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OPENING STATEMENT

We would like to deliver the *Report on the Economic Development of Latvia* 2021 prepared by the experts of the Ministry of Economics for your evaluation. The report assesses the economic situation, as well as forecasts the prospects of economic development.

The Covid-19 pandemic has had a strong and lasting impact on the socio-economic situation on a global scale and also in Latvia. I would like to note that Latvia has developed a clear strategy for overcoming the crisis caused by the pandemic at the end of May 2020. It provides for measures to restore our country's economic activity in three phases. In 2020, we implemented measures to stabilise the financial situation for citizens and entrepreneurs, but in the next two years we are taking measures to reorient the economy, with an emphasis on innovation, digital transformation, lifelong learning and focusing on structural economic change by purposefully adapting state aid mechanisms. From 2023 – in the growth phase – measures are provided to transform the national economy based on the dynamic development of exports of goods and services, ensuring economic growth through productivity growth, automation, digital transformation, support for business growth and fast-growing industries and ecosystems.

Although due to the pandemic situation is difficult, Latvia's economy has stabilized in 2021, and, according to the Ministry of Economics' forecasts, GDP growth could be close to 5% this year. This has been achieved by the excellent performance of entrepreneurs in exports, which has also been promoted by the support initiatives of the Ministry of Economics. Similarly, this year has been successful in attracting investment, which was also fostered by government policies, introducing the "green corridor" principle for priority investment projects. Although uncertainty about the impact of Covid-19 on economic development is still extremely high because it is unclear how long and widely the virus will continue to spread across Europe and globally, most experts predict that growth of 5% in Latvia will continue in 2022.

To boost economic growth and mitigate the effects of the Covid-19 crisis, entrepreneurs will also have access to a number of support programmes in 2022, contributing to economic transformation, productivity and digitisation, housing affordability, reducing inequalities, including rental and social housing, as well as energy efficiency. Next year, there are plans to launch the Recovery and Resilience Facility Plan and the EU Structural Funds support programmes for the new programming period for a total of over 1.6 billion euro in four investment directions – business digitisation, economic transformation and productivity promotion, reduction of regional inequalities, as well as mitigation of climate change mitigation and improvement of energy efficiency. In order to define priorities for economic development for the next seven years, on 16 February 2021 the Cabinet of Ministers approved the "National Industrial Policy Guidelines 2021-2027" developed by the Ministry of Economics, which aim to increase exports to 22 billion euro in 2023 and to 27 billion euro in 2027.

In 2022, we have found the possibility of creating two new support instruments important for entrepreneurs. 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. And also a loan programme for large investment projects with a capital discount will be created for the development of economic operators, competitiveness, increasing exports, providing financing for viable business projects.

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, and in 2022 it is planned to sign the agreement on economic cooperation between the government of the Republic of Latvia and the government of the Kingdom of Saudi Arabia, providing support to Latvian entrepreneurs in entering 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 will contribute 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 work on the 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 Latvia is implementing the "Consult First" initiative aiming to improve the mutual understanding between entrepreneurs and supervisory authorities, thus promoting the understanding fulfilment of requirements rather than entailing punishment. The objectives defined by the initiative have generally been achieved. First, the behavioural culture of controlling authorities has changed from primarily repressive to supportive. The created environment ensures that institutions can learn and master best practices. Second, the initiative contributed to effectivization

and optimisation of the processes by saving the resources of entrepreneurs, reducing the administrative burden, promoting better cooperation. Third, during the evaluation of the introduction of the "Consult First" principle, a positive assessment of the functioning of the institutions was received from customers (economic operators) – the overall *Customer Perception Index* reached an average of 83.03 index points (out of 100) in 2020, the total "Consult First" index is 83.51, respectively. And it has grown in a three-year period.

Provision of a fair competitive environment is also considered to be an essential element in promoting competitiveness. A pressing topic in the competition policy will still be fostering of equal and non-discriminating competition between public persons (for example, state or local government capital companies) and the private sector. In 2022, 6.7 million euro will be invested in ensuring fair competition, internal market and consumer protection. The possibility has also been found to strengthen the capacity of the Competition Council next year by providing additional financing of 168 thousand euro to more effectively comply with competition rules and to monitor the proper functioning of the internal market. Also, 287 thousand euro will be invested in the digitalisation of the processes and services provided by the Consumer Rights Protection Centre next year.

Prudent and meaningful deployment of electronic processes and the development 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 process and on the development of the construction sector. 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 emphasis on the training of industry professionals and the improvement of construction study programmes. The development of a single electronic system for registration of working hours was completed. The system collects data from electronic working time recording systems on the actual working time of employees on the construction site, as well as data on the construction contracts concluded within the framework of the implementation of the specific construction plan.

The Ministry of Economics continues to take targeted measures to boost the competitiveness of the construction sector and to improve quality. In order to ensure the quality of the construction process, it is important to further improve the regulatory framework in the field of construction. In 2021, the Saeima approved amendments to the *Construction Law* relating to the strengthening of responsibility of participants of the construction process. The Ministry of Economics has also developed a number of amendments to the *General and Special Construction Regulations*, as well as improved and updated provisions of construction standards.

Since the launch of the housing guarantee programme in 2014, it has helped more than 18 thousand families with more than 27 thousand children to get housing of adequate size and quality. The total amount of guarantees during the programme was more than 143 million euro.

9.1 million euro in total were allocated for continuation of the housing guarantee support programme and the support programme "Balsts" implemented by the Development Finance Institution Altum in 2022. The housing affordability support programmes play a role in boosting family safety and planning family growth, the programme promotes the development of the real estate market by increasing the number of real estate sales transactions and construction of residential buildings, and the programme has a significant impact on the mortgage market.

An active support programme for the construction of affordable rental houses was developed in 2021, so that in 2022 developers can apply for loans for the construction of up to 700 of such housing units, which will be available to households unable to afford housing on market conditions.

Considerable activities are implemented in the energy sector, which will allow to increase competitiveness of companies.

71.5 million euro were reserved in 2022 for the implementation and monitoring of energy policy, including the reduction of the total costs of mandatory procurement (MP), while 43.6 million euro in the state budget of 2022 are expected to be channelled to support electricity users, support protected users and energy-intensive companies. This support essential both in terms of consumer solvency and energy poverty reduction and in terms of improving international competitiveness of companies, including exports. 26.6 million euro will be spent to maintain oil reserves and 439 thousand euro will be invested in monitoring the implementation of energy policy, the development of a reporting system and ICT solutions.

The development of both gas and electricity infrastructure, as well as diversification of supply routes and sources is important in Latvia at national and regional level, keeping in mind the importance of reduction of energy dependence and long-term decarbonisation goals. In view of the effects of the Covid-19 pandemic, including rising energy prices, particular attention in 2021 was paid to the development of various support mechanisms for households and entrepreneurs.

Active work continues for the development of electricity infrastructure, strengthening of national energy security and integration of the electricity market. The project for synchronization of power grids of Baltic countries with the network of the continental Europe is particularly important for the Baltic States to stop their dependence on Russian and Belorussian

power supply systems and fully integrate them in the European Union electricity market. It is planned to implement this project by the end of 2025.

The establishment of a single natural gas market 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 among regulatory authorities, natural gas transmission system operators and ministries responsible for the sector of the Baltic countries and Finland. The initial participants of the single market area are Finland, Estonia and Latvia, but there are plans to develop the market providing benefits to all players, and also users, of this market, and other European Union Member States will be urged to join it.

On 4 February 2020, the government approved the Latvia's *National Energy and Climate Plan 2021– 2030*, which sets the main action policies and measures for the fulfilment of GHG emissions reduction targets, including targets in energy activities – promoting the use of renewable energy sources and improving energy efficiency; targets were also set in other dimensions of the Energy Union, such as energy security and the internal energy market, research, innovation competitiveness dimensions.

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!

Jānis Vitenbergs,
Minister of Economics

December 2021

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ABBREVIATIONS, MEASUREMENT UNITS, AND SYMBOLS

Abbreviations

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
NCCB	National Construction Control Bureau
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-28	European Union Member States after the enlargement on 1 July 2013
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
IDAL	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
NDP2020	National Development Plan of Latvia 2014-2020
NDP2027	National Development Plan of Latvia 2021-2027
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
TWh	Terawatt-Hour
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 2011 to 2019, GDP grew by 3.3% per year on average.

The Covid-19 pandemic, which in Latvia started in March 2020, has a significant impact on economic development. Like in nearly all countries around the world, in 2020, the economy of Latvia was in recession and the labour market was affected. GDP shrank by 3.6% in Latvia in 2020. With the epidemiological restrictions still in place, there was also a downturn in the economy in Q1 2021 (a drop by 0.7%). However, since spring, when seasonal work resumed and the epidemiological situation improved due to vaccination, economic activity has been gradually increasing. GDP was 10.8% higher in Q2 2021 and 5.1% higher in Q3 2021 than a year ago. At the end of Q2 2021, the economy exceeded levels before the Covid epidemic. In the 3 quarters of 2021, GDP increased by 5.2% compared to the corresponding period of 2020.

The Ministry of Economics forecasts that in 2021 overall economic growth could be close to 5%. While uncertainty about the impact of the Covid-19 crisis on economic development is still extremely high, the relatively high vaccination coverage suggest that in future, different restrictions could be significantly more moderate. That makes it possible to expect that **economic growth could exceed 5% in 2022**. The intensification of the pandemic may reduce the pace of economic growth, but not growth itself.

Table 1.1

Latvia: Key Figures of Economic Development

	2015	2016	2017	2018	2019	2020	2021f	2022f
Gross domestic product (at current prices, billion euro)	24.6	25.4	27.0	29.2	30.6	29.5	32.3	34.9
changes as per cent								
Gross domestic product	3.9	2.4	3.3	4.0	2.5	-3.6	4.8	5.4
Private consumption	2.1	3.4	2.8	2.9	0.2	-7.6	5.2	5.7
Public consumption	2.7	2.3	3.3	1.7	3.4	2.6	4.8	3.0
Gross fixed capital formation	-2.0	-8.2	11.4	11.8	6.9	0.2	4.6	7.0
Export	3.0	3.9	6.4	4.5	2.1	-2.2	5.6	5.6
Import	1.6	3.6	8.6	6.4	3.0	-2.5	12.3	5.4
Consumer prices	0.2	0.1	2.9	2.5	2.8	0.2	3.3	5.5
as a percentage in relation to the GDP, unless indicated otherwise								
General government sector balance	-1.4	0.2	-0.8	-0.8	-0.6	-4.5	-9.3	-4.9
General government debt	37.1	40.4	39.0	37.1	36.7	43.2	49.6	50.0
Export-import balance	-1.7	0.3	-0.6	-0.7	-0.7	1.2	-1.9	-0.9
Changes in the number of the employed (15-74 years of age, % compared to the previous year)	1.3	-0.3	0.2	1.6	0.1	-1.9	-2.8	1.5
Employment rate	60.9	61.6	62.9	64.5	65.0	64.2	62.8	64.1
Unemployment rate (unemployed, % of the economically active population, 15-74 years of age)	9.9	9.6	8.7	7.4	6.3	8.1	7.5	7.0
Average gross wage changes (% compared to the previous period)	6.9	5.0	7.9	8.4	7.2	6.2	10.1	8.3

f – forecast

The Covid-19 crisis has had a significant impact on consumption. As employment and wages were growing, consumption was growing stably until the Covid-19 pandemic, except in 2019. The increase in unemployment and the drop in income caused by the Covid-19 crisis has reduced consumption of households considerably – in 2020, it was 7.6% lower than a year before. In the 3 quarters of 2021, private consumption increased by 4.6% compared to the corresponding period of 2020 due to the base effect. However, private consumption is still low compared to 2019. The support measures implemented by the government to mitigate the negative effects of the Covid-19 pandemic and largely funded at the expense of increasing the state budget deficit, have maintained a positive increase in public consumption. In 2020, it was 2.6% higher than a year before and continued to grow in the 3 quarters of 2021 (4.9% over the year).

The Covid-19 crisis has had a relatively more modest impact on investments. Despite the general reduction in economic activity in 2020, investment increased by 0.2%. There are also positive trends in 2021 – investment in gross fixed capital formation in 3 quarters increased by 4.9%. Although investment in buildings and structures declined during this period year-on-year, investment in machinery and equipment and intellectual property products increased by 16.0% and 18.3% respectively. Investment is expected to continue to grow, driven by the improvement in the economic climate and by significant investment of EU funds. Despite the Covid-19 crisis, net FDI flows attracted to Latvia in 2020 amounted to 887 million euro, that is, 10.2% more than in 2019, and reached 3% of GDP. In the nine months of 2021, net FDI flows attracted to Latvia amounted to 1322 million euro, that is, by 724 million euro more than a year before, and accounted for 5.6% of GDP. The increase in FDI was largely determined by the increase in reinvested profit, which increased almost 2.5 times compared to the corresponding period of the previous year.

Exports of goods play an important role in mitigating the negative effects of the Covid-19 pandemic. In 2020, due to the Covid-19 restrictions in external markets exports decreased by 2.2% in general, while exports increased by 6.4% in the 3 quarters of 2021 year-on-year as the situation on external markets stabilised. Trends in exports of goods and services vary greatly. Exports of Latvian goods grew by 6.4% in 2020 and by 7.7% in the 3 quarters of 2021. The biggest contribution to the increase in exports of goods was given by the increase in exports of machinery and electrical equipment. A significant increase in exports in 2020 was also observed in the food and agricultural product group, as well as in plastics and their products, and in the 3 quarters of 2021 – in exports of wood and its products.

At the same time, **exports of services are significantly below pre-crisis levels**. They fell 21.7% in 2020. The fall was largely influenced by exports of aviation and tourism services affected by the Covid-19 pandemic restrictions, as well as by a drop in exports of transit services. Although the situation has stabilised in 2021 and overall exports of services slightly increased in 3 quarters (by 2.4% year-on-year), its return to pre-crisis levels will take longer.

Since 2011, Latvia has been experiencing low current account deficit, which proves the Latvian economy is externally balanced. The state of the current account in 2020 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. In 2020, the account balance improved compared with 2019, reaching a surplus of 2.9% of GDP. In the nine months of 2021, however, the current account has deficit again – 4.9% of GDP. In the coming years, despite the negative impact of the Covid-19 pandemic on economic development, 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. In 2020, under the influence the Covid-19 crisis accommodation and food service activities, and also arts, entertainment and recreation sectors experienced the most significant drop in volumes. The Covid-19 restrictions also had a significant impact on aviation, land transport and rail companies. There was also a considerable decrease in volumes in financial and insurance activities, information and communication services and business services sectors. Manufacturing was less affected by the pandemic. There was a small decline in manufacturing in 2020 largely affected by the 1st wave of the considerable industry slowdown crisis in March, April and May 2020. In 2020, volumes in agriculture and forestry, construction and public services increased.

In 2021, the Covid-19 pandemic continued to affect sectors with high levels of social contact, while sectors more focused on export of goods developed more successfully. In the 3 quarters of 2021, accommodation and food service activities, and also arts, entertainment and recreation sectors have had the most significant drop in volumes, with a decline of 12.2% and 10.4% across the year, respectively. At the same time, production volumes also decreased in construction (by 4%), which has been largely affected by rising costs, particularly by a significant increase in prices of timber and metals. This has had a negative impact on both existing construction projects and has slowed down new ones. Volumes of agriculture, forestry and fishery decreased (by 4.1%) due to less favourable weather conditions. There was also a slight drop in real estate activities.

In the other key sectors, economic activity increased during the 3 quarters of 2021 compared to the corresponding period of 2020. Investments in health care related to limiting the Covid-19 pandemic have contributed to growth of the sector over that period by 26.3%. Financial and insurance activities also increased rapidly (by 18.8%). Volumes in transportation and storage increased by 4.8%, driven largely by the recovery of the aviation sector during the summer months, as well as by increases in warehousing and support activities for transportation. Volumes in information and communications were 8.9% higher in 3 quarters than a year before driven by an increase in volumes of both information service activities and computer

programming activities. Volumes in trade grew 8.5% year-on-year. The rise was in both trade and repair of motor vehicles and motorcycles and in wholesale and retail trade. Manufacturing grew by 8.4% in the 3 quarters of 2021, driven by growth in woodworking, chemical industry, manufacture of furniture, metalworking and electronics sectors.

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* was activated in the EU, enabling EU countries to increase their general government deficits in 2020, 2021 and 2022 to the extent necessary to mitigate the economic harm caused by the pandemic. In 2020, due to the Covid-19 pandemic, the budget deficit of Latvia increased to 4.5% of GDP, or 1.3 billion euro.

The Saeima approved the budget for 2021 with a deficit of 9.3% of GDP. The high deficit comes from the large package of support measures for Covid-19 mitigation and economic recovery, the impact of which is estimated to amount to 2.2 billion euro or 6.9% of GDP. **The budget for 2022 was approved with a deficit of 4.8% of GDP**. It provides that the majority of support measures related to the Covid-19 crisis will be terminated. Latvia has used the cancellation of deficit restricting regulations, its low level of government debt and low interest rates to finance in the budget of 2022 many of the country's pressing needs and to reduce the tax burden. This has been done assuming that additional current expenditure does not increase government debt by more than one percentage point and that its increase would not exceed economic growth.

The banking sector has managed to maintain its stability after the economic shock caused by the Covid-19 pandemic. It works with profit. However, 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 crisis in the banking sector were mitigated by state support measures, but uncertainty remains relatively high in the banking sector.

Since the Covid-19 epidemic has a negative impact on economic development, **average annual inflation in 2020 was just 0.2%, significantly lower than in 2019.** The biggest lowering impact came from the fall in energy prices caused by a sharp drop in world prices for petroleum products and by falling prices for wearing apparel and footwear. As the pandemic is backing down, consumer prices have started to rise. Prices were rising very rapidly in the eleven months of 2021. Consumer prices rose by 7.5% in November 2021 compared to November 2020, showing the steepest rise since 2008, driven by the economic recovery following the crisis caused by Covid-19 and by rising world prices.

In November 2021, annual average inflation was 2.6%. Consumer prices are expected to stabilise in 2022, but given the base effect, average annual inflation in 2022 is expected to be above the level seen in 2021 and can reach 5.5%. At the same time, it will still be determined by world price fluctuations.

The introduction of the measures to restrict Covid-19 had a significant impact on the situation in the labour market. Since mid-March 2020, when the measures to restrict Covid-19 were introduced, the labour-intensive industries directly linked to population movements and gathering were most negatively affected. Overall, in 2020, the number of employees decreased by 1.9%, or about 17 thousand, which has been the largest drop in the number of employees since 2010. Unemployment also increased significantly with the decline in population employment. In 2020, the unemployment rate in Latvia was 8.1%, significantly exceeding the level of 2019 – by 1.8 percentage points. At the same time, it should be noted that state support programmes, such as subsidised jobs and downtime benefits, significantly mitigated the negative effects of the crisis caused by Covid-19.

A gradual improvement in the epidemiological situation has led to improvements in the labour market. The unemployment rate has been declining since mid-2020 and continues to reduce also in 2021. In October 2021, it was 6.7%, i.e. 1.1 percentage points below the level of October 2020. **The crisis has still left visible "traces" in the labour market**. The number of the employed and the employment rate are still significantly lower than in 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 protracted crisis has increased the share of long-term job seekers, which, together with regional labour market disproportions, may pose structural unemployment risks in the coming years, as well as exacerbate the problem of availability to labour force. In the 3 quarters of 2021, the number of people employed was nearly 32 thousand or 4% lower than in the corresponding period of 2020. It should be noted that the employment rate of the population in this period decreased by 1.9 percentage points year-on-year, and it is 2.4 percentage points below the pre-crisis level (3 quarters of 2019).

Overall, the labour market situation is expected to continue to improve, contributing to the growth of new jobs and the reduction of unemployment. It should be taken into account that it may become increasingly more difficult to find skilled specialists, particularly in sectors like construction and manufacturing, which can exacerbate regional labour market disproportions even further. In 2021, the total number of employees could be 2.8% lower than a year before, while the unemployment rate would fall to an annual average of 7.5%. In 2022, the number of employees is expected to increase by 1.5% or 13 thousand, and unemployment is expected to fall to an average of 7%.

Despite the widespread impact of the Covid-19 crisis on the labour market, the overall **wage dynamics still remains upward**, driven by the increase in the share of both higher qualification and better paid jobs in the labour market and also by limited labour supply. The average monthly gross wage increased by 10.4% in Q3 2021, compared to the corresponding period of

the previous year, rising to an average of 1,280 euro per month, which has been the steepest average wage growth in the past 13 years. The increase in average wages in 2021 has been 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 in the labour market, taking into account the significant job cuts compared to the pre-crisis period, both in accommodation and food service activities and in the retail sector, where wage levels have so far been significantly lower than the economy average.

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. A positive pressure on wages keeps coming from the wage convergence process closer to the level of wages of the EU's economically developed countries and from the growing shortage of skilled labour – shrinking of the labour market, which makes it necessary for entrepreneurs not only to think more actively not only about how to attract new specialists, but also how to keep existing ones, including through a review of wage rates.

Further economic development in the medium terms 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. 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.

The Latvian economic competitiveness is mainly based on technological factors, improvement of production efficiency, innovation and digitalisation, 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 growth in Europe weakens and measures to restrict Covid-19 endure, the pace of economic recovery might be slower.

2. GLOBAL ECONOMIC DEVELOPMENT

The global economic recovery continues; however, new waves of the pandemic and the spread of more contagious strains of the virus have slightly slowed down growth rates. The number of deaths reported due to Covid-19 has already exceeded 5 million worldwide, and public health risks may hinder a complete return to normality. Pandemic outbreaks in critical links of global supply chains have led to supply disruptions that are longer than expected, further promoting inflation in many countries. Overall, risks have increased and policy compromises have become more complicated. The European Commission forecasts global growth to reach 4.5% in 2022[1].

Table 2.1

GDP Growth Rate
changes compared to the previous year, as per cent

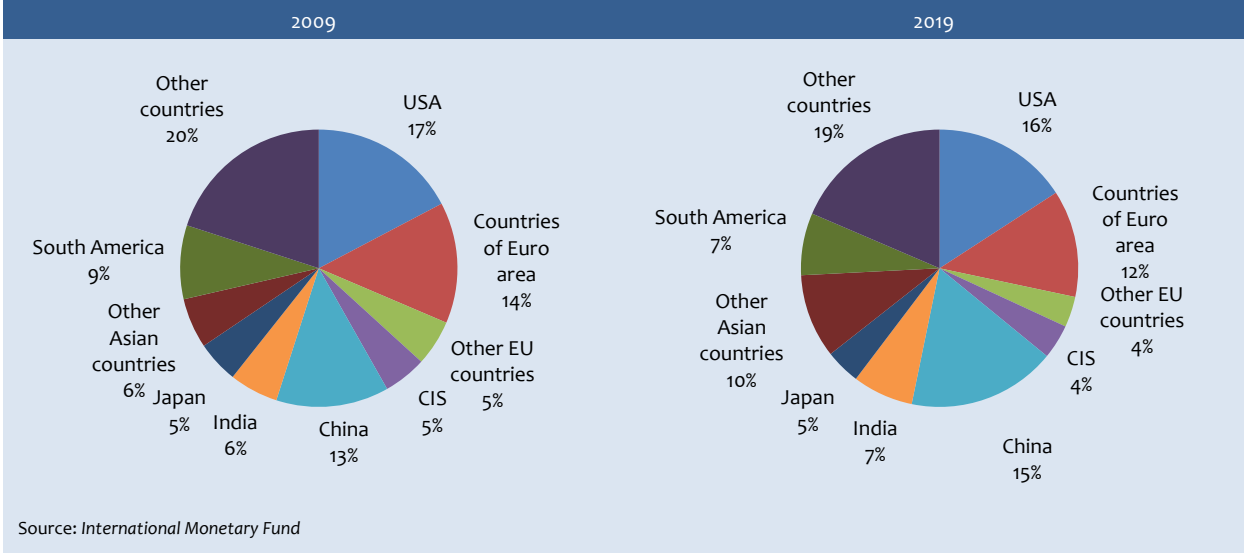
	2018	2019	2020	2021f	2022f
World, including:	**3.5**	**2.9**	**-2.9**	**5.8**	**4.5**
USA	2.9	2.3	-3.4	5.8	4.5
Japan	0.6	0.3	-4.8	2.4	2.3
EU, including:	2.1	1.8	-5.9	5.0	4.3
Euro area	1.8	1.6	-6.4	5.0	4.3
Russia	2.8	2.0	-3.0	3.9	2.6
China	6.7	6.0	2.3	7.9	5.3

Source: *European Commission – European Economic Forecast, Autumn 2021*
f – forecast

The US economy quickly recovered in late 2020 and early 2021. However, the growth rate has declined in recent months as supply-side bottlenecks have limited activity, vaccination rates have fallen sharply, and the incidence of Covid-19 increased in summer. Inflation has also risen, reflecting base effects, rising energy prices, and temporary supply restrictions.

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: *International Monetary Fund*

[1] Unless other source is specified, the data in this chapter is taken from the edition "*European Commission – European Economic Forecast, Autumn 2021*" https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2021-economic-forecast_en

Private consumption and investment are projected to be the main drivers of US economic growth in 2022, as the uncertainty associated with the pandemic will ease and households will reduce their savings accordingly. The phase out of fiscal support from previous economic stimulus programmes and the relatively high inflation rates will, however, have a negative impact on revenue and expenditure.

A rapid economic recovery in China and successful restriction measures have also contributed to a relatively rapid economic recovery in the nearest Asian countries, e.g., Korea, Vietnam, Taiwan.

China's economic growth is projected to be 5.3% in 2022. China's economy is weakened by sluggish private consumption, weak lending growth, and persistent turbulence in the real estate sector. Policy priorities vary from maintaining a predetermined high level of growth to managing China's economic and social imbalances. Short-term risks focus mainly on the real estate, energy, and transport sectors. Meanwhile, geopolitical tensions are expected to dominate in the medium term. China's policy focus has recently shifted to tighter corporate debt management, particularly in the real estate sector, reaching ambitious climate change targets, tighter internet economy regulation, and addressing social inequalities.

Table 2.2

Main Macroeconomic Indicators of the EU Member States
as per cent

	Real GDP			Inflation			Unemployment rate		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
European Union	**-6.4**	**5.0**	**4.3**	**0.3**	**2.4**	**2.2**	**7.9**	**7.9**	**7.5**
United Kingdom	-9.7	6.9	4.8	1.0	2.4	3.2	4.5	4.9	4.7
Austria	-6.7	4.4	4.9	1.4	2.7	2.5	5.4	5.0	4.6
Belgium	-5.7	6.0	2.6	0.4	2.7	2.3	5.6	6.2	6.3
Bulgaria	-4.4	3.8	4.1	1.2	2.4	2.9	5.1	5.1	4.6
Czech Republic	-5.8	3.0	4.4	3.3	3.3	3.4	2.6	2.7	2.6
Denmark	-2.1	4.3	2.7	0.3	1.7	1.9	5.6	4.8	4.5
France	-7.9	6.5	3.8	0.5	1.9	2.1	8.0	8.0	8.0
Greece	-9.0	7.1	5.2	-1.3	0.1	1.0	16.3	15.3	15.0
Croatia	-8.1	8.1	5.6	0.0	2.2	2.0	7.5	6.7	6.2
Estonia	-3.0	9.0	3.7	-0.6	4.0	3.9	6.8	6.8	5.7
Italy	-8.9	6.2	4.3	-0.1	1.8	2.1	9.2	9.8	9.3
Ireland	5.9	14.6	5.1	-0.5	2.3	3.1	5.7	7.5	6.8
Cyprus	-5.2	5.4	4.2	-1.1	1.9	1.7	7.6	7.5	7.1
Latvia	-3.6	4.7	5.0	0.1	3.1	3.6	8.1	7.3	6.9
Lithuania	-0.1	5.0	3.6	1.1	3.8	3.1	8.5	7.1	6.3
Luxembourg	-1.8	5.8	3.7	0.0	3.2	2.2	6.8	6.1	5.8
Malta	-8.3	5.0	6.2	0.8	1.1	1.6	4.3	4.0	3.8
Netherlands	-3.8	4.0	3.3	1.1	2.1	2.2	3.8	3.5	3.6
Poland	-2.5	4.9	5.2	3.7	5.0	5.2	3.2	3.3	3.1
Portugal	-8.4	4.5	5.3	-0.1	0.8	1.7	6.9	6.7	6.5
Romania	-3.9	7.0	5.1	2.3	4.0	4.0	5.0	5.0	4.8
Slovakia	-4.4	3.8	5.3	2.0	2.8	4.3	6.7	6.8	6.4
Slovenia	-4.2	6.4	4.2	-0.3	1.7	2.1	5.0	4.6	4.5
Finland	-2.9	3.4	2.8	0.4	1.8	1.9	7.8	7.7	6.9
Spain	-10.8	4.6	5.5	-0.3	2.8	2.1	15.5	15.2	14.3
Hungary	-4.7	7.4	5.4	3.4	5.1	4.8	4.3	4.1	3.1
Germany	-4.6	2.7	4.6	0.4	3.1	2.2	3.8	3.6	3.4
Sweden	-2.8	3.9	3.5	0.7	2.4	1.9	8.3	8.2	7.1

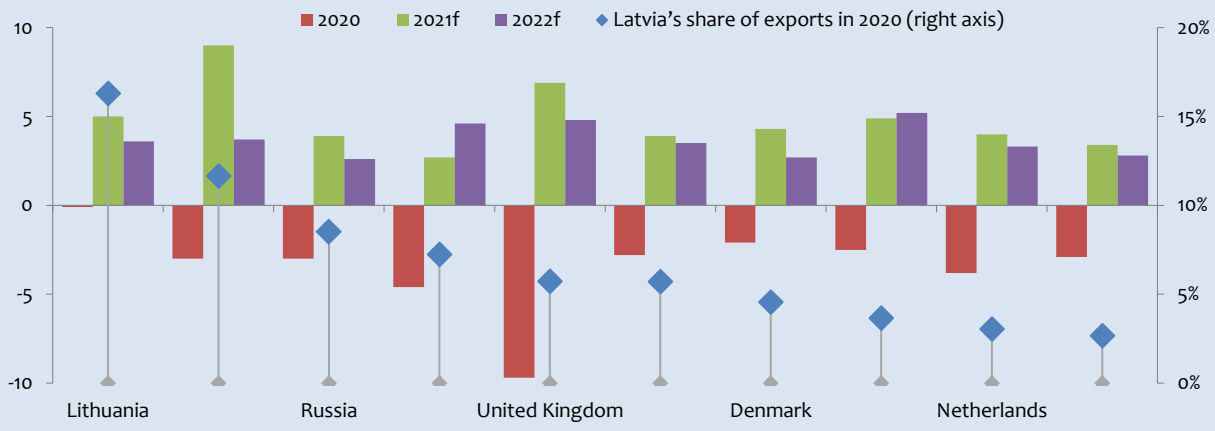
Source: *European Commission – European Economic Forecast, Autumn 2021*
f – forecast

In **Japan**, following moderate growth in 2021, with the continued spread of Covid-19 and the re-introduction of containment measures, real GDP is expected to reach 2.3% in 2022. Economic growth will remain moderate in the future, as rapid post-pandemic growth is gradually becoming more moderate and supportive fiscal policies are reduced. On the domestic side, private consumption will remain stable at the beginning of 2022, as services continue to resume and the situation in the labour market improves.

Following the decline in Q2 2021, due to an outbreak of Covid-19, **India's** economy is recovering fuelled by rising domestic demand. Economic growth is also driven by exports. Economic growth is anticipated to remain at a high level in 2022, with real GDP rising by 7.8%.

Figure 2.2

Economic Development of the Main Partner Countries of Latvia
Annual real GDP growth, as per cent



Source: *CSB, European Commission – European Economic Forecast, Autumn 2021*
f – forecast

Euro area economy operated from 25% to 30% below its capacity during the strictest restrictions. It is estimated that the Euro area economy increased by around 5% in 2021. In 2022, growth rates will slow down to 4.3%.

Real GDP in **Germany** is expected to grow by 2.7% in 2021. Real GDP is forecast to increase by 4.6% in 2022. Easement of containment measures has contributed to increased spending in the services sector in recent months; however, supply bottlenecks are slowing production and limiting export and investment growth. Shortage of materials, higher energy prices, as well as the base effect are likely to increase pressure on inflation in the coming months as well. However, the economy and the labour market will recover. Fiscal deficit is projected to reduce in 2022 and 2023 as policy support is withdrawn and the economy shifts from recovery to expansion.

Despite supply chain disruptions, economic growth of **Sweden** remained strong in the second half of 2021, driven by private consumption and investment. In 2022, GDP growth is projected to be 3.5%. Growth rates will remain relatively high in 2022; however, it will fall slightly in 2023 as recovery impulses fade. The disruption of supply chains and the related temporary closure of factories will hinder production and prevent stocks from replenishing quickly, while the rise in inflation reduces the growth in disposable income.

In 2022, growth of the **United Kingdom** is projected to slow down due to supply shortages, higher unemployment, and rising inflation. This impact is expected to decrease over time, while the withdrawal of the United Kingdom from the EU will continue to have an impact on trade and growth. Real GDP is projected to grow by 4.8% in 2022.

Economic growth rates in **CIS countries** have accelerated in recent years, which was largely underpinned by the economic recovery after recession in the previous years. Improved trade terms, favourable external environment, less volatile macroeconomic conditions, lower inflation, stable currency exchange rates, and growing oil prices have created a favourable environment for regional development in recent years. Yet geopolitical tensions and new strains of Covid-19 cloud the outlook.

Although in autumn 2021 vaccination levels are low and mortality from Covid-19 high, real GDP in **Russia** has exceeded pre-pandemic levels. In future, growth will be affected by a decisive improvement in Russia's trading conditions and by fiscal revenue, which will provide an opportunity to increase expenditure and consumption. Real GDP is expected to grow by 2.6% in 2022.

The disputed presidential elections in August 2020 triggered a wave of large-scale demonstrations; however, the **Belarusian** authoritarian president A.Lukashenko has reinforced his control in power with Russia's economic and political support. Western sanctions will not have an impact on the internal political situation. The economy showed relatively good indicators in 2021. However, growth will be moderate in 2022-2023. A high burden of external debt, economic isolation, and slow vaccination will have a negative impact on economic development.

Ukraine is expected to recover slowly from the pandemic, and economic output will only return to levels of 2019 in 2022. There is another outbreak of tensions in relations with Russia. Following a 4% drop in real GDP in 2020, economic growth is expected to reach 3.5% and 3.6% in 2021 and 2022, respectively.

Although there was an unprecedented decline in the economy in 2020, it was more moderate in the **Baltic States** than in most EU Member States.

Lithuania's economy returned to its pre-pandemic growth path in 2021. While the unemployment rate remains high, strong economic growth leads to increased labour shortages, affecting development of wages. In 2021, higher tax revenue than expected ensures smaller general government budget deficit. In the future, although growth will remain moderate, the economy is expected to continue to be supported by the good financial standing of companies, savings of households and household income growth. Real GDP is projected to grow by 3.6% in 2022.

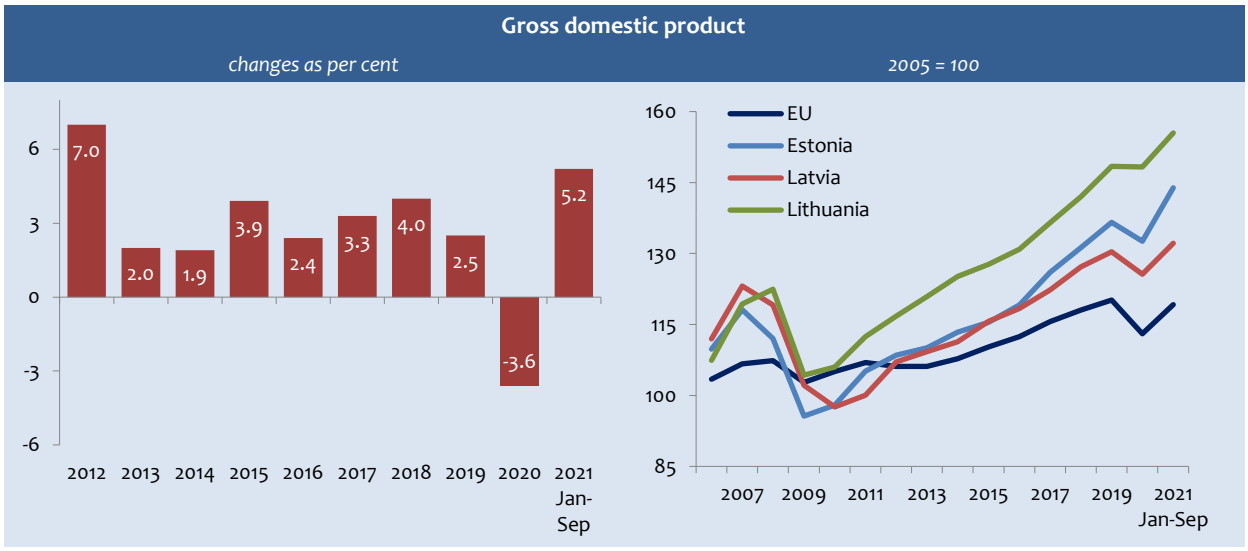
Following a moderate fall in 2020, **Estonia's** GDP is expected to grow by 9% in real terms in 2021, driven by private demand, government incentives and booming exports. Growth is expected to remain strong in 2022-2023, driven by the employment recovery, sustained wage growth and dynamic external demand. Inflation is expected to rise sharply this year, driven by a transitory increase in prices of imported energy, which gradually shifts to other goods and services. The government deficit is projected to fall to 2.2% of GDP in 2023, with public debt remaining the lowest in the EU.

3. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

3.1. DYNAMICS AND STRUCTURE

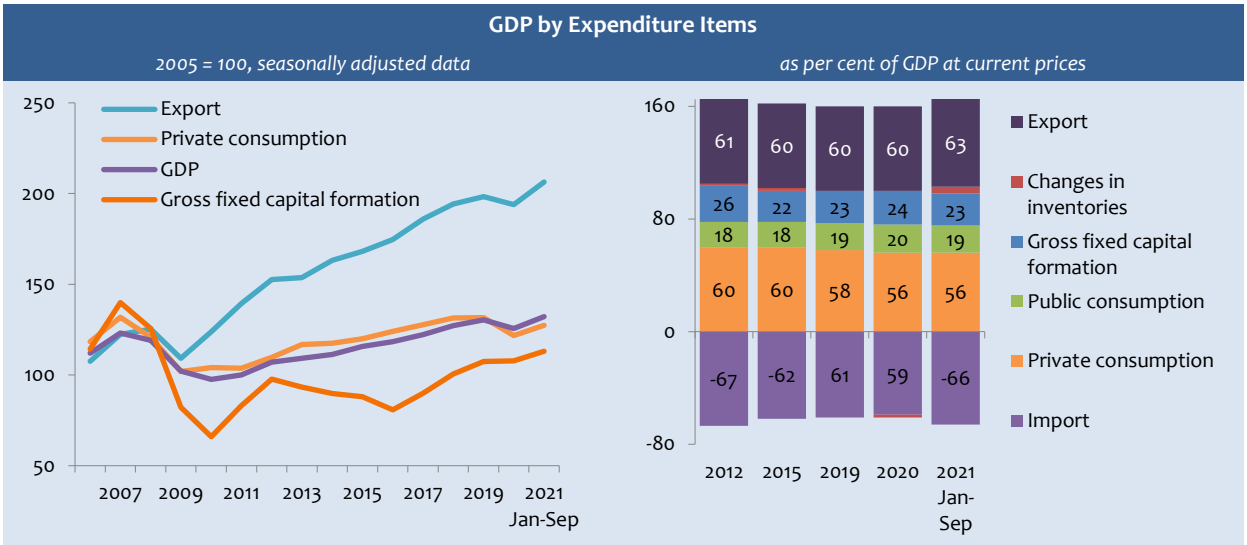
Since 2011, economic growth in Latvia has been one of the most rapid in the EU. In 2011-2012 it reached 4.8% per year on average. During the first years after the crisis, Latvia's economic growth was largely based on an increase in export volumes. The share of exports increased by 19 percentage points – from 42% of GDP in 2009 to 61% of GDP in 2012. From 2013 to 2019, economic growth was slower due to different factors. Overall, GDP was growing by 2.8% per year on average during this period.

Figure 3.1



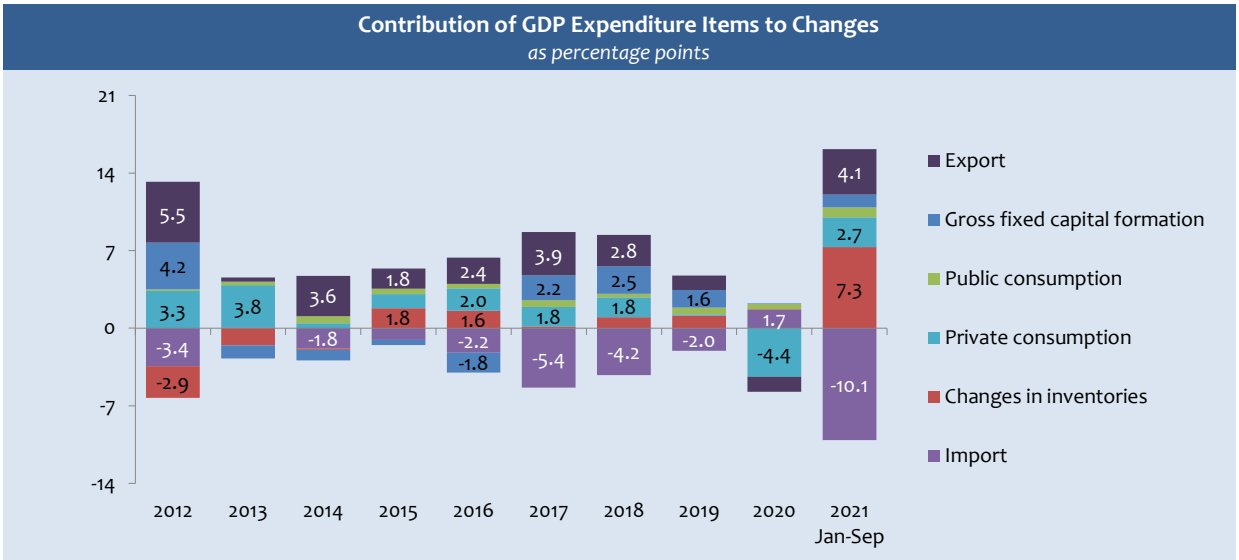
In 2013-2014, the slower economic growth rates were influenced by trends in the external environment – growth in the EU that was slower than previously expected, as well as weakening of the economic situation in Russia. Even though the geopolitical situation in the region was tense, the Latvian economy grew more rapidly in 2015 due to the more rapid increase in private consumption and export volumes. Growth was comparatively weak in 2016 due to the drop in investments and delayed implementation of the EU new programme of the structural funds.

Figure 3.2



Growth became more rapid in 2017-2018 fostered by the improvement of the situation in the EU, the commencement of a new programme of the structural funds, 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, etc., and external factors – revision of global trade relations, *Brexit*, slower growth in the EU countries.

Figure 3.3



Economic development in 2020 was mainly dependent on the negative effects of the Covid-19 crisis. GDP fell by 3.6% in 2020 showing the steepest drop in the past decade. 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 amounts in conditions of the Covid-19 crisis were comparatively stable and even slightly increased. 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.

Economic development in Q1 2021 was still underpinned by the negative effects of the Covid-19 crisis, while in Q2, largely due to the base effect, the economy experienced rapid growth. It also continued in Q3, and GDP has grown by 5.2% in the three quarters of 2021. The biggest impact was from the increase in exports, thanks to the favourable atmosphere in Latvia's

largest export markets. The base effect also provided a rapid increase in household consumption. This year, positive investment trends continued in the field of investment, with government consumption continuing to grow, driven by the continuation of the support measures implemented by the government due to the Covid-19 crisis.

In 2011-2020, comparing the Baltic States, faster growth was observed in Lithuania and Estonia, by 3.4% and 3.1% per year on average, while Latvia showed growth by 2.6%.

Table 3.1

GDP by Expenditure Items
changes compared to the corresponding period of the year before, as per cent

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 Jan-Sep
Gross domestic product	**7.0**	**2.0**	**1.9**	**3.9**	**2.4**	**3.3**	**4.0**	**2.5**	**-3.6**	**5.2**
Private consumption	5.6	6.4	0.7	2.1	3.4	2.9	3.0	0.2	-7.6	4.6
Public consumption	0.8	1.7	3.5	2.7	2.3	3.3	1.7	3.4	2.6	4.9
Gross fixed capital formation	17.7	-4.4	-3.9	-2.0	-8.2	11.4	11.8	6.9	0.2	4.9
Export	9.5	0.7	6.2	3.0	3.9	6.4	4.5	2.1	-2.2	6.4
Import	5.2	-0.1	2.9	1.6	3.6	8.6	6.4	3.0	-2.5	14.7

3.2. CONSUMPTION

Private consumption increased at a very rapid pace in 2012-2013, but since 2014 the increase in private consumption, like overall economic growth, have been more moderate. In 2014-2019, private consumption increased by 2% on average per year. The increase was fostered by growth in wages, but the rise in employment was slow.

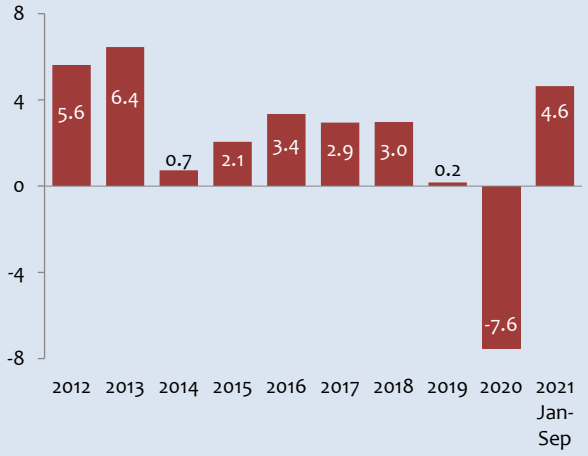
However, in 2020 private consumption declined sharply due to the restrictions caused by the Covid-19 pandemic. The increase in unemployment and the drop in income caused by the Covid-19 crisis reduced private consumption by 7.6% during the year.

In Q1 2021, private consumption continued to decline, but in Q2, thanks to the base effect, it grew rapidly. Also in Q3, a sharp rise in private consumption continued, driven by both the reduction in unemployment and the increase in average wages and the low restrictions caused by the Covid-19 crisis in the summer months. Overall, private consumption increased by 4.6% in the three quarters of 2021 compared to the corresponding period of 2020. However, private consumption is still low compared to 2019.

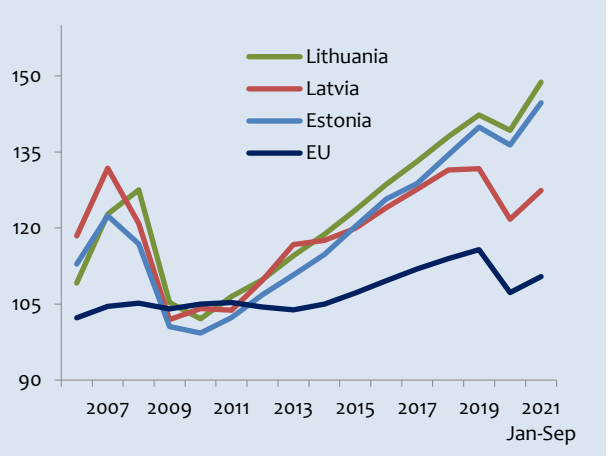
Since 2011, Latvia has been having the slowest increase in private consumption in comparison with other Baltic countries.

Figure 3.4

Private consumption
change compared to the corresponding period of the year before, as per cent



Private Consumption in the Baltic Countries and in the EU
2005 = 100



In the structure of household consumption, most of expenditure is on housing, expenditure on food is the second largest consumption group, while transport is the third priority. The share of expenditure on alcoholic beverages and tobacco, clothing and footwear, transport, communications, recreation and culture, education, restaurants, cafes and hotels in the structure of household consumption expenditures has been dropping since 2010, while the share of expenditure on food, housing, home improvement, as well as health has been growing.

Due to the restrictions imposed due to the Covid-19 crisis in 2020, compared to the previous year, expenditure reduced in all main consumption expenditure groups, except expenditure on food, housing and home improvement. The increase in expenditure on food and the decrease in expenditure on recreation and culture had the biggest effect. In 2020, compared to the previous year, expenditure decreased most rapidly in the consumption group of restaurants and hotels – by 38.4%, recreation and culture – by 28.1% and transport – by 13.4%. The reason was the state of emergency in the country, during which different services were not available on site. Expenditure on clothing and footwear decreased by 10.7% and on alcoholic beverages and tobacco – by 10% compared to a year before. Food consumption and housing costs increased as people stayed more in their households – an increase by 2.8% for food and by 1.2% for housing.

In 2020, compared to 2010, household consumption expenditure increased in all groups of consumption expenditure with the exception of housing and alcoholic beverages and tobacco. Expenditure on transport, food and home improvement made the largest contribution to the increase of consumption expenditure.

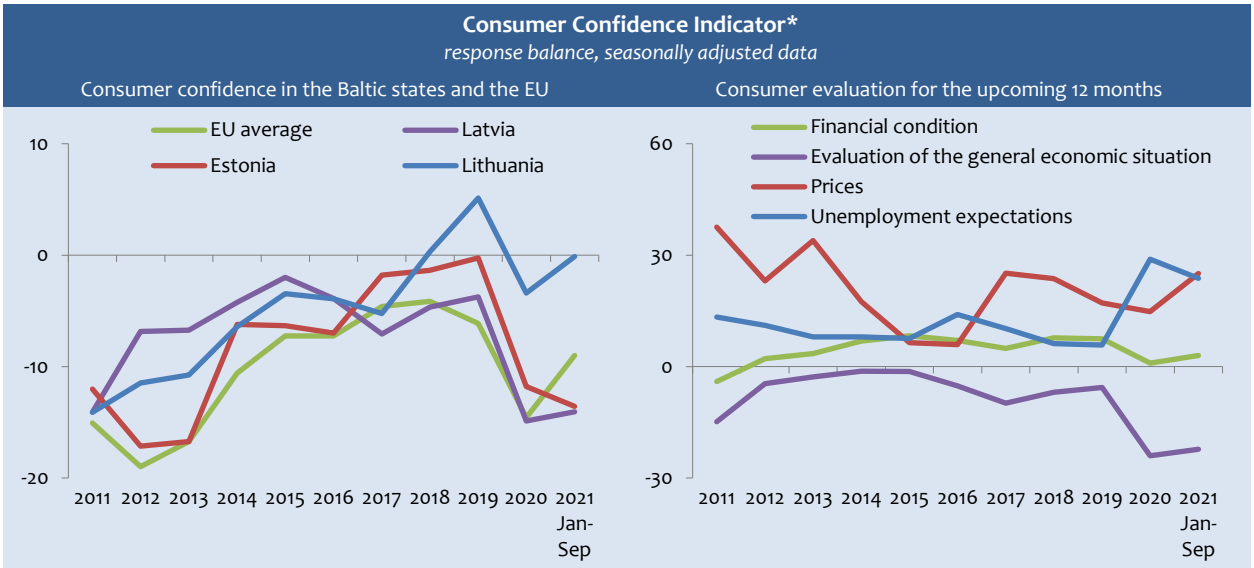
Since 2010, consumer confidence has generally improved although it has been volatile, but it is still negative. The most optimistic confidence level was reached in December 2019, when the indicator reached -1 points, the highest level in the last 5 years. Such an improvement in consumer confidence has been largely fostered by rapid economic growth in recent years. Latvian consumers were generally more optimistic, and consumer confidence has been higher than EU average since mid-2011. The confidence level was more pessimistic in 2017-2018, when Latvia's indicator slipped below the EU average. There has been a similar trend since the end of 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 caused by Covid-19, the lowest level of the indicator in the last 10 years was reached in April and May 2020. Almost all items of the indicator, such as the financial situation of the family, the overall economic situation in the country, unemployment expectations, worsened significantly. Meanwhile, inflation expectations in these months had reached their lowest level in the past three years.

Figure 3.5

Consumer Confidence Indicator*

response balance, seasonally adjusted data



* 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

At the beginning of 2021, consumer confidence started to improve in all the main items of the indicator. As the epidemiological situation of Covid-19 improved and restrictions eased, consumers have become significantly more optimistic and more confident in their lives in the first half of 2021. In Q2, the outlook for the key items, excluding inflation expectations, returned to pre-Covid-19 levels. But optimism subsided in Q3 2021, when a deterioration in the confidence indicator shows growing concerns about the future. This can be explained by uncertainty and concerns about the development of the spread of Covid-19, as well as price increase trends.

Consumers' future assessment of the financial situation of the family has largely stabilised since 2012 and is generally positive during the year. Optimism has been generally growing since the middle of 2017 and until April 2020 reaching its historic low in the last three years – -9.2 points. In 2021, the expectations of the financial situation of the family are assessed more positively, but the item has worsened in Q3 2021.

A growing trend in consumers' assessment of the overall situation in the country has been similar to the assessment of the financial situation of their families since 2010. 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 situation announced at the beginning of 2020 has dramatically reduced consumer optimism and this item reached its lowest level in the past decade – -47 points. The assessment has improved in 2021, yet it has not reached the level before the Covid-19 crisis. Concerns about the future have negatively affected this item also in Q3 2021. It should be noted that future prospects of the country's economic situation is evaluated much more critically than the future of the financial condition of the family.

Unemployment expectations of consumers have been generally falling since 2010 generally sticking to a descending trend regardless of fluctuations. However, since 2016 these expectations resumed growth reaching the highest rise (24.3 points) at 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. In the further months, unemployment expectations stabilised at a rather high level, in Q2 2021 consumers regained confidence in the future, but in Q3 concerns about unemployment returned to the previous high level.

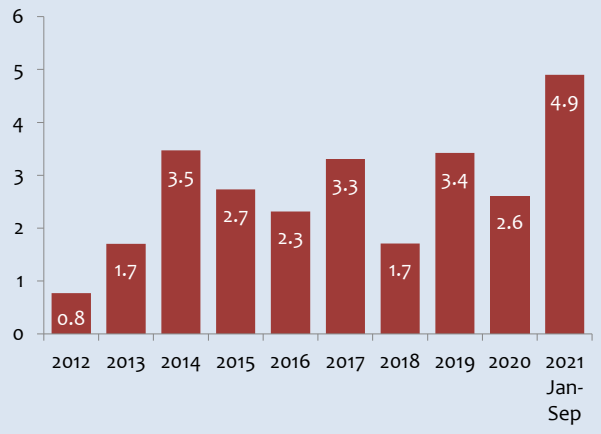
Consumers' inflation expectations had been growing rapidly until April 2011. Since the middle of 2011, inflation expectations have been very cyclical – in this way consumers responded to different changes, however, they have been generally declining. Since the middle of 2013 the drop has been very rapid reaching the level of -2 points in September 2016, the lowest since 2011. At the end of 2016, inflation expectations resumed growth until the middle of 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 influence consumer's inflation expectations in 2020. Concerns of consumers about the increase in prices started to reflect in the dynamics of the item in Q2 2021. Inflation expectations continued to grow in Q3, reaching the highest level since 2013.

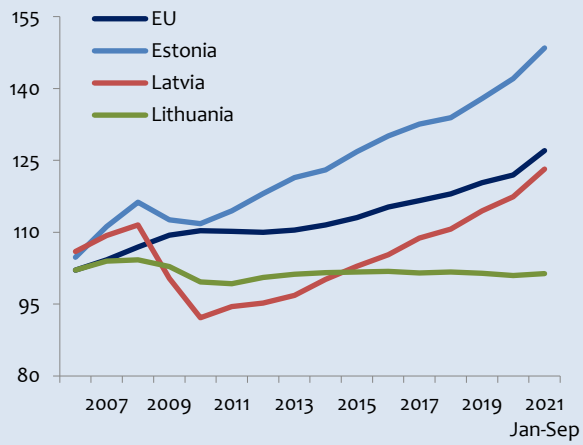
The increase in public consumption or the volumes of public services after the crisis was slow. The government's commitment to continue reducing the national budget deficit in 2012 and 2013 held back a rapid increase in expenditure. As budget income is growing, public consumption has been growing more rapidly since 2014. Overall, from 2014 to 2020, public consumption was growing by 2.7 per cent per year on average.

Figure 3.6

Public consumption
change compared to the corresponding period of the year before, 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 and ensure public defence funding of 2% of GDP. 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 support measures implemented by the government to mitigate the negative effects of the Covid-19 crisis and largely funded at the expense of increasing the state budget deficit, have maintained a positive increase in public consumption in 2020, which continued to grow under the influence of these measures also in the three quarters of 2021.

Since 2011, Latvia has been having the most rapid increase in public consumption in comparison with other Baltic countries.

3.3. INVESTMENT

Investment is an important contributor to Latvia's economic growth. Investment activity has weakened under the influence of the Covid-19 crisis, and in 2020 investment volumes remained only 0.2% above the previous year's level. However, it was one of the best indicators in EU countries. Investment activities are gradually increasing in 2021. In the nine months of this year, the investment volume was 4.9% higher than a year before, significantly affected by the rise in private investment.

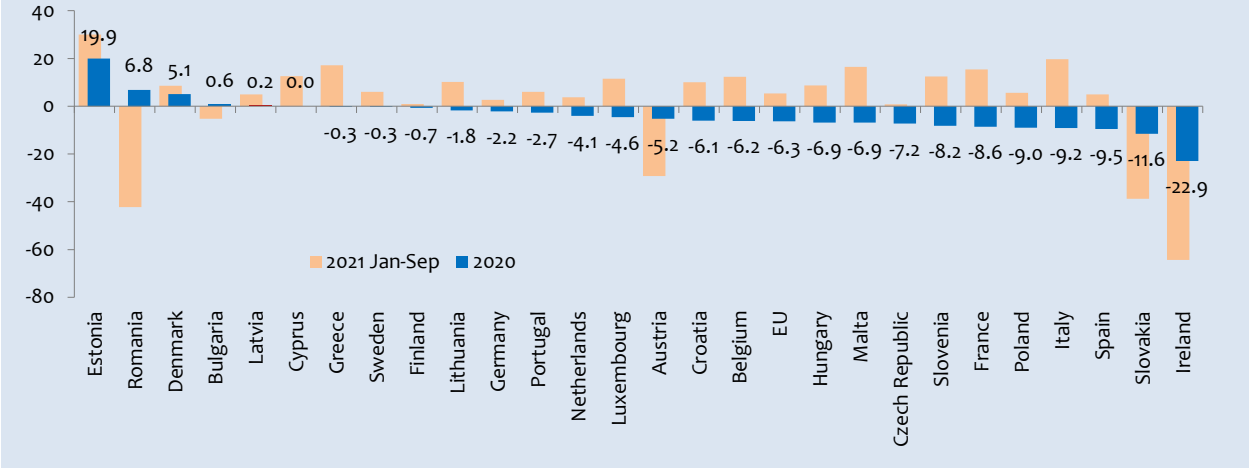
In the long term, investment activities in the Latvian economy are fluctuating, responding sensibly to geopolitical changes, programming periods of EU structural funds, external and internal shocks. Since 2004, when Latvia acceded to the EU, investment has increased rapidly (in 2004-2007 by 21.4% per year on average), driven by foreign capital inflow. A sharp increase in investment continued until 2007, reaching almost 36% of GDP, which was an important factor in increasing productivity.

Investment was hit hard by the global financial crisis. Spending on fixed capital formation over three years (2008-2010) declined by more than half. In 2010, the level of investment was only 19% of GDP, reaching its lowest level since 1998. The long-term decline in credit amount, high debt obligations, and low demand after the financial crisis had reduced investment activity in the post-crisis period.

Figure 3.7

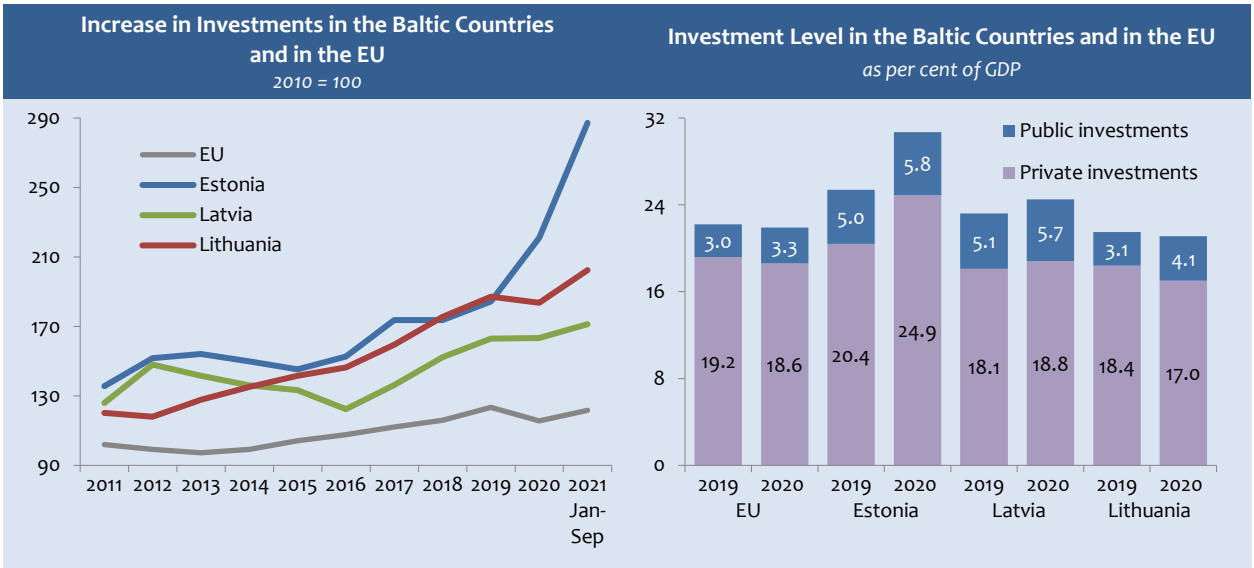
Changes in Investment Amounts in EU Countries

in 2020 and in January-September 2021, to the corresponding period of the previous year, as per cent



The recovery of investment after the crisis was slow. Investment trends have been characterised by unstable dynamics in the last ten years, showing a rapid increase in 2011-2012 and a long weak investment period in 2013-2016. Investment activities have increased significantly since 2017. A large amount of investment come from EU-funded public investment. Therefore, as the absorption of EU structural funds approaches its peak, the growth rate of investment activities is becoming increasingly more moderate. In 2019, expenditure on fixed capital formation was 6.9% higher than a year ago. The decline in investment rates has been exacerbated by the Covid-19 pandemic and uncertainty about its combating possibilities in the near future. In 2020, expenditure on fixed capital formation increased by only 0.2%. In 2011-2020, investment grew annually on average by 5% and represented 22.7% of GDP, a lower level than before the global financial crisis.

Figure 3.8

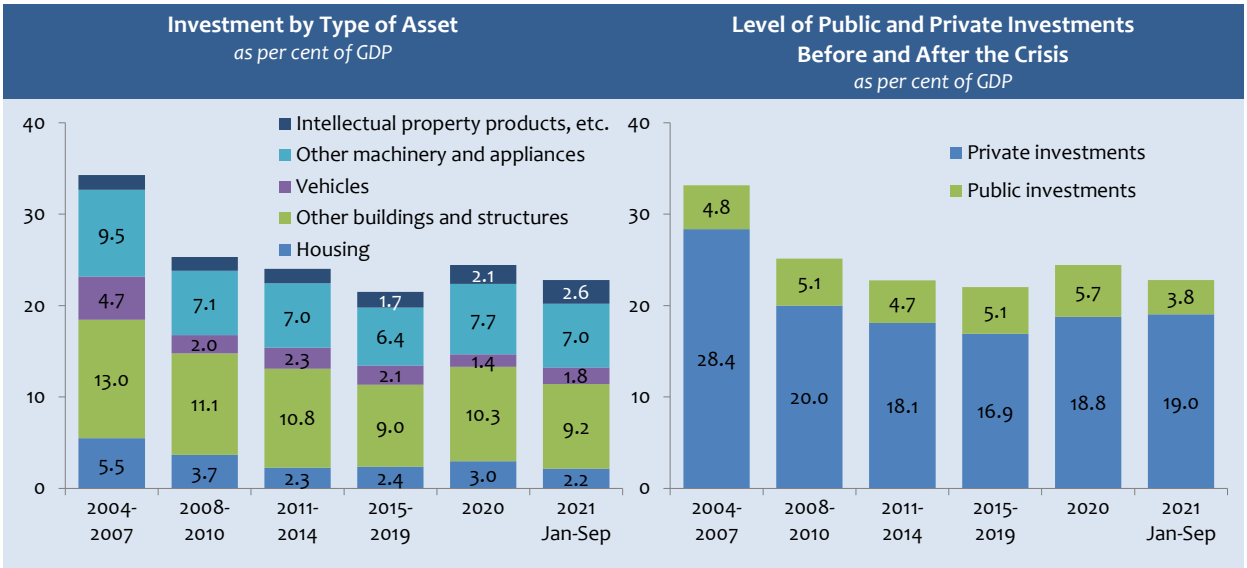


The low level of investment was mainly influenced by weaker activity of private investors than in years of rapid growth. After the global financial crisis, the positive dynamics of private investment had restored only since 2017 and remained positive until 2019 with investment growing by almost 8.5% on average. 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 1.7%, compared to the previous year. In 2021, however, private investment increased again and was up nearly 10% higher in the nine months than a year before. Overall, it should be noted that the level of private investment has been fluctuating in the last ten years at 16-20% of GDP, which is almost 10 percentage points less than in the years of rapid growth.

The funding for investments was provided by entrepreneurs' own resources and EU structural funds, while lending remained very low for a long time. Despite comparatively low costs and growing demand, the credit-to-GDP ratio does not increase. According to the data of the Bank of Latvia, at the end of 2020, the balance of loans to non-financial corporations and households accounted for 40% of GDP, which is well below the level before the crisis. Private investment growth is also limited by low demand and high uncertainty.

The negative effects of the above-mentioned factors on investment are significantly reinforced by the crisis caused by the Covid-19 pandemic. According to the data of the Bank of Latvia, the monthly volume of new loans issued to non-financial corporations remains very volatile and the annual growth rate of domestic loans in the eight months of 2021 remained close to zero (+0.1% for loans to non-financial corporations and +2.0% for loans to households). The outstanding loan-to-GDP ratio improved slightly in 2021 (in Q2 – 39.4%). However, it remains one of the lowest in the EU. Also, an increase in the costs of issued loans has been observed. Lending costs are mainly rising in the segment of small and medium-sized enterprises. Several Latvian credit institutions strengthened their credit standard, with the main reason being the deterioration of the overall economic situation, as well as the increased credit risks of borrowers (see also Section 6.4).

Figure 3.9



Public investments in Latvia are at a relatively high level and play an important role in the accumulation of the 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 increased by 16% per year on average. As EU funding reached its maximum, public investment volumes declined significantly in 2019 and were 8% lower than a year before. Despite the Covid-19 crisis, public investment increased by nearly 7% in 2020, reaching 5.7% of GDP. In 2021, public investment is more moderate. Provisionally, in the nine months of this year, public investment was nearly 15% lower 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. In last five years before the Covid-19 pandemic (2015-2019) investments in buildings and structures have increased by 0.5% annually on average. The decline in these assets due to the global financial crisis was comparatively low, while the recovery after the crisis has been rather rapid, mainly ensured by the economy heating measures. Investment in these assets are stable also under the influence of the crisis caused by Covid-19. It increased by 2.5% in 2020. In the nine months of 2021, investment in buildings and structures were only 1.8% smaller compared to the corresponding period of the previous year.

In the total structure of investments in 2015-2019, investments in housing accounted for a small share of around 10-11%, i.e. 2% of GDP. They are mainly financed from bank loans, the reduction in which under the influence of the global financial crisis along with the increase in debt liabilities of the private sector determined also the drop in investments in these assets. Investment in housing reduced also during the Covid-19 crisis. In 2020, by 1.9% less than in 2019 was invested in housing construction. In the nine months of 2021, investment in these assets reduced by 14.8% compared to the corresponding period of the previous year.

Investments into machinery and appliances react sensibly to shocks and 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. Since 2014, investment in machinery and appliances increased by 5% per year on average. However, it was not sufficient to fully compensate for the drop in investment during the years of the crisis (2008-2010). In 2019, investments in machinery and appliances accounted for 8% of GDP and was almost by half smaller than the average volume in 2004-2007. The restrictions for combating the Covid-19 pandemic were a significant negative factor for investment in manufacturing assets. In 2020, investment in machinery and appliances declined by 2%, compared to the corresponding last year, as 22.5% less was invested in vehicles than a year ago. A rapid increase in investment was observed in 2021. In January-September 2021, investment in manufacturing assets increased by almost 16%. 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. In recent years before the Covid-19 crisis, investment in intellectual property assets grew by an average of 3.5% per year. Investments in intellectual property continued to grow also in 2020 and 2021. In 2020, they were 2.7% higher than in 2019, but in the nine months of this year nearly 17.5% higher than a year earlier.

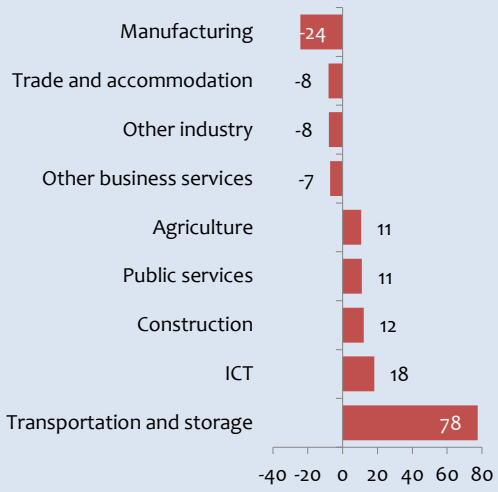
Table 3.2

Gross Capital Formation *annual average*	1995-2007	2008-2010	2011-2019	2018	2019	2020	2021 Jan-Sep
				actual increase			
GDP	**7.4**	**-7.5**	**3.3**	**4.0**	**2.5**	**-3.6**	**5.2**
Gross capital formation	18.1	-25.3	7.0	14.2	10.1	0.3	29.2
– gross fixed capital formation	18.4	-22.2	5.6	11.8	6.9	2.2	4.9
				% of GDP			
Gross capital formation	27.9	27.0	23.7	23.3	23.3	22.4	27.5
– gross fixed capital formation	25.2	25.1	22.5	22.1	23.2	24.5	22.8
– changes in inventories	2.6	1.8	1.3	1.1	0.1	-2.1	4.7

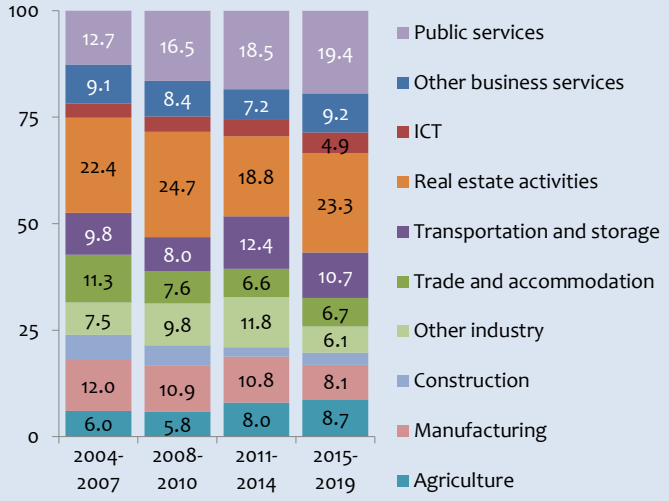
Investments in Latvia's economic sectors are unsustainable, and their volatility is affected by both the cyclicity of the absorption of EU structural funds and the adjustment of private sector investment plans in line with changes in market conditions. Investment levels declined across all sectors under the influence of the global financial crisis. A particularly large drop in investment volumes in construction, trade, accommodation, and food service activities was observed. Investments fell rather moderately in such sectors as information and communication services, health and social care, mining, and energy sectors.

Figure 3.10

Gross Capital Expenditure by Sectors
*changes in the nine months of 2021, as per cent**



Gross Fixed Capital Formation by Sectors
as per cent



* calculated using quarterly data, at current prices

In the five years (2015-2019) before the Covid-19 crisis the intensity of investment was moderate. Investments volume increased more rapidly in services sectors – by an average of 3.2% annually, with the largest contribution from real estate activities, public administration, and information and communication sectors. In sectors manufacturing goods investments increased moderately – by 1.4% per year on average. 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.

The crisis caused by the Covid-19 pandemic has affected the services sectors the most. In 2020, capital investments in services sectors were by 19% lower than a year ago. By 5% 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 the nine months of 2021, compared to the corresponding period last year, the services sector was by 2.6% lower, while the goods sectors decreased by 14.3%, including manufacturing – by 24.3%.

