduce the life cycle costs of buildings. BIM provides modern and transparent construction processes aimed at quality and more efficient use of public funding in construction procurements.

Training seminars for construction specialists on BIM modelling, BIM management, BIM coordination, BIM implementation in enterprises, 3D scanning and other topics were organised in 2022. More than 1,000 people attended the seminars. In addition, consultations were provided to public contracting authorities (seminars were organised) on the application of the BIM guidelines in public procurement and more than 80 persons participated in these events.

At the same time, the development of a standard project for a single construction classification system has been initiated, which could be used both for the classification of elements of BIM models and for the automated preparation of construction cost estimates from the information available in BIM.

## EVALUATION OF COMPETENCE OF CONSTRUCTION SPECIALISTS AND SUPERVISION OF INDEPENDENT PRACTICE

The MoE continues cooperation with non-governmental construction organisations in assessing the competence of construction specialists and supervision of independent practice – in 2022, new delegation agreements were concluded with associations: *Latvian Association of Construction Engineers*, *Latvian Union of Heat, Gas and Water Technology Engineers, Latvian Association of Electric Energy and Energy Construction Specialists*, *Latvian Association of Architects*, *Railwaymen Association of Latvia*, *Latvian Association of Irrigation Engineers* and *Latvian Maritime Association*. The effective period of the delegation agreements is until 31 December 2024. At the same time, the MoE has developed amendments to CM Regulation No. 169 of 20 March 2018 *Regulations Regarding the Evaluation of Competence and Supervision of Independent Practice of Construction Specialists*, determining the possibility for competence testing institutions to define more precisely the minimum scope of independent practice, which is being examined within the framework of supervision of construction specialists, introducing a new decision to annul construction practice certificates that have been suspended for a long time, specifying the time period by which the supervision fee of construction specialists is to be paid, and providing possibilities for competence testing institutions to use the remainder of the supervision fee also for increasing the competence of construction specialists.

In 2022, the MoE organised various competence improvement events for both construction specialists and other parties involved in construction processes (see Box 13.3).

**Box 13.3**

**Competence Improvement Measures in 2022**

In cooperation with Latvia University of Life Sciences and Technologies, the MoE organised training seminars for construction specialists on various topics related to the use of wood in construction, including practical tasks (*Timber products for construction — production, characteristics and quality criteria*; *Characteristics and essential requirements of wooden building structures*; *Design of wooden buildings*). More than 360 people attended the seminars.

In 2022, the MoE continued the organisation of previously started, traditional free training seminars for construction specialists, architects, as well as representatives of state and local government institutions – construction initiators. This year, the range of specialists trained also included energy auditors and construction specialists focused on heat insulation of buildings. The seminars were led by well-known European industry experts and specialists from Austria, Poland, Belgium, Luxembourg, Estonia and the Netherlands. The topic of the problems in the construction process, which may occur at the design stage, such as fire safety solutions and environmental accessibility, was brought up. The protection of third-party properties when building in large cities under dense construction conditions was also considered as an important issue. The seminars focused on details of design, which are not mastered or partly mastered at the university. A total of five training seminars were organised: *Design of structural fire safety solutions for designers of building structures*, *Construction of deep foundations and construction pits under dense construction conditions*, *Improvement of energy performance of buildings to conform to zero emission buildings, Organisation of procurement for a consulting engineer and FIDIC contracts* and *Promotion of good environmental accessibility practices*.

In total, approximately 2,000 persons participated in free seminars organised by the MoE. Video recordings and presentations of seminars with translation into Latvian have been published and are available in CIS https://bis.gov.lv/noderigi/projektesana.

# 14. HOUSING POLICY

The low level of income and purchasing power of the population is the main reason for housing affordability problems in Latvia. Lack of affordable and quality housing is one of the reasons delaying internal mobility within the country and indirectly delaying national economy growth.

The existing housing stock is rapidly deteriorating[1]. The state, local governments and the population face the challenges of timely and optimal building maintenance. Similarly, with the ageing and the relatively poor technical state of the building stock, the energy efficiency of the existing housing stock is also being lost. According to the estimates of MoE, it is currently necessary to renovate more than 23 thousand buildings in the sector of multi-apartment buildings.

The MoE has already carried out a number of important tasks to support housing affordability. For example, a support programme for large families has been set up providing grants to purchase housing or to extend existing housing. In order to reduce design costs, which on average account for approximately 8% of the total construction costs of a single multi-apartment residential house, a model construction design for a multi-apartment house with reinforced concrete load-bearing structures was developed, which is available for free to any developer, and a model construction design for a wooden structure multi-apartment house was developed in 2021, which will also be available free of charge.

## SUPPORT FOR THE CONSTRUCTION OF LOW-COST RENTAL HOUSES AND ESTABLISHMENT OF A LONG-TERM HOUSING AFFORDABILITY FUND

In view of the existing housing affordability problems, particularly in regions, and the OECD recommendations, support programmes for the construction of low-cost rental housing are among the priorities of MoE in 2022. In 2022, a sustainable support model for the construction of affordable, quality and energy-efficient rental housing was developed by establishing a financial instrument for granting long-term low-interest loans and applying a 30% capital rebate. Funding of 42.9 million euro was attracted for the implementation of the support programme within the *Latvian Recovery and Resilience Facility Plan*: at least 700 low-rent apartments that will be available to households that cannot afford quality housing on market conditions are expected to be built.

At the same time, in order to reach a long-term solution for housing affordability, the establishment of a framework and mechanism for the long-term housing affordability fund has started. Through the EC's technical support instrument, the MoE was able to launch an additional cooperation project with the OECD for 450 thousand euro in order to further explore foreign practices and the possibilities of introducing a long-term housing affordability fund in Latvia, a revolving fund, as well as draft recommendations for the necessary legal framework of such fund, fund financing options, and for the fund management model. The full costs of the project will be covered by the EC. The project was launched in September 2021 and will last until spring 2023.

