



Ministry of Economics
Republic of Latvia

ECONOMIC DEVELOPMENT OF LATVIA

2018

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OPENING STATEMENT

Experts of the Ministry of Economics have prepared a Review on the *Economic Development of Latvia*. The review assesses the economic situation, as well as forecasts the prospects of economic development. It is planned that further on experts of the Ministry of Economics will prepare such a review once a year – in December.

It should be noted with pleasure that growth of the Latvian economy was considerably faster in 2017 and 2018 than in the previous years. Export, investments, private and public consumption are growing stably. Export volumes have reached the highest-ever level. An increase is observed in almost all sectors of the national economy. Overall, in three quarters of 2018, the gross domestic product (GDP) increased by 4.7% achieving a higher increase than in 2017, when GDP increased by 4.6%. Taking into account economic growth in countries of the European Union (EU), as well as investments available from EU funds, economic growth is expected to remain stable also in 2019, even though at a slower rate.

However, inertia would not be sufficient here – the government should continue strengthening of competitiveness of the economy, providing businesses with support they need so much to increase productivity and international competitiveness. This is particularly important taking into account that a considerable increase in labour costs is inevitable in conditions of an open labour market.

Producing in a more productive way means to be ahead of your competitors, devote more time and resources to innovation and research, improvement of qualification of employees and advancement to foreign markets. An increase in productivity is a precondition for stable long-term development of the company and the state. A businessman, who is aware of the importance of productivity, invests in trainings of employees, modernise production and use the solutions offered by the state. Increasing productivity is a wide step to the extension of international competitiveness and therefore in the direction of export.

Finding the most effective solutions to raise our competitiveness and productivity globally requires an independent, competent and scientifically sound review of government work is necessary. Therefore on 30 August 2018 the Ministry of Economics signed the *Declaration on cooperation in the area of analysis of productivity and competitiveness* with the University of Latvia and the Latvia's Productivity, Effectiveness, Development and Competitiveness Forum (LV PEDCF). I hope that our cooperation will be successful and will help the public administration find the right solutions for promoting productivity and competitiveness.

The Ministry of Economics is also implementing an informatively explanatory campaign for promotion of

competitiveness and productivity of Latvian companies "Create in Latvia! Compete globally", which aims to inform, educate and motivate businesses and society to become generally more competitive fostering understanding about productivity as a foundation of sustainable economic growth of Latvia, informing about the aid offered by the state to businesses to increase competitiveness, promoting a change in business thinking and motivating businesses to increase investments in productivity growth.

Human capital is particularly important in the promotion of competitiveness – reforms in the education system and restructuring of the labour market in order to prepare and adapt to structural changes. Therefore, ongoing reforms in the education system should be pursued with the emphasis on strengthening the quality of learning of exact and natural sciences in basic education and secondary education and on the development of adult education.

In order to coordinate inter-sectoral cooperation required for planning, development, implementation, and monitoring of labour market reforms or re-arrangement, thereby reducing the disproportion in the Latvian labour market, the Employment Board composed of three ministers (ministers of economics, education and science and welfare) was established. The ministers have agreed to include in priority changes the establishment of a lifelong education system, modern and qualitative general education, increase of number of students in science, technology engineering and mathematics (STEM) disciplines, involvement of employers in the formation and provision of the education supply, improvement of skills and employment of youths.

Support programmes of the EU funds are successfully implemented giving the opportunity of investing 4.4 billion euro in the development of Latvia. The most important planned funding objectives of the EU funds include increasing the financial flow in research and development, facilitating the attraction of private investment, and activating the cooperation of research institutions and entrepreneurs. Significant investments are also planned for the improvements of the information and communication technology and transport infrastructure that directly affect economic productivity and are the basis for creating new, well-paying jobs and increasing the quality of life.

907.2 million euro for targeted investments into modernisation and industrialisation of the Latvian economy are available in activities of the Ministry of Economics in the 2014-2020 programming period, including for promotion of energy efficiency – 377 million euro, to promote competitiveness of small and medium-sized enterprises (SME) – 334.4 million euro and for the development of innovation – 195.5 million euro. The following EU funds activities continue: *Introduction of New Products in Production* (support for acquisition of equipment), *Promotion of International Competitiveness*

(national stands, including entering into external markets (participation in exhibitions)), *Training of the Employed*, *Competence Centres*, *Business Incubators* and *Heat Insulation of Apartment Buildings*, provision of aid to economic operators also in the form of financial instruments (guarantees, loans, venture capital instruments, incl. acceleration funds) will continue and will be extended.

The Ministry of Economics also evaluates proposals of the European Commission for the new multiannual budget of the EU after 2020. We do not support the proposed reduction of funding for the Cohesion Policy and the Common Agricultural Policy. We believe that the EU still needs to promote economic, social and territorial cohesion, to equalise the level of life between less developed and developed EU regions, as well as equalise direct payments into agriculture.

The EU Single Market Forum organised by the Ministry of Economics in cooperation with the European Commission was held on 14 September 2018 in Riga celebrating 25 years of existence of the EU Single Market. At the forum, officials, businessmen and academicians discussed benefits of participation in the EU Single Market, what has been done to strengthen it, things yet to be done, future development trends and considerable challenges. Despite still existing shortcomings in the functioning of the EU Single Market it is important that everyone of us is able to appreciate the self-evident thing it gives us – possibility to freely choose goods and services, travel, work and live within the EU. It is also necessary to be ready to the unique challenge related to the changes brought by *Brexit*, the withdrawal of the United Kingdom from the block of EU countries. In this context, the Ministry of Economics will provide informative support to businesses and the population to have a clear understanding of changes in practical life and business. Cooperation with other EU countries will continue, in particular, for the purposes of strengthening competitiveness of the Baltic – Scandinavian region to remove currently existing obstacles and barriers in the EU Single Market in order to foster opportunities of Latvian businesses to develop provision of their services across borders, including in the digital environment.

At the beginning of 2017 we introduced a regulation and special support programmes for unique and modern quickly growing technology companies or start-ups, which have been appreciated globally. The Ministry of Economics has signed a *Memorandum of Understanding with the Latvian Startup Association Startin.LV*, there is regular communication with representatives of the ecosystem and support for the establishment of the ecosystem, synergy of start-ups with universities and corporations.

Our goal is to make Latvia choice No. 1 for start-ups in the Baltic countries. The *Law On Aid for the Activities of Start-up Companies* and venture capital funding are the foundation for the promotion of development of such companies. Specific aid programmes are introduced specifically for this group of businesses.

An absolutely new procedure of payment of corporate income tax (CIT) regulation was introduced since 1 January 2018, which envisages a 0% rate for reinvested profit. Therefore, the calculation and payment of CIT is postponed until income is distributed, applying a 20% rate at the time of distribution of profits from the gross income to be distributed. The above-mentioned changes in the tax policy will promote investments of companies in development, as well as economic growth in the country in general. It is expected that the CIT of 0% for reinvested profit will improve financial indicators of companies and promote an increase in equity (retained earnings). The turnover, profit and productivity of companies will increase. This will promote issuing of loans by commercial banks. Therefore, faster economic growth, increase in exports and increase in competitiveness are expected.

One of the priorities of the Ministry of Economics is the improvement of the business environment. Targeted reforms and close cooperation with the business community has enabled Latvia to achieve high results – the World Bank's *Doing Business 2018* study ranks Latvia on the 19th place among 190 countries. In turn, Latvia holds the 8th place among EU Member States.

On 15 March 2017 the Cabinet of Ministers approved the *Action Plan for Improvement of the Business Environment* drafted by the Ministry of Economics. The vision of the Ministry of Economics is to create an excellent business environment and to move towards an innovative economic model. We have therefore defined five priority action lines for the further improvement of the business environment such as strengthening the rule of law, developing customer-oriented public administration, digitisation of public services and industry (Industry 4.0), openness of the business environment and increasing the competitiveness of the tax system. A new *Action Plan for Improvement of the Business Environment* is being prepared right now.

In progress towards an excellent business environment since 2017 Latvia has introduced the “Consult first” principle aiming to improve the mutual understanding between entrepreneurs and supervisory authorities promoting fulfilment of the set requirements rather than punishment. A healthy and competitive business environment is based on fair businessmen, who want to observe the requirements of regulatory enactments and institutions based on understanding and cooperation, which are able to balance interests of society and business in their supervisory activities. The Ministry of Economics has intended to carry out an annual evaluation of the implementation of the “Consult first” principle in the work of institutions supervising the market and customer service, which will help to follow up the development of the principle. The first results are expected in 2019.

Provision of a fair competitive environment is also considered to be an essential element in promoting competitiveness. The Cabinet of Ministers has supported the proposals of the Ministry of Economics to the *Competition Law* intending to introduce the principle of neutrality in competition in the activity of public persons. The principle of neutrality in competition requires that, in

doing business, public persons do not enjoy competitive advantages over economic operators from the private sector, because they belong to a public person. Therefore, extensive discussions about the prepared proposals are expected in the Saeima.

With the state making the commitment to implement a number of industrial support measures and with the largest industrial organisations promoting considerable investments in modernisation of their industry, thus raising its competitiveness in the world, on 25 April 2018 a *Memorandum of Development of the Latvian Industry* was signed between representatives of the Ministry of Economics and industrial sectors.

The improvement of the national innovation system continues. Support programmes are being implemented, which foster the attraction of investments from the private sector in research and development (R&D) activities and motivate companies to invest in innovations. The most important support instruments ensure the promotion of cooperation between economic operators and the research sector for the implementation of joint projects, commercialisation of research developments within the scope of fostering wider technology transfer processes, incl. by strengthening the capacity of the Investment and Development Agency of Latvia making it an agency of innovation and technology. At the same time, those activities continue, which are aimed at motivation of the wider community and its involvement in innovation and business activities. We have activated work with state capital companies by creating cooperation mechanisms of these companies and identifying current and future R&D investments in these companies. These activities are closely related to the attempts to achieve targeted improvements and the increase of the rating of Latvia in the *European Innovation Scoreboard*. At the same time, foreign investment attraction activities aimed at the promotion of R&D, development of innovative products and their introduction in the most important sectors of the national economy will be strengthened.

Extensive work is ongoing in the construction sector to improve and simplify the construction process, including by ensuring that the Construction Information System (CIS) supports a full electronic construction process. Since July 2018 CIS ensures submission and cooperation of the construction concept up to reception of a construction permit. Work on further processes continues within the scope of the project in order to ensure a full electronic construction process making CIS a single building and construction information system.

By signing a *Memorandum* of cooperation between members of the Cabinet of Ministers and representatives of the construction sector on 31 May 2016 representatives of the government and the sector have confirmed their readiness to make a necessary contribution and to take measures for faster improvement and promotion of development in the sector. The three-year work enabled the construction sector to reach high development indicators – a quick and considerable reduction in shadow economy, a considerable increase in turnover and export

volumes, a tangible improvement in quality. In order to reach the goals set in the *Memorandum*, representatives of employers in the construction sector jointly with representatives of trade unions have signed a general agreement agreeing on a considerable increase in minimal wages in construction jobs. At the same time, the Saeima has adopted amendments to the Law *On Taxes and Duties*, and since 1 October 2017 electronic registration of working time was introduced in the construction sector.

The construction sector has made a major step to the development of social dialogue, and the initiative and the result achieved by the construction sector will serve as an example for other sectors.

In order to reduce bureaucratic obstacles and simplify the construction process, on 22 June 2017 the Saeima adopted amendments to the *Construction Law*. The amendments provide for a simplified procedure of making amendments to the project documentation also during construction works, as well as for coordination of deviations from technical regulations.

On 20 March 2018 new rules of evaluation of competence of construction specialists and supervision of independent practice entered into force, which improve the system of certification of construction specialists, reinforce supervision of their activity and conditions of further education. The purpose of the regulation is to promote the involvement of knowledgeable and highly qualified specialists in the construction process.

In order to simplify the acquisition of a home for young families, the total funding of the housing support programme has reached 16.9 million providing for issuing a guarantee of the first instalment for 55 million euro. During three years the programme has helped more than 8 thousand families with 11,530 children to get housing of appropriate size and quality. The programme has a considerable effect on the entire market of mortgage crediting – 30% of all housing purchase transactions involved a mortgage loan, in 47% of which the housing guarantee programme was used in 2017.

A sustainable support model was developed for a qualitative and affordable housing for the Latvian population in Latvian regions to ensure that housing costs do not exceed 30% of household income. At present, the lack of apartments for rent is one of the main factors hindering the creation of new jobs in regions outside Riga. At the same time, it is necessary to ensure a fair balance between interests of landlords and tenants, therefore a draft law "Law on Rental of Living Spaces" has been drafted, which will introduce an improved legal regulation for rent and will provide a quick and convenient dispute resolution procedure.

Considerable activities are implemented in the energy sector, which will allow to increase competitiveness of companies. It was decided to change the model of financing of the mandatory procurement component (MPC), which will allow to reduce MPC payments of producing companies. A decision of the European Commission on compliance of the aid mechanism for economic operators,

who produce electricity from renewable energy sources and in highly efficient cogeneration with the internal market, was received. In 2018, a high-level working group led by the Minister of Economics was working to find a sustainable, legally correct solutions for the cancellation of the current system of MPC payments, which is acceptable for the society.

On 3 April 2017 the Latvian natural gas market has opened for competition, and the competition between natural gas merchants has formed with their number reaching 28 merchants. Likewise, the natural gas transmission and storage have been separated from the historical natural gas monopoly AS Latvijas Gāze (JSC) – these functions are currently performed by AS Conexus Baltic Grid (JSC), while the distribution system is currently managed by AS Gaso (JSC). At the same time, the establishment of the single natural gas market of the Baltic region continues within the scope of the regional gas coordination group. In order to strengthen regional natural gas supply security by diversifying supply routes and suppliers, in the next three years, the work on the Baltic-Finland interconnection project will be completed, thereby establishing an interconnection between Estonia and Finland, Balticconnector, connecting the Baltic and European networks, establishing interconnections between Lithuania and Poland, GIPL, and strengthening the regional role of Inčukalns underground gas storage.

In addition to improvement of the legislative conditions of the energy market of Latvia, active work is carried out on the development of electricity infrastructure, to strengthen national energy security and diversification of routes and sources of energy. The project for synchronization of power grids of Baltic countries with the synchronous zone of Central Europe is particularly important to stop the dependence from Russian and Belorussian power supply systems and integrate the Baltic countries in the European Union electricity market. It is planned to implement this project by 2025.

The main objective in the field of energy by 2020 is to increase security of energy supplies, to ensure a competitive energy price to consumers and to facilitate

energy sustainability. At present, Latvia is drafting the *National Energy and Climate Plan 2021-2030*, which will set the main target for transition to low-carbon economy competitive in the region and globally, as well as will set main action policies and measures in all dimensions of the energy union, including to ensure the share of renewable energy sources and to improve energy efficiency, to reduce greenhouse gas (GHG) emissions and for energy security and energy market.

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 Review 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 Review 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 Review!



Arvils Ašeradens,
Deputy Prime Minister,
Minister of Economics

December 2018

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ABBREVIATIONS, MEASUREMENT UNITS AND SYMBOLS

Abbreviations	
ALTUM	Joint Stock Company “Development Finance Institution Altum”
BIF	Baltic Innovation Fund
BIS	Building Information System
CC	Competition Council
CF	Cohesion Fund
CIS	Commonwealth of Independent States
CIT	Corporate income tax
CM	Cabinet of Ministers
CPCB	Corruption Prevention and Combating Bureau
CPI	Consumer Price Index
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
EAGGF	European Agricultural Guidance and Guarantee Fund
EAPP	Expanded Asset Purchase Programme
EC	European Commission
ECC	The European Consumer Centre of Latvia
EEA	European Economic Area
EFSI	European Fund for Strategic Investments
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
EU ETS	European Union Emissions Trading System
EU-15	European Union Member States before the enlargement on May 1, 2004
EU-27	European Union Member States after the enlargement on January 1, 2007
EU-28	European Union Member States after the enlargement on July 1, 2013
Eurostat	Statistical Office of the European Union
FDI	Foreign Direct Investment
FIFG	Financial Instrument for Fisheries Guidance
FTA	Free Trade Agreement
GBSC	Global Business Services Centre
GDP	Gross Domestic Product
GHG	Greenhouse gas emissions
HGP	Heat-electric generating plant
HPP	Hydroelectric Power Plant
ICT	Information and Communication Technologies
IDAL	Investment and Development Agency of Latvia
IMF	International Monetary Fund
JSC	Joint Stock Company
LCCI	Latvian Chamber of Commerce and Industry
LGA	Latvian Guarantee Agency
LLC	Limited Liability Company
LNAB	Latvian National Accreditation Bureau
LTDA	Latvian Tourism Development Agency
LV PEDCF	Latvia’s Productivity, Effectiveness, Development and Competitiveness Forum
LVS	Latvian Standard
MET	Microenterprise tax
MoA	Ministry of Agriculture
MoE	Ministry of Economics
MoEPRD	Ministry of Environmental Protection and Regional Development
MoF	Ministry of Finance
MoH	Ministry of Health
MoJ	Ministry of Justice
MoT	Ministry of Transport
MoW	Ministry of Welfare
MPC	Mandatory procurement component
MSS	Meeting of the State Secretaries
MWh	Megawatt hour
NDP2020	National Development Plan 2014–2020
NPP	Nuclear Power Plant
NRP	National Reform Programme
OECD	Organisation for Economic Co-operation and Development
OP	Operational Programme
PJ	Petajoule
PMB	Procurement Monitoring Bureau
R&D	Research and Development
RES	Renewable energy source
RIS3	National/regional research and innovation strategies for smart specialisation
RTSD	Road Traffic Safety Directorate
SCCB	State Construction Control Bureau
SEC	Sectoral Expert Council
SMM	Small and Medium-Sized Merchants
SOLVIT	EU Internal Market Problem Solving System
SRS	State Revenue Service
STEM	Science, Technology, Engineering and Mathematics
TDI	Trade defence instruments
TWh	Terawatt hour
UGSF	Underground Gas Storage Facility
USA	The United States of America
WTO	World Trade Organization

Country Abbreviations

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

PART I. ECONOMIC DEVELOPMENT TRENDS

1. ECONOMIC DEVELOPMENT TRENDS: OVERVIEW

From 2005 to 2007, a huge inflow of foreign capital stimulated significant growth of private consumption and investment in Latvia. The average annual growth rate of GDP exceeded 10%. In 2008 and 2009, recession set in as the inflow of foreign capital stopped due to the global financial crisis. During the crisis, GDP fell by ¼, external debt almost doubled, the number of the employed decreased by 16%, while the real wages of the employed fell by 12 per cent.

As of the end of 2010, the recession has stopped in Latvia, and growth has resumed with its rates exceeding the average EU indicators. From 2011 to 2017, GDP grew by

3.5% per year on average. In 2017, GDP exceeded the pre-crisis level of 2007 by 0.7 per cent.

In 2017, the growth rate accelerated, GDP increased by 4.6%, which was its fastest growth in the last 6 years. Statistical data evidence that rapid growth continues in 2018 as well. GDP has grown by 4.7% in the 3 quarters 2018. The acceleration of growth in 2017-2018 was fostered by the improvement of the situation in the external environment, private and public investments, increase in employment and wages.

Table 1.1

Latvia: Key Figures of Economic Development								
	2012	2013	2014	2015	2016	2017	2018f	2019f
Gross domestic product (at current prices, billion euro)	21.9	22.8	23.6	24.3	25.0	27.0	29.4	31.3
<i>compared to the previous year, changes as per cent</i>								
Gross domestic product	4.0	2.4	1.9	3.0	2.1	4.6	4.6	3.5
Private consumption	3.1	5.1	1.4	2.5	1.4	4.1	4.5	3.8
Public consumption	0.3	1.6	1.9	1.9	3.9	4.1	3.8	2.5
Gross fixed capital formation	14.4	-6.0	0.1	-0.5	-8.4	13.1	14.2	5.9
Exports	9.8	1.1	6.0	3.1	4.4	6.2	3.0	2.6
Imports	5.4	0.4	1.2	2.1	4.4	8.9	4.9	5.4
Consumption prices	2.3	0.0	0.6	0.2	0.1	2.9	2.6	2.7
<i>as per cent of GDP, unless indicated otherwise</i>								
General government sector balance	-1.2	-1.2	-1.5	-1.4	0.1	-0.6	-1.0	-0.7
General government debt	41.2	39.0	40.9	36.8	40.3	40.0	37.5	36.0
Export-import balance	-4.4	-3.5	-1.4	-0.5	1.2	0.1	0.0	-1.7
Changes in the number of the employed (15-74 years of age, compared to the previous year, as per cent)	1.6	2.1	-1.0*	1.3	-0.3	0.2	1.9	1.1
Employment rate	56.1	58.2	59.1	60.8	61.6	62.9	64.3	65.0
Unemployment rate (unemployed, per cent of the economically active population, 15-74 years of age)	15.0	11.9	10.8	9.9	9.6	8.7	7.5	6.8
Changes in average gross monthly wage, as per cent	3.7	4.6	6.8	6.8	5.0	7.8	8.4	7.5

f – forecast
 * 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

In 2017, private consumption grew by 4.1%, while in the 3 quarters of 2018 – by 4.5% fostered by the increase in employment and wages. Public consumption was also growing faster than in the previous years: In 2017 – by 4.1%, while in the 3 quarters of 2018 – by 3.9 per cent.

Exports keep growing along with the increase in economic activities in the largest outlets of Latvian goods. In 2017, it grew by 6.2%, while in the 3 quarters of 2018 – by 2.8%. Export volumes have reached the historically highest level.

In the 3 quarters of 2018, exports of goods increased by 3.8%, whereas exports of services – by 0.6%. The increase in export of goods was considerably affected by the increase in exports of wood and wood products, as well as machinery and appliances. Exports of vehicles, iron and steel, alcoholic and non-alcoholic beverages, as well as iron and metal articles have also increased. At the same time, growth of exports was negatively influenced by a drop in the volumes of export of electrical appliances and electrical equipment, oilseeds, aircraft and parts thereof, as well as milk and its products. By groups of countries, in this period of time export increased both to EU countries and at a slower rate to CIS countries. Export volumes to other countries, in particular to the United States, have also grown considerably.

Since 2015, current account of the balance of payments in Latvia has been having a small surplus: 0.7% of GDP in 2017, but it was in deficit 1% of GDP in the 3 quarters of 2018. External balance of the Latvian economy is expected to remain balanced also in the coming years.

After the fall in the two previous years, in 2017, rapid growth was observed in investments, which increased by 13.1%. In the 3 quarters of 2018, investments continued to grow – by 15.5%, mainly due to extensive investments in construction assets. Foreign direct investment flows to Latvia also increased. According to the balance of international investment, the amount of FDI accrued in the economy of Latvia at the end of September 2018 reached 14.9 million euro (at the level of 52% of GDP). They increased by 3.1% during the year mainly due to extensive investment of Swedish and Estonian businesses in the Latvian national economy.

The increase in competitiveness of businesses and the demand dynamics in the largest export markets promote growth in manufacturing. This sector grew by 8% in 2017. An increase was observed in all the largest manufacturing sub-sectors. Increases in volumes of fabricated metal products and food industry secured the largest contribution to industrial growth.

More moderate growth in the 3 quarters of 2018 was observed in manufacturing (by 2.5%). Wood processing continues to grow stably. Manufacture of electrical and optical equipment and the development of the chemical industry made a considerable contribution to growth of manufacturing. Production volumes of vehicles, non-metallic minerals, metalworking and manufacture of machines and equipment also increased during this time. On the other hand, there was a drop in manufacture of food products, light industry, manufacture of paper and printing.

In 2017, transportation and storage grew by 7.5%, while in the 3 quarters of 2018 – by 3.3%. Carriage of passengers in the 3 quarters of 2018 increased by 13.5%, postal and courier activities – by 21.5%, warehousing and support activities for transportation – by 0.3%, freight transport – by 1.8 per cent.

Growth also continued in trade, accommodation and food service activities, which increased by 6% in 2017, and by 2.9% in the 3 quarters of 2018. Furthermore, value added

in agriculture and forestry increased by 1.9% in 2017 and by 5.5 per cent in the 3 quarters of 2018.

The construction sector resumed its growth in 2017 after a two-year break. It grew by 18.6% in 2017 and by 21.9% in the 3 quarters of 2018. In 2018, along with the increase in intensity of implementation of projects of the EU structural funds the increase in private investments in construction can be mentioned among the main factors driving the sector. The number of issued construction permits is also growing.

The only large sector, which experienced a drop in 2017, was the finance and insurance sector (by 18.9%), which was largely due to the decrease in the scope of business of non-residents in Latvia. In the 3 quarters of 2018, it continued to reduce influenced by the same factors – by 9 per cent.

Specialists of the Ministry of Economics forecast that **the overall GDP increase in 2018 will be by at least 4.6%**. Growth will continue in 2019, yet at a bit slower rate – by 3.5%. Growth rates in 2019 will be affected by the continuously growing uncertainty in the external environment – the geopolitical situation in the region, the unclarity about the outcome of the Brexit agreement, slower growth in EU countries, etc. Slower increase in demand in external markets, as well as rapidly growing labour costs and slow increase in productivity support the importance of global competitiveness of Latvian manufacturers for further growth even more.

Distinct macroeconomic imbalances of the “fat” years have been eliminated and risks of economic vulnerability due to internal and external shocks have been reduced in the Latvian economy. Public debt is small, budget is close to balance, balance of payments is balanced. However, inflation is growing, this is mainly caused by supply-side factors.

The average inflation in 2017 was 2.9%. The average annual inflation in November 2018 was 2.5%. It is influenced by various supply factors related to the increased tax rates, as well as the rise in demand, stimulated by the growth of economic activities and wages. At the same time, inflation still largely depends on global oil and food price fluctuations. Overall, the average annual inflation might reach 2.6% in 2018, and 2.7 per cent in 2019.

Since 2011, Latvia has returned to growth, and significant improvements have been achieved in the fiscal position. There was a small budget deficit – 155.7 million euro or 0.6% of GDP in 2017. The deficit in 2017 was lower than forecast in the state budget law, where it was set as 1.1% of GDP. The lower level of deficit is explained by better tax income, lower contributions to the EU budget, as well as lower than planned expenses on social benefits.

The medium-term budget framework intends that the general government budget deficit is 1% of gross domestic product in 2018, 0.9% in 2019 and 0.4% in 2020. In 2018, as well as in 2020, the fiscal security reserve of 0.1% of GDP is anticipated.

In the first half of 2018, there was a surplus in the government budget of 605 million euro or 4.4% of GDP, which is considerably more than in the first half of the previous years. On 15 October 2018, the CM approved a

draft state budgetary plan for 2019 if policy remains unchanged, it includes forecast income and expenses, which correspond to the latest macroeconomic forecasts and all the decisions adopted by the end of September. The budgetary plan envisages the fiscal security reserve of 0.1% of GDP or 31 million euro. It is planned to reduce the general government deficit to 0.7% of GDP, and it ensures compliance with conditions of the Latvian fiscal discipline. The state budget for 2019 in its final version will be adopted by a new government, and it will be approved in Saeima.

After the financial market turmoil at the end of 2008 and the beginning of 2009, monetary indicators of Latvia are gradually stabilising – quality of the credit portfolio is improving and the banking sector is generally working with profit. Considerable measures to strengthen the capital of credit institutions have been taken. However, crediting is weak, although residents' deposits are growing. Banks are still cautious in the implementation of more active crediting, and, on the other hand, businesses are also cautious in the implementation of new credit liabilities. Considerable changes are ongoing in the banking system in relation to service of deposits of risky non-resident customers.

Increasing economic activity has a positive impact on the labour market situation – high unemployment rate caused by the crisis is falling, and the employment rate is rising. At the same time, individual population groups, especially persons of a low education level and qualification, elderly people, as well as young people, sense the improvement of the situation weaker than others.

The total number of working population in 2017 constituted 894,8 thousand, which was higher by 0.2% or 1.5 thousand than in 2016. The number of employees in 2018 continued to increase. In Q3 2018, the number of the employed was by 1.9% or 17.2 thousand more than in the corresponding period of 2017.

The employment rate has reached its highest level – it was 62.9% in 2017 and 65.3% in Q3 2018, i.e. by 1.7 percentage points more than in Q3 2017. The increase in the employment rate is mainly attributed to the drop in the number of working age population compared to the number of the employed.

Unemployment continues to decrease. In 2017, it fell to 8.7% or by 0.9 percentage points compared to 2016. Furthermore, the unemployment rate was 7% in Q3 2018. Also, the registered unemployment rate continues to gradually decline reaching 6.1% at the end of October 2018 (to compare, it was 6.6% at the end of October 2017). Improvements in the labour market are delayed by its regional differences and low labour mobility.

With the economic situation becoming more stable, wage growth has resumed since the end of 2010. The average gross wage grew by 40% in 2011-2017. In recent years, its pace has accelerated. The average gross wage grew by 7.9% in 2017. The average gross wage grew by 8% or 75 euro in Q3 2018 compared to Q3 2017, reaching 1006 euro for full-time work.

Strong pressure from the demand side on the labour market is expected to continue further, which could be reflected in a small increase in the number of employees. At the same time, the labour market will continue to be affected by negative demographic trends and regional labour market differences.

In 2018, the number of the employed is expected to generally increase by approximately 1.9% or 16.8 thousand, but the annual average unemployment rate might be close to 7.5%. Furthermore, in 2019 specialists of the Ministry of Economics forecast that the number of the employed will increase by 1.1%, but the unemployment rate will shrink below 7 per cent.

Further economic development depends on the situation in the external environment and progress in reforms. Further development of Latvia's economy will be still closely linked to export possibilities. Therefore the highest risk to the growth of Latvia is linked to global economic development. Further development of the EU's total economic space is particularly 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 support programmes of the EU structural funds and on the improvements in the business environment.