It should be noted that, despite the restrictions for combating the Covid-19 pandemic, investment activity in some sectors is very high. The increase in capital investment in both 2020 and the nine months of 2021 was recorded in sectors such as agriculture, water supply, sewerage, waste management, construction. Investment in health, and information and communication services increased as well.

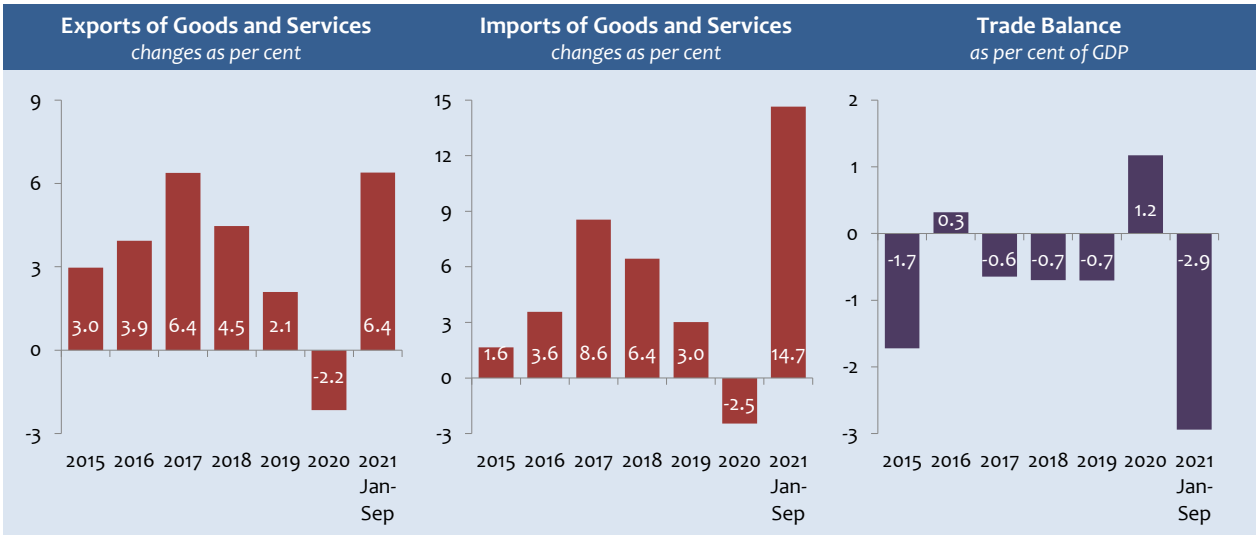
Surveys carried out by the European Investment Bank (EIB) show that Latvian entrepreneurs mark as the most significant long-term barriers to investment the availability of skilled personnel and uncertainty regarding the future. These are also the two most frequently mentioned obstacles in EU Member States. Investments are also limited by high costs of energy sources and shortcomings in business regulation.

Investment dynamics will continue to be influenced by uncertainty regarding the international environment, including new waves of Covid-19, their duration, and strictness of containment measures, as well as the effectiveness of vaccination measures. Increasing the loan portfolio, which has been low for a long time, will also play an important role. EU funding, which is an important incentive for increasing investment levels, will have a positive impact on the investment dynamics. Investment activities are expected to grow more rapidly after the launch of the Rail Baltica project. A number of projects funded under the Recovery and Resilience Facility will also contribute significantly to increasing investment activities. Due to the limited capacity of the construction sector, the large influx of EU investment funds could raise concerns regarding the overheating in the construction sector. As economic activity increases, investment growth can also be hampered by limited availability of building materials and workforce.

3.4. EXPORTS AND IMPORTS

Export has traditionally been one of the main factors of economic growth, and its dynamics is 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.

2020-2021 will be marked in history books as the years of crisis caused by Covid-19, which affected all economic indicators in all countries around the world, including 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 Covid-19 pandemic was observed. In Q2-Q3 of 2020, export volumes were already significantly lower than a year ago. In Q4 of 2020, as external demand increased, moderate growth of exports resumed. In Q1 of 2021, export volumes were similar as a year ago, which in Q2 of 2021, as the external demand had grown considerably, as well as due to the base effect, export volumes increased sharply. In Q3 of 2021, growth of exports endured.

The most important export markets for Latvia are EU countries, including Lithuania and Estonia. Exports to CIS countries, including Russia, make up a smaller share. 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. However, in 2020, as internal demand dropped considerably, import volumes were lower than a year ago. Similarly,

in 2020, import volumes were significantly affected by the reduction in investments and the import value of intermediate goods. In 2021, disparate trends were observed. In particular, in Q1 of 2021, a moderate increase in imports was observed. However, in Q2-Q3 of 2021, as a result of the increase in demand and the base effect, imports of goods and services were significantly higher than a year ago.

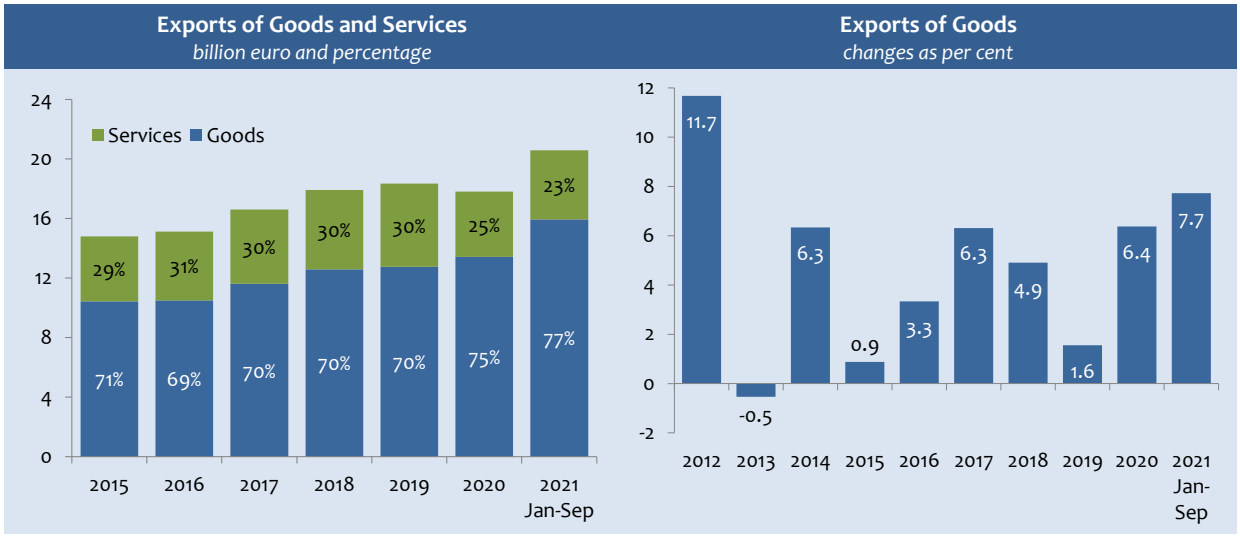
The trade balance, after being negative in 2012-2015, has been in balance since 2016. In 2020, when import volumes were declining more rapidly than export volumes, the indicator reached historically the highest level. An opposite picture is observed in 2021.

Although demand in outlets is currently stable, the risks restricting the development of exports are related to the still high Covid-19 incidence in the country, which may require the imposition of new restrictions, as well as the third wave of the Covid-19 pandemic associated with the spread and containment of new strains of the virus.

EXPORTS

More than two thirds of Latvian export are composed of exports of goods. This proportion has not significantly changed in recent years. However, in 2020 and 2021, due to the restrictions affecting exporting services, the export structure in this period has changed in favour of exports of goods.

Figure 3.12



In Latvia, **exports of goods** were developing dynamically in 2014-2018, 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 crisis were significantly lower than a year ago. 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 indicator. In the three quarters of 2021, 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. In the three quarters of 2021, the export unit value has grown considerably – by 11.3%. Export prices of wood and its products, metals, mineral products, agricultural and medical products, as well as other goods increased rapidly.

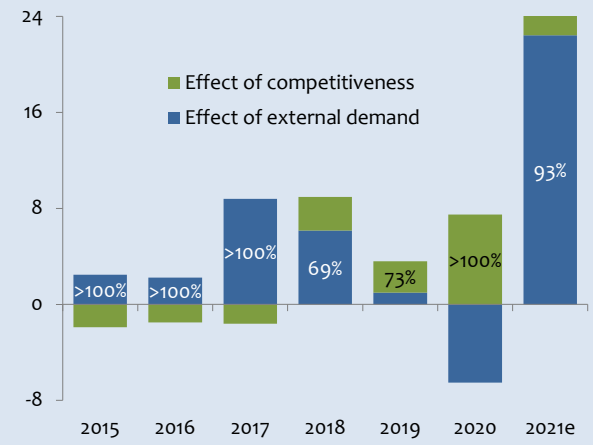
In 2014-2018, the increase in exports of goods was driven by external demand, with a low or even negative role of competitiveness in export growth. In 2019, however, Latvia's exports to EU countries were driven by a more rapid increase in the competitiveness of Latvian companies. With external demand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

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

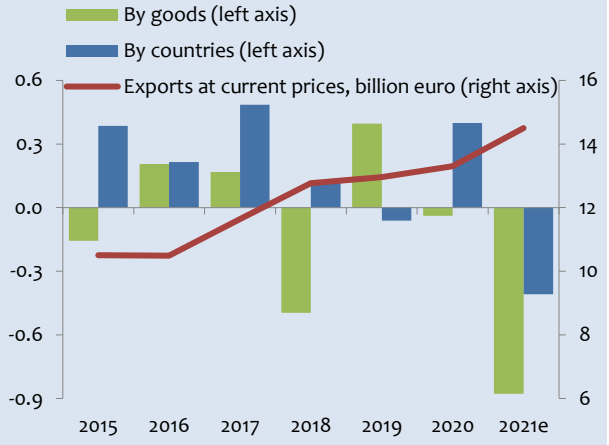
this indicator. An improvement in the diversification indicator for goods was observed in 2015-2017. However, an opposite process was observed in 2018, when exports of wood and wood products grew considerably due to the anticipation of the United Kingdom to withdraw from the EU, which had a negative effect on the diversification indicator for goods. The indicator improved in 2019, when this effect had subsided. In 2020, diversification of exports of goods by groups of goods did not change significantly. In 2021, similarly to 2018, the value the largest groups of export goods has increased rapidly, having a negative impact on the diversification rate of goods.

Figure 3.13

Breakdown of Exports Changes Using the Constant Market Share Analysis
structure of Latvian exports' changes to the EU countries, as per cent



Diversification of Exports of Goods
changes, percentage points



e – evaluation by the Ministry of Economics

Diversification of exports of goods by countries improved in 2015-2018 evidencing of entering into new markets. In 2019, exports to the largest partner countries (Estonia, Lithuania, and Germany) have been growing more rapidly, which has worsened the diversification indicator. In 2020, diversification of exports by countries improved. It can be attributed to reductions in exports to a number of major partner countries such as Russia, Lithuania, and Sweden. Meanwhile, the share of exports to smaller partner countries in total exports is growing. An opposite process is observed in 2021, when the export value to main trade partner countries is growing more rapidly, entailing a negative effect on the diversification rate of countries.

Table 3.3

Exports of Goods
as per cent, at current prices

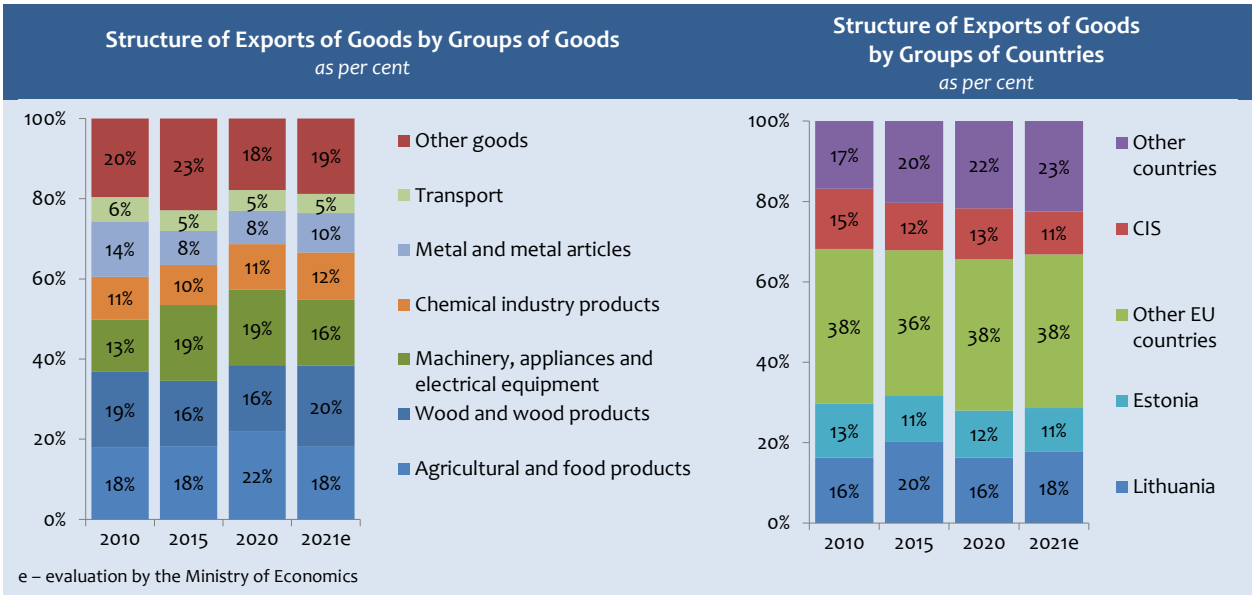
	2020			2021 Jan-Oct		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**2.6**	**2.6**	**100**	**22.2**	**22.2**
Agricultural and food products	22.0	6.6	1.4	18.1	2.0	0.4
Mineral products	4.1	-16.3	-0.8	5.5	65.4	2.7
Chemical industry products	11.4	4.7	0.5	11.7	25.7	2.9
Light industry products	3.5	-0.9	-0.03	3.3	15.1	0.5
Wood and wood products	16.5	-2.0	-0.3	20.1	48.4	8.0
Metal and metal articles	8.2	-0.3	-0.03	9.9	42.8	3.6
Machinery, appliances and electrical equipment	18.9	17.3	2.8	16.5	7.8	1.5
Vehicles	5.2	-14.5	-0.9	4.8	14.4	0.7
Other goods	10.2	-0.2	-0.03	10.1	17.1	1.8

In 2020, export growth was significantly fostered by the export group for electrical appliances and equipment. The export value of cereals, oil seeds, and machinery and appliances also increased significantly.

In January-October 2021, the sharp increase in export value was significantly affected by the increase in the export value of the largest groups of exports of goods – wood and wood products. Similarly, exports of mineral products, iron and steel, land vehicles, and other groups of goods grew rapidly.

In 2020, the amount of exports of goods to the EU countries grew by 1%. A large part of the increase was due to the growth of export of machinery and appliances.

Figure 3.14



e – evaluation by the Ministry of Economics

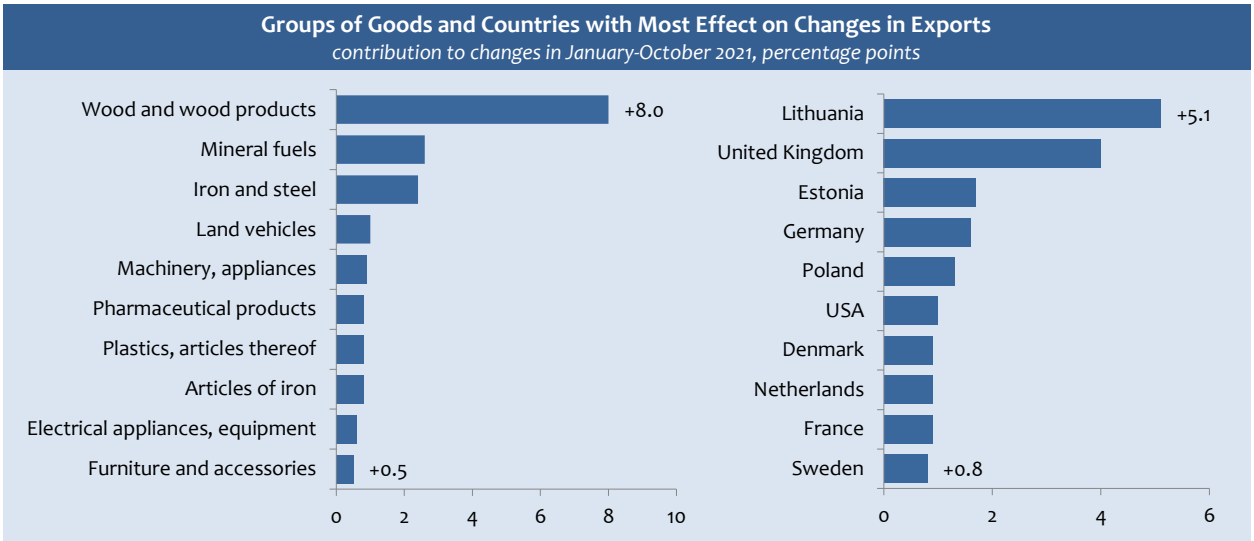
In January-October 2021, export volumes to the EU countries grew similarly to total exports – by 23.2%. Export growth was observed in almost all groups of goods, particularly as the export value of metals and articles thereof, wood and wood products, and mineral products increased sharply. Exports of goods of the chemical industry and machinery and appliances also increased significantly.

In 2020, the volume of exports of goods to the EU countries decreased by 1%. The export value of food industry products and chemical industry products declined slightly more rapidly. The decrease was partly offset by an increase in the export value of vehicles as well as machinery and appliances to CIS countries.

In January-October 2021, exports to CIS countries increased by 5.9%. The export group of chemical industry products made the most significant contribution to its growth. The export value of plastics and articles thereof, textiles and metals and articles thereof also increased significantly. Meanwhile, the value of food industry products exported to CIS countries decreased during this period of time.

In 2020, exports of goods to other countries, excluding EU and CIS countries, grew rapidly – by 10.1%. It was significantly affected by the increase in exports of cereals to Nigeria, Algeria, and other countries. In January-October 2021, exports to other countries continued to grow rapidly – by 28.3%, significantly affected by an increase in the value of wood and wood products exported to the United Kingdom and by an increase in export value of metals and articles thereof.

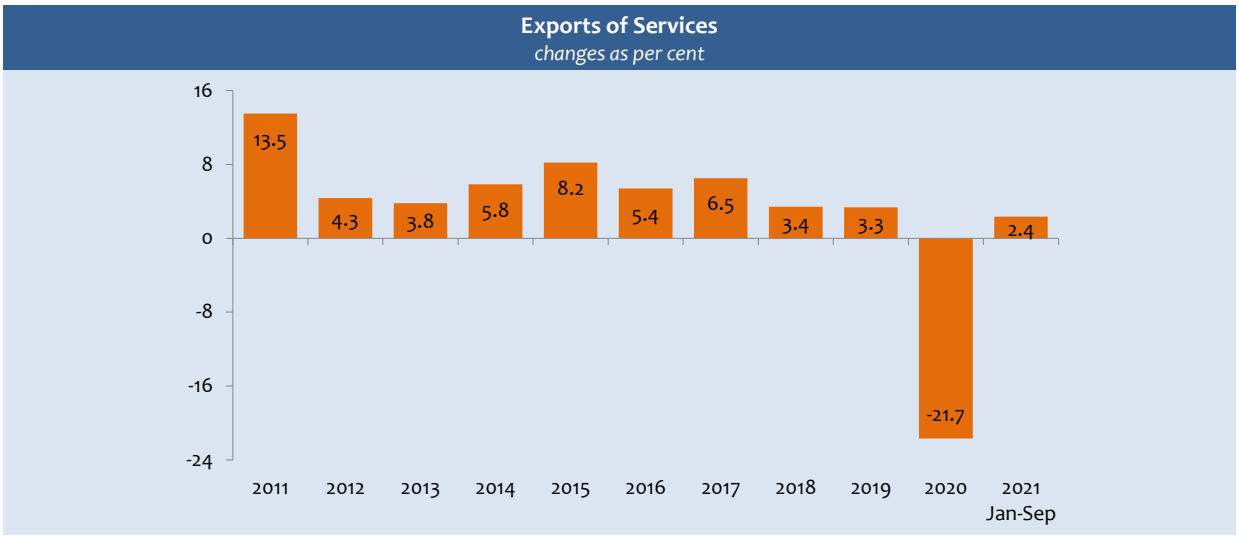
Figure 3.15



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

In 2017, as growth resumed, export rates of goods and services were similar keeping positive export balance.

Figure 3.16



In 2018-2019, exports of services continued to grow; however, their growth was slower than in the previous years.

In 2020, growth of exports of services is greatly impacted by restrictions imposed on travelling, food services activities, and other service activities. In 2020, exports of services decreased by 21.6%. Exports declined particularly rapidly starting from Q2 of 2020.

Exports of services continued to decline at the beginning of 2021; however, in Q2 and Q3 of 2021, partly due to the base effect, exports of services were 14.7% and 14.9% higher, respectively, than a year ago.

Table 3.4

Exports of Services
as per cent, at current prices

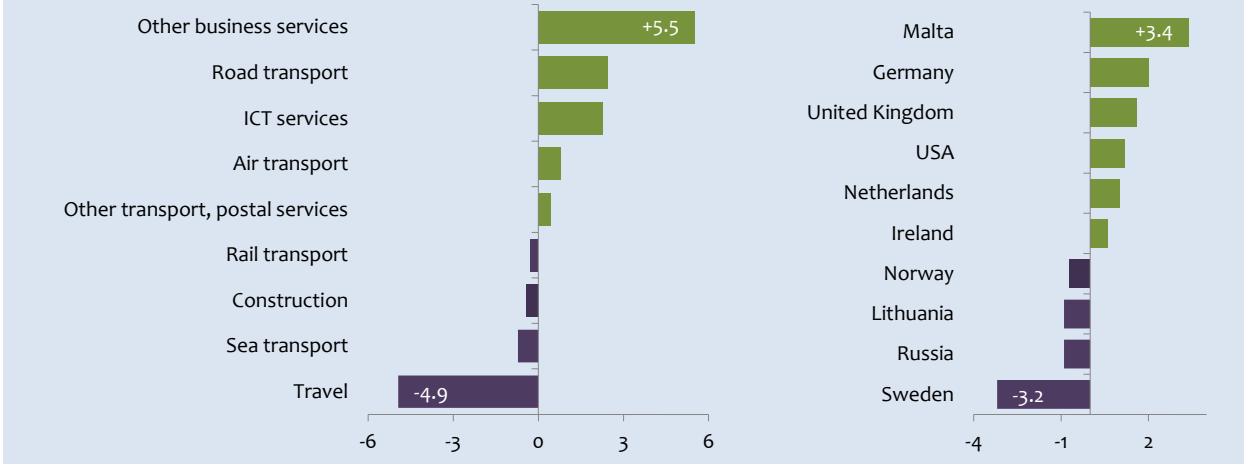
	2020			January-September 2021		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**-21.6**	**-21.6**	**100**	**5.6**	**5.6**
Transport services, including:	32.0	-34.2	-13.1	32.8	8.3	2.7
– sea transport	5.1	-32.2	-1.9	4.1	-14.3	-0.7
– air transport	2.9	-76.4	-7.4	3.9	24.1	0.8
– rail transport	3.6	-46.1	-2.4	3.1	-7.9	-0.3
– road transport	18.9	-7.2	-1.1	20.0	13.1	2.5
– other transport services	1.5	-14.5	-0.2	1.8	30.4	0.4
Travel	8.7	-58.3	-9.5	5.0	-48.3	-4.9
Other services, including:	59.3	2.1	1.0	62.2	13.6	7.9
– construction services	8.2	17.0	0.9	7.0	-5.6	-0.4
– financial and insurance services	3.3	-29.1	-1.1	3.6	7.1	0.2
– ICT services	19.4	0.4	0.1	20.2	11.9	2.3
– other business services	27.0	7.0	1.4	30.0	21.2	5.5
– other services	1.3	-24.7	-0.3	1.4	19.5	0.2

Until 2019, traditionally about 40% of the exports of services had consisted of income from transport services. The last years have not been successful for the export of transport services. In 2019, exports of transport services were similar to the year before, exports of sea and rail transport services declined; however, the fall was compensated by growing exports of road transport services and services provided by other modes of transport. In 2020, exports of services provided by all modes of transport declined significantly. The value of road transport export services declined moderately. In 2021, the development of exports of transport services is similar to the overall trends in exports of services – following a decrease in Q1 of 2021, exports of transport services increased relatively rapidly in Q2-Q3 of 2021, contributing significantly to the overall increase in exports of services in the three quarters of 2021.

In 2019, income from foreign tourists grew by 1.2%. In 2020, under the influence of the Covid-19 crisis, this income declined sharply having a significant declining impact on total exports of services. Similar trends preserved also in the three quarters of 2021.

Figure 3.17

Services Items and Countries with Most Effect on Changes in Latvian Exports
contribution to changes in January-September 2021, percentage points, at current prices



In the three quarters of 2021, exports of construction services also slightly declined, while exports of other economic activity services increased sharply, contributing significantly to the overall exports of services. The increase in exports of ICT services during this period also contributed positively.

Until 2019, slightly less than 60% of total exports of Latvian services were related to EU countries; in 2020, this share increased by 5.2 percentage points Also, in Q1-Q3 of 2021, the share rose by another 1.3 percentage, reaching 64%.

Exports of services to EU countries grew at a faster pace in 2019 than total exports of services. In 2019, transport services (road and air transport) as well as travel accounted for the largest share of exports of services to EU countries. In 2020, exports of services to EU countries decreased more modestly than total exports of services – by 12.1%. However, in the three quarters of 2021, it increased by 6.7%. Travel services to EU countries declined more rapidly during this period; nevertheless, the value of exports of economic activity, transport, and ICT increased.

IMPORTS

Imports of Latvian goods and services has declined in the last years before the Covid-19 pandemic – in particular, from 8.6% in 2017 to 3% in 2019. However, in 2020, import volumes decreased by 2.5% under the influence of the Covid-19 crisis as demand declined. In 2021, as demand restored, imports in the three quarters of 2021 have increased rapidly – by 14.7%.

In 2020, imports of goods at current prices decreased by 4.7% under the influence of the Covid-19 crisis. This was essentially due to reduction in the import value of vehicles and mineral products.

In January-October 2021, imports at current prices increased considerably. The largest positive contribution to the increase in imports of goods was from groups of mineral products, aircraft and parts thereof, wood and wood products, iron and steel, and land vehicles.

Table 3.5

Imports of Goods
as per cent, at current prices

	2020			2021 Jan-Oct		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**-4.7**	**-4.7**	**100**	**29.3**	**29.3**
Agricultural and food products	18.8	5.8	1.0	15.0	3.7	0.7
Mineral products	6.6	-31.2	-2.8	9.6	81.0	5.5
Chemical industry products	16.4	2.9	0.4	16.2	24.3	4.1
Light industry products	5.1	-0.6	-0.03	4.4	8.2	0.4
Wood and wood products	3.9	1.7	0.1	5.0	68.8	2.6
Metal and metal articles	7.8	-4.8	-0.4	9.9	57.9	4.7
Machinery, appliances and electrical equipment	22.6	6.7	1.4	19.8	14.2	3.2
Vehicles	9.1	-33.0	-4.3	11.3	80.6	6.5
Other goods	9.7	-0.5	-0.05	8.8	15.6	1.5

In 2020, imports from EU countries at current prices declined more moderately than total imports of goods – by 3.2%. In January-October 2021, imports of goods from EU countries increased by 21%. The increase was significantly driven by a rise in the import value of vehicles, mineral products, and metals and metal products.

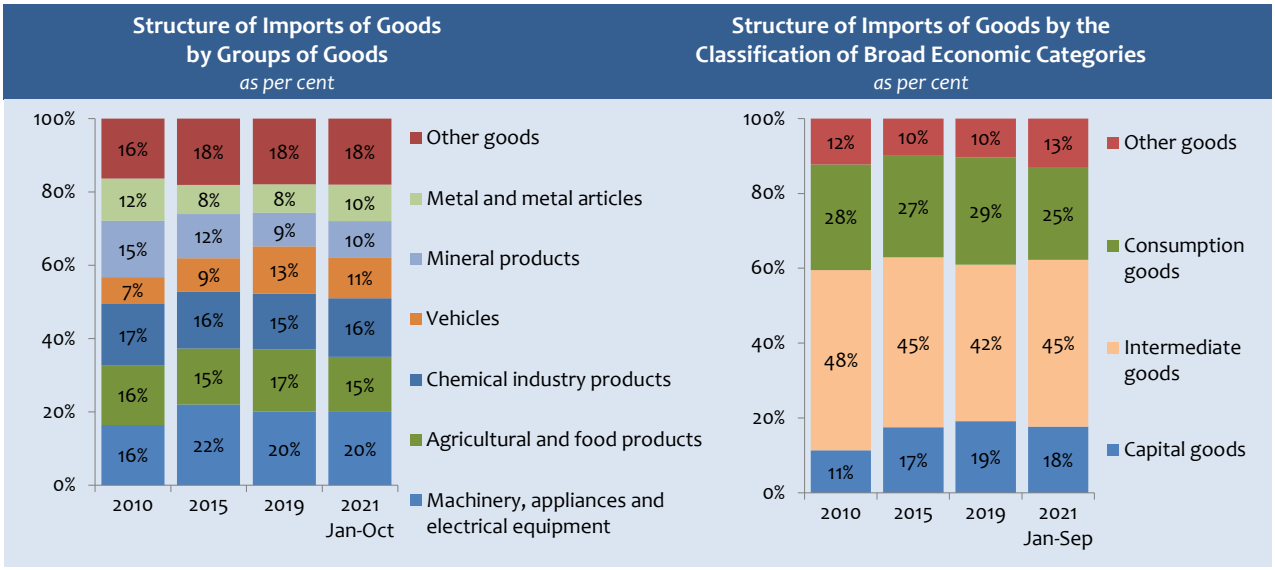
In 2020, imports from CIS countries decreased by 11.4% at current prices. However, in January-October 2021, it increased by 78.5%. This was significantly driven by an increase in the import value of mineral products and metals and metal products from CIS countries.

In 2020, in the group of other countries, except EU and the CIS countries, imports decreased by 7.9% affected by a fall in the import value of vehicles. In January-October 2021, imports of goods from other countries grew rapidly – by 41.7%, driven by an increase in the import value of vehicles, and machinery and appliances.

In the structure of imports of goods in terms of their end use, imports of capital goods increased until 2019. However, in 2021, 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 2021, with fuel prices rising, the share of imports of intermediate goods is also increasing more rapidly.

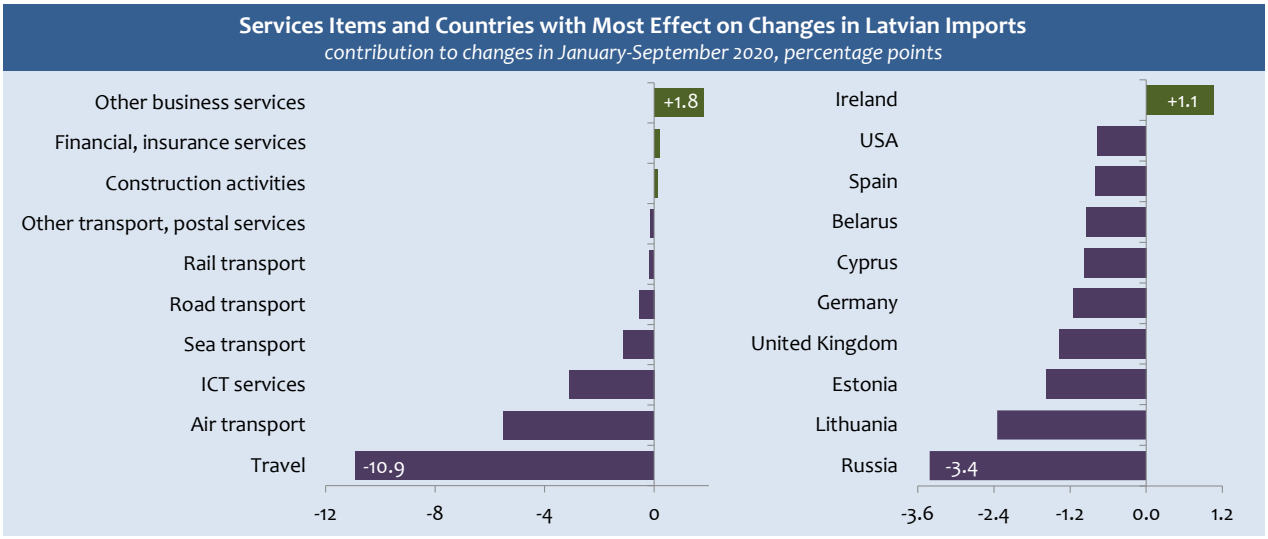
Figure 3.18



In 2019, growth of imports of services was similar to growth of exports of services – 4.8%. 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 2020, imports of services decreased by 18.2%. This was mainly caused by a reduction in all service items except for imports of brokering, financial, and construction services. Imports of travel and different types of transport services declined considerably.

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 has also been growing in recent years. The largest groups of imports of services are services related to brokering, transport, and travel.

Figure 3.19



4. CONTRIBUTION OF SECTORS

4.1. DYNAMICS AND STRUCTURE

In 2009-2010, as labour costs declined, competitiveness of Latvia's producers improved, thus stimulating the growth of exports and the development of tradable sectors. The structure of the economy has changed. In 2008, tradable sectors (agriculture, forestry and fishery, industry, transport services) accounted for only 26.5% of total value added, but in 2010 the share of these services reached 33.1%. In 2020, the share of these sectors slightly shrank to 27.3%. In 2020, compared to 2010, the share declined in all sectors except agriculture, construction, business services and public services. The analysis of economy structures from other perspective shows that in 2020 producing sectors (agriculture, forestry and fishery, industry and construction sectors) accounted for 27%, but services sectors – for 73% of total value added. Compared to 2010, the share of producing industries has reduced in all sectors except agriculture and construction.

Since 2011, GDP has been growing by 2.6% per year on average and exceeds the level of 2007 before the financial crisis.

Table 4.1

Structure of the Economy
by value added, as per cent

	2000	2005	2008	2010	2016	2020	2021 Jan-Sep
Agriculture, forestry and fishing	5.0	4.2	3.3	4.6	3.7	4.6	5.1
Manufacturing	15.2	12.9	10.7	13.3	11.6	12.5	13.4
Other industry	4.2	3.1	3.4	4.8	4.2	2.9	2.9
Construction	7.0	6.8	10.2	4.9	5.3	7.0	6.2
Trade, accommodation and food service activities	15.6	18.4	16.0	17.7	16.6	15.8	16.2
Transportation and storage	11.9	12.3	9.3	10.4	9.1	7.3	7.1
Other business services	23.8	27.3	30.3	28.3	33.2	31.8	30.9
Public services	17.3	15.1	16.9	16.1	16.2	18.1	18.2
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**

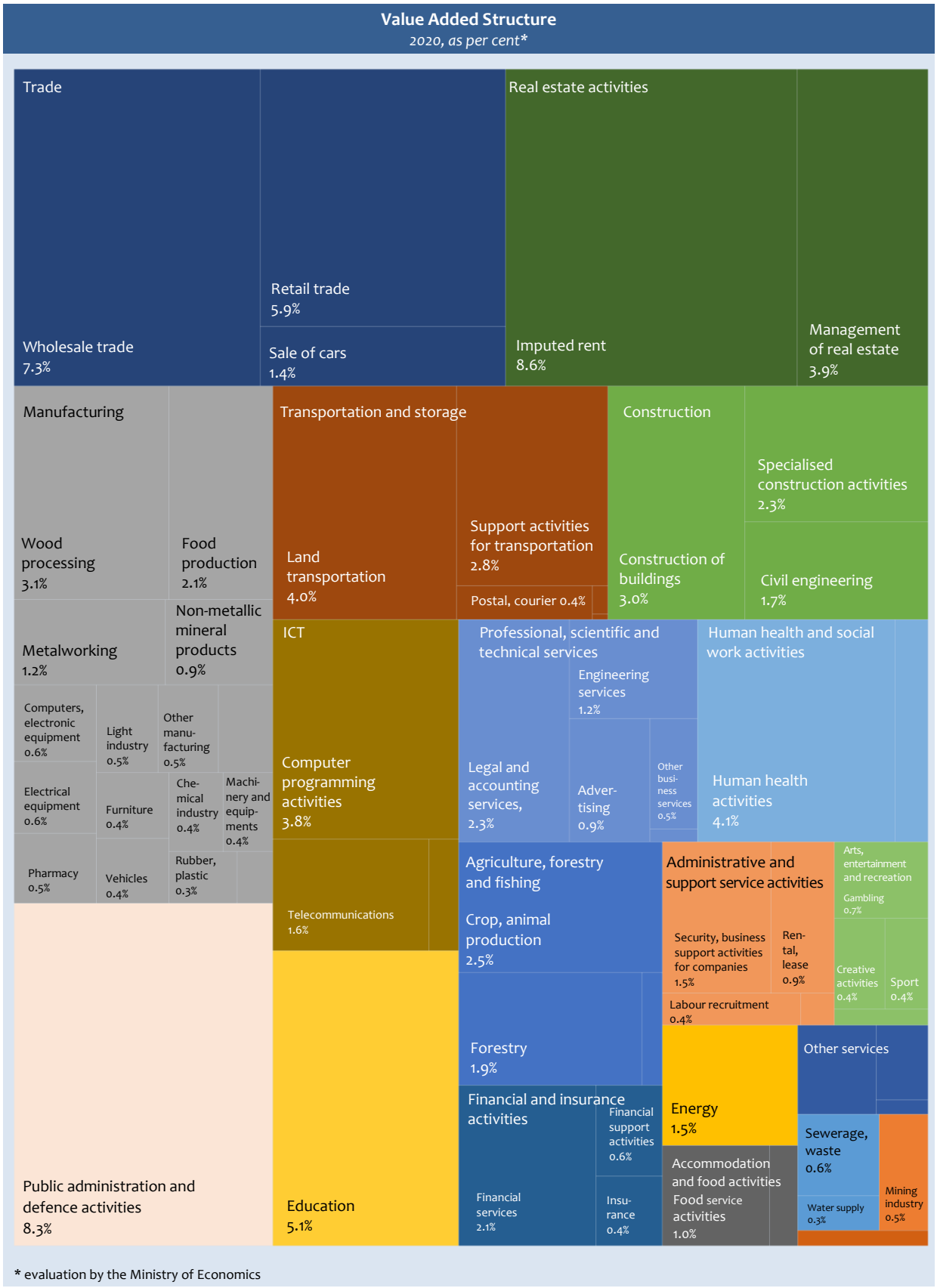
In the main export sector – manufacturing, growth rates in 2010-2012 were significantly higher than the total economic growth, and the sector became the main driving force of the economy. In other tradable sectors, (e.g., the export-oriented business services, transportation and storage), growth after the crisis also resumed faster than in other economic sectors. In 2011-2012, construction, which experienced the largest decline during the crisis, was growing relatively fast.

In 2013-2016, due to a decline in cost competitiveness advantages gained during the crisis and geopolitical situation, exports slowed down, resulting in slower growth of tradable sectors. 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. The largest contribution to growth during this period was in the main export sector – manufacturing, as well as in construction, which recovered from the fall in the previous period. Growth in Latvia 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 most significant decrease in volumes was in transportation and storage, and the drop in volumes in the accommodation and food service activities, arts, entertainment and recreation and other business services, which were affected by the restrictions introduced due to the Covid-19 crisis, also had a significant impact. A small drop in 2020 was observed also in manufacturing, which was largely affected by the first wave of the considerable industry slowdown crisis in spring 2020. Meanwhile, volumes in agriculture and forestry, construction and public services increased.

Figure 4.1



* evaluation by the Ministry of Economics

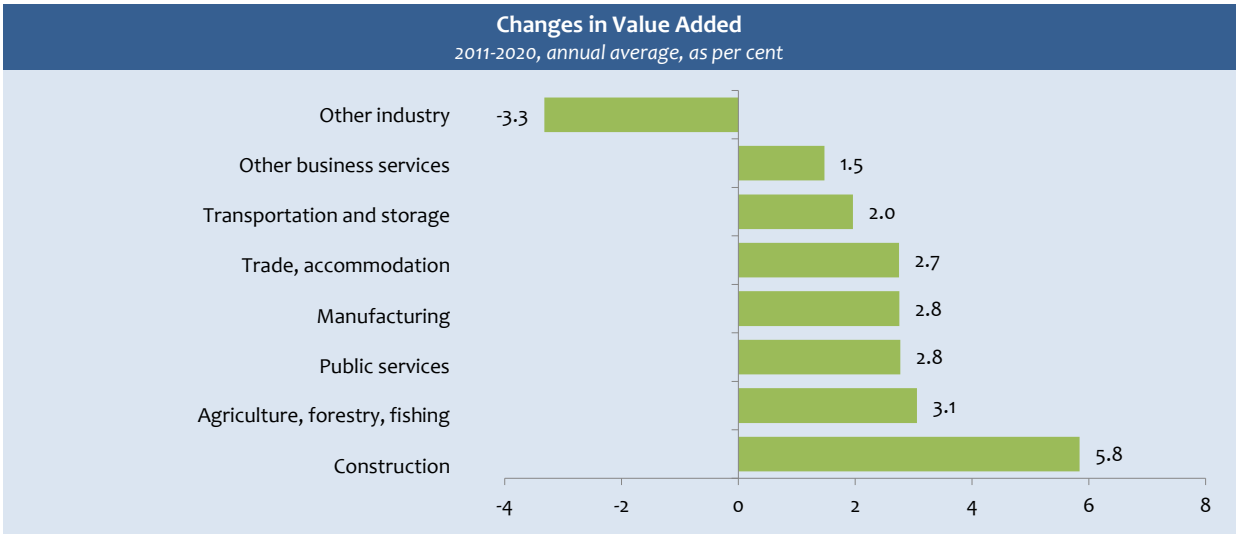
Sharp growth was observed in the economy in 2021. At beginning of the year, the Covid-19 pandemic continued to affect sectors with high levels of social contact, while sectors more focused on export of goods lived through the second wave of the Covid-19 crisis considerably more successfully. As the epidemiological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

Table 4.2

Development Trends of Sectors
compared to the corresponding period of the previous year, changes as per cent

	2017	2018	2019	2020	2021 Jan-Sep
Gross domestic product	**3.3**	**4.0**	**2.5**	**-3.6**	**5.2**
Agriculture, forestry and fishing	1.9	-3.6	19.8	0.6	-4.1
Mining and quarrying	9.1	9.1	-5.2	8.8	6.7
Manufacturing	6.8	7.5	3.7	-0.9	8.4
Food industry	5.2	-2.9	-0.7	-1.7	0.5
Light industry	7.6	-0.8	-2.6	-9.5	12.4
Wood processing	2.1	4.5	0.0	4.5	7.9
Paper industry and publishing	4.5	-3.7	5.7	4.7	13.6
Chemical industry	11.4	7.0	3.9	-1.8	14.9
Manufacture of other non-metallic mineral products	11.1	1.3	-2.1	-1.4	2.7
Metalworking	12.0	3.6	13.5	-5.6	4.6
Manufacture of electrical and optical equipment	15.8	12.1	11.3	12.1	10.9
Manufacture of machinery and equipment	21.5	7.0	-1.9	-2.7	22.6
Manufacture of vehicles	22.8	7.3	-7.7	-15.3	16.6
Other industries	4.3	-1.8	2.8	-14.2	13.1
Electricity, gas, steam and air conditioning supply	-1.9	-38.8	2.6	-6.0	3.5
Construction	14.7	12.4	1.3	1.9	-4.0
Construction of buildings	11.7	16.1	9.3	0.9	-11.3
Civil structures	26.6	6.5	-10.6	-1.5	0.6
Trade	2.6	3.9	6.2	-3.0	8.5
Retail trade	4.3	3.8	2.3	1.5	2.9
Transportation and storage	6.6	3.8	3.5	-13.8	4.8
Transport of freight by railway	-8.4	12.5	-15.8	-42.3	-13.2
Freights transhipped in ports	-2.0	6.9	-5.7	28.0	-9.1
Transport of freight by road	7.0	12.8	-3.8	2.6	16.0
Accommodation and food service activities	9.3	7.6	-3.9	-38.0	-12.2
Information and communication	8.7	9.6	4.4	-6.9	8.9
Financial and insurance activities	-17.7	-2.4	-9.6	-3.0	18.8
Real estate activities	-1.6	2.3	-3.6	-0.6	-1.3
Other business services	4.6	2.7	0.6	-3.6	0.8
Public administration and defence; compulsory social security	3.8	2.8	3.6	1.5	2.4
Education	4.3	3.0	2.7	0.8	4.5
Human health and social work activities	4.4	9.3	9.6	2.4	26.3
Arts, entertainment and recreation	5.1	6.1	2.8	-27.7	-10.4

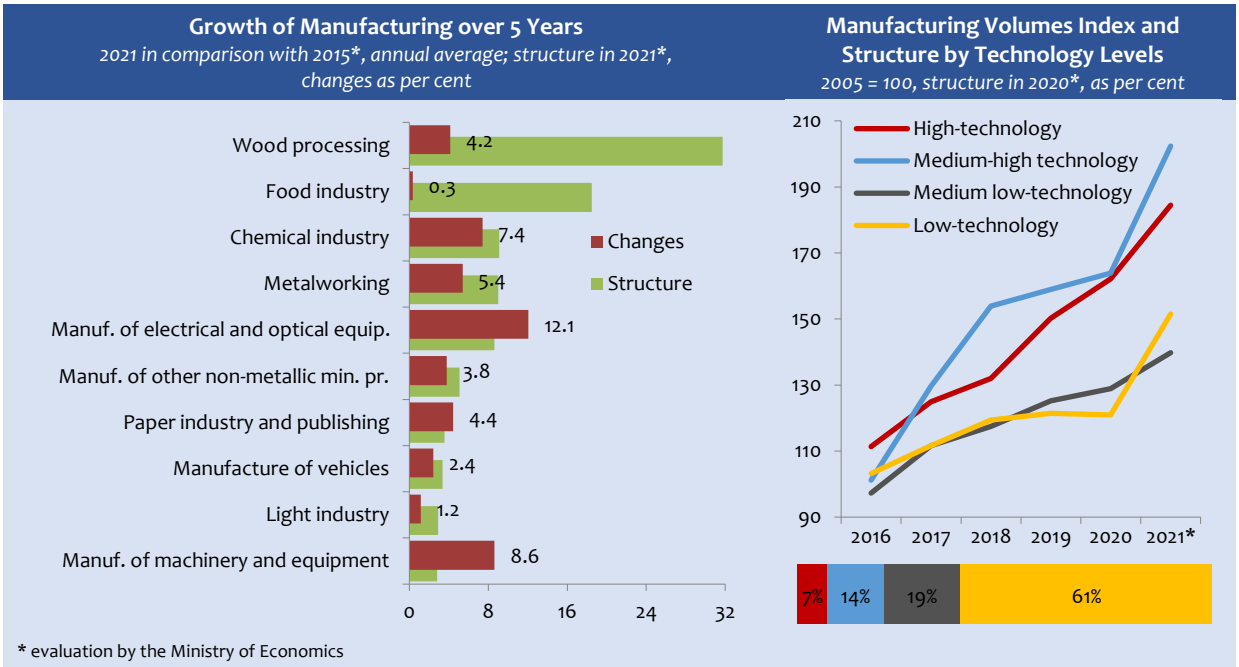
Figure 4.2



4.2. MANUFACTURING

In recent years, manufacturing has made an important contribution to total economic growth. Manufacturing has been growing stably every year since 2015.

Figure 4.3



* evaluation by the Ministry of Economics

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

Year 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 made a considerable contribution to the development of the sector. Manufacturing continued to grow also in 2018 and 2019, yet at a lower rate than a year ago – by 2.7% and 2.1%, respectively. Wood processing, the largest sub-sector of manufacturing, and also metalworking and manufacture of electrical and optical equipment, made a significant contribution to total growth of the sector.

Table 4.3

Structure of Manufacturing and Development Trends of Sectors in January-October 2021
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**	**67.4**	**7.7**
Manufacture of food and beverages	18.5	19.3	39.9	0.6
Light industry	2.9	8.3	82.9	11.6
Wood processing	31.8	20.4	71.7	6.0
Paper industry and publishing	3.6	4.5	67.3	12.5
Chemical industry and related industries	9.1	7.3	74.1	14.2
Manufacture of other non-metallic mineral products	5.1	5.2	49.9	3.1
Manufacture of metals and metal articles	9.0	10.8	65.4	4.8
Manufacture of electrical and optical equipment	8.6	5.2	88.9	8.6
Manufacture of machinery and equipment	2.8	3.2	92.1	22.1
Manufacture of vehicles	3.4	3.4	92.7	15.4
Other manufacturing industries	5.3	12.5	73.5	12.0

* data on the first half of 2021

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 the wood processing and chemical industries due to the drop in volumes/ 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. During this period, production volumes decreased in all sub-sectors of the industry – more rapidly in the food industry. Meanwhile, in the second half of the year increasingly more sub-sectors showed growth rates, and the sector's volumes in this period overall surpassed the previous year's levels. Production volumes of wood processing and manufacture of electrical and optical equipment grew more rapidly during this period.

In 2021, manufacturing is developing 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. 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. Manufacturing volumes of the chemical industry, manufacture of electrical and optical equipment, and other sub-sectors also increased significantly.

In recent years, as producer prices have been rising, stable growth was observed also in turnover of manufacturing. The turnover increased for both products sold on the domestic market and exported products. Owing to export sales, the turnover of manufacturing increased also in 2020. However, domestic sales of products decreased slightly.

In 2021, the turnover of manufacturing is growing rapidly. In January-October 2021, export sales and domestic sales increased by 23.3% and 16.2%, respectively. The turnover of the wood processing, chemical industry, manufacture of machinery and appliances, and manufacture of vehicles increased rapidly.

Every year, around two-thirds 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, and manufacture of electrical and optical equipment. Slightly less than 85% of export sales are attributed to the 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. As the United Kingdom withdrew from the EU in 2020, sales in markets of other countries increased. The share of sales to CIS countries amounts to slightly above 10%.

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

In the first half of 2021, the number of occupied posts in manufacturing has increased by 5.6%, representing the largest increase since 2005. This was largely influenced by the rise in the number of occupied posts in wood processing, the

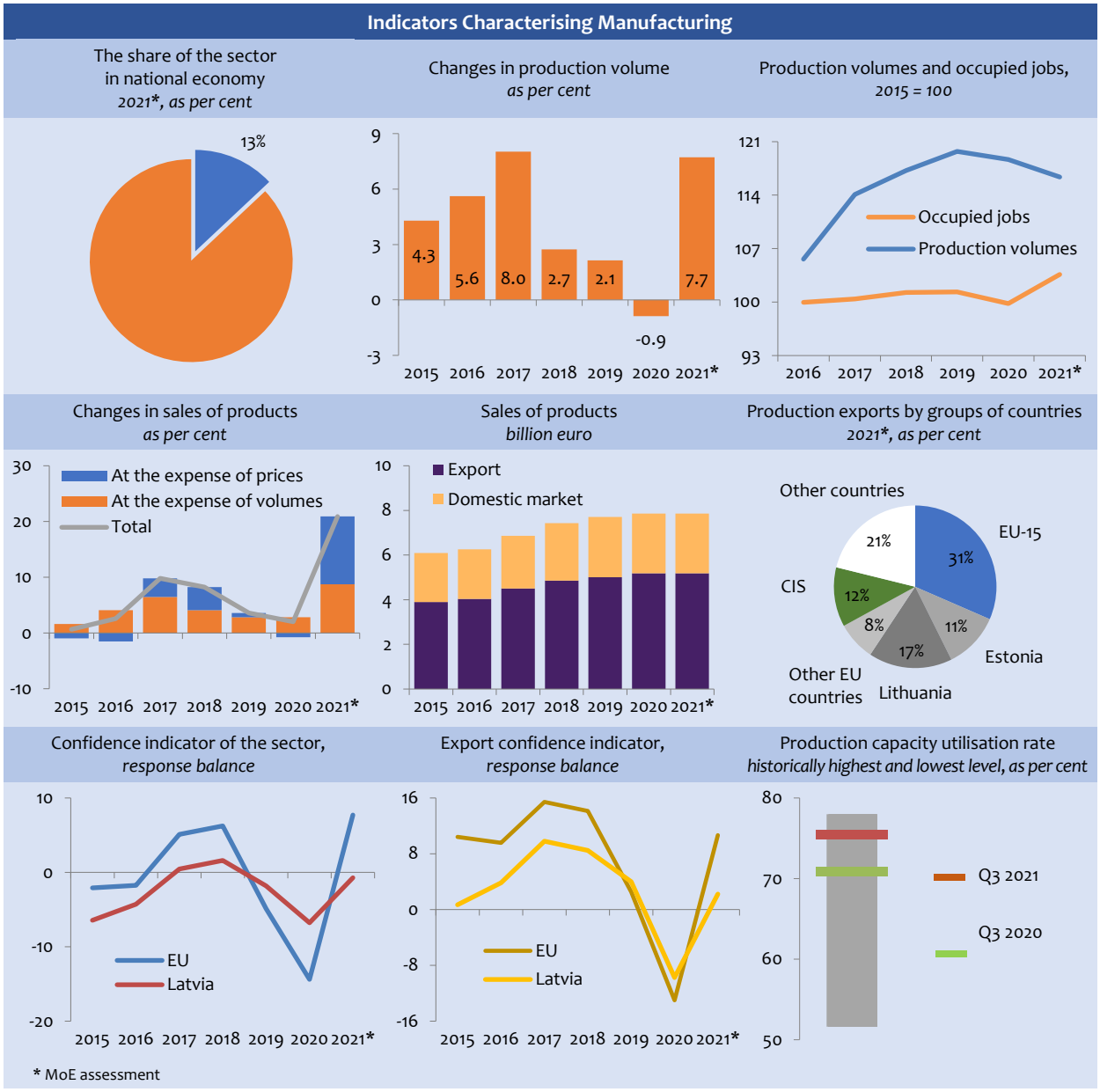
chemical industry, and paper industry and publishing. The number of occupied posts in other main manufacturing sub-sectors also increased.

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 highly negative trends. 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 January-October 2021; however, it was still slightly negative. A more negative indicator was observed in manufacture of other non-metallic mineral products, manufacture of electrical and optical equipment and light industry. Nevertheless, it was positive in wood processing.

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 of 2020, as future opportunities of exports were assessed as exceedingly negative. Meanwhile, in Q2 and Q3 of 2021, export confidence is strongly positive.

Until 2019, production capacity levels in the manufacturing has increased, exceeding the level of 76% in 2019. The adjustments were introduced by the Covid-19 crisis, when manufacturing capacity levels in Q2 of 2020 decreased to the level of 2012, amounting to 69.1%. In 2021, that indicator returned to growth, exceeded the 75% mark in Q3 of 2021.

Figure 4.4



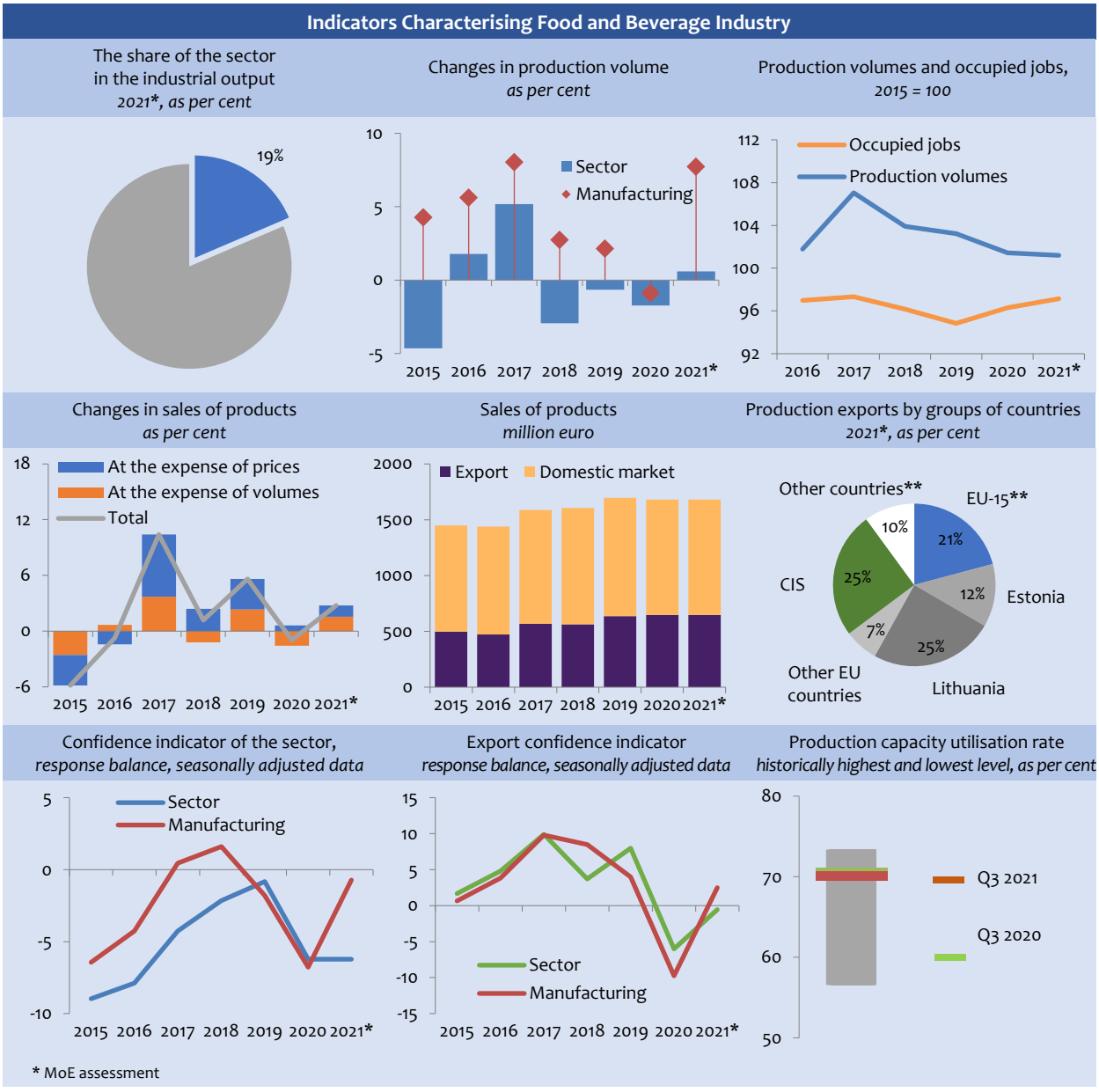
Manufacture of food and beverages is the second largest manufacturing sub-sector in terms of both the output and the number of occupied posts. Although the sector sells most of its products on the domestic market (slightly above 60%), its export sales have gradually increased in recent years. CIS countries are an important outlet for the sector's output of products.

In 2020, manufacture of both food and beverages declined. In January-October 2021, manufacturing volumes of both sub-sectors have been growing steadily.

As producer prices of food products increased, in 2020, the turnover of the sector increased as well. Turnover on domestic markets decreased slightly, while the fall was offset by an increase in exported products. In January-October 2021, sales of the sub-sector have been growing rapidly.

In 2020 and during the first half of 2021, the number of occupied posts in the food industry increased. The confidence indicator of the sector has been negative since 2015. It exceeded the general confidence level of manufacturing only in 2019. Similar trends in the sector's confidence level remain also in 2020 and 2021. The production capacity utilisation rate in the food industry is slightly lower than in manufacturing on average.

Figure 4.5

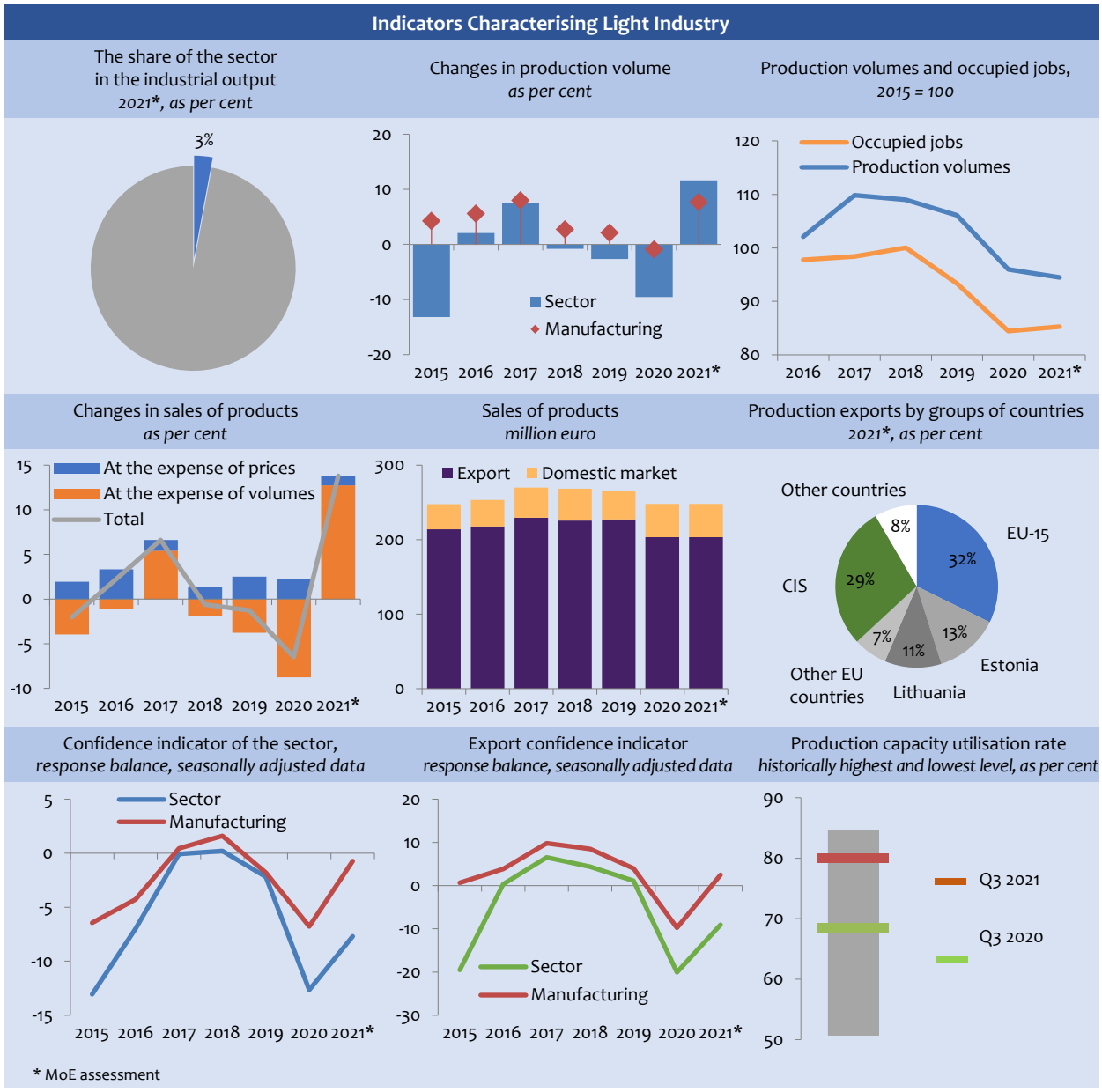


Light industry is considerably affected by global trends, and in conditions of the open EU labour market the sector cannot rely on advantages of cheap labour force like East Asia does. A considerable reduction in production volumes was observed in the sector in 2015. The industry recovered in 2016-2017, while volumes of industry slightly shrank under the effect of the reduction in volumes of manufacture of wearing apparel in 2018-2019. As with other sub-sectors, production volumes in the light industry decreased significantly in 2020; however, the volumes are rising in 2021, already exceeding the pre-crisis level of 2019.

In 2020, sales volumes of the sub-sector decreased by 6.5%, as sales of exported products declined; however, in January-October 2021, it increased by 13.8%.

In 2019-2020, the number of occupied posts in the sector has declined by 5 thousand. In the first half of 2021, the number of occupied posts also did not increase significantly. The confidence indicator has remained strongly negatively over the last three years. Until 2019, the capacity utilisation rate of the sector has been one of the highest in manufacturing, exceeding the 80% mark. In 2021, it slipped slightly below the 80% mark. 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

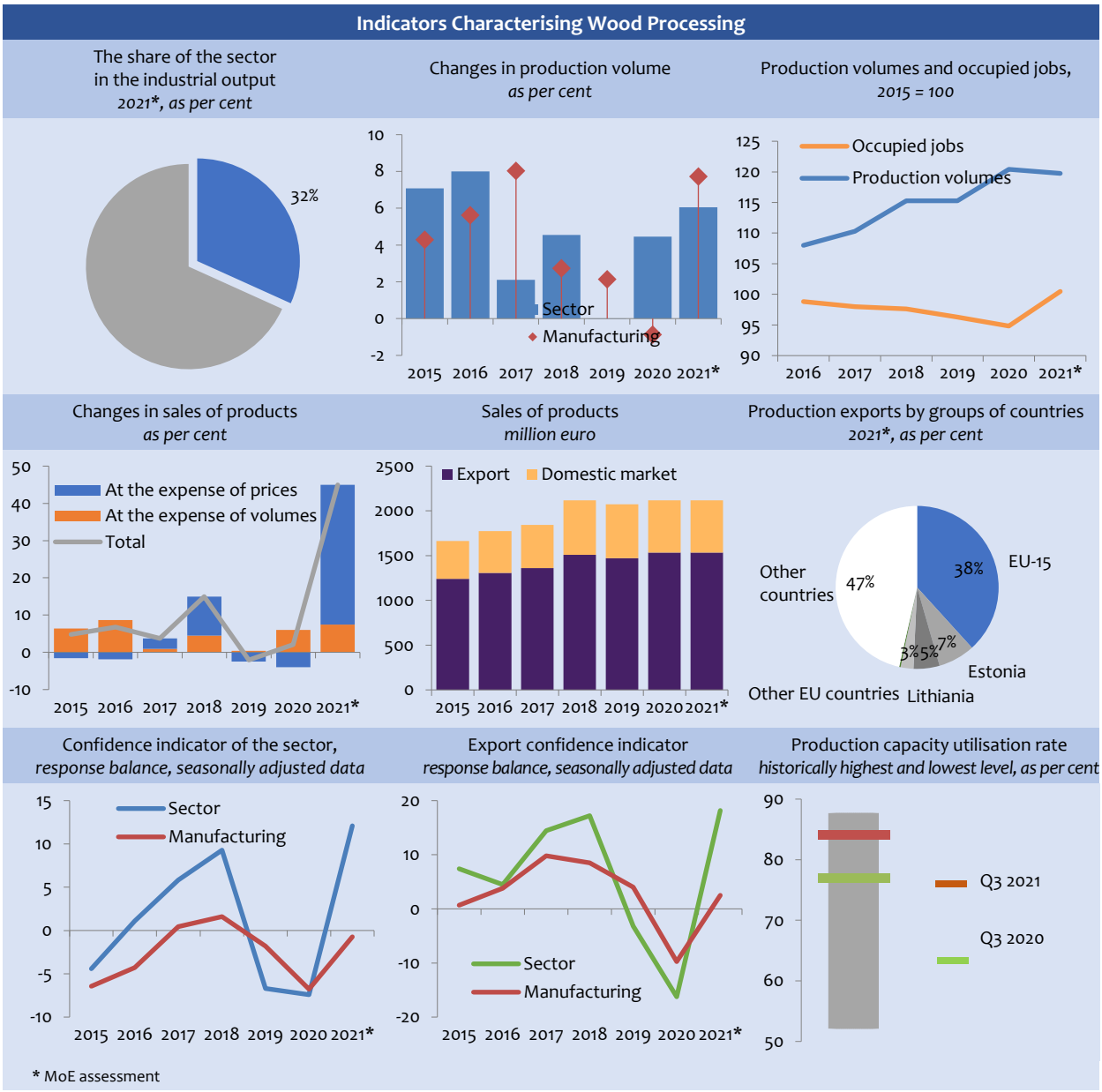


Wood processing is the largest manufacturing sector of Latvia. Traditionally, it accounted for more than 1/4 of the total manufacturing output. Recent years have been successful for wood processing, in particular 2020-2021, when average output volumes exceeded average manufacturing rates. Therefore, the share of the sub-sector in manufacturing continues to grow.

Wood processing is also a strongly export-oriented sector. In January-October 2021, its exports amounted to more than a third of all the products exported by the sector. 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 resumed to rise. In January-October 2021, the sector's output sales have increased by 44.9%.

Despite stable growth in the sector, the number of occupied posts in the sector declined until 2020; however, it returned to growth in 2021. In Q2 of 2021, it exceeded the level of the corresponding quarter of 2009. Until 2018, confidence indicators of the sector have traditionally been considerably above the average level in manufacturing. In 2019-2020, producer confidence declined significantly; nevertheless, it is strongly positive in 2021. The outlook for exports is also assessed positively. The sector's capacity utilisation rate is slightly lower than in 2018. However, it remains higher than in 2019-2020.

Figure 4.7



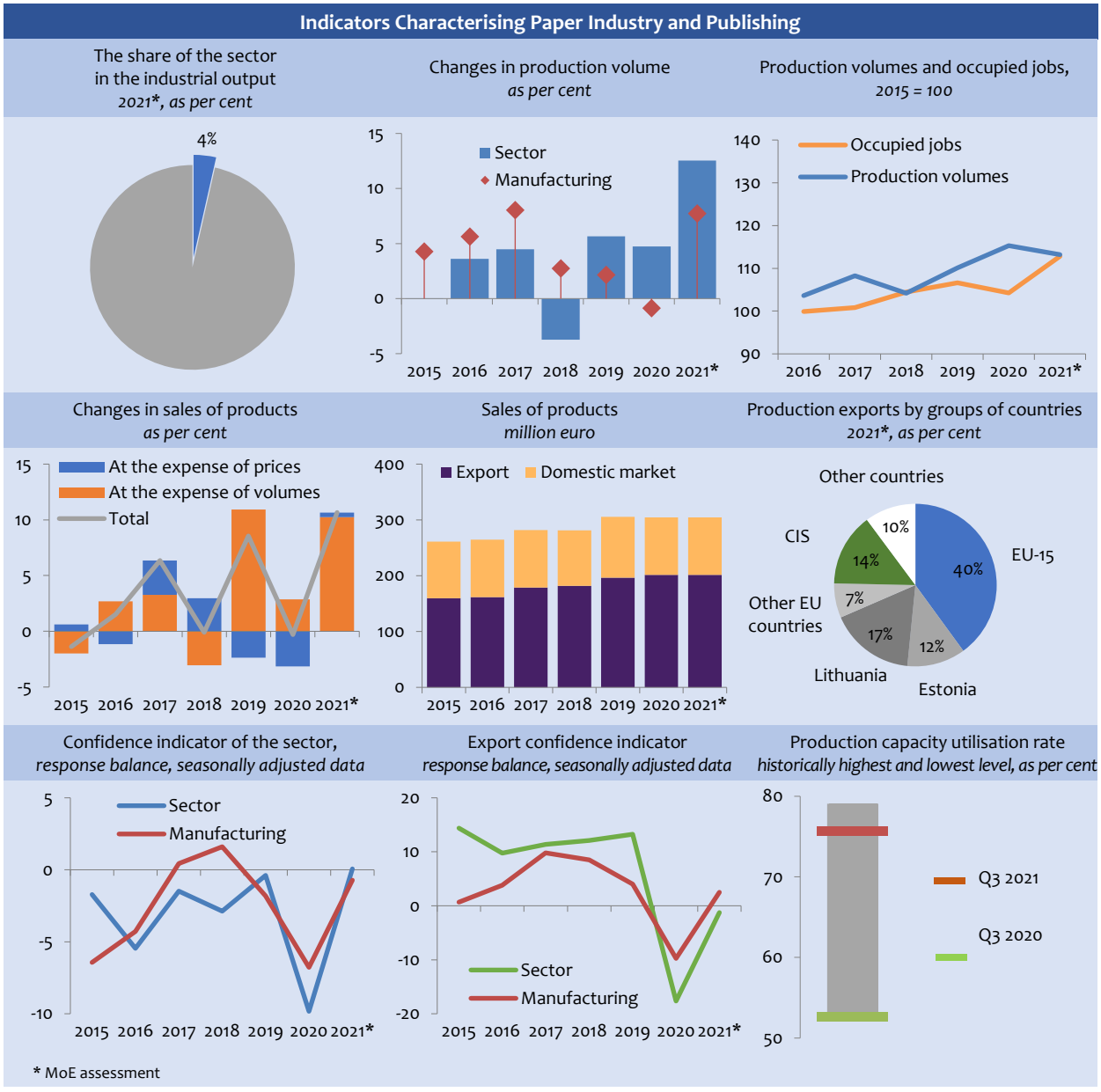
The ***paper industry and publishing*** is gradually reorienting from the domestic to export markets. In 2020 and in January-October 2021, about two thirds of the production were exported.