## HOUSING SUPPORT PROGRAMME

The housing support programme has been highly appreciated by the population so far simplifying for families with children payment of the first instalment for the loan for acquisition or construction of housing. During the years of functioning of the programme, since 2014 it has helped more than 22 thousand families with 33 thousand children to get housing of appropriate size. The total amount of guarantees during the programme was more than 180.9 million euro. Since 2018, when the programme was extended providing that also persons under the age of 35 and having higher or vocational education can get a guarantee for the first instalment for the loan for acquisition or construction of housing. In 2020, an additional support programme named *Balsts* was created, which provides large families with the possibility of obtaining a non-repayable state subsidy for the acquisition or construction of housing. The amount of the subsidy, according to the number of children in the family, is between 8 and 12 thousand euro. The subsidy was increased by 2 thousand euro if the housing meets the energy efficiency requirements for nearly zero-energy buildings. Since the programme started, more than 770 families with more than 2,400 thousand children have received subsidies and a total of 6.4 million euro have been granted in subsidies.

[1] 44.5% of the total number of buildings in the housing stock were constructed before 1941, 51% – in the Soviet period (until 1992) and 4.4% were renewed in the period of the free state. Only 3% of the buildings in the total share of multi-apartment buildings were built after 2003

## RESTORATION OF SOCIAL HOUSING OR CONSTRUCTION OF NEW SOCIAL HOUSING

Both the EC and the OECD have stated in their evaluation that the number of social housing in Latvia is insufficient. According to OECD data, Latvia has the smallest stock of social housing among OECD member states – less than 2% of total residential stock. The condition of social apartments is poor – 15.2% of the population experiences severe housing deprivation, significantly above the EU average of 4.5%.

One of specific objectives of the *EU Cohesion Policy Programme 2021-2027* is promoting the socioeconomic integration of marginalised communities, migrants and disadvantaged groups through integrated measures, including housing and social services. A specific support measure *Restoration of social housing or construction of new social housing* (hereinafter referred to as the Support Programme) is intended for the achievement of this goal.

The objective of the support programme is to ensure access to housing with dignified living conditions for persons who are registered for the types of assistance specified in the *Law on Assistance in Solving Apartment Matters*: renting of residential space owned or leased by a local government and renting of a social apartment.

The total eligible funding available for the support programme is 60.9 million euro (ERDF funding 51.8 million euro and local government budget co-financing 9.1 million euro), within the framework of which it is planned to provide housing to at least 1,865 households (families) by 31 December 2029. Taking into account that approximately two thirds of the residential stock in Latvia is not fit for residential purposes, it is planned that at least 1,200 dwellings will be created within the framework of the measure by renovating premises or groups of premises (apartments) already owned by local governments, while at least 665 dwellings could be created by building new or rebuilding existing residential houses.

It is planned that by the end of 2022 the CM will approve implementing regulations of the support programme and in Q1 2023 the selection of local government project applications will be announced.

# 15. TOURISM POLICY

Promoting exports of tourism is the main priority of the Latvian tourism industry. The target indicator for 2027 set in the *National Development Plan of Latvia for 2021-2027* is the total expenditure of foreign overnight travellers in Latvia of 540 million euro. 2018, when the total annual expenditure of foreign overnight travellers in Latvia amounted to 517 million euro, was chosen as the base year for comparison. Since in 2021, this indicator fell to 145 million euro due to the Covid-19 pandemic, additional support measures are necessary.

Export of Latvian tourism is directly linked to international tourism flows in the world (see Box 15.1).

**Box 15.1**

**Tourism Development Trends in the World and in Latvia**

According to the World Tourism Organization, international tourist flow worldwide has almost doubled (+172%) between January 2022 and July 2022 compared to the same period in 2021. This is a sign of the tourism industry recovery after the Covid-19 pandemic, during which the international tourism flow fell by more than 70%.

In 2022, Latvia's tourism industry is also characterised by upward indicators. According to CSB data, 1.5 million foreign and local visitors were accommodated in Latvian tourist accommodations in the first eight months of 2022, which is by 70% more than in the first eight months of 2021, while lagging behind the indicators of 2019 by 25.4%. This year has been a successful year for Latvia in welcoming cruise ships. According to the Freeport of Riga Authority, the 2022 cruise season in the Port of Riga has reached a record high number of incoming cruise ships– more than 100 cruise ship arrivals, which is by 1/4 more than in the last full cruise season in 2019. In 2022, the industry shows an upward trend also in the field of air travel – in the first seven months of 2022, the Riga airport has served 2.8 million passengers, which is 302% more than in the corresponding period in 2021.

Although Latvia's tourism industry experienced growth in 2022, the recovery of the sector is hampered by the military conflict initiated by Russia in Ukraine. Its impact on the tourism industry is triple. First, the inbound tourism market from Russia, Belarus and Ukraine has been lost (before the Covid-19 pandemic, Russia's incoming tourism market was one of the most significant – in 2019, the number of travellers from Russia accounted for more than 15% of the number of foreign overnight travellers, their expenses being 89.6 million euro). Second, the geopolitical situation negatively affects neighbouring countries of the countries involved in the war, including Baltic States, threatening the reputation of the Baltics as a safe tourist destination. The third important aspect of Russia's hostilities in Ukraine hindering the development of the tourism industry is the rapidly rising energy costs and inflation, which pose a particular threat to the viability of businesses in the hospitality and catering sector.

International tourism organisations predict that countries will reach tourism development rates of 2019 on average not sooner than in 2026. Consequently, the main challenge for tourism until 2024 is to promote the growth of international tourist flows by supporting activities of merchants in the sector to ensure their international competitiveness under conditions of high competition. Tourist destinations around the world compete for the attention of potential tourists, so the level of competition is quite high.

One of the support measures that will promote the creation of new tourism products with high added value for the development of competitiveness and exportability of Latvian tourism industry is activity 1.2.3.6 *Tourism Product Development Programme* of the Specific Objective 1.2.3 *To promote sustainable growth, competitiveness and job creation for SMEs, including through productive investments* of priority axis 1.2 *Business Support* of the Operational Programme of the EU Structural Funds and CF for the programming period 2021-2027. Thematic or geographical tourism networks or clusters will be created within the framework of the programme, bringing together entrepreneurs from different sectors of tourism and related sectors, as well as involving local governments and knowledge dissemination organisations to create new, complex tourism services with higher added value. As part of the activity, no less than 120 small, medium-sized and micro-enterprises are expected to be supported by 2029. The MoE has also proposed to mobilise additional funds to support large enterprises in the tourism industry. By the end of 2022, the MoE is planning to develop CM regulations on implementation of the programme and to commence the programme in Q1 2023.