Scenario of a more rapid growth provides for continuation of growth in the main export markets of Latvia, and the benefits of the Latvian economic competitiveness are mainly based on technological factors, improvement of production efficiency, and innovation, to a lesser extent on cheap labour and low resource prices. In the medium term, growth rates of Latvia could reach an increase of 4-5% a year. By contrast, in the scenario of a weaker growth, with weak growth resuming in Europe and the geopolitical situation not improving, the economic growth rate of Latvia could be much slower.

2. GLOBAL ECONOMIC DEVELOPMENT

Global economy continues to grow. However, in 2019 and 2020 global economy growth rates are expected to be slightly slower than in 2017 and 2018. Overall, economic development prospects are unclear due to several interrelated risks. The drop in global trade volumes, growing uncertainty and growing oil prices will weaken economic growth. High political uncertainty is the main risk to global growth in the near future.

Economic growth of the European Union in 2017 was 2.4% reaching its highest point in ten years after stable growth in the last 6 years. In 2018, the pace of the economy has slightly slowed down. The slowdown in EU growth in 2018 was affected by several factors. Confidence indicators were weak in 2018, and total economic activity was affected by tension in trade, political uncertainty increased in some Member States, as well as growing oil prices had a negative effect on growth.

Domestic demand was the main stimulus for EU growth in 2019. Domestic EU growth driving forces are expected to remain sufficiently strong in 2019 for the growth in economic activity to continue and for unemployment to reduce. Improvements in the labour market, growing wages, expansive fiscal measures in different Member

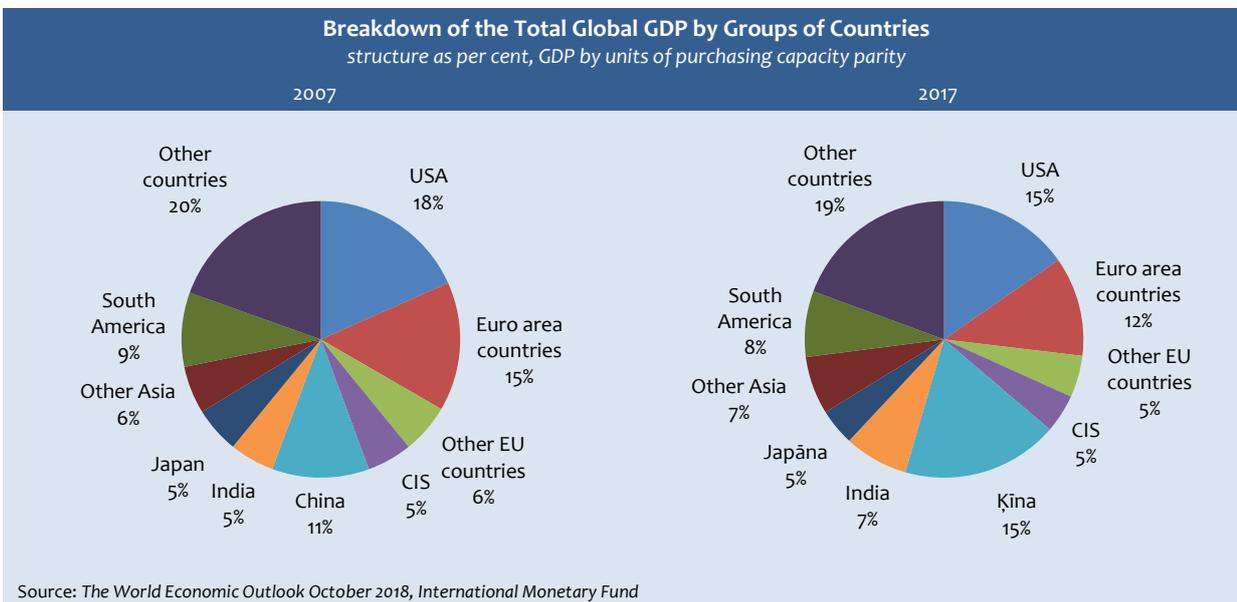
States would have to maintain high private consumption. Amounts of investments might increase taking into account stabilisation of the monetary policy and thanks to still beneficial terms of financing.

Table 2.1

Growth of Gross Domestic Product compared to the previous year, changes as per cent					
	2016	2017	2018f	2019f	2020f
World including:	3.2	3.7	3.7	3.5	3.5
USA	1.6	2.2	2.9	2.6	1.9
Japan	1.0	1.7	1.1	1.0	0.5
EU including:	2.0	2.4	2.1	1.9	1.8
Euro area	1.9	2.4	2.1	1.9	1.7
Russia	-0.2	1.5	1.7	1.6	1.8
China	6.7	6.9	6.6	6.2	5.9

Source: European Commission – European Economic Forecast, Autumn 2018
f – forecast

Figure 2.1



Overall, EU is expected to grow by 1.9% in 2019 and 1.8% in 2020. However, economic development prospects are unclear due to presence of several interrelated risks. External factors such as the drop in global trade volumes, growing uncertainty and growing oil prices will weaken economic growth. The risk of economic development of the EU is also still related to the Brexit process.

Growth in the **Baltic countries** was generally very rapid in 2017 and 2018, mainly thanks to domestic demand and favourable external environment.

Lithuanian economy grew by 4.1% in 2017. High economic growth rates continued also in 2018. Private consumption and investments have grown considerably, and they are also expected to keep stimulating GDP growth. Inflation is

expected to slow down after its rapid increase in 2017 due to the increase in indirect taxes. A tense situation is observed in the labour market, which will continue to make pressure on wages. Lithuania is expected to keep a surplus in its state budget in the coming years and the level of public debt will not exceed 60% of GDP.

Both cyclic factors, including strong external demand, and structural factors, for example, flexible labour market, have promoted economic growth of **Estonia** in recent years.

According to forecasts, the Estonian economy will grow by 2.8% in 2019. Economic growth is mainly based on exports and domestic demand attributable to sustainable competition in industrial production and ICT services sectors of Estonia.

Table 2.2

Main Macroeconomic Indicators of the EU Member States									
as per cent									
	GDP growth			Consumer price changes			Unemployment rate		
	2017	2018f	2019f	2017	2018f	2019f	2017	2018f	2019f
European Union	2.4	2.1	1.9	1.7	2.0	2.0	7.6	6.9	6.6
United Kingdom	1.7	1.3	1.2	2.7	2.6	2.0	4.4	4.3	4.5
Austria	2.6	2.7	2.0	2.2	2.1	2.1	5.5	4.8	4.6
Belgium	1.7	1.5	1.5	2.2	2.3	2.1	7.1	6.4	6.1
Bulgaria	3.8	3.5	3.7	1.2	2.6	2.0	6.2	6.0	5.8
Czech Republic	4.3	3.0	2.9	2.4	2.1	2.2	2.9	2.4	2.5
Denmark	2.3	1.2	1.8	1.1	0.8	1.5	5.7	5.2	4.9
France	2.2	1.7	1.6	1.2	2.1	1.7	9.4	9.0	8.8
Greece	1.5	2.0	2.0	1.1	0.8	1.2	21.5	19.6	18.2
Croatia	2.9	2.8	2.8	1.3	1.6	1.5	11.1	9.1	7.6
Estonia	4.9	3.5	2.8	3.7	3.5	3.3	5.8	5.7	6.0
Italy	1.6	1.1	1.2	1.3	1.3	1.5	11.2	10.7	10.4
Ireland	7.2	7.8	4.5	0.3	0.7	1.2	6.7	5.6	5.1
Cyprus	4.2	3.9	3.5	0.7	0.8	1.3	11.1	8.2	6.3
Latvia	4.6	4.1	3.2	2.9	2.7	2.7	8.7	7.3	6.7
Lithuania	4.1	3.4	2.8	3.7	2.6	2.2	7.1	6.5	6.3
Luxembourg	1.5	3.1	3.0	2.1	2.0	2.0	5.6	5.3	5.2
Malta	6.7	5.4	4.9	1.3	1.8	1.9	4.6	3.9	4.0
Netherlands	2.9	2.8	2.4	1.3	1.6	2.5	4.9	3.9	3.6
Poland	4.8	4.8	3.7	1.6	1.2	2.6	4.9	3.3	2.9
Portugal	2.8	2.2	1.8	1.6	1.5	1.6	9.0	7.1	6.3
Romania	7.3	3.6	3.8	1.1	4.3	3.5	4.9	4.3	4.2
Slovakia	3.2	4.0	4.1	1.4	2.6	2.6	8.1	6.9	6.3
Slovenia	4.9	4.3	3.3	1.6	2.0	2.3	6.6	5.6	5.3
Finland	2.8	2.9	2.2	0.8	1.2	1.6	8.6	7.8	7.2
Spain	3.0	2.6	2.2	2.0	1.8	1.7	17.2	15.6	14.4
Hungary	4.1	4.3	3.4	2.4	3.0	3.3	4.2	3.6	3.3
Germany	2.2	1.7	1.8	1.7	1.8	1.9	3.8	3.5	3.2
Sweden	2.1	2.4	1.8	1.9	2.1	1.9	6.7	6.3	6.2

Source: European Commission – European Economic Forecast, Autumn 2018
f – forecast

German economy has experienced rapid economic growth in the last 6 years. GDP of Germany grew by 2.2% in 2017. In 2018, the GDP growth rate has slightly declined. In 2018, growth was mainly attributed to domestic demand, while the increase in export slowed down.

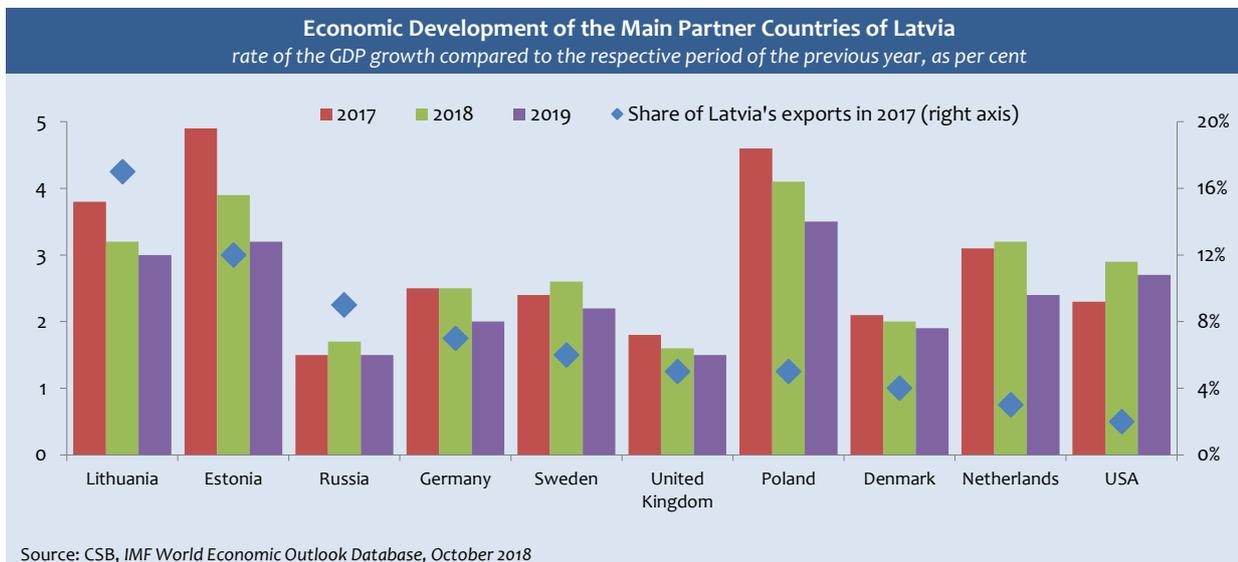
It is expected that the stable situation in the labour market and the wide fiscal space available will be able to promote domestic demand and maintain economic growth further. At the same time, the external environment is becoming less favourable to German exporters. The increase in investments might weaken due to growing tension and

uncertainty in global trade and in the automotive industry. In 2019, GDP growth is forecast at the level of 1.8%.

Economic growth of **Sweden** remains stable, taking into account strong domestic demand. However, growth is expected to become more moderate, because investments

in housing will reduce considerably. GDP growth rate of Sweden is expected to decline to 1.8% in 2019. This will be due to a gradual decline in domestic demand, as well as worsening of the external environment. In 2018, the unemployment rate reduced and is expected to stabilise at the level of about 6 per cent in 2019.

Figure 2.2



Economic growth of the United States was 2.2% in 2017, and it was evaluated at the level of 2.9% in 2018. With fiscal stimuli growing and taking into account the tense situation in the labour market, GDP of the United States is expected to grow by 2.6% in 2019. Furthermore, a decline in the economic growth rate to 2% is expected in 2020, which will be affected by the reduction in monetary policy support measures. Economic growth prospects are closely related to several external risks – economic overheating, worsening of terms of financing, unclarity in the trade policy and narrowing of the fiscal space in 2020.

Economic development of Asian countries is mainly determined by the largest economies of the region – China, Japan, India. Asia is still the fastest growing region in the world economy, however, its economic growth is expected to slow down in the coming years.

Chinese economy was growing very fast in 2017 and in the first half of 2018 – by 6.9%. However, in 2019 and 2020 economic growth rates will slow down as private consumption, export volumes and economic activities in the real estate sector reduce. The impact of the trade tariffs set by the United States might partially reduce by the domestic policy and weaker currency value of China. Overall, growing external risks create unclarity about further economic development.

In 2017, **Japanese** economy grew by 1.7%. GDP growth in Japan is expected to slow down to 1.1% in 2018. In 2019, economic growth will remain stable underpinned by the tense situation in the labour market and expansive monetary policy. GDP increase is expected to reduce further

due to lower domestic demand and fiscal consolidation plans.

Despite the slowdown observed in 2017, and the long-term effects of the demonetisation policy, economic growth of **India** is still largely positive. GDP growth is mainly fostered by strong private consumption and public investments, as well as ongoing structural reforms.

Economic growth rates in **CIS countries** accelerate, which is characterised by economic growth of Russia after recession in the two previous years. Improved trade terms, more favourable external environment, less volatile macroeconomic conditions, lower inflation, stable currency exchange rates and growing oil prices have created a favourable environment for the regional economy.

However, a rather small increase is expected in most of CIS countries. Both cyclic and structural factors restrict short-term and long-term economic prospects. The sanctions imposed against Russia in 2014 restrict access of Russia to certain technologies and capital markets. The new sanctions introduced by the United States in 2017 may negatively affect the construction of energy pipelines and refinancing of public debt.

The unresolved conflict in the east of Ukraine has a negative effect on economy of the country, because lost control over resources in the east have considerably reduced exports and competitiveness of Ukraine. Belarus and Azerbaijan have overcome their economic downturn. Rapid economic growth is observed in the rest of CIS countries.

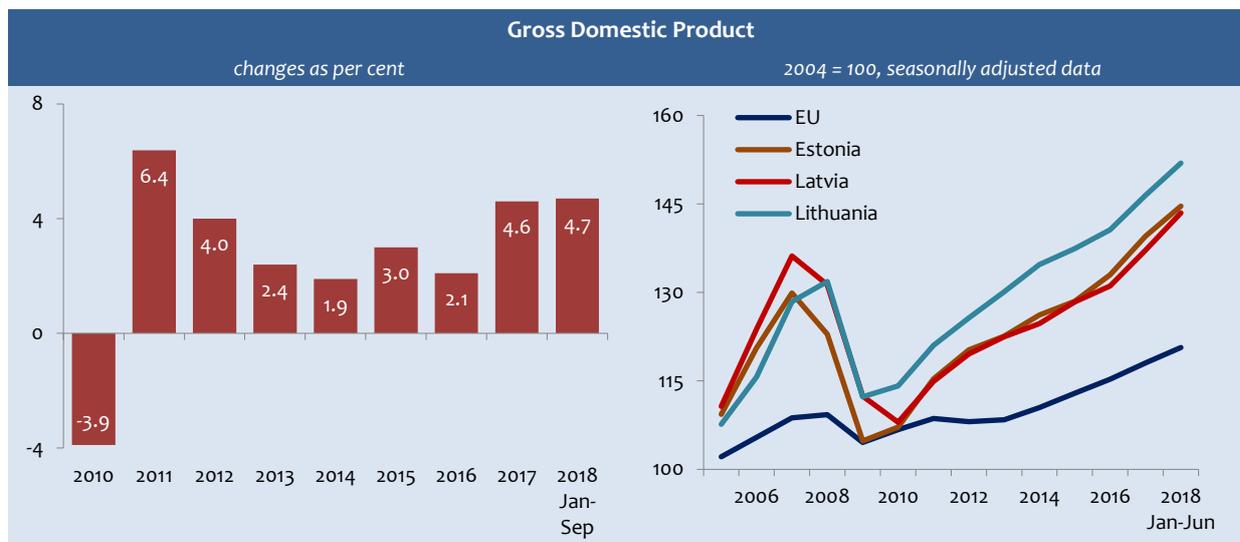
3. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

3.1. DYNAMICS AND STRUCTURE

Since 2011, economic growth has been one of the most rapid ones in the EU. In 2011-2012 it reached 5.2% per year on average. During the first years after the crisis, Latvia's economic growth was largely based on an increase in export volumes. In 2010-2012, the share of exports increased by

7 percentage points – from 54% to 61% of GDP. From 2013 to 2016, economic growth was slower due to different factors. Overall, GDP was growing by 2.3% per year on average during this period.

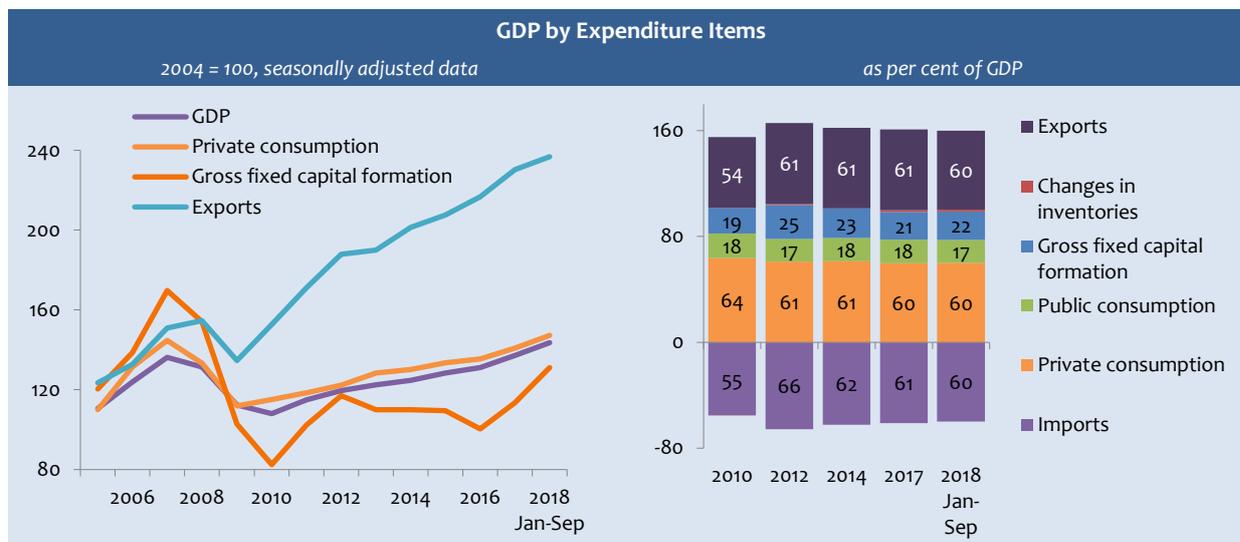
Figure 3.1



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 continued to grow in 2015. Growth was comparatively weak in 2016 due to the drop-in investments and delayed implementation of the new programme of the structural funds.

Figure 3.2



In 2017, Latvia has seen the fastest growth over the last five years. Rapid growth continued also in 2018.

The acceleration of growth in 2017-2018 was fostered by the improvement of the situation in the EU, the commencement of a new programme of the structural funds, increase in employment and wages. In this period, export, investments, private and public consumption were growing steadily.

Export growth was affected by the increase in external demand and have reached the highest-ever level. Furthermore, tangible improvements in the labour market and the increase in personal income fostered an increase in private consumption. Public consumption was also growing faster than in the previous years. After the fall in the previous years, in 2017-2018, rapid growth was observed in investments.

In 2011-2017, growth in all the three Baltic countries was similar. GDP grew slightly faster in Estonia – by 3.8% per year on average, by 3.6% in Lithuania and by 3.5 per cent in Latvia.

Figure 3.3

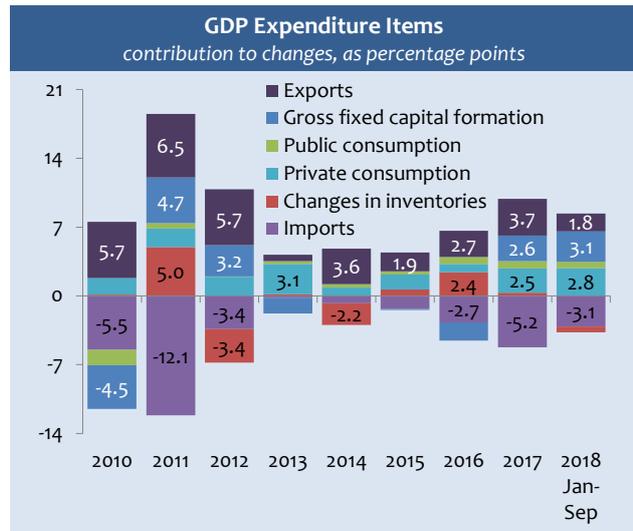


Table 3.1

	2010	2011	2012	2013	2014	2015	2016	2017	2018 Jan-Sep
Gross domestic product	-3.9	6.4	4.0	2.4	1.9	3.0	2.1	4.6	4.7
Private consumption	2.8	3.0	3.1	5.1	1.4	2.5	1.4	4.1	4.5
Public consumption	-8.1	3.0	0.3	1.6	1.9	1.9	3.9	4.1	3.9
Gross fixed capital formation	-19.8	24.0	14.4	-6.0	0.1	-0.5	-8.4	13.1	15.5
Exports	13.4	12.0	9.8	1.1	6.0	3.1	4.4	6.2	2.8
Imports	12.4	22.0	5.4	0.4	1.2	2.1	4.4	8.9	4.7

3.2. CONSUMPTION

From 2011 to 2013, private consumption increased by 3.7% per year on average. Despite the improvement of the situation in the labour market and low inflation, volumes of private consumption similarly to economic growth were more moderate in 2014-2016. The increase in private consumption was only 1.8% per year during this period. The increase was fostered by growth in wages, while the rise in employment was slow.

In 2017-2018, private consumption similarly to total economic growth grew faster provided by an increase in employment and a substantial increase in wages.

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

Figure 3.4

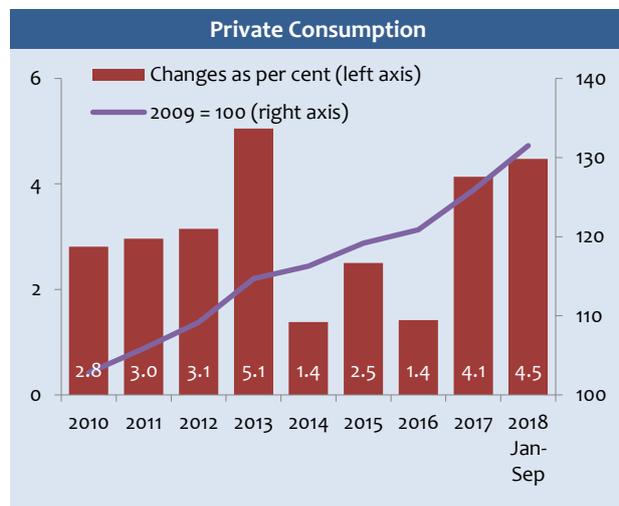
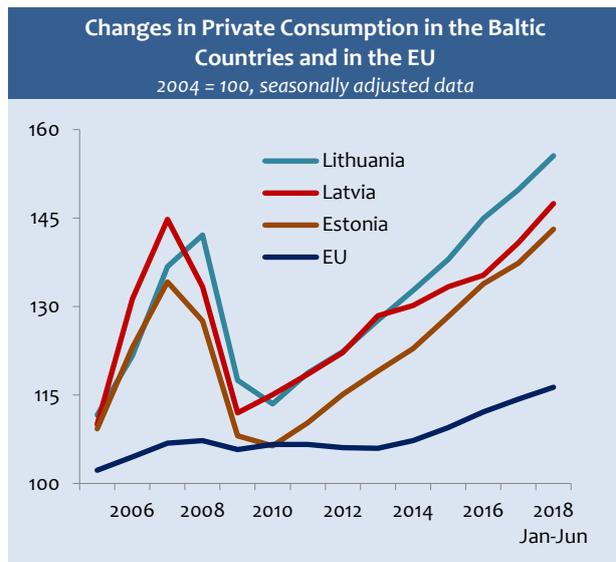


Figure 3.5



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

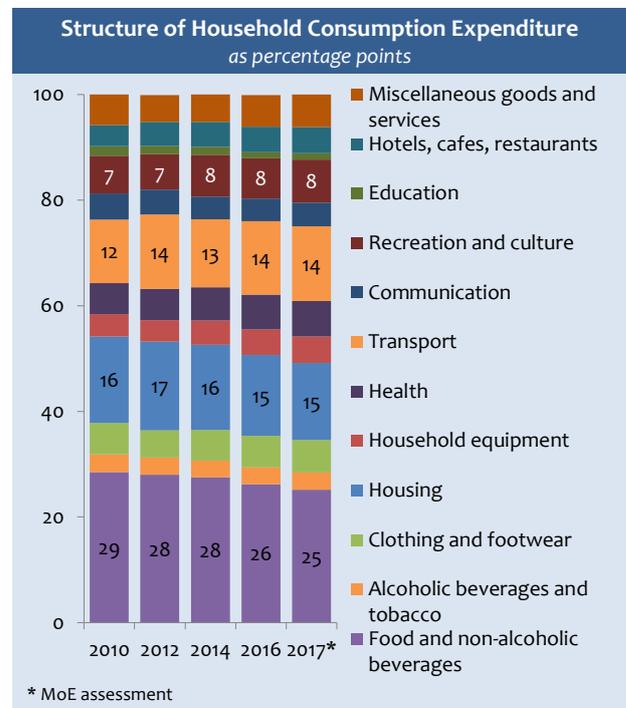
To be noted, in 2017, household expenditure were the highest in monetary terms in the last 10 years. In 2017, in comparison with the previous year, expenditure for the purchase of food remained at the level of the previous year. The amount of expenditure for housing and utility services also remained unchanged. However, expenditure for transport have increased by 7%. This was mainly due to the increase in expenditure for operation of personal vehicles and purchasing of cars. The fastest increase was in expenditure for recreation and culture – by 13%, which form the fourth largest group of expenditure.

In 2017, compared to 2010, household consumption expenditure increased in all groups of consumption expenditure with the exception of education. Expenditure for transport and food made the largest contribution into the increase of consumption expenditure.

Since 2010, the mood of consumers has generally improved, however, it is still negative. The most optimistic mood level was reached in January 2018, when the indicator reached -1 points, the highest level in the last 10 years. Such an improvement in consumer moods has been largely fostered by rapid economic growth in recent years. However, despite the gradual improvement in the mood, it generally lags behind the average level in the European Union.

The consumers’ assessment of the financial situation of their families has largely stabilised since 2012, and tends to improve, with the exception of small drops in the middle of 2013 and at the beginning of 2017. Optimism has been generally growing since the middle of 2017.

Figure 3.6

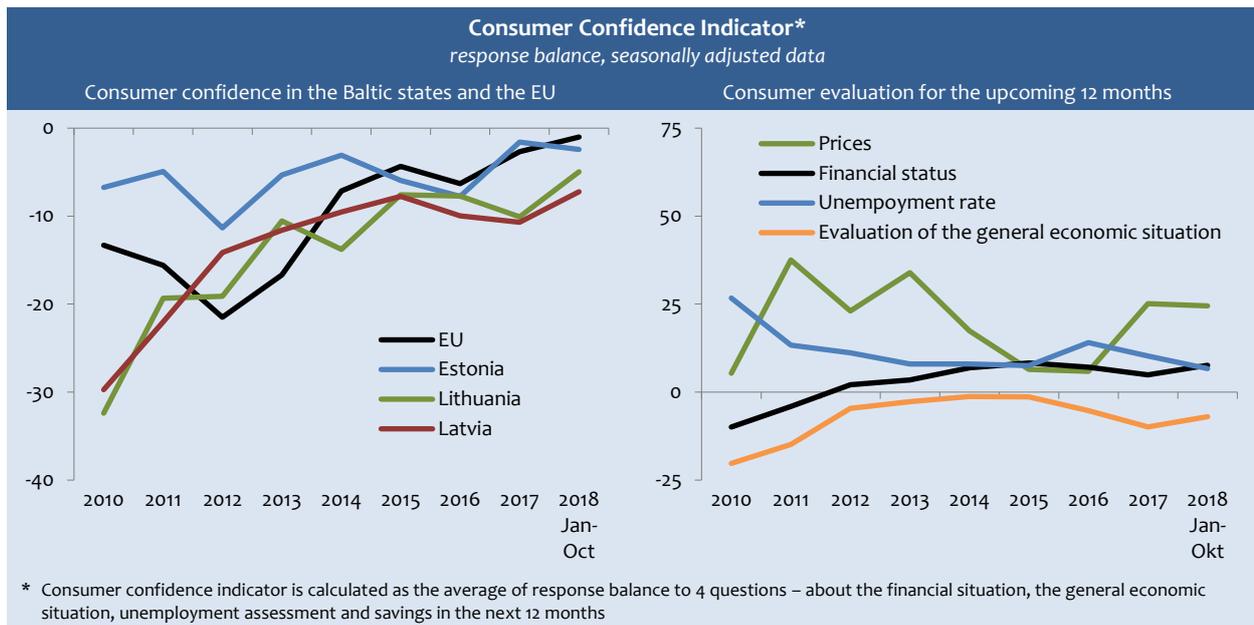


A growing trend in consumers’ assessment of the overall situation in the country has been similar to the assessment of the financial situation of their families since 2010. A rapid increase has been observed until 2012, and in 2012 the mood has stabilised at the same time sticking to the ascending trend. Since the rapid drop at the beginning of 2017 the assessment has improved, however, its increase is no longer rapid and is still negative.