Recently, production volumes in the sector have been volatile. After the fall in 2018, growth of the sector in 2019-2021 was positive. In January-October 2021, production volumes of the sector have increased 021 affected by significant growth in the publishing sub-sector.

The turnover of the sector has been growing in recent years. More rapid growth of sales in the sector was observed in 2019 and 2021 equally 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.

Until 2019, the number of occupied posts in the paper industry and publishing increased more rapidly than in manufacturing on average. After the decline in 2020, in the first half of 2021, the number of occupied posts in the sub-sector slightly increased. In recent years, the confidence indicator of the sector has been negative, particularly in 2020. In 2021, with growth rates in the sector increasing, confidence, albeit slightly, is positive for the first time since 2007. Export opportunities in the sector are also assessed positively during this period. The capacity utilisation rate in paper industry and publishing is similar to the average level in manufacturing.

Figure 4.8

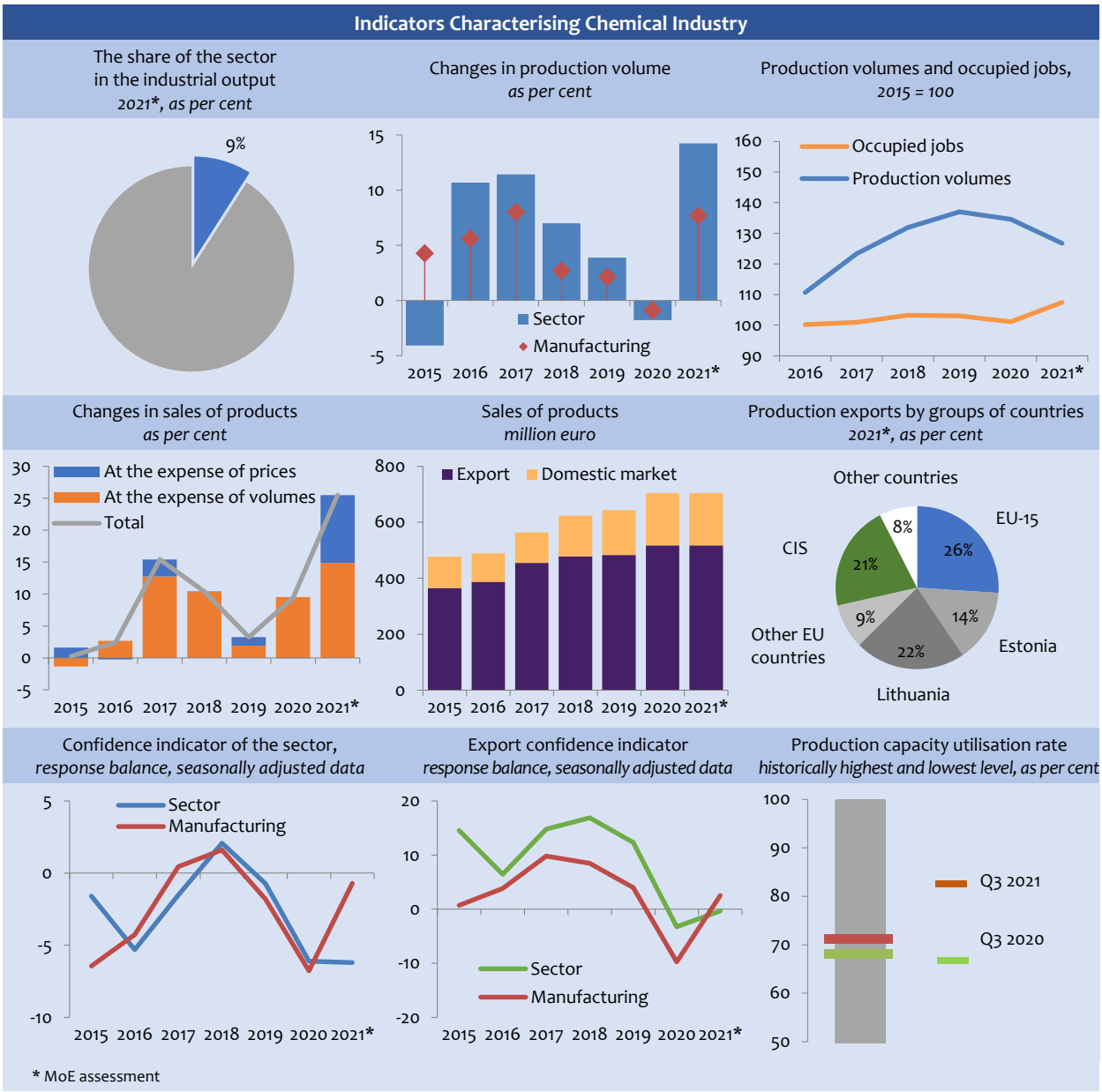


Years 2016-2018 were successful for the ***chemical industry***, which can be attributed to the overall improvement of the economic situation in trading partner countries as considerable part of chemical industry products are exported. In 2019, growth rates of the chemical industry slightly slowed down. Following the decrease in volumes in 2020, rapid growth was observed in January-October 2021, with sub-sector output increasing by 14.2%.

Sales volumes of the sector are also growing rapidly. In 2020, when the sector's volumes declined slightly, its sales increased by 9.5%. Growth in sales also endures in 2021, both in the domestic and export markets.

Until 2018, the number of occupied posts in the chemical industry increased, while declined slightly in 2019 and 2020. In the first half of 2021, the number of occupied posts has resumed growing slightly faster than in manufacturing on average. The confidence of the sub-sector remains negative both in 2020 and in 2021. Export opportunities this year are also evaluated cautiously. In recent years, the capacity utilisation rate of the industry has declined, remaining at the level of 2015.

Figure 4.9



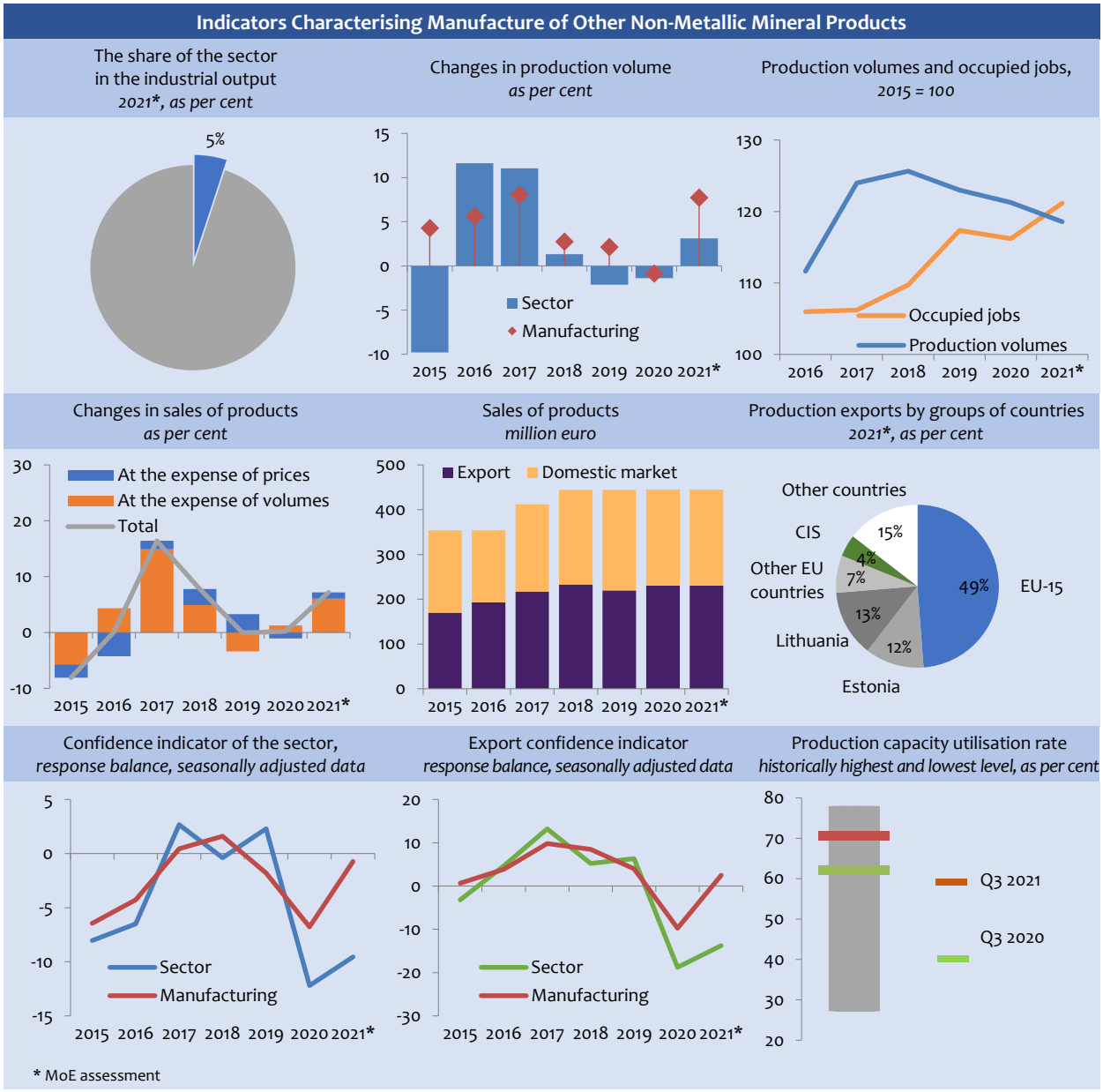
Manufacture of other non-metallic mineral products is closely related to the demand of the construction sector. Sharp growth was observed in the sector in 2016-2017. As the demand for products declined, in 2018, growth of the sub-sector was more moderate. In 2019-2020, manufacturing volumes of non-metallic mineral products declined slightly. In January-October 2021, minor growth in the manufacture of other non-metallic mineral products has been observed.

In 2020-2021, product sales volumes increased. In 2020, export sales grew more rapidly/. Also, sales in the domestic market increased rapidly.

In recent years, the number of occupied posts in the sector has increased comparatively rapidly, even by 7% in 2019. Year 2020 was an exception, when the number of occupied posts in the manufacture of other non-metallic mineral products declined slightly.

The confidence indicator of the sector has been volatile recently. In 2020 and 2021, confidence of the sector was evaluated negatively. The assessment of export opportunities in 2021 is also below manufacturing average. Meanwhile, in 2021, the capacity utilisation rate in the sector is the highest in recent years.

Figure 4.10



In recent years, the ***metalworking*** sector has contributed significantly to the total growth of the manufacturing. In 2018, growth rates of the sector were more moderate, yet they were still above the average level of the sector. Although 2020 was not favourable for the sector, similarly to other manufacturing sub-sectors, in 2021, the sector continues to grow.

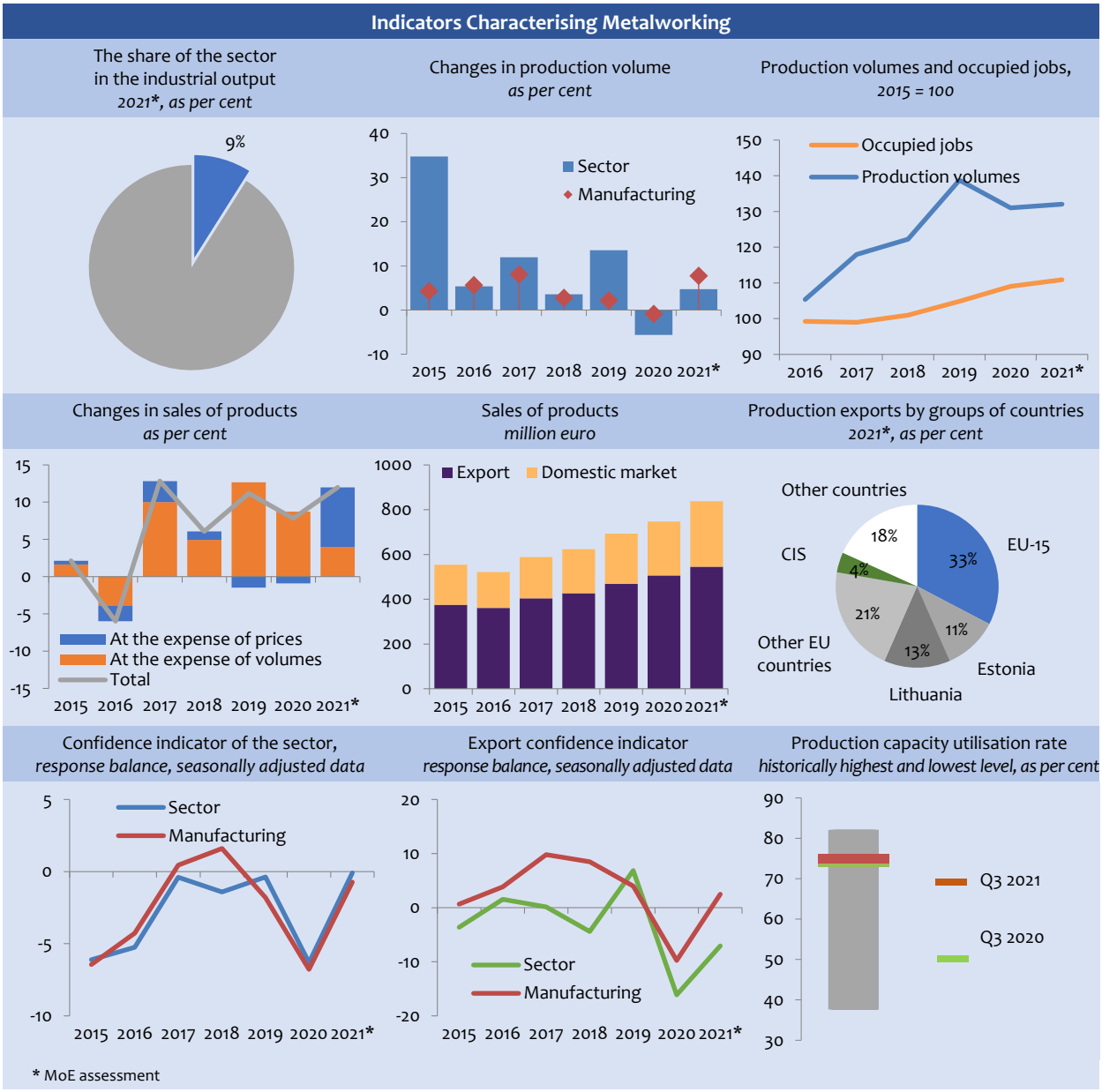
Large part of the products produced by the sub-sector are exported, which means that manufacture of basic metals and articles thereof is significantly affected also by competitiveness of the EU steel manufacturing sector on the global market, which has not been favourable in recent years. The EU has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

Sales volumes of the sector have also been growing considerably in recent years. In 2021, volumes of products sold in the domestic market grew more rapidly.

The metalworking has a growing number of occupied posts every year, particularly in 2020, when the number of occupied posts increased by nearly 2 thousand. Also, the increase endured in 2021.

In recent years, the confidence indicator of metalworking has been negative. In 2020-2021, future export opportunities are also evaluated negatively. Capacity utilisation in metalworking is slightly above the average in manufacturing.

Figure 4.11



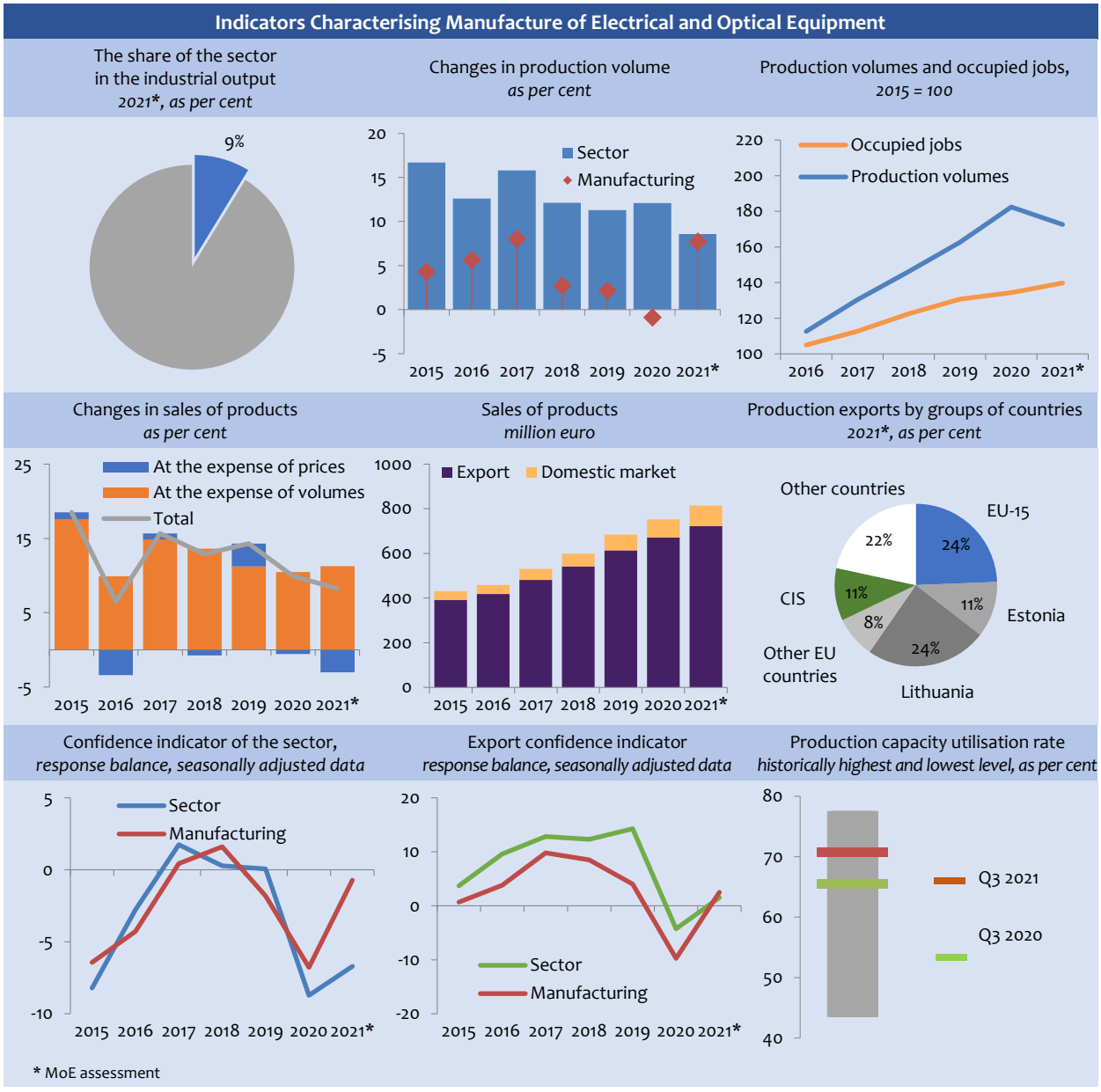
In recent years, ***manufacture of electrical and optical equipment*** has been the most rapidly growing manufacturing sub-sector. Every year, the sector's growth rates are considerably higher than in manufacturing on average. Due to growth of the sub-sector, its share in manufacturing is growing as well. Production volumes of the sector continued to grow rapidly also in 2021.

Despite fluctuations in producer prices, sales volumes of the sector are also growing firmly. The development of the sector is closely related to external demand, about 90% of the production of the sector is exported. Products are sold in the domestic and export markets.

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 2017-2018, the sub-sector provided half of increase in the number of occupied posts in manufacturing. In 2020 and during the first half of 2021, the number of occupied posts was growing rigidly.

In recent years, the confidence indicator of manufacture of electrical and optical equipment has been improving every year; however, in 2020-2021, it is negative. In 2021, export opportunities are evaluated positively. As the output of the sector is growing, the capacity utilisation rate remains relatively high.

Figure 4.12



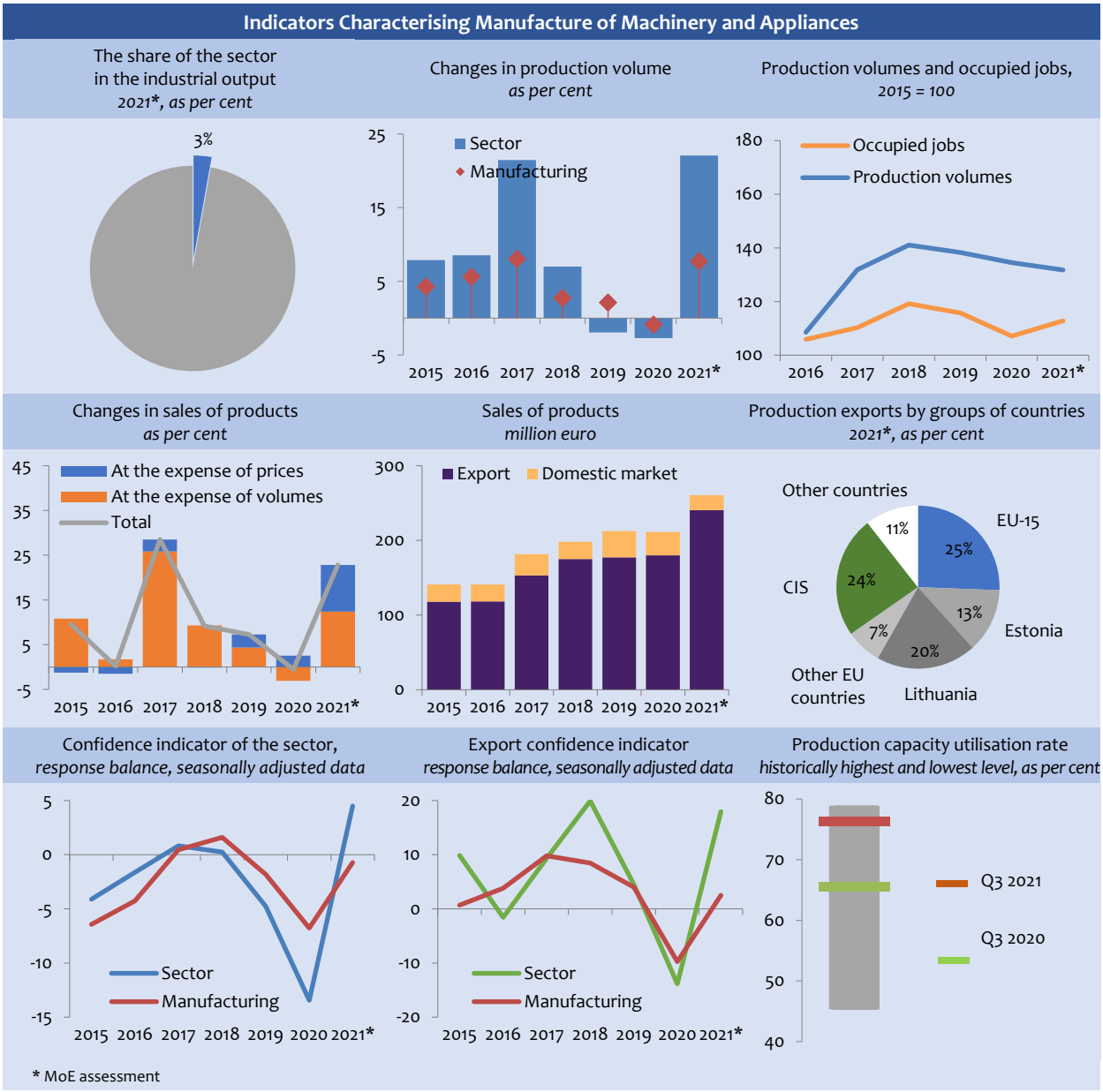
In 2015-2018, growth rates in ***manufacture of machinery and equipment*** were considerably above the average level in manufacturing. In 2017, rapid growth was observed. In 2019, as external demand declined under the influence of the Covid-19 crisis, in 2020, growth rates of the sub-sector were negative. In 2021, the output growth rates are the highest in manufacturing.

In recent years, growth in sales volumes in the sub-sector has been more rapid than output. In 2019, sales volumes were growing particularly rapidly domestically; however, sales volumes of exported increased moderately. An opposite picture is observed in 2020 and in particular in 2021, when all the increase in turnover of the sub-sector was ensured by sales volumes of exported products. It should be noted that almost 90% of the production of the sector is exported. The EU countries are the main outlet for the products, albeit considerable part of products are sold also in CIS countries.

The number of occupied posts in the sector increased in 2017-2018, ensuring a large share of the increase in the number of occupied posts in manufacturing. In 2019-2020, the number of occupied posts in the sub-sector shrank. However, in 2021, it returned to growth.

In 2019 and in particular in 2020, the development of the sector was evaluated negatively; nevertheless, in 2021, the entrepreneurs are optimistic. In 2021, export development potential, however, is not evaluated optimistically. In recent years, the capacity utilisation rate has been volatile, fluctuating around the average level in manufacturing in 2021.

Figure 4.13



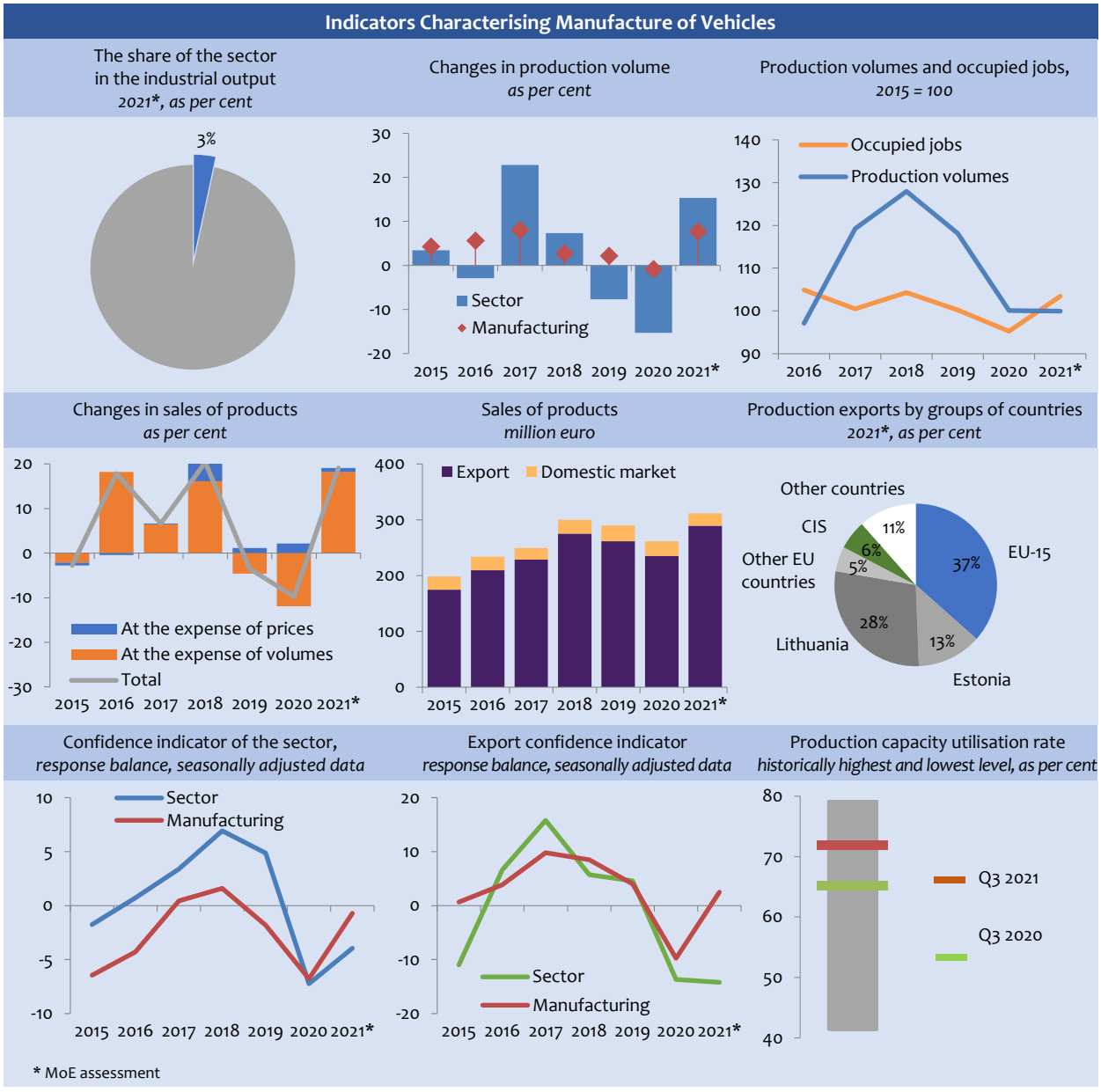
Manufacture of vehicles is evidently focused on external markets – more than 90% of products of the sector are exported. Since the sector largely depends on new orders, it is characterised by particularly pronounced fluctuations in production volumes.

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 of the sub-sector declined. Year 2020 was not successful for the sector due to the general situation in the European automotive sector, including the Latvian companies, which mainly produce spare parts. Similarly to other sub-sectors, in 2021, manufacture of vehicles is growing relatively rapidly.

Sales volumes of the sub-sector grew relatively rapidly in 2017-2018; however, the volumes decreased in 2019-2020. In January-October 2021, sales volumes increased.

The number of occupied posts in manufacture of vehicles declined slightly in 2019-2020;nevertheless, in the first half of 2021, it increased. The confidence indicator of the sector remained negative in 2020-2021, with the sector's export potential being assessed in the same way. The capacity utilisation rate is similar to that of manufacturing.

Figure 4.14



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 the increase in 2015-2016, the share of other industries in the total value added has been declining since 2017. The dynamics in sales volumes in electricity and gas supply sectors is related to weather, as amounts of electricity and heat produced depend on it.

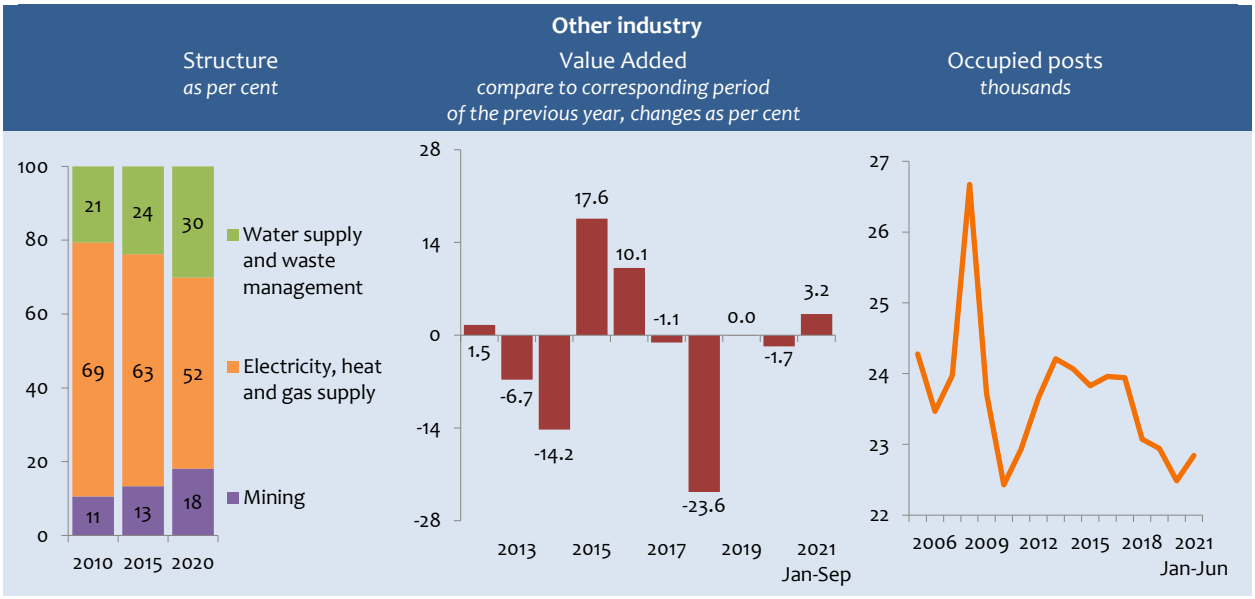
In 2015-2016, after a long drop in production volumes in the previous years, a rapid increase was observed in other industries. Considering that weather in the winter months was much colder, much more electricity and heat energy was consumed.

In 2017-2020, a rapid decline was observed in volumes of other industries being particularly rapid in 2018 under the influence of a drop in electricity and gas supply. The amount of electricity generated by hydropower plants and cogeneration plants, and gas supply to consumers reduced considerably under the effect of warm and dry weather. At the same time, the share of the mining industry increased fostered by a rapid increase in peat extraction volumes. In 2020, other industries experienced a slight drop in production volumes, driven by a drop in electricity generation and supply and a decrease in natural gas supply.

In the three quarters of 2021 production volumes of other industries increased sharply compared to the corresponding period of the previous year. Cold weather increased natural gas and electricity supply at the beginning of the year, while favourable weather contributed to the development of mining and quarrying.

The number of occupied posts increased in mining and water supply and waste management, while remained unchanged in electricity, gas, steam and air conditioning supply.

Figure 4.15

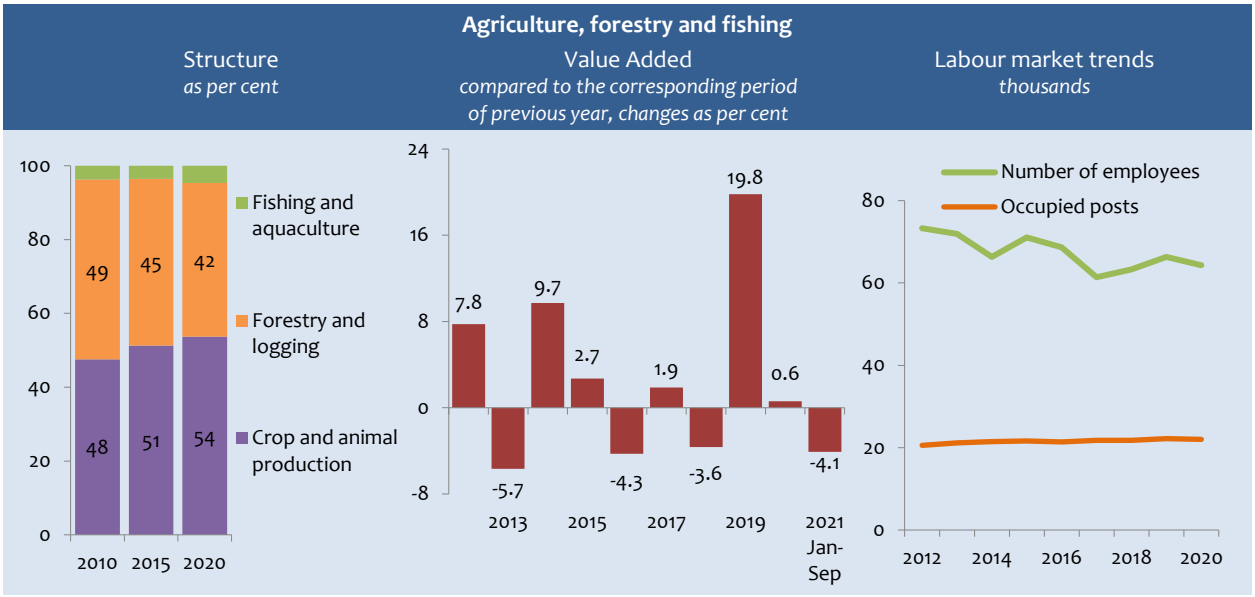


4.4. AGRICULTURE, FORESTRY AND FISHING

Agriculture and forestry dominate in the structure of **agriculture, forestry and fishing**. The activity of the industry is closely related to weather conditions; therefore, growth of the industry is generally volatile. After the increase in 2014-2015, the share of the industry in the total value added reduced in 2016 due to the decrease in crop production. The share of the industry has increased in recent years.

In 2014-2015, despite Russia's embargo on food imports, there was rapid growth in agriculture and forestry fostered by the historically highest harvest of crops. In 2016 and 2018, the volume of the sector decreased due to a fall in crop production due to adverse weather conditions, while in 2017 the sector experienced some growth due to a rise in forestry volumes.

Figure 4.16



In 2019, very rapid growth was observed. The increase was mainly underpinned by growth in agriculture, where volumes of production increased by 38.3%. This increase was underpinned by an increase in crop production volumes – in 2019, Latvia had the highest total crop harvest in its history. The achievement of the record-high crop harvest was significantly affected by good productivity indicators as well as by the increase in crop farming areas.

In 2020, sector volumes increased slightly, driven by a sharp increase in production volumes in crop production, when for the second consecutive year the crop harvest in Latvia was the highest in its history, which was by 0.6% more than in the previous year. Winter of 2020 was favourable for winter crops, while summer was favourable for harvesting, as well as the largest crop areas in Latvian agriculture were sown. However, weather conditions were not favourable for growing vegetables in the open field, and their harvest declined.

Animal production volumes deteriorated slightly in 2020. The number of farmed animals reduced, while an increase was observed in the number of poultry. The number of exported livestock reduced, but the number of exported live pigs increased. A small decrease was observed in meat production volumes, but milk and egg production volumes increased under the influence of an increase in the number of dairy cows and hens.

Prices of agricultural products reduced in 2020. The average purchase price reduced both for milk and meat – by 4.3%. The largest drop in the purchase price was for pork, while the purchase price for eggs rose. In 2020, crop production prices also decreased, driven by a sharp drop in prices for potatoes by 18.5% and vegetables by 12.4%, while the average purchase price of grain increased to 164.94 euro per tonne or by 4.2%, in the second half of 2020 world markets also experienced an increase in cereal prices.

In the forestry sector, production volumes declined sharply in 2020. Volumes of cut wood decreased by 1%, but forest renewal volumes decreased much more rapidly – by 12%. After a fall in the previous year, in 2020, the average purchase price of logs in Latvia increased slightly. It increased for coniferous logs and deciduous trees. In the first half of 2020, the timber market in Europe was affected by the consequences of insect infestations, *Brexit* and the Covid-19 pandemic, while in the second half of 2020 the supply of logs exceeded demand and the prices of logs increased.

In three quarters of 2021 volumes of the industries have reduced. Agricultural production volumes decreased in both crop and animal production. A minor reduction in volumes was observed in forestry, while in fishing production volumes increased rapidly.

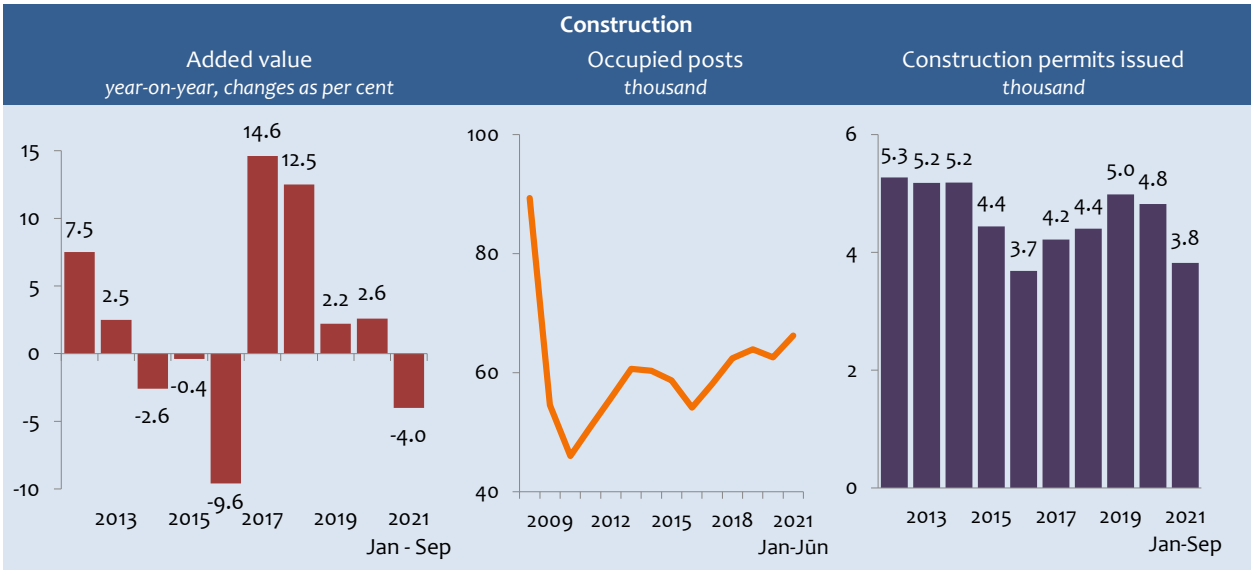
In recent years, the number of the employed and occupied posts in the industry in general has been growing slowly affected by the increase in the number of employees in forestry. In 2020, the Covid-19 crisis has led to a decline in the number of jobs in both agriculture and forestry, while fishing has seen a rapid increase in jobs. In the first half of 2021, occupied posts grew rapidly in agriculture and forestry and exceeded levels before the Covid-19 crisis.

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 recent years. The annual average output increased by 14.4% and the average increase in 2006 and 2007 amounted up to 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 have virtually exploded, labour costs increased 2.6 times and costs of maintenance and operation of machinery and mechanisms almost doubled.

Production volumes dramatically reduced 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 reducing almost twice. The reduction also affected construction costs, affecting labour costs to the largest extent. It should be noted that they remain at a higher level than before the overheating.

Figure 4.17



The demand for services of the industry 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 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.

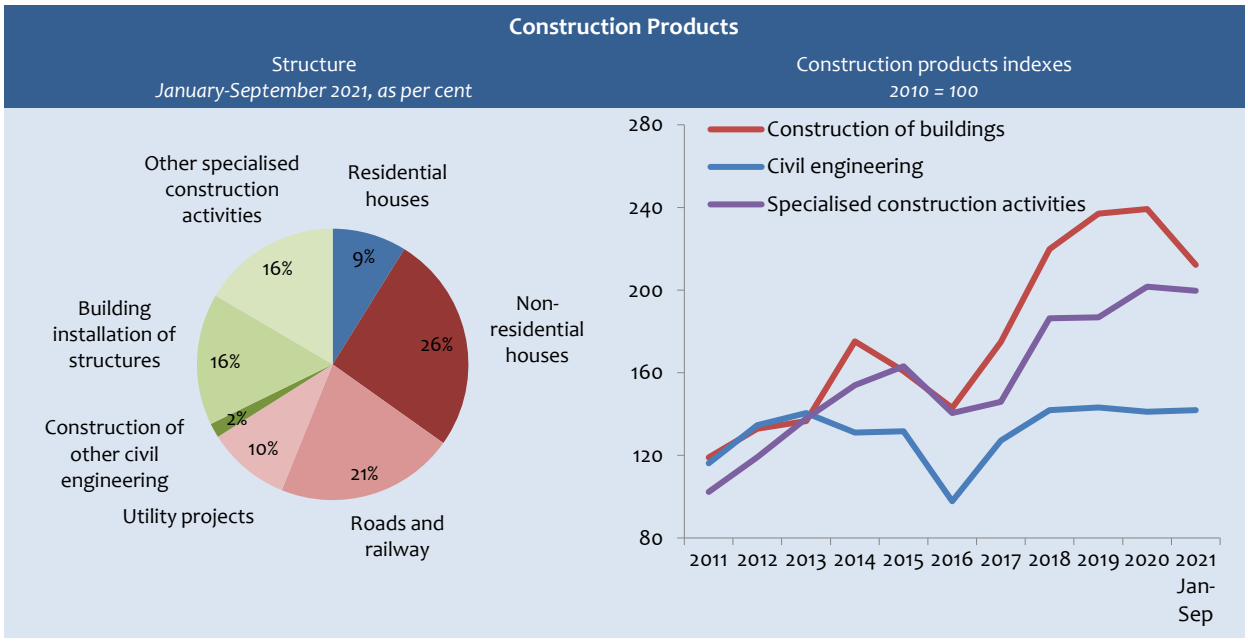
It should be noted that during the transitional period of the EU Structural Funds, construction output decreased by 4.2% annually in 2014-2016 as a result of a reduction in investment in construction. Construction activities shrank in all groups, most rapidly in the group of civil engineering. Negative trends also contributed to the reduction in the number of granted building permits in these years. In the next years since 2017, the industry 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 is 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 first year of the Covid-19 crisis did not reduce activity in the sector. The sector was not subject to strict restrictions. Overall, construction output grew 2.6% in 2020. Last year, the construction development rate remained at the level of 2019.

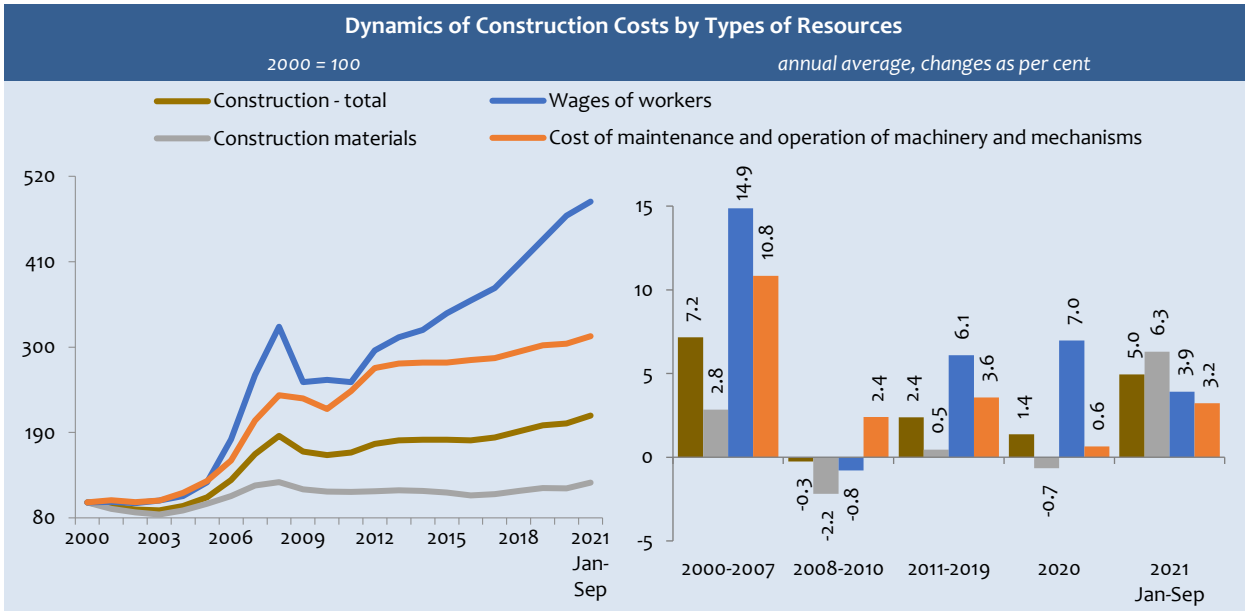
Although the decrease in private investment caused by the economic downturn in Q2 and Q3 had a negative impact on the sector's output, due to the positive indicators of Q1 and Q4, the sector's dynamics year-on-year were positive. In 2020, the Covid-19 crisis caused a slight drop in the number of jobs in construction. Only labour costs increased to a tangible extent this year, while total construction costs continued to increase uniformly and moderately.

Figure 4.18



Year 2021 was not as successful for the sector as the previous year. Construction output in the 3 quarters of 2021 is 4.1% lower than in the 3 quarters of 2020. The decline in Q1 can be more explained by the base effect (the untypically warm winter of 2020, which was favourable for construction), the decline in Q3 – by the decrease in demand as a result of global increases in construction costs, particularly substantial increases in prices of timber and metals. This has had a negative impact on both existing construction projects and has slowed down new ones. It should be noted that the most significant reason for the increase in construction costs in 2021 is the increase in prices of construction materials. During the 3 quarters of 2021, civil engineering volumes increased slightly, while construction of buildings and specialised construction activities declined. The decrease had a bigger effect on construction of buildings.

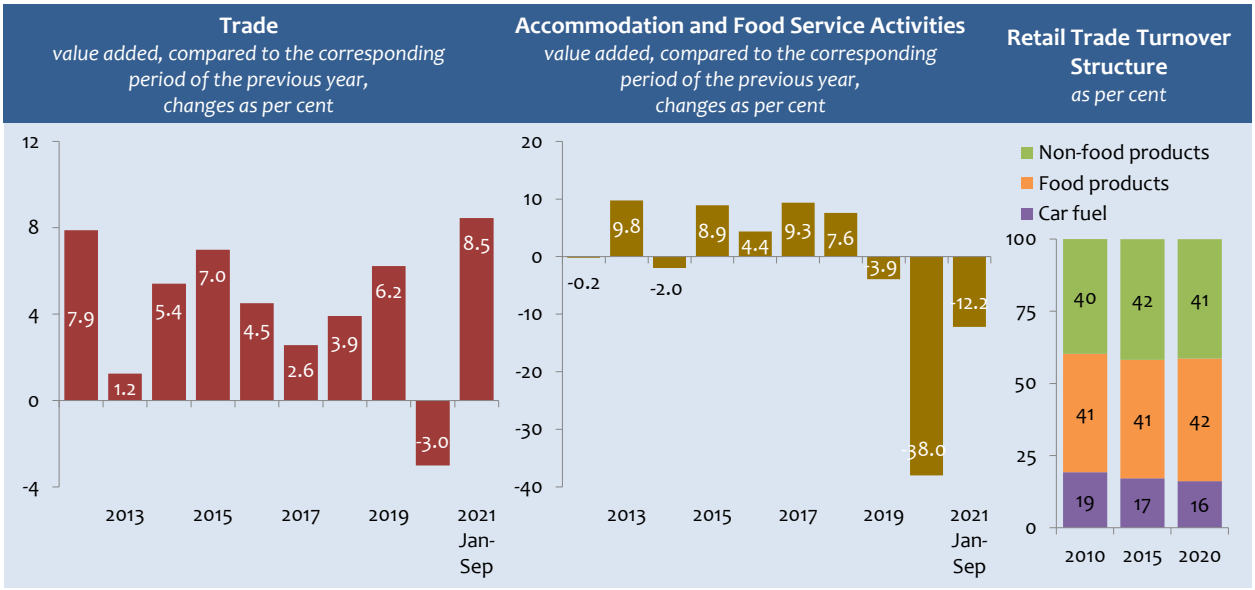
Figure 4.19



4.6. TRADE, ACCOMMODATION AND FOOD SERVICE ACTIVITIES

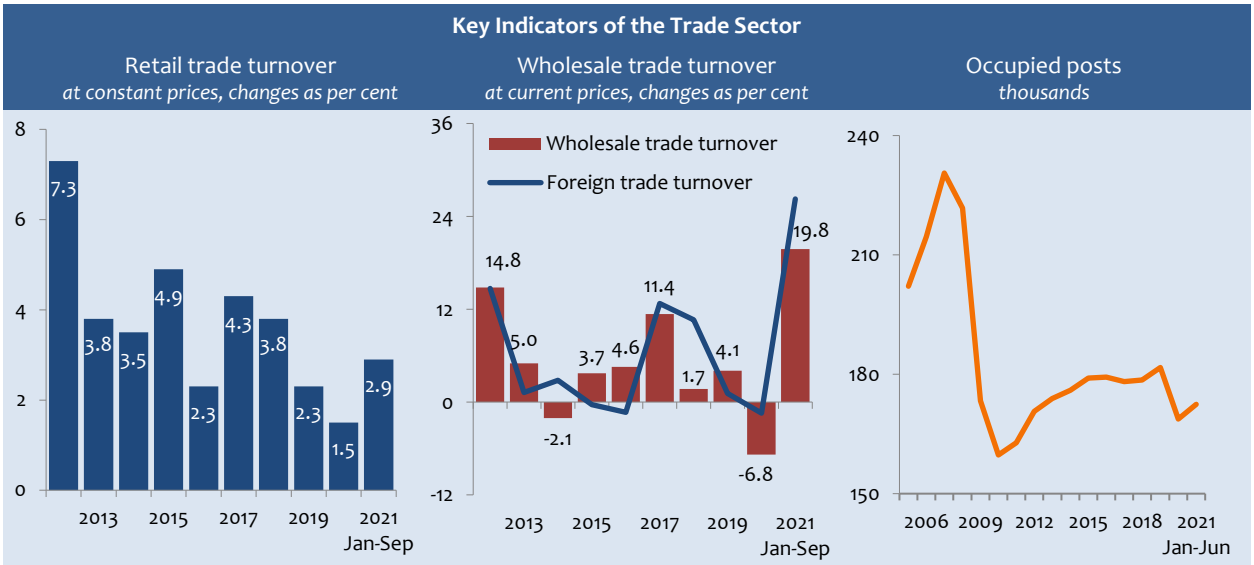
Trade dominates in **trade, accommodation and food service activities** – about 90%. Volumes of services provided in the sector have been generally growing since 2012. The trade sector was positively influenced by an increase in private consumption and retail turnover. Furthermore, accommodation and food service activities were positively affected by the development of the tourism sector.

Figure 4.20



Between 2012 and 2019, services in trade increased every year and overall growth was rapid – on average by 4.8% per year. In general, accommodation and food service activities also experienced a sharp increase in volumes in this period – an average annual increase of 4.1%, 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 4% per year on average. The dynamics of the total retail trade turnover were most seriously affected by the increase in non-food retail trade volumes, the turnover increased sharply for automotive fuel, while retail volumes increased slower in the group of food products. The dynamics of the retail sector were affected by external trade activities.

Figure 4.21



In 2020, the volume of services provided in trade, accommodation and food services activities reduced rapidly. The trade sector was negatively affected by the decline in private consumption, rising unemployment and falling incomes caused by the Covid-19 crisis. Its volumes fell by 3% in 2020. Retail trade turnover in 2020 increased only by 1.5%. Retail volumes of food products and fuel increased, while those of non-food products saw a decline. Meanwhile, the wholesale trade turnover at current prices reduced by 6.8%. Accommodation and food service activities were particularly negatively influenced by the strict measures introduced to restrict the spread of the virus. In 2020, volumes of the industry reduced by 38%.

In 2021, the volume of services provided in trade, accommodation and food services activities grew rapidly. The trade sector was positively influenced by the easement of the restrictions caused by the Covid-19 pandemic. It grew by 8.5% in the three quarters of 2021. The rise in retail trade turnover in the three quarters of 2021 was much steeper than in 2020 and grew by 2.9%. Retail trade of non-food products increased by 3.6%, retail trade of fuel by 7.9%, while trade of food remained almost unchanged. The wholesale trade turnover at current prices grew by 19.8%. Volumes of accommodation and food service activities continued to shrink in Q1 2021, but industry growth was very rapid in Q2, however, it should be taken into account that this sector is recovering from a very deep recession and still significantly lags behind the pre-pandemic level. In three quarters of 2021, industry volumes shrank by 12.2% driven by the more rapid decline in Q1.

The largest share of occupied posts is in trade, but it has shrank in recent years with jobs growing faster in the accommodation and food services activities sector. In 2020, a significant decline in the number of jobs was observed in both sectors due to the Covid-19 crisis, which was particularly rapid in accommodation and food service activities. In the first half of 2021, under the influence of the Covid-19 crisis the decline in the number of jobs in accommodation and food service activities continued, but a rapid increase in jobs was observed in trade.

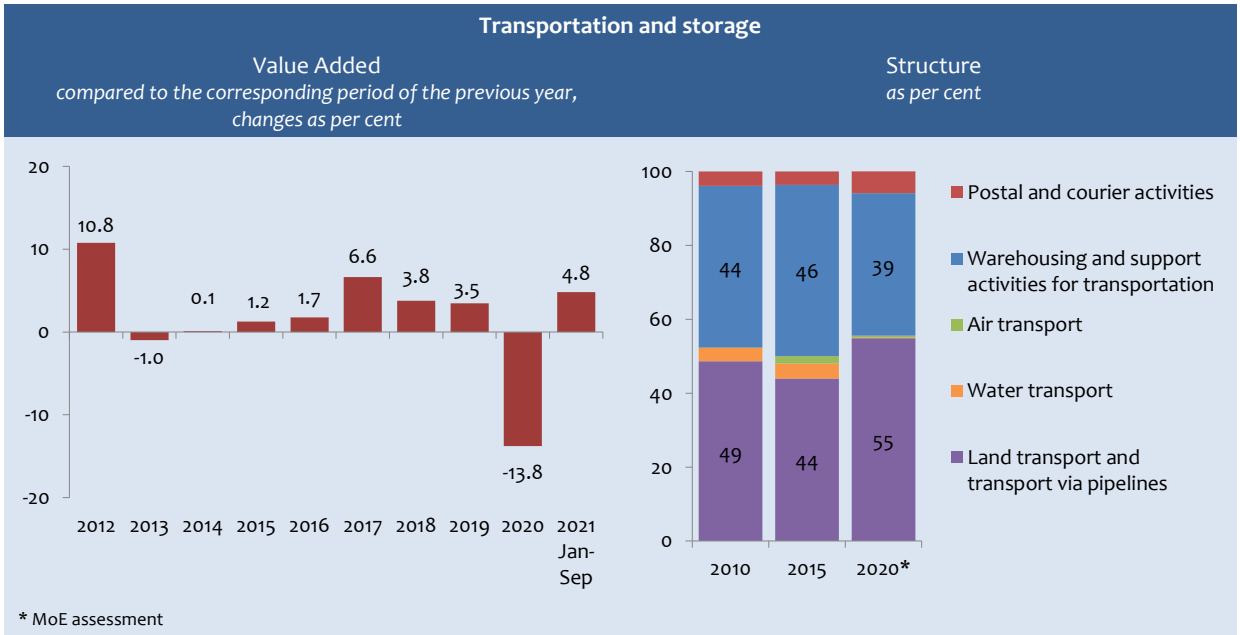
4.7. TRANSPORTATION AND STORAGE

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

After a sharp increase in the post-crisis period, volumes of the sector experienced a small increase in 2013-2016 – 0.5% per year on average. Among other things, it was primarily 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.

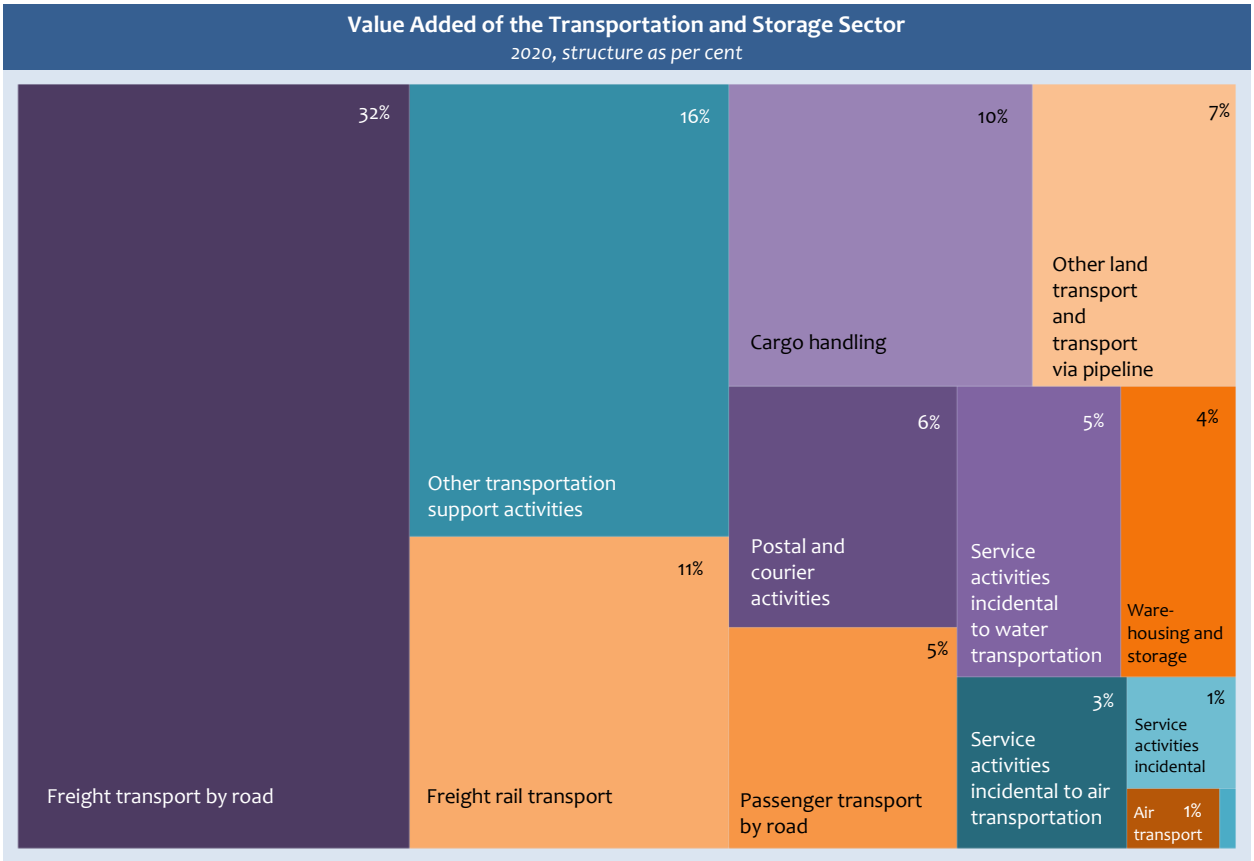
In 2017-2019, increases in industry volumes were the most rapid since 2012 – 4.6% per year on average. Despite the drop in transit freights by railway and in ports, growth of the sector was fostered by the increase in freight transport by road, as well as the increase in the number of passengers in the airport and seaports.

Figure 4.22



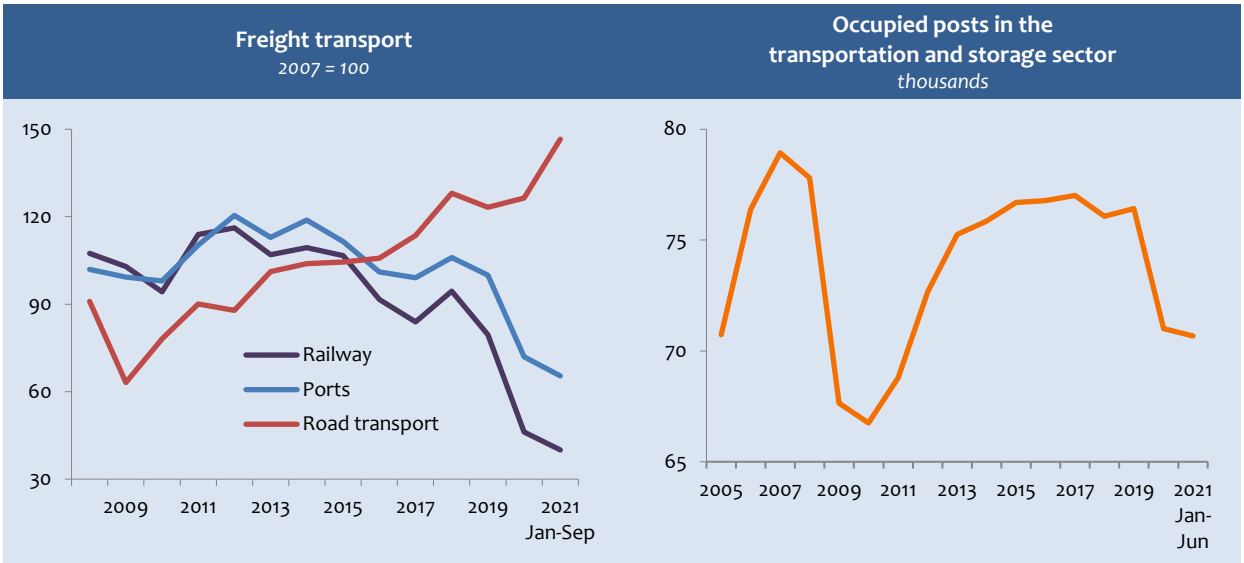
In 2020, volumes of the industry reduced. The restrictions caused by the Covid-19 crisis had a significant impact on aviation, land transport and rail companies. A sharp drop in transit freights was seen in railways and ports, while road freight volumes slightly increased, due to an increase in inland freight volumes. Passenger transport reduced in all modes of transport. The most rapid reduction in passenger numbers was in air transport – by 73.1%, passenger numbers in ports reduced by 59.2% and in road transport by 36.4 per cent.

Figure 4.23



Also in Q1 2021, the sector's volumes continued to decline, but as the epidemiological situation improved and the restrictions introduced were removed, the sector's volumes increased sharply in Q2. In the three quarters of 2021, overall, the sector's volumes increased by 4.8%, the drop in freight volumes was seen in railways and ports, while road freight volumes increased rapidly, driven by increases in both inland and international freight volumes. Despite the rapid increase in Q2, passenger transport continued to decline in all modes of transport in the three quarters due to the movement restrictions imposed in Q1. The most rapid reduction in passenger numbers was in maritime transport – the number of passengers in ports decreased by 55.9%, in air transport – by 21.2% and in road transport – by 18.6%.

Figure 4.24



The biggest share of occupied jobs in transportation and storage is in land transport, transport via pipeline and support activities for transportation. Following the rapid rise in previous years, the number of occupied posts in the air and water transport sectors started to decline in 2019, with the most rapid drop in 2020 under the influence of the Covid-19 crisis. In 2020, occupied posts declined across all transportation and storage sub-sectors. In the first half of 2021, the number of occupied posts kept declining in all transportation sectors, with the exception of postal and courier activities. The steepest drop was in water transport.

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).

Figure 4.25

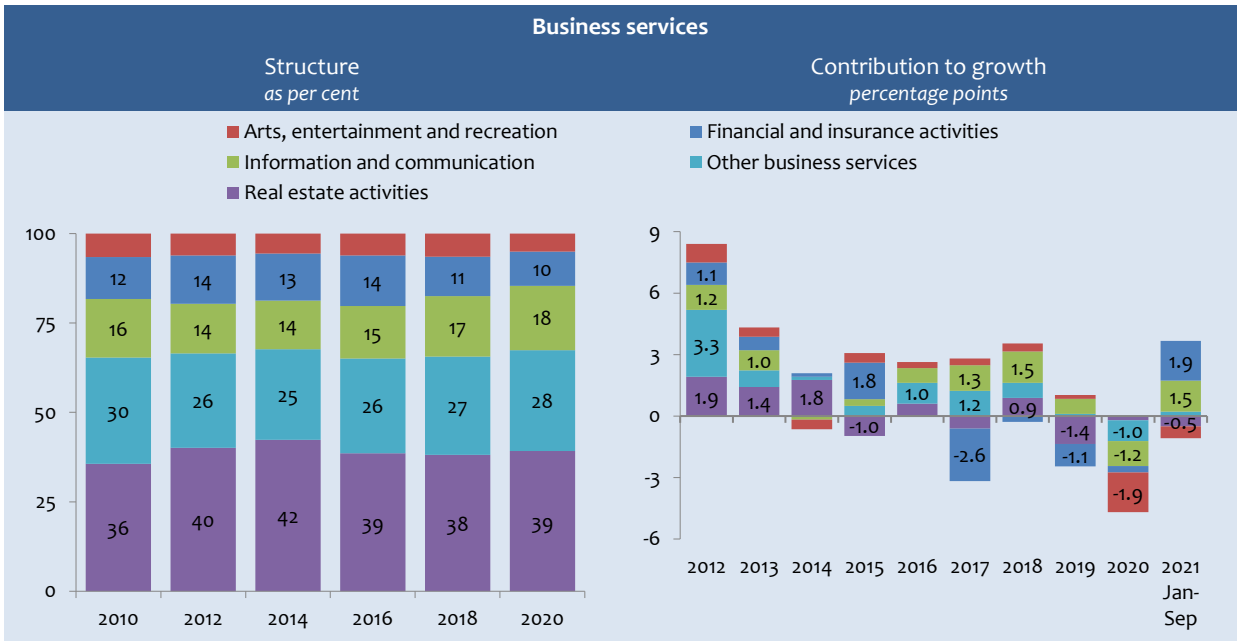
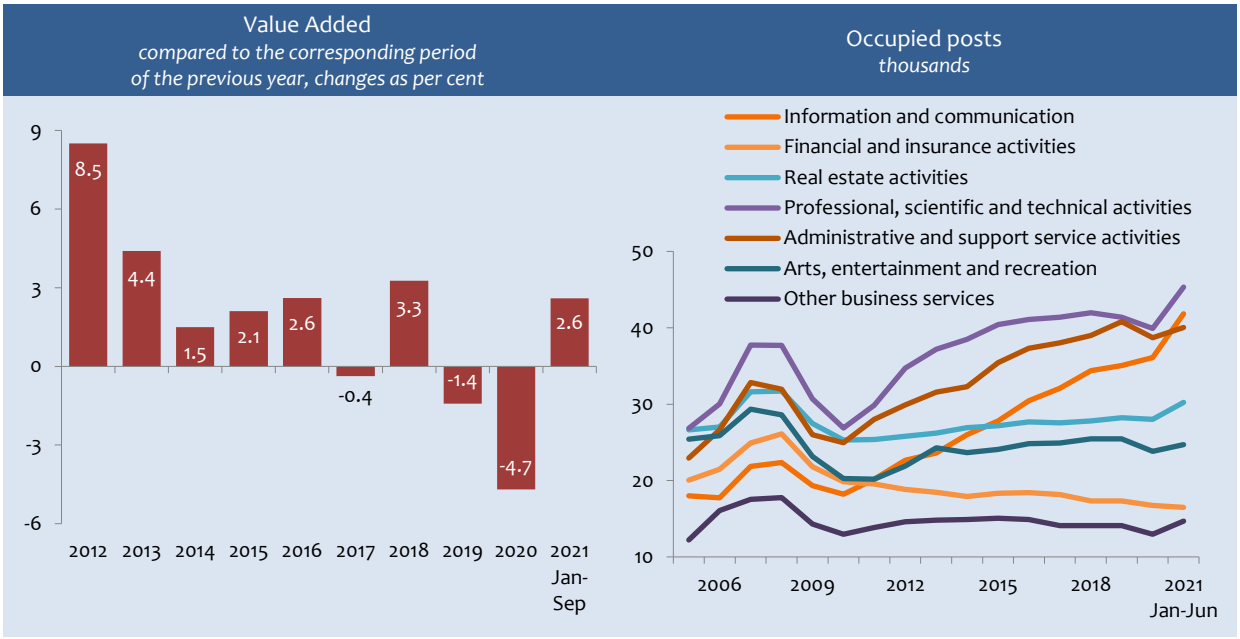


Figure 4.25 cont.



Following the rapid growth in 2011-2013, volumes of business services sectors increased more modestly from 2014-2018 – by 1.8% per year on average. 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, the consolidation of banks and the reduction in the number of employees. In 2019, service sectors volumes declined, driven by a drop in volumes in real estate activities and financial and insurance activities.

In 2020, volumes of business services reduced rapidly in all sectors under the influence of the Covid-19 crisis. The drop in service volumes in arts, entertainment and recreation had a major impact due to the strict measures introduced to limit the Covid-19 pandemic. The drop in information and communication services had a significant impact here. In other sectors, the effects of the volume cuts were similar.

In the three quarters of 2021 volumes of business services increased compared to the respective period of 2020. 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 volumes in information and communication services and the fall in arts, entertainment and recreation and real estate activities also had a big impact.

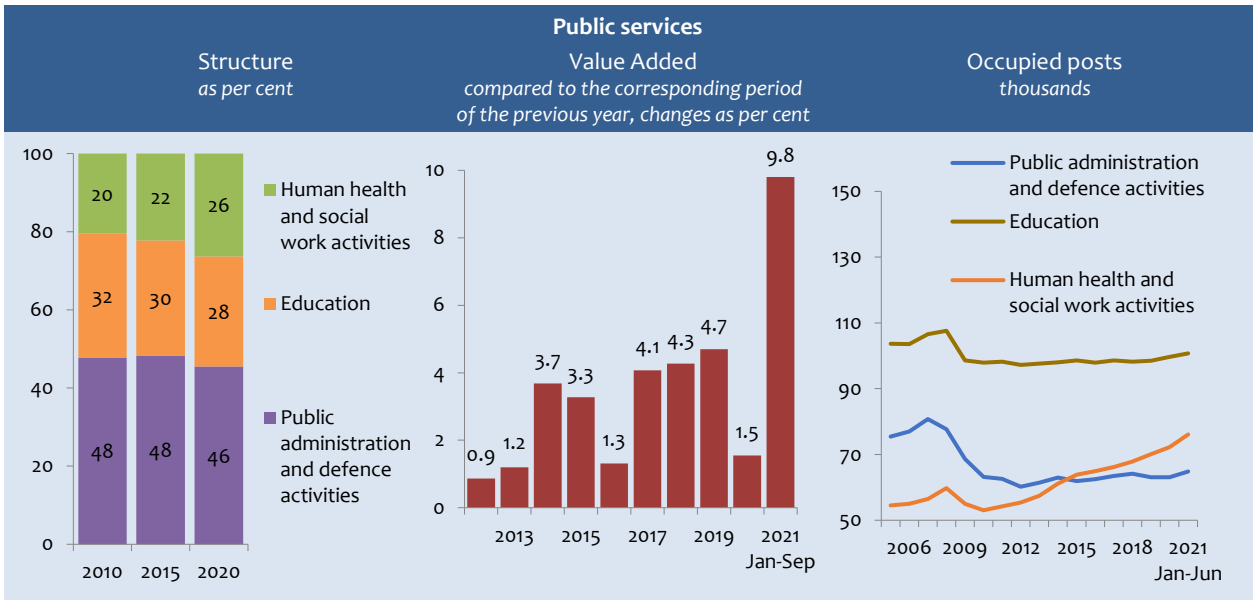
The largest share of occupied posts has been in professional, scientific and technical activities, administrative and support service activities and information and communication sectors, which had the most rapid increase in the number of occupied posts in recent years. In 2020, the number of jobs declined across all business services, excluding information and communication. They declined most sharply in arts, entertainment and recreation. In the first half of 2021, an increase in occupied posts was observed in all services sectors, except financial and insurance activities. The number of occupied posts grew very rapidly in information and communication and in professional, scientific and technical activities.