At the same time, the MoE has stated the need to create large-scale strategically important tourism products. Latvia needs large tourist attractions capable of competing with Estonian and Lithuanian water amusement parks and SPA complexes. In addition to the state budget co-financing, the allocation of which from state budget funds has been forwarded by the MoE as a priority, it is also necessary to attract significant private investments. The MoE emphasises the need for additional funding for targeted tourism marketing activities to promote Latvia's tourism offer and Latvia as a safe and attractive tourist destination.

In assessing the effectiveness of tourism support activities and the overall development of tourism, the collection, processing and analysis of tourism data should be improved, expanded and modernised. Therefore, it is planned to develop a single solution (system) for the acquisition of data relevant to the tourism industry, ensuring the availability of open data for the parties involved, evaluating the efficiency/productivity of projects, activities and investments implemented in tourism.

Also, acquisition of complete data is essential to assess the indicators and growth of Latvia's tourism industry in an international context – Latvian tourism data is used in analysis by both OECD and EC Directorate General for Internal Market, Industry, Entrepreneurship and SMEs, as well as the World Tourism Organization and other large-scale international organisations.

It is at international level that the need for a single data and information platform is emphasised, where uniform monitoring indicators can be developed alongside tourism statistics and information can be shared in areas considered as fundamental pillars of global change in the tourism industry, such as the green and digital transition, sustainability of the tourism industry and smart management of the tourism industry. Together with participants of the tourism ecosystem, the EC has developed a *Transition Pathway for Tourism Plan*, which sets out in detail the actions, targets and conditions for a green and digital transition, sustainability and inclusion in the industry. The transformation of the tourism industry envisages taking measures in 27 areas, for example, investments in circulation are intended to reduce energy consumption, waste and water use and pollution, creating new innovative tourism services and managing tourism destinations in a more sustainable way.

One of the biggest challenges at international level is arranging the short-term rental housing market (see Chapter 14). The MoE has also made initial inputs to arrange the short-term rental housing market as part of its shadow economy mitigation plan to potentially boost tax and duty revenues in the state budget.

Cooperation takes place not only with international organisations, the promotion of cooperation at local level is also very important. The MoE sees tourism policy-making as an open process between the public sector, Latvian entrepreneurs, sectoral associations and other stakeholders. One of the cooperation platforms is the Latvian Tourism Advisory Council, whose meetings include discussions on the current problems of tourism industry representatives and possible solutions.

## LIAA TOURISM SUPPORT MEASURES

In 2022, LIAA continued promotion of local tourism and, as travel restrictions decreased, resumed active promotion of Latvia's tourism offer abroad. In June, *Open Rural Days* were organised with 277 participating rural tourism companies and about 10 thousand visitors. 60 castles and manors participated in the marketing activity *Let's go travel around Latvian castles and manors* from May to September, and around 10 thousand guests visited them as part of the activity. The *Home Café Days*, which took place in 43 destinations throughout the territory of Latvia, were highly popular. In total, home cafés welcomed more than 60 thousand guests between July and October.

LIAA uses *Latvian Tourism Marketing Strategy 2021-2027* for the coordination of foreign tourism marketing activities. In 2022, following Russia's invasion of Ukraine, Russia was removed from the list of priority markets, while Belarus was removed from the list of secondary markets, and no activities were implemented in those markets.

Tourism industry organisations and businesses are involved in the updating of the marketing strategy, and the work is organised in the Marketing and Product Development Sub-Group of the Latvian Tourism Advisory Council. In the Covid-19 post-crisis period, attention is paid to promoting local tourism activities, as well as educating tourism workers on crisis management, changes in international markets, trends in demand, product development, etc. Cooperation is ongoing among the countries of the Baltic Sea region in the fields of joint tourism products and marketing, in ensuring regular communication within the national tourism organisations of the Baltic States within the framework of the Joint Tourism Committee of Baltic States. By making effective use of the resources of international organisations, LIAA participates in the European Travel Commission. Within the framework of the project *Promoting Latvia's International Competitiveness in Tourism*, LIAA provides support in the form of grants for individual marketing activities performed by tourism entrepreneurs, local governments, foundations and associations in foreign markets. Support is also provided to organisers of international conferences, major cultural and sporting events and international exhibitions in Latvia. In the three quarters of 2022:

- one national tourism stand was created, 69 supports in the form of grants were provided;
- 3 marketing and advertising campaigns were launched in primary and secondary markets (Germany, Finland, Sweden, UK, Norway, Poland);
- tourism information materials were prepared, a new version of the Latvian Tourism Portal *latvia.travel* was developed, which was adapted to changes in the digital environment, the content and design of the portal were updated;
- 29 Latvian tourism publicity and foreign specialised tourism promotion activities, 33 foreign media visits and 8 visits of tourism industry representatives were organised;
- 2 market studies were started;
- 9 business tourism promotion events, 9 tourist attraction events and 4 health tourist attraction events in Latvian municipalities were organised.

# 16. CONSUMER RIGHTS PROTECTION AND MARKET SURVEILLANCE

## MARKET SURVEILLANCE

As an EU Member State, Latvia must ensure that the market surveillance system complies with the requirements of the European single market and only safe, compliant goods and services are available on the Latvian market. Market surveillance is part of the overall process of implementing regulatory enactments and is the main tool for monitoring the safety of goods. Moreover, this is a prerequisite for the normal functioning of the internal market and also of the market economy. Market surveillance is aimed at ensuring equal protection for all persons throughout the EU by eliminating unfair competition and fostering confidence in the market.

On 8 November 2022, the CM approved the *National Market Surveillance Strategy 2022-2026*[1] (hereinafter – Strategy), which is part of the common EU market surveillance system and was developed by the MoE in cooperation with 15 Latvian market surveillance authorities in accordance with the single EU form.