The consumers’ assessment of the financial situation of their families largely depends on growth of the state, therefore, it is natural that as the economic situation in the country improves, the consumers’ assessment of the overall situation in the country and also of the financial situation of their families improve.

Unemployment expectations of consumers have been generally falling since 2010 generally sticking to a descending trend regardless of fluctuations. However, since 2016 the expectations resumed growth reaching the highest rise (24.3 points) at the beginning of 2017. 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.

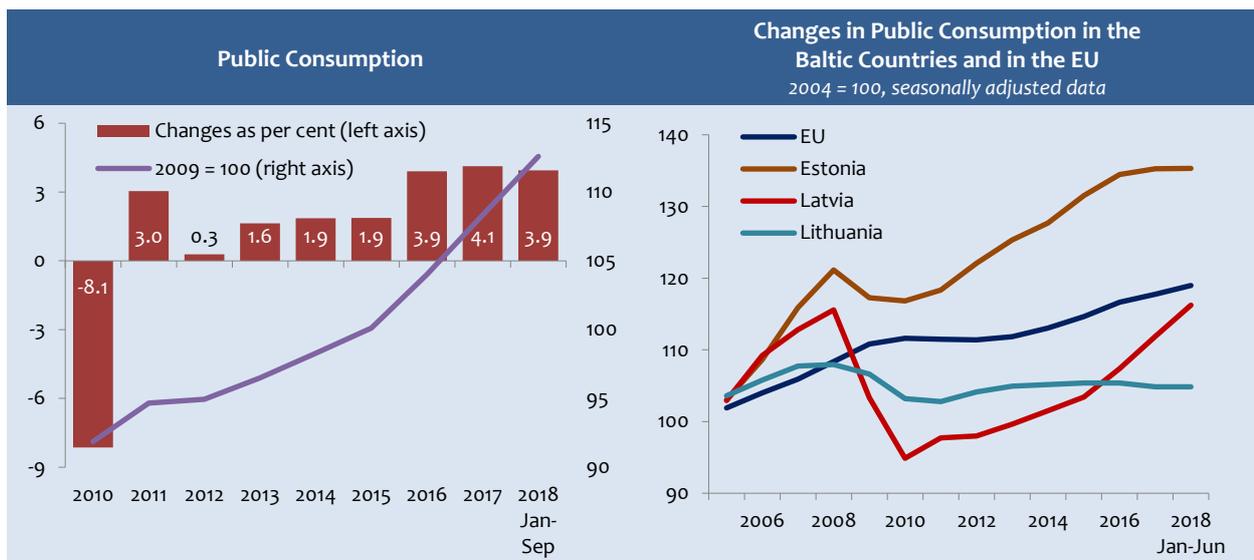
Figure 3.7



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 reduced largely under the influence of a slower rise in prices and high inflation in the previous years.

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 2011 to 2017, public consumption was growing by 2.4 per cent per year on average.

Figure 3.8



In 2017, the fastest increase since 2006 was observed. It continued to grow rapidly also in 2018. Budget expenditure has been growing rapidly in recent years to increase public defence capacity and ensure public defence funding to 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.

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

3.3. INVESTMENT

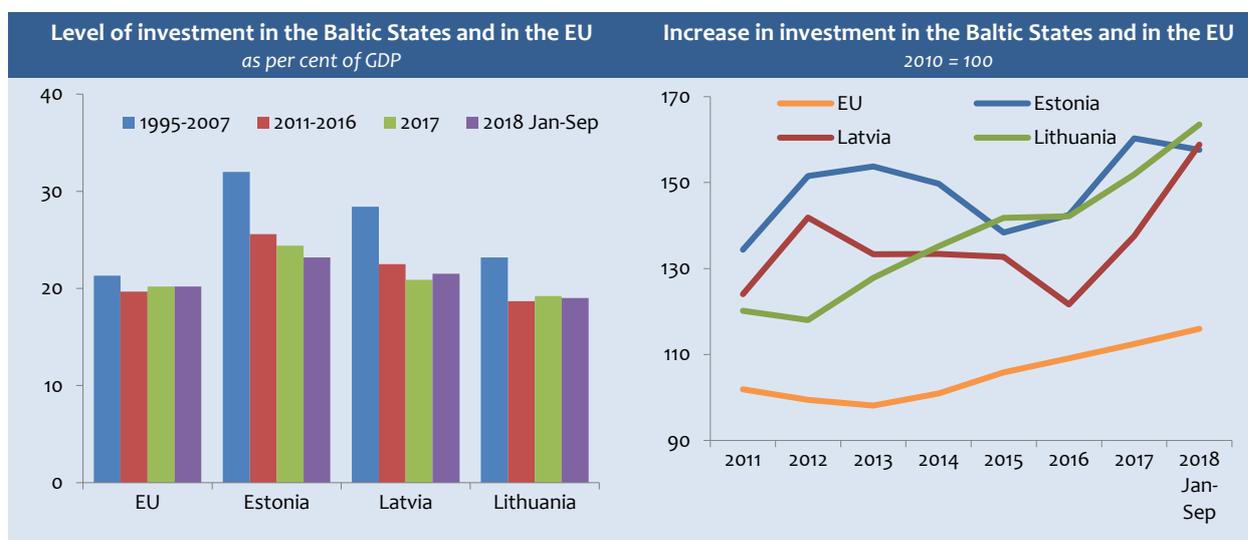
Investment activities in Latvia, as well as across the EU in recent years have increased. Since 2017, the increase in investments in Latvia has been one of the most rapid in the EU countries evidencing that the investment stagnation period has been overcome.

Slow recovery of investments (formation of the gross fixed capital) after the crisis has been observed in almost all EU member states. However, the investment stagnation period in Latvia was longer than generally in the EU, which was mainly affected by weak investment activity of the private sector.

Investments in the Latvian economy after a significant drop under the influence of the financial crisis reached their

historically lowest level in 2010 – 19.4% of GDP. Positive investment dynamics has resumed since the end of 2010. It was very rapid, yet rather unstable. In 2011 and 2012 investments increased by 24% and 14.4%, respectively, which was largely related to the low base effect. Moreover, in 2013, the amount of investments in the Latvian national economy reduced by 6% and remained at the level of 2013 in the subsequent two years. Furthermore, in 2016, investments in the Latvian national economy were by 8.4% smaller than the year before and amounted to 19.6% of GDP, that is, almost reaching the low level of investments of 2010. The decline in investments was mainly related to the cyclicity of acquisition of EU structural funds.

Figure 3.9



Overall, from 2011 to 2016, investments were growing by 3.9% per year considerably lagging the historical (1995-2004)¹ average growth rates (18.3%). The low level of investments and poor dynamics were considerably affected by low lending, relatively low demand, comparatively high level of debt both in the private and public sector, as well as an uncertain external economic and political situation.

In 2017, investments in the formation of the fixed capital were by 13.1% higher and amounted to 20.9% of GDP. Investments continue to grow rapidly also in 2018. In the nine months of this year, they were by 15.5% higher than a year ago.

Despite the increase of the last years, the level of investments is still by 3 percentage points of GDP lower than

¹ The period from 1995 to 2004 may be considered a long-term trend indicator, which excludes any rapid increase in the amount of investments in the years of economic boom and its later drop in the years of recession.

the average indicator in 1995-2004 and considerably lower than in the years of rapid growth (2005-2007).

Lagging behind the indicators of the previous periods is mainly related to the drop-in investments in machinery and equipment. In the years of economic recession (2008-2010), investments into such assets reduced by 62% and amounted to 7.1% of GDP in 2010. In the period from 2011 to 2016, investments in machinery and equipment were growing by 8.4% per year on average and amounted to 8.9% of GDP, however, this is by 2.4 percentage points less than in 1995-2004 on average and by 43.1% less than before the crisis years (1995-2007) on average. In 2017, in comparison with the corresponding period of the previous year, investments in machinery and vehicles generally increased by 8.2%, which was mainly affected by extensive investments in vehicles (increased by 35.8%), and by 1.9% less than a year ago were invested in other machinery and equipment.

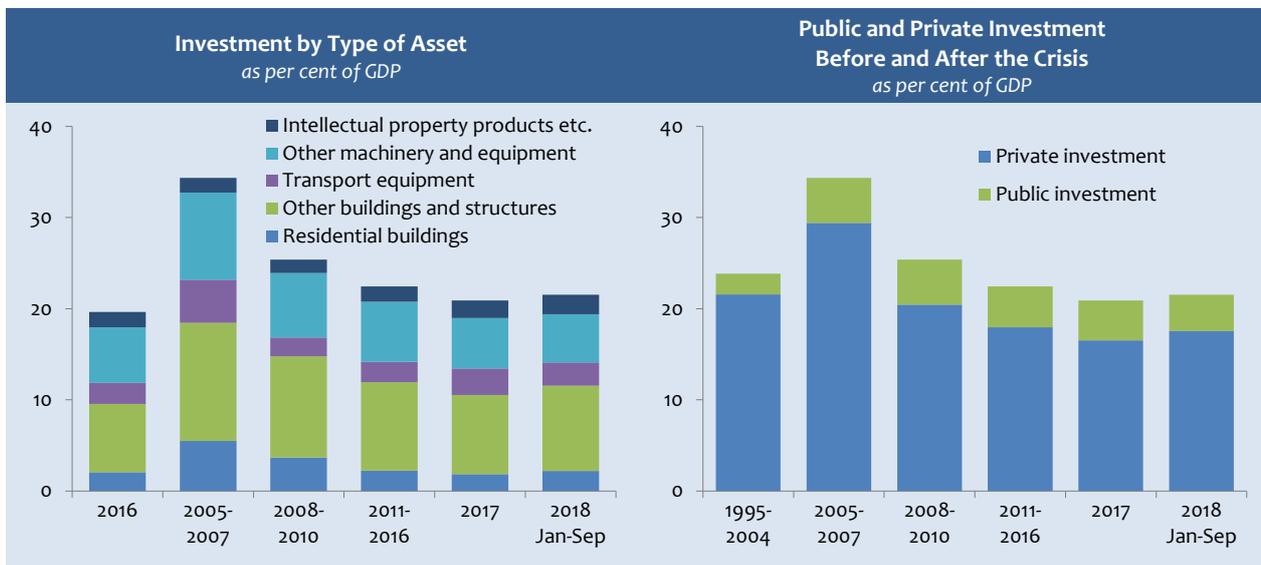
In the structure of total investments, investments in housing historically (1995-2004) constitute a comparatively small part – about 9-10%, i.e. 2-3% of GDP. They are mainly financed from bank loans, the reduction in which under the influence of the global financial crisis along with the increase in debt liabilities of the private sector largely determined the drop-in investments in these assets. In 2010, investments in construction of housing were by 70.2% smaller than in 2007 and amounted to 1.6% of GDP (7.2% of GDP in 2007). In the period from 2011 to 2016, investments in housing were

growing by 2% per year on average and amounted to 2.2% of GDP, which is close to the historical indicators, but much lower than in the years of rapid growth. In 2017, compared to 2016, investment in housing fell by 10.4% and amounted to 8.9% of total investments in the Latvian national economy.

Investments in other buildings and structures were relatively more stable during the crisis. They decreased by 37.5% in 2010, compared to 2007. In the following years (2011-2016), the investment in these assets grew quite rapidly – by 9.7% per year on average, mainly due to the significant public investment in infrastructure projects. In 2017, investments in the construction assets (housing not included) exceeded the level of the year before by 22.8%. Such a rapid increase in investments was largely underpinned by the low level of investments in 2016, which was related to the cyclicity of the programming period of the EU structural funds.

Investments in intellectual property assets have almost not changed remaining at the level of 1.6% of GDP on average (including investments in R&D of 0.6% of GDP) for several years. In the years of economic recession, investments in these assets reduced insignificantly – by 6.7% per year on average, and in the following years (2011-2016) their dynamics was moderate. In 2017, compared to the previous year, investments in intellectual property assets increased by 24.5% and amounted to 1.9% of GDP.

Figure 3.10



In 2018, investments in the construction assets are growing more rapidly, while the level of investment in machinery and equipment remains at the level of the previous year. In the nine months of this year, by 24% more was invested in construction assets than a year before, and their share in total investments amounted to almost 53.6% (11.6% of GDP), including investments in housing reaches 19.1% (2.2% of GDP). Businesses invested by 9.3% more in machinery and equipment than a year ago, which was largely affected by the increase in investments in vehicles –

by 14.5%. By 0.6% more was invested in intellectual property products than a year ago.

Despite the positive dynamics of investments private investments are still at low level. From 2011 to 2016, private investments amounted to 18% of GDP on average, that is by almost 11 percentage points lower level than in the years of rapid growth and by 4 percentage points lower than the historical long-term indicator. In 2017, private investments increased by 9.3%, but in the first half of 2018 increased by

17.2% compared to the corresponding period of the previous year and amounted to 17% of GDP.

Public investments in Latvia remain at a high level and play an important role in the accumulation of the fixed capital. In the weak crediting conditions, the state provides significant support to private investment through the co-funding of EU structural funds. EU structural funds are also an important source of financing of public investments.

In recent years, public investments have been amounting to 1/5 of total investments in the Latvian national economy, and their dynamics is comparatively stable, except for 2016, when public investments were by 20.3% smaller than in

2015 due to temporary suspension of transfers of funding from EU structural funds.

When funding from EU structural funds resumed, in 2017 public investments were by almost 30% higher than a year ago. Furthermore, in the first half a year of 2018 the amount of public investments increased by 16.3%, compared to the corresponding period of the year before. The share of public investments in total investments in Latvia is one of the highest among EU Member States – in accordance with Eurostat data public investments in EU-28 countries in 2017 amounted to 2.8% of GDP on average (in Latvia – 4% of GDP).

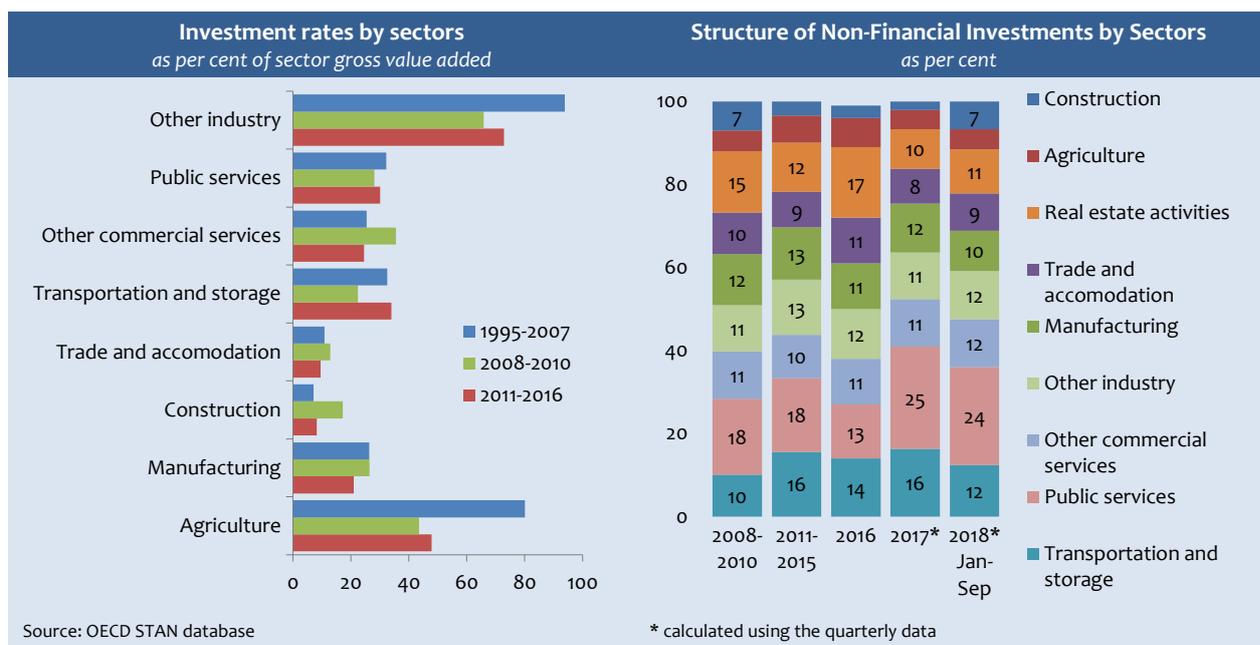
Table 3.2

Gross Capital Formation annual average							
	1995-2007	2008-2010	2011-2016	2015	2016	2017	2018 Jan-Sep
annual changes, as per cent							
GDP	7.4	-7.4	3.3	3.0	2.1	4.6	4.7
Gross capital formation	17.4	-26.4	5.1	2.4	2.5	14.0	10.8
– gross fixed capital formation	17.8	21.4	3.3	-0.5	-8.4	13.1	15.5
as per cent of GDP							
Gross capital formation	31.9	26.4	23.4	22.2	20.7	22.3	22.9
– gross fixed capital formation	28.4	25.4	22.5	22.1	19.6	20.9	21.5
– changes in inventories	3.5	1.0	1.0	0.1	1.1	1.4	1.4

Investments in sectors of the Latvian national economy are rather volatile. Due to the financial crisis, investment fell in all sectors. A particularly large drop in the investment volumes was observed in the construction. In 2010, investments in the construction were by 83.2% lower than

in 2007. A similarly large decrease was observed in the trade, accommodation and catering services sectors. Investments fell rather moderately in such sectors as information and communication services, health and social care, mining and energy industries.

Figure 3.11



As economy has stabilised, the investment activity in several sectors has increased. Overall, the most rapid dynamics since the end of 2010 has been in the services sector. In 2011-2016, investments in services sectors increased by 2.5% per year on average, which was largely affected by extensive investments in transportation and storage services, as well as in trade and accommodation sectors. Furthermore, in sectors manufacturing goods investments increased moderately – by 0.7% per year on average. Overall, it should be noted that the investment intensity¹ in the services sectors in 2011-2016 was on average close to historical indicators, while in manufacturing sectors it was at a lower level.

In 2017 investment activities increased in almost all sectors. Evaluation of the investment volume by sectors using the quarterly data shows that, in 2017, investments in service sectors were by 22% higher than a year ago. Increase in the investments in public services sectors (an increase of 30.5%) and real estate activities (an increase of 111%) contributed the most. Furthermore, investments in manufacturing sectors were by 3.2% lower than a year ago affected by a smaller amount of investments in mining and energy sectors. Investments in manufacturing grew by 2 per cent.

According to provisional data, in the nine months of 2018 investments have increased more rapidly in the sectors manufacturing goods than in the services sectors. By 26% more was invested in the sectors manufacturing goods,

while investments in the services sectors increased by 9.5 per cent.

Increase in the investments in the construction sector (an increase of 218%) and real estate activities (an increase of 63.1%) contributed the most. Investments in manufacturing were by 10% lower than a year ago.

Results of the survey of managers of industrial companies show that the most significant factor encouraging investments is the increase in demand. In recent years, the role of the factors of access to finance in stimulation of investment has increased.

Financial conditions are estimated as an important supportive factor for investment also in 2018, equivalent to the factors of technical nature, such as technological development, availability of skilled labour, etc.

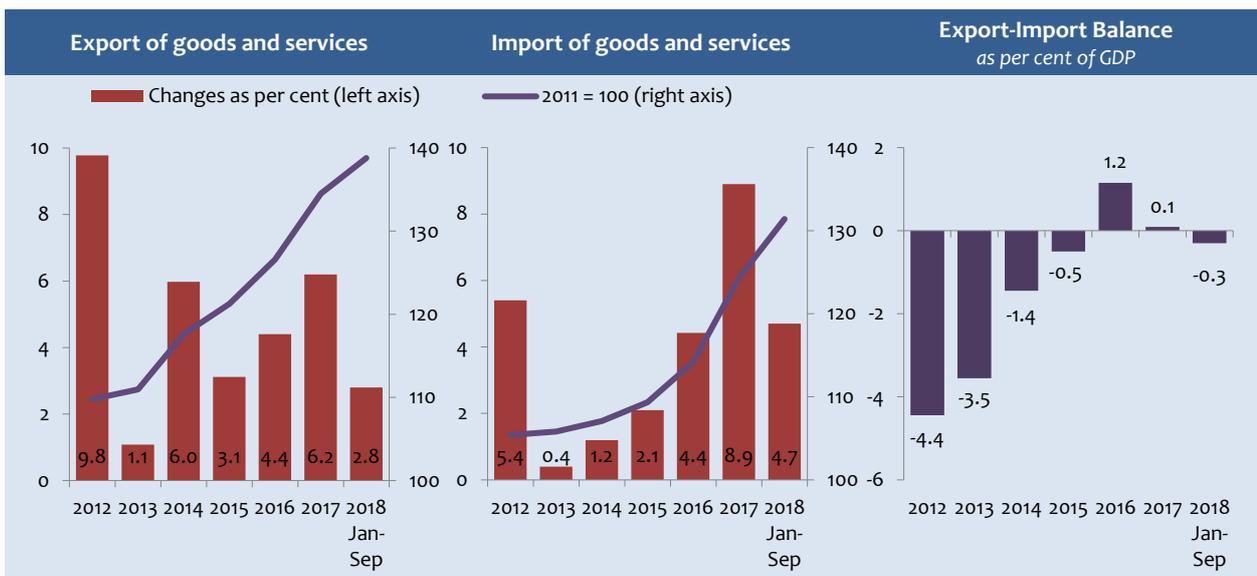
The increase in demand, as well as the positive vision of the future of entrepreneurs can contribute to an increase in investments. The investment process will be positively affected by the extension of availability of EU structural funds. Investment intensity will also be largely determined by the availability of the credit resources and other external sources of funding. If the environment remains favourable to investments, as well as taking into account the production capacity utilisation rate, positive investment dynamics may be expected in the nearest years.

3.4. EXPORTS AND IMPORTS

Exports have been developing dynamically in Latvia in recent years. Export is one of the main factors of economic growth,

and its dynamics is closely related to external demand and rates of development of economies of the partner countries.

Figure 3.12



¹ investment (investments in fixed capital formation) to value added ratio

The development of exports is promoted by rapid economic growth in Lithuania and Estonia and also stable demand in the most important exports market – EU countries, as well as stabilisation of the economic situation in CIS countries, including Russia.

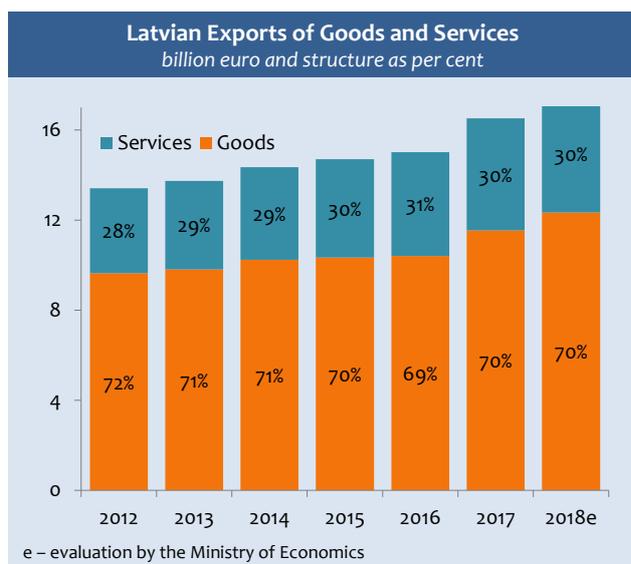
The main factors of development of imports of Latvian goods and services are increases in production volumes in manufacturing and in income available to households. Import volumes have been growing considerably in recent years, as internal demand is growing.

Exports have been growing more rapidly than imports in recent years, the export-import balance has improved from the clearly negative balance of 2012 and in 2016-2017 it was positive.

EXPORTS

More than two thirds of Latvian exports is composed of exports of goods, while the rest is exports of services. This proportion has not significantly changed in recent years.

Figure 3.13



Latvian **exports of goods** grew very sharply from 2010 to 2012, with the growth rate at current prices exceeding 20% annually. By contrast, with the external demand falling and the cost competitiveness advantages gained during the crisis decreasing, export rates started to decrease significantly in 2013-2015, but remained positive. Weaker export development was observed in 2016, when its volumes remained at the previous level.

Starting from 2017, the development of exports was very dynamic, exceeding the 10% mark at current prices in 2017. Exports continued to grow rapidly also in 2018.

In the post crisis period from 2010 to 2011 the development of Latvian exports to EU countries was underpinned by the increase in competitiveness of Latvian companies and a stable external demand, but in 2012-2013 with growth in

the EU worsening, external demand reduced significantly, and the development of exports was mainly determined by the increase in competitiveness. Improvement of the competitiveness of the Latvian producers in the post-crisis years was mainly driven by a decrease in labour costs. Whereas, since 2014 the increase in exports of goods has been mainly determined by external demand, and the role of competitiveness in export growth reduced.

Table 3.3

Export Dynamics of Latvian Goods				
changes as per cent, at current prices				
	2015	2016	2017	2018 Jan-Oct
Total	1.1	-0.1	11.1	8.3
Agricultural and food products	-2.9	3.8	19.2	2.4
Mineral products	-17.2	-27.1	3.1	6.3
Chemical industry products	3.1	8.9	8.1	5.7
Light industry products	-9.4	-15.0	9.6	-4.4
Wood and wood products	0.6	4.1	7.1	17.7
Metal and metal articles	-3.8	-6.3	21.0	15.8
Machinery, appliances and electrical equipment	15.0	-6.3	10.8	9.2
Vehicles	3.0	21.4	8.7	8.6
Other goods	8.0	7.0	5.3	3.9

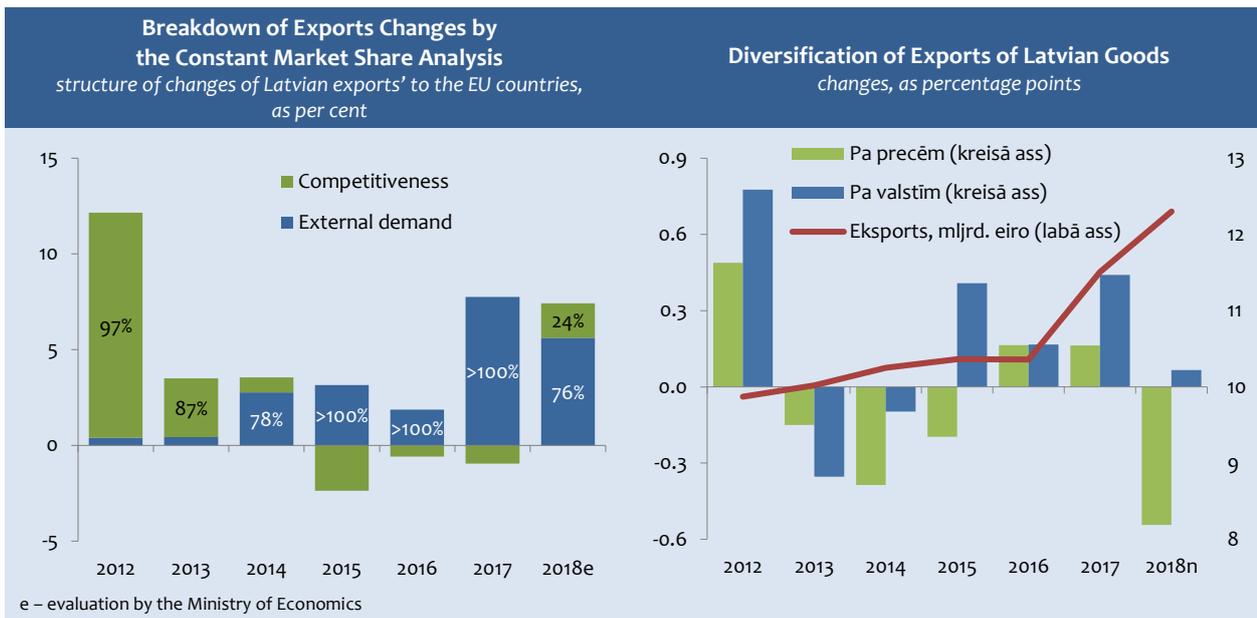
More rapid growth of larger products groups such as wood and wood products and agricultural and food products results in a worse diversification indicator of exports of goods, but more rapid development of comparatively smaller export groups improves this indicator. An improvement in the diversification indicator for goods was observed in 2015-2017. An opposite process is observed in 2018, when exports of wood and wood products grow considerably having a negative effect on the diversification indicator for goods.

Diversification of exports of goods by countries have improved in recent years evidencing the entering into new markets.

In 2017, export volumes of essentially all groups of goods increased. More rapid growth was observed in the group of agricultural and food products. Volumes of exports of machinery, appliances and electrical equipment, as well as metal and metal articles also increased rapidly.

To be noted, in January-October 2018, the increase in exports was considerably affected by the increase in exports of wood and wood products, as well as machinery and appliances. Exports of vehicles, iron and steel, alcoholic and non-alcoholic beverages, as well as iron and steel articles have also increased. At the same time, the development of exports was negatively influenced by a drop in the volumes of export of oilseeds, aircraft and parts thereof, electrical appliances and electrical equipment, as well as dairy produce.