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). The government's commitment to continue reducing the national budget deficit in the post-crisis period held back a rapid increase in expenditure. With the government expenditure increasing, a steady growth has been observed in the public services sectors since 2014. A slower increase was observed in 2016, when only public administration and defence activities had a stable rise in volumes.

Overall, in 2014-2019, volumes of public services increased by 3.6% per year on average. The most rapid increase was observed in health and the slowest – in public administration and defence activities. Consumption on the increase of defence capabilities of the state, health and education has increased considerably in recent years.

Figure 4.26



In 2020, public services were also negatively affected by the Covid-19 crisis. Total volumes of services increased by only 1.5%. Volumes of public administration and defence activities increased by 1.5%, volumes of health and social work activities – by 2.4% and volumes of education services – by 0.8%.

In the three quarters of 2021, total volumes of services showed a rapid increase caused by the increase in human health and social work activities – by 26.3%. Volumes of public administration and defence activities increased by 2.4%, but volumes of education by 4.5%.

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 2020, the number of jobs continued to rise in health and education, while it remained unchanged in public administration. In the first half of 2021, health experienced a rapid increase in the number of occupied posts, but it increased significantly also in public administration and education.

5. ECONOMIC DEVELOPMENT FORECASTS

ECONOMIC DEVELOPMENT IN 2022[1]

Also, in 2021, the spread of the Covid-19 virus and the epidemiological safety measures for its containment continued to influence the consumers, enterprises, sectors, and the wider economy. The sectors related to the gathering and servicing of people – mainly retail, accommodation and food service activities, transport services, the arts, entertainment, and recreation – have been hit more severely. According to the CSB data, in Q1-Q3 of 2021, compared to the corresponding period last year, GDP has increased by 5.2%. As the spread of Covid-19 infection increased again in the autumn, and the government imposed a series of restrictive measures, in Q4 of 2021, overall economic development rates are expected to be slightly slower than in the previous two quarters. Overall, in 2021, economic growth could be close to 5%.

In 2022, the economy will continue to grow. The main risks to growth are high energy prices, which will likely endure at the beginning of 2022, new Covid-19 virus mutations and the progress of revaccination, and problems in global supply chains that may not be resolved in 2022. It will affect businesses and consumers.

Private consumption has recovered rapidly in the last quarters, and positive trends are anticipated to endure in 2022 as well. It will be underpinned by further increases in wages and the favourable situation in the labour market. In 2022, private consumption could grow by 5.7%, providing a significant contribution to economic growth.

In 2022, the growth of gross fixed capital formation is forecast at 7%. The increase will be largely affected by public investments. Additional funding available in REACT-EU or recovery assistance for cohesion and European territories for the 2014-2020 programming period, *Next Generation EU* fund (1.82 billion euro) for the implementation of the Latvian Recovery and Resilience Facility Plan in the coming years. Also, the launch of the new EU funds programming period 2021-2027 will boost investment in construction, machinery and appliances, and intellectual property products.

The impact of restrictions on exporters of goods has been short-lived, and the recovery from the shock caused by Covid-19 has been more rapid. Despite the problems in global supply chains and rising prices of resources, Latvian producers maintain their competitiveness, and economic growth in the main export markets of Latvia contributes to rising export volumes of goods. Services sectors (i.e., tourism, air transport) have been hit harder by the Covid-19 crisis. Given the still low base effect, in 2022, exports of services will increase more rapidly than exports of goods. Overall, growth rate of exports of goods and services can reach 5.6% in 2022.

Considering that the role of exports in economic development will remain significant, in 2022, growth is expected to endure in manufacturing. In 2022 growth rates might be more moderate than in 2021 and may reach 5.5%. Overall, manufacturing indicators will be affected by trends in larger sub-sectors – wood processing, food industry, and metalworking.

To a large extent, in 2021, adverse weather conditions affected the fall in volumes in agriculture and forestry. Given the base effect, in 2022, sector volumes are expected to grow by 4.7%. Positive trends are also anticipated in other sectors, as growth rates in 2022 can be more rapid, compared to2021. The increase in energy output, as in agriculture, will depend partly on favourable weather conditions. Growth is also expected to endure in mining and quarrying, where it has been stable in recent years.

In 2022, a sharp increase is forecast in construction. In 2022, the sector is anticipated to grow by 7.7%, following a decline in 2021. It will mainly be determined by the above-mentioned public investments. At the same time, the sector's capacity to fulfil the planned orders and avoid potential overheating due to limited resources is vitally important.

In 2022, stable growth rates are expected in the IT sector. Growth is also anticipated in the sectors related to private consumption and domestic market-oriented sectors – i.e., retail trade and other commercial services. The projected increase in external trade turnover will have a positive impact on the development of the wholesale sector.

In 2022, transportation and storage is expected to grow within 3-4%. On the one hand, no reason to anticipate significant improvements in transit freight flows can be stated. On the other hand, the sector development will be positively affected by the recovery of the aviation sector from the fall caused by the Covid-19 crisis and by the growth of the land transport sector.

In view of the significant drop in volumes during the Covid-19 crisis, relatively rapid growth rates are expected in the most severely affected sectors – accommodation and food service activities, the arts, entertainment, and recreation. At the same

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

time, in 2022, these sectors will not reach the level of 2019, and certain sectors may need several years to reach pre-crisis levels.

Current vaccination coverage allows to hope that in future the various restrictions due to the spread of the Covid-19 infection could be significantly relaxed. The Ministry of Economics forecasts that economic growth can reach a total of 5.4% in 2022. At the same time, uncertainty regarding the spread of Covid-19, including new strains of the virus and their impact on the epidemiological situation, remains elevated. It may curb the economic growth rate; however, not the economic development.

DEVELOPMENT PROSPECTS FOR 2023-2027

The Covid-19 crisis has contributed to changes that are likely to persist after the pandemic, such as increased use of e-commerce and other digital solutions, forms of remote work, increasingly localised global value chains, etc. The configuration of Global production is changing under the influence of the Covid-19 crisis and the new industrial revolution. Progress is being made towards shorter value chains and localisation of production. It opens up wider opportunities for Latvia to integrate into Global production networks, including higher value-added activities.

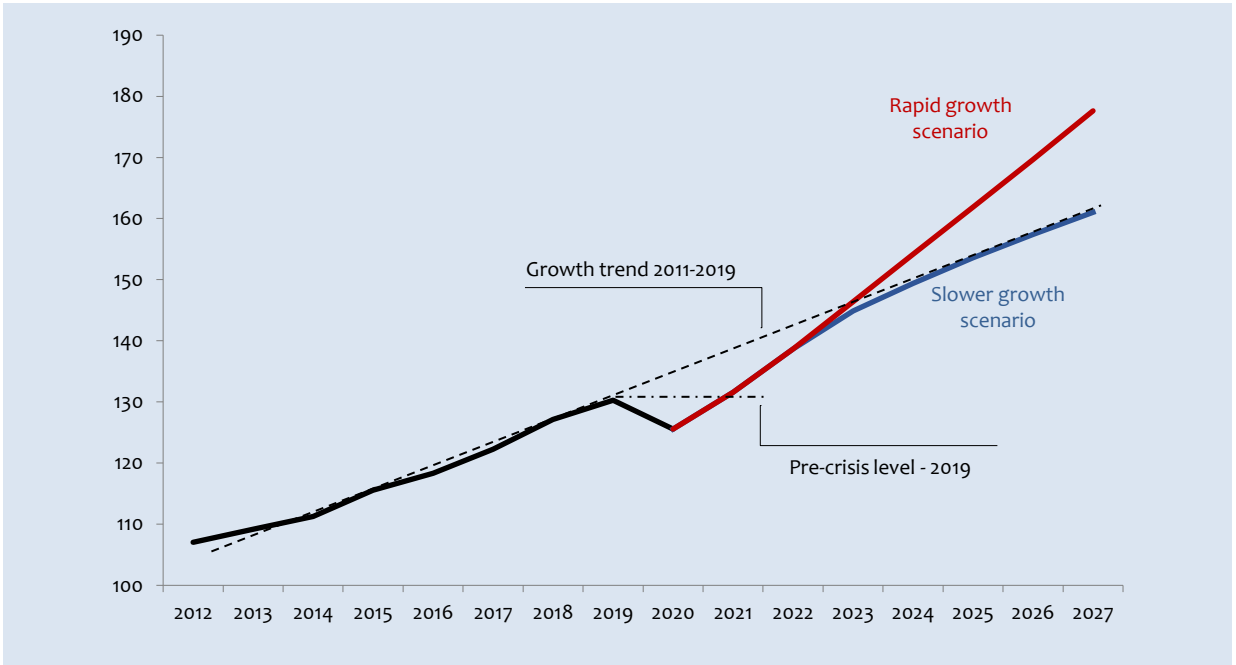
The constraints created by the Covid-19 pandemic have a negative impact on the economy; however, the challenges to economic development in the medium term, which have already been identified in policy planning documents, such as the need to increase exports of goods and services and productivity of economy, remain the same.

Scenarios of slower and more rapid or target growth are developed for the medium term until 2027. 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, the ability to embrace the opportunities and advantages brought by the Covid-19 crisis and the advancements in technology.

Figure 5.1

Forecast of Latvian GDP

2011 = 100



The main driving force of the Latvian economy will be the income from exports and the extension of export possibilities, the ability to get integrated in the production chains with higher value-added products and increase of hi-tech and medium-high tech sectors. In the medium term, more rapid development is expected in the sectors that will be able to boost their productivity through overcoming the technological lag, introduce new digital solutions, modernise their production and investments, boost investments in human capital, research, and innovation to develop new products and services. Also, other supply-side factors will influence the development.

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. In the scenario of slower growth, annual export growth rates for 2023-2027 might on average be around 3.7% annually. Private consumption will grow relatively slowly. Annual average GDP growth rates in 2023-2027 might reach merely 3%.

The medium-term scenario of more rapid growth foresees a larger increase in investments, which contributes to the introduction of state-of-the-art technologies, the development of new products and services, the wider use of digital solutions, and the efficiency improvement of processes. Investments in human capital in the development of new skills will play an important role in the medium term, providing productive sectors with the workforce needed for growth. In this scenario, GDP growth rates can on average reach 5% annually in the medium term.

In the rapid growth scenario private investments will also play a vital role. Overall, in the following years, Latvia is entering a comfortable investment climate, which will also be strengthened by Latvia's high credit rating. To achieve faster productivity growth and ensure sustainable economic growth, it is crucial not only to invest available public finances in a sustainable manner, but also to encourage more private investment by stimulating lending growth, capital market development, and the use of financial instruments.

Table 5.1

Forecast of Latvian GDP by Expenditure Items
changes as per cent

	Fact		Forecasts			
	2018	2019	2020	2021	2022	2023-2027 annual average
Gross domestic product	**4.0**	**2.5**	**-3.6**	**4.8**	**5.4**	**3.0 .. 5.0**
Private consumption	3.0	0.2	-7.6	5.2	5.7	3.6 .. 5.2
Public consumption	1.7	3.4	2.6	4.8	3.0	2.4 .. 3.4
Gross fixed capital formation	11.8	6.9	0.2	4.6	7.0	4.4 .. 7.5
Export	4.5	2.1	-2.2	5.6	5.6	3.7 .. 5.7
Import	6.4	3.0	-2.5	12.3	5.4	3.9 .. 5.6

The most rapid growth scenario envisages that exports and manufacturing retain a relatively rapid growth rate in the medium term, based on both the competitiveness of Latvian producers and growing external demand. At the same time, growth will not be so closely related to the extensive increase in material-intensive production volumes but more to the use of the latest technological processes, etc. More rapid development is expected in high and medium-high-tech sectors due to the above-mentioned factors. In the medium-term, exports should grow more rapidly than the rest of the economy Consequently, investments, including private investments, should also increase more rapidly.

Table 5.2

Forecast of Latvian GDP by Sectors
changes as per cent

	Fact		Forecasts			
	2018	2019	2020	2021	2022	2023-2027 annual average
Gross domestic product	**4.0**	**2.5**	**-3.6**	**4.8**	**5.4**	**3.0 .. 5.0**
Agriculture, forestry	-3.6	19.8	0.6	-3.3	4.7	2.3 .. 3.2
Manufacturing	7.5	3.7	-0.9	7.0	5.5	3.2 .. 5.3
Other industry	-23.8	0.0	-1.9	3.2	3.8	1.9 .. 3.3
Construction	12.4	1.3	1.9	-2.2	7.7	4.7 .. 9.5
Trade, accommodation	4.3	5.0	-6.8	6.3	7.4	3.5 .. 5.5
Transportation and storage	3.8	3.5	-13.8	4.4	3.4	3.0 .. 5.3
Other business services	3.3	-1.4	-4.7	2.9	5.5	3.4 .. 5.0
Public services	4.3	4.7	1.5	8.0	3.0	2.4 .. 3.4

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 medium term, rapid development of information and communication is expected from main sectors of the economy. This is related to the increasingly growing demand for digitalisation of production and services processes, as well as global IT sector development trends. The development of sectors oriented to domestic demand – trade and other business services – will be closely related to the dynamics in private consumption and the demand created by other sectors of the economy.

A slower increase in the medium term is forecast in the energy sector and mining and quarrying. In the medium term, growth in transportation and storage will be slower due to the impact of the Covid-19 crisis and the need to search for new types of cargo and delivery paths to replace persistently shrinking volumes of petroleum products and hard coal from Russia.

6. ECONOMIC STABILITY AND COMPETITIVENESS

6.1. PRICES

CONSUMER PRICES

After the deflation caused by the crisis, consumer prices started to grow again in 2011. External factors and global price fluctuations for 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 duties on fuel, alcoholic beverages and tobacco products, fluctuations in administrative prices and increased consumption. In 2013-2016, consumer price growth was very moderate, but it increased sharply in 2017-2019.

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*
2020	July	0.2	0.5	1.4
	August	-0.5	-0.2	1.2
	September	0.0	-0.3	0.9
	October	0.0	-0.7	0.7
	November	-0.3	-0.7	0.4
	December	0.0	-0.5	0.2
2021	January	0.4	-0.5	0.0
	February	0.4	-0.2	-0.2
	March	0.8	0.3	-0.3
	April	0.9	1.7	-0.2
	May	0.5	2.6	0.1
	June	0.3	2.7	0.4
	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

There was a drop in prices in 2020, when the drop in demand due to the Covid-19 crisis had a significant impact on consumer price levels. Consumer prices fell 0.5% in December 2020 compared with December of the previous year, while annual average inflation was 0.2%. The biggest diminishing effect came from the fall in energy prices caused by a sharp drop in world prices for petroleum products and by falling prices for wearing apparel and footwear, which has been the steepest drop in prices in this consumption group since 2009. The biggest increasing effect in 2020 came from the increase in prices of services, where price increases for out-patient, catering services, recreational and cultural services had the biggest effect, while prices declined for rentals for housing, passenger transport and accommodation services due to the effects of Covid-19 restrictions, motor vehicle insurance. Food prices also rose, but their rise was more moderate than the rise in global food prices, which saw a sharp increase from June 2020.

Prices were rising very rapidly in the eleven months of 2021. Consumer prices rose by 7.5% in November 2021 compared to December 2020, showing the steepest rise since 2008 in January-November, driven by the economic recovery following

the crisis caused by Covid-19 and by rising world prices. Compared with November of the previous year, consumer prices rose by 7.5%. The annual average inflation in November was 2.6%.

The main factors affecting prices in Latvia in 2021:

- the increase in prices of natural gas, heat energy and electricity affected the increase in prices in the eleven months of 2021 the most, which increased the overall level of consumer prices by 2 percentage points. The increase in prices of natural gas was underpinned by the increase in global oil prices. Natural gas tariffs were increased on January 1 and July 1 and in the eleven months the prices of natural gas increased by 51.3% in total. The increase in prices of natural gas affected the appreciation of heat energy, in particular in recent month. Its price has increased by 21.8% in the eleven months. Prices of heat energy experienced the most rapid increase in September and November due to the increase of the tariff in Riga. The price of electricity increased by 23.9% driven by the increase in prices of natural gas, lower output of hydroelectric power plants due to weather, as well as the increase in demand;
- the big increasing effect came from the increase in prices of fuel due to the increase in global crude oil prices. Fuel prices in Latvia grew by 34.9% in January-November increasing the overall level of consumer prices by 1.9 percentage points. In November 2021, global crude oil prices increased by 61% compared to December 2020, growing almost continuously throughout 2021, showing a small drop only in April, August and November. In October, the Brent crude oil price reached its highest level since October 2014 – 86 USD per barrel, exceeding more than four times the record-low price seen in April 2020 – 19 USD per barrel, driven by a sharp drop in energy demand due to the Covid-19 pandemic. The rapid rise in crude oil prices during the eleven months of 2021 was affected by OPEC+ decision not to change the planned moderate increase in extraction volumes, continuing limited crude oil supplies despite high crude oil prices and rising demand, as the economy was recovering following the crisis caused by Covid-19;
- the increase of food prices, which was affected by the increase of global food prices. Prices of food and non-alcoholic beverages have increased by 5.7% in the eleventh months increasing the total level of consumer prices by 1.5 percentage points. The biggest increasing effect came from the increase in prices of dairy products, fresh vegetables and potatoes, bread and cereal crops, while the diminishing effect came from pork, fruit and vegetable juices. Changes in food prices are largely determined by global price fluctuations. Global food prices surged in all months of the year, excluding June and July, reaching their highest level since June 2011 in November. In January-November, global food prices rose by 24%. They grew in all major food groups, with the fastest growth in vegetable oils and sugar and the slowest growth in dairy products and meat. Global food prices have been rising rapidly since mid-2020, driven by weaker supplies from major producing countries and a sharp rise in import demand, for vegetable oils and sugar – also by the rising prices of crude oil diverting more products to manufacturing of biofuels. Meanwhile, slower price increases for dairy products were affected by weaker global import demand and growing exports from Oceania in the summer months, while meat prices have declined since August this year, mainly due to falling prices for pork due to the decline in Chinese purchases, particularly from the European Union;
- increase in prices of services – by 3.1%, which increased the overall level of consumer prices by 0.9 percentage points. The biggest impact came from the increase in prices of out-patient services caused by the appreciation of dental services and higher prices of specialist medical services, recreational and cultural services (participation in recreational and sporting events and television subscription fees) and catering service activities. Meanwhile, prices of passenger air transport and transport by sea decreased;
- the rise in prices of clothing and footwear, which was the steepest rise in prices in January-November since 2003. It was affected by a sharp rise in prices in April and a slower drop in prices in the summer months, driven by an increase in demand due to the easement of measures limiting the spread of Covid-19. In the eleven months of 2021, prices of clothing and footwear increased by 5.3% increasing the overall price level by 0.3 percentage points.

In total, the annual average inflation will reach 3.3% in 2021. Changes in consumer prices are also expected to exceed the level of seasonal fluctuations in the coming months. 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 is expected. As the pandemic is backing down, consumer prices are expected to stabilise, but given the base effect, average annual average inflation in 2022 is expected to be above the level seen in 2021 and can reach 5-6% with the increase in 12-month prices by 1-2% (December on December). At the same time, it will still be determined by global price fluctuations.

Figure 6.2

Goods and Services with Most Effect on Changes in Consumer Prices
contribution to 11-month changes in November 2021, percentage points

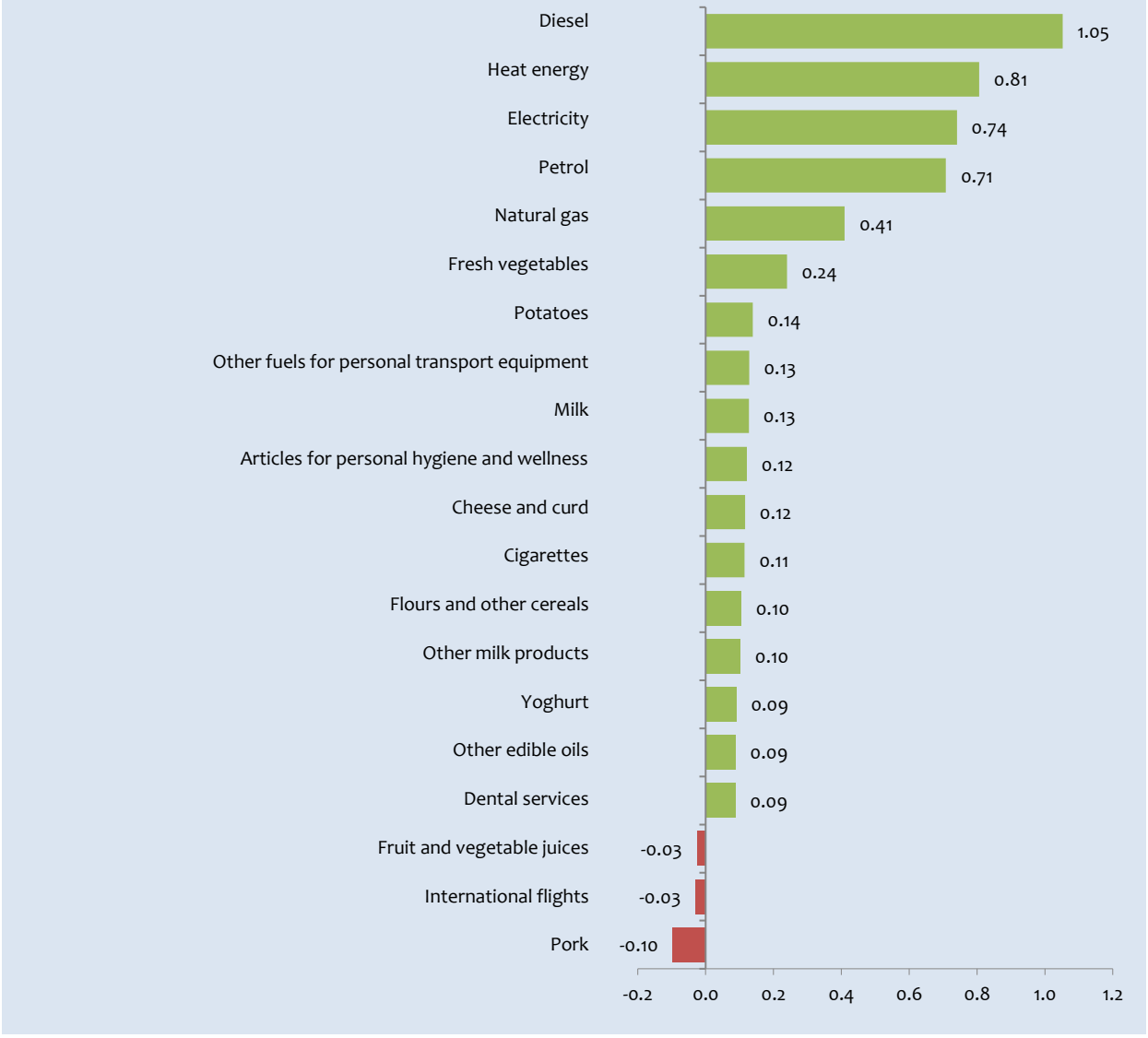


Figure 6.3

Consumer Price Index by Groups and Subgroups
by months, December of the previous year = 100

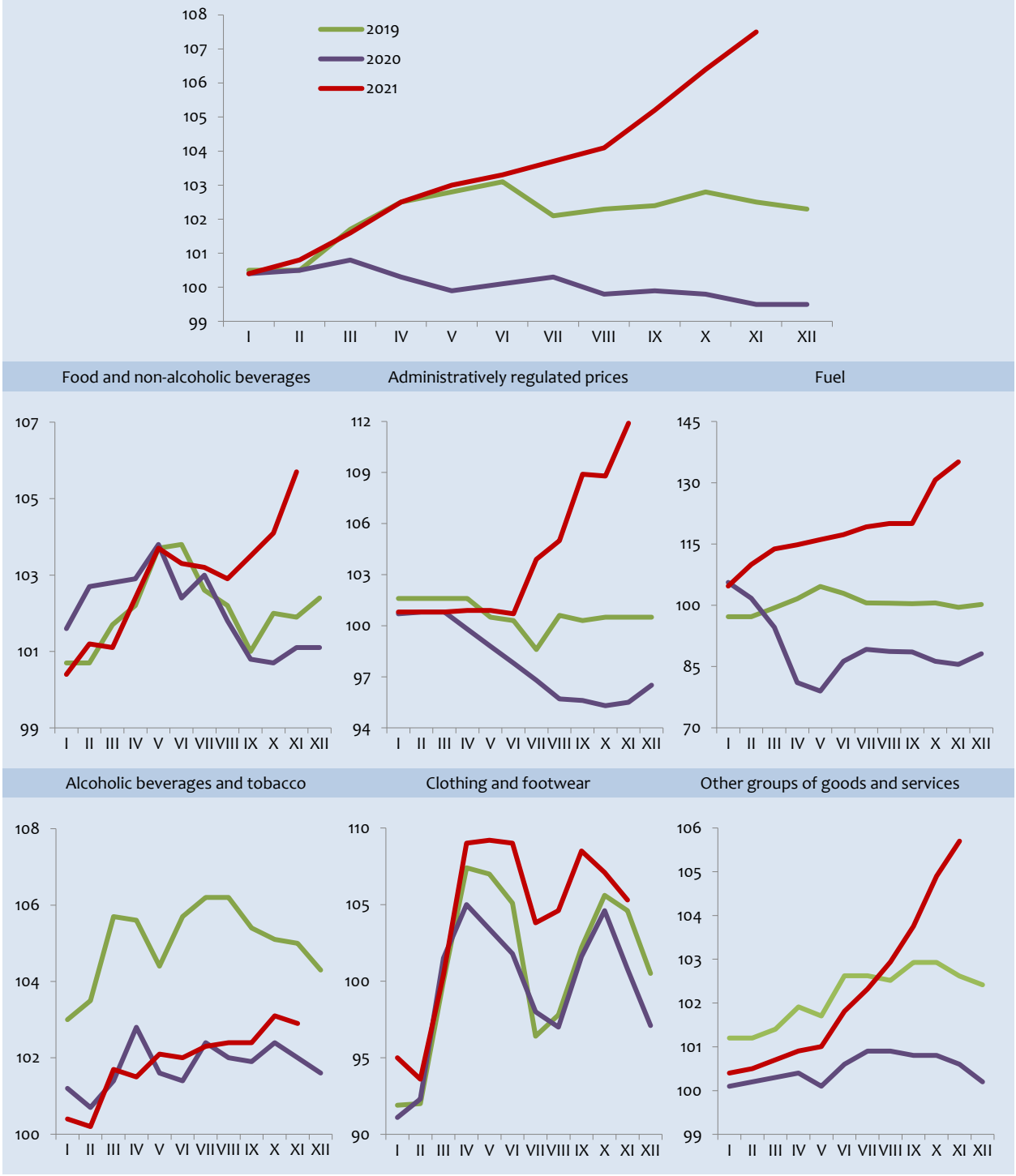
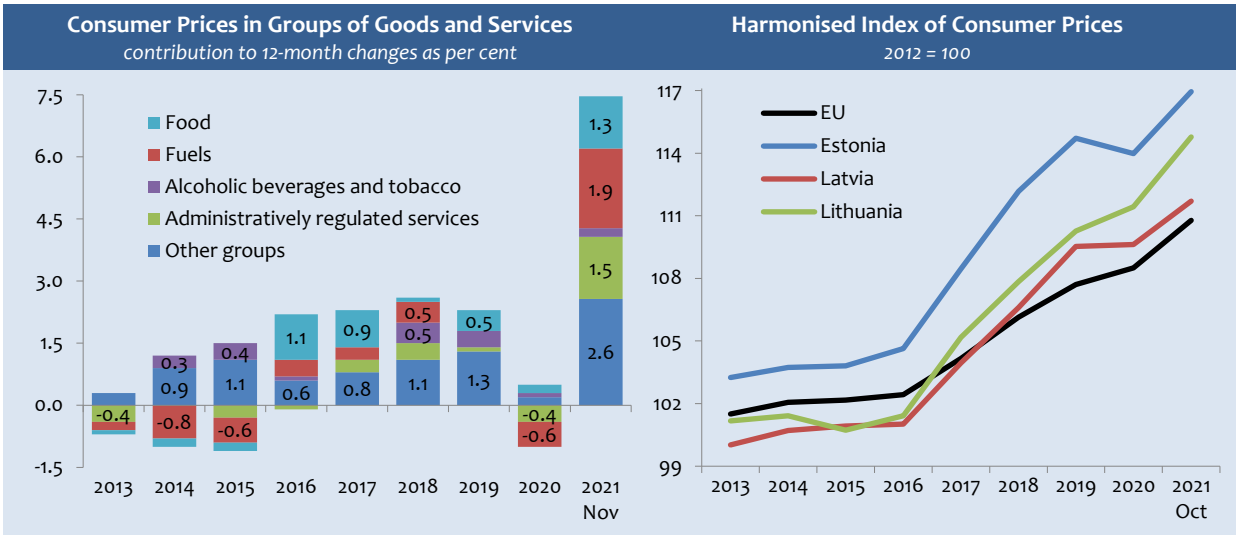


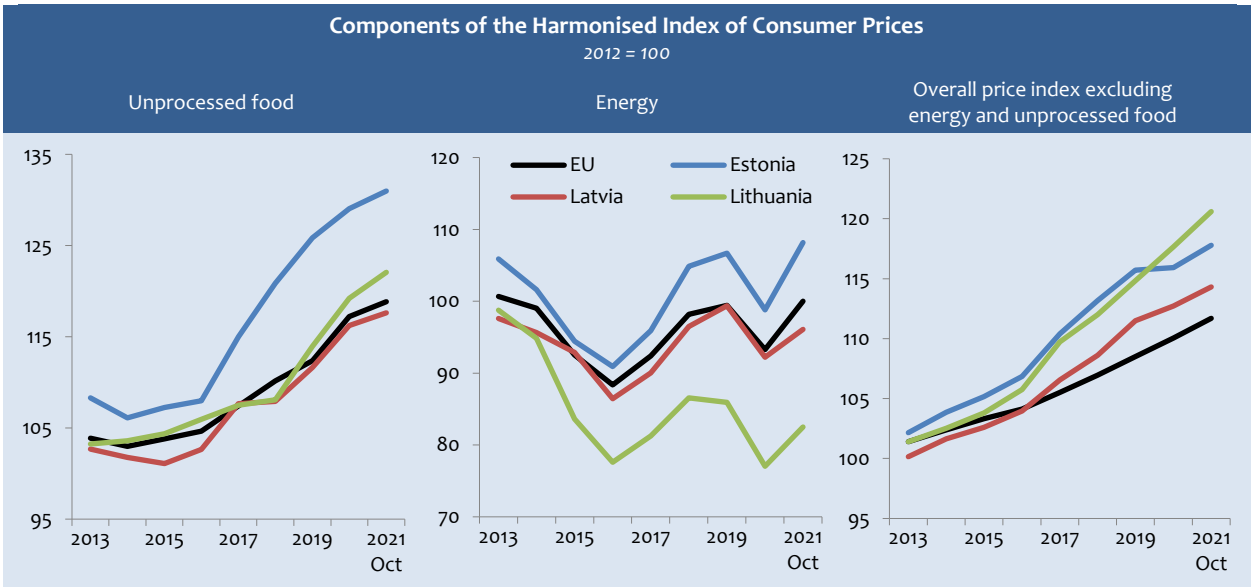
Figure 6.4



In the European Union, 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 oil, a very sharp rise in prices was seen in 2017-2019. As economic activity and therefore private consumption increased, as well as global prices increased, prices in the European Union increased in all major consumption groups, excluding communications. The increase in prices of services had the biggest effect. The Baltic States experienced more rapid price increases than the EU as a whole, with the highest inflation rate seen in Estonia and the lowest in Latvia.

On the other hand, in 2020, Covid-19 reduced consumer prices. In 2020, annual average inflation in the EU was only 0.7%. The biggest increasing impact came from the increase in prices of services, among them the most powerful in out-patient, catering services and package recreational services. The rise in food prices also had a big impact, affected by a sharp rise in global food prices in the second half of the year. The biggest diminishing effect came from the fall in prices of energy resources and non-food products, which were affected by the decline in demand due to the Covid-19 pandemic. With economic activity increasing and countries rapidly starting vaccination against Covid-19, consumer prices increased sharply in 2021. In October 2021, annual average inflation in the EU was 2.1%. Prices increased in all the main consumption groups. The rise in prices of energy sources had the biggest effect, which was driven by the sharp increase in prices of crude oil and natural gas.

Figure 6.5



When comparing the Baltic countries, in 2020, the highest annual average inflation was in Lithuania affected by a significant increase in prices of services and food. In Latvia, the increase in prices of services also had a considerable effect, but the drop in prices of energy and the increase in prices of food had the biggest effect. Prices in Estonia reduced most sharply, with the increasing effect coming only from the increase in food prices, the decline in prices of energy had the biggest effect, while prices of services remained unchanged.

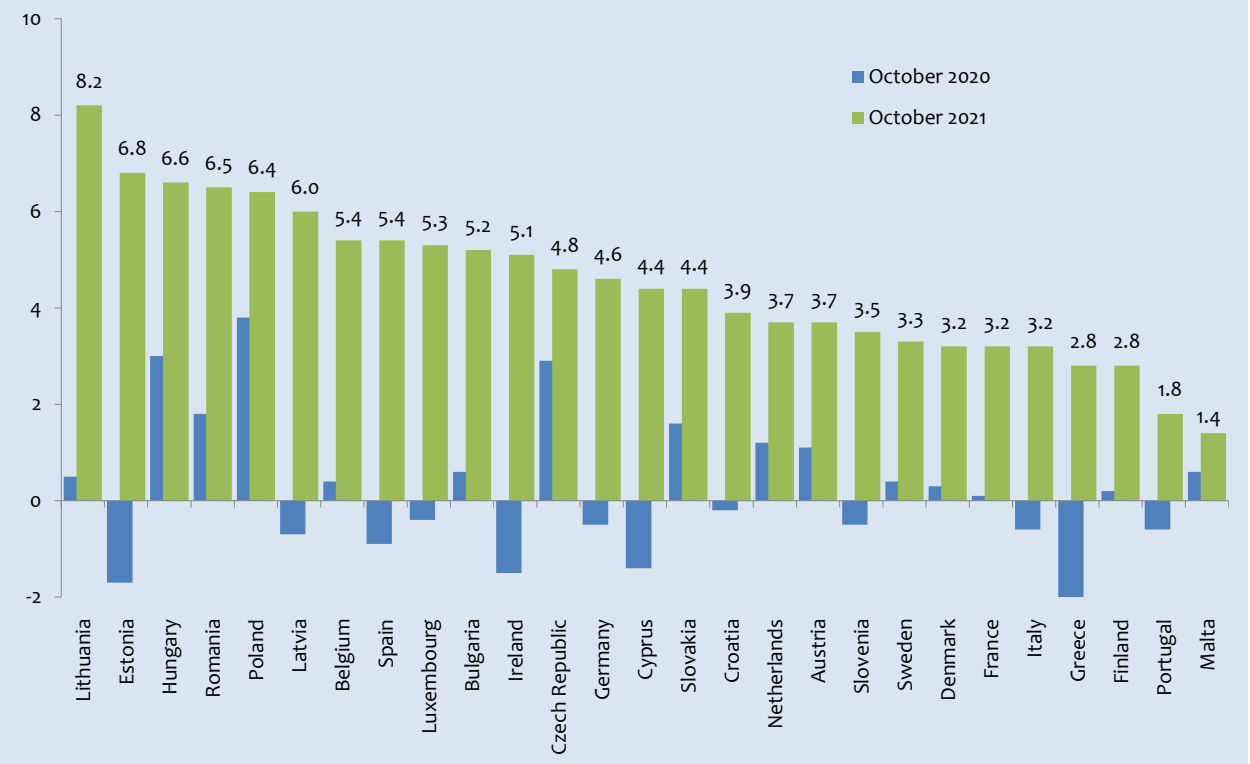
It should be noted that since 2013 Latvia has been having the lowest core inflation among the Baltic countries affected by a slower increase in private consumption than in the other countries and therefore slower increase in prices of services. Prices of alcoholic beverages and tobacco in Latvia also increased slower, because the equalisation of the excise tax with the EU level in Estonia and Lithuania is more rapid. It should be noted that energy prices have returned to the level of 2013 in Estonia and Latvia in 2021, but is still in lower level in Lithuania.

In October 2021, the highest annual average inflation was in Lithuania – 3%. In Estonia, average annual inflation was 2.6%, while in Latvia it was the lowest – 1.9%. The increase in prices of energy and services had the biggest effect. Energy prices increased most rapidly in Estonia and prices of services – in Lithuania, while Latvia experienced the lowest growth in both prices of energy and services among the Baltic States. The increase in food prices had a bigger impact in Latvia than in Lithuania and Estonia.

In October 2021, compared to October 2020, the price level grew by 4.4% in the EU countries as a whole, and by 4.1% in the Euro Area. Inflation increased most rapidly in Estonia, Lithuania, Latvia and Ireland, while prices increased most slowly in Malta and the Czech Republic. The highest inflation in October 2021 was in Lithuania, Estonia, Hungary and Romania, while the lowest – in Malta and Portugal.

Figure 6.6

Changes in the Harmonised Index of Consumer Prices in the EU Member States
12-month inflation, as per cent



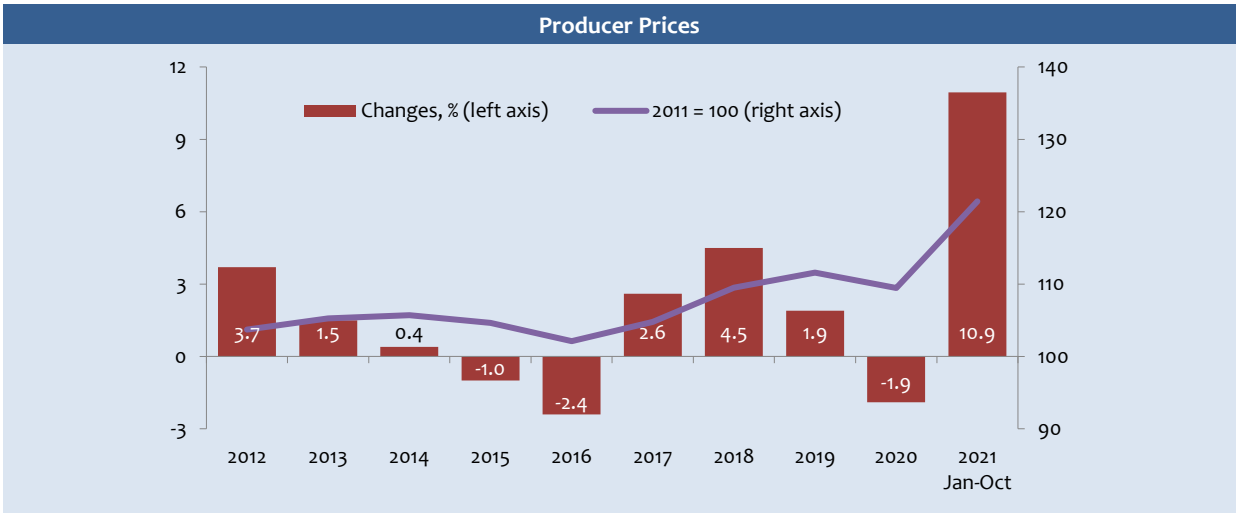
PRODUCER PRICES

After a drop in 2015-2016 producer prices showed a considerable increase in 2017-2018, and it slowed down in 2019. In 2019, producer prices increased for the products sold on the domestic market affected by the rise in prices of electricity, gas, steam and air conditioning supply.

In 2020, producer prices reduced under the influence of Covid-19. In 2020, the producer prices of products sold on the domestic market reduced by 2.9%, while prices of exported products – by 0.9%. Producer prices reduced in all industrial sectors. Electricity, gas, steam and air conditioning supply had the biggest effect on the fall in producer prices.

In 2021, a sharp increase was observed for producer prices, which was the most rapid since 2008. In January-October 2021, producer prices in the industry increased by 10.9% compared to the relevant period of the previous year. Prices of products sold on the domestic market grew by 9.3%, while prices of exported products – by 12.4%. Producer prices increased in all industrial sectors. Manufacturing had the biggest effect on the increase in producer prices.

Figure 6.7



A similar trend has been observed in producer prices in manufacturing since 2012. Following the rapid increase in prices in 2017-2018, in 2019, manufacturing experienced very moderate increases, affected by slower growth in the EU and a slight drop in prices of energy sources and raw materials. Despite the impact of the Covid-19 pandemic and the sharp fall in energy prices, the fall in producer prices in manufacturing was very small in 2020. In 2020, the decline in producer prices in manufacturing was similar for the products sold on the domestic market and for exported products – by 0.9% and 0.7%, respectively. Furthermore, in January-October 2021, compared to the previous year, producer prices in manufacturing for exported products increased more rapidly than for the products sold on the domestic market – by 12.4% and 8.9%, 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 drop was observed in global prices of energy sources and raw materials in 2020 under the influence of the Covid-19 crisis, while they increased sharply in 2021. The price of products for domestic market, in its turn, is affected by the domestic demand and growing growth rates.

When viewed by sector, the most significant decline in producer prices in manufacturing in 2020 was in wood processing, while the most significant increase in prices – in repair of machinery and manufacture of food products. It should be noted that global food prices, despite the effects of the Covid-19 pandemic, as strong demand was preserved, started to rise rapidly from mid-2020. In manufacture of food products, in 2020 prices were influenced by the price increases in exported products, while prices reduced for the products sold on the domestic market.

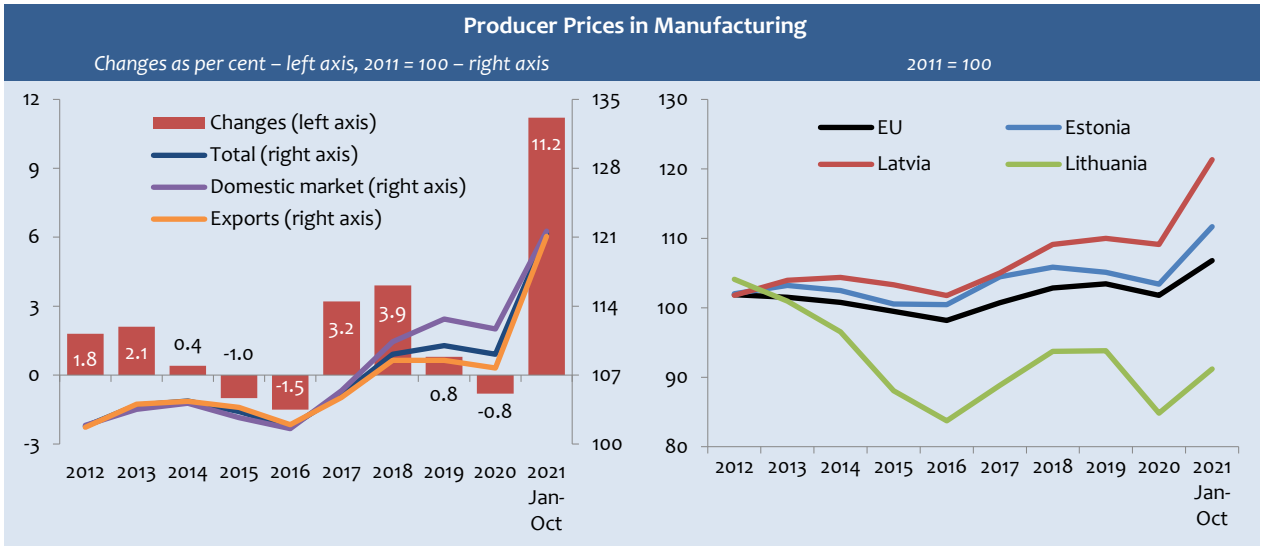
In the ten months of 2021, wood processing saw the most influential increase in producer prices, which was the steepest rise in prices in the sector over the past 20 years. The increase in prices of exported products had the greatest impact in wood processing. It should be noted that average procurement prices for logs increased sharply in the first half of 2021 following a fall in the previous years. The increase in producer prices in manufacture of chemicals, metalworking, manufacture of food and manufacture of machinery and appliances had the biggest effect in manufacturing, while prices decreased significantly in the manufacture of computer, electronic and optical products and in publishing.

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. Meanwhile, producer prices in the EU increased very rapidly in 2021, with the economy recovering

and significantly growing demand for raw materials and energy sources. When comparing the EU countries, producer prices in manufacturing in January-October 2021, compared to the respective period of the previous year, increased in all the countries, except Ireland. They increased most sharply in Greece, Latvia, Bulgaria and the Netherlands.

If we compare the Baltic countries, in 2021, producer prices in manufacturing rose sharply in all the three countries. They increased the most rapidly in Latvia – by 11.2%. In Estonia and Lithuania they increased slower – by 8% and 7.5%, respectively.

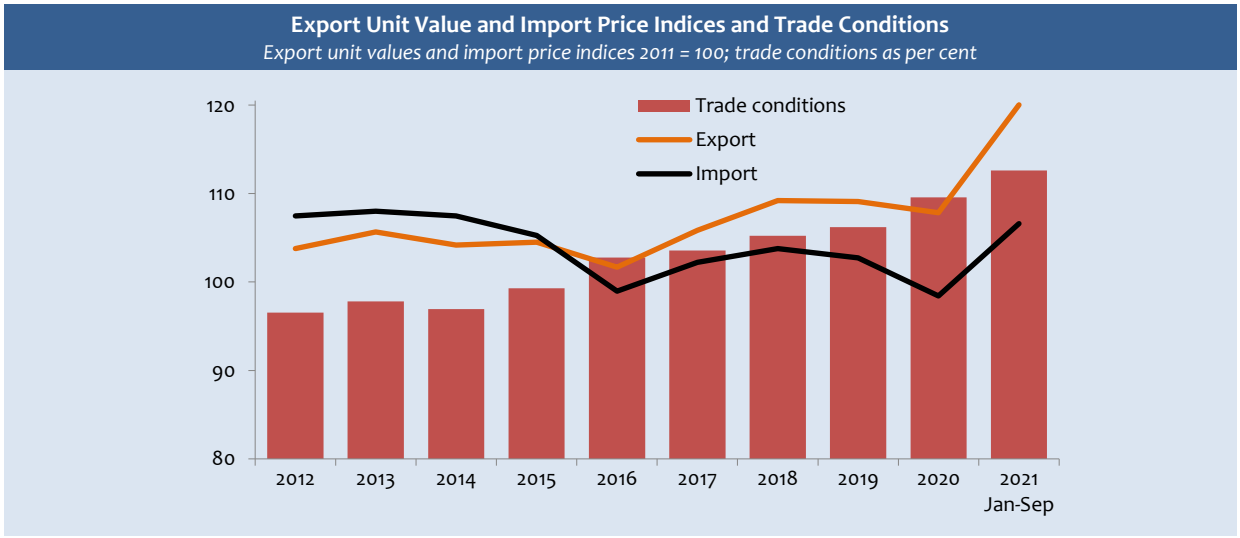
Figure 6.8



FOREIGN TRADE UNIT VALUE INDICES

The trade conditions improved and returned to the level of 2011 in 2015. Since 2016, the trade conditions have been improving sharply. 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 and coke and refined petroleum products. In 2019, 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 base metals and coke and refined petroleum products.

Figure 6.9



In 2020, trade conditions continued to improve, and the unit value index for exported goods exceeded the price index for imported goods by more than 9 percentage points. In 2020, the export unit value reduced by 1.1%, but the import price

index reduced more rapidly – by 4.2%. The export unit value index was mostly affected by the drop in the unit value of wood and wood products, coke and refined petroleum products and base metals, while the import price index – by the drop in value of coke and refined petroleum products and mining of valuable minerals.

In January-September 2021, the unit value of exported goods grew by 11.3%, while the prices of imported goods – by 8.2% compared to the relevant period of the year before. The unit value index for exported goods exceeded the price index for imported goods by more than 13 percentage points. The total export unit value index was most affected by the increase in the unit value of wood and wood products, base metals, agricultural products, mining of valuable minerals and chemical substances and chemical products, as well as by the fall in unit value of computers, electronic and optical devices. The total import price index was most affected by the increase in prices of base metals, chemical substances and chemical products, wood and wood products and coke and refined petroleum products, while a diminishing effect came from the drop in prices of mining of valuable minerals and computers, electronic and optical equipment.

6.2. BALANCE OF PAYMENTS

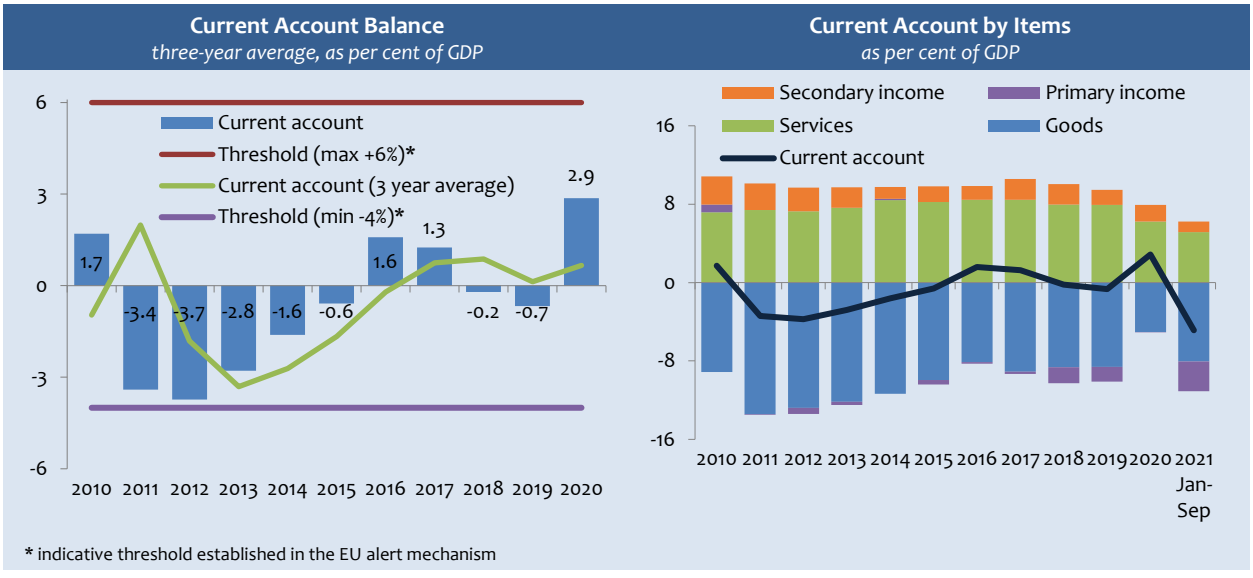
CURRENT ACCOUNT

Latvia is sensitive to external shocks, which is reflected in the condition of its current account of the balance of payments. In recent years, the current account of the balance of payments was close to balance. Since 2010, the current account does not exceed the indicative thresholds set in the EU Alert Mechanism and is evaluated as sustainable.

From 2015 to 2019, the current account balance was positive – 0.1% of GDP on average. Its fluctuations were moderate, yet an overall downward trend can be observed – in particular, from surplus of 1.6% of GDP in 2016 to deficit of 0.7% of GDP in 2019.

Since 2020 the state of the current account has been 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. In 2020, compared with 2019, the current account balance improved, reaching a surplus of 2.9% of GDP. In the nine months of 2021, however, the current account reached a deficit of 4.9% of GDP.

Figure 6.10



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.

Latvia is characterised by a high deficit of trade in goods. In the past five years (2015-2019) before the Covid-19 pandemic, the external trade deficit averaged 8.2% of GDP. However, even before the outbreak of the pandemic, there was a reduction in external trade flows. The export dynamics of goods in 2019 were more moderate than a year before (increase by 1.4%)

reflecting gradual weakening of external demand. The rates of increase in imports were also slower compared to the previous year (increase by 2%).

The Covid-19 pandemic containment measures had a strong impact on trade intensity. Due to the decline in domestic demand during the Covid-19 crisis, imports of goods fell by 3.2%. Exports of goods were stable. Their value increased by 5.2%, compared with 2019, which provided for a reduction in the external trade deficit of goods from -8.6% in 2019 to 5% of GDP in 2020.

In the nine months of 2021, the export value of goods was 20.2% higher than a year ago, significantly affected by an increase in the export value of wood and wood products, mineral products and iron and steel. The import value increased slightly faster than the export value – by almost 24%, and the trade deficit reached 8% of GDP (5.8% of GDP in the nine months of 2020).

Table 6.1

Balance of Payments of Latvia
as per cent of GDP

	2016	2017	2018	2019	2020	2021 Jan-Sep
Current account	1.6	1.3	-0.2	-0.7	2.9	-4.9
Trade balance	-8.1	-9.1	-8.6	-8.6	-5.0	-8.0
Export	41.4	43.1	43.2	41.6	45.5	48.8
Import	49.5	52.2	51.8	50.3	50.5	56.9
Balance of services	8.4	8.4	7.9	7.9	6.2	5.1
Primary income	-0.1	-0.3	-1.6	-1.5	0.0	-3.1
Secondary income	1.4	2.1	2.1	1.5	1.7	1.1
Capital account	1.2	1.0	1.8	1.5	1.8	1.4
Financial account	3.6	2.2	2.4	1.2	6.2	-3.4
Direct investment	-0.3	-1.9	-2.2	-2.9	-2.2	-5.7
Assets	0.9	1.9	-0.9	0.3	0.6	-0.1
Liabilities	1.2	3.7	1.3	3.2	2.8	5.7
Portfolio investment**	5.3	6.6	-4.3	-1.7	13.4	6.6
Assets	7.1	5.9	-3.7	1.0	10.6	5.8
Liabilities	1.8	-0.7	0.5	2.7	-2.8	-0.9
Other investment	-1.8	-5.8	9.3	6.2	-6.5	-5.4
Assets	2.0	1.0	-1.4	0.1	-0.2	-0.4
Liabilities	3.8	6.8	-10.7	-6.1	6.3	4.9
Reserve assets	0.5	3.3	-0.4	-0.3	1.5	1.0
Deviation	0.9	0.0	0.8	0.4	1.6	0.1

* 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 amount only to half of exports of services thus ensuring a stable surplus in the balance of services.

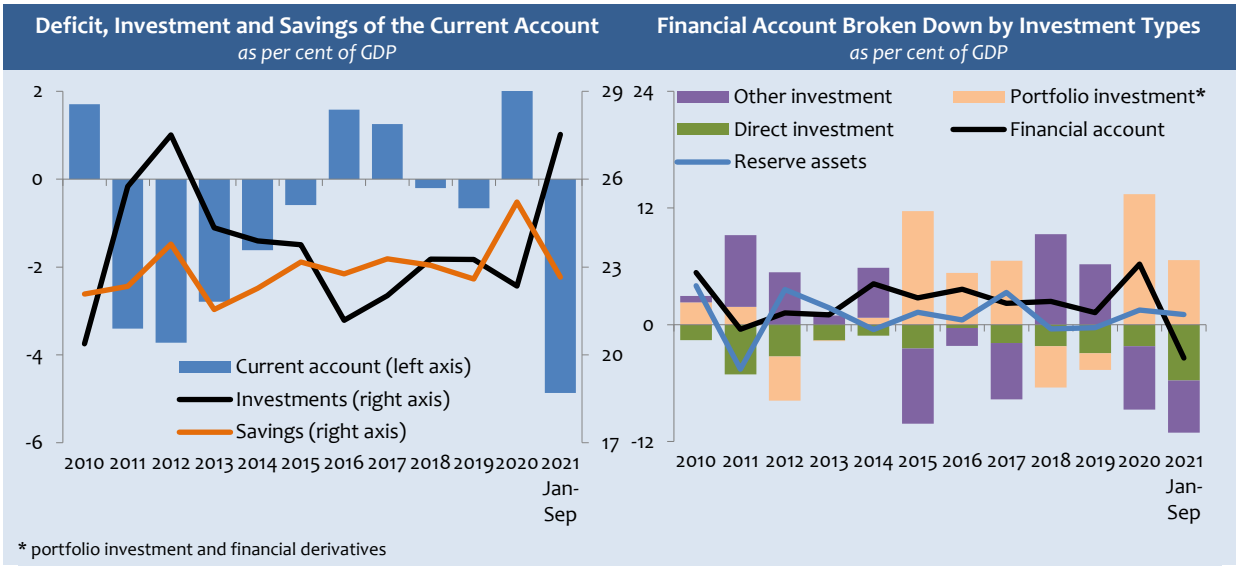
The shock related to the Covid-19 pandemic had a stronger impact on cross-border trade of services rather than trade of goods. In 2020, cross-border flows of services reduced significantly, underpinned by movement restrictions and cautious attitude of the population to leisure and business trips, which affected the drop in the value of trips and air and road transport services. Total exports of services decreased by 21.6%, while imports decreased slightly more moderately – by 19.4%, thus the surplus of the balance of services decreased from 7.9% of GDP in 2019 to 6.2% of GDP in 2020.

The partial cancellation of the restrictions of the Covid-19 pandemic contributed to an increase in exports and imports of services in 2021, but the surplus of services continued to shrink. In the nine months of this year, imports of services at current prices were 18% higher than a year ago, while exports increased by 5.6% and the surplus of the balance of services decreased to 5.1% of GDP (6.4% of GDP in the nine months of 2020).

The primary income balance in the last five years (2015-2019) has been negative – 0.7% of GDP per year on average with relatively small fluctuations mainly underpinned by changes in non-residents' investment income, as well as 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 deficit decreased and was in balance. Meanwhile, in the nine months of 2021, its deficit increased to 3.1% of GDP, driven by an increase in direct foreign investment income.

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 at the level of 1.8% of GDP on average. In 2020 and in the nine months of 2021, the secondary income account had a surplus – 1.7% and 1.1% of GDP, respectively. The inflow of EU structural funds dominates in the capital account. The capital account surplus has been 1.4% on average since 2015, including at the level of 1.8% of GDP in 2020. The positive balance of capital account in the nine months of 2021 is slightly lower than a year ago, reaching 1.4% of GDP. Changes in capital account surplus are mainly related to changes in EU funds uptake activities.

Figure 6.11



The condition of the current account balance until 2019 proved that savings and domestic investments were balanced. Over the last five years (2015-2019) savings have been 22.7% of GDP on average, but investments – 22.9% of GDP. In 2020, the current account surplus was driven by an increase in savings from 22.6% in 2019 to 25.2% of GDP in 2020, while investment decreased, reaching 22.4% of GDP in 2020. In the nine months of 2021, the partial cancellation of the restrictions for fighting Covid-19 stimulated demand by reducing the level of "forced" savings. At the same time, investment activities also increased, which led to an increase in current account deficit.

CROSS-BORDER FINANCIAL FLOWS

The state of the financial account balance was mainly affected by the public sector, i.e. the financial sector stabilisation measures, the measures of the Bank of Latvia for the restructuring of public sector debt within the framework of the expanded asset purchase programme (EAPP), as well as the pandemic emergency purchase programme (PEPP) announced by ECB in March 2020 to reduce the uncertainty caused by the Covid-19 pandemic in the financial markets and to ensure that inflation returns to 2% in the medium term.

Between 2015-2019, 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 the nine months of 2021, financial account assets grew more modestly than liabilities, which also contributed to the negative financial account balance of -3.4% of GDP. The direct investment balance of the balance of payments financial account shows the inflow of foreign direct investment, which is in line with the average level of recent years also in the pandemic years.

The foreign gross debt of Latvia has slightly increased. This was determined by the government's borrowing, as well as 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) continued to reduce. According to Latvia's international investment balance data, at the end of September 2021 gross external debt was almost 123% of GDP, including the government's gross external debt amounted to EUR 10,728 million (35% of GDP).

The status of the balance of payment accounts in the near future will be determined by the scale and duration of the Covid-19 pandemic, the restrictions imposed for combatting it, and the scope of economic activity support measures.

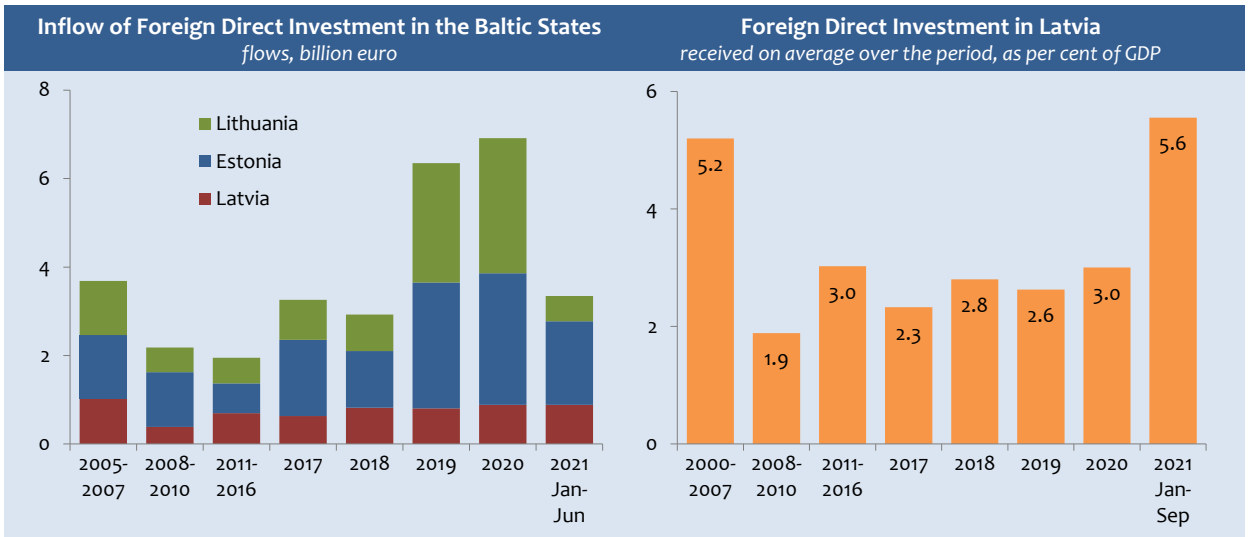
6.3. FOREIGN DIRECT INVESTMENT

Intensity of foreign direct investment (FDI) is moderate in almost all countries of the world. According to the data published by the United Nations Conference on Trade and Development (UNCTAD), global cross-border investment flows have already been following a downward trend since 2016. 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 restrictions for containment of the Covid-19 pandemic are also a significant obstacle to cross-border investment flows. It was noted in the UN World Investment Report published in 2021 that global FDI flows decreased to USD 1 trillion in 2020, which is 35% less than in 2019. Global restrictive measures in response to the Covid-19 pandemic have slowed down the implementation of the launched investment projects and forced international companies to reconsider their plans for new projects.

The intensity of FDI attraction has also weakened in the EU countries. In 2020, the amount of FDI attracted was nearly 3.5 times smaller than in 2019. However, foreign investor activities in the Baltic States remained at a relatively high level and FDI inflow increased by nearly 9%. The cross-border flows of direct investment were more moderate in 2021, driven by a smaller volume of FDI entering the Lithuanian economy than a year ago. However, the Latvian and Estonian economies increased. In the first half of 2021, total net flows of attracted FDI in the Baltic States amounted to 3.4 billion euro, which is slightly less than a year ago. Nearly a third (27%) of the total amount of FDI transactions was in the Latvian economy. The share of Estonia and Lithuania in total FDI transactions amounted to 26% and 17%, respectively.

Figure 6.12



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 the last three years (2017-2019) before the Covid-19 pandemic, FDI flows in the Latvian economy fluctuated at 2.3-2.8% of GDP.

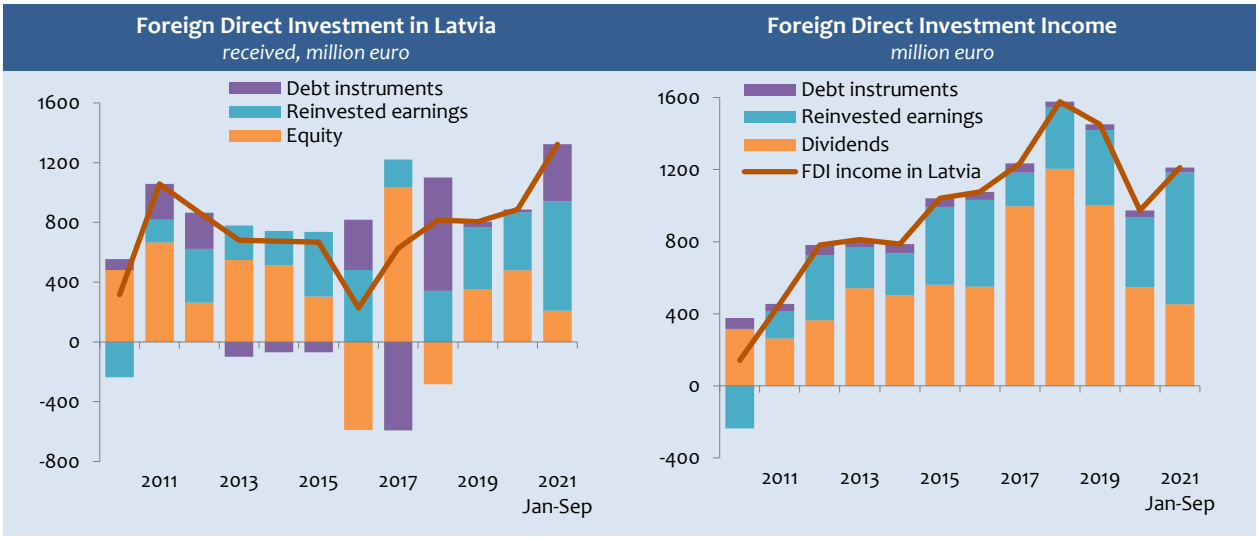
The intensity of FDI flows attracted to Latvia has not decreased in the years of the Covid-19 crisis. In 2020, FDI attracted in Latvia amounted to 887 million euro. Compared to 2019, FDI flows increased by 10.2% and reached 3% of GDP.

In the nine months of 2021, net FDI flows attracted to Latvia amounted to 1322 million euro, i.e., by 724 million euro more than a year before, accounting for 5.6% of GDP. The increase in FDI was largely determined by the increase in reinvested profit, which rose almost 2.5 times, compared to the corresponding period last year. However, non-resident investment in

the equity capital of companies registered in Latvia was slightly lower than a year ago. Extensive investments were made in trade and manufacturing, as well as in real estate activities. The largest flows of investments to Latvia came from Russia, Lithuania, Sweden, and Estonia.

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, affected by the slowdown in economic growth. In response to the outbreaks of the Covid-19 pandemic and its containment restrictions, FDI income continued to decline in 2020 and was nearly a third lower than a year before. Although income grew in 2021 and was nearly twice higher in the nine months of 2021, compared to the corresponding period last year, the level before the pandemic has not yet been reached. The largest share of FDI income is reinvested in 2021.

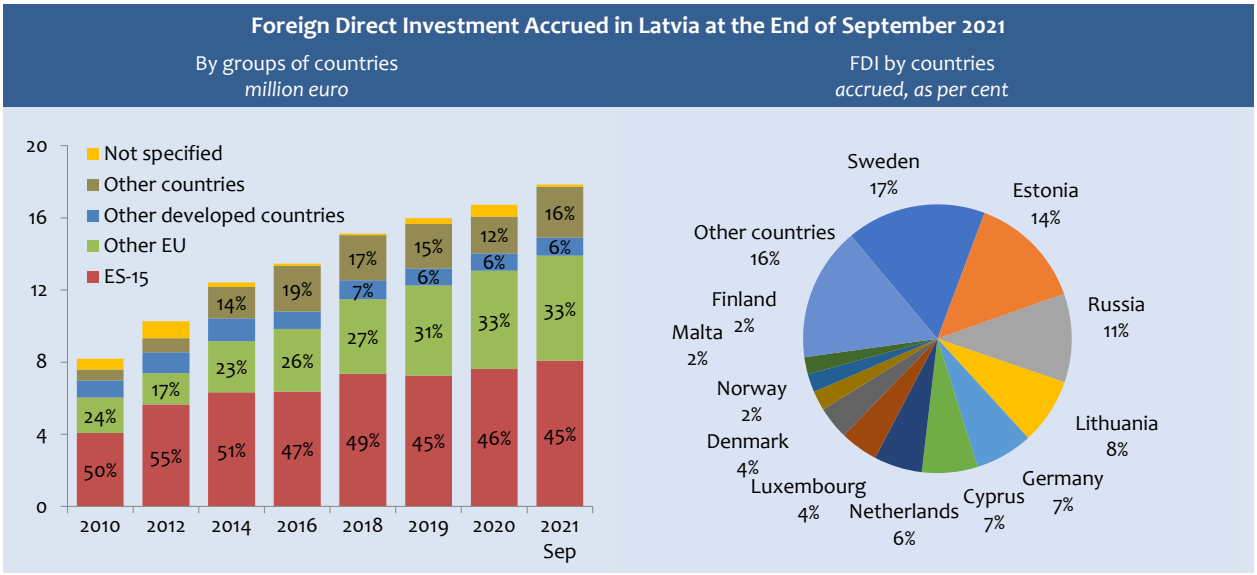
Figure 6.13



The amount of FDI accrued in the Latvian economy is growing year on year. The amount of FDI accrued at the end of September 2021 reached 17.8 billion euro (58% of GDP). It grew by 6.7%, compared to the end of 2020, mainly underpinned by the increase in investment in manufacturing and trade.

The geopolitical structure of FDI accrued is comparatively 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 2021.

Figure 6.14



Sweden is the largest investor in the economy of Latvia. The initiatives of its businessmen reached almost 16% of total accrued FDI (15.2% at the end of 2019). It is mainly the investment in the financial intermediation. Investments of businesses from Estonia, Russia, the Netherlands, Cyprus, Lithuania, and Germany are also extensive.

Since 2013, investments of Russian investors in Latvia increased significantly. At the end of September 2021, the accrued direct investment of Russia was 3.4 times higher than in 2013, and Russia was the third major 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. It should be noted that activities of Latvian businessmen in the Baltic neighbouring countries are much more moderate.

Most of FDI is attracted in service sectors. At the end of September 2021, the accrued FDI in the services sector constituted 77% of the accrued FDI in the economy of Latvia. It increased by 33%, compared to the end of 2015; and by 5.4%since the end of 2020.

Almost 74% of accrued FDI in service sectors are investments in financial intermediation, real estate, and trade activities. Non-resident investment in sectors like trade, information and communication, as well as professional, scientific and technical activities has increased significantly since the end of 2019. Moreover, the amount of accrued FDI in accommodation and food service activities declined by almost 25%.

At the end of September 2021, the accrued FDI in manufacturing of goods amounted to 23.5%. 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 22.4%. Despite the positive dynamics in FDI attraction, Latvia still lags behind Lithuania and Estonia in terms of FDI accrued in manufacturing.

Table 6.2

FDI by Sectors
balances at the end of the period

	million euro			*structure, as per cent*		
	2011	2020	2021 Sep	2011	2020	2021 Sep
Agriculture	263	694	735	2.8	4.1	4.1
Manufacturing	1 113	1 946	2 301	11.9	11.6	12.9
Other industry	386	698	773	4.1	4.2	4.3
Construction	482	440	394	5.2	2.6	2.2
Trade and accommodation	1 329	2731	3 293	14.3	16.3	18.4
Transportation and storage	400	727	754	4.3	4.3	4.2
Financial intermediation	2 534	4 058	4 191	27.2	24.3	23.5
Real estate activities	1 109	2 759	2 792	11.9	16.5	15.6
Other services	688	1 409	1 651	7.4	8.4	9.2
Unclassified activity	1 019	1 264	965	10.9	7.6	5.4
Total	**9 323**	**16 726**	**17 849**	**100**	**100**	**100**

Overall, it should be noted that the shock of the Covid-19 pandemic has not significantly altered the intensity of FDI flows, maintaining trends of the previous periods. The amount of FDI flows attracted in 2022 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 the ability to combat the spread of the pandemic and by an active FDI attraction policy Also, global trends will influence cross-border investment flows. According to UNCTAD estimates, a more rapid increase in global FDI flows will resume in 2022, driven largely by strong investment support from governments.