The strategy was developed in compliance with the requirements of the *Regulation on market surveillance and compliance of products*. The purpose of this Regulation is to ensure a comprehensive functioning of the market surveillance systems of EU Member States in order to obtain assurance that the resources, powers and responsibilities of the authorities involved are sufficient for effective market surveillance.

The strategy includes information on Latvia's market surveillance system, institutions involved and practices, enforcement of EU legislation related to market surveillance in the territory of Latvia, also at the borders of the EU, and cooperation with EU Member States. The strategy includes conclusions on challenges in the Latvian surveillance system, an evaluation of the existing shortcomings and necessary improvements, and proposed options for implementing them, as well as identified priority areas for market surveillance.

The strategy covers a number of EU product legislation, all stages of the product supply chain, including imports and digital supply chains. Account has also been taken of the rapid development of e-commerce and the popularity of smart products, which require additional skills from market supervisors in the use of digital tools, for example, through inspections, market monitoring and data-driven monitoring. The document emphasises that, taking into account the objectives of the EU Green Deal and the rise in energy prices, the introduction of energy efficiency and ecodesign requirements and clarification of requirements for both merchants and consumers should be implemented more effectively in order to promote sustainable consumer habits.

At the same time, laboratory testing of products is essential to verify the safety and conformity of products. In Latvia, the availability of laboratories that meet such needs is limited, so institutions often have to use the services of foreign laboratories. The proper delivery of samples to foreign laboratories is an expensive and time-consuming process and therefore the strategy calls for incentives to develop local laboratories, such as construction products and energy efficiency.

The evaluation of the results of the implementation of the strategy and market surveillance will use common indicators developed by the EU Product Compliance Network, such as resources for market surveillance, number of tests and laboratory examinations, number of non-compliances, etc. The results are planned to be collected annually and discussed in the Market Surveillance Council. The implementation of the strategy will be evaluated and reviewed at least every two years.

[1] https://www.em.gov.lv/lv/tirgus-uzraudziba

## CONSUMER RIGHTS

Consumers are the largest driver of the economy. Today the range of fundamental rights of consumers is rather extensive: the right to secure own needs, the right to safe goods and services, the right to be informed, the right to choose, the right to resolution of disputes, etc. In order to ensure their observation and to protect consumers' economic interests, it is important to ensure the implementation of the consumer rights protection policy in different directions. Moreover, consumer rights protection requirements should be taken into account, also when developing and implementing other policies.

The modern consumer policy includes protection of rights by law, help in quick and effective resolution of disputes with traders, guarantee of safety of any goods purchased in the single market, alignment of consumer rights with economic and social changes, in particular in the area of digital technologies, energy, financial services, as well as provide consumers with the possibility to choose the goods and services they need and want on the basis of clear, accurate and consistent information. Taking into account the rapid dynamics under the influence of rapid development of globalisation, digitalisation and technologies, also the consumer rights protection policy is made as flexible as possible to respond to the changes operatively.

Over the past year the market situation has been affected both by Russia's war against Ukraine and by the global energy crisis, which also directly affects commodity prices and increases the cost of living as a whole. At this difficult time, consumer rights still need to be protected. In particular, the issue of cost increases has been pressing and service providers and traders must act in accordance with the principles of fair commercial practices. The consumer rights protection system in Latvia is constantly being developed to ensure effective market surveillance and consumer rights protection. The MoE is working to improve the existing framework and ensure a high level of consumer rights protection. There is also active participation in shaping of the international consumer protection policy, research and adoption of good practices of other countries.

In the field of consumer protection, the MoE is working closely with the Consumer Rights Protection Centre (CRPC). The CRPC is the main coordinating authority in the area of surveillance of laws and regulations on consumer protection, and the goal of its operations is to ensure efficient protection of consumer rights and interests. In order to perform the entrusted functions, the CRPC implements different activities related to monitoring of the consumer rights protection, considers consumer complaints, informs and advises consumers and entrepreneurs, implements monitoring activities to prevent unfair commercial practices, controls e-commerce and advertising, licences non-bank credit providers and extrajudicial debt recovery service providers, takes measures on the safety and compliance of goods and services, carries out the national metrological supervision, supervision of dangerous equipment and investigations of dangerous equipment accidents. Taking into account the current economic situation in the world and the tense geopolitical situation in neighbouring countries, as well as the rapid pace of innovation and digitalisation, not only the adaptation of supervisory work to new market conditions is taking place, but also the regulatory framework is being updated and European regulation is being transposed into national regulatory enactments.

In 2022, the MoE continued updating consumer rights on toy safety issues and work on a proposal for a Regulation on product safety. The new proposal will replace the current *Directive 2001/95/EC of the European Parliament and of the Council on general product safety*. The proposal aims to update and modernise the general framework for the safety of non-food consumer products while maintaining the function of the consumer safety net currently carried out by the General Safety Directive. This proposal incorporates solutions to the various market surveillance challenges posed by new technologies and online sales. The introduction of uniform requirements for non-food consumer products ensures a level-playing field for businesses. The proposal for a Regulation lays down the general requirement that consumer goods should be safe, defines certain obligations for businesses and includes the conditions for the development of standards necessary to implement the general safety requirement. The proposal for a Regulation seeks to harmonise market surveillance rules for products in the harmonised and non-harmonised fields.

Work on the proposal for a directive on consumer credits continued in 2022. This should ensure a consistently high level of consumer protection, the suitability of the rules for the digital age, and a clearer and more coherent legal framework for businesses by reducing barriers to issuing credits in other Member States. The general objectives are to reduce damage and risks to customers associated with taking loans in a volatile market, to facilitate cross-border issuance of consumer credits and to increase the competitiveness of the internal market. The new Directive will replace the Directive of 2008 while maintaining many elements of it. Among the main middle ground changes introduced in the text is the requirement to improve the quality of pre-contractual consumer information in advertising and pre-contractual information forms, thus contributing to the effectiveness of information. The proposal also covers professional ethics rules and the obligations of credit providers to ensure that employees have the appropriate skills and knowledge. Strengthening the customer solvency assessment requirements by reducing the possibility of granting a loan to a person who will not be able to repay the loan is vital. The proposal also incorporates the obligation for Member States to promote financial education and improve access to debt advisory services.