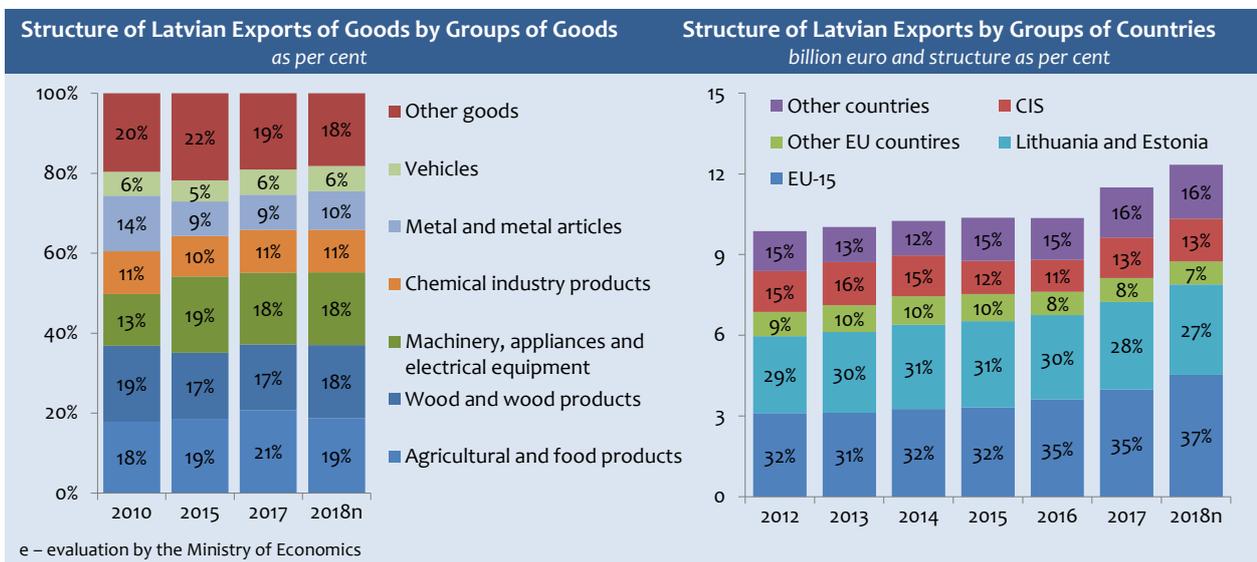
Figure 3.14



The amount of exports to the EU countries grew slightly slower than total exports (by 6.8%) in 2017. A large part of the increase was due to the growth of export of agricultural and food products.

Furthermore, the amount of exports to the EU countries also grew slightly more rapidly in January-October 2018 – by 8.6%. This was considerably influenced by the increase in the export value of wood and wood products, electrical appliances and equipment, as well as vehicles. The largest decline was observed in the value of exports of oilseeds.

Figure 3.15



After the rapid drop in export volumes of goods in 2016, in 2017 exports to CIS countries increased considerably – by 26.9% (including Russia by 32.2%). This increase was mainly underpinned by a particularly rapid increase in the export value of alcoholic and non-alcoholic beverages, as well as machinery, appliances and electrical equipment.

Exports to the CIS countries grew as fast as total exports in January-October 2018 – by 7.9%. It was still considerably affected by exports of alcoholic and non-alcoholic beverages. Volumes of exports of optical devices grew similarly. By the contrast export value of chemical industry products reduced.

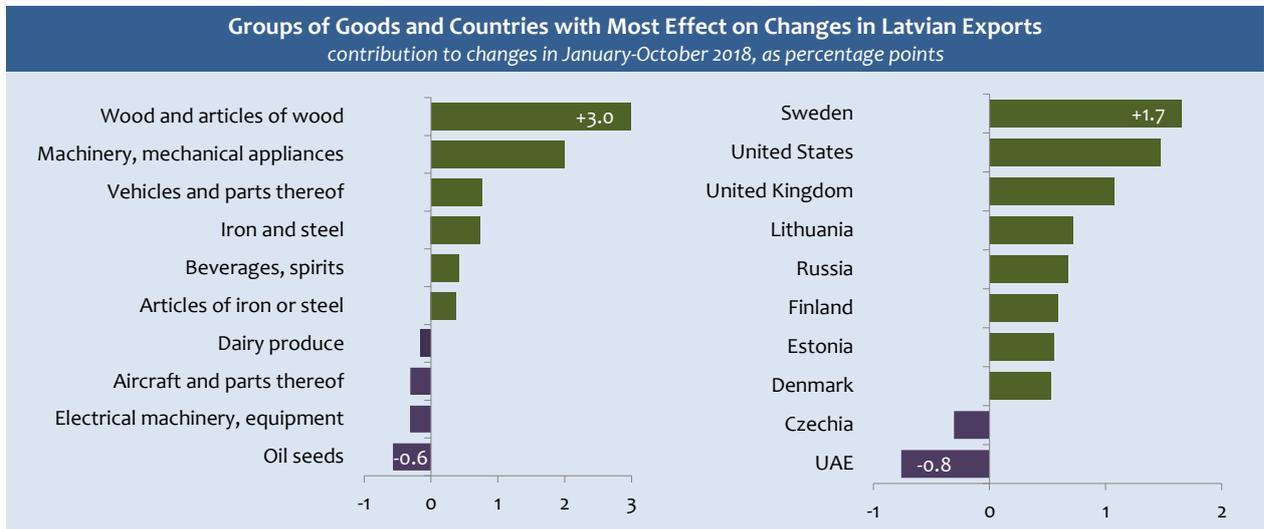
The rapid increase in exports of goods (by 19.9%) to the other countries (except EU and CIS countries) was largely

affected by the growth of exports of machinery, appliances and electrical equipment to the United States and United Arab Emirates in 2017.

The amount of exports to the other countries increased comparatively rapidly also in January-October 2018 – by

6.9%. Similarly to 2017, this was mainly attributed to exports of machinery and appliances to the United States. By the contrast, export value of electrical appliances and equipment reduced.

Figure 3.16



During the crisis, **exports of services** decreased less than exports of goods. In 2011-2012, exports of services steadily increased, as well as exports of goods. Growth rates slightly decelerated in 2013, but since 2014 the growth in services exports has been comparatively stable.

The positive balance of services in 2011-2013 covered about 60-70% of the negative balance of trade in goods, but in

2013-2014 – already about 90%, due to the balance of trade in goods improving significantly. In 2015-2016 the balance continued to improve and the balance of services completely covered the negative balance of trade in goods. In January-September 2018, as imports of services were growing more rapidly, the positive balance of services has slightly reduced.

Table 3.4

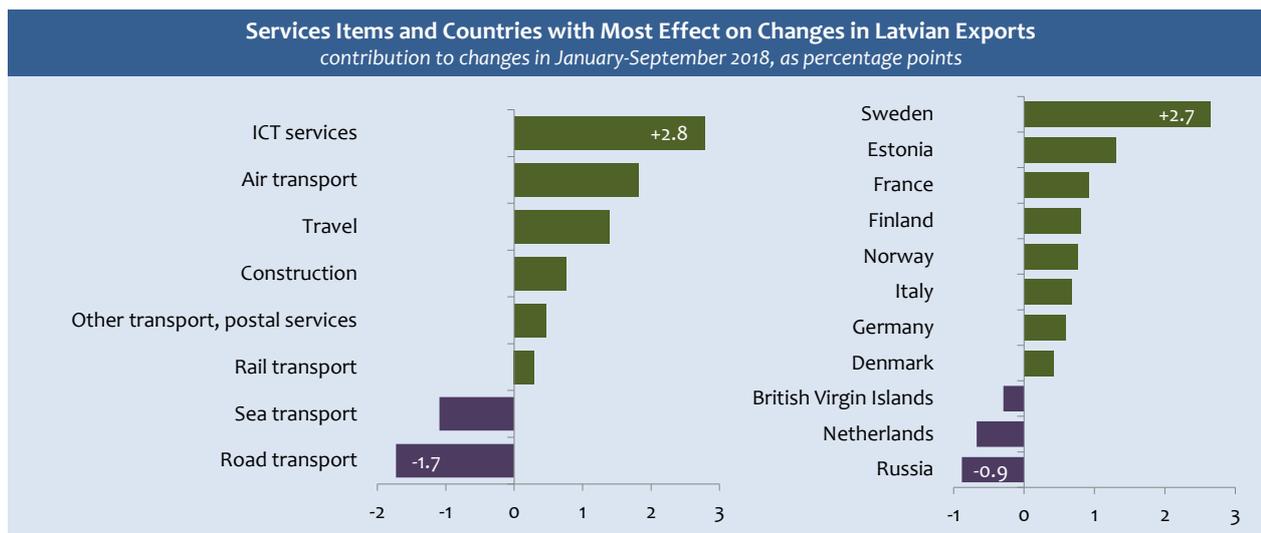
	Export of Services as per cent						
	2017			2018 Jan-Sep			
	structure	changes	contribution to the changes	structure	changes	contribution to the changes	
Total	100	8.0	8.0	100	7.1	7.1	
Transport services, including:	41.7	8.6	3.6	41.1	3.3	1.4	
– sea transport	8.5	5.0	0.4	7.6	-7.7	-0.7	
– air transport	9.2	9.6	0.9	10.8	22.1	2.1	
– rail transport	5.9	-7.9	-0.5	6.5	16.4	1.0	
– road transport	17.3	16.4	2.6	14.9	-8.7	-1.5	
– other transport services	1.0	29.7	0.2	1.1	55.2	0.4	
Travel	16.9	3.2	0.6	17.4	7.2	1.3	
Other services, including:	41.4	9.3	3.8	41.6	11.1	4.4	
– construction services	5.3	37.7	1.6	4.8	5.6	0.3	
– financial and insurance services	7.5	-16.7	-1.6	6.5	-8.2	-0.6	
– ICT services	12.6	17.0	2.0	14.1	25.1	3.0	
– other commercial services	14.6	10.4	1.5	14.7	12.2	1.7	
– other services	1.5	34.5	0.4	1.5	3.6	0.1	

More than 40% of the exports of services consist of income from transport services. 2017 and also 3 quarters of 2018 were comparatively successful for exports of transport services. In 2017, exports of road transport services increased more rapidly, while exports of rail transport services slightly shrank. In three quarters of 2018, volumes of exports of air transport services increased more rapidly, while exports of road transport services reduced.

Both in 2017 and January-September 2018, the income from foreign tourists grew.

Almost two thirds of the total exports of the Latvian services are related to the EU countries. The amount of exports to the EU countries increased both in 2017, and in three quarters of 2018 – by 13.2% and 10.2%, respectively. Transport services (road transport and air transport) and travel constitute the largest share of exports of services to the EU countries.

Figure 3.17



IMPORTS

Similarly to exports, volumes of imports of goods also grew very sharply from 2010 to 2012, while the growth rate was close to zero in 2013-2014. However, since 2015, sharp growth of imports of Latvian goods has resumed. Rapid import growth rates continued also in 2018.

The **increase in imports** in 2017 was 14.6%, which has been the sharpest increase since 2011. Import volumes of essentially all groups of goods increased. Imports of aircraft and parts thereof, machinery and appliances and mineral products have grown most rapidly.

Imports of goods continued to grow rapidly also in January-October 2018. The increase by 11.1% was positively affected by the increase in volumes of imports of machinery and appliances, iron and steel, refined petroleum products and other.

The amount of imports to the EU countries in 2017 followed similar trends total imports of goods – an increase by 11.6%. Imports of agricultural and food products increased most rapidly.

The growth of imports of goods from EU countries continued also in the ten months of 2018 – by 5.6%. It was positively affected by increases in imports of mineral products, vehicles, as well as machinery and appliances.

Imports from CIS countries increased by 15.6% and 20.4% in 2017 and in the ten months of 2018, respectively. The

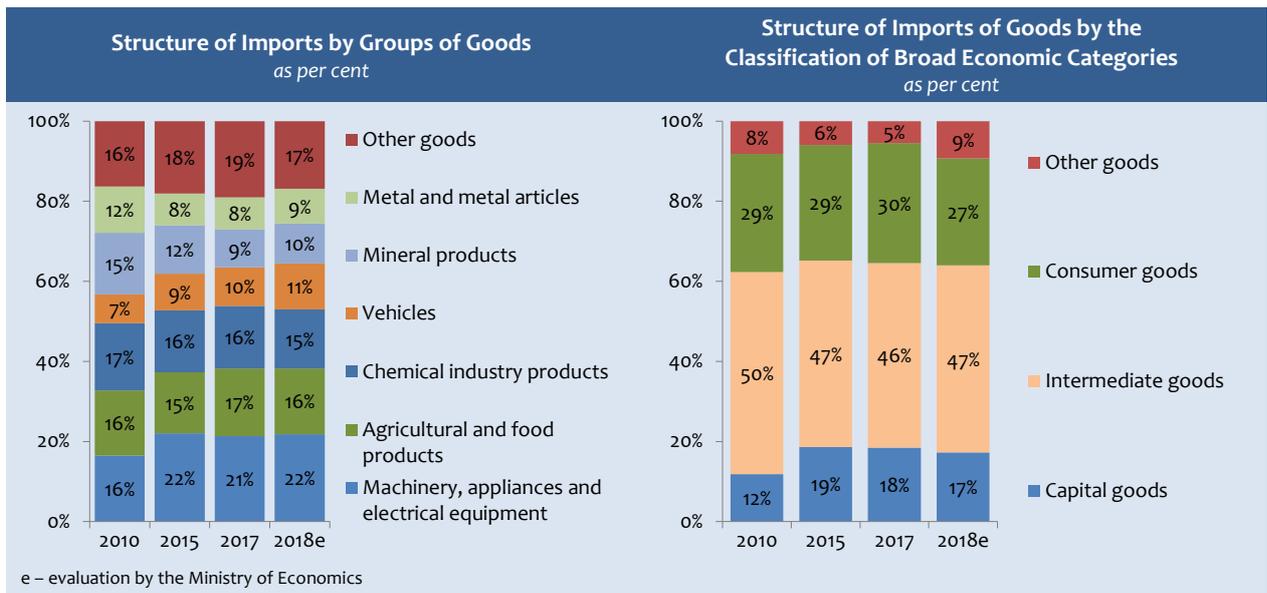
sharp increase in imports was fostered by increases in imports of mineral products and iron and steel in 2017, and by increases in volumes of imports of iron and steel, wood and wood products, as well as cereal crops in 2018.

Table 3.5

Import Dynamics of Latvian Goods				
changes as per cent, at current prices				
	2015	2016	2017	2018 Jan-Oct
Total	-1.3	-1.9	14.6	11.1
Agricultural and food products	-4.5	7.2	16.0	9.6
Mineral products	-18.1	-26.8	20.3	12.4
Chemical industry products	0.4	2.0	11.1	3.4
Light industry products	-11.7	-5.4	5.8	1.0
Wood and wood products	8.6	13.3	10.5	30.8
Metal and metal articles	-5.3	-5.5	20.3	20.9
Machinery, appliances and electrical equipment	8.3	-4.3	13.9	16.7
Vehicles	17.3	7.0	31.8	30.8
Other goods	-0.8	5.2	-0.2	-12.8

The structure of imports has not significantly changed in terms of end use of goods in recent years.

Figure 3.18

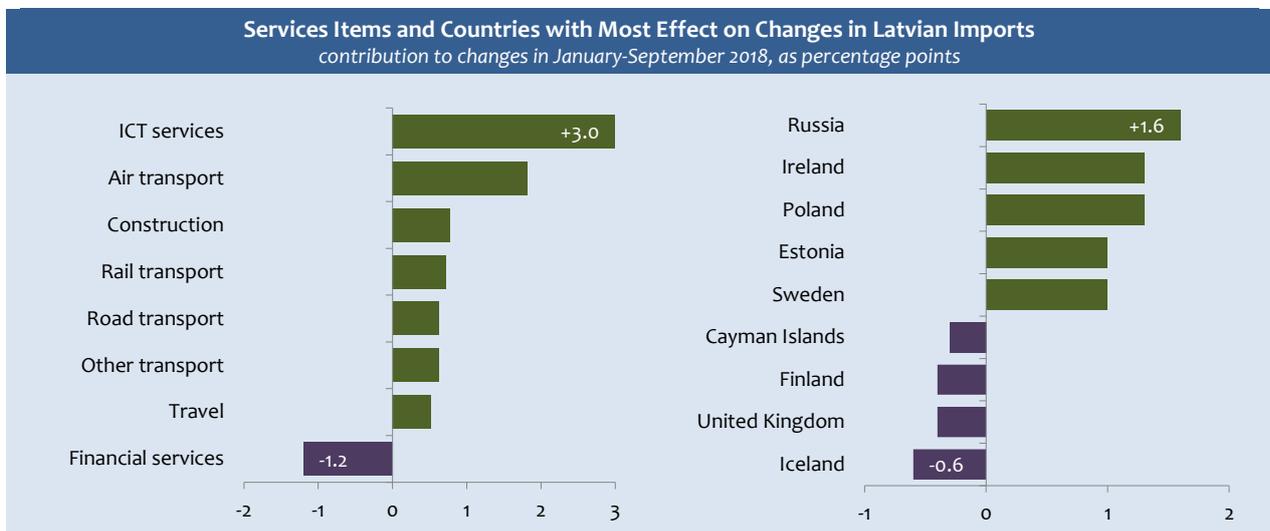


The development of **imports of services** in 2017 and in January-September 2018 was slightly more rapid than the development of exports. Volumes of imports of services related to trade mediation, as well as import of sea transport, construction and financial and insurance services developed more rapidly in 2017. Volumes of imports of trade-related services also grew rapidly in three quarters of

2018. Imports of ICT and air transport services have also increased considerably. Imports of financial services has reduced.

Two thirds of all services are provided to Latvia by EU countries. The largest groups of imports are transport and travel related services.

Figure 3.19



4. CONTRIBUTION OF SECTORS

4.1. DYNAMICS AND STRUCTURE

During the crisis, when labour costs dropped, competitiveness of the Latvian producers improved. This was the reason for the growth of export and also the development of tradable sectors. The structure of the national economy has changed. In 2008, tradable sectors (agriculture, forestry, industry, as well as transport services) accounted for only

27% of total value added, in 2010 the share of these sectors reached 33%. In 2017, the share of these sectors slightly shrank – to 29.7%. The share has reduced in all sectors, with the exception of construction and commercial services sectors in 2017, compared to 2010. Meanwhile, the share of public services sectors remained unchanged.

Table 4.1

Structure of the Economy value added, as per cent							
	2000	2005	2008	2010	2016	2017	2018 Jan-Sep
Agriculture, forestry and fishing	5.1	4.3	3.3	4.4	3.7	3.7	4.2
Manufacturing	15.4	13.0	10.8	13.5	11.9	12.2	12.1
Other industries	4.2	3.2	3.4	4.8	4.3	4.3	4.1
Construction	7.0	6.7	10.1	5.0	5.4	6.1	6.6
Trade, accommodation	15.4	18.0	15.7	17.3	16.3	16.4	16.0
Transportation and storage	11.9	12.3	9.3	10.5	9.1	9.5	9.5
Other commercial services	23.9	27.3	30.5	28.4	33.1	31.8	32.1
Public services	17.1	15.1	16.9	16.0	16.2	16.0	15.4
Total	100						

Figure 4.1

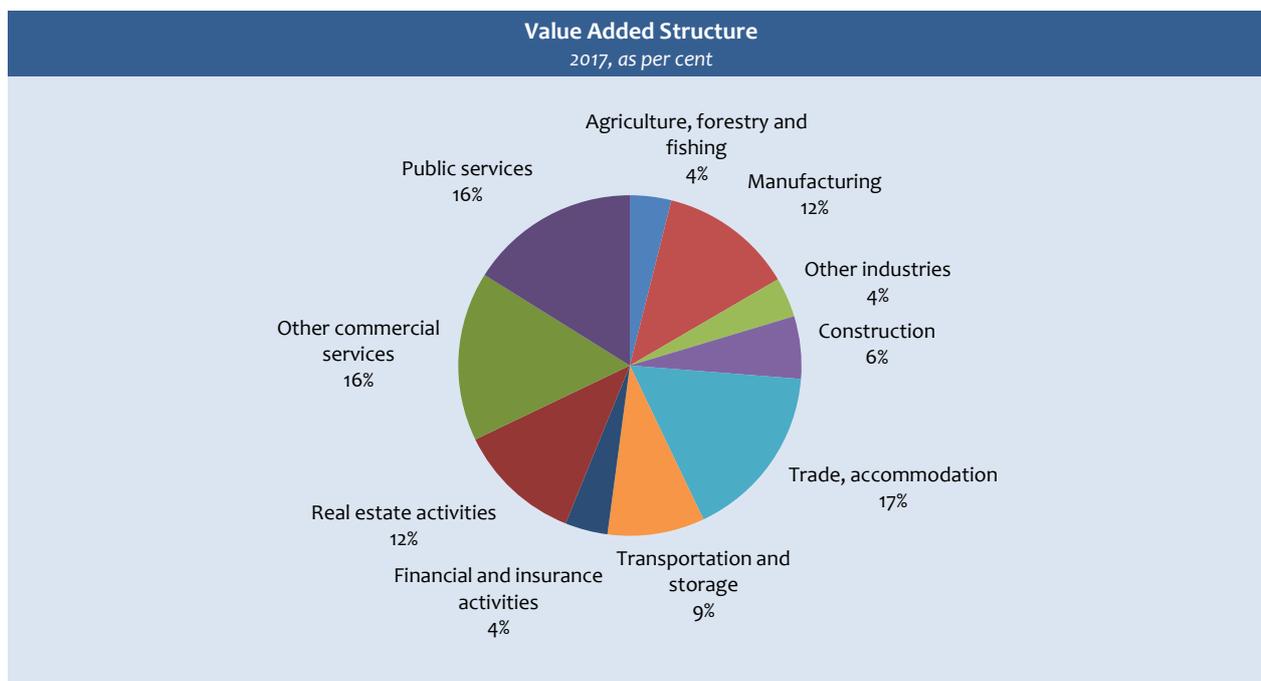


Table 4.2

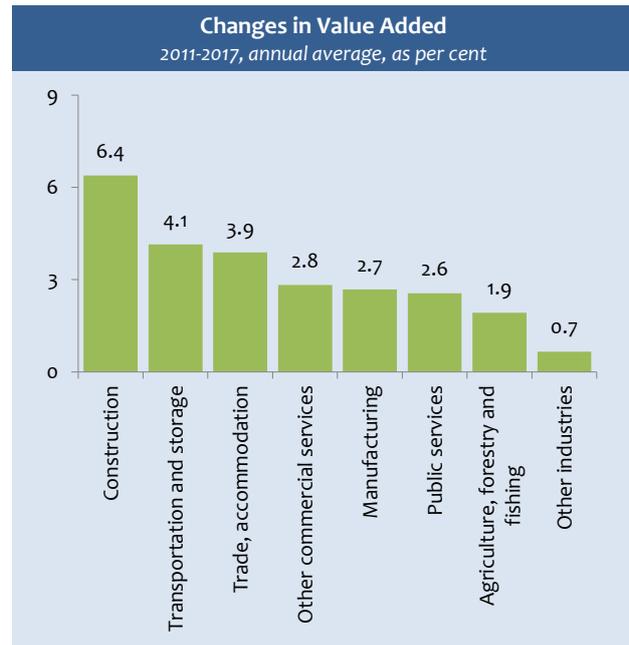
Development Trends of Sectors <i>compared to the corresponding period of the previous year before, changes as per cent</i>					
	2014	2015	2016	2017	2018 Jan-Sep
Gross domestic product	1.9	3.0	2.1	4.6	4.7
Agriculture, forestry and fishing	0.2	12.5	-9.8	1.9	5.5
Mining	-9.8	6.7	3.6	18.0	2.2
Manufacturing	0.4	0.4	2.8	8.0	2.5
Food industry	0.1	-4.6	1.8	5.2	-2.8
Light industry	-13.6	-13.2	2.1	7.6	-1.2
Wood processing	6.9	7.1	8.0	2.1	4.3
Paper industry and publishing	-0.6	0.0	3.6	4.5	-2.6
Chemical industry	-2.6	-4.1	10.7	11.4	6.9
Manufacture of other non-metallic mineral products	1.2	-9.8	11.6	11.1	4.1
Metalworking	-10.5	34.8	5.4	12.0	2.9
Manufacture of electrical and optical equipment	32.3	16.7	12.6	15.8	7.5
Manufacture of machinery and equipment	2.4	7.9	8.5	21.5	7.4
Manufacture of vehicles	-15.2	3.5	-2.9	22.8	7.8
Other industries	-12.0	3.5	0.8	4.3	-2.4
Electricity and gas supply	-14.3	22.6	18.0	7.3	0.2
Construction	10.6	0.6	-16.6	19.4	21.9
Construction of buildings	28.2	-8.2	-11.1	22.4	46.1
Civil engineering	-6.8	0.4	-25.7	30.0	31.9
Specialised construction activities	11.7	5.9	-13.9	3.9	19.2
Trade	5.3	7.3	2.7	5.3	2.2
Retail trade	3.5	4.9	2.3	4.3	5.3
Transportation and storage	1.3	-7.7	6.1	7.5	3.4
Transport of freight by railway	2.2	-2.4	-14.1	-8.4	-2.3
Freights transhipped in ports	5.2	-6.2	-9.3	-2.0	-4.6
Transport of freight by road	2.7	0.5	1.3	7.0	13.6
Accommodation and food service activities	3.6	6.0	1.3	4.3	5.8
Information and communication	-2.4	2.1	5.1	6.4	11.8
Financial and insurance activities	11.6	4.8	3.1	-18.9	-9.0
Real estate activities	1.4	1.4	0.2	0.5	3.2
Other commercial services	-5.7	5.9	1.2	6.3	3.7
Public administration, defence activities	1.5	0.5	5.5	3.6	3.2
Education	4.1	0.7	0.6	5.6	1.9
Human health and social work activities	6.8	5.5	1.4	5.6	4.8
Arts, entertainment and recreation	1.1	-3.7	5.0	8.5	4.5

In the main export sector – manufacturing, growth rates in 2010-2012 were significantly faster than the total economic growth, and this sector became the main driver of national economy. In other tradable sectors, for example, in the export-oriented commercial services sector, and the transportation and storage sector, after the crisis growth also resumed faster than in other economic sectors. From 2011 to 2014, the construction sector, which experienced the biggest drop during the crisis, was growing relatively fast.

In 2014-2016, due to a decline in the cost competitive advantages acquired during the crisis, as well as due to the geopolitical situation, export growth slowed down, resulting in slower growth of tradable sectors. Growth continued in all sectors with the exception of construction. Domestic market-oriented sectors – trade and commercial services – have contributed more to the growth. With the national budget expenditure growing, the volume of public services also increased.

Since 2010, when GDP dropped to the lowest level in the last ten year, it has been growing by 3.5% per year on average and exceeded the pre-crisis level in 2017. In 2017, Latvia has seen the fastest growth over the last five years. The increase in construction and manufacturing had the biggest effect. Rapid growth continued also in 2018.

Figure 4.2



4.2. MANUFACTURING

In recent years, when production costs were gradually dropping, competitiveness of producers has improved promoting the development of manufacturing. In recent

years, this sector has made an important contribution to the economic growth.

Figure 4.3

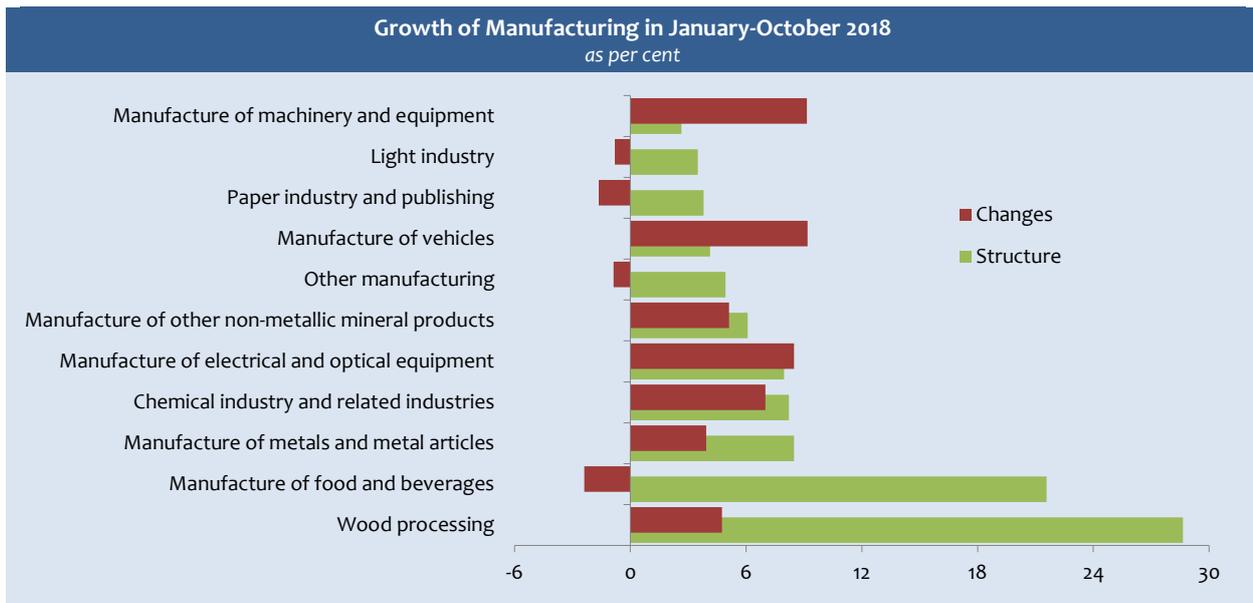
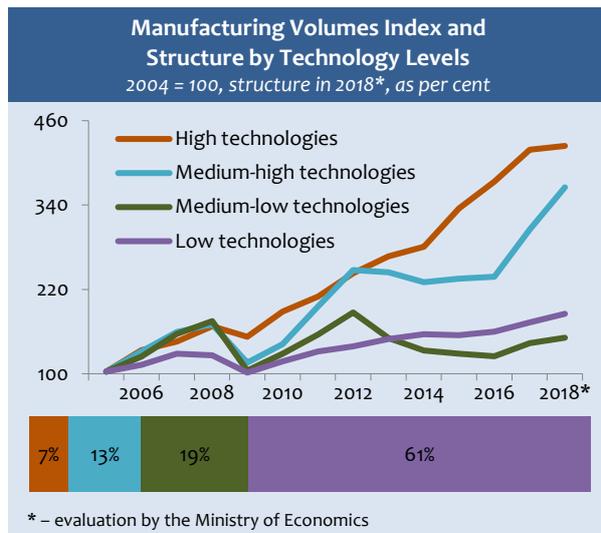


Figure 4.4



Reduction of the competitive advantages acquired during the crisis, as well as the weak demand in export markets have slowed down the growth of the manufacturing in 2013-2014. At the same time, development trends in the sub-sectors of manufacturing differed considerably. 2014 was a year with the negative sign for manufacturing affected by trends in the foreign markets – slower than expected economic growth in the EU, as well as the economic crisis in Russia.