A major role in the attraction of foreign investment in Latvia is played by the Investment and Development Agency of Latvia (IDAL). The strategy of the IDAL 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.

To promote investment attraction, IDAL and the Ministry of Economics proposed to supplement the Law on the Suppression of Consequences of the Spread of COVID-19 Infection by introducing a "green corridor, for large-scale investments in priority axes. The introduction of the "green corridor" aims to achieve a 50% reduction in the duration of major investment projects, thereby significantly improving the competitiveness of attracting foreign direct investment and contributing to a rapid improvement in the economic situation (for the 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. It works 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, but uncertainty remains relatively high also in the banking sector.

In accordance with the information from FCMC, **bank profitability reduced**, but it is still positive. In 2020, the banking sector's profits declined by 36% compared to 2019, while the first half of 2021 there was an increase in profits and banks operated with a profit of 146 million euro (40 million euro in the first half of 2020). Banks' profits were largely affected by concerns about the further development of the Covid-19 pandemic, as a result of which banks formed preventive provisions. Despite the fact that banks' profits increased during the first half of the year, the risk of profitability remains relatively high. Overall, 13 banks and 3 branches of EU banks are operating in Latvia. The capitalization level of the banking sector remained at a high level. In Q2 2021, the average capital adequacy ratio of the banking sector reached 25.08%. Return on assets (ROA) of the banking sector[1] shrank considerably and was 1.18%. Return on equity (ROE)[2] increased to 10.7% (EU – 7.6%).

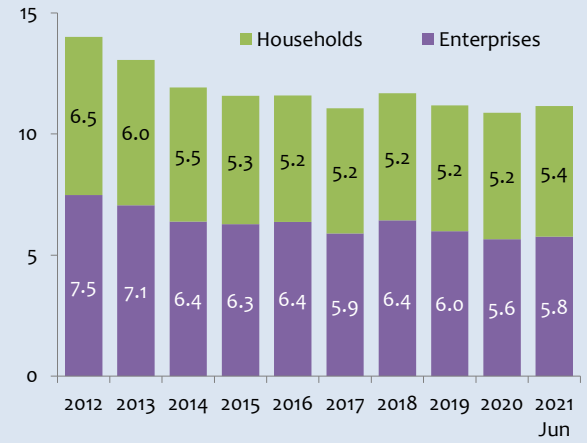
The increase in the **assets of Latvian banks** has been seen since Q3 of 2018. Despite the fact that several credit institutions ceased operations, bank assets also increased at the beginning of 2021 and amounted to 25.3 billion euro in Q2, which was 8.6% or 2 billion more than a year ago. The share of non-bank credits in total assets remained unchanged and amounted to 56%, while the share of debt securities was 15%.

The development of crediting is still evaluated as weak, and it was weak also before the Covid-19 pandemic. According to the FCMC data **outstanding amounts of loans to non-banks** increased by 6.1% at the end of Q2 2021 compared to the corresponding period of the year before.

Figure 6.15

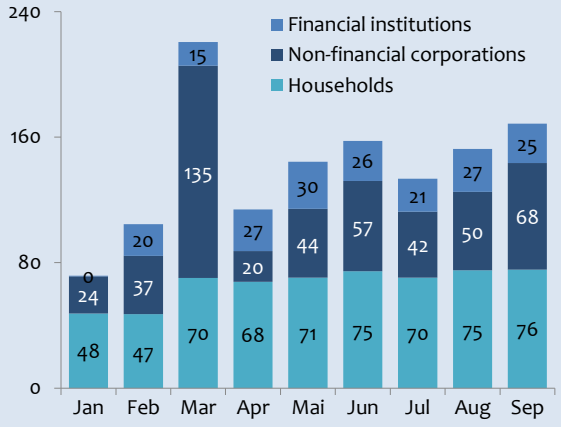
Credit portfolio of households and non-financial corporations

at the end of the period, billion euro



New loans granted to residents by category of borrowers

2021, million euro



Source: FCMC, Credit Register Data

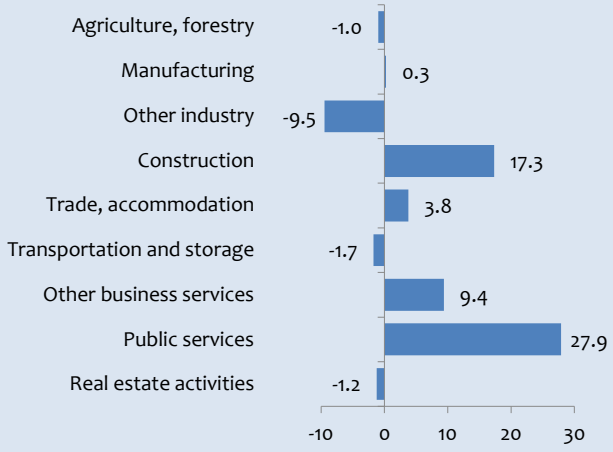
[1] ROA – profit/loss to assets ratio
[2] ROE – profit/loss to capital and reserves ratio

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 caused by the Covid-19 pandemic on crediting of households was smaller than on crediting of business.

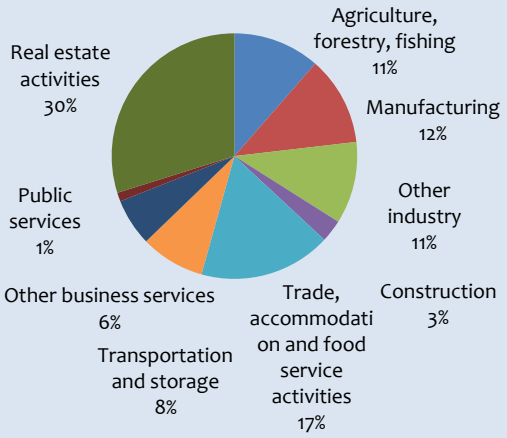
Figure 6.16

Loans for domestic non-financial corporations by sectors of economy

changes, at the end of Q2 2021, compared to late Q2 2020, as per cent



structure, at the end of Q2 2021, as per cent



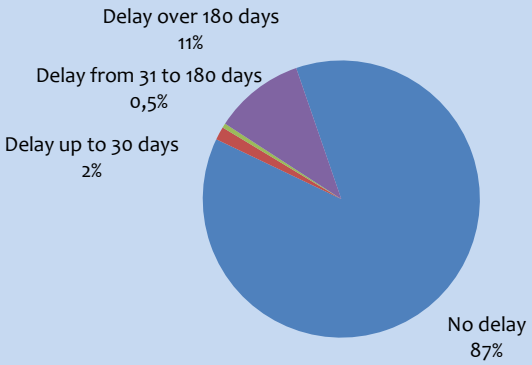
Source: FCMC

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 has a negative impact on the scope of investment and, consequently, on the faster development of companies. In accordance with FCMC data, the amount of balances of credits issued to non-financial corporations increased only by 0.1% in Q2 2021 compared to the corresponding period of the previous year. There are also enterprises, which do not qualify for credits, because they are operating in the shadow economy. Sectors like real estate activities (1/3 of loans) and trade (14% of loans) are most credited sectors in the economy. It is also worth mentioning the state aid to entrepreneurs to overcome the effects of the pandemic, but with the cessation of aid some companies could face risks of insolvency, so it is important not to delay the resolution of financial problems of companies.

Figure 6.17

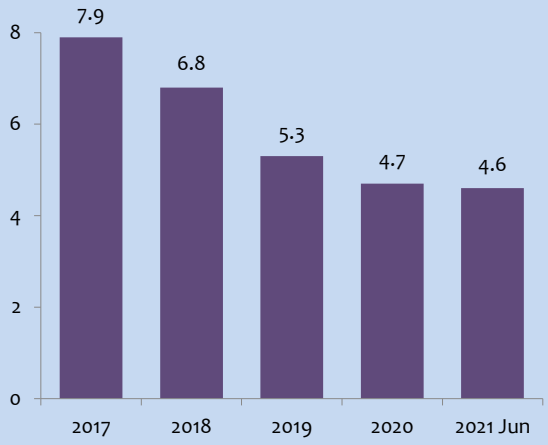
Statistics of Overdue Payment Days

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

New crediting is still developing moderately. Loans amounting to 168.9 million euro were newly issued in September 2021. The volume of new credits issued for acquisition of consumer goods has increased this year. However, consumer crediting is developing unevenly and even declined at the beginning of the pandemic. The volume of new credits issued for acquisition of housing increased. Given the uncertainty of the current 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.

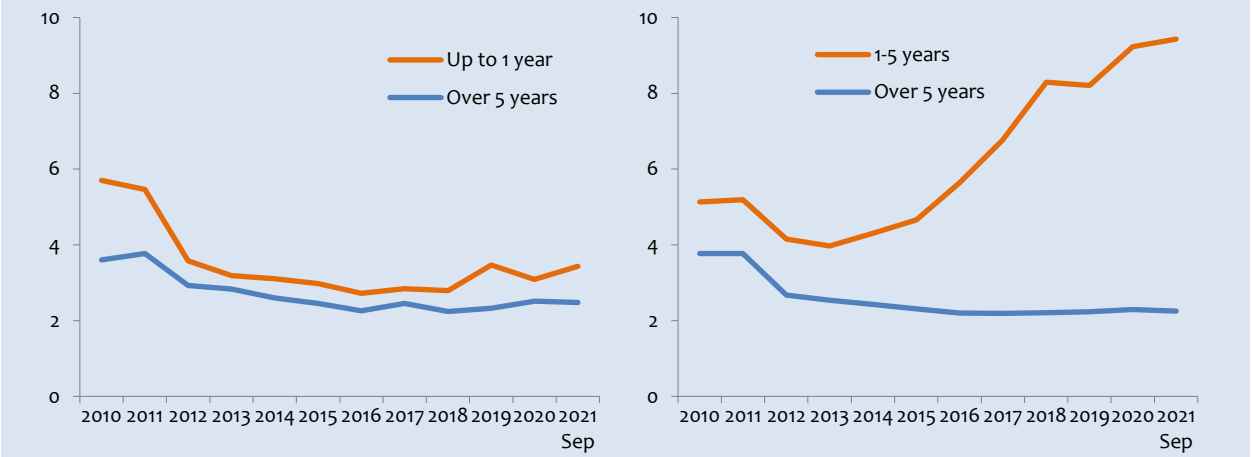
The development of crediting of business is uneven. According to the Credit Register, loans amounting to 67.8 million euro were newly issued to resident non-financial corporations in September 2021. More than half of these loans have been issued to microenterprises and 1/3 to large enterprises. Most new loans have been issued for financial and insurance activities and for the electricity, gas and steam and air conditioning supply.

Until the pandemic, the **quality of credit portfolio** has been gradually improving since 2011, mainly due to improvement of the economic situation, as well as 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, which focused on the support of borrowers and therefore helped entrepreneurs and households to overcome short-term liquidity problems. In accordance with the Credit Register statistics (as at 09.2021), the amount of liabilities with overdue payments in the total credit portfolio of banks was 12.6%. Most of them (10.6%) were linked to a delay longer than 180 days. Given the further uncertainty surrounding the Covid-19 pandemic, the quality of the credit portfolio is expected to deteriorate. Overall, in Q2 2021, 41% of non-bank customer loans subject to review measures are non-performing loans and their share is declining (77% in Q2 2019).

Long-term **interest rates** (on outstanding amounts) for credits granted to non-financial corporations are almost unchanged and amounted to 2.48% in September 2021. Short-term interest rates (up to 1 year) for non-financial corporations slightly increased and in September amounted to 3.43%. Long-term interest rates (on outstanding amounts) for loans granted to households for house purchase are also almost unchanged and in September amounted to 2.32%. Short-term interest rates (1-5 years) for loans granted to households for house purchase continue to grow and in September reached 9.43%, which is one of the highest indicators in the last 10 years.

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

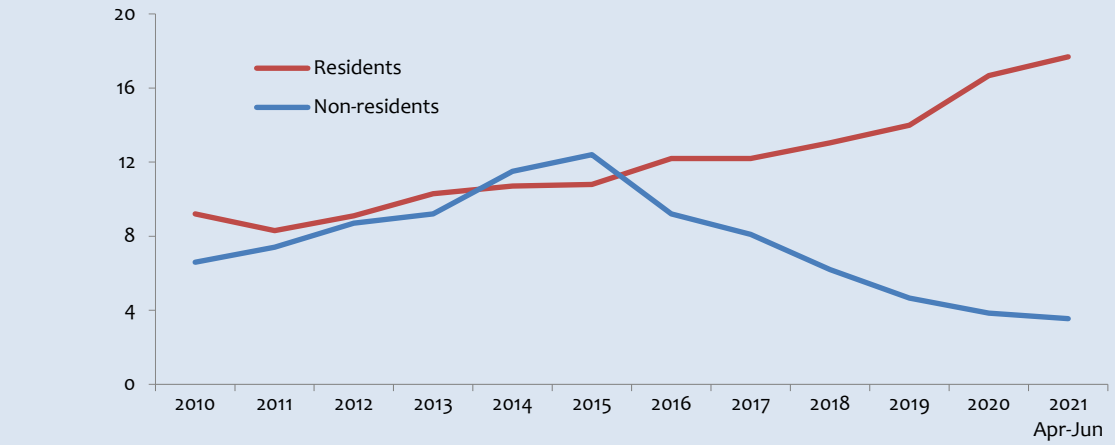
A more rapid increase in **deposit volumes** started in Q2 2020, which coincides with the onset of the Covid-19 crisis, when the population was more cautious in its spending and was more inclined to make savings because of uncertainty of future economic developments. Formation of savings was also boosted by the limited capacity of the population to spend due to the restrictions on trade. In Q2 2021, deposits amounted to 21.3 billion euro, which was by 8.9% more than in the corresponding period a year before. Changes in the structure and in the dynamics of deposits were caused by the sharp drop in volumes of deposits of non-residents. The share of deposits of non-residents has shrank from 53% in Q2 2015 to 17% in Q2 2021. The balance of deposits of non-residents in Q2 2021 amounted to 3.5 billion euro, which is 17% less than a year before. 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, and in Q2 2021 it was 17.7 billion euro, which is 16% higher than in the corresponding period of the year before.

Overall, in the financial sector, as in other sectors, further development of the situation will depend to a large extent on the spread of the Covid-19 pandemic and on the ability to contain it as soon as possible. Despite various support measures, there is also high uncertainty in the banking sector 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 fiscal policy of Latvia is focused on ensuring sustainable economic growth and implementation of a responsible fiscal policy in line with the conditions of the fiscal discipline. In recent years, until the Covid-19 pandemic, the general government deficit was 0.6%-0.8% of GDP (see Table 6.3).

The Covid-19 pandemic has led to significant changes in the fiscal policy that has been implemented so far, which is based on meeting the structural deficit target of -0.5% of GDP. In 2020, the *general escape clause of the Stability and Growth Pact* was activated in the EU, enabling EU countries to increase their general government deficits in 2020, 2021, and 2022 to the extent necessary to mitigate the harm caused to the economy by the pandemic.

Table 6.3

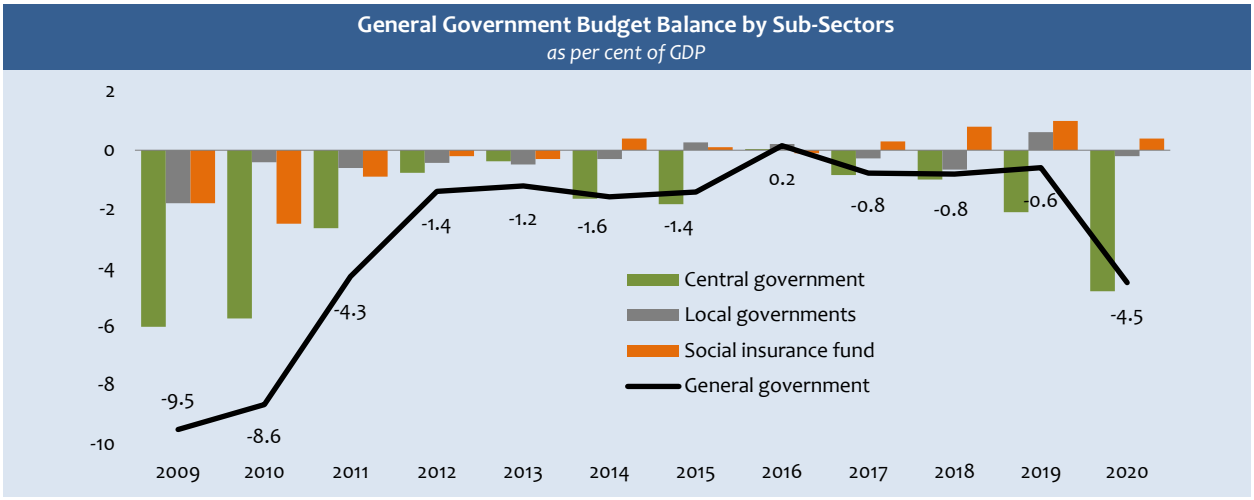
General Government Budget

	billion euro					*as per cent of GDP*				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Revenue	9.5	10.2	11.2	11.5	11.4	37.5	37.9	38.5	37.6	38.6
Expenditure	9.5	10.4	11.5	11.7	12.7	37.4	38.7	39.3	38.2	43.1
Balance	0.04	-0.21	-0.23	-0.17	-1.33	0.2	-0.8	-0.8	-0.6	-4.5

Due to the Covid-19 pandemic, the general government budget deficit of Latvia increased considerably, significantly exceeded the level before the pandemic. In 2020, as tax revenues declined and as expenditures on economic support increased, the deficit already amounted to 1.3 billion euro or 4.5% of GDP.

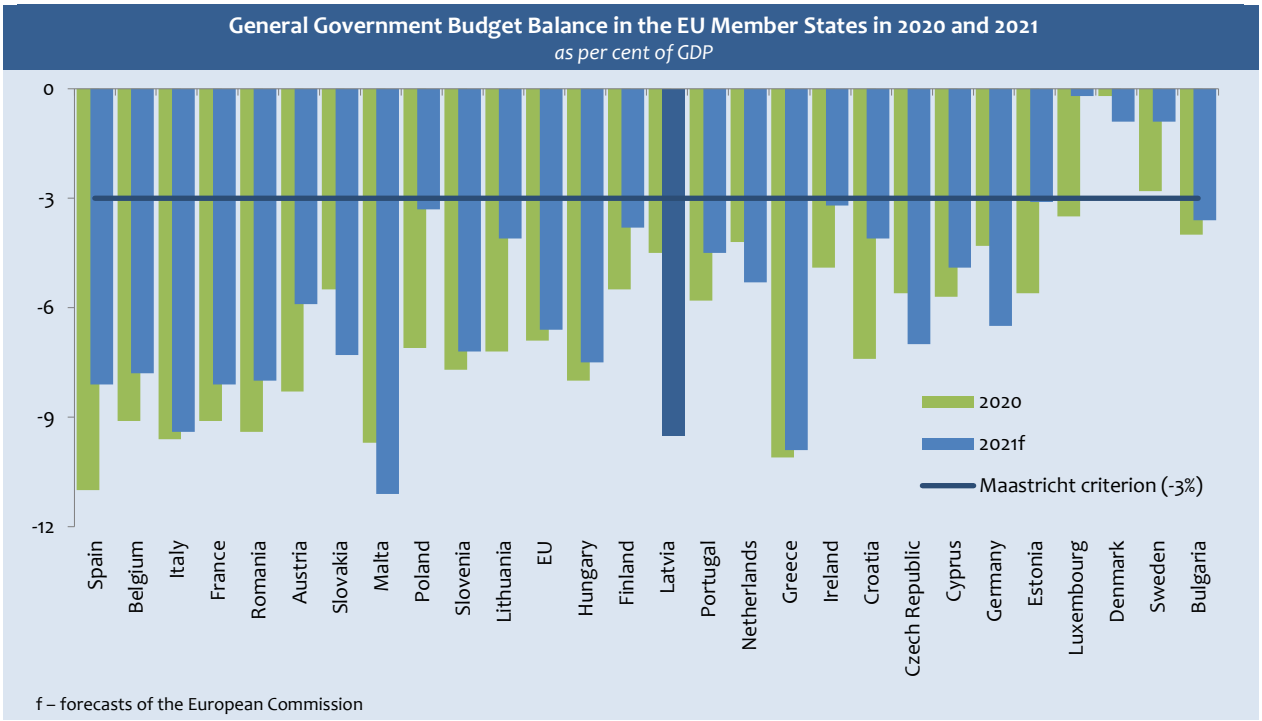
In 2020, the budget deficit was in central government and local government budgets. A surplus in the Social Insurance Fund was recorded (see Figure 6.20).

Figure 6.20



According to Figure 6.21, in 2020, the Latvian budget balance to GDP showed much better performance than the majority of the EU countries. Overall, in recent years, until the Covid-19 pandemic budgets of EU countries tended to improve. The average level of budget deficit of the EU in 2019 was 0.5% of GDP Nevertheless, it increased to 6.9% under the influence of the pandemic in 2020. In 2020, a deficit in the state budget in all EU countries was observed. It was the highest in Spain, Greece, Malta, and Italy (above 9.5% in all of them). The budget deficit did not exceed the Maastricht criterion (3% of GDP) only in two EU Member States – Denmark and Sweden.

Figure 6.21



f – forecasts of the European Commission

In accordance with the EC's forecasts in autumn 2021, the average level of budget deficit in the EU is expected to be 6.6% of GDP, while in 2022 – 3.6%. The highest budget deficit in 2021, which may exceed 9% of GDP, is expected in Malta, Greece, Latvia, and Italy.

The Saeima approved the budget for 2021 with a deficit of 2.9 billion euro or 9.3% of GDP. The high deficit comes from the large package of support measures to mitigate the negative consequences of the crisis caused by Covid-19, the impact of which the Ministry of Finance evaluated as 2.2 billion euro or 6.9% of GDP in 2021.

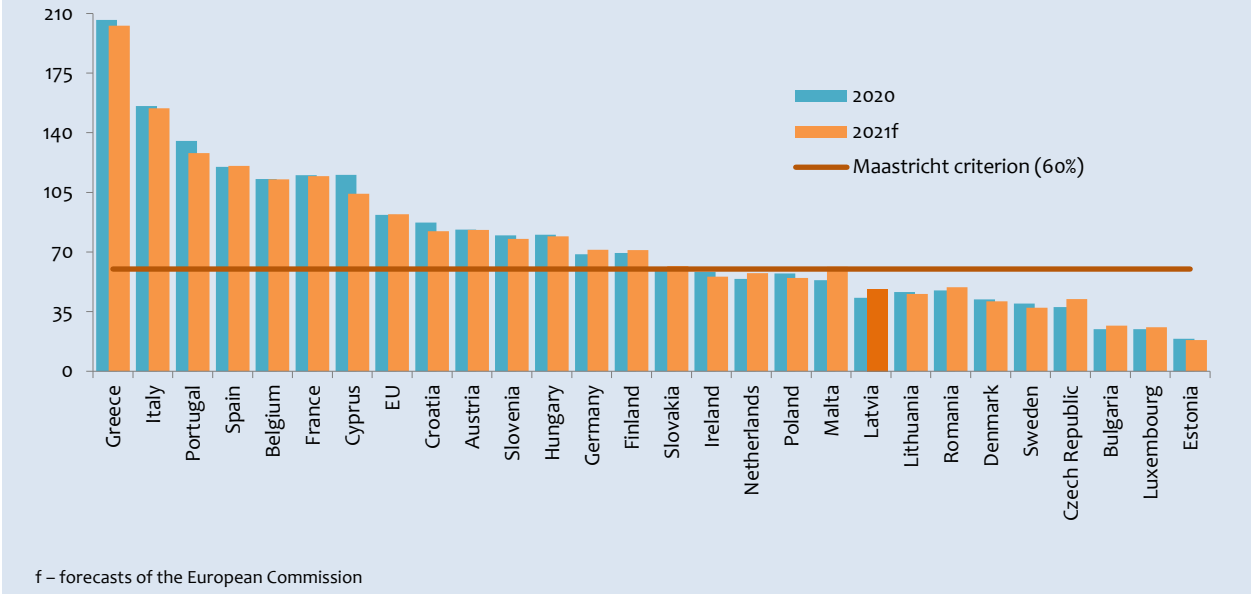
The Saeima approved the budget for 2022 with a deficit of 4.8% of GDP. It provides that the majority of support measures related to the Covid-19 crisis will be terminated. Latvia has used the cancellation of deficit restricting regulations, its low level of government debt and low interest rates to finance in the budget of 2022 many of the country's pressing needs and to reduce the tax burden. This has been done assuming that additional current expenditure does not increase government debt by more than one percentage point and that its increase would not exceed economic growth.

In the next years the budget deficit is expected to continue to decrease from 2.1% of GDP in 2023 and to 1.3% of GDP in 2024.

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

Figure 6.22

General Government Debt in the EU Member States in 2020 and 2021
as per cent of GDP

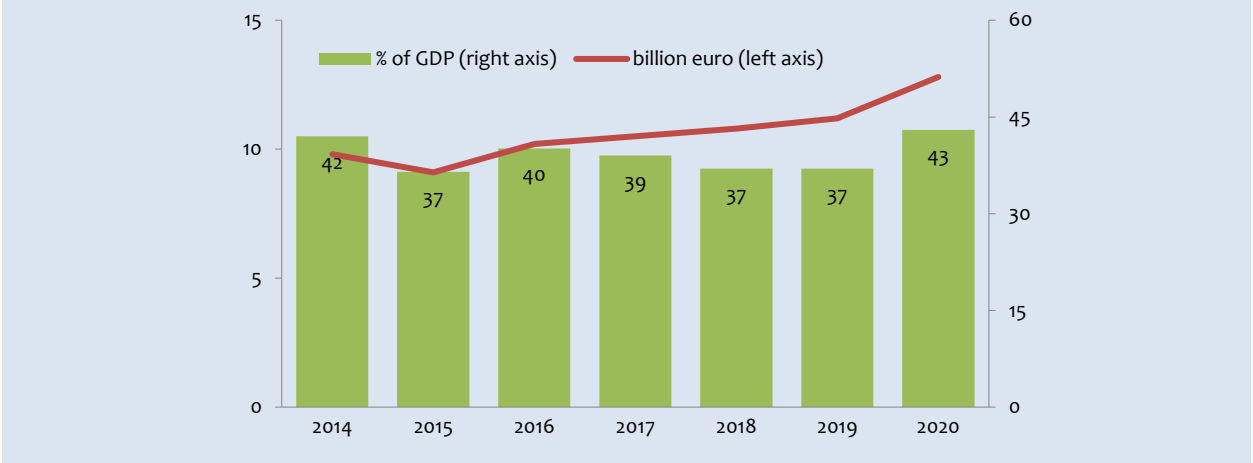


f – forecasts of the European Commission

The average level of public debt in the EU in 2020 was 90.1% of GDP (in 2019 – 77.2% of GDP). In 2020, across 13 EU member states, the public debt exceeded the Maastricht criterion, which is 60% of GDP. The highest public debt to GDP in 2020 was in Greece, Italy, Portugal, and Spain, where it exceeded 120% of GDP. The lowest general government debt to GDP was registered in Estonia, Bulgaria, and Luxembourg. As indicated by the EC forecasts for autumn 2021, the average level of public debt in the EU will increase to 92.1% of GDP in 2021 and slightly decline in 2022 – to 90%, due to the effects of the Covid-19 pandemic.

Figure 6.23

General Government Consolidated Gross Debt by Nominal Value at the End of the Year



The general government debt tended to decline until the Covid-19 pandemic. It reached 11.2 billion euro or 36.7% of GDP in 2019. The outbreak of Covid-19 caused the need to provide considerable amounts of funding to mitigate the impact caused by the Covid-19 crisis in 2020. Government debt increased to 43.2% of GDP or 12.8 billion euro in 2020 (see Figure 6.23).

According to the assessments of the Ministry of Finance, the need to provide financial resources due to the spread of Covid-19 will lead to an increase in general government debt to 48.8% of GDP in 2021 and to 51.7% of GDP in 2022. Following the planned repayment of government debt in 2022-2023, as well as the stabilisation of the situation due to the effects of the outbreak of Covid-19 on the fiscal performance of the government budget, the amount of the general government debt volume, starting in 2023, will decrease slightly and stabilise in relation to GDP in the medium term.

By implementing timely loan 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.

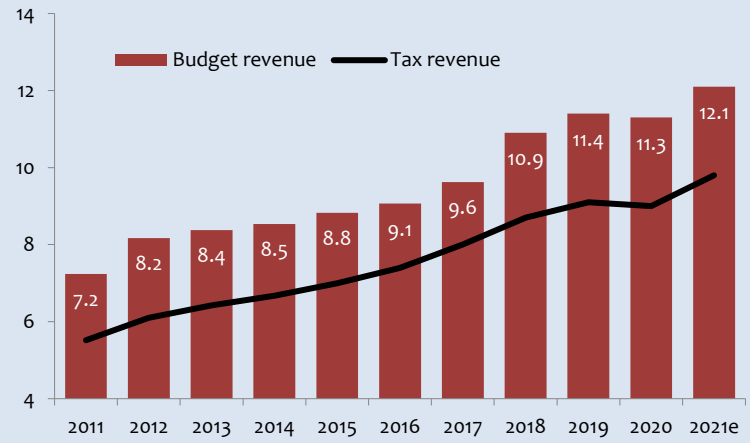
6.6. BUDGET REVENUE AND EXPENDITURE

BUDGET REVENUE[1]

Since 2011, as the economic situation has improved after the economic crisis, the budget revenues have increased. From 2010 to 2020, **consolidated general budget revenue** increased 1.7 times. In 2020, budget revenue amounted to 11.4 billion euro and slightly reduced compared to 2019. In 2021, budget revenue resumed growth. In the 3 quarters, it amounted to 9.4 billion euro, which is by 11.5% more than in the relevant period of 2020. As the economy is recovering from the Covid-19 pandemic shock, positive dynamics in budget revenue restore as well.

Figure 6.24

General Government Consolidated Budget Revenues
billion euro



e – evaluation by the Ministry of Economics

Tax revenue constitutes approximately 3/4 of all budget revenue. A stable increase in tax revenue was observed in 2011-2019. In 2020, there was a small reduction in tax revenue due to the Covid-19 pandemic, but it resumed growth in 2021.

In recent years **employment taxes** account for approximately a half of all tax revenues. In 2021, employment taxes generally increased after the reduction of the previous year caused by the Covid-19 pandemic.

In 2012-2019, personal income tax revenue increased, primarily affected by the improvement of the situation in the labour market. In the 3 quarters of 2021, personal income tax revenue continued to reduce and was 2.9% lower than in the 3 quarters of 2020. It should be noted that from 2021 tax benefits were extended, for example, the non-taxable minimum for

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

pensioners increased. On the other hand, in the 3 quarters of 2021, the dynamics of mandatory state social insurance contributions revenue is positive, the increase amounted to 4.8% compared to the respective period of 2020.

Table 6.4

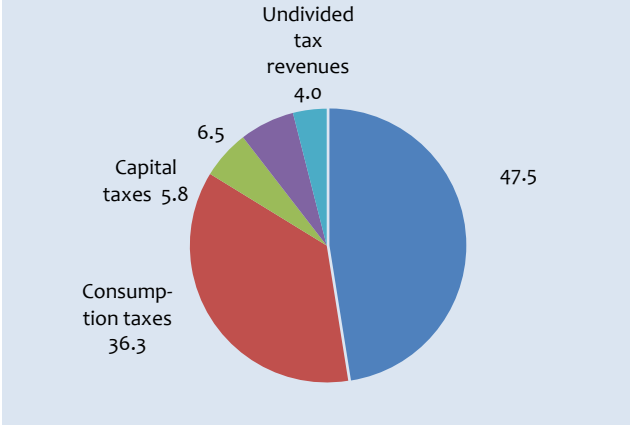
Budget Revenue
as per cent of GDP

	2015	2016	2017	2018	2019	2020	2021 Jan-Sep
General government consolidated budget revenues	**35.9**	**35.7**	**35.7**	**37.3**	**37.2**	**38.4**	**39.4**
I Tax revenues	**28.5**	**29.2**	**29.7**	**29.7**	**29.6**	**30.5**	**30.7**
1. Indirect taxes	11.2	11.5	11.6	12.1	12.3	12.4	12.5
– value-added tax	7.7	8.0	8.1	8.4	8.6	8.6	8.9
– excise tax	3.2	3.4	3.4	3.5	3.5	3.6	3.5
– customs duty	0.2	0.2	0.2	0.2	0.2	0.2	0.2
2. Income taxes and property taxes	8.2	8.5	8.7	7.7	7.2	7.6	7.1
– corporate income tax	1.6	1.7	1.6	1.0	0.1	0.7	1.0
– personal income tax	5.8	6.0	6.3	5.9	6.3	6.2	5.3
– real estate tax	0.8	0.9	0.8	0.8	0.7	0.8	0.8
3. Social insurance contributions	8.3	8.3	8.4	8.7	9.1	9.5	9.0
4. Other taxes	0.8	0.9	1.0	1.1	1.0	1.0	2.1
II Other revenues	**7.4**	**6.5**	**6.0**	**7.6**	**7.7**	**7.8**	**8.7**

Consumption taxes revenues constitute approximately 1/3 of all tax revenues. In recent years, consumption taxes revenue has increased due to the rise in private consumption and, consequently, the increase in retail turnover. In the 3 quarters of 2021, consumption taxes revenue was 12.8% higher than in the 3 quarters of the previous year showing the recovery of private consumption after the shock caused by the Covid-19 pandemic.

Figure 6.25

General Government Consolidated Budget
Tax Revenues by Tax Groups
January-September 2021, as per cent



In 2021, the excise tax for alcoholic beverages and tobacco continues to increase. The excise tax calculation procedure has been changed for the liquid used in electronic cigarettes and for tobacco replacement products. Fresh fruit, berries and vegetables keep their reduced value added tax rate of 5%.

In 2010-2019, value added tax revenue increased. After its reduction in 2020, in the 3 quarters of 2021 its increase reached 15.9% compared to the 3 quarters of 2020. Revenue from the consumption part of the excise tax also increased during this period, but not so evidently.

Capital taxes 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 taxes revenue resumed growth and is still growing in 2021. In the 3 quarters of 2021, corporate income tax and real estate tax revenue has increased by 47.5% and 3.5%, respectively, compared to the respective period of 2020.

In the 3 quarters of 2021, **resource taxes** revenue constituted 6.5% of all tax revenues. Since 2010, natural resources tax revenue has been growing. In 2011-2019, revenue from excise tax on oil products and natural gas was increasing. In the 3 quarters of 2021, resource taxes revenue was 5.1% higher than in the 3 quarters of the previous year.

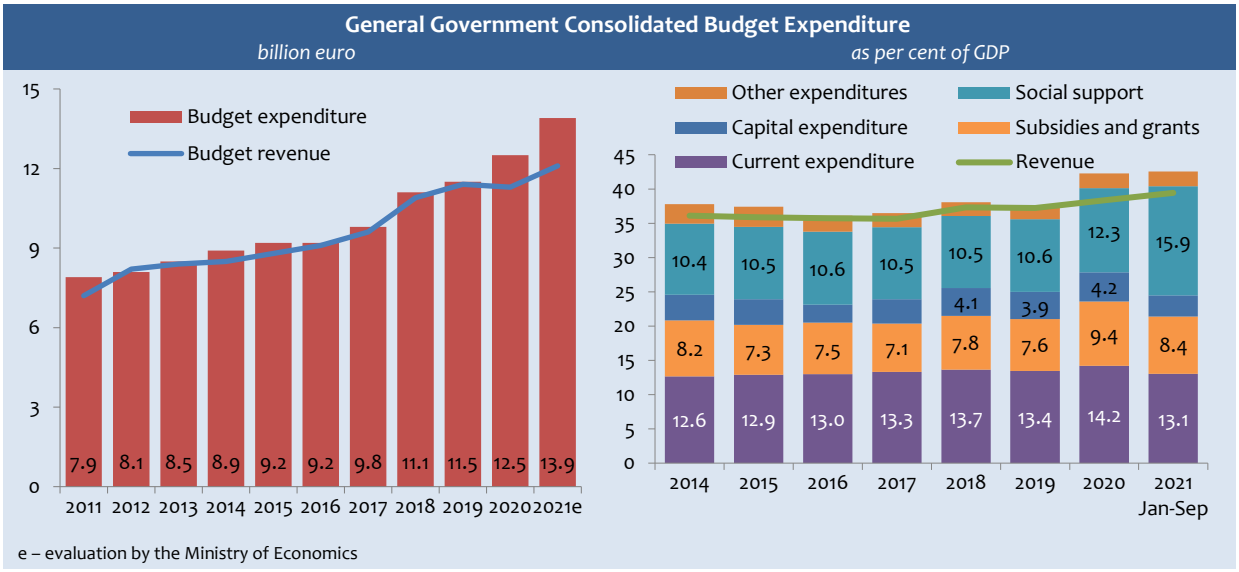
BUDGET EXPENDITURE

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). In 2020, general government consolidated budget expenditure increased by 8.2%, reaching 12.5 billion euro. The increase continued also in the 3 quarters of 2021. General government consolidated budget expenditure amounted to 10.1 billion euro in this period and increased by 17.9%.

Since 2016, **expenditure on subsidies and grants** has been growing. This trend continued in the 3 quarters of 2021. Expenditure on subsidies and grants increased by 10.3%.

In recent years, **capital expenditure** has increased. In the 3 quarters of 2021, capital expenditure continued to increase. It is 2.2% higher than in the relevant period of 2020.

Figure 6.26

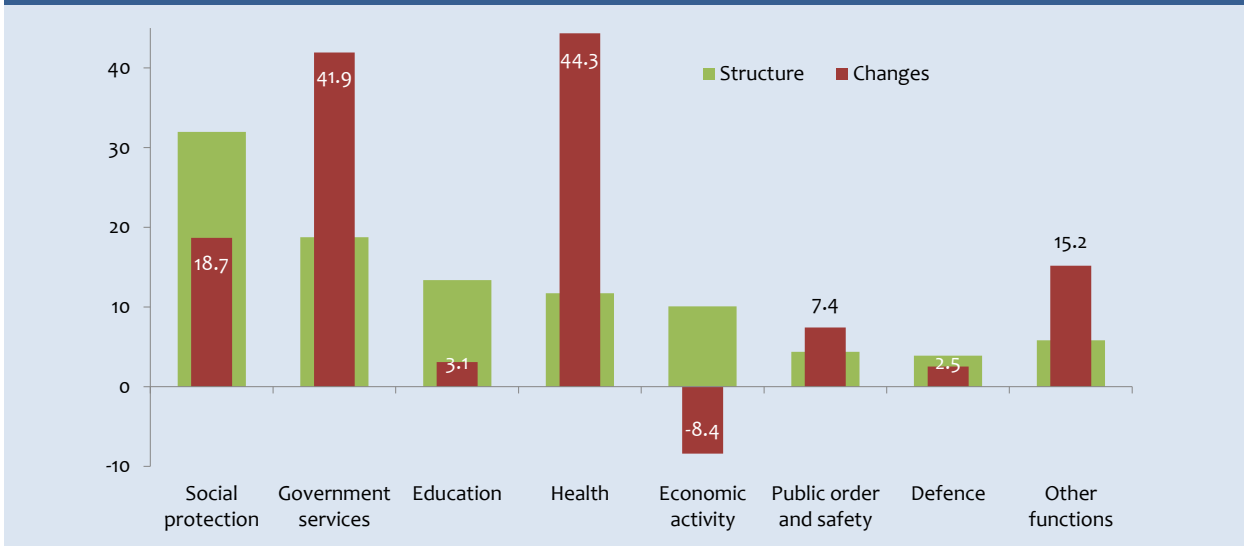


Since 2011, **current expenditure** has been growing. In the 3 quarters of 2021, current expenditure was 1.8% higher than in the 3 quarters of 2020.

During the Covid-19 pandemic, changes have been introduced into the structure of budget expenditure by functional categories. In the 3 quarters of 2021, the highest increase was in the areas related to combatting the pandemic and provision of support to overcome it: social protection, health and general government services.

Figure 6.27

General Government Consolidated Budget Expenditure by Function in January-September 2021
as per cent



6.7. PRODUCTIVITY AND COMPETITIVENESS

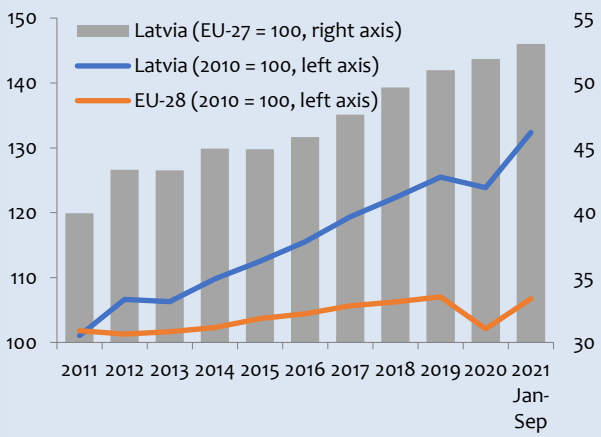
PRODUCTIVITY

Long-term economic growth of Latvia is supported by productivity growth. Productivity has been growing by 14.3% per year in the last five years (2015-2019) before the Covid-19 pandemic, i.e., almost 3 times more rapidly than in the EU on average. The Covid-19 pandemic has a negative impact on productivity. Productivity was 1.3% lower than a year before in 2020 under the influence of the measures for containment of the pandemic (EU average drop by 4.6%). Overall, in 2020, GDP per employed in the Latvian national economy reached 52% (almost 72% according to PPS) of the EU average, and the productivity gap has reduced by 7 percentage points since 2015.

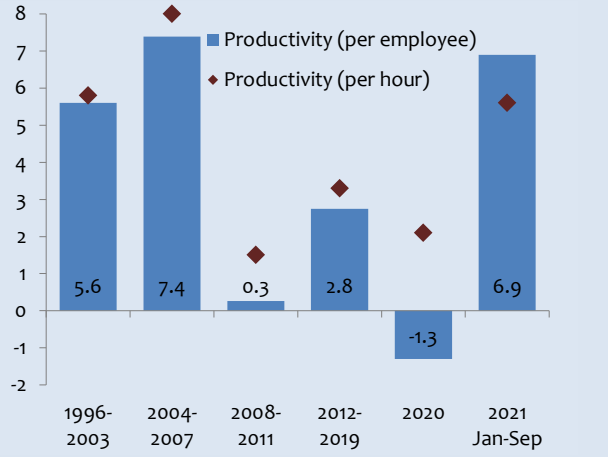
Productivity growth rates in Latvia tend to decline in the long term. The most rapid increase was observed before 2008, after Latvia acceded to the EU, which became a significant incentive for the inflow of foreign investments. Productivity convergence process accelerated in this period.

Figure 6.28

Productivity Latvia and EU



Productivity Dynamics
annual average growth rates, as per cent



The global financial crisis influenced not only the decline in economic activities, but also productivity dynamics. In the first years of economic recession (2008-2009), productivity declined by almost 3%, which was rather insignificant, compared to the drop in GDP (by 17.4%) mainly due to the strong adjustments in the labour market.

Although the effects of the crisis have not been long and positive productivity dynamics has resumed since 2010, they are still half slower than the average in 1996-2007. In the last five years preceding the crisis caused by the Covid-19 pandemic, transportation and storage, manufacturing, and trade contributed most to increasing the overall productivity of the economy. Dynamics were positive also in other sectors, except financial intermediation, where productivity was at a 18% lower level in 2019, compared to 2014.

In 2020, the Covid-19 pandemic has brought a global strong and lasting impact on the socio-economic situation. Similarly to all countries around the world, in 2020, due to the Covid-19 pandemic, the economy of Latvia is in recession and the labour market has been significantly affected. However, its impact on productivity remains uncertain. In particular, the number of employees declined by 1.3%. In terms of the number of hours worked, productivity has increased by 2.1%, which is slightly below the trend of the last decade. Different fluctuations in productivity rates were largely affected by state support for the preservation of jobs, mainly in the form of shortened working time schemes, which contributed to the reduction of hours worked, rather than affected the level of employment.

In 2020, productivity in services sectors fell by 2.8% driven mainly by a drop in output in the trade, accommodation, and transport services sectors. The negative impact of these sectors on productivity dynamics was partly offset by productivity growth in manufacturing and agriculture.

In the nine months of 2021, productivity (per employee) in the Latvian economy was at a 6.9% higher level than in the period concerned a year ago. Trade and public services made the largest contribution to the increase in productivity.

In times of high uncertainty, it is difficult to fully assess the impact of the Covid-19 pandemic on the future productivity dynamics. In the short term, productivity fluctuations lead to adjustments in product, labour and capital markets in response to measures to combat the pandemic and to stabilise the economy. However, the impact of the Covid-19 pandemic on long-term productivity trends will largely determine change in business models and consumer behaviour. It is evident that changes are taking place, for example, the degree of digitisation (e-services, remote work, etc.) is significantly increasing. However, great uncertainty regarding the nature 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

Labour costs are growing faster than productivity. Over the last five years (2016-2020), labour costs have increased by 41.8%, or almost three times faster than productivity. As a result, nominal unit labour costs (ULC)[1] increased significantly – by 28.8%. This indicates growing risks of declining competitiveness of Latvian entrepreneurs.

Statistical data shows that in years of 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 product unit labour costs (ULC). Meanwhile, the serious adjustments to product and labour markets created by the global financial crisis in 2009-2011 bridged the gap between the dynamics of productivity and labour costs.

After the economic recovery ULC has increased. Particularly strong dynamics of nominal ULC have been observed in the last years before the Covid-19 pandemic. In 2019, compared to 2015, ULC rose 20.5%, driven by a nearly 4-fold 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 integrated EU labour market and more tense situation in the domestic labour market. A falling unemployment rate and a growing number of vacant jobs evidence that a mismatch between labour demand and supply in the Latvian labour market increases.

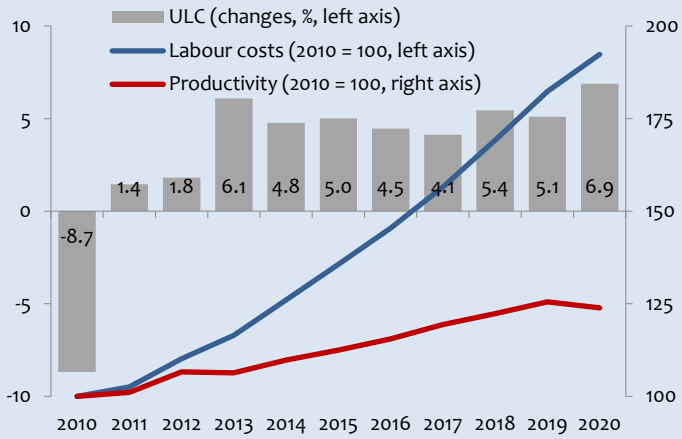
Labour costs per production unit continued to grow also in the years of the Covid-19 pandemic Due to the decline in economic activity, labour costs increased more slowly in 2020 than a year ago – by 5.3% (by 7.8% in 2019). Despite a more moderate increase in labour costs, it did not compensate for a drop in productivity (by 1.3%), resulting in an increase in unit labour costs (ULC) of 6.9%.

[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.

In the nine months of 2021, labour costs continued to grow, and were 11% higher than a year ago. However, pressure on unit labour cost was more moderate than a year ago, due to the increase in productivity by nearly 7%. In the nine months of 2021, unit labour costs of products were by 3.8% higher than a year ago.

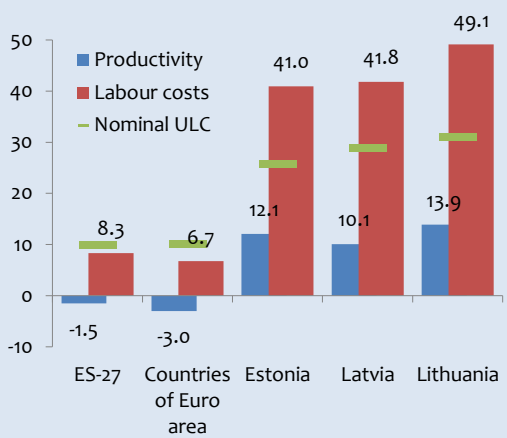
Figure 6.29

ULC, Productivity and Labour Costs



ULC, Productivity and Labour Costs in the Baltic Countries and in the EU

2020, compared to 2015, as per cent

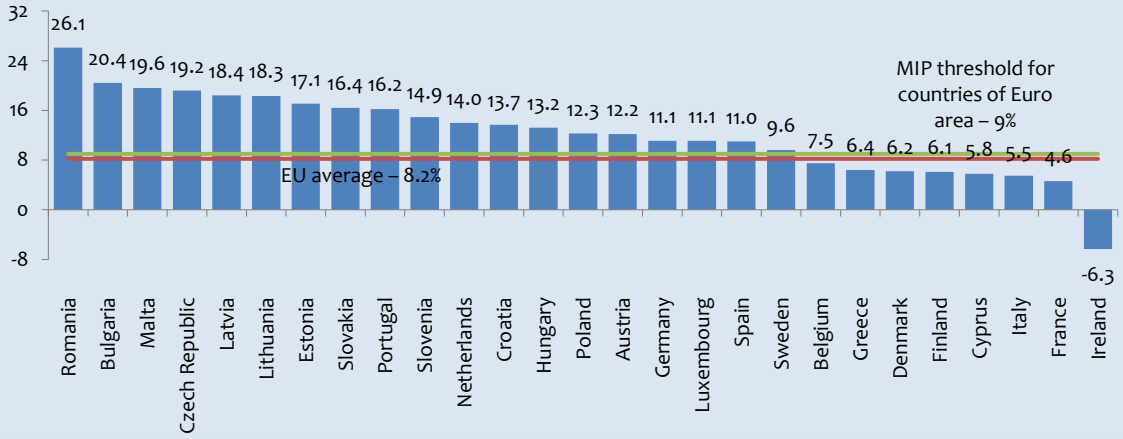


Sharp growth of nominal ULC is observed in all the Baltic countries. In the last three years (2018-2020), it increased by 18.4% in Latvia, by 17.1% in Estonia and by 18.3% in Lithuania – much more rapidly than in the EU on average (4%), and this indicator has significantly exceeded the threshold (9%) set for this indicator in the EU Alert Mechanism (MIP) (for details see Chapter 6.8).

Figure 6.30

Nominal ULC in EU Countries

changes as per cent, over three years (2020 compared to 2017)



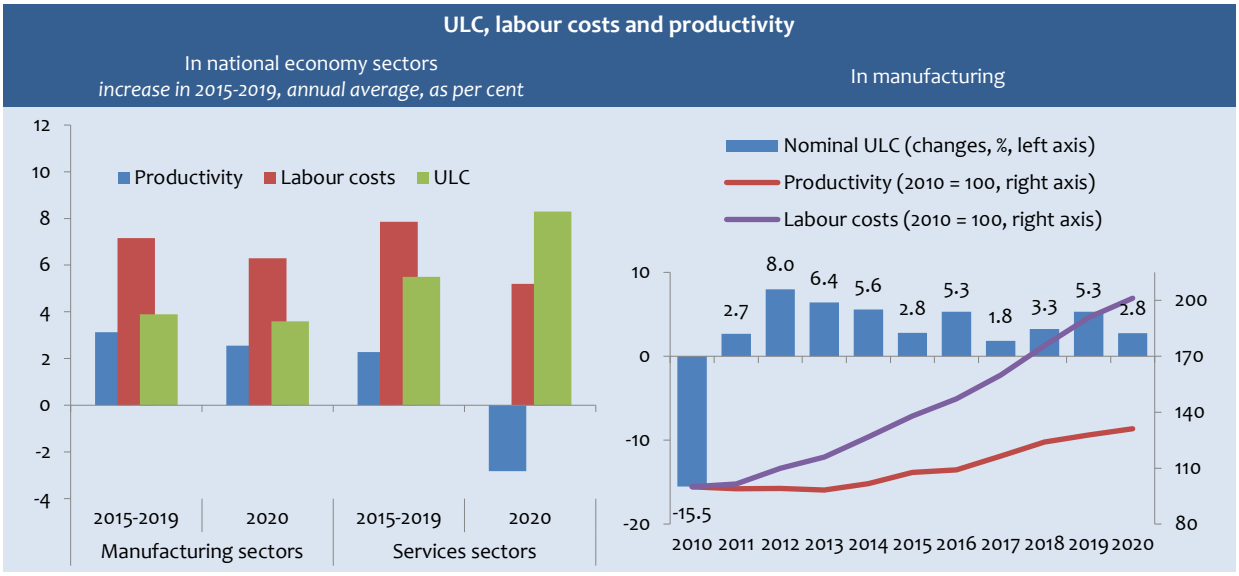
Cost competitiveness reduction risks are observed in both manufacturing and services sectors. The dynamics of labour costs in the last five years (2015-2019) before the Covid-19 pandemic in both mentioned groups of sectors were very similar – they increased by almost 7.2% and 7.9% on average every year, respectively. However, productivity in manufacturing sectors increased almost one and a half times more rapidly than in the services sectors – by 3.1% and 2.3%, respectively. Therefore, also the nominal ULC increase in manufacturing sectors was more moderate.

The shock related to the Covid-19 pandemic has a stronger impact on adjustments in the products market than in the labour market. In 2020, labour costs in manufacturing and services sectors continued to grow – by 6.3% and 5.2%, respectively. Despite that productivity in goods manufacturing sectors increased by 2.6%, it was not able to offset the increase in labour

costs, and ULC increased by 3.6%. Productivity in services sectors was 2.8% lower than a year before increasing the nominal ULC by 8.3%.

Financial services, as well as energy and water supply and public utilities faced the highest rise in nominal ULC in 2020 affected not only by the increase in labour costs, but also by the drop in productivity. Also, a large increase in nominal ULC in the accommodation and food service activities, as well as information and communication was observed.

Figure 6.31

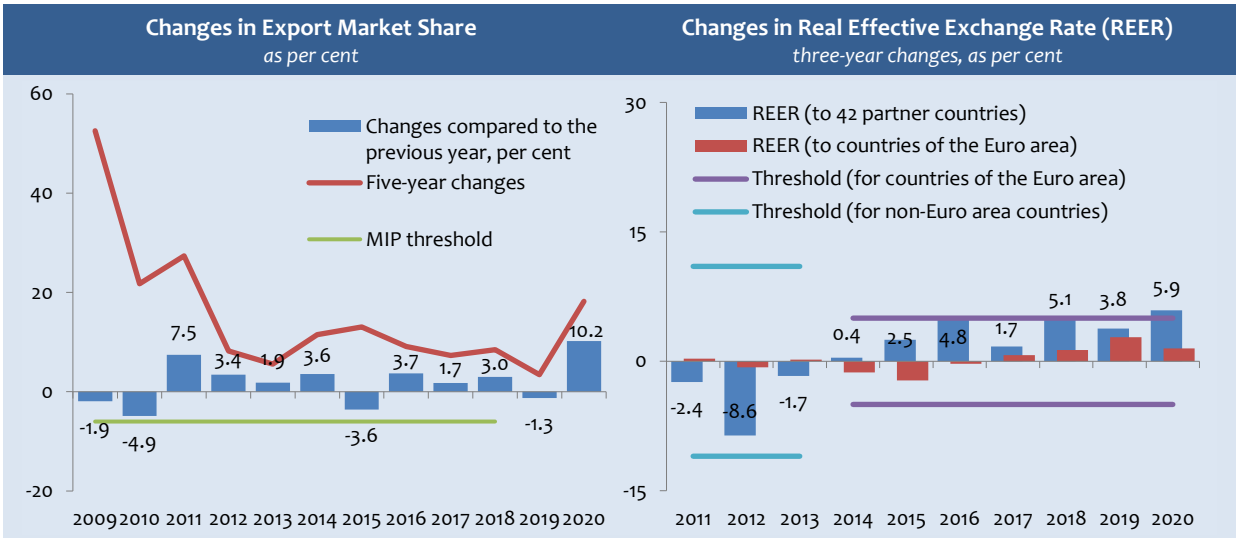


The ULC dynamics continued to increase in all sectors of the economy also in 2021. In the near future, changes in productivity and labour costs will be largely determined by measures to combat the Covid-19 pandemic and boost economic activity.

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 had been growing two times faster than productivity in the last two years (2015-2019) before the Covid-19 pandemic.

In 2020, both productivity and labour costs have increased by 2.6% and 5.4%, respectively, thus elevating nominal unit labour costs of products by 2.8%. 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.

Figure 6.32



In 2021, the dynamics of productivity and labour costs in manufacturing remained positive. In the nine months of this year, compared to the corresponding period last year, productivity increased by 4%. However, labour costs rose by 7.5%. As the gap between the growth rates of productivity and labour costs is expanding, nominal ULC is growing more rapidly as well – by 3.3%, getting close to the trends of the crisis caused before the pandemic.

The labour costs dynamics in Latvian manufacturing exceeds significantly 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.

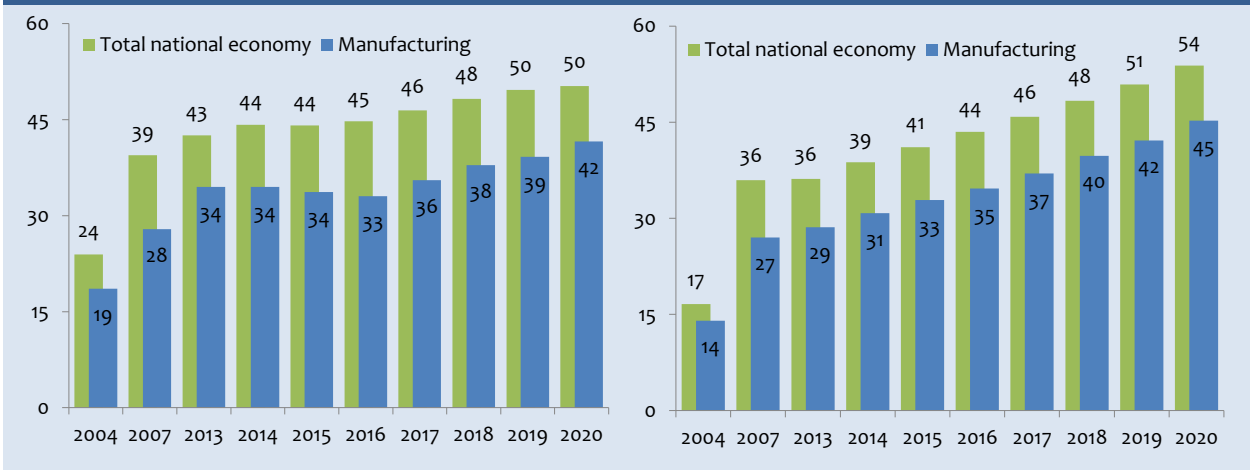
Despite the negative trends in cost competitiveness indicators, the long-term dynamics of the Latvia's export market share are improving. In the last five years (2016-2020), the Latvia's export market share in world markets increased by 17.8%, largely affected by the positive changes in 2020. Although in 2019 the Latvia's services export market share in world markets reduced by 1.3%, in 2020 it increased by 10.2% underpinned by the significant increase in the goods export market share by 15.7%. In 2020, the goods and services export market share of Estonia and Lithuania also increased – by 5.6% per 9.4%, respectively.

The real effective exchange rate (REER) is growing. The consumer price index (CPI) based REER to 42 trade partner countries has increased 6.9% in the last three years (2017-2020), 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.

Figure 6.33

Convergence of Productivity and Labour Costs with the EU Average Level

as per cent of the EU-28 average



In the long term, the increase in labour costs, which is not compensated by a corresponding rise in productivity, may have a negative impact 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 2020, labour costs per employee in the Latvian economy were almost 54% of the EU average, whereas in the manufacturing industry – 45%. Compared to 2015, in 2020, the labour cost gap has decreased by 12 percentage points, while in terms of productivity index in the national economy fell by 6.2 percentage points However, in manufacturing it declined by 8 percentage point. It implies that the wage convergence process is faster than productivity convergence.

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 mitigation risks even more. Therefore, strengthening of Latvia's competitiveness will largely depend on the ability to reduce the productivity gap.

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 24 November 2021, the European Commission published an **Alert Mechanism Report**[1] (AMP) 2022, which states that no macroeconomic imbalances have been stated in Latvia, although two indicators exceed the set limits or thresholds: real effective exchange rate (REER) changes, and nominal unit labour cost (NULC) index (see Table 6.5).

Table 6.5

List of Indicators of the Macroeconomic Imbalance Procedure for Latvia

	Thresholds	2013	2014	2015	2016	2017	2018	2019	2020
External imbalances and competitiveness									
Current account balance (% of GDP, 3 year average)	-4%/6%	-3.3	-2.7	-1.7	-0.2	0.7	0.9	0.1	0.7
Net international investment position (% of GDP)	-35%	-67.9	-64.1	-60.1	-54.2	-51.4	-45.2	-40.1	-34.7
Real effective exchange rate – 42 trading partners, HICP deflator (3 year % change)	±5%* & ±11%	-1.7	0.4	2.5	4.8	1.7	5.1	3.8	5.9
Export market share – % of world exports (5 year % change)	-6%	5.6	11.5	13.0	9.1	7.3	8.5	3.4	18.2
Nominal unit labour cost index (3 year % change)	9%* & 12%	9.6	13.2	16.7	14.9	14.2	14.7	15.4	18.4
Internal imbalances									
Deflated house prices (% y-o-y change)	6%	6.4	4.7	-2.8	7.2	5.3	6.3	5.8	2.7
Private sector credit flow (as % of GDP, consolidated)	14%	-0.6	-4.6	-0.8	2.5	2.7	-0.2	1.1	-1.8
Private sector debt (as % of GDP, consolidated)	133%	90.7	82.2	78.3	78.3	75.6	69.7	66.2	66.5
General government sector debt (as % of GDP)	60%	40.4	41.6	37.1	40.4	39.0	37.1	36.7	43.2
Unemployment rate (3 year average)	10%	14.4	12.6	10.9	10.1	9.4	8.6	7.5	7.3
Total financial sector liabilities (% y-o-y change)	16.5%	5.7	10.9	13.3	4.7	6.2	-3.5	4.6	10.8
New employment indicators									
Activity rate – % of total population aged 15-64 (3 year % change)	-0.2 percentage points	1.0	1.8	1.3	2.3	2.4	2.0	1.0	1.2
Long-term unemployment rate – % of economically active population (3 year % change)	0.5 percentage points	-3.1	-4.2	-3.3	-1.7	-1.3	-1.4	-1.6	-1.1
Youth unemployment rate – % of economically active population (3 year % change)	2 percentage points	-13.0	-11.4	-12.2	-5.9	-2.6	-4.1	-4.9	-2.1

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

It is noted in AMR that after a 3.6% decrease in Latvia's GDP in 2020, real GDP is forecast to increase by 4.7% in 2021 and 5% in 2022, while the nominal GDP level in 2022 is forecast to be 12.9% above its 2019 level.

The current account had a surplus of 2.9% of GDP in 2020, improving the net international investment position (NIIP) to -34.7% of GDP. Latvia's negative NIIP consists mainly of government debt and FDI posing a low risk to sudden flight or

[1] https://ec.europa.eu/info/publications/2022-european-semester-alert-mechanism-report_en

appreciation in servicing cost. The current account balance is forecast to turn slightly negative again in 2022, but the NIIP will continue improving.

Cost competitiveness indicators worsened in 2020. The unit labour cost index, which has been above the threshold since 2014, increased further in 2020, due to the combination of declining productivity and continued wage growth. Wage growth was affected both by skills shortages and because Covid-19 related job losses accrued predominantly in the low-wage sectors. Covid-19 related productivity effects are expected to be transitory but the wage pressures coming from falling labour supply are expected to remain a factor going forward as demographic decline is expected to persist. Latvia's export market share increased considerably in 2020. The harmonised index of consumer prices (HICP)-based real effective exchange rate appreciated, considerably influenced by depreciation of the Russian rouble, which fell some 20% in 2020, and surpassed the threshold for the first time.

Real house price growth slowed considerably in 2020, following several years of dynamic price growth. Private sector debt levels stayed stable, with subdued credit in the corporate sector. The financial sector is sound and well capitalised, but profitability deteriorated significantly in 2020.

The unemployment rate increased to 8.1% in 2020, in light of the Covid-19 crisis. Also youth unemployment started to increase in 2020 and continued to increase further in 2021. The worsening in the labour market conditions due the Covid-19 crisis is expected to be temporary with the unemployment rate approaching its pre-crisis level by 2023.

Indicators of the macroeconomic imbalance procedure (both the primary list and the auxiliary list) have been selected so as to better and faster warn about potential macroeconomic imbalances, 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.

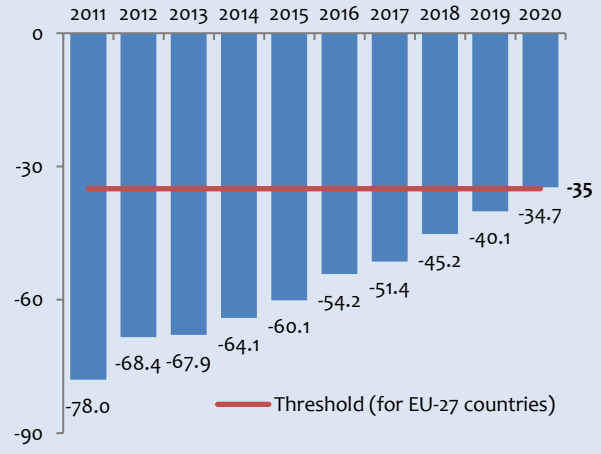
The 3 year average current account balance of Latvia does not surpass the thresholds and has been positive since 2017. The countries, where the 3-year average current account balance in 2020 surpassed the upper threshold, were the Netherlands, Denmark, Germany and Slovenia, and the lower threshold was surpassed in Romania, Ireland and Cyprus.

The net international investment position of Latvia improved to -34.7% of GDP in 2020 and no longer surpasses the threshold (see Figure 6.35). Meanwhile, 10 of EU-27 countries surpassed the NIIP threshold, for of which had it lower that -100% of GDP (Greece, Ireland, Cyprus and Portugal). FDI is considered the safest means of raising foreign capital included in NIIP. In 2020, FDI constituted 34.9% of the total attracted foreign capital in Latvia.

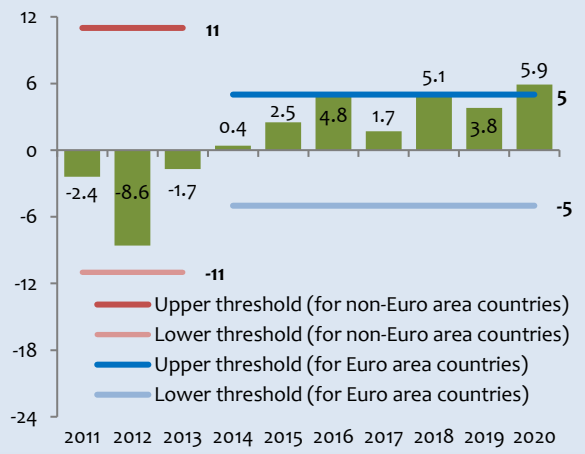
Until 2020, Latvia surpassed the real effective exchange rate 3 year change neither before nor after its accession to the Euro area. However, in 2020 it surpassed the upper threshold, and as data of the previous years were updated, it was stated that the upper threshold was surpassed also in 2018 (see Figure 6.35). Out of EU-27 countries, only real effective exchange rate 3 year changes of Slovakia, Estonia and Lithuania surpassed the upper threshold in 2020.

Figure 6.35

Net international investment position of Latvia
as per cent of GDP



Real effective exchange rate (42 trading partners, HICP deflator)
3 year percentage change



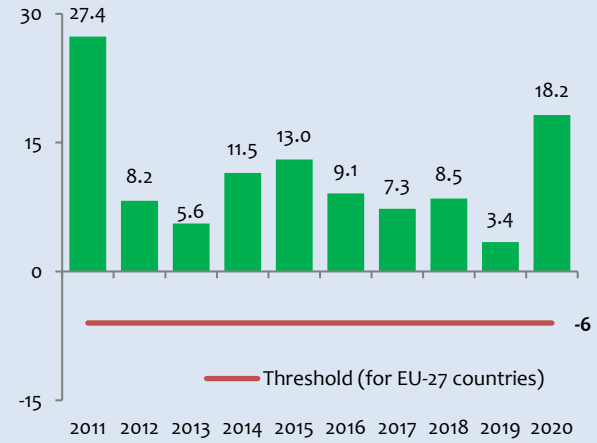
Source: *Eurostat*

In 2020, Latvian exports showed good results reflecting in the increase of the Latvian export share market as a percentage of world exports. Therefore, the export market share 5 year % changes indicator improved considerably (see Figure 6.36). Meanwhile, this indicator in Greece, France and Spain was -6% below the threshold.

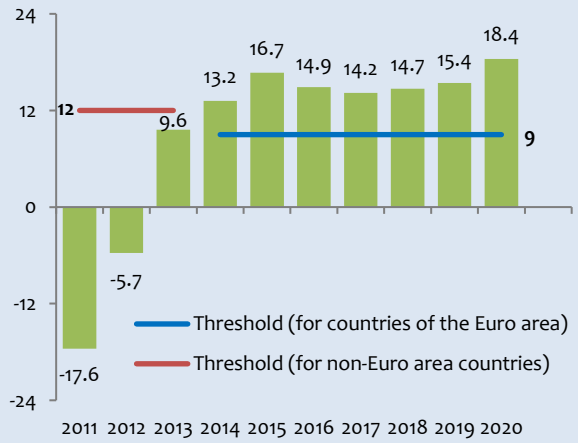
Since the accession of Latvia to the Euro area in 2014, the nominal unit labour cost index exceeds the threshold set for Euro area countries (see Figure 6.36). 12 Euro area and 6 non-Euro area EU-27 countries exceeded this threshold in 2020.

Figure 6.36

Export market share of Latvia
% of world exports
5 year percentage change



Nominal unit labour cost index in Latvia
3 year percentage change



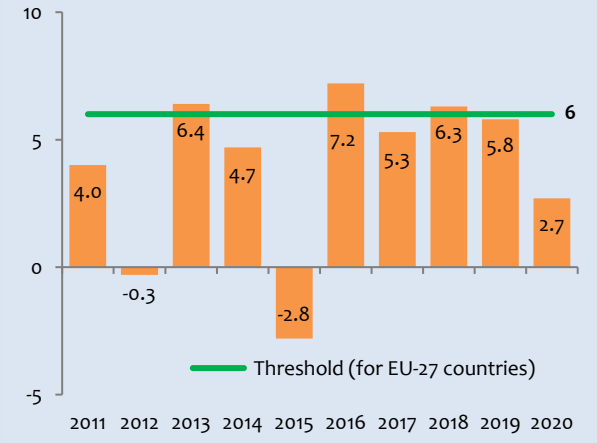
Source: *Eurostat*

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

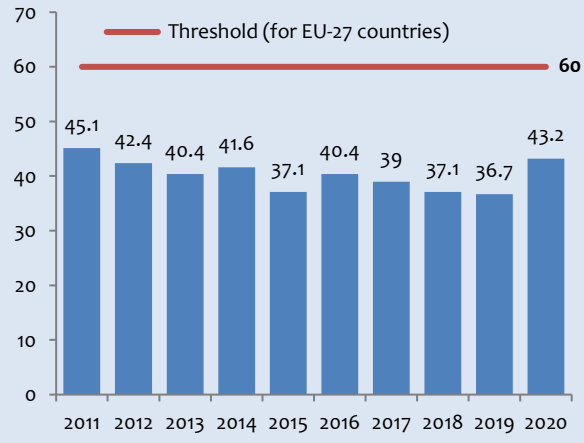
After 2010, the house price index of Latvia exceeded the threshold in 2013, 2016 and 2018 (see Figure 6.37). Out of EU-27 countries, Luxembourg, Portugal, Slovakia, Croatia, Slovakia, Germany, Poland, Estonia, Lithuania and Austria exceeded the house price index threshold in 2020.

Figure 6.37

House price index in Latvia
1 year percentage changes, deflated



General government debt of Latvia
as per cent of GDP



Source: *Eurostat*

The private sector credit flow of Latvia has not exceeded the threshold since 2010. In 2020, out of EU-27 countries, this indicator exceeded this threshold only in Luxembourg.

The private sector debt approached the threshold in Latvia only in 2010. After 2010, the private sector debt continues to decrease. In 2020, this indicator exceed this threshold in 12 of EU-27 countries.

The general government debt of Latvia reached its highest level (47.3% of GDP) on 2010, however, it did not exceed the threshold. Then government debt reduced to 36.9% with small variations in 2019, and increased again in 2020 (see Figure 6.37). In 2020, this indicator exceed this threshold in 13 of EU-27 countries.