The MoE has prepared amendments to the *Consumer Rights Protection Law* and the *Civil Procedure Law*, which are currently in the process of inter-institutional coordination. These amendments will set out the requirements applicable to the collective remedy framework (collective actions) in line with the directive adopted by the EU. Collective actions will be an efficient and effective procedural means to prevent breaches of consumer rights and to enable consumers to obtain compensation of inflicted damage through a collective action.

Discussions are currently underway in the EU on the development of various new laws and regulations that Member States will have to transpose in their legislation. Member States are discussing the proposal for a directive on empowering consumers for the *green* transition designed to provide better protection of consumers against unfair practices and better information. The regulation aims to strengthen consumer rights and promote sustainable consumption and a *green* circular economy in the EU: if consumers have the opportunity to make informed purchase decisions, they will be able to choose sustainable consumption, also using information that indicates whether the product can be repaired and its longevity in comparison with other goods. Discussions have also been launched on the proposal for a directive on liability for defective products, providing that liability regulations reflect the nature and risks of digital age and circular economy products. The proposal aims to ease the burden of proof on injured parties in complex cases and to reduce the restrictions on bringing actions while striking a fair balance between the general legitimate interests of manufacturers, injured parties and consumers.

2022 has also been important in the field of consumer protection and has called for increased involvement of CRPC (see Box 16.1) and MoE.

**Box 16.1**

**Activities of the Consumer Rights Protection Centre (CRPC) in 2022**

In the nine months of 2022, the CRPC provided 21,620 consultations, i.e. 3,576 fewer consultations than over the same period in 2021 and received 2,502 written applications and complaints (hereafter – applications), i.e. showing a 17% decrease from 2021. The decline in demand for consultations and the shrinking of the number of applications is explained by the reduced flow of applications and consultations related to the consequences caused by Covid-19, when customers had limited opportunities to use many previously purchased services, moreover, it was unclear how to act to implement consumer rights at that time. It is also possible that the decrease is related to the increase in prices due to the geopolitical situation, because the funds are spent more on food and goods of first necessity and less on other goods and services. Consumer habits are also changing – they get acquainted with the information available on the CRPC website, more questions are asked on *Facebook* and *Twitter* accounts of the authority, and many answers can be found on the internet. It should be noted that virtual assistant Zintis gets gradually involved in providing answers.

The CRPC has provided the most consultations explaining regulatory enactments, which are not always within the competence of CRPC, therefore the persons to be consulted have been directed to the competent authority. Merchants are actively interested in the requirements specified in regulatory enactments for goods and services. There are still questions about the conformity of goods with contract terms and consumers' right to opt out of distance purchases, as well as other issues related to distance trade.

As the Covid-19 virus recedes, consumers are making trips again, so the number of applications received for aviation services has increased – 314, i.e. by 177 more applications than during the corresponding time period of 2021. Applications are still received regarding events that did not happen, as on 1 April 2022 all restrictions on the organisation of events were lifted and it was possible for merchants to fulfil their contractual obligations. However, both because several merchants failed to keep their businesses during the pandemic and because the war in Ukraine prevented several artists from arriving in Latvia, several merchants were unable to arrange the rescheduled events and consumers were unable to attend the event or receive cash refunds. For these reasons, 204 application were received, showing an increase of 52% compared to last year. Although the CRPC carries out a serious activity in the area of parking supervision, the number of applications received remains almost constant every year. In 2021, 91 applications were received, while in 2022 103 applications were received over the same period. In 2022, the number of applications for tourism services (52) decreased compared to 2021 (167). In 2021, consumers actively resolved issued with refunds for travels that did not happen during the Covid-19 crisis.

One of the most pressing problems for consumers is non-receiving distance purchases. In the nine months of 2022, 396 applications were received, while in 2021 519 applications were received over the same period. Also, in 2022, several merchants were stated who, according to the CRPC, abused consumer trust and cheated consumers. Consumers complained most often about the quality of electric goods, footwear, furniture and mobile phones. On 15 March 2022, amendments to the *Consumer Rights Protection Law* came into force, introducing new provisions on the purchase and quality of digital services, digital content or goods with digital elements, as well as aspects of consumer rights regarding the conformity of goods with the provisions of the contract were amended and clarified.

The European Consumer Centre (*ECC Latvia*) continues to provide support and information in case of unsuccessful EU cross-border purchases. *ECC Latvia* is a member of the European Consumer Centres Network (*ECC-NET*) that operates within the framework of CRPC with the EC's support. In the first nine months of 2022, consumers and businesses received 769 consultations and more than 501 complaints about cross-border problems within the EU have been dealt with. Many complaints and consultations were received about online shopping – complaints from residents of other EU countries about problems with Latvian e-undertakings, and residents of Latvia about online sales outlets registered in other EU countries. There were also many complaints about cancelled or rescheduled events. In the wake of the Covid-19 pandemic, the number of complaints and consultations about air travel and package travel has increased as active travel began again.

**Box 16.1 continued**

In the nine months of 2022, 211 proceedings on violations of the collective interests of consumers were initiated, including about implemented commercial practices and terms of contracts offered to consumers. However, in 206 cases violations were prevented voluntarily within the scope of preventive supervision activities without initiating a case. Cases were mostly initiated and preventive supervision was carried out in the field of advertising of tourism providers, online platforms and smoking products, as well as on *green notifications* in the field of fashion and cosmetics. Similarly, cases were initiated in relation to influencer marketing, financial services and debt recovery, as well as e-commerce (online stores that do not deliver goods). For example, in the field of tourism, cases were initiated through increased supervision, how the tourism service provider secures the money paid by the customer, as well as for the reimbursement of money to consumers from the sanctioned company LLC *TT Baltics*.