Starting from 2015, manufacturing has been growing steady. Wood processing, manufacture of basic metals, as well as 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 individual food products.

2017, when production volumes increased by 8%, has been one of the most successful years in the development of manufacturing in recent years. Volumes of all subsectors increased, and the development of food industry and manufacture of electrical and optical equipment made a considerable contribution to the development of the sector. Volumes of metalworking production also increased.

Manufacturing volumes in the largest industrial sector – wood processing in the ten months of 2018 were growing steady. Manufacture of electrical and optical equipment and the development of the chemical industry made a considerable contribution to the growth of manufacturing. Production volumes of vehicles, non-metallic minerals, metalworking and manufacture of machines and equipment also increased during this time.

The ten months of 2018 were not favourable for the second largest manufacturing subsector – food industry. The paper industry and publishing subsector also had a negative effect on the development of the sector.

Table 4.3

Structure of Manufacturing and Development Trends of Sectors in January-October 2018
as per cent

	Output structure	Structure of occupied jobs	Share of exports in the sales	Changes in production volumes
Manufacturing – total	100	100	65.4	2.9
Manufacture of food and beverages	21.4	19.7	34.9	-2.7
Light industry	3.5	10.0	84.6	-0.6
Wood processing	28.6	20.3	71.5	4.8
Paper industry and publishing	3.8	4.2	65.4	-2.8
Chemical industry and related industries	8.3	7.2	76.8	7.3
Manufacture of other non-metallic mineral products	6.2	4.9	52.1	3.8
Manufacture of metals and metal articles	8.5	10.0	68.8	3.2
Manufacture of electrical and optical equipment	8.0	4.7	90.4	9.2
Manufacture of machinery and equipment	2.6	3.4	89.0	6.9
Manufacture of vehicles	4.1	3.4	91.9	8.3
Other manufacturing industries	5.0	12.1	66.2	-1.5

In 2017-2018, as producer prices were growing, stable growth was observed also in the increase in turnover of the manufacturing. The turnover similarly rapidly increased for products sold on the domestic market as well as for exported products.

Wood processing had the biggest positive contribution to the increase in total turnover in the ten months of 2018. The turnover of vehicles, chemical industry, as well as non-metallic mineral products also increased considerably.

In recent years, about two thirds of all the products produced in manufacturing have been exported. The

industries with the share of exports in sales above 90% are manufacture of vehicles and electrical and optical equipment. Manufacture of machinery and equipment and wood processing also have extensive sales volumes in exports. Products of the food industry are mainly sold in the domestic market.

More than two thirds of products produced in manufacturing are sold in markets of the EU countries. Similar volumes are sold in markets of CIS and other countries. This share has not significantly changed in recent years, only the share of third countries in the export structure of the production of the manufacturing slightly increases, which indicates that Latvian producers are able to find new markets.

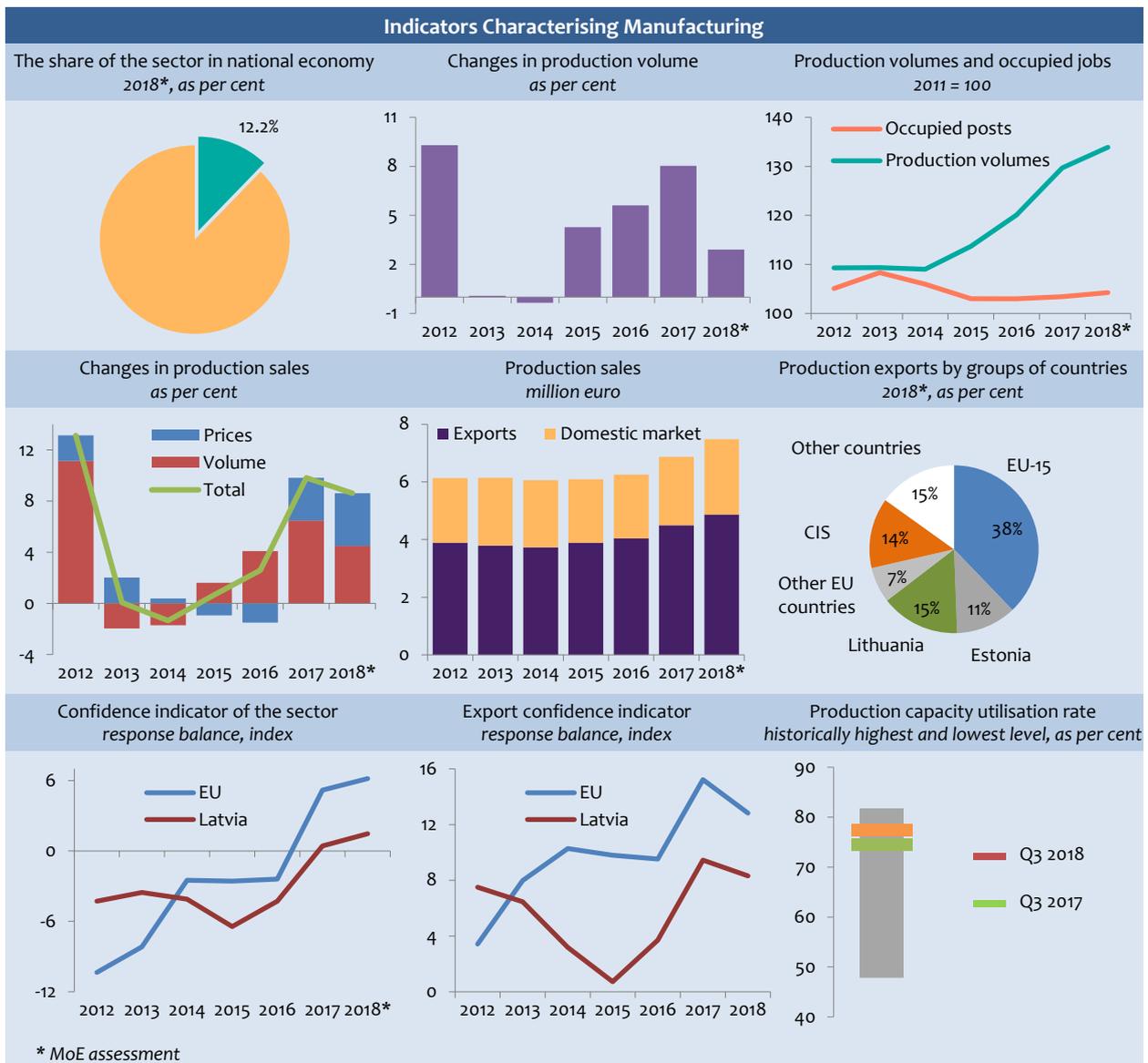
In recent years, the number of occupied jobs in manufacturing has been growing very slowly, which indicated a comparatively rapid increase in productivity.

Also in the three quarters of 2018, the number of occupied jobs in manufacturing was increasing very moderately – by 0.8%. Manufacture of electronic and optical equipment contributed more to the increase in the number of jobs. The number of jobs in manufacture of machinery and equipment, light industry, chemical industry and manufacture of other non-metallic mineral products increased as well. By contrast, labour demand in the food industry is shrinking year on year.

Since 2015, confidence indicators of manufacturing and export have been improving year on year. Clearly exporting manufacturing subsectors such as wood processing and manufacture of vehicles have the most positive future vision.

In the period from 2012 to 2016, the production capacity utilisation rate in the manufacturing remained at the level of 72-73%. In 2017, the capacity utilisation rate rose above 74% and continued to grow also in 2018 approaching the EU average.

Figure 4.5



Manufacture of food and beverages is the second largest manufacturing sector in terms of both the output and the number of jobs occupied. The sector sells more than a third of its production in external markets. Russia’s embargo on food products has had a significant impact on development of the sector. In 2014, 43% of all exported production was sold in CIS markets, while in 2018 – only 33 per cent.

In 2017, the rapid growth of the food industry was fostered by a considerable increase in volumes of manufacture of beverages. By contrast, in 2018, volumes of manufacture of beverages and other food products slightly shrank. As prices of producers of food products resumed their growth, in 2017

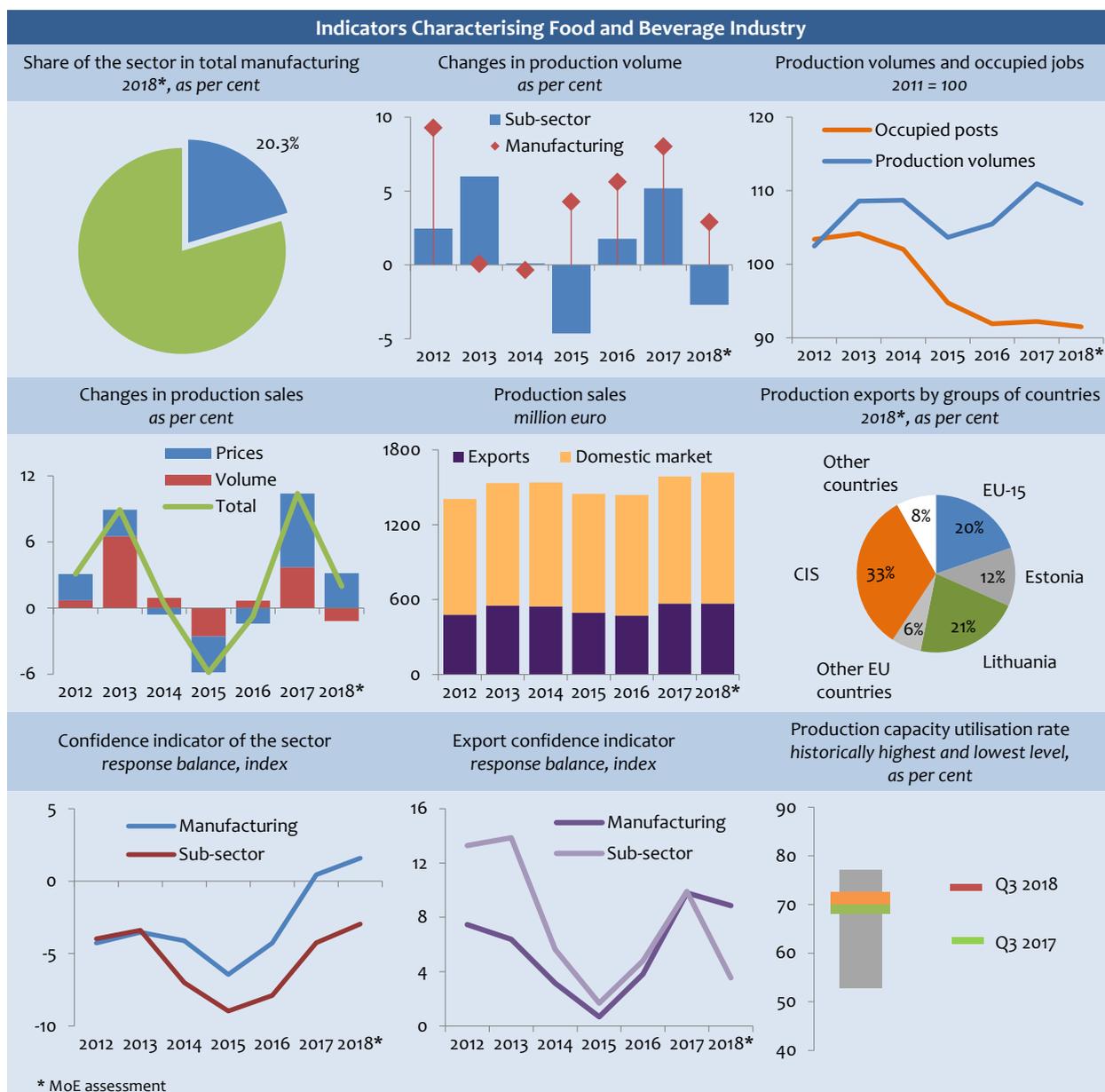
and also in 2018 the turnover of the sector, including for the products sold in the domestic market, increased. After a sharp increase in 2017, volumes of exported products slightly reduced in 2018.

The number of occupied jobs in the food industry has been dropping since 2013. In five years, the number of occupied jobs in the sector has considerably reduced.

Although confidence of the industry in recent years has been clearly negative, it still tends to gradually improve.

The production capacity utilisation rate in the food industry is considerably lower than in manufacturing on average.

Figure 4.6



The *light industry* gradually recovered in 2016-2017 after a considerable drop in production volumes in 2014-2015. In 2017, volumes of manufacture of wearing apparel increased considerably, but manufacture of textiles – more moderately. In 2018, as volumes of manufacture of textiles reduced, a small decline is also observed in the entire light industry.

In 2017-2018, producer prices in the light industry did not increase significantly. Sales volumes of the sector increased in 2017, which has been the sharpest increase since 2013. However, in 2018, its volumes declined. It was affected by the drop in sales volumes of exported products.

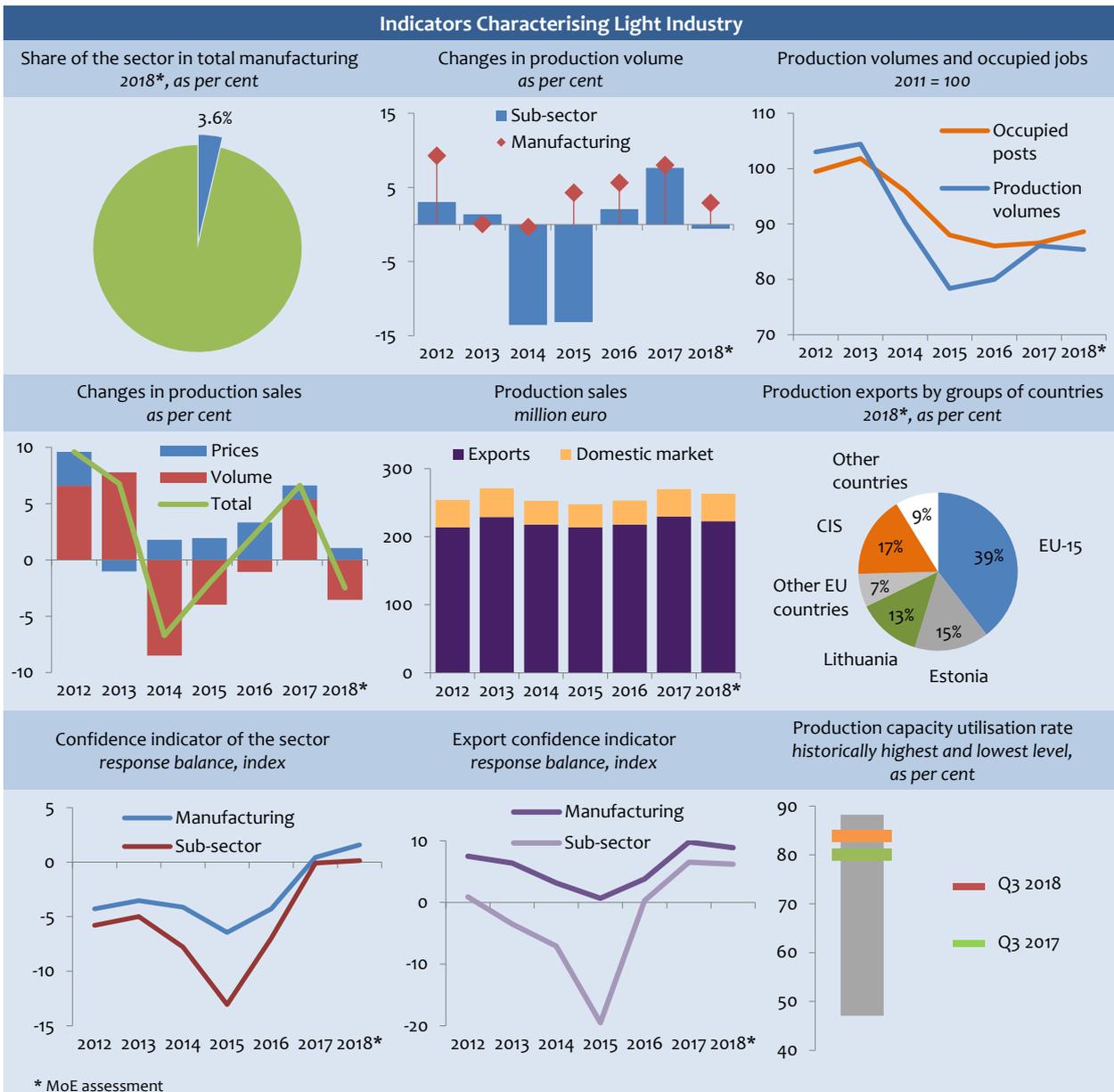
From 2013 to 2016, the number of occupied jobs in the light industry was gradually reducing. However, their number increased in 2017-2018.

Also confidence indicators have significantly improved in recent years reaching a positive industry development vision in the last two years.

It should be noted that the production capacity utilisation rate is one of the highest in manufacturing.

Taking into account sales volumes of the sector, its development is closely related to changes in demand and competitiveness in the external markets.

Figure 4.7



Wood processing is the largest manufacturing sector of Latvia. It accounts for more than one fourth of the total manufacturing output. Recent years have been comparatively successful for wood processing, including 2018, when industry output volumes exceed average manufacturing rates.

In 2015-2016, producer prices in wood processing reduced also slightly affecting the increase in sales volumes. In 2018, producer prices increased sharply significantly affecting the increase in turnover of the industry.

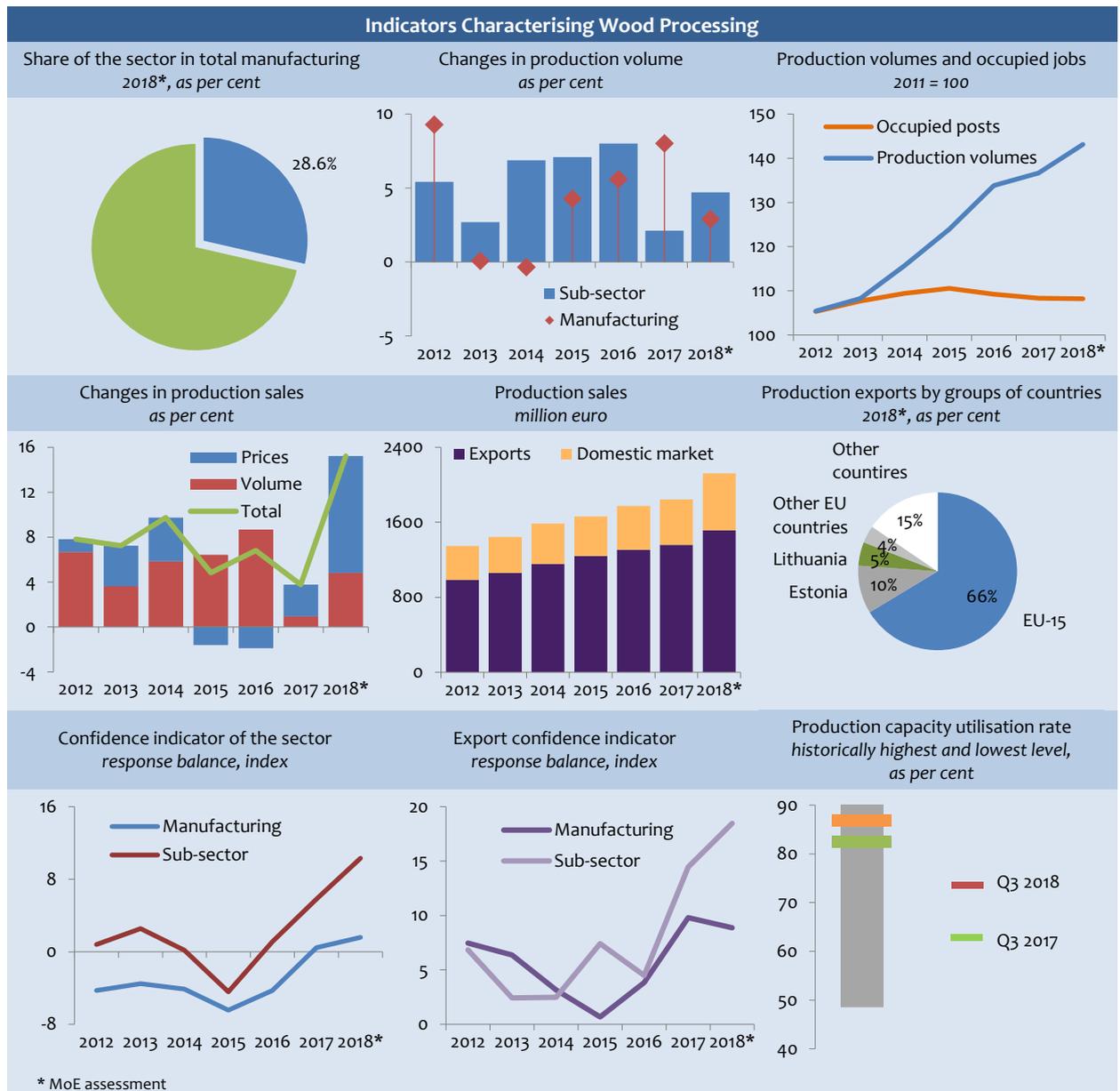
Wood processing is a clearly export-oriented sector, its exports amount to almost one third of all the products exported by manufacturing. EU-15 countries have

traditionally been the export market of this sector. It should be noted that volumes of products sold in the domestic market grew considerably in 2018.

Despite stable sector growth, the number of occupied jobs has not been growing in recent years, which evidences of the rise in productivity of the sector.

In recent years, confidence indicators of the sector have been considerably above the average level in manufacturing. Export opportunities in the future are also evaluated positively. The production capacity utilisation rate is one of the highest in the entire manufacturing.

Figure 4.8



The *paper industry and publishing* is gradually reorienting from the domestic market to export markets. About two thirds of the production were exported in 2018.

Production volumes in the sector have been volatile recently. 2018 is evaluated as negative after the increase in 2016-2017. In 2016-2017, development of the industry was positively evaluated by a considerable increase in publishing output. In 2018, output volumes of manufacture of articles of paper and publishing have sharply reduced.

The production of the sector has been gradually growing in the last three years. This is considerably fostered by the increase in volumes of exported products, while the products

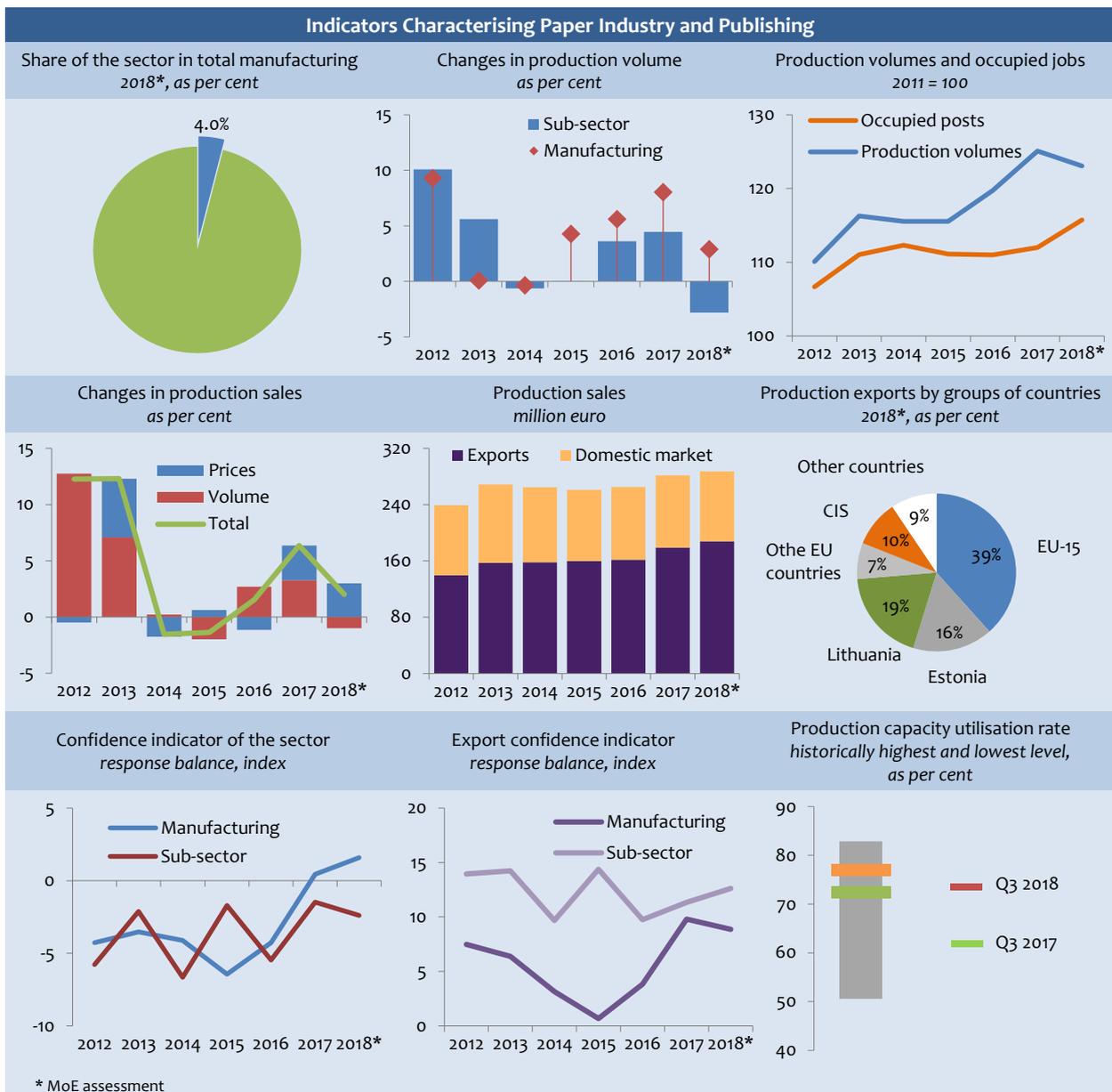
sold in the domestic market have slightly reduced. The EU countries are the main outlet for the products.

In recent years, the number of occupied jobs in the paper industry and publishing has also been growing more rapidly than in manufacturing on average.

Although the confidence indicator of the sector has been very volatile over the years, future export opportunities of the sector are still evaluated positively.

In 2018, the capacity utilisation rate of the sector, which is similar to the average in manufacturing, also continued to increase.

Figure 4.9



Growth of the *chemical industry* was weak in 2013-2015. By contrast, output volumes of the sector increased 2016-2017. This is partially explained by the improvement of the economic situation in Russia and CIS countries in general. The CIS countries are an important outlet for products of the chemical industry.

Also 2018 is successful for the chemical industry, when industry volumes outpace manufacturing growth rates. Volumes of manufacture of chemicals and chemical products and rubber and plastic products increased more rapidly, while production volumes of pharmacy were slower.