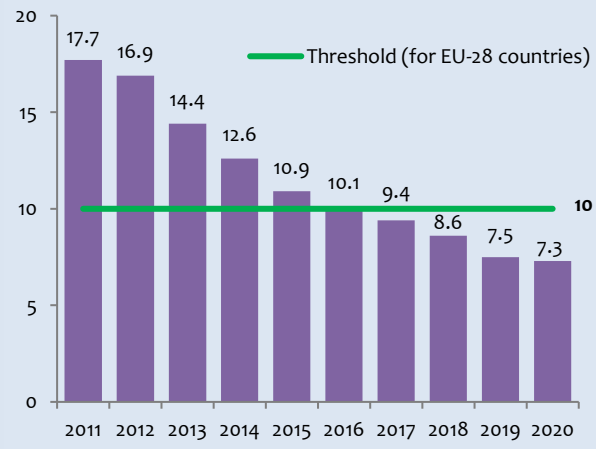
The increase in total financial sector liabilities in Latvia has never exceeded the set 16.5% threshold. Out of EU-27 countries the total financial sector liabilities increase threshold in 2020 was surpassed by Hungary, Lithuania, Greece and Estonia.

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.

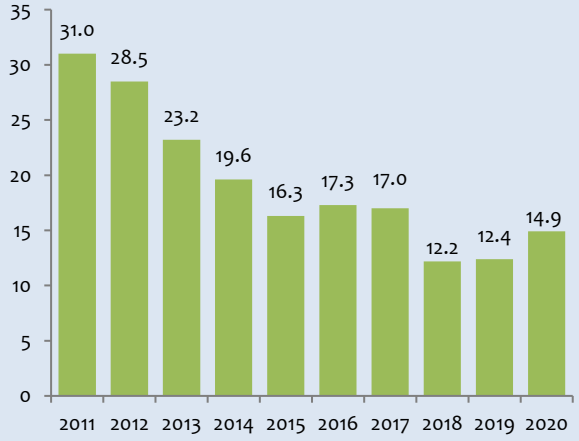
The three-year average unemployment rate in Latvia exceeded the 10% threshold from 2010 to 2016. It reached the highest value in 2011, but then reduced. It was 7.3% in 2020 (see Figure 6.38). In 2020, out of EU-27 countries the 3-year average unemployment rate exceeded the 10% threshold only in Greece and Spain.

Figure 6.38

Unemployment rate in Latvia
3 year average, as per cent



Youth unemployment rate in Latvia
as per cent of economically active population aged 15-24



Source: *Eurostat*

3 year average unemployment rate in Latvia was the highest in 2011 and then reduce and since 2017 this indicator has not longer surpassed the threshold (see Figure 6.38). Long-term unemployment 3 year average and youth unemployment 3 year average show similar trends. However, 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). After 2012, long-term unemployment and youth unemployment indicators no longer exceeded the thresholds. In 2020, long-term unemployment was 2.2% of the economically active population, youth unemployment was 14.9% of the economically active youths aged 15-24, but 7.1% of youths aged 15 to 24 were not in employment, education or training.

In 2020, none of EU-27 countries had 3 year changes in percentage points in the long-term unemployment rate exceeding the threshold, but 3 year changes in percentage points in youth unemployment exceeded the threshold in Luxembourg, Lithuania, Sweden, Estonia, Slovenia and Hungary.

Three year changes in percentage points in the economically active population level in Latvia exceeded the threshold in 2011, but then showed an increase and no longer surpassed the threshold. In 2020, out of EU-27 countries this indicator surpassed the threshold in Portugal, France, Ireland, Greece, Italy and Spain.

6.9. LATVIA IN INTERNATIONAL RATINGS

INDEXES

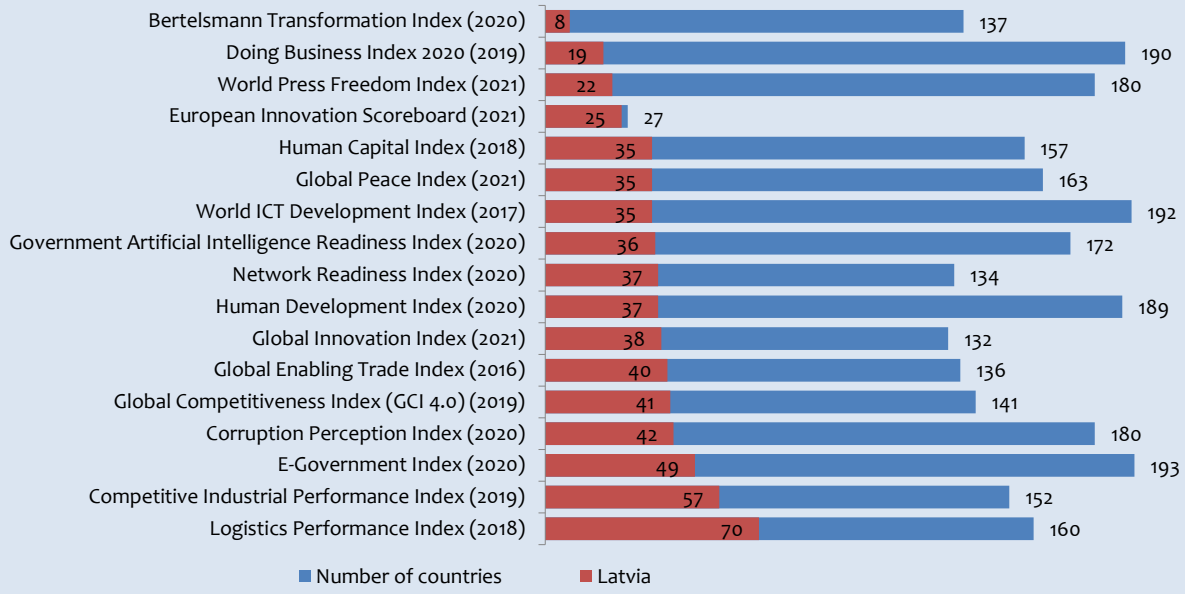
The indexes created by the United Nations (UN), the World Bank group, the World Economic Forum and other organisations characterise Latvia as a country, which carries out many reforms to improve its competitiveness improving the business

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 indexes have been arranged starting from the highest place reached (see Figure 6.37), but their descriptions are broken down into main thematic groups. Many indexes are issued once in 2 years, while the preparation of other indexes was delayed by the Covid-19 pandemic.

Figure 6.37

Latvia's Position in the Most Popular International Ratings in 2021
position according to the year of the latest publication; number of countries in the index



Source: *Bertelsmann Stiftung's Transformation Index, Bertelsmann Stiftung; Doing Business 2020: Sustaining the Pace of Reforms, International Bank for Reconstruction and Development, The World Bank; 2021 World Press Freedom Index, Reporters Without Borders; European Innovation Scoreboard 2021, European Commission; Global Peace Index 2021: Measuring Peace in a Complex World, Institute for Economics and Peace; World Development Report 2019: The Changing Nature of Work, International Bank for Reconstruction and Development, The World Bank; Measuring the Information Society Report 2017, International Telecommunication Union; The Global Innovation Index 2021: Tracking Innovation through the COVID-19 Crisis, World Intellectual Property Organization; Government Artificial Intelligence Readiness Index 2020, Oxford Insights, International Development Research Centre; The Network Readiness Index 2020: Accelerating Digital Transformation in a post-COVID Global Economy, Portulans Institute; Human Development Report 2020, United Nations Development Programme; The Global Enabling Trade Index 2016, World Economic Forum, Global Alliance for Trade Facilitation; The Global Competitiveness Report 2019, World Economic Forum; Corruption Perceptions Index 2020, Transparency International; United Nations E-Government Survey 2020, United Nations; Competitive Industrial Performance Index 2021, United Nations Industrial Development Organization; Logistics Performance Index 2018, International Bank for Reconstruction and Development, The World Bank.*

Comprehensive indexes

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.

In the **Human Development Index 2020** created by the UN Development Programme, which is based on the data of 2019 and includes life expectancy, literacy, education level, GDP per capita and other indicators, Latvia was ranked 37th (Estonia – 29th, Lithuania – 34th) among 189 countries of the world moving 2 positions up compared to 2019.

Indexes characterising institutional environment

In the **Transformation Index 2020** created by Bertelsmann Stiftung, which evaluates the quality of democracy, market economy and political governance Latvia, like in the index of 2018, is ranked 8th (Estonia is the 2nd, Lithuania is the 4th) among 137 countries of the world.

In the **Corruption Perceptions Index 2020** created by the International anti-corruption organisation *Transparency International*, Latvia was ranked 42nd (Estonia – 17th, Lithuania – 35th) among 180 countries of the world moving 2 up positions compared to the result of 2019.

In the **2021 World Press Freedom Index** created by the International press and freedom of expression organisation "Reporters Without Borders", in 2021, like in the index of 2020, Latvia was ranked 22nd (Estonia – 15th, Lithuania – 28th) among 180 countries.

In the **Global Peace Index 2021** created by the Institute for Economics and Peace, in 2021 Latvia was ranked 35th (Estonia – 30th, Lithuania – 37th) among 163 countries of the world having moved 1 position down compared to the result of 2020.

Indexes 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 2020** created by the UN Department of Economic and Social Affairs, which analyses the progress of using e-government, in 2020 Latvia was ranked 49th (Estonia – 3rd, Lithuania – 20th) among 193 countries of the world moving 8 positions up compared to the result of 2018.

In the **Government Artificial Intelligence Readiness Index 2020** created by *Oxford Insights* and the International Development Research Centre, in 2020 Latvia was ranked 36th (Estonia – 17th, Lithuania – 26th) among 172 countries moving 3 positions down compared to 2019.

In 2020, in the **Network Readiness Index 2020** created by the *Portulans Institute*, which analyses digital transformation by 4 pillars (technology development, human capital, governance and economic and social effects), Latvia was ranked 37th (Estonia – 23rd, Lithuania – 29th) among 134 of the world moving 2 positions up compared to the result of 2019.

In the **Digital Economy and Society Index (DESI) 2021** created by the European Commission in 2021, Latvia is 17th (Estonia – 7th, Lithuania – 14th) among EU-27 countries. Since 2021, the DESI index has been structured into 4 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 6.30).

Table 6.30

Performance of Baltic Countries in Digital Economy and Society Index 2021*

	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	-	**41.7**	-	**50.2**	-	**37.6**	-	**68.1**	-	**50.7**
Estonia	5	57.9	18	46.6	9	41.5	1	91.8	**7**	**59.4**
Latvia	20	41.1	14	50.4	23	26.8	10	79.6	**17**	**49.5**
Lithuania	17	46.1	25	41.7	12	41.2	12	78.0	**14**	**51.8**

* the results were converted to the scale 0-100, where 100 is the best result

Source: *European Commission, Digital Economy and Society Index (DESI) 2021*

Indexes characterising business environment

In 2019, ***Doing Business 2020*** created by the World Bank Group, which compared the business environment of 190 countries, placed Latvia 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 **Competitive Industrial Performance Index 2021** created by the UN Industrial Development Organization, which is based on the data of 2019 and analyses the ability of industrial enterprises of countries to produce and export by transforming them competitively and structurally, Latvia was placed 57th (Estonia – 49th place, Lithuania – 49th) among 152 countries of the world.

In the **Global Enabling Trade Index 2016** created by the World Economic Forum and the Global Alliance for Trade Facilitation, which evaluates the ability of countries to facilitate flows of goods across borders, Latvia was placed 40th (Estonia – 14th place, Lithuania– 29th) among 136 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).

Indexes characterising innovation environment

In the **Global Innovation Index 2021** created by the World Intellectual Property Organisation Latvia was ranked 38th (Estonia – 21th, Lithuania – 39th) among 132 countries of the world moving 2 positions down compared to the result of 2020. The following indicators were noted as strengths of Latvia: pupil-teacher ratio in secondary education, tertiary enrolment, compliance with environmental management system and quality management principles standards, ease of getting credit, females with advanced degrees, gross domestic expenditure on research and development financed by abroad, high-tech imports, labour productivity growth, ICT services exports, as well as increase in creative industry products.

In the **European Innovation Scoreboard 2021** created by the European Commission Latvia is ranked 25th (Estonia – 9th place, Lithuania – 18th place) among EU-27 and it slipped down to the group of *emerging innovators*, because in 2020 there was a sharp (from 0.215% to 0.019% of GDP) decline in venture capital investments and development of environment-related technologies. At the same time, above EU average share of non-innovators with potential to innovate has been noted.

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.

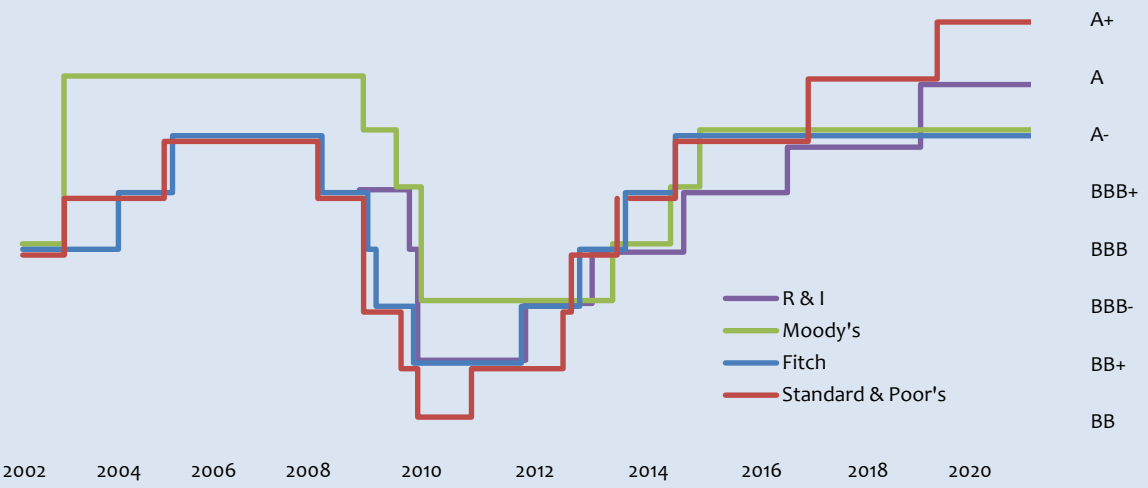
In February 2020, the international rating agency *S&P Global Ratings* increased the credit rating of Latvia from "A" to "A+", which is historically the highest credit rating set for Latvia. In August 2020 and in February 2021, the agency confirmed that Latvia corresponded to "A+" level with a stable outlook. Other rating agencies have also not changed their rating of Latvia in 2021 (see Figure 6.38).

In their rating, credit rating agencies appreciated Latvia's flexibility and resilience to the impact of the Covid-19 pandemic allowing for a forecast of high economic recovery rates. Thanks to the funds available from the Recovery and Resilience Facility and the implementation of extensive investment projects, more rapid economic growth could be expected starting from 2022. Although the level of public debt has increased, it is still relatively low and debt service costs are evaluated as

moderate. Low population income levels and long-term demographic challenges are still mentioned as the main obstacles for increasing the credit rating.

Figure 6.38

Credit Ratings of Latvia for Long-Term Liabilities



Source: State Treasury

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 these countries, but credit ratings of Latvia and Lithuania are similar.

Table 6.8

Credit Ratings of the Baltic Countries for Long-Term Liabilities in 2020

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

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

The credit rating of Estonia is 1-2 levels higher than the credit rating of Latvia and Lithuania. In 2021, all three international rating agencies kept Estonia's credit rating at the existing level. Only the assessment of the outlook has been changed. In August, *S&P Global Ratings* increased its outlook from stable to positive. *S&P Global Ratings* took into account the forecasts of Estonia's strong economic recovery from the impact of the Covid-19 pandemic as early as 2021 and the positive impact of fiscal support measures on the process of economic recovery in the short term.

In February 2021, *Moody's Ratings* increased Lithuania's rating from "A3" to "A2" changing the outlook from positive to stable. *Moody's* took into account the forecasts of Lithuania's economic recovery from the impact of the Covid-19 pandemic in the medium term, as well as stabilisation of the public debt as early as 2022. Geopolitical risks also remained stable at the beginning of the year. Other rating agencies did not change their ratings and outlook during the year.

7. LABOUR MARKET

7.1. EMPLOYMENT AND UNEMPLOYMENT

During the period from 2011 to 2019 (after the financial crisis of 2008), Latvia was showing solid economic growth, which brought tangible improvements to the labour market. The employment rate of the population increased by around 1/4 or 13 percentage points – from 52% in 2010 to 65% in 2019, with an average increase of 1.4 percentage points annually, while the unemployment rate decreased 3 times from 19.5% in 2010 to 6.3% in 2019.

Like most countries in the world, the year 2020 came to Latvia with new challenges brought by the global Covid-19 pandemic. Overall, Latvia's economy and labour market are not strongly dependent on the sectors primarily affected by the Covid-19 crisis (tourism, accommodation and food service activities, international passenger transport/air and water transport), the share of employees in Latvia in 2019 was the fifth lowest among the EU-27 countries in the corresponding sectors. However, it should be noted that the restrictions introduced to stop the pandemic and the global drop in demand directly or indirectly affected most sectors of the economy in Latvia, particularly labour-intensive sectors. The total number of employees aged 15 to 74 decreased by 1.9% (17 thousand) in 2020 compared to 2019, which, in relative terms, represented the seventh largest drop in employment among the EU-27. The most significant reduction in the number of employees in 2020 was observed in the business sector and in transport services (mainly passenger transport), with a total reduction by 12 thousand employees. Similarly, a significant drop in employment was recorded in accommodation and food service activities, arts and entertainment, and construction.

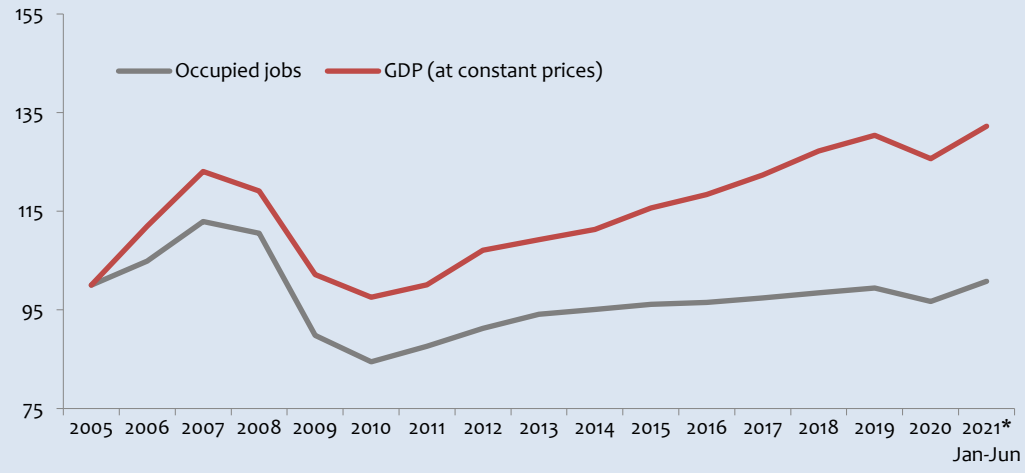
At the same time, not all sectors are experiencing a decline in economic activity. During the crisis, individual sectors have not only been able to maintain growth, but also to increase it by creating new job opportunities. The most significant increase in jobs and employment in 2020 was seen in the services sector – information and communication services, professional, scientific and technical activities and other services, where the number of employees increased by nearly 14 thousand compared to 2019.

Overall due to Covid-19 pandemic the employment rate within age cohort 15 to 74 in 2020 decreased by 0.8 percentage points (to 64.2%) compared to 2019, while the unemployment rate increased to an average of 8.1% (1.8 percentage points higher than the average in 2019).

Figure 7.1

GDP and occupied jobs

2005 = 100



* From 2021, data of the State Revenue Service 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.

With an increase in economic activities, also the situation in labour market gradually improves. Since April 2021 the employment growth has resumed as well as the unemployment continues to fall. At the same time, the crisis has left visible traces in the labour market. The number of the employed and the employment rate are still significantly lower than in 2019.

The crisis has also affected the economic activity of the population, which, along with demographic processes, is narrowing labour market supply and increases the risks of labour shortages.

In the three quarters of 2021, the number of employed was nearly 32 thousand or 4% lower than in the corresponding period of 2020, which has been the largest drop in employment since 2010. It should be noted that the employment rate on an annual basis in 2021 declined by 1.9 percentage points – lagging the pre-crisis level (first 3 quarters of 2019) by around 2.4 percentage points.

As the shock of the pandemic reduces and the economy is gradually adapting to the new conditions, since April 2021 there have been observed also visible improvements in the labour market. The number of the employed increased by 32.4 thousand between March and October 2021. In Q3 2021 totally 876.9 thousand persons or 63.5% of the population aged 15-74 were employed. Compared to Q2 2021, the number of the employed has increased by 15.3 thousand or 1.8%, which has been the most significant quarterly increase in employment since the onset of the Covid-19 pandemic crisis. Similarly, also the employment rate in Q3 2021 exceeded the previous quarter's figures by 1.2 percentage points, while it remained significantly lower than in neighbouring countries – in Q3 2021 the share of the employed population in Estonia amounted to 67.4% of the total population aged 15-74, but 66 percent in Lithuania.

Unemployment rates have also continued to fall since mid-2020. The unemployment rate decreased to 6.7% in October 2021 (1.1 percentage points less than in October 2020), while overall it decreased to an average of 7.2% in Q3 2021 – 1.2 percentage points lower than in Q3 2020 (8.4%) and 0.7 percentage points lower than in the previous quarter (7.9%).

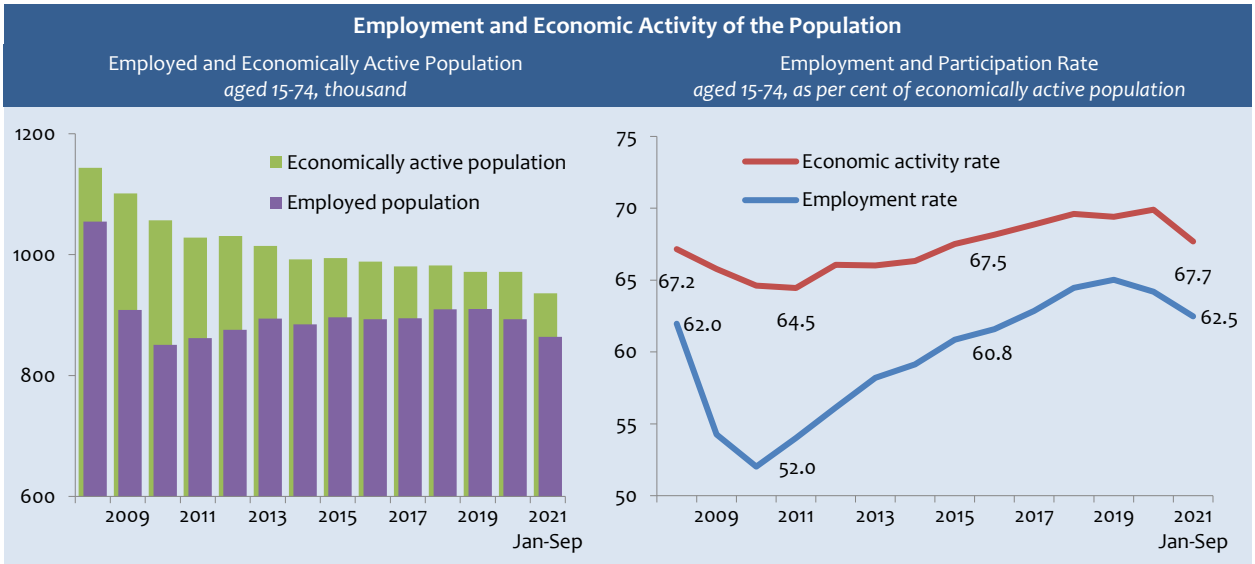
In Q3 2021 totally there were 67.9 thousand people aged 15-74 looking for a job, which is 7.5% (5.5 thousand) less than in Q2 2021 and 16.6% (13.5 thousand) less than in Q3 of 2020, respectively. At the same time, the unemployment rate in Q3 remained higher in Latvia than in Lithuania (6.7%) and Estonia (5.7%). Overall, the unemployment rate in Latvia in Q2 2021 was the eighth highest among the EU-27, exceeding the EU-27 average by 0.7 percentage points.

The negative effects of the Covid-19 pandemic on the labour market have so far been mitigated by the state support measures in place, which have partly saved both jobs and incomes, however, as the crisis persists, the impact of the pandemic on the labour market is expanding. Between March 2020 and August 2021, the number of the employed aged 15-74 (seasonally adjusted data) in Latvia in total has declined by 35.6 thousand, thus each month of the crisis has brought on an average 1.9 thousand employment decline.

It should be noted that state intervention measures compensate economic activity decline mainly in the short term, however, if the economic activities remain at low levels for a long period of time, the impact of the crisis on the labour market will widen.

Figure 7.2

Employment and Economic Activity of the 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

e – evaluation

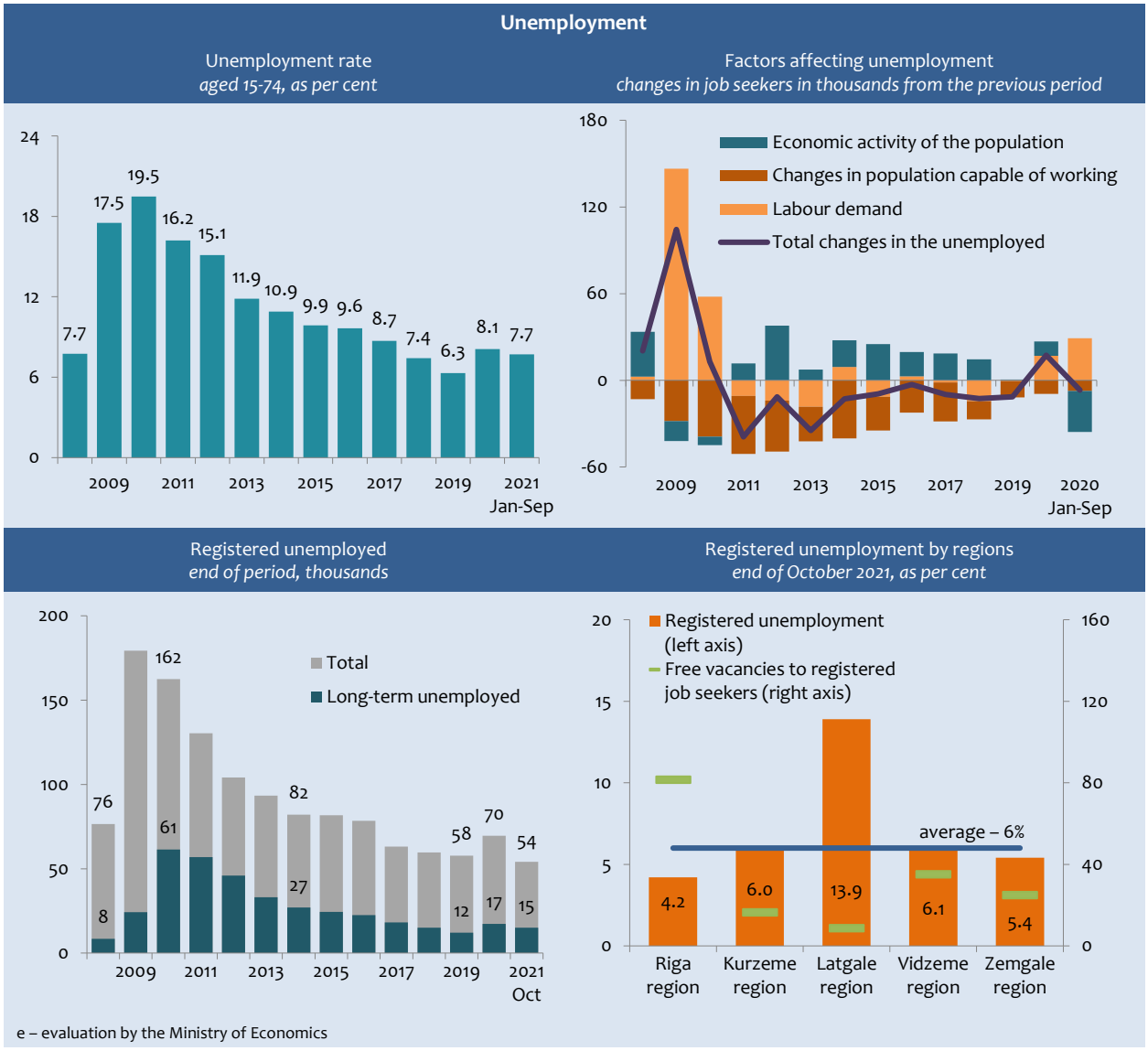
The prolonged uncertainty about the exit point of the pandemic crisis has negatively affected also the supply side of the labour market. Although there was still an increase in population economic activity in 2020, however since Q4 2020 the

labour force participation rate in labour market has declined. In Q3 2021, the economic activity rate of the population aged 15-74 was 68.5%, which is 1.6 percentage points lower than a year ago.

Overall, the number of economically active population aged 15-74 decreased to 944.8 thousand in Q3 2021, which is by 29.4 thousand (by 3%) less than in the corresponding period of 2020.

It should be noted that the declining economically active population and labour supply factors have so far been one of the most important drivers of unemployment in Latvia. The decline in economic activity of the population has been a key factor in the decline in unemployment in the first half of 2021 – accounted for around 4/5 of the decrease in the number of job seekers, while continued pressure on the supply side of the labour market is caused by not particularly favourable demographic situation. The number of persons in private households aged 15-74 has decreased by more than 67 thousand or 4.6% over the last 5 years (from Q3 2016 to Q3 2021), whereas over the last year the decrease has been by 8.9 thousand (0.6%), when comparing Q3 2021 to the corresponding period of the previous year.

Figure 7.3



Considering the gradual decline in labour supply, alongside of overcoming the crisis and boosting employment, **the shortage of skilled labour has become an increasingly significant problem, especially in sectors which have suffered less from the crisis and those who are growing faster.**

It should be noted that the current crisis has accelerated economy digitalisation trends and job automation, thereby increasing the productivity potential of the labour force on the one hand, while on the other hand changing the demand

structure for skills – skill needs in individual occupations may vary significantly from what they were a year before the crisis. It should be considered that skills demand and supply mismatches can contribute to increase of labour shortages with specific qualifications, as well as increase structural unemployment.

The protracted crisis and the decline in the number of vacancies available on the labour market have generally reduced the chance of a rapid return of the unemployed to employment contributing to the increase in long-term unemployment. The share of registered long-term job seekers (unemployed longer than a year) in the total number of unemployed increased by more than 10 percentage points between the end of April 2020 and the end of October 2021 – from 17.2% to 28%, respectively. At the end of October 2021, approximately 17 thousand job seekers were unemployed for more than a year.

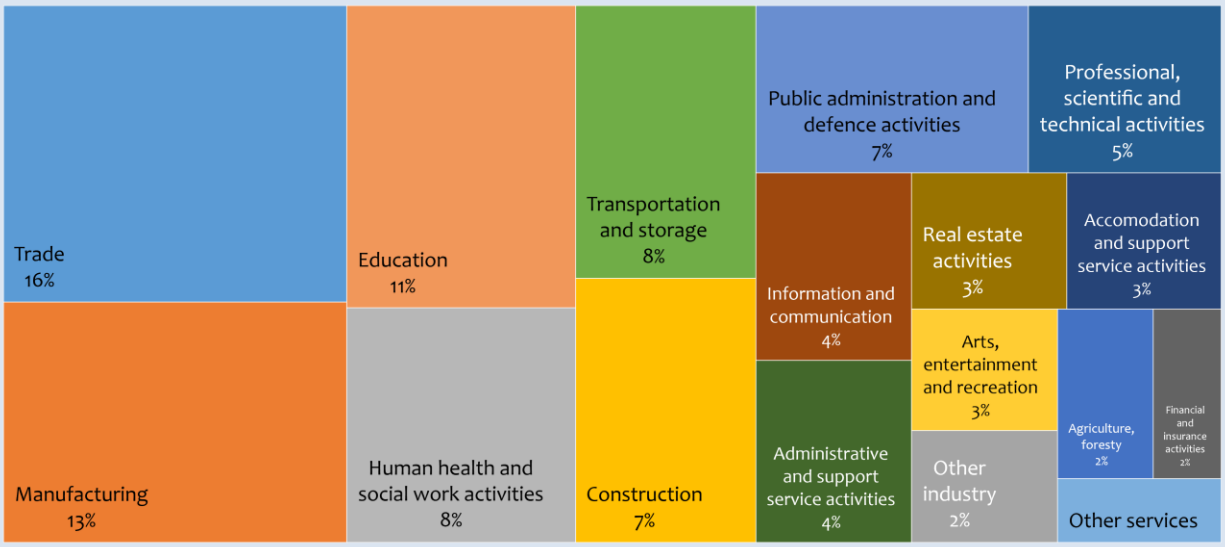
Not just changes in skills demand, but also high long-term unemployment causes an increase in structural unemployment. Namely, the longer these people are out of work, the greater the risk of losing their previous job skills and abilities, and the more difficult it is for them to adapt to new labour market needs. There is a high risk that some of the unemployed may have problems finding jobs that match their skills in the coming years, since recovery in the sectors directly affected by the Covid-19 crisis might be relatively slow, but in sectors where job opportunities can potentially be developed, skills previously acquired will not necessarily be required.

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, is still more than twice as high as the average in Latvia and more than 3 times higher than in the Riga Region, which together with the low geographical mobility of the labour force, increases the risks of structural unemployment and labour shortage in the most economically active Latvian regions.

At the same time, it has to be taken into account that matching of labour demand and labour supply is influenced not only by education and skills of the labour force, but also by the wage level, therefore there are still vacancies, even though the unemployment rate is high.

Figure 7.4

Occupied jobs by sectors
structure at the end of June 2021, as per cent



Along with the increase in economic activities also an increase in occupied jobs are accompanied in most sectors of the economy. In Q2 2021, compared to Q1, the number of occupied jobs increased by 26.2 thousand or 2.9% and reached 940.2 thousand.

The largest increase in jobs in Q2 of 2021, compared to Q1, was observed in trade, construction, accommodation and food service activities as well as in manufacturing. Meanwhile, it should be noted, that in both accommodation and food service activities as well as in trade the number jobs are still significantly lagging behind the pre-crisis levels. In Q2 2021 there were nearly 8 thousand less jobs in accommodation and food service activities, but in retail/trade – by almost 1.1 thousand less, compared to Q2 2019.

The most significant increase in the number of jobs in Q2 2021 compared to the previous quarter was in the private sector, which accounted for approximately 94% of the total increase in occupied jobs – the number of jobs occupied in the private sector increased by approximately 24.8 thousand.

A more moderate increase in labour demand is observed in the public sector – the number of occupied jobs in the public sector increased by 1443 jobs in Q2 2021 compared to the previous quarter.

The largest increase in the number of occupied jobs compared to the pre-crisis period was in information and communication, human health and social work activities, and in professional, scientific and technical activities.

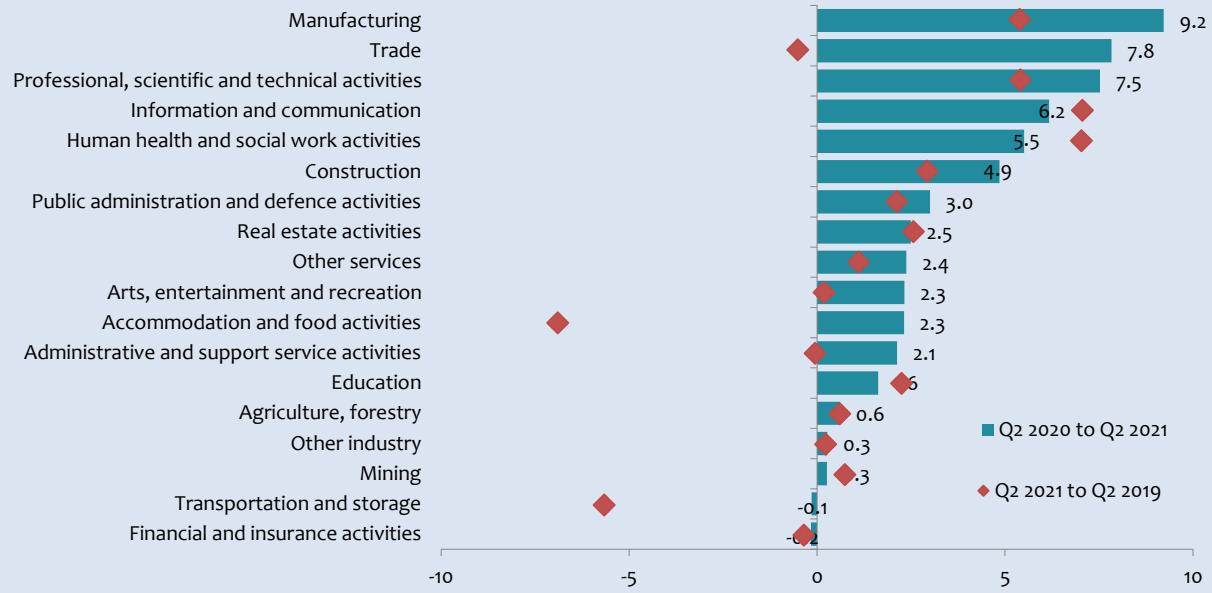
The main drop in labour demand was in accommodation and food service activities, trade, it was also experienced by sectors such as transportation and storage, financial and insurance activities, administrative and support service activities, and arts and entertainment.

Overall, in the past 10 years (between Q2 2011 and Q2 2021) the total number of occupied jobs increased by 123.1 thousand or 15.1%. The largest increase in jobs was observed in human health and social work activities (by 22.8 thousand), information and communication (by 21.6 thousand) and construction (by 14.7 thousand). Meanwhile, the biggest job cuts were observed in financial services.

Figure 7.5

Increase in the number of occupied jobs in economic sectors

thousands



* From Q1 2021, data of the State Revenue Service 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.

7.2. WAGES

Since the end of 2010, there has been a steady increase in wages in Latvia, which has been facilitated by both an increase in the demand for labour and a contraction in the supply side of the labour market. The positive dynamics of labour productivity has also partly ensured the growth of wages. From 2010-2020 wages and salaries have grown by an average of 6.1% per year, but over the past four years the wage growth rates have stable stayed above 6% yearly average.

Although average wages continued to increase in 2020, due to the declining labour market activity, wage growth rates have overall reduced. In 2020 the average monthly gross wage increased by 6.2%, which was significantly lower than in 2018 and 2019, when average gross wage growth was 8.4% and 7.2%, respectively.

Despite the widespread impact of the Covid-19 crisis on the labour market, the overall wage dynamics still remains upward, driven by the increase in the share of both higher qualification and better paid jobs in the labour market as well as limited labour supply. In the first half of 2021 the growth of gross wages reached an average of 9.8 percent.

The average monthly gross wage increased by 10.2% in Q2 2021, rising to an average of 1,237 euro per month, which has been the steepest average wage growth in the past 13 years.

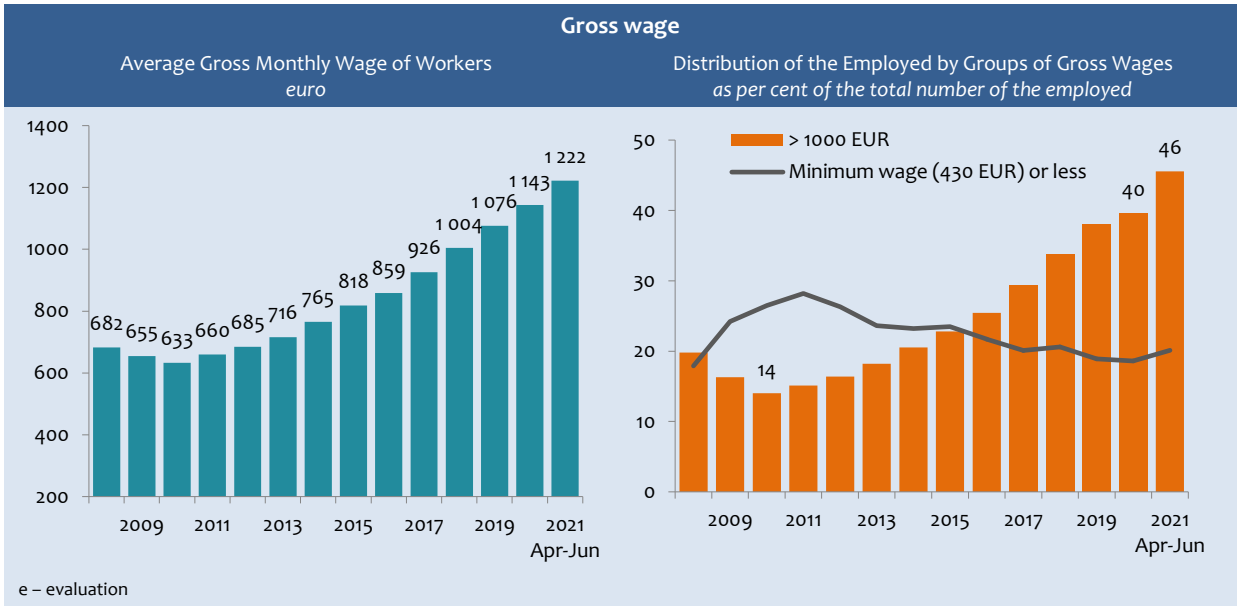
The increase in average wages in 2021 has been significantly affected by an increase in the minimum wage rate by 16.3% – from 430 euro in 2020 to 500 euro, as well as a reduction in the share of lower-paid jobs in the labour market, taking into account the significant job cuts compared to the pre-crisis period, both in accommodation and food service activities and in the retail sector, where wage levels have so far been significantly lower than the economy average.

At the same time, 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. Consequently, 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.

Although wages have increased significantly in both the private and public sectors in Q2 2021, the increase in wages in the public sector was more rapid. In Q2 2021, compared to Q2 2020, the average gross wage in the public sector increased by 13.4% (to an average of 1,291 euro) and by 9% in the private sector (to an average of 1,215 euro). The more rapid increase in wages in the public sector has been largely determined by the revised wage rates in the education and health sectors.

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 past 2 years, largely affected by a more significant increase in labour demand – in 2011-2020, the number of occupied jobs grew by 15.8% in the private sector and only by 0.6% in the public sector.

Figure 7.6



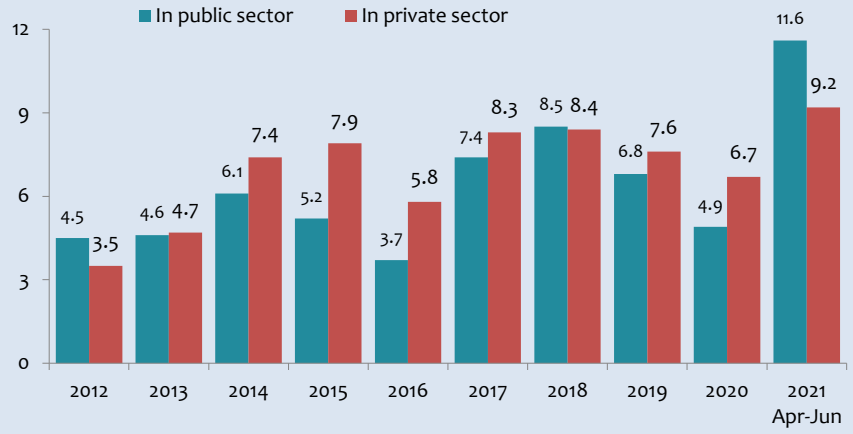
A positive trend is still observed in the waging structure. Although in Q2 2021 the share of minimum wage recipients slightly increased, predominantly affected by the increase in the minimum wage rate, the overall trend still shows a decline in the share of low-paid workers, as evidenced by an increasing trend in the share of employees earning wages above 1,000 euro per month. In Q3 2021, almost half (46%) of all the employed had a gross wage above 1,000 euro.

It should be noted that between 2010 and 2021 the share of the employed receiving the minimal wage or less has reduced by 6.4 percentage points. Furthermore, the share of the employed receiving more than 1,000 euro has increased by 31.5 percentage points in this period.

In Q2 2021, the increase in wages was observed in all sectors. The most significant increase in wages was in health and social work activities – by around 35%, and in education – 12.5%, affected by both the paid premiums for work during the Covid-19 pandemic and the overall revision of wage rates in the sectors.

Figure 7.7

Wages in the Private and Public Sector
changes as per cent compared to the previous year

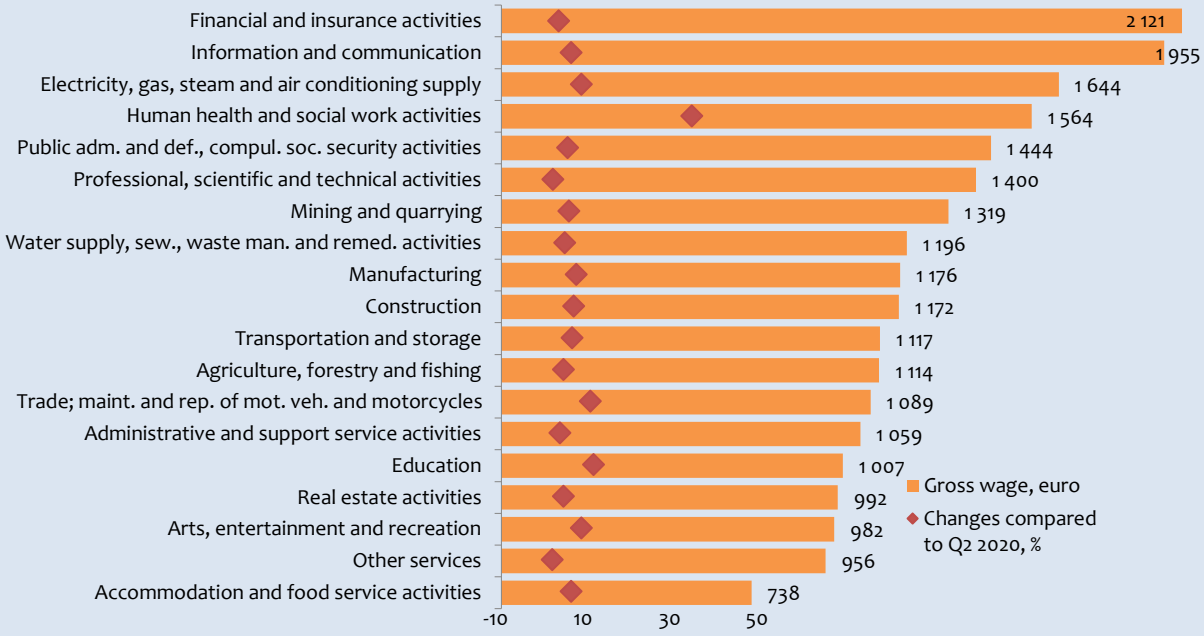


At the same time, wages continue to stagnate in the sectors most directly affected by the crisis. Although the wage level in accommodation and food service activities has resumed growth, it is still 4.5% lower than in Q2 2019. It should be noted that accommodation and food service activities still have the lowest wages among sectors – 778 euro in Q2 2021.

The highest wages in Q2 2021 were still in financial services – the average gross monthly wage was 2,258 euro.

Figure 7.8

Average Gross Monthly Wage in Economic Sectors
Q2 of 2021



7.3. LABOUR MARKET FORECASTS

The labour market forecasts until 2027 are prepared in accordance with the medium-term economic growth forecasts (see Chapter 5).

Although economic activity and labour demand in many sectors remains significantly below pre-crisis levels (2019), however as the pandemic shock reduces, the overall situation in labour market is stabilising and over the next 2-3 years a further activity return is expected.

The total number of employees is expected to fall by 2.8% in 2021 (by nearly 25 thousand to 868 thousand) compared to 2020, while the unemployment rate might decrease to 7.5% (to 70.6 thousand job seekers). The decline in the number of employees in 2021 is largely affected by the delayed impact of the Covid-19 pandemic crisis on the labour market, as well as the relatively high base effect in the employment figures of 2020.

Although the first shock of the Covid-19 crisis in Latvia was already observed in Q2 2020, it should be noted that the transmission of economic shocks to the labour market is often delayed and the full impact is seen with an average shift of 1-2 quarters. Overall, employment rates remained at a relatively high level in the 3 quarters of 2020 and the most significant reduction in the number of employees was only observed during the winter season 2020/2021, while the crisis in the labour market reached its deepest point in March 2021, leaving a significant impact on overall employment rates in 2020.

There is a significant decrease in the number of economically active population in 2021 (the number of economically active population is expected to shrink by 33 thousand in 2021 compared to 2020), taking into account both the negative demographic trends and the decline in economic activity of the population, which have together led to a decline in unemployment along with the employment drop.

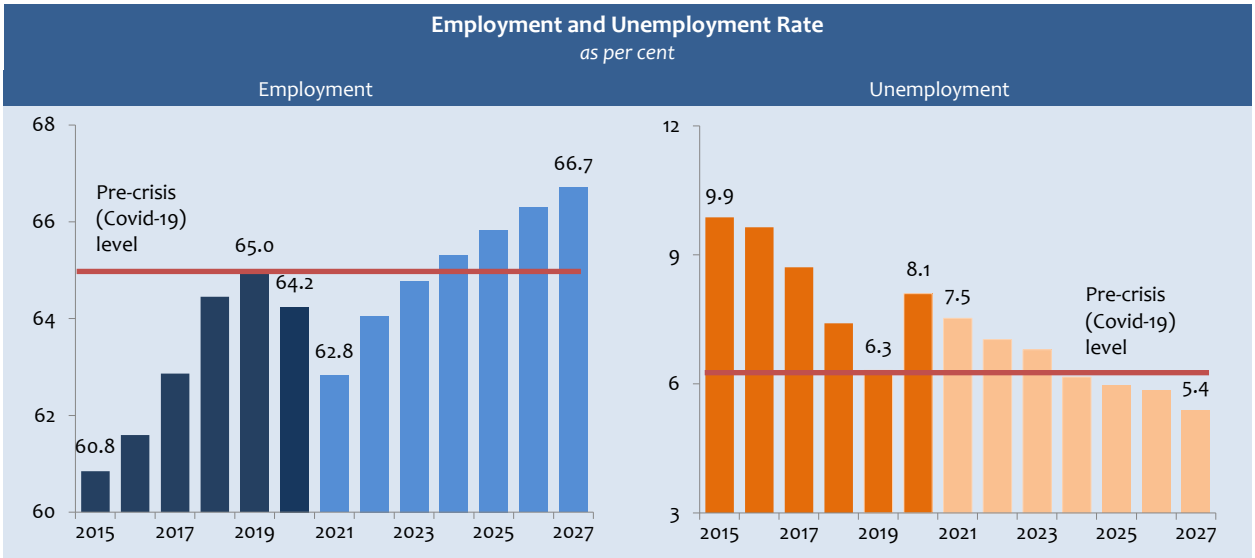
Overall, much more visible improvements in the labour market could be seen in 2022. The number of employees in the age group from 15 to 74 could increase by 1.5% or 13 thousand in 2022, while employment rates could rise by 1.2 percentage points compared to 2021. Overall, the average number of employed could reach 881 thousand in 2022 and the employment rate could rise to 64.1% of the population aged 15-74.

The unemployment rate is expected to fall to an average of 7% in 2022, while the number of job seekers could fall by around 4 thousand compared to 2021 – decline to an average 70 thousand in 2022.

At the same time, it should be noted that the preconditions for improvement in the labour market are the recovery of normal economic circulation and phasing out of the restrictions introduced, which, in turn, are directly linked to the restoration of epidemiological safety and the sufficient vaccination coverage.

Overall, relative employment and unemployment indicators could return to the levels of 2019 around mid-2023, but 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.

Figure 7.9



Available labour resources will continue to shrink in the coming years, and the problem of labour shortages could become particularly pronounced starting from the second half of 2023, given the recovery of labour demand. In 2023, the unemployment rate could fall to an average of 6.8%, while the employment rate could reach 64.8% Overall, the unemployment rate is expected to fall to 5.4% by 2027, while the employment rate is expected to rise to 66.7 percent.

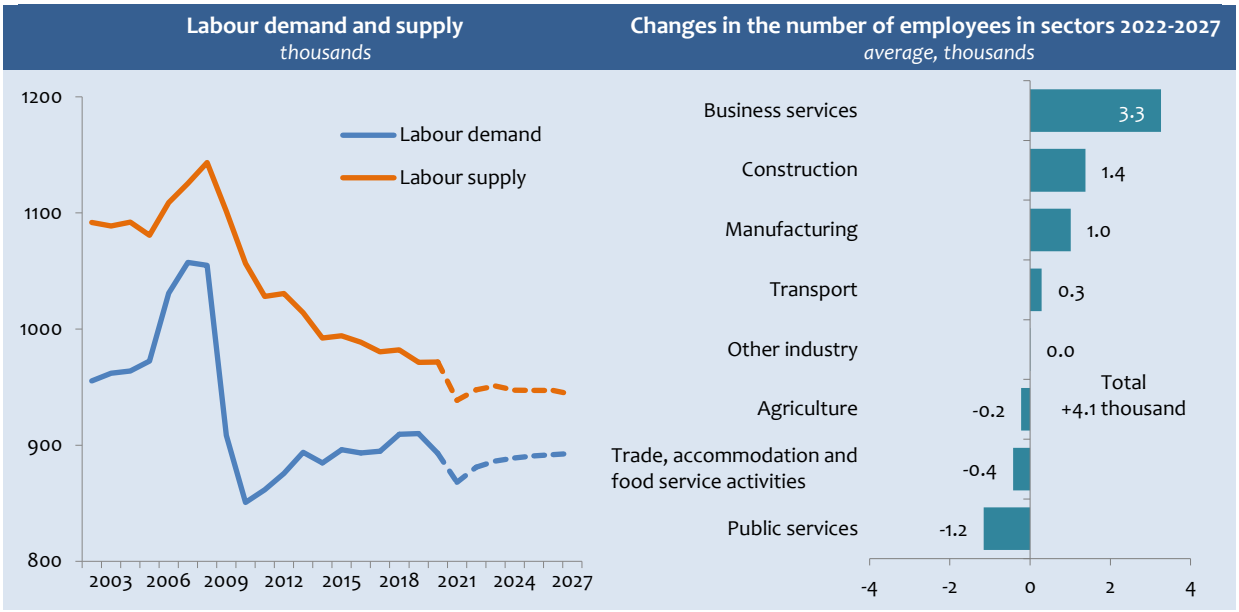
The decline in labour stocks in coming years will be largely determined by the reduction in the number of the population capable of working, as well as ageing of existing labour force and leaving of the labour market.

According to demographic forecasts of the Ministry of Economics the Latvian population might decrease by approximately 56 thousand by 2027, compared to the beginning of 2021. The most significant reduction in population will be observed among people in working age. The population aged 15-64 is expected to fall by nearly 64 thousand or more than 5% by 2027, which will also have a negative reflection on the overall labour supply.

Considering shrinking numbers of the working age population, the economically active population in 2027 is expected to be 2.9% or almost 28 thousand smaller compared to 2020. At the same time, the negative impact of demographic trends on labour supply will be reduced by the increase in economic activity of the population. By 2027, the rate of participation of the population in the labour market could reach 70.5% – by 0.6 percentage points higher than in 2020 and by 1.1 percentage points higher than in 2019.

Considering the labour force ageing trends, the main employment opportunities in the coming years will be created by labour replacement demand. In accordance with MoE forecasts, about half of all the vacancies in 2022-2027 could come from replacement demand.

Figure 7.10



The Covid-19 crisis has so far most deeply affected sectors such as accommodation and food service activities, on-site retail trade, various entertainment, arts and sports activities, passenger transport, travel agencies and tourism operators and other areas directly related to population gathering and movement. Although the prevalence of Covid-19 is likely to gradually decline in the coming years, however it should be borne in mind that the emergence of new strains and seasonal outbreaks may persist for a longer time, so the recovery of these sectors may not be quickly, and the labour demand might not fully return to pre-crisis levels (2019) in the coming years.

Given the impact of the crisis, as well as 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. It is expected that the number of employees in trade in 2027 could be by 7.1% less than in 2020.

So far, the most significant drop in labour demand has been in accommodation and food service activities. From 2022, labour demand is expected to gradually return to the sector, however the number of employed in the sector could reach the level of 2019 not earlier than in 2026/2027.

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 to pre-crisis level by 2027. The number of employed in transportation and storage by 2027 could still be by 6.2 thousand less than on average in 2019.

Starting from 2022, the employment could rise also in arts and entertainment. The number employed in the sector could get close to the pre-crisis level around 2025, however the labour demand in arts and entertainment in 2027 might be still by 0.6% lower than in 2020.

At the same time, changes in population habits introduced by the crisis not only have reduced certain activities, but also create new opportunities and needs in the labour market. It is expected that the sectors less affected by the crisis will recover more quickly and might bet the main drivers for the economy over the next years.

The most significant increase in labour demand until 2027 could be seen 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 7.8 thousand by 2027, compared to 2020.

A significant increase in labour demand until 2027 is expected in the construction sector, which will be largely 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 2.4 thousand by 2027, compared to 2020.

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 be mainly based 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 employees in manufacturing in 2027 could be 0.7% (0.8 thousand) less than in 2020.

A 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 2027 the number of employed in public administration might decrease by 2.4 thousand, while in education – by 3.4 thousand, compared to 2020. At the same time, the number of employees could continue to grow in health and social care sector. In 2027 the number of employed in health and social care sector could exceed the level of 2020 by more than 7 thousand.

7.4. EMPLOYMENT POLICY

Since the beginning of the crisis caused by Covid-19 in mid-March 2020, when measures to slow the Covid-19 pandemic were introduced, state support measures for entrepreneurs and individuals, which mitigated the negative effects of the crisis have played a key role in the maintaining labour market activity and overcoming of the Covid-19 crisis. Support mechanisms such as downtime allowance and support for wage subsidies have helped companies to save jobs during the periods of state of emergency and protected people from complete loss of income, which has been particularly important in the sectors directly affected by the crisis. In order to minimise the negative effects of the restrictive measures imposed during the Covid-19 crisis, support is also provided to vulnerable groups of the population, including the unemployed (an unemployment assistance benefit has been introduced, the period of employment without losing unemployment status has been extended to four months, employment support measures have been expanded, etc.).

In 2021, as the epidemiological situation has gradually improved and vaccination coverage has increased, improvements in the labour market and adaptation to the new conditions are observed.

In the context of the Covid-19 crisis and overcoming it, the strengthening of human capital has become more pressing than ever. The effects of the Covid-19 crisis vary: for some sectors directly affected by the crisis, recovery will take longer, while others , such as ICT, continue to grow, create new job opportunities and increase demand for employees.

MEDIUM-TERM AND 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, therefore, substantial improvements in the Latvian labour market are necessary to change migration flows. Measures to foster birth rates are also 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 (promotion of economic activity of the population), sound labour force migration policy, including 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 labour market 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. LDDK (Employers' Confederation of Latvia) and LBAS (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, including local governments of Latvia and the Latvian Association of Local Governments.

In order to foster changes in the labour market providing specialists required for economics and, 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, of low qualification labour force). In 2021, the Board continued its work, 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. Ministers also agreed to continue developing the education quality monitoring system. 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 Strategy for Latvia for Mitigation of the Consequences of the Crisis Caused by Covid-19 addresses the use of the opportunities created by the crisis for the transformation of the Latvian economy in favour of the development of knowledge-intensive exports of goods and services. Society and the economy need the right skills to reorient. The strategy provides for the creation of a functional adult education system for reducing the share of low qualified persons, for continuous improvement of skills and competences and for changing the socio-economic paradigm – the introduction of future concept of lifelong learning. The goal is to involve 165 thousand people in adult education by 2023. Public investment in human capital development is expected to focus on sectors with high export potential (STEM sectors), with a special focus on developing the digital skills of the population and businesses. The measures imposed to limit the spread of the Covid-19 infection and related challenges have already contributed to the automation and digitalisation of many processes. Strengthening human capital and lifelong learning are among Latvia's development priorities in the *National Industrial Policy Guidelines for 2021-2027*.

ADULT EDUCATION

In 2020, only 6.6% of Latvia's population aged 25-64 were involved in educational activities, while in the Nordic countries this rate was three and even four times higher. To raise awareness and understanding of the population about education as a permanent process throughout life, in August and September 2021, the Ministry of Economics launched a broad public awareness campaign *"Be competitive! Dare to learn at any age"."*[1].

[1] Information about the campaign is available here: https://www.em.gov.lv/lv/muzizglitibas-informesanas-kampana

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, as well as in overcoming the economic crisis caused by the Covid-19 pandemic and its restriction measures. 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 the EU funds adult education project *Improving the professional competence of employees* implemented by the State Education Development Agency. Since the launch of the project, training has been carried out in five 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. The 6th application round closed in July 2021. Training in this round fully dedicated to learning different digital skills, started in autumn 2021. The next application of the population for training is scheduled to be announced in January 2022.

Overall, more than 45 thousand workers had started training by October 2021, including 8.2 thousand employees in the remote training round. 37 thousand people have already completed their education. In total, more than 55 thousand employees are expected to be involved in the project by the end of 2023.

The Ministry of Economics 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, 10 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, 5 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 2000 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. 3 projects implemented by the LCCI, LICTA, and IDAL, 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 (intended 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 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 RRF 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 RRF funding by 2027, while at least 1273 entrepreneurs are expected to be supported from ERDF funding by 2029. The investment is expected to be divided into three parts:

- the Massive Open Online Courses, 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;
- The European Digital Innovation Centres will offer improvement of digital skills of higher levels by organising specialised training on topics such as cyber security, artificial intelligence and high-performance computing;

– MoE will continue its cooperation with industry associations to support the development of the digital skills of employees in key areas of entrepreneurs. Support will primarily be provided in training 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.

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, and 12.1 thousand persons in the nine months of 2021. SEA continues to develop the availability of training in the electronic environment. In September 2021, SEA launched training pilot project *"Future Skills Initiative"*. Unemployed, job seekers and employed people who want to upgrade their skills and improve their competitiveness in the labour market have the possibility of receiving training support of up to 500 euro within the pilot project for the mastering of digital and other high-potential skills in demand on the labour market in open online courses on international e-learning platforms such as *Coursera*, etc.

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 State Employment Agency. The active and preventive labour market measures that are being implemented foster economic activity and competitiveness of the population in the labour market.

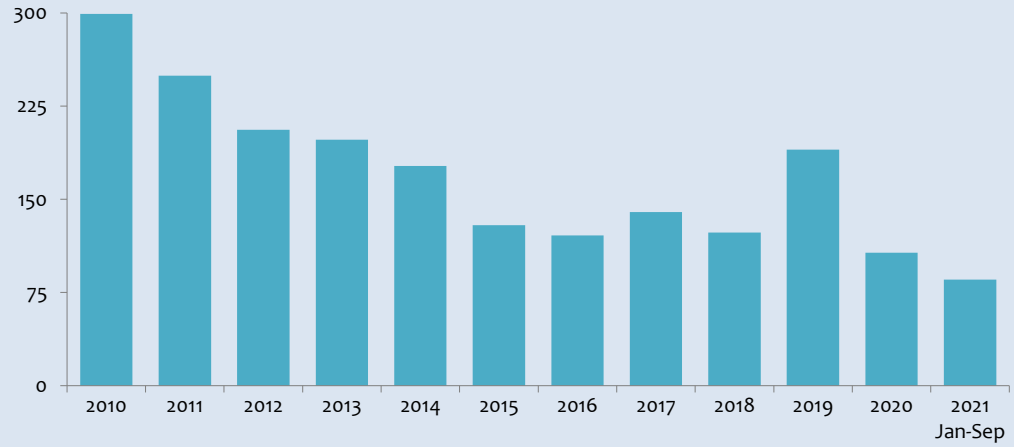
The most important measures implemented by SEA:

– 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, including unemployed with addictions, support for regional mobility (getting to work or training), etc.

In recent years, increased attention has been paid to those population groups (long-term unemployed, youth neither in employment, nor in education or training, pre-retirement unemployed and disabled people), for whom it is most difficult to return to the labour market and who need more targeted support to promote their economic activity and inclusion in the labour market.

Figure 7.11

Involvement* in active labour market measures
thousand



* 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.

Data source: SEA

With the improvements in the labour market situation, since 2010 the involvement in active labour market measures has reduced. Although the Covid-19 crisis in 2020 had a negative impact on the labour market and the number of unemployed people increased, participation in active labour market measures did not increase, partly due to the measures to restrict the spread of Covid-19 – on-site activities were temporarily suspended. However, unemployment was significantly tempered by the support measures implemented by the government, including downtime benefits and support for wage subsidies, which mitigated the effects of Covid-19 on the economy. In 2020, 60.2 thousand unique persons participating in 107.1 thousand activities (number of participation) were involved in active employment measures and received support. The funding for active labour market policy measures reduced from 91.1 million euro in 2010 to 27.1 million euro in 2020.

To overcome the Covid-19 crisis, the services and measures provided by SEA have been revised and improved, adapting them to the labour market situation and the restrictions in the country in relation to the variable epidemiological situation. Several SEA services and measures are offered remotely. Among other things, existing employment support measures were extended and new ones were introduced – the period of participation in paid temporary public works was extended to 6 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; a support measure has been developed in cooperation with MoES for students of higher education establishments, who have become unemployed, which would allow students to develop research, organisational, IT skills while performing certain tasks in their educational establishment, a grant is paid to students during their participation, etc.

In total, during the nine months of 2021, 54.3 thousand persons were involved in the SEA active labour market measures participating in 85.3 thousand activities (participations).

INTERNAL LABOUR MOBILITY

The availability of labour force in territories with higher economic activity is delayed by the availability of high-quality housing for the population with average income. Within the scope of cooperation with Ministry of Economics OECD, experts having evaluated foreign experience and good practices, have developed proposals for effective support instruments for ensuring affordability of housing in Latvia.

Since March 2018 the attraction of qualified labour force to regions has been facilitated by the state support available to young professionals for acquisition of a home within the scope of the ALTUM housing guarantee programme (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 labour market measures. Also, in order to address regional unemployment challenges, persons employed by employers can receive financial compensation to cover expenses of transport and rental of a dwelling in the first four months after starting the legal employment relationship. In 2020, regional mobility support for getting to work was granted to 140 persons.

SMART IMMIGRATION

The shortage of highly qualified specialists, which is currently experienced by a number of 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 Ministry of Economics. 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. For instance, the period for application of a vacancy has been shortened from a month to 10 days, if an employer wants to invite a foreigner from a third country for employment.

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 IT education platform called *Baltic IT Society* or *BITS.education* has been created. The platform collects IT education programmes to promote the preparation in Latvia of new IT professionals, who are ready for the international market, and creates digital campaigns to attract students from foreign countries. For example, the international level interdisciplinary ICT bachelor's study programme *Computer Science and Organisational Technologies* or the programme of Baltic ICT leaders was created by the University of Latvia and the Riga Technical University (RTU) in cooperation with the University at Buffalo (United States of America), and it is coordinated by RTU Riga Business School. At the same time, to strengthen the capacity of teaching of digital subjects in Latvian universities, qualifications of teaching staff are increased. In the autumn semester of 2021, 22 teachers started upskilling studies for high-level digital skills at the University at Buffalo.

REMIGRATION

One of solutions for the reduction of labour shortage in Latvia is to foster the return of the population living abroad. 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 also 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. With the support of the coordinators, 914 families returned to Latvia from March 2018 to July 2021.

SEA and IDAL also perform measures to address potential remigrants by providing information and advice, participating in the 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.

In order to connect professional nationals living abroad and companies in Latvia, including by fostering Latvian employers to get actively involved in promotion of remigration, private investments have also started in recent years, for example, the *Latvija strādā* movement launched 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

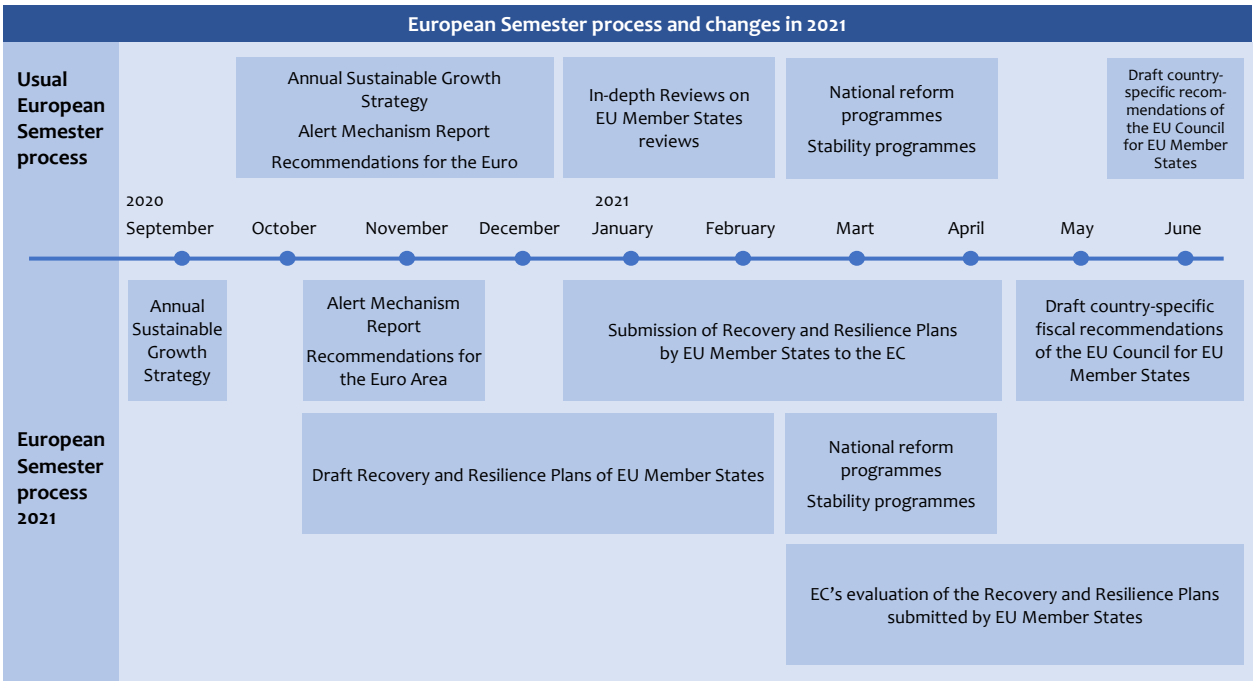
On 12 January 2010, the EC published its *Annual Growth Survey* among other things offering to launch from January 2011 a new economic policy surveillance and coordination mechanism in the EU –the European Semester.

The European Semester starts every year on November, when the EC publishes the key documents, the evaluation of which starts the European Semester of the next year, and these are *Annual Sustainable Growth Strategy*, *Alert Mechanism Report*, *Draft Joint Employment Report, Single Market Performance Report* and *EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area*. In the abovementioned documents the EC evaluates the economic situation across the EU and offers economic policy priorities for the next year. These documents serve as a basis for further discussions between EU Member States and the EC at different meetings of the EU Council.

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* or *Convergence Programme*). After both documents have been submitted, the EC prepares its assessment and in June makes a 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.

Taking into account the rapid spread of the Covid-19 pandemic worldwide and its negative impact on economic development, in 2021, the EC proposed changes in the coordination and monitoring of economic policies at the EU level, incl. in the European Semester process (see Figure 8.1). Major changes in the European Semester process 2021 were related to the change in the deadlines for the publication of key documents related to the European Semester process, as well as the need for development of new documents, taking into account the launch of the EU multiannual financial framework for 2021-2027 and the need to link these two processes more closely. Thus, for instance, the *Annual Sustainable Growth Strategy 2021* was published in September, that is in advance of the other documents (*Alert Mechanism Report* and *EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area*, which were published in November 2020.

Figure 8.1



In 2021, within the European Semester process the EC urged EU Member States to draft *National Recovery and Resilience Plans* in the context of the new *EU Recovery and Resilience Facility* (see section 8.2). In 2021, the EC drew up In-depth reviews for those EU Member States where macroeconomic imbalances had been identified within the *Alert Mechanism Report 2021*. Another major novelty to the European Semester 2021 was related to the annual EU Council's country-specific recommendations. They were made for all EU Member States in terms of fiscal policy, in line with the requirements of the *Stability and Growth Pact*. In 2021, the EC published evaluations about the *National Recovery and Resilience Plans* submitted by EU Member States, which were discussed in the EU Council between EU Member States and the EC.

Since the economic situation in EU Member States has stabilised, it was decided to return to the usual European Semester process starting from 2022. On 24 November 2021, the EC published the *Annual Sustainable Growth Strategy* 2022, the *Alert Mechanism Report* 2022 (see section 6.8), a Proposal for EU Council's Recommendations on the Economic Policy of the Euro Area (see Box 8.1), a Proposal for a *Joint Employment Report* and other documents.

In its *Annual Sustainable Growth Strategy 2022*, the EC proposed to continue to focus on four complimentary dimensions of competitive sustainability as guiding principles for the EU's recovery: environmental sustainability, productivity, fairness, and macroeconomic stability. The EC indicates that the four dimensions are interrelated, and they should be mutually reinforcing, and they are particularly important in the further implementation of the objectives set in the Recovery and Resilience Facility (see section 8.2).