In the light of the energy crisis, in 2022, the CRPC, together with other supervisory authorities, is taking both supervisory and consumer outreach measures to make consumers more aware of their rights and opportunities, such as taking heat-saving measures, using allocators. At the same time, the CRPC is still dealing with issues that have arisen during the Covid-19 pandemic related to cancelled and rescheduled concerts. Given the further growth and topicality of influencer marketing, in the nine months of 2022, the CRPC performed both influencer monitoring and education measures. Upon the coming into force of a new regulation on the requirements for indicating prices, several information events have been organised for businesses and consultations were provided to help in the implementation of requirements. The resolution of the above-mentioned issues will continue in 2023.

In financial services, a negative trend in fraudsters' activities continued in 2022, with many consumers suffering major financial damage, when they were called and their bank account access information was defrauded using various methods, as well as asking to invest in dubious transactions with cryptocurrency or borrowing money. The CRPC actively engaged in consumer outreach campaigns, promoting financial literacy, regularly publishing warning notices, as well as discussing these problems with financial service provider associations. The CRPC also continued to pay close attention to how businesses evaluate in their commercial practices the ability of consumers to repay a loan, what crediting advertisements are and how appropriate the calculation of debts and other payments is.

Licencing and supervision of providers of consumer crediting services and debt recollection services, registration of and supervision of observation of general requirements by mediators in real estate credits continues. In view of the risks of insolvency, enhanced supervision and issuing/change of licences of tourism providers is carried out.

2022 was characterised by continued decline in the number of consumer lending providers, however, lending volumes, contrary to the previous period, increased significantly. As rising energy prices significantly boosted inflation, the CRPC discussed with financial industry associations being forthcoming and helping consumers in difficulty and called for increased standards for assessing solvency. The CRPC continues to monitor the regulation for anti-money laundering and countering the proliferation and financial of terrorism, as well as the regulation on sanctions of the Republic of Latvia and international sanctions in relation to providers of consumer crediting and out-of-court debt services.

The following priority axes are set by the CRPC for **market surveillance** in 2022: improvement of safety and conformity of goods and services in fields such as construction products, electrical appliances, personal protection equipment, machinery, explosive equipment, toys, pleasure boats, vehicles and their components, radio and telecommunication terminal units, unmanned aircraft, as well as ecodesign and energy labelling inspections. Dangerous equipment is inspected in the fields of supervision of elevators, cargo cranes and hoists intended for people. The most important work in state metrological supervision is related to water consumptions meters, measuring instruments at electricity and heat generation sites, as well as control of pre-packaged products in dairy companies.

In the nine months of 2022, the CRPC has inspected 945 goods through market surveillance. The highest number of inspections – 345 – are related to the labelling of electrical goods (non-conformities have been detected in 79% of cases). 110 transportable pressure vessels (gas cylinders) (non-conformities detected in 43% of cases), 87 toys (non-conformities detected in 71% of cases) and 72 radio equipment units (non-conformities detected in 44% of cases) have been inspected. 42 inspections of construction products have been carried out, including 87 inspections of models of construction product and 33 of them underwent expert examination of construction product samples in testing laboratories. 34 models of construction products were inadequate (39% of cases), including 15 models of construction products that were subjected to expert examination.

The CRPC inspected 34 unmanned aircrafts, with non-conformities found in eight models. Five samples of unmanned aircraft were taken for the expert examination and expert examination found one of them to be non-conforming. Ship equipment was subjected to 20 inspections, with non-conformities found in one model. Five samples have been submitted to a testing laboratory for expert examination, but the results are not yet known.

39 inspections were also carried out to control pre-packaged goods, examining 115 batches of pre-packaged goods (mostly in the dairy processing sector), and non-conformities were found in 35 or 30% of batches. 75 inspections of dangerous equipment were carried out, a total of 227 dangerous equipment units were inspected and 92 (40%) were found to be non-conforming. Most of the non-conformities were found in elevators – 34 units, of which 27 did not undergo technical inspection. 66 inspections were carried out – six within market supervision of measuring instruments and 60 within supervision of the use of measuring instruments. The main focus was on supervision of water consumption meters and inspections of electricity and heat production companies in cooperation with the State Construction Control Bureau. During market surveillance, 12 measuring instruments were inspected and seven of them or 58% were non-conforming. 302 measuring instruments were inspected with supervision of use, of which 79 or 26% were non-conforming.

In the nine months of 2022, 153 samples were taken. 94 samples of products were taken in various areas of consumption and technical products (including five samples of unmanned aircraft, five samples of ship equipment and five samples of electrical products to check conformity to ecodesign requirements), 33 samples were taken in the field of construction products and 26 samples in the field of measuring instruments.

The MoE is working closely with the CRPC to maintain a safe and stable tourism services market. When issuing a licence, the CRPC each time registers the tourism operator and the tourism agent in the *Database of Providers of Tourism Services.* A special permit (licence) is received by all tourism agents and tour operators who sell package travel services to travellers. This can increase consumer safety.

A tourism service provider has a duty to submit the following information to the CRPC once a quarter:

- the number of agreements on package travel services and agreements on the provision of related tourism services concluded with travellers;
- the number and amount of advance payments received from travellers;
- quarterly turnover in the field of package travel services and related tourism services.

By using the information received, the CRPC may ensure appropriate supervision of the sector and, if necessary, take precautionary measures in a timely manner so that consumers do not experience difficulties.

In 2022, the MoE, in co-operation with the CRPC, made amendments to CM Regulations No. 380 of 26 June 2018 *Regulations on the Procedure of Preparation and Provision of Complex and Related Tourism Service and Rights and Duties of Providers of Complex and Related Tourism Services and Travellers*. The purpose of the amendments is to improve the conditions regarding the rights and obligations of providers of package and related travel services, tourism agents and travellers, to lay down clear and proportional rules for the amount of security of the tour operator and providers of related travel services, moreover, to provide opportunities for the CRPC both to request the necessary information for surveillance and to react if non-conformities with the requirements of regulatory enactments have been determined.

# 17. COMPETITION POLICY

Provision of a fair competitive environment is also considered to be an essential element in promoting competitiveness in the country. A pressing topic in the competition policy is still supervising that companies do not breach the law and act fairly, as well as fostering of equal and non-discriminating competition between public administrative bodies (for example, state or local government capital companies) and the private sector.