Both in 2017 and 2018, sales volumes of the industry grew considerably. In 2017, the rapid increase was affected by the increase in volumes of exported products, but in 2018

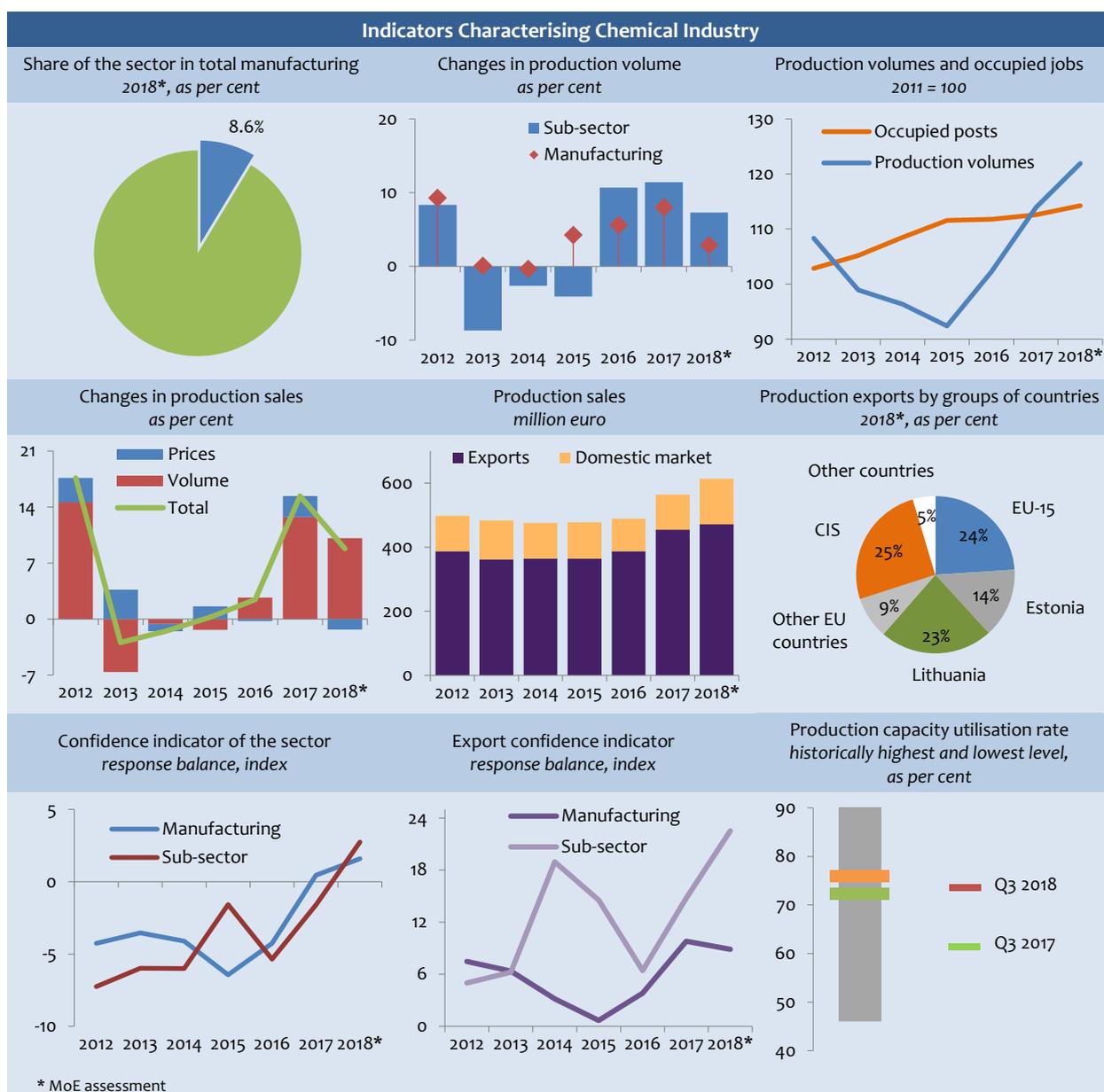
by the increase in volumes of products sold in the domestic market.

Chemical industry is the only manufacturing sector, where the number of occupied jobs is growing year on year. In 2018, their number increased slightly more rapidly than a year before.

As industry growth rates are accelerating, also the confidence indicator in the chemical industry is improving. Development has been evaluated positively in the last two years. Also export opportunities of the sector are estimated as optimistic.

In 2017-2018, the capacity utilisation rate of the sector, which is similar to the average in manufacturing, increased.

Figure 4.10



Manufacture of other non-metallic mineral products is closely related to the demand of the construction sector. 2015 was not successful for development of the industry. By contrast, stable growth was observed in the industry in 2016-2017. 2018 is positive for the industry, its growth is more dynamic than in manufacturing, in total.

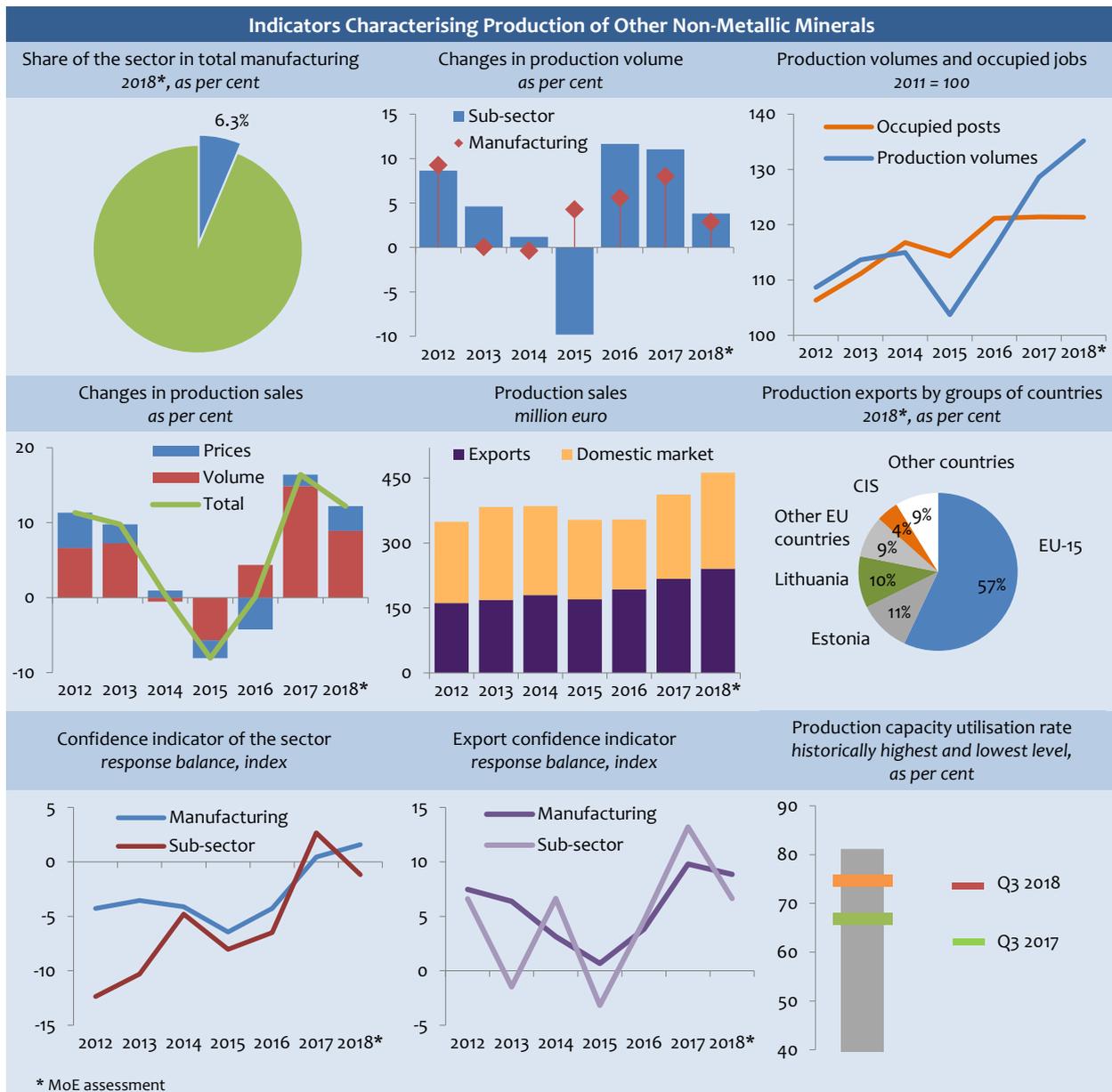
In 2015-2016, sales volumes of the industry were negative affected by the drop in producer prices, but in 2017-2018 sales volumes increased considerably. Sales turnover grew at a similar pace in the domestic market and export markets. About a half of products are sold in the domestic market. However, the share of industry export volumes in recent years tends to increase.

The number of occupied jobs in the industry increased until 2016, but has not significantly changed in the last two years.

The confidence indicator of the sector is developing similarly to growth of the sector. The confidence indicator of the industry worsened in 2018. Nevertheless, the evaluation of export opportunities is still positive.

The capacity utilisation rate in the sector reduced considerably in 2015, but in 2018 it increased considerably, however, it is still slightly below the average in manufacturing.

Figure 4.11



During the post-crisis years, the *production of metals and metal articles* contributed significantly to the total growth of the manufacturing. In 2013-2014, the industry was significantly affected by ceasing of the operation of Liepājas Metalurģis JSC, one of the largest manufacturing companies. By contrast, in 2015, when it resumed operations, growth of the sector was very rapid.

The development of the sector is significantly affected by worsening of competitiveness of the EU steel sector in the global market. However, in 2016-2018 volumes of production of metals and metal articles increased. In 2018, growth of the industry was secured by an increase in the output of fabricated metal products, while manufacture of basic metals reduced.

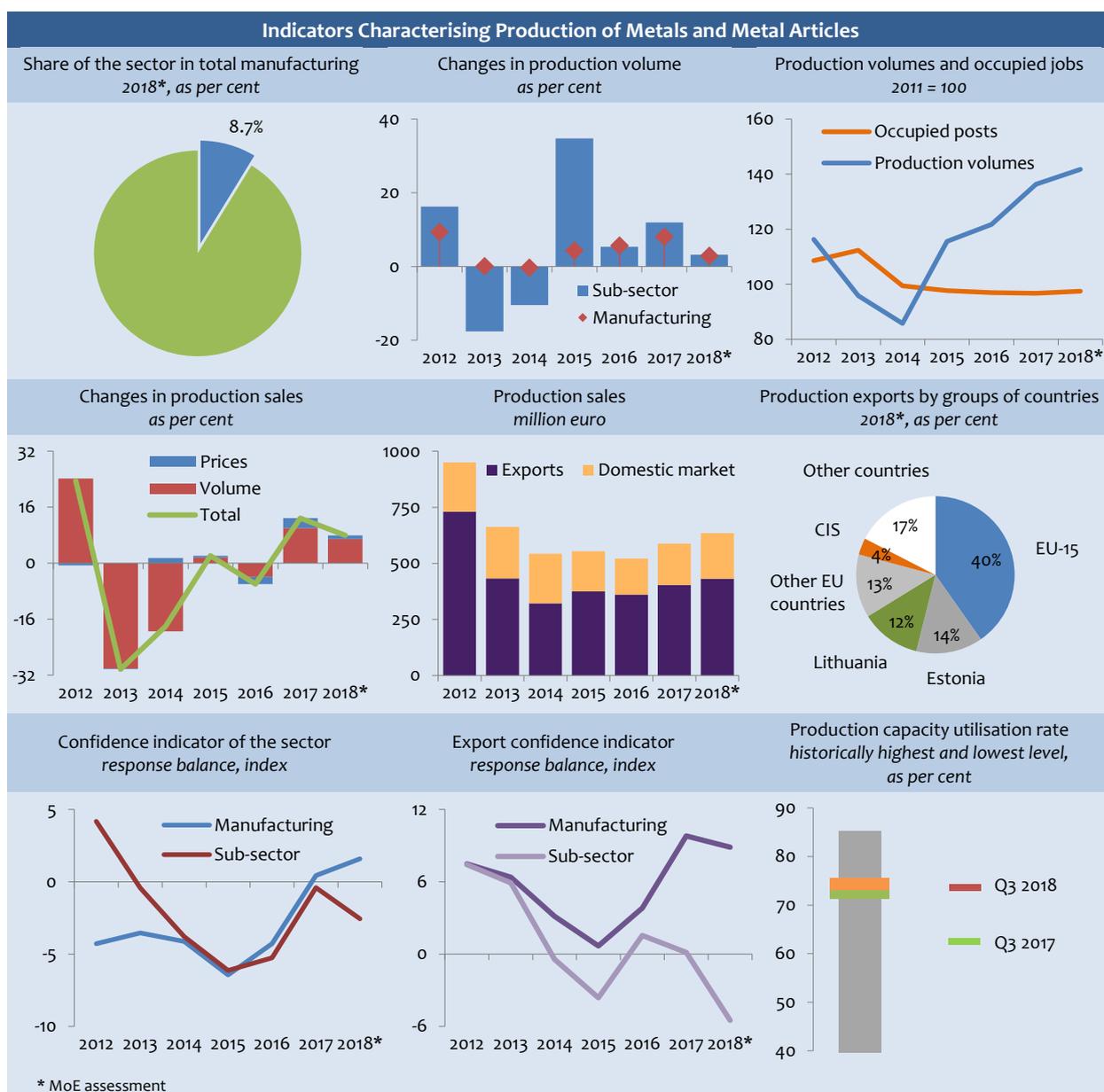
The turnover of the sector has also been growing in the last two years, which is also positively affected by changes of producer prices in the sector. Volumes of products sold in the domestic market are growing slightly more rapidly, exported products – more moderately.

The number of occupied jobs in the metalworking industry reduced considerably in 2014-2015, but has not significantly changed in the last two years.

The confidence indicator of production of metals and metal articles in recent years has been negative. Also export development opportunities are evaluated as comparatively pessimistic.

Capacity utilisation rate in metalworking is slightly below the average in manufacturing.

Figure 4.12



Production of electrical and optical equipment in recent years has been one of the most rapidly growing manufacturing sectors. Although growth rates of the sector have become slower, they are still considerably higher than in manufacturing on average. The share of the sector in manufacturing in ten years has doubled.

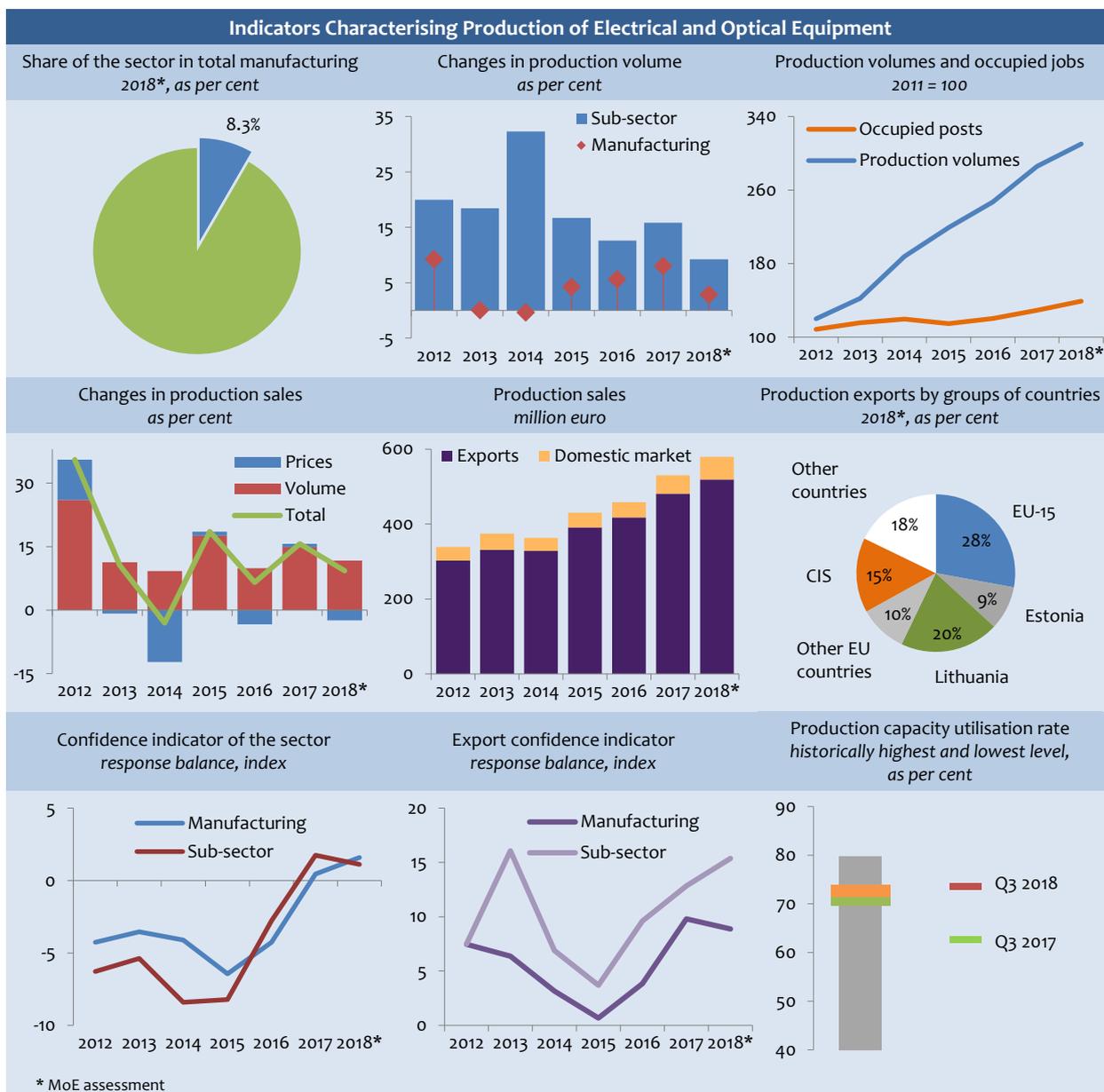
Despite fluctuations in producer prices, sales volumes of the industry are also growing steady. The development of the sector is closely related to external demand, because more than 90% of the production of the industry is exported. However, volumes of products sold in the domestic market are also growing rapidly.

Although most of the industry's growth is ensured by a rise in productivity, also the increase in the number of jobs has also been comparatively rapid in recent years. In 2017 and in 2018 the sector secured half of the increase in the number of occupied jobs in manufacturing.

The confidence indicator of production of electrical and optical equipment has improved in recent years. Development of the sector was evaluated positively in 2017-2018. Also export opportunities of the sector are estimated as optimistic.

Although the output of the sector is growing rapidly, the capacity utilisation rate remains slightly lower than the average in manufacturing.

Figure 4.13



Growth rates in *manufacture of machinery and equipment* in 2013-2014 were very moderate affected by weak external demand. The demand is growing, industry growth rates have considerably improved and have been clearly above the average level in manufacturing in recent years. Clearly rapid growth of the sector was observed in 2017.

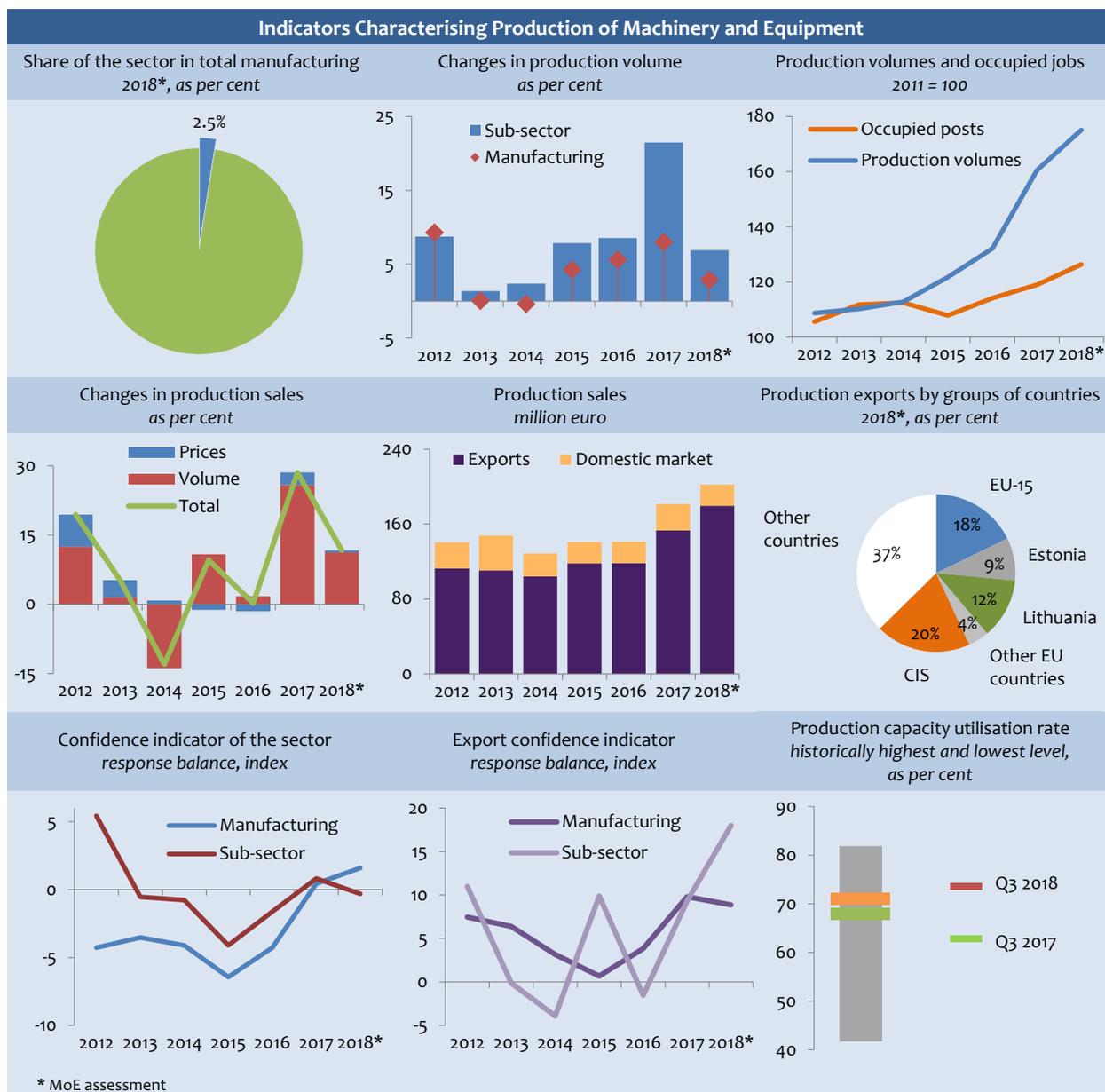
Sales volumes of the industry were stably growing in 2017-2018. The turnover was also positively affected by the increase in producer prices. In 2018, sales volumes in the domestic market reduced considerably, however, they were compensated by a rapid rise in volumes of exported products. It should be noted that about 90% of the production of the industry is exported.

The number of occupied jobs in the industry is also growing. In the last three years the sector has secured a big share of the increase in the number of occupied jobs in manufacturing.

Development of the sector was evaluated cautiously in 2017-2018. By contrast, export opportunities of the sector are estimated with more optimism.

Although the output of the sector has been growing year on year, the capacity utilisation rate remains lower than the average in manufacturing.

Figure 4.14



Production of vehicles is clearly focused on external markets – more than 90% of the production of the industry is exported. Since the industry largely depends on new orders, it is characterized by very pronounced fluctuations in production volumes.

Development of the sector in 2013-2016 was stagnating. By contrast, in 2017, when external demand was growing rapidly, growth of the sector has been the strongest in recent years. This was considerably affected by the increase in production volumes of cars and trailers.

Sales volumes of the sector have been growing rapidly in the last three years. Producer prices also have a positive contribution to its growth. In 2018, sales volumes in the

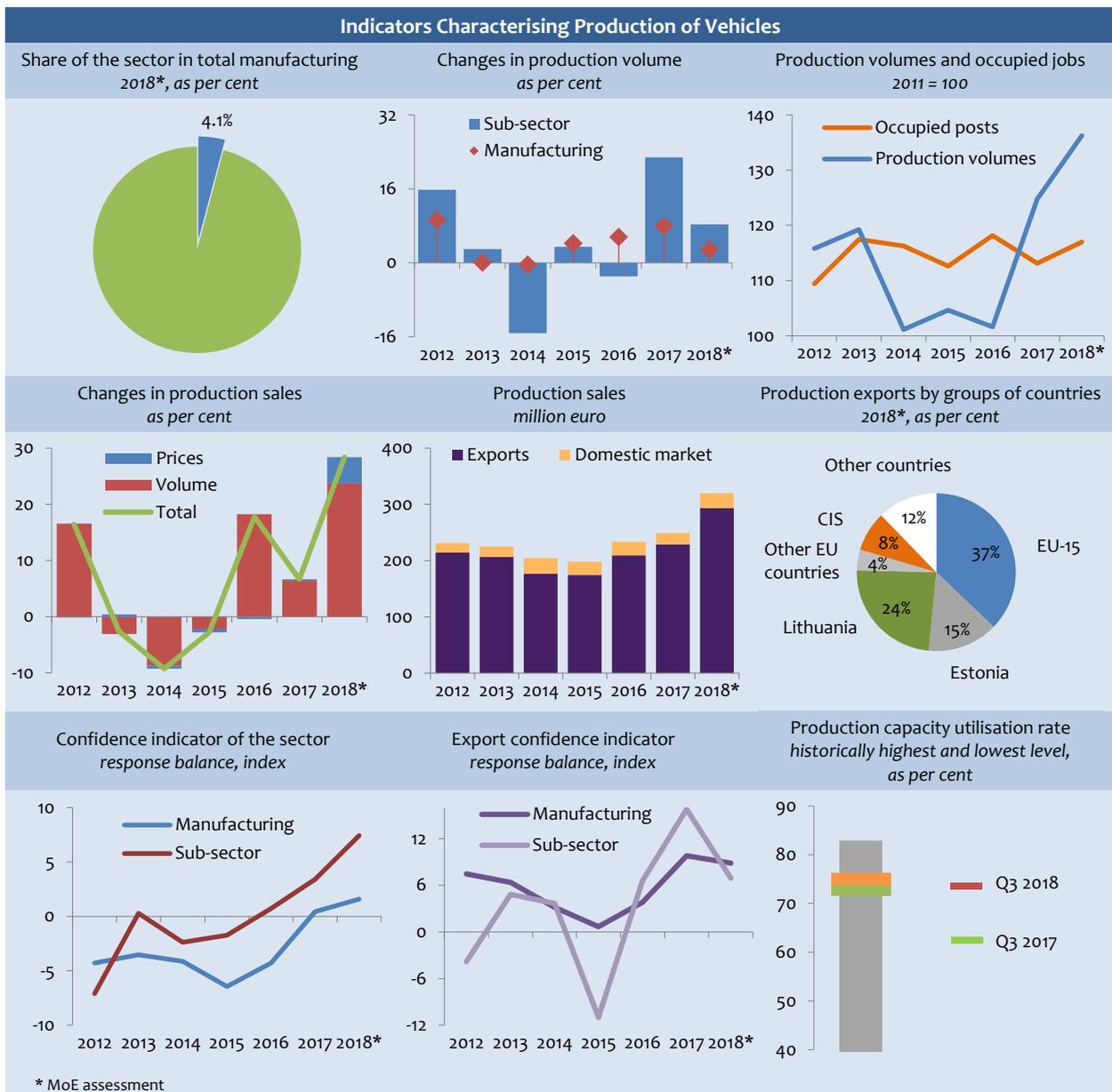
domestic market and sales volumes of exported products grew equally rapidly.

The number of occupied jobs in production of vehicles has not significantly changed in recent years, which means that growth in the industry is mainly based on the increase in productivity.

The confidence indicator in the industry is gradually improving. In the last three years the development of the industry has been evaluated positively. Also export opportunities of the sector are estimated as optimistic.

As production volumes of the industry are growing, the capacity utilisation rate, which is similar to the average in manufacturing, increases.

Figure 4.15



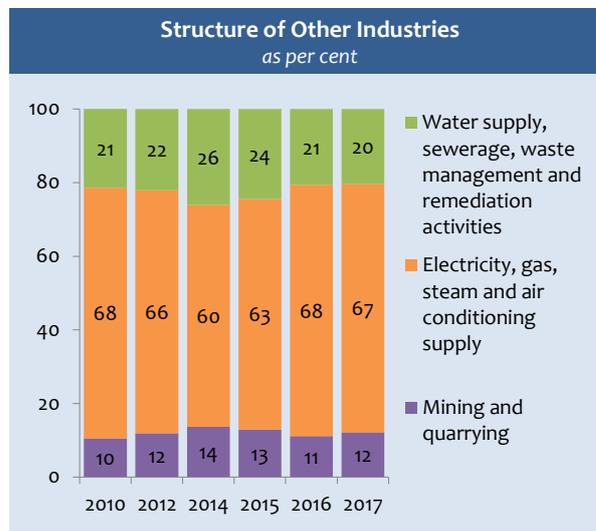
4.3. OTHER INDUSTRIES

Electricity and gas supply dominate in the structure of **other industries** (mining and quarrying; electricity, gas, steam and air conditioning supply; water supply, sewerage, waste management and remediation activities). After the drop in 2011-2014, the share of other industries in the total value added has been growing since 2015. The dynamics in sales volumes in electricity and gas supply sectors is related to weather, as amounts of electricity and heat produced depend on this.

Production volumes of other industries shrank in 2010-2014. This was mainly due to the weather, resulting in smaller volumes of electricity and heat produced. Mining volumes also reduced.

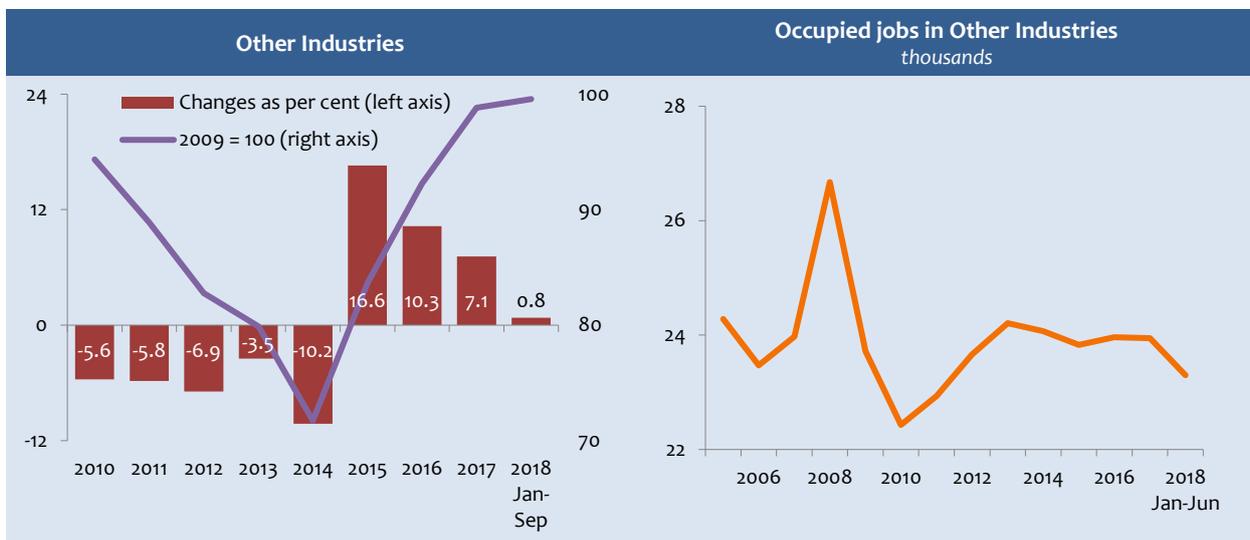
By contrast, a rapid increase has been observed in other industries since 2015. Taking into account that weather in the winter months of 2016-2017 was much colder, more electricity and heat energy was consumed. In 2017, the share of the mining industry also increased fostered by a considerable increase in peat extraction volumes. In 2018, growth of other industries was very moderate.