The ***National Reform Programme of Latvia for the implementation of the Europe 2020 strategy*** (hereinafter – NRP of Latvia) was approved by the Cabinet of Ministers 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, on 13 April 2021 the Cabinet of Ministers approved the tenth ***Progress Report on the Implementation of the NRP of Latvia*** (hereinafter – Progress Report) and *Latvia's Stability Programme for 2021-2024*. Both documents were submitted to the EC on 15 April 2021.

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 2020, gives a short description of the progress of Latvia in the achievement of objectives of the *Europe 2020 strategy* and UN sustainable development goals.

Box 8.1

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

According to the EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area published on 24 November 2021, euro area Member States in the period 2022–2023 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.

When evaluating the national programmes submitted by the EU Member States and their implementation, on 2 June 2021 the EC published proposals for EU Council's country-specific recommendations for the EU Member States, which were approved by the European Council on 18 June 2021 after discussions at different EU Council's meetings (see Box 8.2). The European Semester of 2021 has been completed with the approval of these recommendations by the European Council.

Box 8.2

The EU Council's Country-Specific Recommendations for Latvia 2021

The following recommendations are made for Latvia:

- In 2022, maintain a supportive fiscal stance, including the impulse provided by the Recovery and Resilience Facility, and preserve nationally financed investment. Keep the growth of nationally financed current expenditure under control.
- When economic conditions allow, pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions and ensuring fiscal sustainability in the medium term. At the same time, enhance investment to boost growth potential.
- Pay particular attention to the composition of public finances, both on the revenue and expenditure sides of the budget, and to the quality of budgetary measures, to ensure a sustainable and inclusive recovery. Prioritise sustainable and growth-enhancing investment, notably supporting the green and digital transition and structural reforms that will help provide financing for public policy and contribute to the long-term sustainability of public finances, including by strengthening the coverage, adequacy, and sustainability of health and social protection systems.

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 priorities, formulating necessary reforms and policy activities, as well as successfully implementing *National Reform Programme of Latvia* and *Stability Programme of Latvia*.

It should be noted that the *National Reform Programme of Latvia* and the *Stability Programme of Latvia* are being implemented in close cooperation with the European Commission. The progress on the implementation of both programmes is being regularly discussed in the bilateral meetings between Latvia and the EC. The Ministry of Economics 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 2022*, which will have to be submitted to the EC by 15 April 2022 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 bln 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 Ministry of Finance, the contribution of EU funds to Latvia's GDP in 2020 was 1.2 percentage points.

Table 8.2

Progress of the implementation of activities in competence of the Ministry of Economics
as at 29 November 2021

	Support programme	EU funds funding (allocation) *million euro*	Scope of paying *million euro*	*% of allocation*
1.2.1.1.	Competence centres	63.2	51.2	81.1%
1.2.1.2.	Technology transfer system	30.0	11.6	38.6%
1.2.1.4.	Introduction of new products	45.1	29.0	64.3%
1.2.2.1.	Employee training	14.7	8.0	54.3%
1.2.2.2.	Motivation for innovation	4.8	3.3	69.1%
1.2.2.3.	ICT and non-technological training	6.9	2.1	30.1%
3.1.1.1.	Loan guarantees	43.8	40.2	91.9%
3.1.1.2.	Mezzanine loans	7.0	6.4	91.9%
3.1.1.3.	Support for attracting financing for small and medium-sized enterprises in the capital markets	1.0	0.0	0.0%
3.1.1.4.	Microcredits and start loans	15.0	13.8	91.9%
3.1.1.5.	Production premises	43.0	18.1	42.0%
3.1.1.6.	Business incubators	29.9	14.3	48.0%
3.1.2.1.	Venture capital	30.6	28.1	91.9%
3.1.2.2.	Technology accelerator	14.6	13.4	91.9%
3.2.1.1.	Cluster programme	6.7	5.4	80.5%
3.2.1.2.	International competitiveness	76.8	39.1	50.9%
4.1.1.	Energy efficiency of manufacturing enterprises	23.7	13.8	58.0%
4.2.1.1.	Energy efficiency of multi-apartment buildings	141.5	88.6	62.6%
4.2.1.2.	Energy efficiency of public buildings	93.4	55.9	59.9%
4.3.1.	Energy efficiency of district heating	49.6	40.5	81.6%
Total		**741.4**	**482.9**	**65.1%**

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

In order to promote investments in Latvian industry and promote economic activity, at the sitting of 28 July 2020, the Cabinet of Ministers decided on 3.5 mln euro reallocation of unused funding from the first selection round for **creation or reconstruction of production premises and infrastructure** to the second selection round of projects. This provides for supporting of a larger number of project applications submitted in the second selection round. Also, taking into account that the economic consequences of Covid-19 and to make it possible for economic operators to plan their cash flows right now, an extension for the implementation of the project until 31 December 2023 was approved at the CM meeting on 5 October 2021.

52 project applications in total were submitted to the Central Finance and Contracting Agency (hereinafter – CFCA) in the second selection round of projects. Currently, the implementation of 18 projects continues, while 6 projects have already been implemented within the second round of activity 3.1.1.5. Additional reallocated funding will help to effectively manage the funding available in the programme and will make it possible to support future project applications with the highest score.

Currently, the implementation of 10 projects continues within the first round of the programme, while 23 projects have already been fully implemented. In total, projects with a total investment of 34 mln euro have been completed within the project.

In 2021, the evaluation of projects for the third round of support from EU funds (started in 2020) was completed **for the performance of reconstruction or renovation works that increase the energy efficiency of industrial production buildings and warehouses**, as well as the purchase of energy efficient production and ancillary equipment to replace existing, less energy efficient equipment. It is also envisaged in the third round that funding may be invested in the renovation, reconstruction or creation of building engineering systems, the recovery of secondary energy sources from technological production processes and the use of renewable energy sources, as well as the preparation of technical project documentation. 29 projects with the total EU funds support amount of 8.4 mln euro were approved in the third round and are now implemented.

The opportunity to receive **EU funds co-financing for the issue of shares** has caused the greatest interest among entrepreneurs. The European Regional Development Fund funding available for the activity is 1 mln euro, private co-funding – at least 1 mln euro. Three project selection rounds have been announced for this activity so far. 14 undertakings applied for the first two selection rounds, of which contracts were concluded with 3 undertakings. From the project submitted for the third project application selection round it can be concluded that 5 undertakings in total could be approved.

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 (a detailed description of this communication is reflected 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. However, considering the Covid-19 pandemic and the related crisis, the EC was urged to present a revised EU multiannual financial framework for 2021-2027.

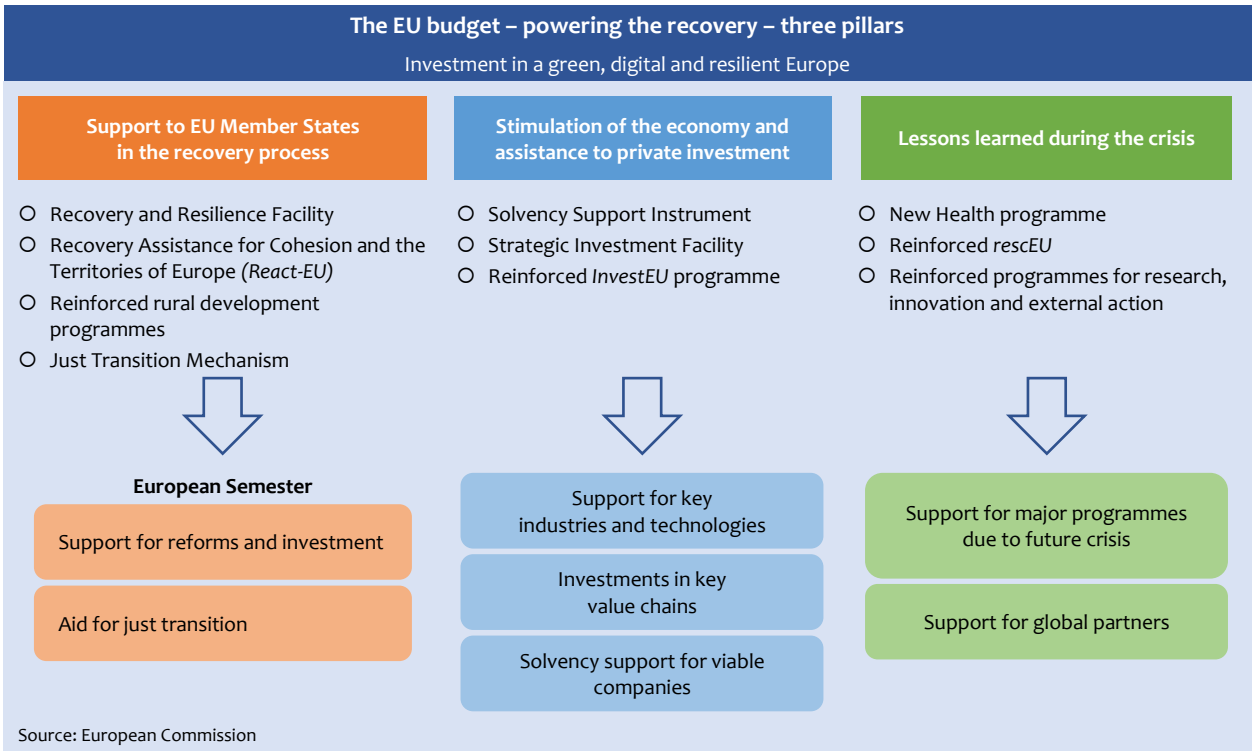
On 27 May 2020, the EC presented a revised proposal for the EU multiannual financial framework for 2021-2027 by publishing a communication ***"The EU budget powering the recovery plan for Europe"***[2]. The EU's long-term priorities to boost the green and digital transitions have been integrated in the 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).

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 instrument will boost the EU budget with new financing raised on the financial markets. This will be a one-off emergency instrument, put in place for 2021 – 2024, which can be used by EU Member States exclusively for economic recovery measures.

[1] https://eur-lex.europa.eu/resource.html?uri=cellar:c2bc7dbd-4fc3-11e8-be1d-01aa75ed71a1.0007.02/DOC_1&format=PDF
[2] https://eur-lex.europa.eu/resource.html?uri=cellar:4524c01c-a0e6-11ea-9d2d-01aa75ed71a1.0006.02/DOC_1&format=PDF

Figure 8.2



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 Section 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 will be 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 will have to draft *National Recovery and Resilience Plans*, which will be 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 order to ensure efficient and effective use of funding, specific milestones and targets to be reached are set for each EU Member State within *National 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 will play 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 will help 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 current 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 is related to 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, the Union's Civil Protection Mechanism,*** will be expanded and reinforced to equip the Union to prepare for and respond to future crises. The flagship programme ***Horizon Europe*** will be reinforced to fund vital research in health, resilience and the green and digital transitions. Other EU programmes, including its external instruments, will be strengthened to align the future EU financial framework fully with economic recovery needs. Special instruments will be 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 bln euro, which is historically the highest amount so far, of which 1,100 bln euro will come from the EU multiannual financial framework, 750 bln euro will come from the new *European Recovery Instrument* (*Next Generation EU)* and 540 bln euro will come from the *Support to Mitigate Unemployment Risks in an Emergency (SURE)/European Stability Mechanism (ESM)*.

The ***National Development Plan of Latvia*** is the main document in the country, in accordance to 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 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.

In order to start using the EU funding and implementing the support programmes funded by EU funds, the ***Operational Programme for the EU Funds Programming Period 2021-2027*** is prepared. It includes detailed information on investment lines of EU funds, specific support objectives, etc. Information about the planned EU investments in Latvia in 2021-2027 is reflected in Box 8.3 and in Figure 8.3.

Box 8.3

EU funds support in 2021-2027

The European Commission 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 European Regional Development Fund, the Cohesion Fund and the European Social Fund (hereinafter – EU Funds) – among Member States and support programmes.

The Ministry of Economics (hereinafter – 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 investments planned by the MoE is 947 mln euro and covers priorities such as digital transformation, productivity, social inequality, and climate and energy efficiency.

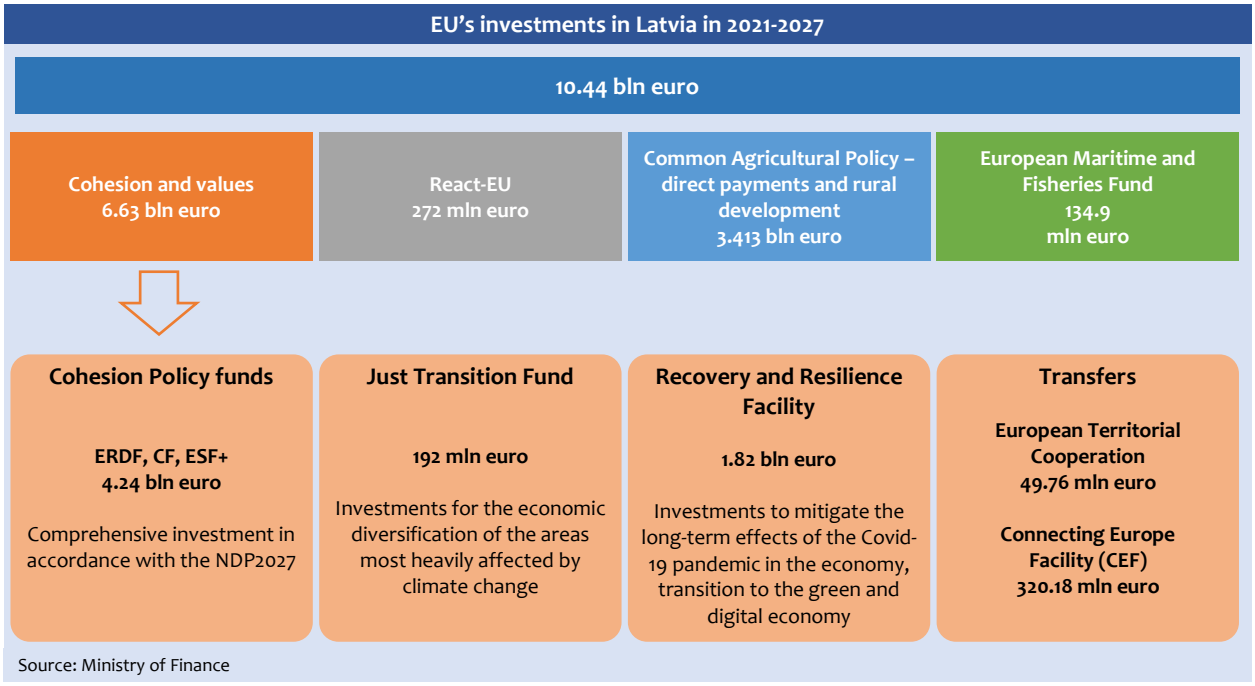
The programme includes measures to:

- ensure the transformation of the economy to the production of products and services with higher value added;
- 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 funding of EU funds for the MoE activities for:

- digital transformation – 44 mln euro, including support for digitalisation for the development of new products and services – 21.15 mln euro, development of digital skills (training) – 10 mln euro, EDIC and digital maturity test – 8 mln euro and digitisation of financial instruments – 5 mln euro.
- productivity – 366 mln euro, including support for development of SME business – 97 mln euro, financial instruments for SMEs – 164.4 mln euro, support for research and innovation in the development of new products – 51.7 mln euro, financial instruments for research and innovation – 50 mln euro.
- reducing inequalities – 83 mln euro, including access to social housing – 60.9 mln euro and improving accessibility of the environment – 21.75 mln euro;
- climate and energy efficiency – 457 mln euro, including support for energy efficiency in residential buildings – 163.1 mln euro, energy efficiency in public buildings – 104.4 mln euro, heating and cooling – 56.5 mln euro, RES in business 43.5 mln euro, promotion of the use of RES in production – 23.49 mln euro, promotion of biomethane production – 21.75 mln euro, "greening" of business – 44.06 mln euro.

Figure 8.3

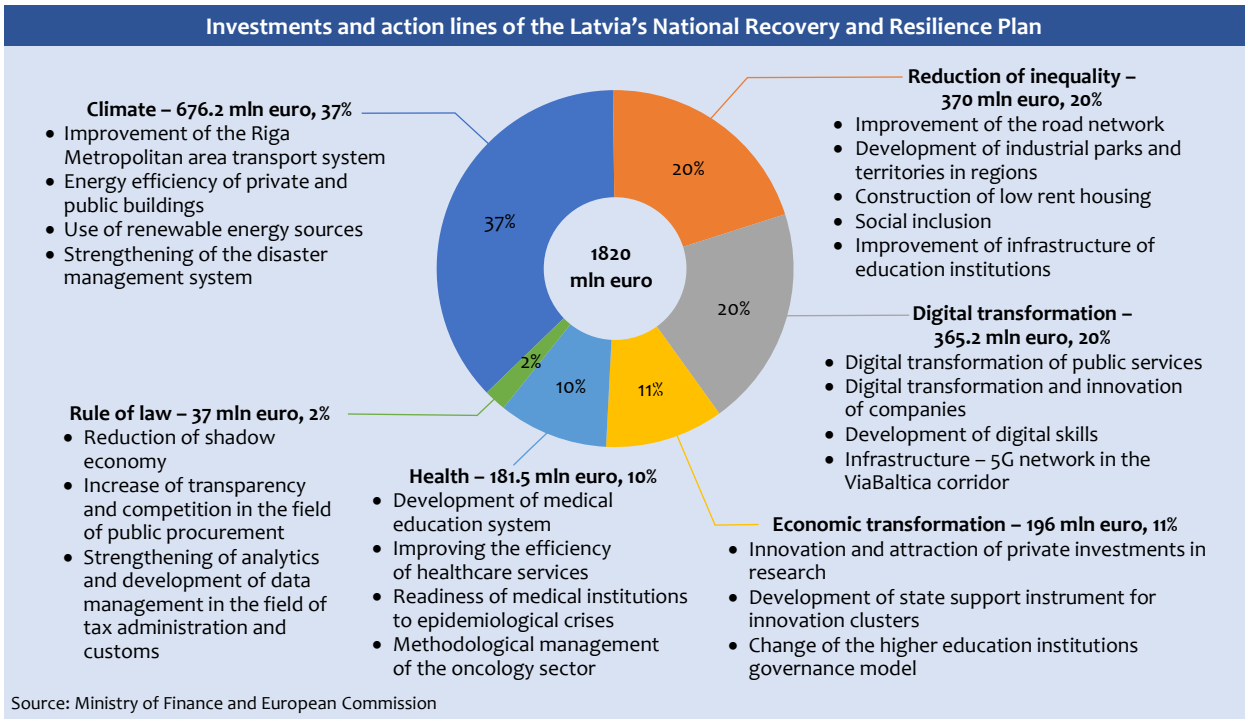


Source: Ministry of Finance

The *Latvia's National Recovery and Resilience Plan* (hereinafter – LNRRP) is another important document in acquiring EU funding in Latvia in the context of the *European Recovery and Resilience Facility*. LNRRP was submitted for review to the EC on 30 April 2021, and was approved on 22 June 2021. Then followed the evaluation of LNRRP at the EU Council, where it was approved on 13 July 2021. LNRRP is based on 6 lines (see Figure 8.4):

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

Figure 8.4



Source: Ministry of Finance and European Commission

The submission and the beginning of the implementation of LNRRP projects are scheduled for the end of 2021. Projects can be submitted by entrepreneurs, local governments and state organisations. Funding from the Recovery and Resilience Facility will be available until 31 August 2026. LNRRP includes investment projects and reforms aimed at contributing 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 country-specific recommendations of the EU Council for Latvia and the *National Reform Programme of Latvia* (see Chapter 8.1).

8.3. EU SINGLE MARKET

The EU Single Market unites 30 countries (27 EU Member States and 3 countries of the European Economic Area (EEA) – Norway, Iceland and Liechtenstein) having over 500 mln consumers. The EU Single Market means a territory without internal borders providing free circulation of goods, services and capital, as well as free movement of people. The EU Single Market as we see it today is the result of continued work, when EU Member States gradually, step-by-step coordinate decisions on closer integration on a daily basis. Unified principles and rules for economic operators have been developed, border control has been cancelled, a more competitive business environment has been created, 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, as well as many other benefits were provided.

On 5 May 2021, the European Commission published the *Updated Industrial Strategy*, which pays special attention to innovation, competitiveness of the EU industry and, in particular, a strong and fully-functioning Single Market.

The Covid-19 crisis has highlighted the importance of analysing the EU's industrial policy and the Single Market as one, to better take into account the economic and social impact that disrupts the free flow of goods, services and people. The Covid-19 crisis showed the barriers that still exist in the Single Market. The restrictions introduced during the pandemic resulted in a significant interruption of the free movement of people, goods and services as well as global supply chains (especially regarding availability of essential products) and triggered economic recession (a significant reduction in demand).

The *Single Market Report* included in the *Updated Industrial Strategy* provided an assessment of the resilience of the Single Market, taking into account the experience of the Covid-19 crisis, reported on key indicators in the industrial strategy and competitiveness, as well as assessed the implementation of the *Single Market Enforcement Action Plan* of March 2020.

The planned EU activities for the strengthening of the single market in 2022 aim at improving existing instruments (*Single Market Report*) as well as introducing new ones – single market emergency instrument, a single form for the notification on the posting of workers as well as strengthening monitoring of EU and imported products etc.

In accordance with Articles 34-36 and 49-62 of the *Treaty on the Functioning of the European Union* (TFEU), the MoE supervises and coordinates the freedom of provision of goods and services and the right to do business in Latvia. Within the scope of its' competence is also identification of legal provisions which may potentially or actually hinder the use of freedoms of the EU Single Market, including the evaluation of draft laws and regulations.

An electronic **Single Market Centre** is available on the MoE website[1] providing essential information on different EU information and assistance services. The main purpose of the EU Single Market Centre is to help entrepreneurs to use all the advantages related to the EU Single Market, as well as to provide practical assistance in relation to the limitations of the freedom of provision of goods and services.

The **technical regulations notification** serves as 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 of coordination of technical regulations, and provide its comments and objections regarding draft laws prepared by any Member State, which might potentially affect economic operator's product exports or cross-border provision of 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 in Latvian. If 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 the respective EU country, the economic operator has the right to submit its objections to the responsible ministry which is competent to coordinate the respective policy area in Latvia.

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

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. IMI system helps to implement 67 administrative cooperation procedures in 17 different policy areas. Every year, IMI operating areas are extended and adapted to the needs of national regulatory authorities – for example, in 2020, a consumer protection cooperation module and a module for resolution of cases and exchange of information within the European Judicial Network was introduced.

In accordance with the *Services Directive (2006/123/EC),* Member States are obliged to inform about services which may cause significant harm to human health, life and the environment, therefore, the IMI system has an *Alert mechanism* which ensures cooperation among supervisory authorities for risk prevention. 127 Latvian responsible authorities of different areas are registered in the IMI system – 63 authorities in the services area, 30 – deal with professional qualifications, 9 – with posting of workers, 6 – with patients' rights, 2 – with e-commerce, 2 – with train drivers' licences, 32 – with public procurement (one authority can deal with several areas).

From January to November 2021 Latvia processed 172 information requests within the IMI system: 131 in the professional qualifications area, 36 in the posting of workers and 5 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 decisions of public authorities in case of incorrect application of EU law. In situations, when a citizen or an economic operator is harmed by unfair decisions taken by responsible authorities of other Member States, the SOLVIT Centre operates as a problem-solving tool free of charge. There are SOLVIT Centres in each EU/EEA Member State. From January to November 2021 the Latvian SOLVIT Centre received 32 complaints as a Home Center on problems of Latvian citizens in other EU countries and 7 complaints as a Lead Center on problems of EU citizens in Latvia. 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) EU's legal norms (regulations, directives, etc.) have been violated. Most frequently the Latvian SOLVIT Centre solves 1) cases of citizens related to social benefits and residence permits, 2) cases of economic operators related to restrictions on freedom of provision of goods and services, repayment of value added tax and recognition of professional qualifications.

To promote commercial activities and innovation in the services sector, as well as gradual modernisation and simplification of state administration, one of Latvia's priorities is promotion of the **freedom of provision of services**. In the services area MoE in cooperation with other national authorities and non-governmental organisations analyses the requirements of laws and regulations on a regular basis and prepare recommendations for required changes to reduce an administrative burden on undertakings. Administrative barriers and procedures are reviewed by removing or simplifying requirements for issue of permits, licences, certificates, certifications and other documents, as well as promoting to carry out the necessary procedures electronically.

The information necessary for business is available electronically, as well as e-services are available in the portal of **Government Services** *www.latvija.lv* (see also Chapter 9). The Portal fulfils the functions defined in the *Services Directive (2006/123/EC)*, which was transposed in the Latvian legal systems by the *Freedom to Provide Services Law* – each EU member state should have a single electronic contact point, where detailed information should be available on public services related to business in the services areas, and it should provide the possibility to fulfil electronically necessary administrative requirements for the provision of services in the member state. Information about life situations, interinstitutional information and functionality in the Private persons section is managed by SRDA in cooperation with institutions involved, but the Entrepreneurs section – by MoE.

9. IMPROVEMENT OF THE BUSINESS ENVIRONMENT

Measures for improvement of the business environment in Latvia have been implemented since 1999. The Ministry of Economics, with the participation of a wide range of sectoral ministries and organizations representing entrepreneurs, prepares the *Action Plan for Improvement of the Business Environment* (hereinafter referred to as the *Business Plan*), which is updated and approved by the government every other year. The *Business Plan* is a business policy making tool, which hears and solves the problems identified by businesses, and it has so far helped to introduce almost 600 measures for improvement of the business environment.

Taking into account that until now Business Plan process has been resource and time consuming, on 7 September 2021, CM approved the change of conceptual approach in the development and implementation of *Actions for Improvement of the Business Environment* proposed by MoE to make it faster and specific goal oriented (see Box 9.1).

Box 9.1

Improvement of the Action Plan for Improvement of the Business Environment

The improvement of the regulatory enactments regulating business and the services provided by public administration will not be changed, but will be replaced by a more efficient process of identifying and administering the necessary measures, replacing the existing policy planning document with a digital environment (for example, as one of sections on the MoE website), establishing feedback and allowing continuous follow-up to the progress of the implementation of the measures.

The new process requires the Latvian Chamber of Commerce and Industry, the Employers' Confederation of Latvia and the Foreign Investors' Council in Latvia to submit to MoE by March 15 each year proposals regarding the necessary measures to improve the business environment. The proposals will be evaluated and approved by CM. The national regulatory authorities responsible for the specific measures will submit to MoE by March 31 each year information on the progress made from the time of approval of the measure by CM. Each responsible national regulatory authority, in accordance with the budgetary resources allocated to it, will be responsible for the implementation of the measure within the time limit specified, in accordance with the measures approved by CM for the improvement of the business environment.

With a view to examining the change in the process of *improving the business environment* proposed, a pilot project was launched in 2021, defining the following lines of action as the primary issues to be addressed in the improvement of the business environment:

- data collection and re-use;
- improvement of the construction process and related requirements;
- improvement of the local government planning area;
- 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.

Further discussions are expected between the parties concerned on the listed lines of action in order to reach agreements on specific measures, the result indicators to be achieved, and to coordinate these measures with the responsible national regulatory authorities and to direct them for approval to CM.

INTRODUCTION OF THE "CONSULT FIRST" PRINCIPLE

In progress towards an excellent business environment in Latvia, for 3 years, from 2018 to 2020, work was gradually carried out for the targeted implementation of the "Consult First" principle in the activities of supervisory authorities.

The "Consult First" initiative is considered successful, it has been positively evaluated by institutions and businesses and is a valuable benefit for public administration and the business environment. The implementation of the initiative has generally reached the set goals. First, the behavioural culture of controlling authorities has changed from primarily repressive to supportive. The created environment ensured that institutions can learn and master "best practices". Second, this initiative has contributed to effectivization and optimisation of the processes by saving the resources of entrepreneurs, reducing the administrative burden, promoting better cooperation. Third, during the introduction of the "Consult First" principle, a positive assessment of the functioning of the institutions was received from customers (economic operators) – the overall *Customer Perception Index* reached an average of 83.03 index points (out of 100) in 2020; the total "Consult First" index is 83.51, respectively. And it has grown in a 3-year period.

The "Consult First" initiative has been assessed positively by the institutions involved and business associations and very good results have been achieved through it. The implementation of the principle contributes to compliance with the requirements of regulatory enactments and therefore fairer competition in the market, thus creating a stable business environment favourable for investments. The chosen form of voluntary cooperation (memorandum of cooperation), the jointly drafted "Consult First" guidelines, regular assessment of the progress and the exchange of best practices were the elements that ensured the successful implementation of the "Consult First" principle in the work of institutions. In the mid-term implementation of the "Consult First" principle, other institutions expressed their intention to join the initiative, which also implement the 'Consult First" values in

their activities and thus extended the scope of range of members of the Memorandum in 2019 (currently these are 29 institutions). The "Consult First" initiative has succeeded in making a positive move.

Entrepreneurs confirm that employees of supervisory authorities cannot be influenced in decision-making, apply and interpret regulatory requirements consistently and uniformly and impose sanctions proportional to infringements. Entrepreneurs appreciate that their voluntary activities to prevent non-compliance are often supported and a "leniency" regime is applied to the introduction of new legal requirements, recognise that authorities use modern and customer-friendly channels for the transfer of information, and mainly evaluate communication as kind and responsive.

In conditions of the emergency situation, the practical use of the "Consult First" principle became usual for many institutions, the volume of consulting increased many times and the forms of consulting transformed in the most accessible methods for customers. The consequences caused by the effects of the Covid-19 pandemic merely reinforced confidence in the importance, value and need for entrepreneurs of institutional support, consultations, information and a kind, positive attitude both daily and in crisis situations. This stage has helped to accelerate changes for effectivization of various processes – promoting electronic circulation of information, promoting both remote consultations and remote supervision activities, and developing self-checking tools and introducing virtual consultants, which generally point to a customer-oriented approach and significantly facilitate cooperation opportunities and access to authorities of entrepreneurs.

Thanks to the "Consult First" initiative, a positive experience-oriented culture has established in public authorities, which authorities continue to develop further. The supervisory authorities are still undergoing ongoing changes, including the extending the development of the application of different digital tools in daily work, so that even at a distance, the state is closer and more open to cooperation and businesses. Customer-oriented public administration is an essential prerequisite for effective and long-term positive cooperation between public authorities and private sector organisations.

PUBLIC INFORMATION ABOUT LEGAL PROTECTION PROCEEDINGS

In 2021, 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, including taking into account the recommendations contained in the International Monetary Fund's *Evaluation of the insolvency framework in Latvia* and the *Directive on restructuring and insolvency*, which should be introduced by Latvia and other EU Member States by 17 July 2021.

Box 9.2

Interreg Baltic Sea Region Transnational Cooperation Programme Project "RestartBSR"

The purpose of the project is to build institutional capacity for representatives of the innovation area to support businesses in financial difficulty. Capacity building activities will ensure smaller number of insolvency proceedings in such companies, foster performance of the Baltic Sea Region in non-technological innovations and increase the number of companies able to resume business, which will, in turn, result in total growth of the region, as well as preservation of jobs and increase in their number. To achieve the goal, best practices were analysed, tools for supporting companies in financial difficulties were developed, as well as processes for the development of recommendations for policy implementers for further actions to handle the existing situation are organised. In 2021, a number of national working groups, as well as the 2nd Innovation Laboratory took place.

10 recommendations were developed with international and national project partners, as well as cooperation partners:

1. To ensure strong political will and decision to implement Directive (EU) 2019/1023 essentially not only formally, with complementing RestartBSR activities.
2. To implement a two-level support system: levels of operation coordination and executor functions.
3. To establish one central support implementation coordination unit accepted by the public administration authorities-services involved in the field of economics, finance, law, national taxes and other relevant organisations. The central coordination unit should be state governed or state delegated function executor. The coordination unit should supervise the executor level.
4. Ensure high-quality performance of executor level functions through one or several private support organisations that provide services to companies in distress situations.
5. To ensure long-term financing. The best option recommended in Latvia is state budget, as it will ensure long term solution and reduce risk of dishonest decisions taken by executor level institutions. It is recommended to consider involving other options: structural funds, private organisation co-financing or Horizon Europe Framework projects.
6. To limit the number of entrepreneurs in distress situations, develop the business crisis education support courses that include knowledge on company crisis management, financial literacy, design thinking and business ethics. The course should be online, free of charge and managed by the central coordination unit. The course should be accessible also through the state service websites and organizations working directly with entrepreneurs (agencies, associations, etc.).
7. Ensure identification of companies in distress situation in a timely manner.
8. To ensure support advertisement, including web solutions with high search engine ranking, social networks, traditional media. To use clear and simple messages.
9. To provide both coordination and executor units, including mentors, with high reputations.
10. To provide and ensure maximum confidentiality and data protection when providing support to businesses.

The insolvency regulations are improved for the implementation of these recommendations and the requirements of the Directive, and work continues on the implementation of *Interreg Baltic Sea Region transnational cooperation programme project "RestartBSR" ("Restart SMEs in the Baltic Sea Region")* started in 2019 (see Box 9.2).

DIGITALISATION OF THE BUSINESS ENVIRONMENT

One of the priorities in creating an excellent business environment is to promote the use of digital solutions in business, the digitisation of 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 existing processes, 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. Although Latvia exceeds the OECD and EU average after the deployment of the high-speed broadband network, only a few Latvian companies use new digital technologies, such as analysis of large databases, radio frequency identification technology, etc.

It should be noted that the results of a study[1] published by the European Commission show that nearly 40% of surveyed Latvian companies use at least one artificial intelligence technology, which is close to the EU average (40%). Latvia is significantly ahead of Estonia (27%), but still lags behind Lithuania (54%). The European Commission emphasises that improvements in the integration of digital services by businesses is limited by the shortage of high-skilled professionals. To make Latvian SMEs use digital opportunities more, it would be important to reduce the factors hindering development. Industry association leaders, for example, acknowledge that the main barriers to a more active digital transformation of companies are a lack of free finances in companies, as well as insufficient knowledge of the digital solutions available.

The Digital Economy and Society Index (DESI) of 2020 ranks Latvia the 18th among 28 countries. Latvia's level of digital development is broadly in line with the EU average. Latvia's performance exceeds the EU average in terms of connectivity (4th) and digital public services (5th), while it is lagging behind in the use of Internet services (19th), human capital (24th) and integration of digital technology (23rd). Improvements have been made 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, as well as an approach based on different life situations adopted for the purposes of provision of public services).

An increasing number of citizens are making use of online banking and e-administration services but half of the population still has no or low digital skills. 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 availability of basic infrastructure in regional centres, the provision of electronic communications services to citizens in regions is still not possible until the "last mile" connection and adequate service provision policy are provided.

The Covid-19 crisis has accelerated economy digitalisation trends and job automation, so the new structure of jobs and skills may differ from what it was before the crisis, but it is equally an opportunity to create and find new solutions for business development, the introduction of new solutions and the creation of innovative products.

SINGLE INFORMATIVE PORTAL WWW.LATVIJA.LV

Since 2020, the *State service portal www.latvija.lv* has also been fulfilling the function of a single contact point for products by implementing *Regulation (EU) 2019/515 of the European Parliament and of the Council on the mutual recognition of goods lawfully marketed in another Member State and repealing Regulation (EC) No 764/2008* and *Regulation (EU) 2018/1724 of the European Parliament and of the Council 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*. This contact point provides information on the mutual recognition of products, general and technical product rules, remedies and market surveillance authorities in the non-regulated product area in Latvia. By the end of 2020, such single contact points such products have been established in all EU Member States.

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

[1] https://ec.europa.eu/digital-single-market/en/news/european-enterprise-survey-use-technologies-based-artificial-intelligence

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, creation of a new design to enable the population and companies to easily and conveniently find necessary information and receive public services electronically. In order to foster improvement of functionality and the quality of content of the business section of the portal, MoE in cooperation with other ministries and their subordinated institutions in 2021 continue to update information about available services in a user-friendly way and in accordance with the requirements of the *Services Directive and the Single Digital Gateway Regulation*. Work on the new version of www.latvija.lv is expected to be completed in 2023.

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.

In accordance with the European Innovation Scoreboard 2021, Latvia's achievements in several innovation indicators have been appreciated. Since the previous reporting year, foreign direct investment net inflows have increased by 38% with total number of public-private co-publications increasing almost three times, while entrepreneurial activity among the economically active population exceeds the EU average by 221%. It is assessed positively that 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 2020, changes were made to the *European Innovation Scoreboard* methodology by amending or adding 14 out of 32 existing indicators, while only 27 indicators were assessed previously. Similarly, in view of developments in *European Innovation Scoreboard* indicators and similar results over the years in all Member States, the thresholds for breakdown into groups were increased, where, following changes in methodology, Latvia ranks 25th among EU Member States. Until now, in order to get into the group of moderate innovators, the Member State had to reach at least 50% of the EU average in the Scoreboard, and Latvia so far has been able to do that (56% of the EU average). Currently, the countries not reaching at least 70% of the EU average are ranked in the emerging innovators group.

Compared to the previous year, Latvia's figures in the *European Innovation Scoreboard* 2021 have increased significantly in three dimensions of innovation – use of information technologies, human resources and digitalisation. Compared to the EU average, Latvia has the highest results in the share of the population with tertiary education (128.2% of the EU average), trade mark applications per billion GDP (104.3% of the EU average) and the share of enterprises providing information and communication technologies training to employees (80% of the EU average). Latvia has the lowest indicators in government support for business research and development (5% of the EU average), research and development expenditure in the business sector (8.5% of the EU average), the share of innovators amount small and medium-sized enterprises (41.3% of the EU average) and doctorate graduates (22.1% of the EU average).

In 2021, Latvia ranks 38th among 132 countries in the Global Innovation Index. 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 has to be followed – it can be noted here that in 2021 Latvia still retains 45th place among 132 countries. In 2020, Latvia was 36th among 131 countries, while in 2019 – 45th among 129 countries.

Box 10.1

Proportion of innovative businesses

Between 2016 and 2018, 32.9% of all Latvian companies were innovative, which is 2.6 percentage points more than in the previous period (2014-2016), however this indicator is lagging behind the average in the EU countries (2014-2016: EU-27 – 49.5%). The turnover of innovative companies in the total turnover of companies increased by 6.4 percentage points over this period reaching 59.7%, indicating that demand for the products of innovative companies or services has 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 R&D in 2020 amounted to 205 mln EUR or 0.7% of GDP. They rose by 4.8%, compared to 2019. Investments of businesses in R&D also increased by 15.2% affected by the implemented R&D measures for promotion of innovation in state capital companies, as well as measures to promote innovation in SMEs. Overall, the structure of R&D financing evidences that investments in research and development in Latvia depend on ESIF funding.

Private sector investments in R&D have been low in Latvia for a long time. From 2011 to 2020 investments of businesses in R&D amounted on average to 23.9% of total investments in R&D (0.15% of GDP). This indicator significantly lags behind EU Member States, where businesses provide more than half of total investments in R&D (2018: EU-27 – 58.9%; Latvia – 23.3%). Similarly, private sector investments in the sector of higher education and science in Latvia are insignificant, which is an evidence of insufficient cooperation between businesses and scientists. 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 in achieving these indicators. SOE's assets account for 13.2% (2018) of the assets of all capital companies. Approximately half of these assets are formed by three capital companies under the decisive influence of the state. SOEs have identified a discrepancy between the national R&D targets and the existing regulation, the shortcomings of which create obstacles to setting ambitious and specific R&D targets for SOEs on the part of holders of capital shares or board of directors and, consequently, to the achievement of national R&D target values. 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 and is seen as a driving force for R&D activities in the state industry.

PUBLIC PROCUREMENT IN THE FIELD OF INNOVATION

Public procurement in the field of innovation also plays and important role in the innovation system. In 2021 work on the implementation of the Interreg Europe project "Fostering the role of public authorities as demanders of innovation through public procurement", launched in 2018, (iBuy) continues.

The aim of the project is to promote the wider use of innovation procurement procedures by applying new procurement models to promote innovation and to create a framework for raising awareness among policy makers on innovation procurement, its potential and the opportunities provided. In order to achieve the goal, best practices were analysed; an information material was prepared containing the essential information on innovation procurement – its types and procedures, market research and evaluation criteria; newsletters on good practices and current events in the field of innovation procurement in Latvia and the EU are sent to all stakeholders periodically; as well as guidelines have been developed for the implementation of innovation procurement – a methodical material that will serve as support for public sector in the implementation of innovation procurement.

SPACE INDUSTRY

Being aware of the rapid development of the global space industry, Latvia sees additional opportunities for increasing its active involvement. With a view to highlighting space market opportunities and increasing their uptake, various support and communication activities have been organised for the development of the Latvian space industry and the establishment of the space ecosystem in Latvia. Given that the Latvian space industry has inherited large and high value added infrastructure (scientific instruments, radars, antennas, equipment, etc.) and benefits from the status of an Associate Member of the European Space Agency (since 2020), the EU Space Programme and national innovation support programmes, Latvia plays a competitive role in the global space industry; however, its potential is not being fully exploited yet.

The limiting factors are the shortage of human resources, which has a negative impact on both innovation creation and internationalisation activities, as well as limited access to infrastructure maintenance and modernisation financing opportunities. 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. Moreover, 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). Currently, several members of the Latvian space working group are working towards developing the concept of commercialisation in the space sector, the demand for which has been highlighted by the European Space Agency and various countries. Finally, at the end of 2020, the *Latvian Space Strategy for 2021-2027* was approved and signed as a result of the joint work of the Ministry of Economics and the Ministry of Education and Science.

THE NEW COUNTRY BRAND CONCEPT

In 2021, a new concept of the consolidated country brand was developed. Latvia's new country brand is based on three values: "natural playground", "ready for any challenges" and "connecting worlds apart".

To introduce these 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 main aim of the mission approach is first, to define the challenge and then, to provide a solution to it through an intersectoral cooperation.

The first (pilot) mission to be launched is "The Sea 2030", considering that the Baltic Sea is one of the most polluted and threatened seas in the world. The mission aims to develop solutions and instruments to restore the Baltic Sea environment in the long term by promoting global innovation and development in various related industries.

ESTABLISHMENT OF A KNOWLEDGE TRANSFER SYSTEM SUPPORTING INNOVATION

IDAL, which at the same time ensures functions of a Single Technology Transfer Centre, is a central element, a mediator in the ecosystem of innovations in Latvia, which fosters cooperation between research organisations and industries along with competence centres. IDAL also develops the awareness and development of technology transfer in public research organisations, improves their industrial property management policy, as well as 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 is 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 purpose of improvement of the knowledge and technology transfer system is to improve cooperation skills of the research and business sector, 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 make a contribution to the achievement of the goals of the *Latvian Smart Specialisation Strategy*, foster commercialisation of state-funded research results available to research organisations in Latvia and abroad, as well as to 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 of technology development.

By now 100 projects for commercialisation of ideas have received support, 282 agreements for support to start-ups in participation in exhibitions and visits to potential investors, as well as 267 innovation voucher agreements have been concluded within the scope of the *Technology Transfer Programme*. The activities of the *Technology Transfer Programme* to support economic operators and research organisations are scheduled to continue until 2023, and later support for R&D activities will be provided within the next programming period of EU funds.

CREATION OF START-UPS

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. 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.

In 2021, work on the improvement of the regulatory framework for the start-up eco-system continued, taking into account the results and recommendations of the *Start-Up Ecosystem Study* conducted in 2019. 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 start-up, which have received this aid had grown rapidly. Aid for 42 start-ups was approved since the launch of the programme providing support of 1,344 thsd euro to the attraction of highly qualified employees and of 1,440 thsd euro for 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.

Given that the process of developing a business idea may be longer than five years for individual start-ups, the amendments increase the age since their registration in the Commercial Register as one of the qualification criteria. It is intended to reduce the requirement for employees in a start-up with a master's or doctoral degree from 70% to 50%. It is intended to cancel employment restrictions with other undertakings (to support the recruitment of highly qualified employees). It is envisaged that not only autonomous undertakings will be supported, but also those whose shareholders own other undertakings. It is envisaged to extend the aid period from 12 months in the current version of the law to 24 months. It is envisaged to cancel the requirement to suspend employment in other companies before the start-up receives the decision

granting the aid and allowing start-ups to apply for the support programme repeatedly, including 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 integrate the requirements of the amendments to the *Law on Aid for Activities of the 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* for the purposes of introducing 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.

In 2021, a wide range of informative activities (seminars, public discussions, publications, individual consultations, etc.) arising from the cooperation agreement concluded between the Ministry of Economics and the Latvian Startup Association, the Latvian Private and Venture Capital Association and the Latvian Business Angel Network was provided on the basis of CM protocol decision of 10 December 2020 "On start-up ecosystem promotion and development measures" (prot. No. 82 §60). Cooperation agreements provide for the implementation of measures to promote the ecosystem of start-ups until 15 December 2021. Similarly, the Investor of the Year 2020 online award ceremony and a panel discussion of investment industry experts on venture capital opportunities for growth of Latvian companies was held on 11 February 2021.

NORWEGIAN FINANCIAL INSTRUMENT

In 2021, activities were started within the Norwegian Financial Mechanism 2014-2020 programme "Business Development, Innovation and Small and Medium-sized Enterprises" (hereinafter referred to as NFI Programme). The funding available for the implementation of the NFI Programme amounts to 14.7 mln euro, with the allocation of 12.5 mln euro from the Norwegian financial instrument, while the Latvian state co-financing is 2.2 mln euro, and 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 NFI 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. On 7 October 2021, the IDAL Technology Business Centre (hereinafter – TBC) was opened, which is part of the NFI Programme (a pre-defined project). Funding amounting to 2 mln euro is available for TBC activities. The project will be implemented in cooperation with TBC partners – University of Latvia, Riga Technical University and Rīga Stradiņš University. The purpose of TBC is to promote the development of business ideas aimed at developing technologically intensive products in cooperation with higher education institutions, developers of innovative business ideas or their teams by providing support for development of ideas, prototyping and the conversion of research developments into competitive business projects.

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 mln euro, incl. ERDF of 63.2 mln euro, including by raising private sector funding for research and development of at least 46.7 mln euro.

191 research projects were approved within the second round, of which 174 were completed. 149 performers of economic activities received support as at 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 masters and doctors 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 is 24.5 mln euro.

As at October 2021, more than 200 research projects have been approved, including more than 80 intersectoral research projects, within the scope of the fourth round. The co-funding of companies involved in R&D projects in October 2021 was

20 mln euro. 164 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.

The Covid-19 pandemic influenced the reduction in income of the companies involved in the Competence Centre Programme, which depend on the flow of orders and reduction in the purchasing capacity. At the same time, the difficulties complicated forecasts of the companies regarding the impact of Covid-19 pandemic on cost items, which increase the risk to project implementation changes. Presently, most of research projects proceed according to the plan without changing the achievement of the initially set goals.

In the future, digital transformation of companies, investment in research and development of new products or technologies will play an increasingly important role in promoting competitiveness. In particular, emphasis should be placed on the production of export capable products with commercial 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 will mark 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 European Commission, MoE delegated IDAL the implementation of pilot projects in three development areas such as 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 2021, 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 IDAL in the development of ecosystems. In the photonics and smart materials ecosystem, the agreement on the IDAL's support for Horizon Europe project application (*Innovation Hubs*) in the role of a provisionally associated partner.

Several high-level visits abroad to strategic cooperation partners for the photonics and smart materials ecosystem have been organised. Agreement on practical steps in promoting cooperation. There is an agreement on the organisation of the association's annual industry event in Latvia with *Photonics Sweden*. Provisional intention to extend the activity with the participation of another Nordic photonic and smart materials ecosystem.

A biobank law, a draft law on secondary use of health data are being developed within the framework of the biomedical ecosystem. In-depth work has been carried out with the Children's Clinical University project – creation of a roadmap, aligned activities, attracting potential partners, bilateral sessions with Latvian start-ups.

Work on ICT verticals – 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 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 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 forms 101 mln euro. In addition to this funding, the Development Financial Institution "Altum" (ALTUM) should attract indicatively its funding or use the repaid funding of funds (for direct microcrediting, for support to starters of economic activity and mezzanine loans) of 68 mln euro, as well as external funding of indicatively 36.15 mln euro (for ensuring venture capital and acceleration services) should be attracted.

It is important to ensure continuity of availability of funding to SME also in the new programming period of EU funds after 2020 and state support programmes should continue to be implemented in the form of financial instruments: ensuring loans for starters of business, providing guaranteed, as well as fostering the availability of venture capital instruments. The development of guarantee and venture capital instruments should be ensured as a priority, at the same time ensuring mutual complementarity with the activities planned by InvestEU.

SUPPORT PROGRAMMES FOR MITIGATION OF THE CONSEQUENCES OF COVID-19

In spring 2020, the challenges posed by the spread of the Covid-19 virus and the resulting restrictions adopted by the government led to the development of additional state support programmes. The programmes for mitigation of the consequences of Covid-19 are primarily aimed at helping businesses overcome the liquidity difficulties caused by the spread of the virus, as well as providing funding for the implementation of investment projects by adapting or transforming their current business model.

On 24 November 2020, a state support programme was approved – downtime support for taxpayers, which includes downtime support to compensate remuneration of employees and patent-fee payers, as well as to compensate remuneration of self-employed persons. The support was paid in the amount of 142.9 mln euro.

On 10 November 2020, a state support programme was approved – support for subsidised wages to compensate remuneration of part-time workers. The support was paid in the amount of 23.3 mln euro. Downtime and wage subsidy support has been provided to a total of 121,693 taxpayers. In autumn 2021, amendments were proposed to the support programme for taxpayers to be able to apply for support in October and November 2021.

On 10 November 2020, a state support programme for enterprises to compensate the decline in the flow of working capital was approved. A total of 40,272 companies have been supported with 501.37 mln euro.

In autumn 2021, the amendments prepared by MoE were approved in the programme for wage subsidies and compensation of the decline in the flow of working capital so that taxpayers can apply for the support in October and November 2021. The criteria for receiving support are updated, and additional funding is granted.

On 8 April 2021, the state support programme for shopping centres (above 7500 m^2) was approved, where support was granted to compensate the decline in rental turnover of the owned shopping centre to cover operational costs (payments related to the use of the building, including electricity, water and heat, real estate rental, liability payments, including credit payments, and outsourcing costs) from 1 December 2020 to 31 December 2021. The support was provided to 20 shopping centres and amounted to 7.8 mln euro.

On 29 April 2021, a state support programme for sports centres (above 500 m^2) was approved, where support was granted to sports centres to compensate the decline in turnover of a sports centre owned, managed or rented for internal areas to cover operational costs (utility payments, including for electricity, water and heat, real estate rental, liability payments, including credit payments, and outsourcing costs) from 1 December 2020 to 31 December 2021. The support was provided to 74 sports centres and amounted to 6.4 mln euro.

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 will be 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 and entertainment places for sports centres, cultural, recreation and entertainment places owned, managed and leased by them to cover operational costs (payments related to the use of the building and premises, including for electricity, water and heat, real estate rental, liability payments, including credit payments, and outsourcing costs) from 1 October 2021 to 30 June 2022. The support programme funding is 50 mln euro.

PORTFOLIO GUARANTEES

On 12 September 2017, a state aid programme, portfolio guarantees, was approved. A portfolio guarantee provides entrepreneurs with the opportunity to receive investment and working capital loans and financial leasing with a term of 1-10 years and in the amount of up to 250 thsd euro. The aid programme is implemented by ALTUM, which in the process of open selection has selected and concluded agreements with 5 credit institutions, which are able to grant loans within the scope of available funding with a state guarantee to companies without direct involvement of ALTUM. 7.8 mln euro of repaid public funding are available for issuing of the guarantees. Since the start of the programme from 2018 to 30 September 2021, 544 guarantees in the amount of 22.62 mln euro have been issued within the framework of the portfolio guarantee programme providing financial services to companies in the amount of 28.28 mln euro.

ACCELERATION FUNDS

The acceleration programme is implemented in the 2014-2020 programming period of EU funds within the framework 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 support programme is introduced by ALTUM, which selected within a public procurement and concluded agreements with 3 financial intermediaries (fund managers), where 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 mln euro. By 30 September 2021, 120 agreements for 4.80 mln euro (including private funding) 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 Cohesion Fund and taking into account market development trends, several venture capital instruments are offered, which are implemented within activity 3.1.2.1 "Venture capital" of 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 support programme is introduced by ALTUM, which selected within a public procurement and concluded agreements with 3 financial intermediaries (fund managers), where one financial intermediary manages a seed capital funds and two financial intermediaries manage one growth capital fund each. The public funding available for implementing the activity is 58.38 mln euro. By 30 September 2021, 20 agreements for 16.91 mln euro (including private funding) have been concluded within the scope of venture capital funds.

MICROCREDITING

The *Start Loan Programme* is implemented in the 2014-2020 programming period of EU funds is implemented within the framework of *activity 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"*. Loans to starters are introduced in the form of direct financial instruments.The *Start Loan Programme* is an important type of state aid for companies at an early stage. Already in the 2007-2013 programming period of EU structural funds and the Cohesion Fund the start programme was one of the most popular state aid programmes among new businesses, and many new and currently already popular small and medium-sized enterprises started commercial activity with its help. Overall, 1559 start loans for the total amount of 30.79 mln euro were issued in the 2007-2013 programming period of EU structural funds and the Cohesion Fund, 27.74 mln euro of which were loan amounts and 3.05 mln euro were grants for interest rate subsidies.

Since June 2016 start loans were also provided 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 not older than 5 years of their establishment, the maximum loan amount is 150 thsd euro. Start loans are an important instrument for starters of business, ensuring access to funding 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) for the implementation of business projects in the necessary amount.

459 start loans for a 12.3 mln euro and 129 microloans for 1.7 mln euro have been closed by 30 September 2021.

LOAN GUARANTEE PROGRAMMES

Loan guarantee support activities for starting business and development in situations, when own funds of the company are not a sufficient security to attract the necessary funding from commercial banks or the company is classified as too risky.

ERDF funding of 49.8 mln euro for the support of small and medium-sized enterprises and 3.51 mln euro of repaid funding of the previous EU funds periods for the support of large enterprises is available from the 2014-2020 programming period of the EU funds for the implementation of the support programme.

The programme has been functioning since June 2016 and by 30 September 2021 741 guarantees amounting to 185.99 mln euro were issued, guaranteeing financial services for at least 303 mln 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 *activity 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 provides opportunities to receive funding to 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, inefficient equity, security). The parallel loan instrument allows to resolve 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 itself 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, which allows to consider that the part of the loan from ALTUM is technically subordinated.

These opportunities make the use of the product more understandable from the point of view of credit policy of commercial banks. Furthermore, from the point of view of customers – businesses a parallel loan is a way to reduce participation of the customer, which is rather difficult to accumulate for companies. The programme has been functioning since July 2016, and 18 parallel loans for 9.3 mln euro have been issued by 30 September 2021.

11.2. SUPPORTING ACCESS TO FOREIGN MARKETS

To strengthen and extend economic, industrial, scientific, and technical cooperation, including by creating favourable conditions for cooperation between economic operators, Latvia has concluded agreements on economic cooperation with the United Arab Emirates, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Russia, Kuwait, China, Moldova, Turkmenistan, Tajikistan, Ukraine, Uzbekistan, Turkey. At the same time, to support Latvian entrepreneurs in entering into new markets, negotiations have now been completed and an intergovernmental economic cooperation agreement with Saudi Arabia is planned.

An Intergovernmental Commission or a United Commission was established to ensure functioning of these agreements. The agenda includes matters of bilateral economic cooperation, which are topical for both contracting countries at the level of governments and businesses in various areas: industry, travel, transport, pharmacy, agriculture, financial services, communication, professional training, investment raising, technology and innovation, etc.

In 2021, despite the restrictions introduced due to the Covid-19 pandemic, the 8th meeting of the Intergovernmental Commission of Latvia and Uzbekistan, the 8th meeting of the Intergovernmental Commission of Latvia and Kazakhstan, and the 4th meeting of the Regional Cooperation Work Group of the Intergovernmental Commission of Latvia and Russia were held online.

Also, to continue intergovernmental dialogue, a series of meetings and visits were held looking into the possibilities of extending Latvia's cooperation with Lithuania, Estonia, Germany, France, the United Arab Emirates, the United States, China, Ukraine, and other countries.

LATVIA'S FOREIGN ECONOMIC REPRESENTATIONS

Representations of the Investment and Development Agency of Latvia (IDAL) are operating in several countries of the world for the purposes of resolution of economic matters and provision of support to Latvian businesses by organising national stands at international trade shows abroad, organising trade missions, providing advice on foreign markets, and organising business meetings with potential business partners.

In 2021, Latvia's foreign economic representation provided support in Brussels, the United States, the United Arab Emirates, Austria, Denmark, South Korea, France, Italy, Japan, Russia, Beijing, Shanghai, the United Kingdom, the Netherlands, Norway, Finland, Ukraine, Germany, and Sweden.

During the 9 months of 2021, IDAL has provided a total of 1124 consultations on foreign markets and business partners, identified 337 export projects and requests. The problems of economic operators have also been identified and 9581 consultations on solutions to overcome the Covid-19 crisis situation have been provided, opinions on non-compliance with self-isolation rules have been evaluated and provided.

IDAL 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 IDAL – providing advice to economic operators regardless of the industry, providing access to information in 65 countries around the world and specific resources developed by the EC.

During the 9 months of 2021, 955 consultations were provided, 7 trainings and information activities were organised in the framework of the EEN project involving 493 participants; 24 B2B events, with participation of 255 economic operators from Latvia were co-organised. Thanks to these activities, statements about 11 cooperation agreements concluded between Latvian and foreign commercial companies/organisations have been received.

Due to the crisis caused by the Covid-19 pandemic and the quarantine conditions introduced in Latvia and abroad, almost all export promotion activities (stands at trade shows, trade missions and fairs) in 2021 continued to be held online or were cancelled. On-site events continued in China and Japan, but without the participation of Latvian economic operators. During the 9 months of 2021, IDAL organised the participation of 86 Latvian economic operators in 12 national stands, 66 contracts were concluded, 12 online trade missions and fairs were organised abroad with participation of 79 participants. IDAL will also organise national stands in 2022 (~ 30 national stands) to the extent possible as far as the epidemiological situation permits.

NATIONAL PLATFORM FOR BUSINESS DEVELOPMENT

To improve the awareness of potential and existing economic operators of business developments, enhance IDAL's customer service processes, and reduce the burden on economic operators in the process of obtaining information and communication, IDAL 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 (see Box 11.1).

Box 11.1

National Platform for Business Development "business.gov.lv"

The National Platform for Business Development "business.gov.lv" (hereinafter – "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 has the ability to create its profile, indicating industry of interest, topics and other criteria for receiving personalised information, has the possibility to apply electronically to the services provided by IDAL, including the possibility to submit forms, payment requests and other documents electronically.

The platform provides in one place information about industry development, news abroad, and different events offered to economic operators. It posts business news that could interest economic operators. The creation of the content of the portal is supported by the sectoral ministries, the Central Statistical Bureau, the Financial Institution ALTUM, the Latvian Chamber of Commerce and Industry, the Bank of Latvia and other commercial banks and institutions.

EXPORT MARKETING ACTIVITIES

In the first half of 2021, most export marketing activities abroad were cancelled due to the Covid-19 pandemic. Therefore, Latvian economic operators had a limited possibility to use the export support grants available to economic operators for participation in trade shows, trade missions and conferences within *activity 3.2.1.2 "Promoting international competitiveness" of the specific objective 3.2.1 "Increasing the share of exports of high value added products and services" of the Operational Programme "Growth and Employment"* (hereinafter – the "Programme" and within the corresponding project "Promoting international competitiveness" (hereinafter – the "Project").

Following the rapidly changing market trends, where various digital solutions become increasingly more important in searching for business partners, entering new markets and product positioning, identifying the pressing needs of economic operators for maintaining competitiveness and providing continued support for economic operators in these changing pandemic conditions, the list of activities to be supported was updated, supplementing it with new or updated and adjusted activities and eligible cost items, and amendments were made to CM Regulations No.678 of 1 December 2015, which entered into force on 18 May 2021, making the Programme more attractive and relevant to the needs of economic operators.

The programme was supplemented with new supported activities such as participation in international digital industry platforms, including digital trade shows, adaptation of products/services to foreign markets, including the development of trademarks and industrial designs, publicity in foreign specialised printed and digital industry media, preparation of all forms of advertising content and the development of marketing materials, telemarketing services in search for foreign industry partners, participation in international industry associations, development of digital solutions for websites, online stores, applications and virtual communication platforms, development and acquisition of market research in target markets, recruitment of a foreign expert in the relevant industry to develop an export strategy, etc.

The overall funding of the programme also increased significantly – to 64,754,939 euro, and the support available to the economic operator or the final beneficiary increased to 40,000 euro per calendar year.

In the nine months of 2021, 595 thsd EUR was paid to target groups from the Project funds – 30.1% for participation in international trade shows, including digital trade shows, conferences, fairs, digital platforms, industry associations, and publicity in industry media, product adaptation to foreign markets, development of marketing materials, telemarketing services, website development, including online store development, 69.9% for certification of production facilities/products, 87 supports were provided for assessing the conformity of production facilities and products of the project target group (36 unique grant beneficiaries) and 109 applications for export support operations were approved, including 493 supported activities amounting to 1.9 mln EUR for participation of the project target group in trade shows, including digital trade shows, conferences, fairs, digital platforms, industry associations, and publicity in industry media, product adaptation to foreign markets, development of marketing materials, telemarketing services, website development, including online store development (26 unique grant beneficiaries).

Since the Project funding will also be available to economic operators in 2022-2023 in the form of grants for extensive and comprehensive export promotion activities, emphasis will be placed on the meaningful use of this funding.

EXPO 2020 DUBAI

On 1 October 2021, Latvia became a participant in the international Expo 2020 Dubai with its pavilion. Latvia's participation in the exhibition is organised by IDAL. The expo will be held for six months and will close on 31 March 2022. Participation of 220 Latvian companies in different activities both on site and remotely is planned at the expo. The main emphasis is on the following economic industries – construction and innovative construction materials, information and communication technologies, pharmaceuticals, food industry, and transport and logistics. 13 trade missions and many other activities will be organised with a view to promote exports, attract investment, develop tourism, and encourage different types of cooperation.

11.3. POLICY FOR ATTRACTION OF FOREIGN INVESTMENT

The *Guidelines for Promoting Latvian Exports of Goods and Services and Attracting Foreign Investments*, which define the main tasks in attraction of foreign direct investment (hereinafter – FDI), are integrated into the *National Industrial Policy Guidelines 2021-2027* (hereinafter – NIP 2027) developed by MoE.

FDI attraction policy is aimed at raising the competitiveness of Latvia as an attractive investment environment, considering the aspects, which are significant 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 in sectors that are defined as medium-high and high technology sectors. In accordance with NIP 2027, Latvia's task in the coming years is to promote greater investment in RIS3 areas by purposefully promoting the growth of foreign direct investment in knowledge-intensive sectors with high added value, including:

- bioeconomy;
- smart energy;
- biomedicine, medical appliances, bio-pharmacy and bio-technology;
- smart materials, technology and engineering systems;
- information and communication technologies (ICT).

The priority in the attraction process of foreign investment must be geographically closest neighbouring countries where Latvia is recognized and no extensive additional resources have to be invested for informative activities; also to 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, Russia, India.

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. *FICIL Sentiment Index 2020* or the assessment of foreign investors working in Latvia for the potential of the competitiveness of the economy and the investment environment was published in January 2021.

The results of the survey of foreign investors evidences of a positive assessment of the Latvian investment environment, and foreign investors assessed the potential economy drivers mainly above the average. The investors noted that the investment environment has slightly improved compared to 2019. Moreover, 68% of the surveyed investors in the study have admitted that they planned to increase the amount of investment in Latvia. More than half of the interviewed foreign investors see progress in the financial sector stability indicator in Latvia. Also, nearly half of investors have pointed to progress in the matter of government support and communication with policy makers. In turn, in the opinion of foreign investors minor progress has been made in areas of demography, uncertainty and quality of the tax system. The quality of business law and unethical or illegal conduct are another two other areas where more than half of foreign investors have not seen progress.

The Investment and Development Agency of Latvia (IDAL) plays a significant role in the attraction of foreign investment in Latvia. Its strategy for attracting investment focuses on qualitative servicing of incoming investment projects and active operation in attracting investment projects through addressing potential investors. The target set by IDAL in attraction of investment in 2020 – 2023 is to attract at least 432 million euro in FDI (with at least 250 million euro in RIS 3 areas), with a total of at least 4500 jobs (of which at least 600 in the fields of the *Smart Specialisation Strategy* RIS 3).

In 2020, the largest investment attraction projects implemented by IDAL were the business services centres "Norwegian Air" and "Swisscom", IT companies from Germany "Prime Force" and "QSC AG", and the Hongkong-based biomedical company "Longenesis" in the group of start-ups.

The investment attraction trend remains positive also in 2021. Data for the first six months of 2021 show that in this period 313 million euro were attracted in investments in mechanical engineering, renewable energy resources, aquaculture, electronics, smart materials, engineering services, real estate and other industries. Among the investment projects attracted in the first six months of 2021 are both "green corridor" projects in high added-value priority industries (see Box 11.2) and several Belarusian companies that have moved their activities fully or partly to Latvia in 2021.

Box 11.2

"Green corridor" for priority investments

Given the increasing competition in attracting foreign investment between European countries, it is necessary to act proactively in attracting innovative and technologically advanced foreign companies to Latvia. The creation of a "green corridor" for priority investments is to be mentioned as the most important progress in 2021.

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 investment attraction and increasing Latvia's competitiveness, in February 2021, CM approved the MoE and IDAL offer to create a "green corridor" to accelerate the bureaucracy and administrative processes for high value added investment projects. The "green corridor" is for investment projects in priority industries covering smart specialisation, international business services centres, as well as construction, transport 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 using an accelerated procedure, reducing the waiting time approximately by half.

The "green corridor" of investment has already delivered its first positive results. The review of applications for priority investment projects started in March 2021 and 8 investment projects with a total contribution of 88 million euro and 619 jobs created were approved during the first six months of its functioning.

To promote the recognition of the Latvian business environment among foreign investors, in 2020 IDAL created a new website https://investinlatvia.org, which provides structured information of interest to investors. Improvements to the website continued in 2021, its Google rating increased from the 9th to the 22nd place (October 2021), SEO and design was optimised, new website sections were added, and original content on smart specialisation was created to be distributed via Cision in international media.

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 2030 – Competitive Energy for the Society (Energy Strategy 2030) approved at the Cabinet of Ministers 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 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 national and regional level, keeping in mind the importance of reduction of energy dependence and long-term decarbonisation goals. In view of the effects of the Covid-19 pandemic, including rising energy prices, particular attention in 2021 has been paid to the development of various support mechanisms to provide support for both household and entrepreneurs during the energy price crisis.

ELECTRICITY MARKET

The full liberalisation of electricity market was completed on 1 January 2015, which means that households, as well as legal electricity consumers are free to choose the trader by mutually agreeing on the electricity price. According to the electricity trade register of the Public Utilities Regulation Commission (hereinafter referred to as the Regulator), 43 traders were registered for sale of electricity in November 2021.

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 2020, the average electricity price at the *Nord Pool* exchange was 34.05 euro/MWh. In 2020, due to the reduction in economic activity caused by the Covid-19 pandemic, as well as optimal weather, which contributed to generation of electricity from renewable energy sources, the price reduced by 26% compared to 2019. However, in the first 10 months of 2021, the average electricity price at *Nord Pool* exchange has rapidly increased to 73.00 euro/MWh. In the first 10 months of 2021, the highest average monthly price of energy was in September, when it reached 123.50 EUR/MWh. In Europe, the rise in electricity prices was mainly influenced by cold weather in winter and hot and dry weather in summer, the sharp rise in natural gas prices, the rise in carbon dioxide gas allowance prices as well as the economic recovery from the pandemic crisis. Simultaneous increase in electricity demand and low levels of electricity generation from renewable energy sources contributed to the demand for other energy sources increasing electricity generation in fossil fuel power plants, which in turn affected increase in emission allowances and fossil energy prices. Thus, the price increase affected all forms of electricity generation and reflected in electricity prices. According to the electricity market review data of the transmission system operator JSC Augstsprieguma tīkls for 2020, Latvia's total electricity consumption decreased by 2.2% compared to 2019 amounting to 7.1 TWh. From this amount, the share of electricity produced by Latvia was 77% in 2020. In 2020, compared to 2019, the amount of electricity produced by combined heat and power plants (hereinafter – CHPP) reduced by 38.4% affected by much worse weather conditions at the beginning of the year.

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 licences in total to distribution system operators, of which 99% of services in the territory of the state are provided by JSC Sadales tīkls.

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 Public Utilities Commission approved the new tariffs of the distribution system services of JSC Sadales tīkls, which will be in force from 1 January 2020 and until 2024 inclusive. Thus, the variable components of differentiated tariffs (fee for distribution of electricity) reduced – by 8% on average. The component for the provision of the connection fee (fixed fee) has remained unchanged. JSC Sadales tīkls was able to reduce the tariff thanks to the efficiency improvement programme initiated in 2017, which will continue until 2022. Despite the current increase in electricity prices and reduction in electricity consumption, the solution has been found together with JSC Sadales tīkls for not increasing tariffs of electricity system services in 2022, thus not causing additional load for businesses, local governments and households.

One of the most important topics in the electricity market still is **integration and synchronisation of electricity networks of Baltic States with the European network** (hereinafter referred to as the synchronisation project), work on which started in 2007, when Prime Ministers of the Baltic countries proposed the idea to investigate into such an opportunity. This project is at the top of the EU energy policy agenda, and is one of priority projects not only at the level of Baltic countries, but also at the EU level, because by construction of additional electricity interconnections it improves functioning of the EU's internal energy market and facilitates the achievement of goals of the Energy Union. The synchronisation project is part of the total EU integration process, the implementation of which is intended until the end of 2025.

Within the framework of the synchronisation project, energy systems of Baltic countries will start functioning in a synchronous mode with the network of the Continental Europe, at the same time disconnecting from the IPS/UPS (Russian and Belorussian energy system) network. Internal electricity trade between Russia and Belarus, as well as other CIS countries, which jointly with the Baltic countries form BRELL (abbreviation of *Belarus, Russia, Estonia, Latvia, Lithuania*), and fluctuations of their power system modes and accidents technically affect and strain the electrical transmission network of the Baltic states by limiting their ability 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 to find the most cost-effective solution. The project aims to reconstruct and build internal infrastructure of each Baltic country, as well as to construct a new *Harmony link* submarine direct current cable between Lithuania and Poland.

On 27 May 2019, the agreement on connection of electricity systems to the network of the Continental Europe entered into force. In order to continue advancement to the completion of the synchronisation project by the end of 2025, EC in cooperation with the Baltic countries and Poland drafted a roadmap on further implementation of the synchronisation project from the political point of view. At the meeting of 18 June 2019, CM confirmed Latvia's commitment to continue the synchronisation project and delegated the Prime Minister Krišjānis Kariņš to sign the political roadmap at the European Council meeting on 20-21 June 2019.

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 mln euro. The total costs of measures of the first phase of the synchronisation project of the Baltic countries is 430.39 mln euro, of which 75% or 322.79 mln euro will be covered from the CEF funding, while other costs will have to be covered by electricity transmission system operators of Baltic countries. Co-funding of 57.75 mln 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 by the European Commission on 1 October 2020. Therefore, the Baltic States will receive 719 mln EUR co-financing for the 2nd phase of synchronisation project, securing a significant portion of financing for all the infrastructure works necessary in the 2nd phase. In addition, the request for CEF funding of 178 mln EUR for the implementation of the 2nd phase was submitted to the European Commission in October 2021.

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. At the same time, the Latvian government urged the transmission system operator to develop a methodology for the calculation of electricity trade capacities to ensure preservation of electricity trade with third countries,

starting trading electricity through the already existing Latvian-Russian interconnector, which has recently not been used for commercial flows.

In order to ensure the organisation of electricity trade on the Latvian-Russian border, Estonian and Latvian public service regulators approved the methodology for calculating interstate trading capacity. The methodology took into account Lithuania's initial requirement not to use Lithuania-Belarus line capacity for trade with Russia, so the trading capacity on the Latvian-Russian border was reduced by 38%, i.e. by applying a factor of 0.62. In turn, in order to ensure that electricity flows from Belarus do not enter the Baltic States in transit through Russia, Latvia introduced a regulation, which stipulates that JSC Augstsprieguma tīkls is obliged to request a guarantee of origin from Russian authorities to certify that electricity imported from Russia was produced in Russia.
Since the Astravets NPP started operating in test mode on 3 November 2020 and Lithuania stopped trading electricity with Belarus, on 5 November 2020 Latvia opened the Latvian-Russian interconnector for trading electricity.

On 15 September 2021, Lithuania reduced the maximum total transfer capacity for electricity lines from Belarus to Lithuania, demonstrating its wish to ensure additional protection against inflow of electricity from Belarus into Lithuania. In response to this solution, on 13 October 2021 a new capacity calculation methodology approved by the Public Utilities Commission for trade with Russia entered into force in Latvia, cancelling the 0.62 factor that was applied so far and thereby increasing trading capacity volumes with Russia, which is being partly compensated by the reduction in Lithuania-Belarus cross-sectional capacity.