Free and fair competition stimulates the development of businesses, allows consumers to get diverse goods of higher quality for competitive prices. Competition has become the foundation for the general economic competitiveness increase, promotion of efficiency of operations and innovation of businesses, as well as public welfare.

Moreover, the goal of the competition policy is to protect free and fair competition, promote its development in all national economy areas among market players, create new and innovative products, as well as to prevent different anti-competitive measures, incl. unjustified involvement of public administrative bodies in business.

The Competition Council (CC) is responsible for the implementation of the competition policy in the country. The CC investigates and prevents infringements of the competition law, controls market concentration, monitors that state and municipal regulatory enactments do not create unjustified obstacles for free and fair competition among companies, and educates the society, thereby promoting understanding about the competition law and contributing to intolerance towards distortion of competition. In order to strengthen the application of the competition law, the CC cooperates not only with other national level law enforcement institutions, but also with international level organisations and foreign competition supervisors.

For market surveillance to be effective, the CC has the right to set priorities in its activities to prevent above all severe violations of the competition law. When a smaller potential violation is identified, the CC uses alternative methods, incl. the public administration principle *consult first* allowing to preventively improve the competition environment in national economy sectors.

In 2022, the CC's activities focused on three main strategic lines (see Box 17.1):

- detection and prevention of significant violations of competition and market distortions, as well as prevention of unfavourable effect of market concentration;
- strengthening and growth of the CC capacity;
- promoting understanding of undertakings and public administrative bodies about free and fair competition, shaping competition policy and culture at national and international level.

According to the CC's practices and the results of the opinion poll of 2022, Latvia has two important issues in the field of competition: bid-rigging and distortions of competition caused by state and local governments or public administrative bodies, which often take the form of creating uneven conditions of competition, discrimination of entrepreneurs or pushing them out of the market.

In 2022, the CC devoted significant resources both to combating cartels, including discovering for a first time a prohibited agreement in the private procurement, and supervision of public administrative bodies. Public administrative bodies have been particularly topical on the CC's agenda since 2020, when amendments to the *Competition Law* came into force, which gave the CC broader powers to confront competition distortions caused by public administrative bodies. In order to prevent violations of competition neutrality, it is essential to ensure immediate changes in the conduct of a public administrative bodies, which also provides immediate benefits to the public, so the CC uses negotiation procedures as the most effective tool for preventing possible violations.

The CC has started to prepare summaries by sector or industry, emphasising the most important conclusions and challenges arising from the state and local governments shareholding in capital companies, for example, in the fields of health, public transport, house management, etc.

In order to identify barriers to free and fair competition in a timely manner, in 2022 the CC focused on sectors with significant influence in the national economy and on markets where rapid development is taking place or innovations are being introduced. The authority paid particular attention to digital markets and the energy sector, such as the retail fuel market and the woodchips market, which saw a sharp rise in prices in 2022 and negatively influenced general public.

In underperforming markets, the CC monitors and confronts abuses of dominant market position and prevents harmful concentrations of markets.

The CC needs to implement extensive communication activities both at national level and in the international environment to make entrepreneurs to understand the benefits of fair and free competition and also to act in good faith. The CC has defined the education of market participants on fair competition as one of the CC's main priorities.

The CC continues to develop tools that encourage entrepreneurs and public administrative bodies to control their own actions and participate in the prevention of competition violations, for example, by developing easy-to-use self-assessment tools. One of the plans for the future is to start developing a digital merger reporting tool for entrepreneurs.

The CC also participates in the identification and elimination of undue restrictions of competition in laws and other regulatory enactments, as well as in the process of improvement of the regulatory framework of competition law.

**Box 17.1**

**Activities of the Competition Council (CC) in 2022**

In order to ensure the detection of significant **competition violations and market distortions**, two forbidden agreements were detected in nine months of 2022, punishing a total of five companies, moreover, a settlement was entered into with two companies, and the companies will not appeal the CC's decision in court. One case of abuse of dominant position also completed, with CC entering into a settlement with *Rīgas Siltums* to stop the exploitative practice of recovering irrecoverable debts for heat. According to the settlement, *Rīgas Siltums* paid a fine of 201,329.64 euro into the state budget. A decision was also taken regarding a procedural violation in the activities of JSC *Liepājas Autobusu parks*. A fine of 43,704.68 euro was imposed on the company for non-cooperation with the CC during its procedural activities.

Using the *Consult First* principle, five preventive activities were implemented in cases of small market participants and minor potential violations, with a total of nine persons warned about possible violations of the *Competition Law*. On suspicion of a prohibited agreement, in the nine months four dawn-raids were carried out in a total of nine companies to obtain evidence of possible violations of the *Competition Law*. At the same time, in the nine months of 2022, 69 image copies obtained during the proceedings were analysed in search of evidence.

The CC has been able to ensure an **evaluation of merger** in 12 cases. In the nine months of 2022, an in-depth investigation was conducted in four merger cases: in the case of merger of JSC *Dobeles dzirnavnieks* and AB *Baltic Mill*, the parent company of JSC *Rīgas Dzirnavnieks*; in the case of merger of LLC *Tet* and LLC *Telia Latvija*; in the case of merger of JSC *TAK investīcijas* and LLC *Zaļā josta*; in the case of merger of JSC *AB CITY*, the parent company of JSC *Repharm*, and JSC *Olainfarm*. To prevent significant negative consequences for competition, the merger of JSC *AB CITY* and JSC *Olainfarm* was permitted with binding conditions. In other cases, the merger was permitted without any objections.

In the nine months of 2022, significant resources were devoted to the **representation of the CC in courts**, including proceedings in the so-called *Construction companies' cartel* case began. 23 decisions of the CC are in court in different instances. *Moller* group companies terminated proceedings in the *Volkswagen* dealer cartel case and paid to the state budget more than 7 million euro in fines imposed by the CC. The court also upheld the CC's decision on the detected cartel in the amelioration sector, as well as the CC's decision to prohibit *RIMI* to use of retail premises in *DOMINA Shopping* centre, which has been on trial since 2017.