Figure 4.16



The number of occupied jobs in all industries has increased since the crisis, but the number of jobs in mining and in electricity and gas supply has been shrinking in recent years.

Figure 4.17



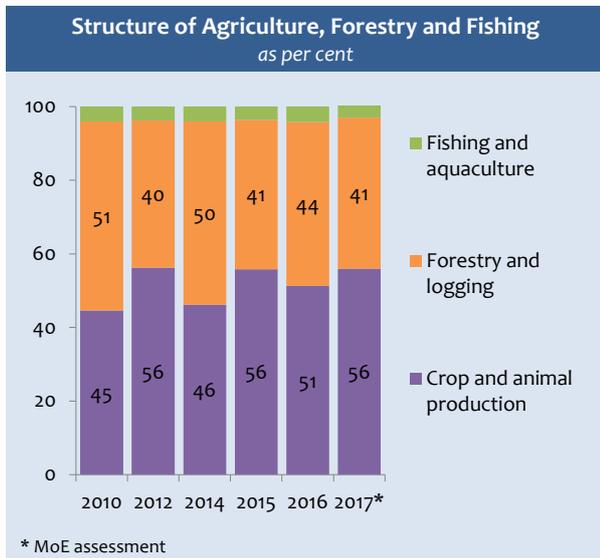
4.4. AGRICULTURE, FORESTRY AND FISHING

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 drop in 2011-2013, the share of the industry in the total value added

increased in 2014 due to the increase in forestry volumes and in 2015 – due to the increase in agricultural volumes. The share of the industry has reduced in recent years.

In 2014, the animal production sector was negatively affected by the restrictions on food imports for dairy products imposed by Russia, while the harvest of crops and volumes of grown vegetables in plant production increased. Forestry was positively affected by growth in wood processing.

Figure 4.18

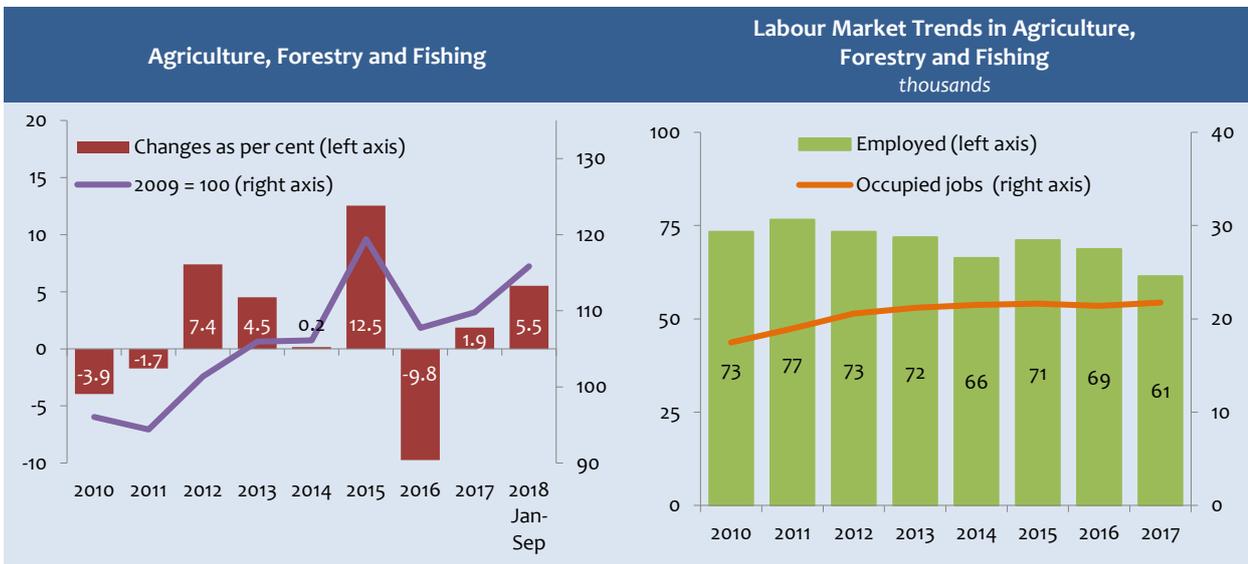


In 2015, despite Russia’s embargo on food imports, there was rapid growth in agriculture and forestry fostered by the biggest harvest of crops in the history of Latvia.

Volumes of the industry reduced sharply in 2016, compared to 2015. Volumes of agricultural production reduced by 3.4% underpinned by the drop in crop production volumes by 5.5%. Animal production volumes remained unchanged. Harvest of crops reduced under the influence of meteorological conditions, however, it was one of the highest in the history of Latvia, it was higher only in 2015. Harvest of vegetables had a small increase. At the same time, prices of agricultural products shrank as well, which was mainly affected by the drop in prices of crop products. It should be noted that the average milk purchase price in 2016 was the lowest since 2010 – 215 euro per ton, although it increased sharply in the second half of the year. In 2016, volumes of cut wood shrank by 1%, while forest renewal volumes reduced by 7%. Average purchase prices of logs continued to reduce.

In 2017, very moderate growth was generally observed. In 2017, volumes of agricultural products increased by 2%, crop production volumes (by 1.5%) and animal production volumes (by 2.8%) increased as well. Although there was unfavourable weather, the highest average crop harvest in the history of Latvia was reached in 2017 caused by productivity of winter crops, because the crops were gathered before the unfavourable weather. By contrast, autumn 2017 was particularly unfavourable for productivity of spring crops, potatoes and vegetables. Productivity of spring crops has been the lowest in the last six years. The number of exported livestock and pigs in animal production increased in 2017, despite the effect of the African swine fever. Volumes of meat, milk and egg production also increased.

Figure 4.19



At the same time, prices of agricultural products increased considerably in 2017. They increased in all main groups of products, with the exception of edible potatoes and poultry (slaughter weight), prices of which remained essentially unchanged. Purchase prices of milk increased most rapidly – by 42.6% (to 306 euro per ton).

In 2017, volumes of cut wood increased – by 8% and forest renewal volumes – by 5%. After the drop in the previous three years, average purchase prices of logs in Latvia increased in 2017.

In 2018, a rapid increase in volumes of the industry is observed due to favourable weather and rapid growth of forestry.

The number of the employed has reduced rapidly, but the number of occupied jobs is growing in the industry and have exceed the pre-crisis level. This is explained by a different data registration system. The employed include self-employed persons, who constitute about half of the total

number of the employed in agriculture, forestry and fishing. Occupied jobs increase due to the increase in jobs on wage, while the number of employed reduces due to the drop in the number of self-employed, which means that labour force on wages is still used more in the industry.

4.5. CONSTRUCTION

Growth of **construction** is largely subject to cyclical fluctuations. Construction volumes dramatically reduced during the crisis, industry output shrank more than twice in the period from 2008 to 2010.

The demand for services of the industry resumed growth in 2011. The recovery of the construction sector was largely due to more active acquisition of the European Union 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. In 2011, the construction volumes outside Latvia exceeded the indicator of 2008 more than 5 times. Growth of the construction sector continued in the period from 2012 to 2014.

Overall, during this time the sector was rapidly recovering from the shock caused by the crisis. This was largely fostered by public procurement and the European Union structural funds. The annual increase in the average volume of construction output in the post-crisis period in 2011-2014 was 11.2%. It should be noted that pre-crisis volumes have not been reached yet, the industry constituted 70% of the pre-crisis level in 2014. The increase in construction

activities also reflected in the increase in the number of granted construction permits.

Figure 4.20

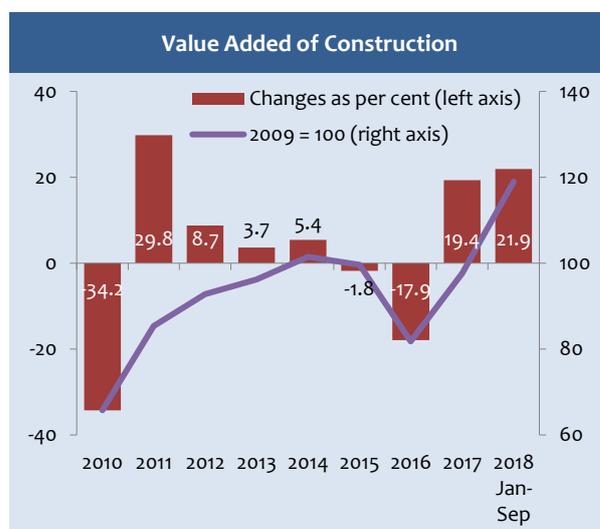
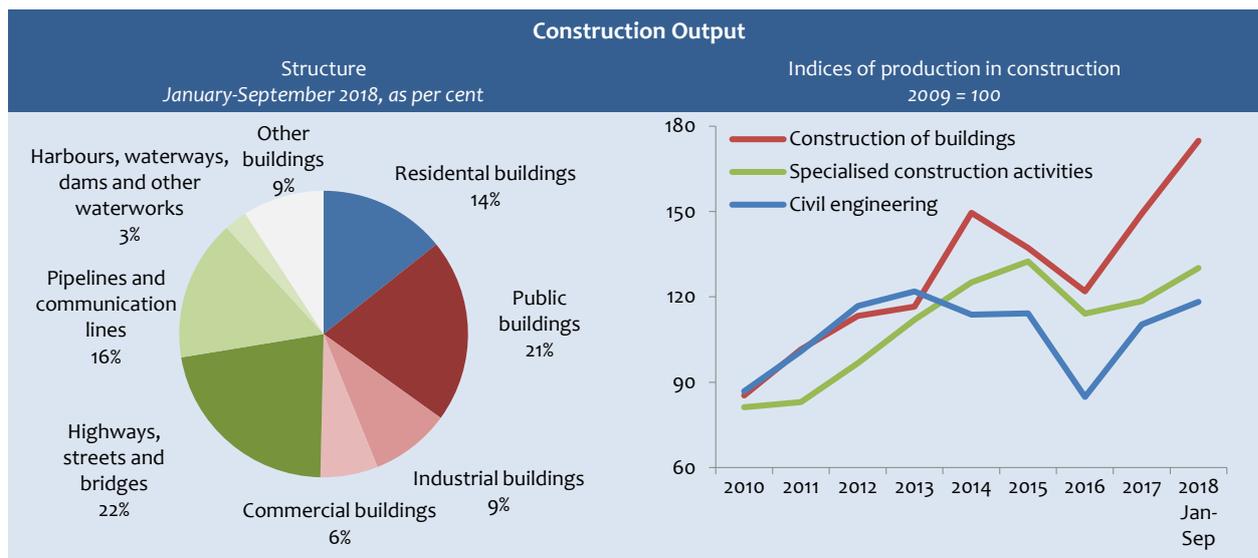


Figure 4.21



In this period, the rise in volumes of construction of buildings made the biggest contribution to the construction sector (by 15.4% per year on average). Volumes of

specialised construction activities grew more moderately – by 11.5%, main activities in this area are demolition and site preparation, electrical, plumbing and other construction

installation activities, as well as building completion and finishing. By contrast, volumes of civil engineering grew the slowest – by 7.5 per cent.

The development of the construction sector stopped for the next two years. This is mainly explained by the transition period of the European Union structural funds, when investments in construction reduced. In 2015-2016, volumes of construction products shrank by 8.6% per year on average. 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 construction permits in these years.

The construction sector resumed its growth in 2017 after a two-year break. Volumes of production in construction were by 18.6% higher than in 2016. The increase in the intensity of implementation of projects of the European Union structural funds after the transition period had a positive influence. Growth of the industry was mainly fostered by the increase in construction of civil structures and construction of buildings.

The fastest growth was observed in the category of civil engineering buildings. Volumes of construction were by 30% higher compared to the previous year. The growth in

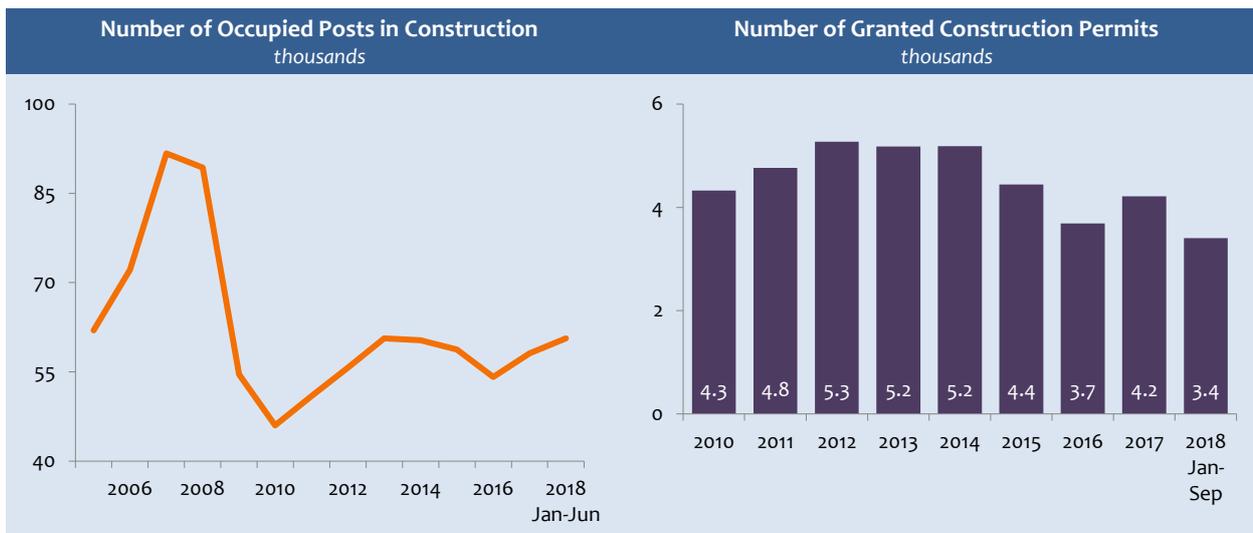
volumes of construction of civil engineering buildings is expected to continue in the next years in view of the implementation of projects of European Union Structural Funds and extensive infrastructure projects.

Construction of buildings generally grew by 22.4%. The slowest increase in 2017 was observed in the group of specialised construction activities, the volume of construction works was by 3.9% higher than in 2016.

The development of the industry in 2018 evidences that construction development rates may be characterised as rapid for the second year in a row. In the 3 quarters of 2018, construction volumes exceeded the achievements of the corresponding period a year before by 22.1%. In 2018, along with the increase in intensity of implementation of projects of the European Union structural funds the increase in private investments in construction is among the main factors driving the sector.

The number of granted construction permits has also increased rapidly. In the 3 quarters of 2018, 3402 construction permits were issued, which was by 152 more than in the corresponding period a year before. More than half of the total number of granted construction permits were intended for construction of one-dwelling buildings.

Figure 4.22



The export potential of the industry has grown considerably in the last decade. In 2008, the industry almost completely operated in the domestic market, less than 1% of the total volume of construction works were carried out outside Latvia. In 2017, more than 1/10 of the volume of construction products were exported.

In the last two years, the development of the industry has affected the prices of services provided by builders. The index of construction costs in 2017 and 2018 was growing more rapidly than in the previous years. When analysing the increase in construction costs, it should be concluded that wages of workers apply the biggest pressure on the costs.

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. During the economic recession, the number of persons employed in the sector was significantly adjusted reducing almost twice.

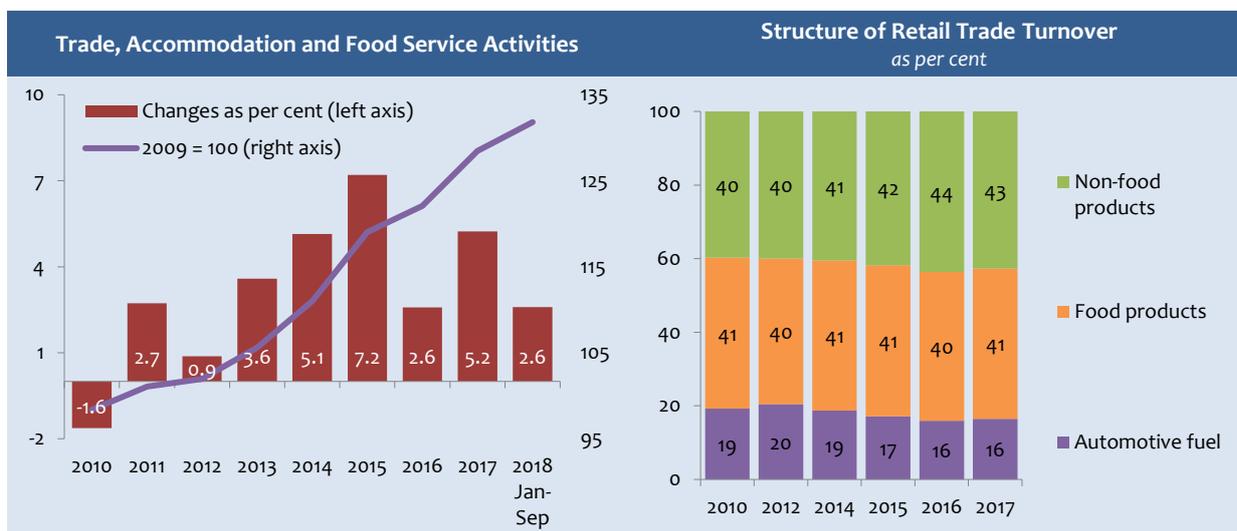
The number of the employed started to evenly increase in 2011. A reduction was observed in 2015 and 2016, when outputs of construction reduced. Since 2016, the sector has resumed attraction of employees. At present, the number of the employed (about 60 thousand) is higher than in 2010, however, increase rates were considerably slower than the increase in output. This means that the sector is largely developing at the account of the increase in productivity.

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 growing since 2010. The trade sector was positively influenced by an increase in private consumption

and retail turnover. Furthermore, accommodation and food service activities positively affect the development of the tourism sector.

Figure 4.23



Although the retail turnover is growing rapidly, growth in trade in post-crisis years was generally very moderate, the sharpest increase was in accommodation and food service activities, which increased by 15.5 per cent in 2011.

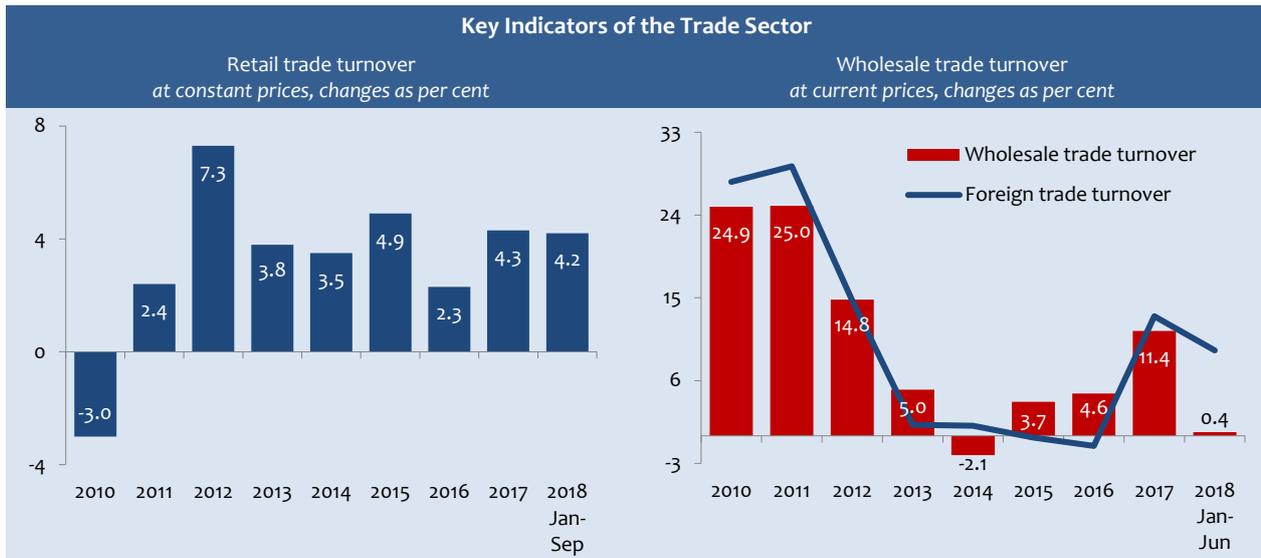
In 2013-2015, growth in the entire sector was very rapid. In this period, growth rates of both trade and accommodation and food service activities were essentially similar – by 5.2% and 6.3% per year on average, respectively. In this period, retail turnover increased by 4.1% per year on average. Retail volumes increased equally rapidly in the automotive fuel and non-food goods group, the increase in volumes of food products was slightly slower. The increase in retail trade of automotive fuel was fostered by comparatively low fuel prices, however, the rise in retail turnover of non-food products made the biggest contribution. Weaker external trade activities, in their turn, affected wholesale trade. Wholesale turnover at current prices increased only by 2.2% per year on average in this period.

In 2016, the increase in the volumes of services provided in trade, accommodation and food service activities was slower than in the previous year. Volumes in trade grew by 2.7%, while in accommodation and food service activities – by 1.3%. Despite the increase in wages and improvements in

the labour market, the retail trade turnover grew moderately in 2016. The dynamics of the total trade turnover was most seriously affected by the drop in food retail trade volumes and a slower increase in fuel turnover. This is explained by the base effect, because a very rapid increase in fuel retail trade volumes was observed a year before. Although the foreign trade turnover has dropped largely affected by a considerable reduction in prices, in particular prices of oil products, in 2016, the turnover of the wholesale sector increased.

In 2017, growth of trade, accommodation and food service activities was more rapid than in 2016. This was affected by the increase in private consumption facilitated by an increase in employment and a considerable increase in wages. Volumes in trade grew by 5.3%, while in accommodation and food service activities – by 4.3%. The fastest rise was observed in volumes of retail trade of non-food products, which account for 55% of total retail trade. With the external trade turnover growing, volumes of retail trade are growing as well. Wholesale trade turnover increased significantly in 2017 – by 11.4 per cent.

Figure 4.24



Growth of the sector continued in 2018. In the three quarters of 2018, volumes in trade grew by 2.2%, while in accommodation and food service activities – by 5.8%. Retail trade turnover increased by 4.2% in the nine months of 2018. The fastest increase was observed in food retail trade volumes. By contrast, turnover of non-food goods still made the biggest contribution from the total increase in retail trade turnover. The turnover of the wholesale trade sector basically remained at the level of the corresponding period of the previous year.

The largest share of occupied jobs is in trade, however, it has been shrinking in recent years with jobs growing faster in the accommodation and food service activities sector.

Figure 4.25



4.7. TRANSPORTATION AND STORAGE

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

After a sharp increase in the post-crisis period, the sector increased only by 1% in the period from 2012 to 2017 affected by the decline in transit freight transport, mainly due to the Russian transport policy and growing competition. Since the end of nineties Russia has been forwarding the goals to develop its own transportation infrastructure to be independent from transit countries.

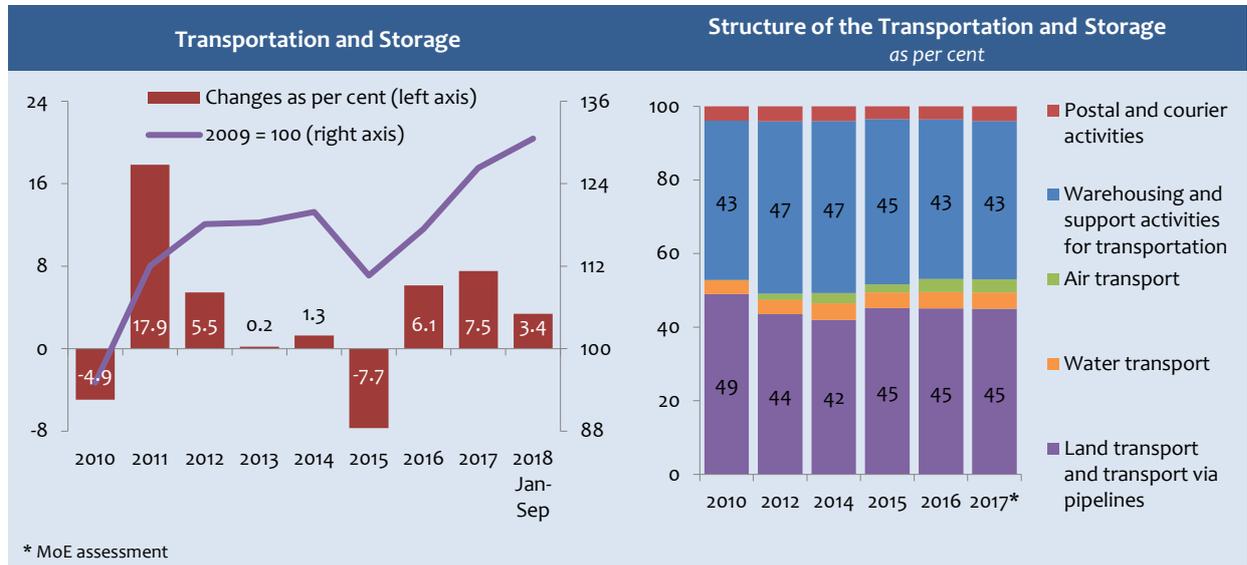
Despite the drop in transit freights by railway and in ports, growth of the sector in recent years has been due to the increase in freight transport by road, as well as the increase in passengers in the airport and sea ports.

In 2017, the increase in volumes of the sector was the fastest since the post-crisis period. Carriage of passengers increased by 11%, warehousing and support activities for transportation – by 10%, postal and courier activities – by 14%, freight transport – by 2%.

Growth of the sector continued in the three quarters of 2018. Growth of the sector was underpinned by the increase in passengers in the airport and sea ports. Carriage of

passengers increased by 13.5%, postal and courier activities – by 21.5%, warehousing and support activities for transportation – by 0.3%, freight transport – by 1.8 per cent.

Figure 4.26



The biggest share of occupied jobs in transportation and storage is in land transport and transport via pipeline and support activities for transportation, where the number of

occupied jobs has not considerably changed in recent years. The sharpest rise in the number of occupied jobs in recent years has been in air and water transport sectors.