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, is currently 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, which, although of a highly seasonal nature, is characterized by a negative impact on the dynamics of electricity prices in the *Nord Pool* Latvian and Lithuanian bidding areas. In addition, the load 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 interconnector LitPol Link stage 1 with transmission capacity of 500 MW started its operation at the end of 2015. It is also supplemented by the Lithuanian-Swedish interconnector NordBalt with transmission capacity of 700 MW.

Part of the NordBalt project is the 330kV transmission line project Kurzemes loks implemented in the western region of Latvia, which started in 2010 and has been implemented in 3 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, which 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 mln euro were covered by CEF.

In the coming years, the development of electricity transmission infrastructure is one of planned priorities, which will promote closer integration of Latvia into the Baltic's electricity market, as well as will strengthen operational efficiency and interoperability of infrastructure.

Construction of the third Estonian-Latvian interconnection was also strategically important, which will allow eliminating 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. In March 2021, the third Estonia-Latvia interconnection was commissioned. Total costs of the third Estonian-Latvian interconnection was approximately 170 mln euro. The total project costs in the territory of Latvia were 79 mln euro. In November 2014, EU co-funding of 65% was granted for the construction of the third Estonian-Latvian interconnection from CEF funds (112 mln EUR).

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 authorization procedures, at the same time respecting the environmental assessment and protection standards. In Q4 2021, the EC included the synchronisation project and the Latvia-Sweden electricity interconnector 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 co-financing of the Connecting Europe Facility (CEF). At the same

time, attracting the CEF funding (CEF has 5.84 bln EUR 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 thsd families/persons) 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 in accordance with 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 (VUDIS), the controller of which is the State Construction Control Bureau. With regard to VUDIS – each electricity trader providing the service has a link to VUDIS so that after data exchange it allocates once a month a reduction for an electricity bill for those of its 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 has entered into force since 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 EUR support for electricity settlements. Large families receive a support of 10 EUR. However, considering the rapid increase in electricity prices in 2021, the regulation was immediately amended and from 1 November 2021 to 31 December 2022 the support to the above-mentioned groups of protected consumers was increased by 10 EUR (reaching 15 and 20 EUR depending on the group of protected consumers).

NATURAL GAS MARKET

Since April 2017, the natural gas market has been fully liberalised, which is mainly related to the purpose of creating an effectively functioning and integrated EU energy market, ensuring high flexibility of the system, competition among companies, competitive prices, as well as 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, namely, 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 2020 was 1115 mln m^3. In ten years (2011-2020), the share of natural gas has reduced by 8.7 percentage points and amounted for 20.6% in 2020. The drop in natural gas consumption was also accompanied by the drop in the volume of imported natural gas, which may be largely linked to the use of alternative fuel resources and facilitating energy efficiency measures. Despite the drop in its share, natural gas still occupies an important role 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. It should also be taken into account that natural gas consumption is always seasonal in nature, because, for instance, the demand for natural gas in 2020 is explained by comparatively low outdoor temperatures in months of the heating season.

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 between regulatory authorities, natural gas transmission system operators and ministries responsible for the 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 with Finland and Estonia. Amendments to the Energy 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 currently functioning with two balancing zones – the combined Latvian and Estonian balancing zone and Finland. At the same time, parallel work is ongoing on a single IT platform, 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 in the process.

The results of 2020 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, thus 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 the market providing benefits to all participants of this market, including consumers, urging 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 supply of natural gas, as well the creation of a highly liquid and integrated regional natural gas market in Latvia and in the entire Baltic region are considered to be one of the most important future priorities on the natural gas market. It is important to emphasise the need to continue work on provision of safe and accessible infrastructure, which corresponds to market conditions. In order to improve security of natural gas supply in the Baltic region and to create an effective market, there are plans to implement several projects (see Box 12.1).

Box 12.1

Projects for Improvement of Security of Natural Gas Supply and Creation of an Effective Market in the Baltic Region

GIPL interconnector of the Lithuanian-Polish natural gas supply systems

The purpose of GIPL is to connect Lithuanian and Polish natural gas transmission systems, ensuring connection of Eastern part of the Baltic natural gas transmission systems to the Central European natural gas transmission network. GIPL plays an important role in strengthening energy security of the region, because isolation of natural gas transmission systems of Baltic countries will be prevented by enabling access to the single EU natural gas market. GIPL also provides for ensuring alternative natural gas supply routes and access to new gas trading platforms. In the long term, the GIPL project might potentially increase the use of the Inčukalns underground gas storage facility and create other cooperation opportunities for Baltic countries and Poland. The GIPL interconnector will cover 357 km in the territory of Poland and 165 km in the territory of Lithuania. Transmission capacities PL-LT will be 2.4 bln m^3/year and LT-PL 1.9 bln m^3/year. The implementation of the GIPL project is an important stage in the achievement of EU energy policy goals – creation of a single energy market at EU level, as well as creation of the European Energy Union. Taking into account the role of GIPL in the region, it is important that the project is implemented by the end of 2021.

Latvian-Lithuanian interconnector's modernisation project

At present, there are already flows in both directions in the Latvian-Lithuanian interconnector. Last year, 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. The study identifies 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 up approximately 130 GWh/d in the Latvian direction and to 119 GWh/d in the Lithuanian direction. The planned investments are 10.3 mln euro, of which 4.7 mln 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 has the only natural gas storage facility and an important strategic site 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, including the active natural gas volume of approximately 2.3 billion m^3, thus fully securing 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 European Commission allocated 50% co-funding for it (the total project investments amount to 88 million euro) from CEF funding. The implementation of this project intends to improve technical infrastructure of UGSF, operational flexibility of the storage facility and safety of operation of equipment.

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 project for synchronisation of electric networks of 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.

Cyber security is one of challenges in the natural gas sector that are increasing 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 in cyber security matters may significantly improve cyber security of the entire industry.

12.2. PROMOTING ENERGY EFFICIENCY

The Latvian government has set[1] 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 – 500.0 thsd m^2).

The main task of implementation of energy efficiency improvement measures is to limit an increase in final consumption of primary energy sources and energy. In accordance with the indicative energy efficiency target achievement trajectory, the Latvia's total primary energy consumption in 2020 should not exceed 225 PJ and the final energy consumption in 2020 should not exceed 187 PJ.

Energy savings for end consumers are obtained through financial support programmes for energy efficiency of residential public and production buildings and public lighting. The measures taken by the parties responsible for the energy efficiency duty scheme and the measures stated in mandatory energy audits and introduced by companies have also made a contribution to advancement to state energy efficiency targets.

Energy efficiency of companies is one of foundations of increase in EU competitiveness, therefore, since 2015 all large companies of the EU are obliged to conduct regular energy audits.

The *Energy Efficiency Law* provides that large companies and companies with energy consumption above 500 MWh two calendar years in a row should conduct an energy audit or introduce a certified energy management system, as well as implement energy efficiency measures with the highest energy saving or economic pay-off.

By November 2021, approximately 887 Latvian companies have conducted an energy audit, or have introduced a certified energy management system according to ISO 50 001.

As a result of the audit, the companies have identified the possibilities for improvement of their buildings, introducing energy efficient lighting, production equipment and transport. Effective use of energy will allow companies to save costs, as well as will help Latvia to reach its energy efficiency targets.

From 2014-2018, the accumulated final energy saving obtained as a result of implementation of energy improvement measures until 2020 was 6959 GWh or 70% of the mandatory cumulative target (9896 GWh). In order to ensure the fulfilment of the accumulated final consumption target, an assessment of the accrued energy saving was carried out in 2020 based on up-to-date information on promotion and regulatory measures adopted by state and local governments, which improve energy efficiency. The information on the accumulated final energy saving obtained as a result of implementation of energy improvement measures in 2014-2020 will be updated in 2022.

Taking into account that from 1 January 2020 maintenance of the energy efficiency monitoring system is transferred to supervision by the State Construction Control Bureau, it is expected that collection, summarising, serving of information and calculations will improve within the scope of the monitoring system.

[1] *National Energy and Climate Plan of Latvia 2021-2030.* Riga, 2020. https://likumi.lv/ta/id/312423-par-latvijas-nacionalo-energetikas-un-klimata-planu-20212030-gadam.

In 2018, EU Member States agreed that they should reach an increase of energy efficiency by 32.5% by 2030. Therefore, each Member State should contribute to reaching of this target, as well as observe the horizontal principle "energy efficiency first" in its development planning. This principle is included in the *National Energy and Climate Plan*.

Latvia defined in its *National Energy and Climate Plan* that a preferable situation in heating by 2030 is promoting the development of a district heating system (hereinafter referred to as DH) wherever technically and economically feasible. More renewable energy source technologies (in particular zero-emission technologies) should be used. More central and individual cooling should be introduced. If the development of DH is promoted, benefits for economy and society would increase – the performance of DH systems would significantly improve, the continuous heating supply at appropriate costs would be ensured and heating costs for consumers would be reduced. Effective district heating would ensure improvement in air quality and increased comfort of the population. The impact of heating generation on climate change would reduce and the decarbonisation of heating and cooling would be promoted.

Several programmes supervised by the MoE are currently being implemented to support energy efficiency (see Box 12.2).

Box 12.2

Support Programmes for Improvement of Energy Efficiency (Conditions as at November 2021)

Energy efficiency programme for multi-apartment houses:

- 989 projects requesting ERDF funding of 201 mln euro were submitted to the Development financing institution Altum;
- 415 positive decisions on granting of grants were taken;
- the implementation of 290 projects has completed, 98 projects are being implemented, incl. at the construction stage;
- 87 Altum loans for 15.4 mln euro were issued;
- 207 guarantees for 37.3 mln 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 thsd tons.

Energy efficiency programme for private houses:

- 243 projects requesting funding of 1.46 mln euro were approved for the Development financing institution 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:

- 134 project applications requesting ERDF funding of 104.3 mln euro were received;
- the implementation of 69 projects requesting ERDF funding of 40.6 mln euro has been completed;
- the total area of state-owned buildings, which will be renewed within projects – 115,162 m^2;
- the annual average energy consumption of the buildings after a year of implementation of the project – 110 kWh/ m^2.

Energy efficiency programme for production buildings:

- 73 agreements for Cohesion Fund funding of 20.20 mln euro were concluded;
- the implementation of 39 projects for Cohesion Fund funding of 9.61 mln euro has been completed.

The following indicators will be achieved within the framework of approved projects:

- annual energy savings – 169.6 GWh;
- installed capacity of renewable energy sources (heating boilers + solar collectors) – 9.5 MW;
- annual CO2 reduction – 22.5 thsd tons.

Energy efficiency programme for the district heating system:

- 97 agreements for Cohesion Fund funding of 48.79 mln euro were concluded;
- the implementation of 74 projects for Cohesion Fund funding of 26.10 mln euro has been completed.

The following indicators will be achieved within the framework of approved projects:

- additional installed capacity of renewable energy sources – 9.31 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 CO2 reduction – 163.03 thsd tons.

12.3. ENERGY FROM RENEWABLE SOURCES

On 4 February 2020, CM approved the *National Energy and Climate Plan of Latvia 2021-2030* (hereinafter – NECP), which sets the main action policies and measures for the fulfilment of greenhouse gas (hereinafter – GHG) emissions reduction targets and energy policy targets – ensuring the renewable energy share (hereinafter – RES) and improving energy efficiency, at the same time setting targets and action policies in other dimensions of the Energy Union – internal energy market, energy security and innovation, competitiveness and research. In 2020 – 2021, work on the implementation of NECP started by developing necessary changes to regulatory enactments and by developing a support programmes, for example, for the improvement of energy efficiency of multi-apartment buildings and private houses, purchasing of electric vehicles and other conditions.

On 16 April 2020, Amendments to the Alternative Fuel Infrastructure Development Plan for 2017 – 2020 were approved, which set short-term more efficient measures, which, inter alia, ensure a reduction of GHG emissions from transport.

On 5 October 2021, the Transport Development Guidelines 2021-2027 were approved setting out action policies and measures in the transport sector, which, among other things, will ensure the fulfilment of GHG emission reduction targets and energy policy targets.

CONSUMPTION OF RENEWABLE ENERGY SOURCES

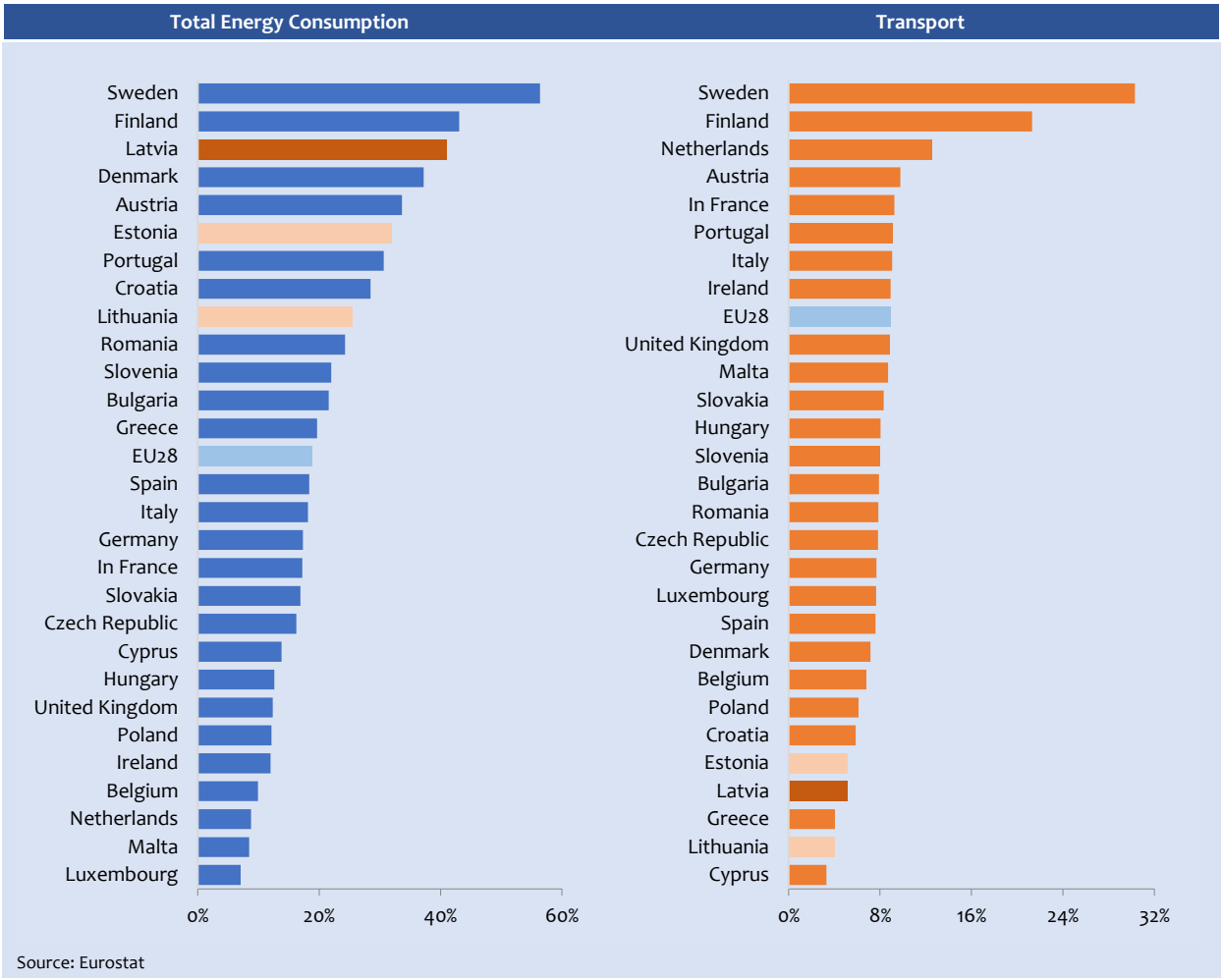
The National Reform Programme of Latvia for the implementation of Europe 2020 strategy and also the *Energy Development Guidelines for 2016-2020* sets national targets for 2020 – to achieve a 40% share of RES in the gross final energy consumption and a 10% share of renewable energy in the transport sector final consumption. Latvia has the 3rd highest share of renewable energy in the final energy consumption in the EU. It was 41.97% in 2019 (the EU average is 19.7%), which means that Latvia has exceeded the target set for 2020 – 40%. Furthermore, in the transport sector the share of renewable energy reached 5.1% in 2019, which is significantly lower than the EU average of 8.9% and significantly lower than the EU target of 10% for 2020 (see Figure 12.1).

In 2020, the consumption of RES was 74.4 PJ. The main type of RES in Latvia is woodfuel (firewood, wood residues, woodchips, wood briquettes, wood pellets) and hydroenergy. In 2019, the share of woodfuel in the total consumption of RES was 79.2% (82% in 2019), while in 2020, compared to 2019, the volume of electricity generated at hydropower plants, wind power plants and solar power plants, and microgenerators increased by 23%. The small reduction in the consumption of RES in 2020 was affected by a small reduction in the use of biogas in the transformation sector and in the use of biomass in the final energy consumption, at the same time, taking into account the much bigger reduction in total energy consumption, the share of RES in the total energy consumption continued to grow.

In 2020, Latvia produced 5725 GWh of electricity, 3,650 GWh of which were made of RES. Volumes produced from RES increased by 14.3% compared to 2019. Last year, cogeneration plants produced 2940 GWh of electricity, 29.4% of which were produced from RES (biogas and biomass cogeneration plants). Primary electricity produced from RES increased by 23% or 520 GWh in 2020, compared to 2019. In 2020, HPP produced 2,603 GWh of electricity, which is 23.4% or 495 GWh more than in 2019. Wind power plants (WPP) produced 177 GWh in 2020, which is 14.9% or 23 GWh of electricity more than in the previous year, while solar power plants produced 5 GWh of electricity, which is 66.7% more than a year ago.

Figure 12.1

The share of Renewable Energy in Different EU Member States in 2019
percentage in final energy consumption



Source: Eurostat

SUPPORT FOR ACQUISITION OF RENEWABLE ENERGY SOURCES

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. Starting from 1 January 2018, the costs raising from capacity payments to cogeneration power plants are attributed to end consumers in proportion to their system connection parameters, while the costs for electricity purchased within the scope of mandatory electricity procurement are distributed in proportion to the electricity end consumption.

MoE is constantly reviewing and looking for solutions for the improvement of the existing support mechanism, and its policy has been aimed at the reduction of the mandatory procurement component (hereinafter referred to as MPC) for end users of electricity. In 2014-2017, MPC was 26.79 EUR/MWh, from 1 July 2018 it reduced to 22.68 EUR/MWh[1], while from 1 January 2021 the decisions adopted by the government allowed for the reduction of the MPC rate to 17.51 EUR/MWh. Thus, in 2021, MPC payments of households and businesses reduced by an average of 23%. In order to promote competitiveness of energy-intensive manufacturing companies at export markets, from 2017 industry companies are entitled to a reduced participation in the MPC payment[2]. On 22 December 2020, CM adopted the decision to extend for a year, until 31 December 2021, the period, for which energy-intensive manufacturing industry companies may apply for MPC reduction. Considering that previously the support could be received by a much narrower range of industries than the conditions of the European

[1] From 1 January 2019, the average value of the mandatory procurement and capacity component remains at the same level – 22.68 EUR/MWh https://www.sprk.gov.lv/content/tarifi-1

[2] Information about aid granted to companies is published on the website of the Ministry of Economics: https://www.em.gov.lv/lv/nozares_politika/atjaunojama_energija_un_kogeneracija/atbalsts_energoietilpigiem_apstrades_rupniecibas_uznemumiem/

Commission permitted, as well as impact of the Covid-19 crisis on companies, the scope of manufacturing industries that are supported was extended.

IMPROVEMENT OF LEGISLATION

In the field of legislation, the process of improving the legislation governing mandatory electricity procurement system continued in 2021. Following the legislative authorization granted in the Amendments to the *Electricity Market Law* adopted by the Saeima in 2020, MoE worked on amendments 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". The purpose of the amendments is to improve the methodology for the calculation of the prevention of overcompensation of power plants, to define the conditions for the application and control of the principle of the single technological cycle of power plants, and to define the procedure for the termination of support, when the total support period reaches 20 years. These amendments are considered to be the final stage of the extensive process of adjusting the mandatory electricity procurement system, which included both the improvement of the regulatory base and the strengthening of the supervision and control of support recipients.

MoE gradually contributes to the development of electricity self-consumption by working on improvements to the electricity net accounting system (hereinafter – NETO system). The NETO system, which has been functioning in Latvia from 2014, is offered to the electricity producers, which produce electricity for self-consumption using RES, such as solar panels or wind turbines. It provides the possibility to transfer the excessive electricity produced to the electrical network and use it again, when necessary. In spring 2020, first changes to the NETO system entered into force – the payment of the variable part of MPC was cancelled for the amount of electricity, which the participant of the NETO system transfers to the electrical network and receives back within one year.

In 2021, further review and modernisation of the NETO system continued by working on the draft amendments to the *Electricity Market Law*. The amendments provide for the extension of the current NETO system, among other things by introducing the so-called remote self-consumption possibility – determining that electricity generated in one user's object within the NETO system can be used in other objects of the same user. Until now, the NETO system has only been offered to households, but the amendments also aim to open it up for legal persons to provide an opportunity for small companies to reduce costs of electricity. Other improvements are also envisaged, which should make the installation and use of electricity generation facilities more cost-effective, thereby reducing their pay-off period.

In 2021, amendments to the *Energy Law* and the *Electricity Market Law* were drafted and forwarded for approval in order to determine 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.

A new "Transport Energy Law" was drafted and forwarded for approval in 2021, which will impose on fuel suppliers the renewable transport energy implementation obligation and to 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 national cities and on the transport used by the municipalities of national cities. This will ensure compliance with Latvia's binding RES targets for transport, as well as will make a significant contribution to the reduction of GHG emissions and emissions of air pollutants in the transport sector.

12.4. REDUCING GREENHOUSE GAS EMISSIONS

Over the last decades, climate has changed the fastest in the history of instrument meteorological observations, and the temperature is expected to increase even faster in the 21st century 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 12.3).

Box 12.3

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.

A common EU GHG emission reduction target has been set within the EU, and it is divided 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:

- 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).

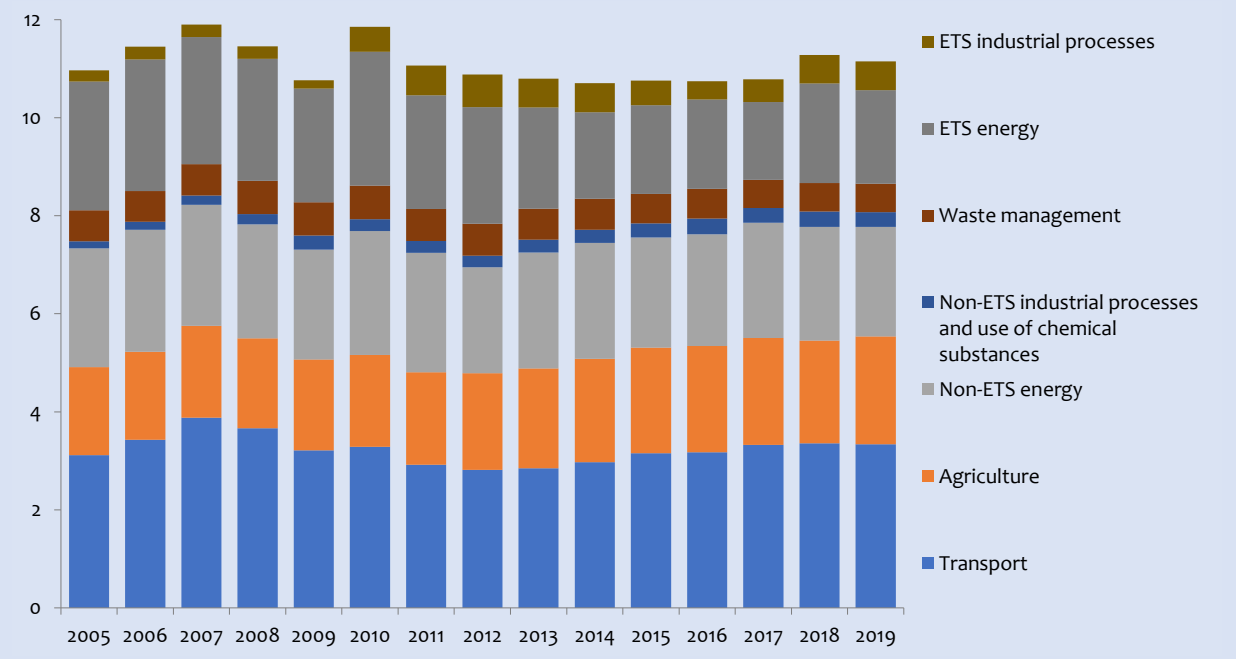
Enforcement of the **EU ETS target** is the responsibility of the EC. In order to meet this target, conditions for the operation of EU ETS and the responsibilities of EU ETS operators have been approved by EU legislation. Measures for reduction of the amount of GHG emissions of EU ETS operators are set in a harmonised way in the *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 are redistributed among all EU Member States, including Latvia. For the period from 2013 to 2020 the target of each EU Member State and its fulfilment conditions are set in *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 permitted to increase the amount of Latvia's non-ETS GHG emissions by no more than 17%. In the period from 2021 to 2030 Latvia should reduce GHG emissions from non-ETS activities by 6% in comparison with 2005. The target for the entire period is divided into binding annual targets.

According to the 2021 GHG inventory for 1990–2019[1] (hereinafter – 2020 GHG inventory) and a rough GHG inventory for 2020[2], total GHG emissions of Latvia from 1990 to 2019 and 2020 have reduced by 57% and 59.6% respectively, while in the period from 2005 to 2019 (see Figure 12.2) and 2020 total GHG emissions of Latvia increased by 1.7% and reduced by 4.5% respectively. Latvia's total GHG emissions in 2019 amounted to 11,144.3 kt CO2 eqv. but approximate GHG emissions in 2019 – 10,466.3 kt CO_2 eqv.

Figure 12.2

GHG emission trends from non-ETS and ETS activities from 2005 to 2019[3]
thsd kt of CO2 eq.



[1] Available at: https://unfccc.int/documents/227704
[2] Available at: https://cdr.eionet.europa.eu/lv/eu/mmr/art08_proxy/envxwuuw/
[3] The data of 2018 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 European Commission and the Secretariat of the UN Framework Convention on Climate Change. In this section, the approximated GHG inventory data for 2018 are included for approximate description of the situation in 2018.

In 2019, non-ETS GHG emissions dominated in the total amount of GHG emissions of Latvia with 77.7%[1]. The estimated share of GHG emissions from non-ETS activities in the total amount of GHG emissions of Latvia in 2020 was larger – 80.7%. GHG emissions generated by Latvian ETS operators in 2019 amounted to 2,493.1 kt CO_2 eqv., but in 2020 – 2,022 kt CO_2 eqv. or 22.4% or 19.3%, respectively, of Latvia's total GHG emissions.

The development of GHG emissions from non-ETS activities suggests an increase of emissions by 6.8% from 2005 to 2019 and by 4.2% from 2005 to 2020. Overall, until 2020 Latvia was within the annual targets set for non-ETS activities in *Decision No 406/2009/EC*[2]. 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.

In 2019, the biggest source of GHG emissions was energy (31.9% of total GHG emission without land use, land use change and forestry sector) followed by transport (29.9%) and agriculture (19.8%), the rest was industrial processes and product use and waste management. In 2019, total emissions of the energy sector (including transport) reduced by 61.8% in comparison with 1990, and by 4.2% in comparison with 2005.

On 28 February 2020, the informative report "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] The non-ETS activities subject to Decision 406/2009/EC, the calculation of GHG emissions has been carried out using the formula defined by the European Commission – total GHG emissions minus amount of CO_2 emissions verified by EU ETS operators minus local aviation CO_2 emissions

[2] Available at: https://eur-lex.europa.eu/legal-content/LV/TXT/PDF/?uri=CELEX:32009D0406&from=EN

13. CONSTRUCTION POLICY

The construction sector operated in conditions of major turbulence caused by a number of global processes, events and trends (see Box 13.1).

Box 13.1

Conditions affecting the construction sector

The Covid-19 pandemic has had a significant impact on the global economy as a whole, negatively affecting the production processes of goods, including construction products, as well as logistics chains, delaying deliveries of construction products and hindering the availability of individual construction products. Epidemiological restrictions and measures to reduce the spread of the pandemic have an impact on the availability of labour force delaying both production processes and global transport flows. Moreover, given that most countries of the world, like Latvia, have chosen to heat the economy and mitigate the consequences of the Covid-19 pandemic by investing in infrastructure, aid programmes for economic recovery cause to a rapid increase in demand for construction materials that is significantly above their supply. This in turn leads to a sharp rise in prices for construction materials.

Other factors unrelated to the Covid-19 pandemic are also contributing to the rise in prices of construction materials. Ecological problems such as forest fires, spreading pests and diseases significantly hamper the availability of raw materials, and prices of wood products increased several times in spring and summer 2021. Similarly, the rise in prices of certain categories of construction materials was driven by a sharp rise in energy prices.

Although the price of wood as a raw material has returned to the level of the beginning of 2021, the prices of construction products continue to rise, this has an impact on the development of the construction sector in the coming years and makes it considerably more difficult to forecast prices of construction works and the development of the construction sector.

Despite the difficult conditions, a sound government policy has managed to maintain a stable turnover in the construction sector and avoid a sharp drop in the output of construction products in 2021. In Q3 of 2021, compared to Q3 2020, the output of construction products decreased by 3.3%, according to calendar-adjusted data at constant prices. The increase in the output of construction products occurred in all civil engineering sectors – by 4.8% in construction of roads and railways, by 3.4% in construction of utility projects and by 3.5% in construction of other civil engineering projects. Declines in products have been observed in the other construction sector. In the nine months of 2021, the output of construction products decreased by 4.1%, according to calendar-adjusted data, including by 11.3% in construction of buildings, by 0.9% in specialised construction activities, and increased by 0.6% in civil engineering.

Given that the construction sector plays a major role in heating the economy and in mitigating the consequences of the Covid-19 pandemic, inflow of cash into the construction sector is expected in 2022-2027. Construction will involve at least 30-40% of investments from total public funding available in the coming years (see Box 13.2).

Box 13.2

Construction projects and public funding

Distribution of total available public funding:

- Continuation of the absorption of the Cohesion Fund 2014-2020 (1698 projects underway for 3.8 bln euro (+589 mln euro in 2019) – 85.6% of the total investment of EU funds amounting to 4.4 bln euro;
- 2.062 bln euro – state aid to mitigate the effects of the Covid-19 pandemic;
- 2.2 bln euro– state budget funding under the NDP;
- 272 mln euro – recovery aid for cohesion and European territories – REACT-EU programme;
- 1.993 bln euro – European Recovery and Resilience Funding – RRF, investments to mitigate the effects of the long-term Covid-19 pandemic in the economy, the transition to the green and digital economy;
- 198 mln euro – Just Transition Fund (JTF), investments for the economic diversification of the areas most heavily affected by climate change;
- 4.63 bln euro– Cohesion Policy Instruments – ERDF, ESF+, CF, the largest amount of funding for comprehensive investment under NDP 2021-2027 measures;
- 2.962 bln euro– other foreign funding – requested funding for transport, climate, energy, education and digital solutions, including the construction of Rail Baltica.

In view of the fact that cyclicality was significantly hampering the development of the construction sector in the past, the rapid growth of volumes was replaced by equally sharp drops in volumes, the Ministry of Economics 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 13.3).

Box 13.3

On expected changes in costs of labour force and construction materials in the construction sector and their impact on the economy

Every year, the Ministry of Economics conducts the study *On expected changes in costs of labour force and construction materials in the construction sector and their impact on the economy.* The study includes an assessment and analysis of the factors affecting the costs of labour and construction materials, including an assessment of shares of both direct and indirect impact indicators, including measures to combat the shadow economy, lending, availability of funding and labour, and the impact of the Covid-19 pandemic. The study also assesses the impact of external factors, as well as the decisions taken by the EU and global common market and by the EU.

On the basis of the information and assessments collected over time from 2020 to 2021, this September it can be concluded that construction volumes and costs will continue to grow by 6.6% in 2021 and by 5.6% in 2022. The risks of overheating construction are significantly lower than in 2006-2008. Consequently, the experts in that study do not see any significant reasoning not to pursue the public construction plans that have been launched and planned. The study can be found on the website of the Ministry of Economics https://www.em.gov.lv/lv/buvniecibas-sector-attistiba-strategia-un-petijumi. At the same time, it should be noted that the study was carried out in summer 2021, before the third wave of Covid-19 began in Latvia and the world, and before strict epidemiological measures were re-introduced, the results of the study show overall trends and they should be adjusted in line with current development trends in the global economy.

The Ministry of Economics continues to take targeted measures to boost the competitiveness of the construction sector and to improve quality. In order to ensure the quality of the construction process, it is important to further improve the regulatory framework in the field of construction. In 2021, the Saeima approved amendments to the *Construction Law* relating to the strengthening of responsibility of participants of the construction process. The Ministry of Economics has developed a number of amendments to the *General and Special Construction Regulations*, as well as improved and updated provisions of construction standards (see Box 13.4).

The construction sector has been affected by decision No. 22 of the Competition Council of 30 July 2021 "On statement of a violation and the imposition of a fine", by which the Competition Council stated a violation of the prohibition specified in Section 11(1) of the Competition Law and Section 101(1) of the Treaty on the Functioning of the European Union in the activities of 10 largest Latvian construction undertakings, and due to the stated violation a penalty was imposed on each construction undertaking corresponding to its involvement and role. 8 out of 10 construction undertakings disagreed with the decision of the Competition Council and appealed the decision of the Competition Council to the Economic Court.

Box 13.4

Significant legislative initiatives in 2021

Amendments to the **Construction Law** (entered into force on 19 May 2021):

- the regulation regarding the responsibility of the participants in the construction process has been significantly improved, distinguishing the responsibility of the participant in the construction process as a legal person and a certified construction specialist as a natural person, the scope of responsibility of each participant in the construction process, including the construction initiator, has been clearly defined, avoiding overlapping of responsibilities;
- the competence, rights and obligations of the authorities controlling construction have been clarified;
- the regulation for obtaining the information necessary for carrying out the architectural and structural design and the responsibility for the sufficiency of the information;
- the tacit consent principle has been introduced.

On 3 June 2021, amendments to the **Construction Law** providing for the introduction of strict liability of the construction initiator for damage to the life or health of third parties or damage caused to their property, have been submitted to MoSS for coordination. At the same time, a draft law **Law on Mandatory Insurance of Civil Liability in Construction** has been transferred for coordination, which is an instrument for enforcing the strict liability of the construction initiator, ensuring meaningful protection of third parties in the construction process.

Amendments to CM Regulations No. 500 of 19 August 2014 on the **"General Construction Regulations"** (entered into force on 1 November 2021) –the existing breakdown of structures into groups has been updated and revised.

Amendments to CM Regulations No. 529 of 2 September 2014 **"Construction Regulations for Buildings"** (entered into force on 1 November 2021) –harmonisation of renewal and reconstruction of buildings and their parts is simplified for faster and more efficient construction process and reduction of administrative burden and costs.

Amendments to CM Regulations No. 253 of 9 May 2017 **"Construction Regulations for Individual Engineering Structures"** (entered into force on 1 November 2021) – simplification of harmonisation of renewal and reconstruction of engineering structures has been simplified for faster and more efficient construction process and reduction of administrative burden and costs. These regulations also apply to electricity structures, and consequently the provisions of CM No. 573 of 30 September 2014 "Construction regulations for structures for electricity generation, transmission and distribution structures" were repealed.

Amendments to CM Regulations No. 633 of 14 October 2014 **"Construction Regulations on Roads and Streets"** (entered into force on 1 November 2021) – harmonisation of renewal of municipal roads, streets, merchants' roads is simplified for improved process of construction of merchants' roads, cycleways and footways and for faster and more efficient construction process and reduction of administrative burden and costs.

Box 13.4 continued

Amendments to CM Regulations No. 501 of 19 August 2014 **"Procedure for the Installation, Construction and Supervision of Electronic Communications Networks"** (announced by MoSS on 10 June 2021) – the established procedures are revised to provide more convenient solutions in the construction information system by reducing the types of construction concept applications, as well as to eliminate the shortcomings identified in practice.

The General Construction Requirements **construction standard LBN 200-21** (entered into force on 1 November 2021) combined two significant construction standards on design for residential buildings and public buildings creating a single common and mutually agreed construction standard on common requirements for the design of all structures. Requirements for fire safety, internal engineering networks and electromobility were transferred from construction standards for residential buildings and public buildings, thus amending the related construction standards – LBN 201-15 "Fire Safety of Structures", LBN 221-15 "Internal Water Pipeline and Sewerage of Buildings", LBN 231-15 "Heating and Ventilation of Residential and Public Buildings" and LBN 261-15 "Internal Wiring of Buildings".

Amendments have been made to the Latvian construction standard **LBN 003-19 "Construction Climatology"** (entered into force on 1 May 2021) updating all climatic data that have not yet been updated on meteorological conditions in Latvia during the period from 1989 to 2018, thereby providing the construction specialists with more up-to-date data applicable to engineering survey, design of buildings and performance of construction works.

On 1 January 2021, amendments to Latvian construction standard **LBN 016-15 "Construction Acoustics"** entered into force with a new requirement stating that starting from 1 January 2021 sound insulation measurements for not less than three inspection structures for second and third group multi-apartment residential and public buildings should be made in order to assess insulation properties of structures.

"Design of Structures" **construction standard LBN 001-21** has been prepared with a view to combining eight Latvian construction standards for the design of concrete, steel, stone, wood, steel and concrete composite, aluminium, seismically resistant structures, as well as geotechnical design in one regulation, and improving them.

On 4 June 2021, amendments to CM Regulations No. 169 **"Rules of Evaluation of Competence of Construction Specialists and Supervision of Independent Practice"** have entered into force, which provide for incentives for professional improvement for construction specialists who obtained the education specified in Section 13 of the Construction Law after 1 October 2014, reduce fragmentation in the fields of electricity and electronic communications and networks, as well as the right of the competence assessment body to take into account the scientific pedagogical work of the person and to include it into the independent practice of the construction specialist, thereby facilitating the involvement of a qualified teaching staff in scientific pedagogical work.

The draft CM Regulations **"Regulations on Mandatory Provisions for Public Procurement Contracts for Construction Works and Their Content"** were announced in January 2021 by MoSS and the harmonisation of the draft regulations has started. The draft regulations provide for the introduction of uniform provisions on acceptance of construction works, and payment, as well as uniform provisions on reinforcing of contractual obligations to be included in each contract for construction works under a public procurement without changing their content. The introduction of uniform acceptance and transfer conditions for construction works, a payment procedure and contract performance guarantees will contribute to the transparency of the process of public construction works, reduce the risk of corruption and the implementation of unsuccessful processes.

In 2021, **informative material on decentralised ventilation systems, their prices and installation costs** was prepared and recommendations for complex requirements for ventilation and heating systems to be included in the design task were developed, taking into account the interaction and interlinking of all engineering systems.

At the same time, in order to reduce future violations of competition law, having examined the MoE information report "On the impact of the Competition Council Decision No. 22 of 30 July 2021 "On statement of a violation and the imposition of a fine" and proposals to mitigate the risk of violation of competition law", the Latvian government approved complex measures to promote competition and limit the shadow economy in the construction sector. The plan of measures approved by the government can be read on the MoE website.

DIGITALISATION THE CONSTRUCTION SECTOR

The digitisation of the construction sector continues. On 28 August 2020, the implementation of the ERDF project "Construction process and information system development (round 1)" ended. Several processes have been improved/developed within the framework of the project – the most important are the process of examining and coordinating construction concepts and building designs and the process of supervising the construction process. Participants in the construction process, the bodies controlling construction, as well as other bodies and persons related to the construction process were provided with an opportunity to perform all activities related to the implementation of the administrative process on an electronically convenient and easily accessible platform of the construction information system. From 1 January 2020, with a transition to the electronic construction administrative process, the construction information system is used to initiate construction, obtain a construction permit, request and receive technical and special regulations, submit a building design, obtain all necessary coordinations and acceptances, initiate the commissioning of a structure, and receive a statement on commissioning of a structure.

The implementation of round 2 of the ERDF project started in 2020 and continued in 2021. 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 have been improved.

In 2021, the construction information system has been improved – the process of supervision of operation of structures (establishment of a structure operation file, creation of a house file, Register of Residential House Administrators, statement regarding non-existence of a structure), the process of managing the energy performance of buildings, the process of submitting and coordinating a construction concept and a building design (coordinations from third parties), the construction monitoring process (construction works log, registration for construction waste), notification and information (reports from managers to owners, system notifications to administrators and owners, use of VEDLUDB data in construction boards and authorities for verification of competence of construction specialists), as well as integration with other systems (Register of Enforcement Cases, Spatial Development Planning Information System, Single Electronic Working Time Registration Database, Real Estate State Cadastre Information System, State Unified Computerised Land Register, Waste Transportation Registration System, Information System of the Register of Natural Persons, etc.).

BUILDING INFORMATION MODELLING

The Ministry of Economics continues to implement the measures provided for in the **building information modelling** (BIM) road map. The implementation of BIM in Latvia is essential to increase 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 consists of modern and transparent construction processes aimed at quality and more efficient use of public funding in construction procurements.

A work group was created in 2019 representing national regulatory authorities, capital companies, education institutions, non-governmental organisations of the construction sector for the development of a BIM roadmap. The BIM roadmap is a document describing BIM implementation goals, the most essential benefits and priority tasks. The roadmap has been developed to promote common understanding of the goals to be reached and necessary tasks for implementation of BIM, as well as promotion of public leadership and political support in the implementation of BIM in Latvia.

The BIM roadmap lays down main action lines necessary for its successful implementation in the construction sector – development of standards, guidelines and regulatory requirements to increase competence of new and existing construction specialists in work with digital tools, identification and demonstration of examples and good practices. Non-governmental organisations, education and state institutions have expressed their support to the measures included in the BIM roadmap by signing the BIM roadmap[1] in December 2019.

From 2019 to 2021, several tasks set in the BIM roadmap were fulfilled, including in 2019 guidelines for employers and the construction sector for setting BIM requirements in public procurements and guidelines for BIM consultation procurements were developed (available at: https://www.vni.lv/lat/projekti/bim_kompetences_centrs/?doc=1160), standards of the ISO 19650 series were taken over, a study of the necessary investments for the implementation of BIM in companies was conducted, as well as training materials on BIM modelling, BIM management and BIM coordination were drafted (available at: https://www.lvs.lv/page?slug=bim).

In 2020 and 2021, consultations were provided to public contracting authorities on the application of BIM guidelines in public procurements, training for construction specialists on BIM modelling, BIM management, BIM coordination, BIM implementation in companies and 2D scanning was conducted, as well as several studies were conducted – a study of the definition of BIM indicators for evaluation of benefits of BIM and good practices in the implementation of BIM projects in Latvia were identified, a study on the evaluation of the Construction Classification System in BIM projects and a study on the common data environment (CDE) and requirements for ensuring it in public construction procurements to be implemented in the BIM environment.

[1] https://www.em.gov.lv/lv/buvniecibas-informacijas-modelesana-bim

STANDARDS OF PROFESSIONS IN CONSTRUCTION AND CONSTRUCTION STANDARDS

In 2021, standards of professions in construction "Building Construction Engineer" "Construction Engineer of Engineering Systems" and "Construction Engineer" were revised by introducing modern and construction digitalisation related skills and competences, it will therefore be possible to improve study programmes in construction.

Construction Standard on Technical Inspection of Structures LBN 405-21 (entered into force on 1 November 2021), redrafting the previous regulation LBN 405-15 "Technical Inspection of Structures", as a number of significant shortcomings have been stated over time in the practice of observing and application of the construction standard – the construction regulation did not include a single regulation on the technical inspection of structures, it was unclear what kind of structures it covered. The regulation included in LBN 405-15 "Technical Inspection of Structures" leads to a situation where in most cases only visual inspection of the structure is carried out, rather than an assessment of its actual technical state of the structure, the construction standard contains an incomplete list of methods, which will not be sufficient in all cases to carry out a complete inspection of a structure. The new regulation includes requirements for the preparation of an inspection opinion in the Construction Information System, taking into account the development of the Construction Information System, ensuring compliance with the options offered by the Construction Information System. Consequently, amendments were made to the related regulation "Construction Regulations for Hydro-Technical and Amelioration Structures", clarifying the references to Article 9 of the Construction Law, insofar as it relates to the regulation for deviations from the technical requirements of construction standards.

USE OF WOOD IN CONSTRUCTION

On 23 April 2021, the Ministry of Economics and several state administrative authorities, non-governmental organisations and state capital companies signed the *Memorandum of Cooperation on Promoting the Use of Wood in Construction*, agreeing on joint cooperation in promoting the production and use in construction of wooden construction materials and construction products with high added value, contributing to sustainable construction and the growth of the Latvian economy.

With the transition to "green construction", the use of wood products in construction is becoming more and more topical. Following trends, in 2021, MoE organised a cycle of training seminars "Design and Fire Protection of Modern Wooden Structures" with a view to familiarising Latvian construction designers, as well as contracting authorities with European best practices and latest trends in the development of wooden structures and the development of Eurocodes. More than 350 people visited the seminars online. During the seminar, a video recording was provided with simultaneous interpreting into Latvian. Seminar recording and presentations are published the CIS website https://bis.gov.lv/noderigi/projektesana.

At the same time, in 2021, the Ministry of Economics conducted a procurement for 197,500 euro to develop a model building design for a multi-apartment residential building with wooden load-bearing structures, thereby promoting the construction of new, energy-efficient housing and the demand for the use of wooden construction products in construction of buildings.

LATVIAN CONSTRUCTION COUNCIL

The Latvian Construction Council (hereinafter – Council) is an advisory coordinating body the purpose of which is to promote public participation in the development and implementation of construction policy. The Council is elected for a period of three years and the elections to the Council were held in 2021. The Council is composed of representatives of four ministries (MoE, MoES, MoT, MoEPRD) and the Latvian Association of Local and Regional Governments, as well as 15 representatives of the various fields of the construction industry elected by the sector.

In 2021, representatives of the following organisations representing the construction sector were elected to the Council: Latvian Chamber of Commerce and Industry, Association for Construction Industry Digitalisation, Latvian Road Builder, Latvian Sustainable Building Council, Latvian Building Engineers Union, Latvian Association of Electric Energy and Energy Construction Specialists, Latvian Contractors' Partnership, Association of Manufacturers of Construction Materials, Latvian Union of Heat, Gas and Water Technology Engineers, Association of Transport Works Engineers, Latvian Association of Architects, Latvian Association of Structural Engineers, Latvian Association of Consulting Engineers, Latvian Association of Landscape Architects and Alliance of Real Estate Developers.

The Council will provide MoE and other sectoral ministries with proposals on draft legislation and draft policy planning documents for the next three years, informing the public about the developments in the construction sector, as well as promoting the integration of construction matters into sectoral policy. The previous Council work is described on the MoE website: https://www.em.gov.lv/lv/padomes-sezu-darba-kartiba-protokoli.

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 of the state and indirectly delaying national economy growth.

The housing stock in Latvia 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 23,000 buildings in the sector of multi-apartment buildings.

MoE is cooperating with OECD to resolve the situation with housing affordability. In June 2020, OECD presented its study of housing affordability in Latvia (see Box 14.1).

Box 14.1

OECD study on housing affordability in Latvia

OECD study shows that the average household expenditure on housing in Latvia is below the OECD average. Low spending on housing has created another challenge – poor housing quality. Most of the housing has been built during Soviet power and has not been properly maintained. More than a third of households live in overcrowded housing, which is the highest rate in the OECD. Many households do not have the option to move to more qualitative housing without spending more than 30% of their disposable income.

Mortgage loans are not available for a large part of the population. State support for housing affordability is received by a small proportion of vulnerable households and low-income households, as well as the level of support is limited. The state offers mortgage loan guarantees to families with children and young specialists. This support can mainly be used by households with higher income. Thus, the existing housing support is not available to a large proportion of households – the "missing middle", which constitutes approximately 44% of all Latvian households, which are too wealthy to receive social housing or housing benefits, but whose income is insufficient to obtain mortgage loan.

OECD recommends Latvia:

- to improve assessment of housing affordability and quality;
- to invest more in quality affordable housing and to reduce construction costs by considering establishing a revolving fund;
- to develop a more affordable and attractive rental market, to diversify the offer of housing providers;
- to close the gap among the "missing middle", by better calibrating housing support for different households by considering developing a housing refurbishment programme; expanding housing support for lower-income households.

The Ministry of Economics 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 to support housing affordability by 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 has been developed, which is available for free for any developer, and a model construction design for a wooden structure multi-apartment house will be developed by the end of 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 2021. Work is ongoing on a sustainable support model for the construction of affordable, quality and energy-efficient rental housing by establishing a financial instrument for granting long-term low-interest loans and applying a 30% capital rebate. Funding of 42.9 million EUR has been mobilised for the implementation of the support programme within the framework of the *Recovery and Resilience Facility*. 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 within it.

In parallel, in order to provide a long-term solution for housing affordability, work has started on the establishment of a framework and mechanism for the long-term housing affordability fund. In order to ensure this, MoE, through the European Commission's technical support instrument, was able to launch an additional cooperation project with the OECD for 450,000

[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.

EUR in order to further explore foreign practices and the possibilities of introducing a long-term housing affordability fund in Latvia – a revolving fund, 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 European Commission. 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 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 18 thsd families with 27 thsd children to get housing of appropriate size. The total amount of guarantees during the programme was more than 139 mln EUR. Since 2018, when the programme was extended providing that also persons younger than 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 10 thsd EUR. The subsidy is increased by 2 thsd EUR if the housing meets the energy efficiency requirements for nearly zero-energy buildings. Since the programme started, more than 440 families with more than 1,340 thousand children have received subsidies and 3.6 mln EUR have been granted in subsidies.

IMPROVED DECISION-MAKING PROCEDURE IN MULTI-APARTMENT RESIDENTIAL HOUSES

Amendments to the *Law On Residential Properties* entered into force on 2 March 2021, which provide for a simplified decision-making process, reducing the number of votes for the creation of parking spaces for the disabled, creation of electric vehicle parking spaces, reducing to a minimum the cases where the consent of all apartment owners is required, and clearly stating that 50%+1 votes of apartment owners are needed on matters such as the refurbishment of buildings.

In addition, amendments to the *Law On Residential Properties*, which entered into force on 6 June 2021, provide for the possibility of dividing several buildings, which have been constructed on a single land plot, into apartment properties, as well as for a simplified, separate decision-making procedure for each house, which concerns the repair, refurbishment or reconstruction only of these buildings. They also provide that accessibility of environment measures can be implemented by disabled people without coordination with other apartment owners.

The draft law "Amendments to the Law On Residential Properties" and the draft law "Amendments to the Law on Administration of Residential Houses" were submitted to the Saeima, which provides for the establishment of a legal framework for the adoption of decisions by the community of apartment owners in electronic form, including by using BIS functionality, as well as keeping of the house file within BIS.

POSSIBILITY TO RECOVER DEBTS FOR RESIDENTIAL HOUSE ADMINISTRATION AND UTILITIES HAS BEEN ENSURED

On 1 March 2021, amendments to the *Civil Procedure Law* entered into force, which provide for the prioritisation of the administration expenses and utility debt claims (of 5%) against the mortgage creditor's claim, if the apartment is sold at an auction, thus securing the debt for house administration services, as well as the possibility of recovery of utility debts in the event of forced alienation of property.

TECHNICAL CONDITION OF BUILDINGS

In 2020, the Ministry of Economy, in cooperation with other cooperation partners, developed an "Action Plan for the Improvement of the Technical Condition of the Residential Stock"[1], the purpose of which is to carry out an investigation of the problems and causes thereof with regard to the Latvian residential buildings stock and its technical condition, providing proposals and solutions for a secure residential stock.

One of the measures already active in the process of identifying the technical condition of the residential stock is the study of the mechanical strength and stability of the enclosures of serial multi-apartment buildings and the preparation of

[1] The Action Plan is available here: https://likumi.lv/ta/id/319472-par-ricibas-planu-pasakumiem-dzivojama-fonda-tehniska-stavokla-pilnveidosanai-ekspluatacijas-laika

standardized solutions. Buildings of series 464 and 467 were so far inspected, and no signs of loss of mechanical strength or stability in the buildings have been stated. If the buildings keep being used in the current way, as well as if the measures for the maintenance of buildings and restoration of individual elements specified in the studies are performed, the buildings are safe for further use.

The study of the mechanical strength and stability of the enclosures of multi-apartment buildings of series 103 and the preparation of standardized solutions started in 2021 and will be completed by the end of the year.

NEW ENERGY PERFORMANCE CLASSIFICATION SYSTEM FOR BUILDINGS

Since 2 November 2020, when the amendments to the *Law on the Energy Performance of Buildings* entered into force, the energy performance classification system for buildings in Latvia has been changed. By transposing the requirements of *Directive 2018/844*, the *Law on the Energy Performance of Buildings*[1] provides that buildings shall be classified according to the amount of energy needed in the building. This classification includes the following indicators: 1) energy performance assessment for heating; 2) assessment of the primary energy of the building. Before these amendments, the energy performance classes of buildings were determined on the basis of only the specific heating consumption of the building.

In view of the above, the regulatory framework for calculating the energy performance of buildings and the energy certification of buildings was fully revised in 2021[2], and now includes a new energy performance classification system for buildings, setting overall primary energy indicators that include energy consumption for room heating, room cooling, household hot water supply, ventilation, built-in lighting and other engineering systems of the building. More specifically, these provisions contain minimum permissible values for non-renewable primary energy to be achieved. As a result, the needs for the share of use of renewable energy sources shall be determined on a case-by-case basis based on the overall conditions for achieving non-renewable primary energy indicators.

AMENDMENTS DURING THE COVID-19 EMERGENCY

To limit the spread of the Covid-19 virus, MoE prepared amendments to several regulations of the Cabinet of Ministers[3] [4], providing for the postponement of access to measuring devices in apartments, including ensuring the re-verification of meters, while at the same time the necessary temporary solutions were defined in relation to the determination of the parts to be paid during this period. This has been done in order to avoid negative consequences for the population, who would not be able to fulfil the obligations laid down in the regulations due to the restrictions imposed during the emergency.

[1] Section 9(1) of the Law on the Energy Performance of Buildings

[2] On 16 April 2021, Regulations of the Cabinet of Ministers No. 222 of 8 April 2021 "Procedures for the Calculation of Energy Performance of Buildings and Rules of Energy Certification of Buildings" entered into force

[3] Regulations of the Cabinet of Ministers No.1013 of 9 December 2008 "Procedures by which an Apartment Owner in a Residential Apartment House shall Pay for Services, which are Related to Usage of the Residential Property"

[4] Regulations of the Cabinet of Ministers No.524 of 15 September 2015 "Procedure of determination, calculation and registration of the portion to be paid by each owner of a residential house for the services required to maintain the residential house"

15. TOURISM POLICY

Sustainable development of the Latvian tourism industry, promoting increase in the competitiveness of tourism services in foreign markets, has been set as the objective of the Latvian tourism development policy. The development of domestic and international tourism is promoted, increasing the competitiveness of the tourism industry and export of tourism services.

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 data from the World Tourism Organization, the industry that hit ever-new development records before the pandemic, experienced its worst year in its history in 2020, when international tourist flows world-wide declined by 73%. As the Covid-19 restrictions continue, the number of international tourists continues to fall also in 2021, when the drop between January and May reached 85% compared to 2019 and 65% compared to 2020. As borders are gradually opening, vaccination increases, the sensation of security of the population increases and the coordination of travel improves, the World Tourism Organisation forecasts in its scenario forecast of 2021 that the drop in the number of international tourists could be between 63% and 75% compared to 2019.

According to the Central Statistical Bureau of Latvia, tourism exports fell by 63.9% in 2020 under the influence of the Covid-19 pandemic compared to the previous year and reached 505 mln euro. Foreign travellers' expenses in Latvia decreased by 44.5% in business trips and by 57.7% in personal trips. In 2020, however, the balance of foreign and Latvian travellers remained positive meaning that tourism exports are higher than imports. The balance was 125 mln euro. The balance of travellers in Latvia has been positive since 2011.

In 2020, 3.2 mln foreign travellers visited Latvia, which is 61.6% less than in 2019. Most travellers came to Latvia from Lithuania (1.3 mln), Estonia (0.8 mln), Russia (0.3 mln), Poland (147 thsd) and Germany (100 thsd). According to data on operations of hotels and other tourist accommodations, in 2020, 715 thsd foreign travellers used accommodation services in Latvia, which is 63.3% less than in the previous year.

In Latvia, the active tourism season started in 2021 only at the beginning of July, when Covid-19 digital certificates were available, allowing free travel on the EU territory. In general, tourism rates in Latvia are therefore lower in 2021 than in 2020, when travel within the "Baltic bubble" was possible in the active tourism season, when Latvia was visited by our neighbours from Lithuania and Estonia, whom later joined Finland. In 2021, the restrictions were wider and the tourism season was shorter.

The situation in the tourism industry remains very fragile, affected by the spread of new types of the Covid-19 virus, differences in vaccination coverage across different regions of the world and the restrictions imposed by countries. In addition to vaccination and safe and responsible travel, coordinated national action on travel restrictions, uniform security protocols and effective communication will play an important role in rebuilding of travellers' trust.

The International Tourism Organisation forecasts that countries will return to the tourism development indicators of 2019 no later than in 2026, so the main challenge for tourism until 2022 will be to contribute to the gradual recovery of international tourist flows and to support the activities of economic operators in the industry during the recovery period in order to ensure their international competitiveness in conditions of high competition. As travel restrictions reduce, world tourist destinations will fight for the attention of potential tourists and fierce competition is expected in the coming years. In response to the consequences of the Covid-19 pandemic and the changes in global tourism demand, the implementation of tourism development and promotion measures will face challenges, so the main actions for the recovery of the tourism industry until 2022 will be:

1) to stimulate demand for priority foreign markets by targeted tourism promotion activities in target markets, gradually returning the lost share of the foreign tourism market – 15% per annum (compared to 2020);
2) to stimulate domestic demand by partially compensating for the decrease in the flow of foreign tourists and increasing the share of domestic tourism in the total structure of tourism;
3) to support tourism business in sectors with high added value and potential to attract foreign tourists, to create a positive image of the country at international level and export revenues (business and event tourism industry);
4) to provide support and competence in product reorientation and development, adapting to new realities, especially in the field of digitalisation;
5) to promote the development of ecosystems for mutual synergy between businesses in the tourism industry and cross-sectoral cooperation, thereby creating added value, new services, increasing the competitiveness and productivity of the tourism industry.

The main objectives, development principles, action lines and tasks to be implemented of Latvian tourism policy are set out in the draft *Latvian Tourism Development Plan for 2021-2027* (see Box 15.2).

Box 15.2

Draft Latvian Tourism Development Plan for 2021-2027

The policy priorities in the draft *Latvian Tourism Development Plan for 2021-2027* are:

1) strengthening the international competitiveness and promoting exports of the tourism industry;
2) creating attractive tourism offers in the context of local values and lifestyle;
3) improving tourism management for effectivisation of cooperation and performance, education and research.

The competitiveness of national tourism in the tourism industry is an important indicator for the successful development of the tourism industry. According to data from the World Economic Forum, Latvia is currently in 53rd place in the Travel & Tourism Competitiveness Index, but the aim is to reach the 50th place by 2027.

In the period from 2021 to 2027, support is intended for the tourism cooperation networks system for promotion of business, health, nature and cultural tourism. Support is planned to strengthen the export capacity of tourism operators, to improvement accessibility and tourism infrastructure, to implement smart destination development initiatives, cross-border cooperation initiatives and projects, to stimulate local tourism flows and to improve the tourism management system and to include the values of Latvian tourism in the process of shaping the country image of Latvia.

The strategic settings of the tourism policy of the Ministry of Economics are based on the lines set out in the *National Development Plan for 2021-2027 and the National Industrial Policy Guidelines*, the discussions with the institutions involved in national development planning, as well as the New European Industrial Strategy.

Based on the priorities and action lines set out in the draft *Latvian Tourism Development Plan for 2021-2027*, the *Latvian Tourism Marketing Strategy for 2021-2027* is developed building on the previous period's strategy for 2018-2023 and taking into account the consequences of the crisis caused by the Covid-19 pandemic and changes, latest trends in the market, studies and discussions with industry participants.

The aim of the strategy is to create a framework for smart, coordinated and vivid communication of the Latvian tourism industry and to increase the tourism product abroad and in the domestic market, promoting the recognition of the country image, sustainable development of tourism and the efficient use of funds intended for tourism marketing.

Digital development is relatively low in the industry, but technology developments show that smart tourism is becoming a necessity. Digitalisation is increasingly becoming the basis for the competitiveness of the tourism and travel industry. Also, the EU's responsible authorities set "Digitalisation and innovation", "Sustainable and responsible tourism", "Promoting Europe as a tourism destination and internationalisation of tourism businesses", "Skills and training/labour mobility" and "Improving the regulatory business environment and funding promoting accessibility" as the main priorities of the tourism policy for 2021-2027. In the process of improving the efficiency of tourism, the development of digitisation of public administration is equally important: the task of the state is to ensure the registration of real-time data available to all, a full database of tourism resources and support for the full development of the tourism information infrastructure system.

Climate change also has an increasing impact on the tourism industry. It can influence the development of tourism in Latvia both as a hindering factor and as a developing factor. Climate change can alter the visual quality, aesthetic, ecological, economic, scientific, historical and recreative value of landscapes, which in turn can change the behaviour and habits of tourists, and affect the economy of the specific place, region or country. On the other hand, the increase in air temperatures and the increase in the number of sunny days could lead to increased tourism flows.

Tourism supply is fragmented, monotonous in Latvian regions and satisfies unconnected basic tourism needs, often not being offered as a package and not covering a wider scale – the tourist destination, so the tourist is not interested in staying longer. In order to develop regional tourism, first, it all necessary to optimise the management of tourism by adapting it to the needs of tourist destinations and, second, to encourage the development of new products for the needs of export and local tourists, the latter will also be able to attract foreign tourists along with increasing capacity.

A study has been carried out on the situation in tourism companies and on the impact of Covid-19 on their activities, the cooperation activities of the Baltic Sea Region countries have been implemented, and work also continues on measures to promote the export of medical tourism that are implemented separately.

In 2021, substantial support as provided to the tourism companies affected by the spread of Covid-19. Funding from the State budget programme "Emergency funds" was granted to economic operators in the tourism industry affected by Covid-19. Aid of 1,956 thsd euro was provided to 144 operators of the tourism industry affected by Covid-19.

IDAL TOURISM SUPPORT MEASURES

In 2021, IDAL prioritised tourism promotion activities in close markets, with the greatest potential to attract tourists in Lithuania, Estonia, Finland, and Poland.

In summer 2021, IDAL paid attention to **local tourism services** through a number of local tourism promotion activities. In June, Open Rural Days were organised with 240 participating rural tourism companies. At the end of July, the Close Up Latvia! game and the Home Café Days started, which took place at 33 destinations and closed in early October. In total, 448 pop-up house cafés were created in Latvia during the campaign, each working for one weekend, and attracted more than 30 thousand guests in total.

In order to encourage citizens to travel in Latvia during the autumn and winter season, IDAL carried out a campaign to promote local tourism "#ārgājis. The idea of the campaign is to invite all Latvian residents to join the #ārgājis movement and use this time to study the Latvian tourism industry in different seasons. The campaign was launched at the end of September and continued throughout the autumn and winter seasons. The campaign specifically highlighted seasonal tourism sites, inviting to visit both nature and other tourism sites.

In its **marketing communication**, IDAL focuses on individual travellers, as group tourism has still not recovered. Trends shown that traditional tourist destinations, mainly visited by organised tourist groups, have poorer tourism indicators. Individual travellers cannot compensate for those flows. The situation is particularly unfavourable in Riga, where the tourism flows are mainly made up of foreign travellers, but their numbers have fallen considerably. On the other hand, the best situation is in rural tourism, since local travellers are largely capable to cover the capacity available here.

IDAL uses the *Latvian Tourism Marketing Strategy for 2018-2023* to coordinate foreign tourism marketing activities. It is updated in 2021 in line with the changes in the tourism industry due to the situation with the Covid-19 pandemic. 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. The updated strategy is developed for the period until 2027.

In the post-crisis period, attention will be paid to local tourism activities, as well as to educating tourism workers on crisis management, changes in international markets, trends in demand etc. IDAL implements cooperation among the countries of the Baltic Sea region in the fields of joint tourism products and marketing, ensuring regular communication with the national tourism organisations of the Baltic States within the framework of the Joint Tourism Committee of Baltic States. IDAL is involved in the European Travel Commission ensuring the efficient use of resources from international organisations.

As part of the project 3.2.1.2/16/I/002 "**Promoting Latvia's International Competitiveness in Tourism**", support is provided for activities to promote the competitiveness of tourism industry operators in external markets, as well as Latvian tourism marketing activities are implemented in the local and foreign markets. In the first three quarters of 2021:

- 2 national tourism stands were organised, 11 aids in the form of grants were provided;
- 1 tourism marketing and advertising campaign was implemented, 4 marketing and advertising campaigns were launched, 34 types of tourism information and marketing materials were prepared;
- 18 Latvian tourism publicity and foreign specialised tourism promotion activities, 8 foreign media visits and 1 visit of tourism industry representatives were implemented;
- one market research was carried out;
- 8 business tourism promotion events and 11 tourist attraction events were organised in Latvian municipalities.

16. CONSUMER RIGHTS PROTECTION AND MARKET SURVEILLANCE

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, it is important to ensure the implementation of the consumer rights protection policy in different directions. When shaping the consumer protection policy, all the necessary measures to protect rights and economic interests of consumers should be taken. Consumer rights protection requirements should be taken into account, when defining and implementing other policies directions.

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 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 flexible to respond to the situation dynamically. The policy is implemented in such a way to foster more complete use of the potential of e-commerce to create a favourable and safe environment for consumers.

Therefore, one of important aspects is information of consumers and businessmen on consumer rights protection matters through different informative campaigns, by preparing advertising videos and distributing other materials. In line with our dynamic daily life, the development of e-commerce and rapid development of information technologies, it is important to emphasise the right of consumers to be informed and educated, because it is important for consumers to take well-considered decisions at every step in this fast daily life.

The consumer rights protection system in Latvia is constantly being developed to ensure effective market surveillance and consumer rights protection. The Ministry of Economics is working to improve and develop the existing framework and ensure a high level of consumer rights protection. There is also active cooperation in shaping of the international consumer protection policy and good practices of other countries are used for protection of consumers.

The Ministry of Economics cooperates closely with the Consumer Rights Protection Centre (CRPC) regarding consumer protection.

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 ensure the performance of functions, the CRPC implements activities related to monitoring of the consumer rights protection (in the field of protection of consumers' economic interests and supervision of the respect for consumer rights in the draft agreements and agreements concluded by consumers with producers, sellers or service providers), considers consumer complaints, informs and advises consumers and entrepreneurs, implements monitoring activities in relation to unfair commercial practices, e-commerce and advertising, licences non-bank credit providers and extrajudicial debt recovery service providers, 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 (see Box 16.1).

Along with the rapid pace of innovation and digitalisation in the world, 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. The trend of recent years shows that the number of internet users is growing rapidly, and Latvians have also made an online purchase at least once. Entrepreneurs are also increasingly using the digital environment. The development of e-commerce brings many benefits, but it is important to protect consumer rights in these changes. In 2021, MoE continued work on updating of consumer rights in connection with the sale of goods in person and by means of distance communication, as well as started work on the development of rules for the purchase of digital content and digital services, which currently is a very topical type of goods among consumers.

At the same time, it is important to protect consumers from unfair traders who systematically do not deliver goods ordered by consumers and do not reimburse the price of the purchase in the event of undelivered goods. Amendments to the *Consumer Rights Protection Law* entered into force in 2021. They strengthen the investigation and enforcement powers of CRPC, including the powers to clarify personal accounts, review personal account statements, obtain data at the disposal of electronic communications operators, and limit access to online interfaces.

2021 has also been important in the field of consumer protection in connection with the Covid-19 pandemic worldwide, which has required increased involvement of CRPC and the Ministry of Economics.

Box 16.1

Activities of the Consumer Rights Protection Centre in 2021

In handling consumer complaints and providing consultations in the first 10 months of 2021, CRPC has provided 27,506 consultations, which is by 4162 consultations less than in the corresponding period of 2020. In the 10 months of 2021, CRPC has received 2476 applications and complaints, which is 10% lower than in 2020. The decline in demand for consultations and the shrinking of the number of complaints is explained by the reduced flow of complaints and consultations related to the consequences caused by Covid-19 in 2021, when customer had limited opportunities to use may previously purchased services.

Since in 2021, physical sale in shops was restricted from time to time and a big share of sales we organised directly in the e-environment, most consultations have been given to both consumers and traders on the matters related to distance trading. The question of the duration of provision of repair of goods and provision of answers to consumer complaints is still important for consumers. Undertakings delayed the provision of answers to consumers and repaired goods for a long time referring to the obstacles caused by the Covid-19 crisis – shortage of employees, illness of employees, quarantine, as well as long deliveries of parts.

Consumers have complained most about purchased electrical goods, footwear, computer equipment and mobile phones. Although less, CRPC still continued to receive consumer applications in the context of the crisis caused by Covid-19. CRPC was mostly approached by consumers who had purchased and could not use package holiday services and air services, or attend the planned concerts, festivals, cultural and sports events.

Similarly, as in the past, CRPC still received signals about e-undertakings, who had received full payment for the goods from consumers, but did not deliver the goods or repay the money. It should be acknowledged that there are significantly fewer complaints in 2021, which could indicate that the e-commerce environment has sorted things out and has stabilised.

The European Consumer Centre (hereinafter referred to as 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 European Commission's support. In the ten months of 2021, consumers and businesses received 760 consultations and more than 300 complaints about cross-border problems within the EU have been dealt with. Most complaints and consultations are still directly or indirectly related to the problems caused by Covid-19 – cancellations of flights, cancellation of package holiday services, and cancellation or postponement of events. The number of complaints and consultations on online shopping has increased – 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.

In the 10 months of 2021, 183 proceedings on **violations of the collective interests of consumers** had been initiated, including about implemented commercial practices and terms of contracts offered to consumers. The proceedings were mainly initiated in case of unfair commercial practices, which do not meet professional care standards and are misleading, offering consumers goods or services without indicating appropriate or without specifying at all the information laid down in regulatory enactments, or implementing other rights or duties arising from regulatory enactments or contacts in an inappropriate way. Many cases have been initiated in the field of tourism, with increased monitoring of the securing of customer money by providers of tourism services, as well as practices in the online environment (influencers, trade in social networks, practice in online shops), consumer solvency assessment when concluding crediting agreements, in particular taking into account the new requirements of regulatory enactments.

In order to promote a single interpretation, a question and answer document on consumer rights in various areas has been published and developed on the CRPC website: http://www.ptac.gov.lv/lv/buj-covid-19.

The decisions on the unprecedented practices of CRPC, which penalised two social media content creators or influencers for not identifying commercial and paid content in their social media records, had a major public resonance.

In financial services, 2021 marks a striking negative trend, as fraudsters have done a great deal of financial damage by calling and defrauding bank account access information through a variety of methods, asking consumers to invest in dubious transactions with cryptocurrency, and borrowing money. More than 20 complaints about this matter have also been received by CRPC.

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, as well as supervision of and issuing/amendment of licences to providers of tourism services is actively performed taking into account insolvency risks.

Year 2021 marks the continued decline in the number of consumer lending providers as well as in lending volumes. This is due to both the increase in state duties and the consequences of Covid-19.

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 CRPC for **market surveillance** in 2021: improvement of safety and compliance 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 aerial vehicles, as well as targeted supervision inspections in the field of e-commerce.

Projects for inspection of dangerous equipment – in the fields of surveillance of elevators, cargo cranes and hoists intended for people – are also implemented. Supervision projects in state metrological supervision are implemented in priority areas like water consumptions meters, supervision of measurement instruments at electricity and heat generation sites, as well as control of pre-packaged products in companies.

Taking into account the spread of Covid-19, CRPC continues to monitor the prices of face masks (respirators, hygienic and medical masks), as well as is involved in public procurement related to the purchase of personal protective equipment and face masks to meet the needs of the state. There is also active participation in the verification of epidemiological safety requirements in shopping areas.

In the 9 months of 2021, CRPC carried out 1971 market supervision inspections, 62 metrological supervision inspections in companies, where measuring instruments are used, and in companies distributing measuring instruments. 44 inspections were carried out in metrological supervision of pre-packaged products and 74 inspections – in supervision of dangerous equipment.