The CC implemented several measures to integrate the **principle of competitive neutrality** among public administrative bodies. In the three quarters of 2022, the CC received more than 60 complaints regarding actions of public administrative bodies – state, local governments and their capital companies. In five cases, the CC carried out an in-depth investigation to ensure competitive neutrality. Possible competitive neutrality discrepancies were resolved in Ventspils, Liepaja, Jurmala, Riga and elsewhere. Affected markets include the real estate rental market, publishing market, residential house management, and are also related to trade regulation in municipalities.

**In order to promote understanding of fair competition among market participants**, in 2022 the CC participated in 27 educational events (seminars, webinars, conferences), where entrepreneurs and contracting authorities, as well as society as a whole were introduced with the Competition Law. At the same time, in 2022, active work started on developing seminar content for enterprises to better understand vertical agreements. Two seminars were held in 2022 and similar educational activities are planned in 2023.

In order to promote fair competition, a **self-assessment tool has been developed** for procurement organizers to identify cartels, as well as guidelines – what can be done and what should not be done by companies within the framework of mutual cooperation in the face of the challenges posed by the consequences of war, including shortages of raw materials. The CC has also prepared guidelines for entrepreneurs regarding the procedures for distribution of the imposed fine and a financial self-assessment tool for entrepreneurs, as well as a self-assessment tool for traders/suppliers regarding unfair trade practices.

In 2022, the CC has **maintained its high three-star rating in the international *Global Competition Review (GCR)* ranking** for the eighth consecutive year, ranking among the world's 32 leading competition authorities. Competition authorities of Belgium, Lithuania, Switzerland, Israel and other countries are ranked the same as Latvia's. More than 140 countries of the world have competition authorities, but only 32 of them are included in the GCR rating.

In order to ensure the detection of possible violations and the promotion of competition in all sectors of the national economy in the most efficient and qualitative manner, the CC needs to continuously develop and strengthen its institutional capacity in line with modern developments.

In 2022, work was completed on the transposition of Directive 2019/1/EU[1] of the European Parliament and of the Council into national legislation, thus contributing to promotion of fair competition in the internal market for the benefit of the

1 *Directive 2019/1 of the European Parliament and of the Council of 11 December 2018 to empower the competition authorities of the Member States to be more effective enforcers and to ensure the proper functioning of the internal market*

general public (including consumers). Namely, amendments to the *Competition Law* were adopted by the Saeima, which strengthen the CC with the necessary guarantees of independence, resources and enforcement powers for the effective investigation and prevention of infringements of competition law, in particular in the application of Articles 101 and 102 of the *TFEU*. The law also provides that the CC will continue to be under the supervision of the CM which will be achieved through the MoE, and that the capacity of the Council – the CC's decision-making body – should be increased from three to five Council members. The operational independence of the CC is strengthened by ensuring full independence of the institution in solving internal organisational issues of the institution.

Following amendments to the *Competition Law*, the CM also supported amendments to Regulations No. 179 of 29 March 2016 *Procedures for the Determination of Fines for the Infringements Provided for in Section 11(1), Section 13 and Section 14.[1] of the Competition Law and Sections 5, 6, 7 and 8 of the Unfair Retail Trade Practices Prohibition Law*, to determine the procedures by which the CC applies a fine for violations of the *Prohibition of Unfair Trading Practices Law* and to improve the methodology necessary for the calculation of a fine and the calculation of pecuniary penalty for violations of competition law.

In 2022, considerable time has been devoted to identifying and evaluating potential solutions to introduce a centralised compensation procedure (mechanism) by which losses caused by violations of competition law could be recovered from market participants on behalf of public contracting authorities, in order to ensure the protection of the rights and interests of the state and local government laid down in law. In accordance with the conclusions drawn, active work will continue to develop an informative report and forward it for review by the CM to decide on the measures to be implemented in the future, which would promote more active involvement of public contracting authorities in the recovery of losses, which have arisen due to violations of competition law implemented by market participants.

The CC continues to systematically demonstrate its effectiveness and public benefit from the implementation of fair competition policy. The authority's priority objective is not to penalise companies, but to raise awareness of fair competition among market participants and to prevent potential infringements. It is the benefit of consumers from competing markets that is one of the efficiency indicators of the CC, which the CC focuses on when carrying out both investigative, supervisory and educational activities. In 2022, the CC's calculated public benefit from competition supervision was 52 million euro. Taking into account the budget of the CC, each euro allocated to the authority has generated a public benefit of approximately 24 euro. At the same time, fines imposed by the CC and paid into the state budget are almost four times the budget of the authority. In 2022, companies have already paid more than 8 million euro into the state budget for violations of competition law.

Thus, the CC has confirmed its usefulness and contribution to the Latvian economy both in terms of public benefit and in terms of the fines paid by companies into the state budget. The guarantees of independence granted in 2022 will enable the authority to pursue directly its unrelenting efforts to strengthen its capacity, including its financial capacity, in order to bring even greater public benefits.

One of the main priorities of the CC in 2022 was to introduce legislative changes in the internal processes of the authority and explain them to market participants, so that changes to the law would benefit the business environment as a whole.

Similarly, in 2022, the CC strengthened its information technology capacity by setting up an ICT laboratory and planning training for employees so that they are able to use state-of-the-art ICT technical equipment for more efficient acquisition and processing of electronic evidence, paying particular attention to the development of an automated cartel screening tool. Additional resources are devoted to strengthening the authority's economic analysis capacity, which will ensure deeper and more economically accurate investigation of mergers, market surveillance, abuse of dominant position cases, etc., paying more attention to the economic assessment of the impact on competition.

In 2023, it is also planned to establish the CC Advisory Council in order to organise closer and more efficient cooperation with partners in matters of development and application of competition policy, for example, by providing the competition supervisory authority with recommendations regarding the operational strategy, competition supervision directions and possibilities for improvement of work, as well as opinions regarding the guidelines prepared by it, the case prioritisation strategy, priorities of operation of the CC and the activity report.

At the same time, proposals will also be prepared for the necessary improvements in regulatory enactments, so that after the adoption of new proposals of the European Parliament and the Council – the *Digital Markets Act* and the *Regulations on foreign subsidies distorting the internal market* – as EU legislation the legal system of Latvia would be adjusted to implement the duties and rights imposed on the Member State in the field of supervision.