Figure 4.27

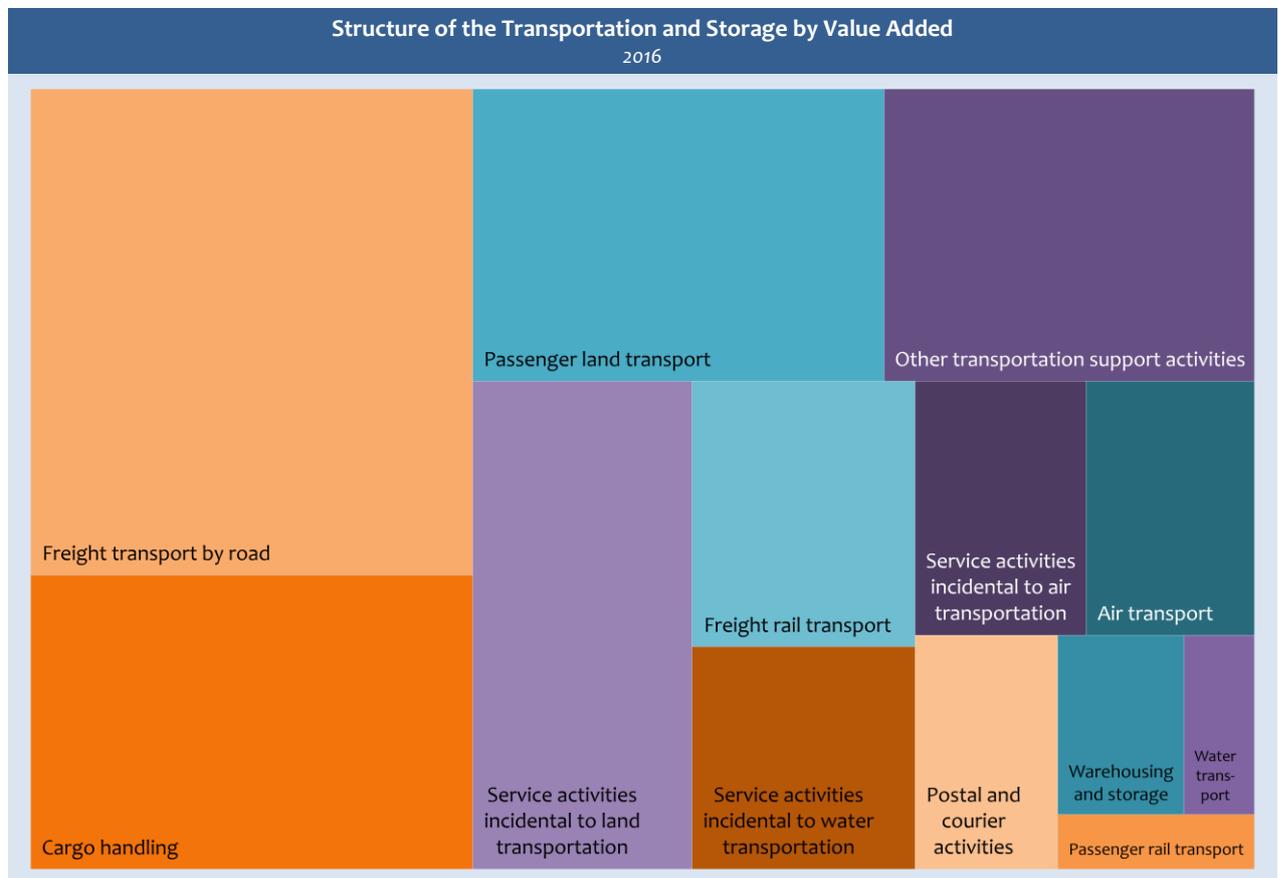
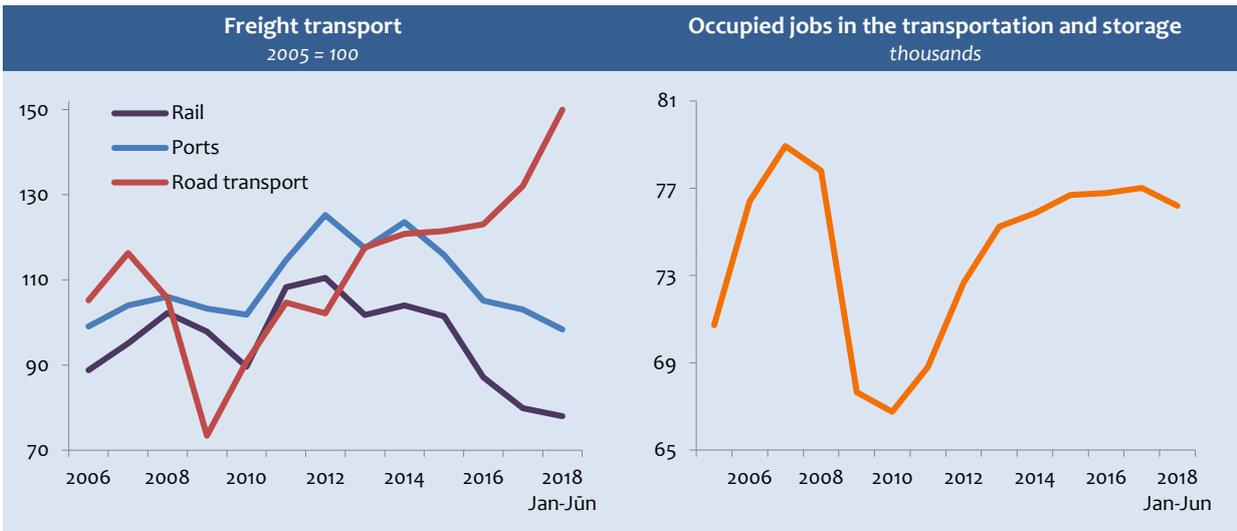


Figure 4.28



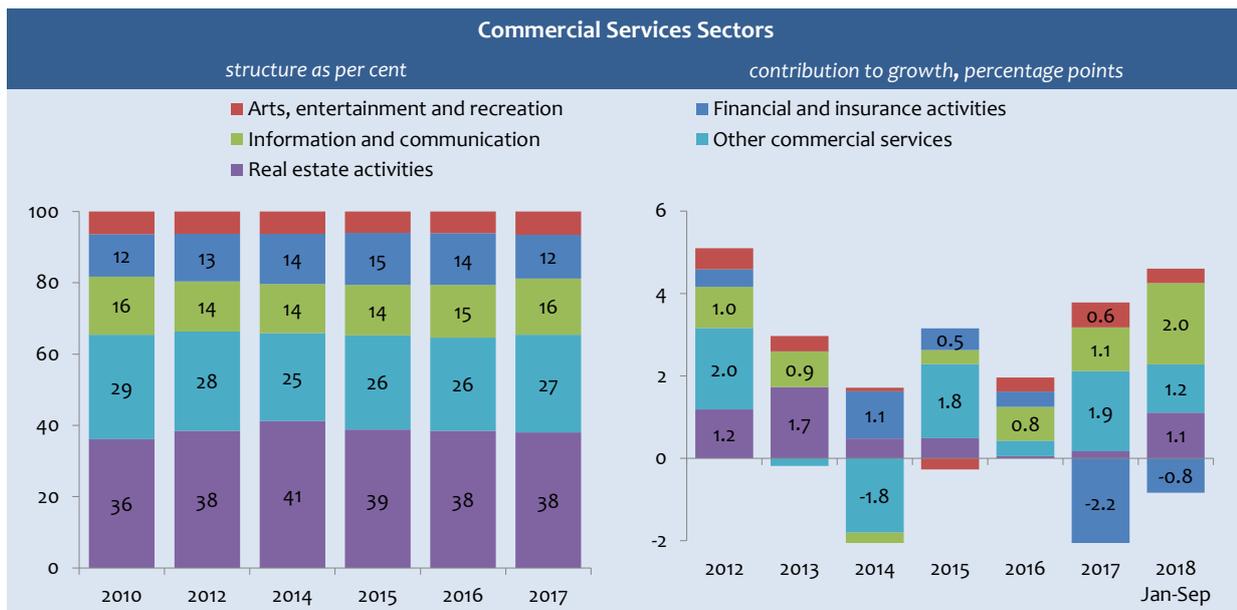
4.8. BUSINESS SERVICES

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

Sharp growth was observed in commercial services in 2011-2013. Volumes of the services grew by 4.6% per year on

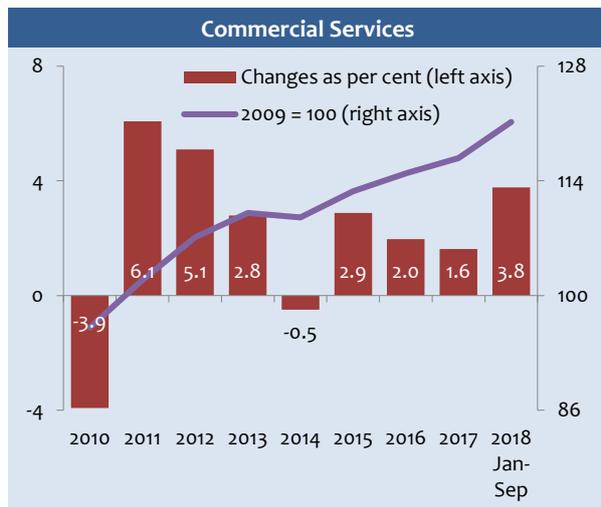
average. They increased in all the main commercial services sectors, with the exception of financial and insurance activities. By contrast, in 2014 volumes of the commercial services sectors reduced due to the drop in information and communication, professional, scientific and technical activities and administrative activities. Since 2015, volumes of commercial services sectors have been growing steadily, although they are more moderate than in the post-crisis period.

Figure 6.29



In 2017, volumes of services in commercial services sectors grew slower than in 2016. The increase was mainly underpinned by growth in professional, scientific and technical activities and administrative and support service activities, while volumes reduced sharply in financial and insurance activities mainly due to the reduction of the volume of non-resident business in Latvia and merging of banks and reduction of the number of the employed.

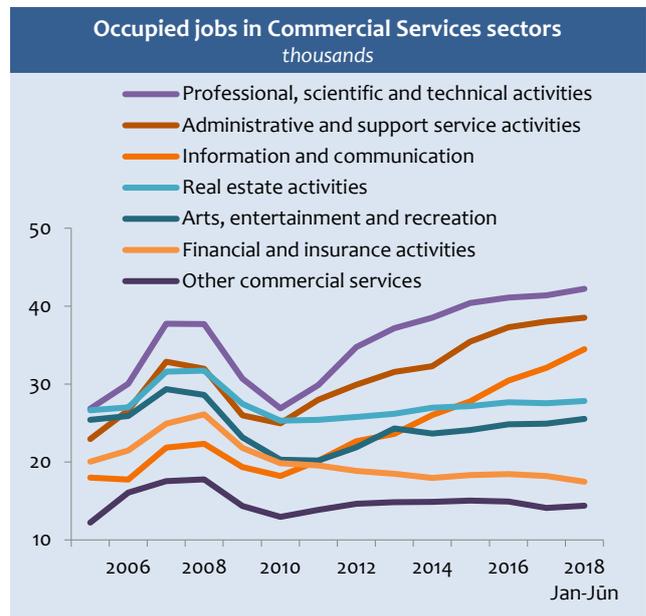
Figure 4.30



In 2018, volumes of services in commercial services sectors grew more rapidly than in 2017. The growth was mainly determined by growth in information and communication,

while volumes in financial and insurance activities continued to reduce.

Figure 4.31



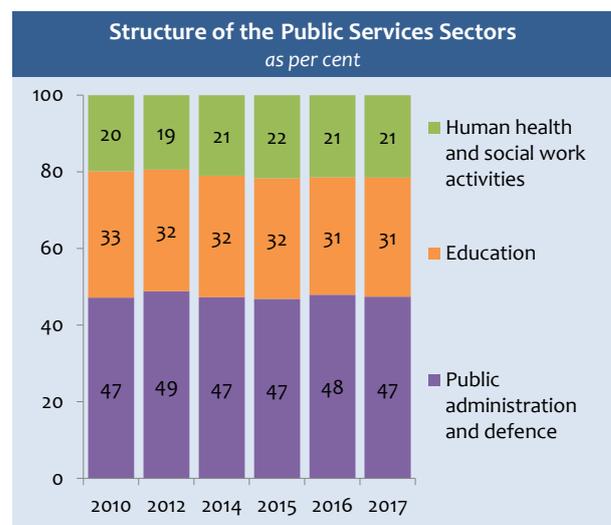
The largest share in occupied jobs has been in professional, scientific and technical activities, administrative and support service activities and information and communication sectors, which had the most rapid increase in the number of occupied jobs in recent years.

4.9. PUBLIC SERVICES

Public administration and defence activities dominate in the structure of **public services** (Public administration and defence; 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. In 2012, volumes of public services reduced under the influence of the drop in volumes in public administration and defence. With the government expenditure increasing, a steady growth has been observed in the public services sectors since 2013. A slower increase was observed in 2015, when only health had a stable rise in volumes.

In 2017, growth of public services has been the most rapid since 2006. Since 2010, volumes of the sector increased by 2.6% per year on average with the most rapid increase in health and the slowest – in public administration and defence. The sector continued to grow rapidly also in 2018. Public consumption on the increase of defence capabilities of the state, health and education has increased considerably in recent years.

Figure 4.32



Education has the highest share of occupied jobs, while public administration and health have an equal share. The most rapid increase in recent years has been observed in health, while it remained unchanged in public administration and education.

Figure 4.33

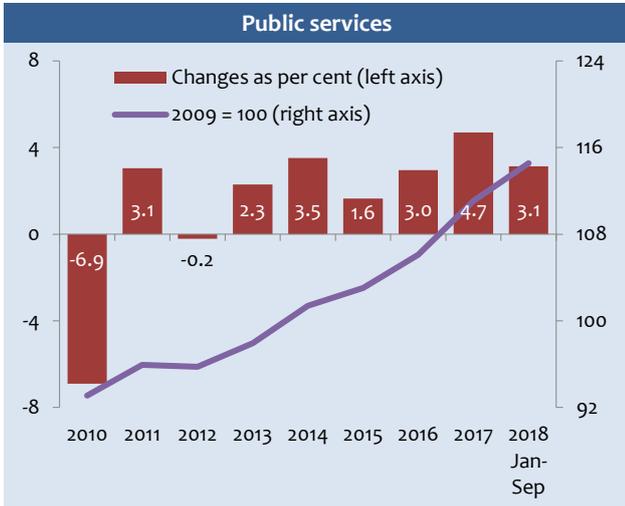
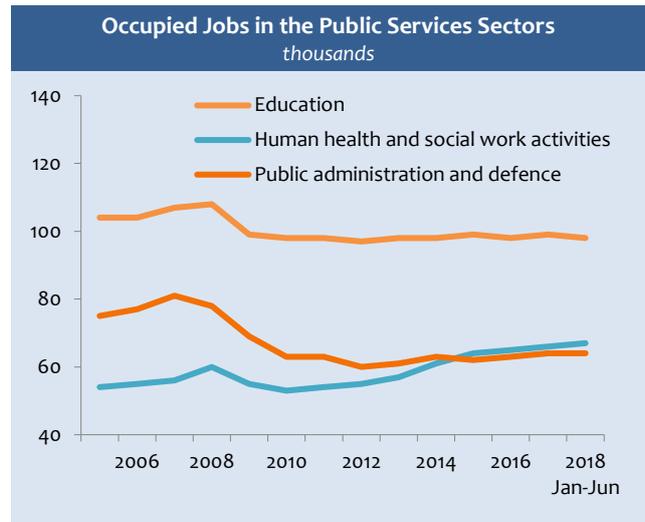


Figure 4.34



5. ECONOMIC DEVELOPMENT FORECASTS

ECONOMIC DEVELOPMENT IN 2019¹

After moderate growth from 2013 to 2016, GDP growth rates increased in 2017, and economic growth reached 4.6%. According to the latest statistical data, GDP growth rates are expected to be 4.6% also in 2018. However, economic development may slow down in 2019 mainly due to weaker growth in the largest export markets of Latvia and the growing uncertainty in the external environment.

Development of the economy is closely related to export opportunities. GDP growth rates in the EU are expected to be slower in 2019 than in 2018. Export dynamics may also slow down due to the weak demand in the CIS markets. Third countries are an important export direction, but their share in the export structure is relatively small. Uncertainty in external markets will limit export opportunities, and in 2019 export growth rates may be slower than in 2018. Growth rates of services exports are expected to be more rapid than the increase in exports of goods. Lower external demand, growing labour costs, and the slow rise in productivity imply that particular attention should be paid to foster global competitiveness of Latvian producers.

Investments are important for development of the economy. In 2017 and 2018, growth in gross fixed capital formation was well above 10%. Considering the high base effect, in 2019 the increase in investments might be slower and reach 6%. An increase will be fostered by investments from the EU funds and projects by private investors. More rapid growth in investments will be limited by the entrepreneurs' vigilance towards the increased uncertainty in the external environment and the still conservative crediting policy of the banks.

The increase of private consumption will still be affected by improvements in the labour market – growth of employment and wages. In 2019, similarly to the previous two years, private consumption might grow by 3.8%, thus making the most considerable contribution to the economic growth.

Concerning sectors, growth in manufacturing will also persist in 2019; however, growth rates will not be rapid due to the situation in export markets. Similarly, growth rates in the construction sector will be slower than in 2018, but still relatively high. In transport sector growth rates will be moderate– development of the sector will largely depend on the geopolitical situation in the region. Stable growth rates are expected in sectors related to exports of services – accommodation and catering service activities and the ICT sector. In 2019, stable growth is also expected in the sectors related to private consumption and domestic market oriented sectors – retail trade and other business services.

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

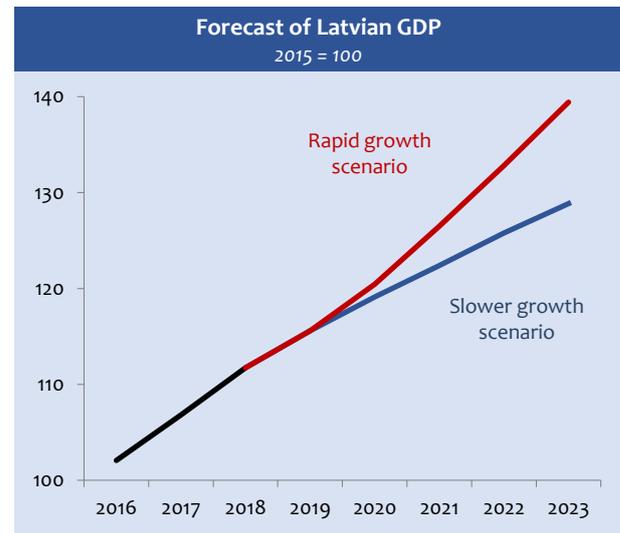
The Ministry of Economics forecasts that the growth rate of GDP may reach 3.5% in 2019.

DEVELOPMENT PERSPECTIVES FOR 2020-2023

Slower and rapid growth scenarios are developed for the medium term until 2023. Basic assumptions of the scenarios are based on different trends of global economic developments in the medium term and the efficiency of structural policy implemented by Latvia.

For Latvia, as a small open economy with a relatively high degree of market liberalisation, growth is significantly affected by the global economic development and maintenance of stable competitiveness.

Figure 5.1



Further development of the EU's economy is particularly important for Latvia. There is still big uncertainty associated with the UK's exit from the EU (Brexit), and there is no clarity about the future economic relations between the UK and the EU, and how it may affect economic development of the whole EU, including Latvia.

Income from exports, expansion of export possibilities, ability to integrate in the global value chains with higher value added products, and ability to create more qualitative final products are the main drivers of economic growth. At the same time, in the medium term in open labour market conditions the increase in labour costs will remain comparatively fast and competitive advantages of labour

costs will continue to decrease. In the medium and long term, more rapid development is expected in the sectors, which can boost productivity through overcoming the technological lags, modernisation of production, investments in human capital, research and innovation, and other supply-side factors.

The slower growth scenario assumes that the global economic development is uneven, and convergence of wages with the Western European countries will continue in conditions of the open labour market in the medium term.

This will result in a negative effect on competitiveness of companies in low value added segments. Furthermore, a transition to higher value added economy will happen gradually.

In the scenario of slower growth, the annual export growth rates during this period might be around 2.5%. Private consumption and investments will grow slowly. By contrast, annual GDP growth rates on average from 2020-2023 are estimated to be 2.7%.

Table 5.1

Forecast of Latvian GDP by Expenditure Items changes as per cent						
	Fact				Forecasts	
	2015	2016	2017	2018	2019	2020-2023 annual average
Gross domestic product	3.0	2.1	4.6	4.6	3.5	2.7 ... 4.8
Private consumption	2.5	1.4	4.1	4.5	3.8	3.1 ... 4.9
Public consumption	1.9	3.9	4.1	3.8	2.5	2.7 ... 3.4
Gross fixed capital formation	-0.5	-8.4	13.1	14.2	5.9	3.5 ... 5.9
Exports of goods and services	3.1	4.4	6.2	3.0	2.6	2.5 ... 5.0
Imports of goods and services	2.1	4.4	8.9	4.9	5.4	3.4 ... 5.4

The rapid growth scenario for the future years assumes a continued stable growth in the main export markets of Latvia, and the benefits of the economic competitiveness are mainly based on technological factors, improvement of production efficiency, and innovation; to a lesser extent on cheap labour and low resource prices. Annual average GDP growth rates in the medium term may reach 4.8%.

In this scenario, exports and manufacturing retain a relatively fast 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 linked to extensive material-intensive production, but with the use of the latest technological processes, digitalisation (Industry 4.0 concept), optimisation of processes, etc. Faster development due to the abovementioned factors is expected in high and medium-high technology sectors.

In the medium term, exports should grow more rapidly than the rest of the economy. Investments should also increase rapidly; however, they should not exceed 25-30% of GDP.

Table 5.2

Forecast of Latvian GDP by Sectors changes as per cent						
	Fact				Forecasts	
	2015	2016	2017	2018	2019	2020-2023 annual average
Gross domestic product	3.0	2.1	4.6	4.6	3.5	2.7 ... 4.8
Agriculture, forestry	12.5	-9.8	1.9	5.1	2.9	1.9 ... 3.2
Manufacturing	0.4	2.8	8.0	2.5	3.1	2.8 ... 5.3
Other industries	16.6	10.3	7.1	1.4	3.1	2.8 ... 4.3
Construction	-1.8	-14.7	19.4	17.7	7.1	3.6 ... 5.3
Trade, accommodation	7.2	2.6	5.2	2.5	4.0	3.1 ... 5.2
Transportation and storage	-7.7	6.1	7.5	4.5	3.3	2.7 ... 4.3
Other business services	2.9	2.0	1.6	4.2	3.6	2.6 ... 4.3
Public services	1.6	3.0	4.7	3.4	2.6	2.6 ... 3.6

One of the most rapid developments in the main sectors of the economy in the medium term is expected in the ICT sector. It is related to the increasingly growing demand for digitalisation of production and services processes and IT sector development trends.

Growth in transport and storage will largely be fostered by the development of air transport and road transport sectors. At the same time, the dynamics in the transit sector will be slower, underpinned the need to search for new types of cargo and delivery paths to replace persistently shrinking volumes of oil products and coal from Russia.

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 economy.

Although export is the main growth driver in the scenario of rapid growth, it does not mean that the share of export sectors will particularly grow. Any sector requires services of other sectors on a large scale (for example, the company itself cannot directly perform IT services, logistics and transport, other business services, even accounting services, etc.). Therefore, growth in any sector creates a relevant increase in other sectors, especially in business services.

6. ECONOMIC STABILITY AND COMPETITIVENESS

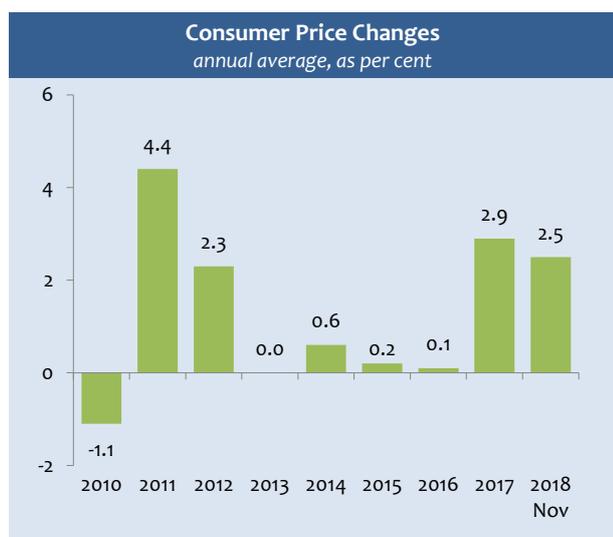
6.1. PRICES

CONSUMER PRICES

Table 6.1

After the deflation caused by the crisis, consumer prices started to grow again in 2011. External factors started to affect the total price level increasingly more seriously. In 2011-2012, the increase in consumer prices in Latvia was determined by the increase in world prices for food and oil. The increase in prices was also determined by internal factors such as the increase in administrative prices of natural gas and heat energy. In 2013-2016, the increase in consumer prices was very moderate. The drop of world food and oil prices had a great influence in this period. The drop in oil prices, in turn, affected the drop of prices of gas and heat energy. The increase in this period was mainly influenced by the rise in prices of services. Water supply and other housing related services, catering services and outpatient services saw the most rapid increase.

Figure 6.1



In 2017, one of the highest price increases in recent years was observed. In December 2017, consumer prices increased by 2.2% (12-month inflation), but the annual average inflation was 2.9%. The level of consumer prices was affected by the increase in global prices of food and oil. The increase in prices of services also had a considerable effect on the level of consumer prices.

In the eleven months of 2018, the price increase was higher than in the corresponding period last year. In November 2018, compared to December 2017, consumer prices rose by 3%. The annual average inflation in November was 2.5 per cent.

Consumer Price Changes by Months as per cent				
		compared to the previous month	compared to the respective month of the previous year	annual average
2017	January	0.1	2.9	0.4
	February	0.4	3.3	0.7
	March	0.9	3.4	1.0
	April	0.4	3.4	1.4
	May	0.0	2.8	1.7
	June	0.2	3.0	2.0
	July	-0.7	2.6	2.2
	August	-0.2	3.1	2.5
	September	0.3	2.9	2.7
	October	0.7	2.8	2.8
	November	0.1	2.7	2.9
	December	0.0	2.2	2.9
2018	January	0.0	2.0	2.9
	February	0.2	1.8	2.7
	March	1.2	2.2	2.6
	April	0.2	2.0	2.5
	May	0.3	2.3	2.5
	June	0.6	2.8	2.4
	July	-0.8	2.6	2.4
	August	-0.1	2.8	2.4
	September	0.6	3.2	2.4
	October	0.7	3.2	2.5
	November	-0.1	3.0	2.5

The main factors affecting prices in Latvia in 2018:

- the rise in fuel prices had the biggest effect on the rise of prices in the eleven months of 2018 affected by the increase in excise tax from January 2018 and the rise of world prices for oil products. Since the beginning of the year, world oil prices have been gradually growing with a small drop only in February, June and August. At the beginning of October the oil price has reached the highest level in the last four years – 86 USD per barrel. This was mainly caused by the increase in demand, limited extraction of oil by the largest exporting countries, as well as the decision of the United States to withdraw from the Iran nuclear deal and therefore

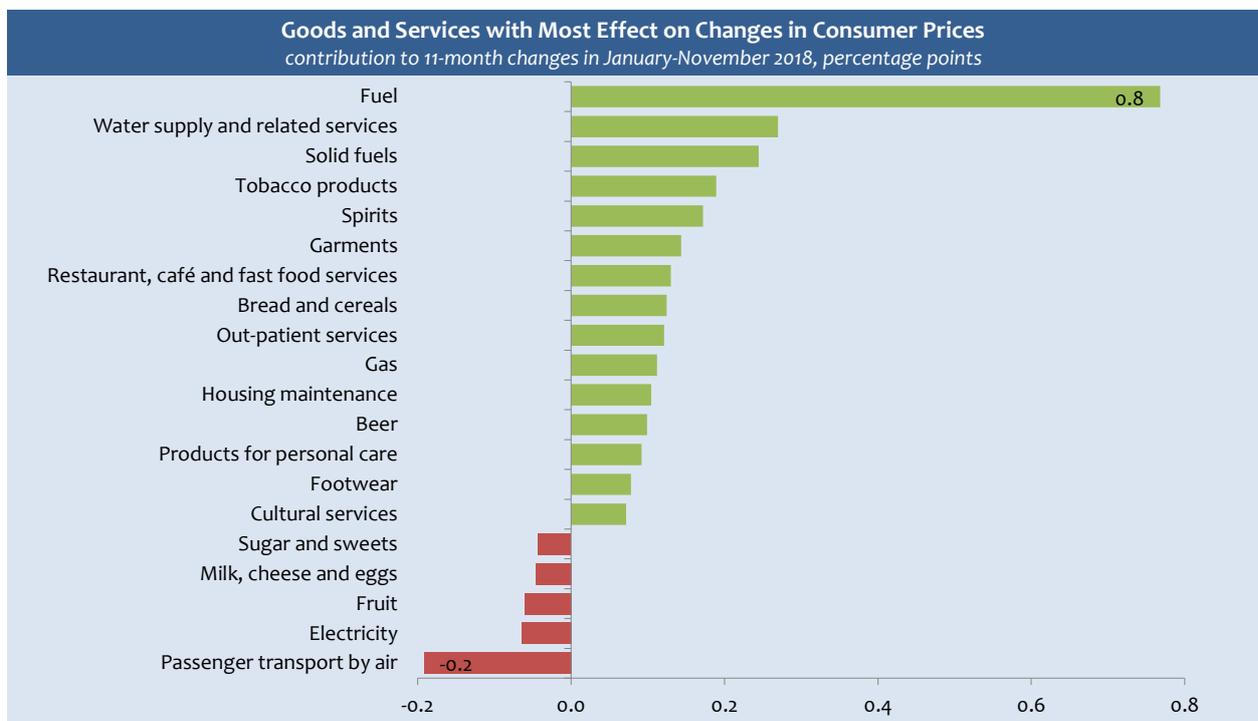
renewal of sanctions against exports of Iranian crude oil. However, since the middle of October, the oil price has been reducing sharply falling to 58 USD per barrel at the end of November. This was underpinned by high crude oil extraction volumes and lowered global economy growth forecasts. This November, compared to December 2017, oil prices practically remained unchanged, but, compared to November of the previous year, oil prices were by 3% higher. In Latvia, in January-November fuel prices grew by 13.5% and increased the overall price level by 0.8 percentage points;

- increase in prices of services – by 2.4%, which increased the overall level of consumer prices by 0.7 percentage points. The most rapid increase was observed also in the services related to housing maintenance – water supply and sewerage services, as well as waste collection, which were affected by the increase in the tax on natural resources. Prices also increased in catering services, health, recreational and cultural services. By contrast, the most rapid decline was in passenger air transport services;
- prices of alcoholic beverages and tobacco grew by 6.4% due to the increase in the excise tax rate, which together increased the total level of prices by 0.5 percentage points. The sharpest rise in prices was for spirits;
- the increase in natural gas trading prices due to the dynamics of world oil prices affected the increase in prices of heat energy (by 1.7%) and gas (by 10.2%), which together with the increase in prices of solid fuel (by 17.5%) increased the total level of consumer prices by 0.4 percentage points. Furthermore, when new mandatory procurement and capacity components

entered into force, prices of electricity reduced by 2.2% slightly reducing the average price level in the group of goods and services related to housing;

- the increase in prices of clothing and footwear, which exceeded the level of seasonal changes both in spring and in autumn and has been the fastest since 2007. In the eleven months of 2018, prices of clothing and footwear increased by 3.8% increasing the overall price level by 0.2 percentage points. The increase in prices is largely explained by growing private consumption;
- food prices in the eleven months remained unchanged affected by the drop in VAT at the beginning of the year and by the drop in world prices of food. Bread and cereals, non-alcoholic beverages and fish had an increasing effect, while sugar, dairy products and fruits had a decreasing effect. Changes in food prices are largely determined by the world price fluctuations. In November 2018, compared to December, world food prices dropped by 4.9%, which was affected by a drop in prices in all major food groups, except cereals. Prices of vegetable oils, mainly palm oil reduced the most rapidly due to large stocks and slow global import demand. Prices reduced rapidly also for sugar promoted by extensive export delivery and good production opportunities, however, in recent months the increase in sugar prices is promoted by the use of sugar cane for production of ethanol in Brazil. Only cereals saw an increase in prices fostered by strong global demand, as well as drop in products in the largest producing countries, mainly due to unfavourable weather conditions. In November 2018, world food prices were by 8.5% lower than in November 2017.

Figure 6.2



In total, the annual average inflation may reach 2.6% in 2018. In 2019, the annual average inflation will be similar to that observed in 2018. It will still be influenced by various supply factors related to the increased excise tax, as well as

the rise in demand, stimulated by the growth of economic activities and wages. At the same time, inflation will still largely depend on world oil and food price fluctuations.

Figure 6.3

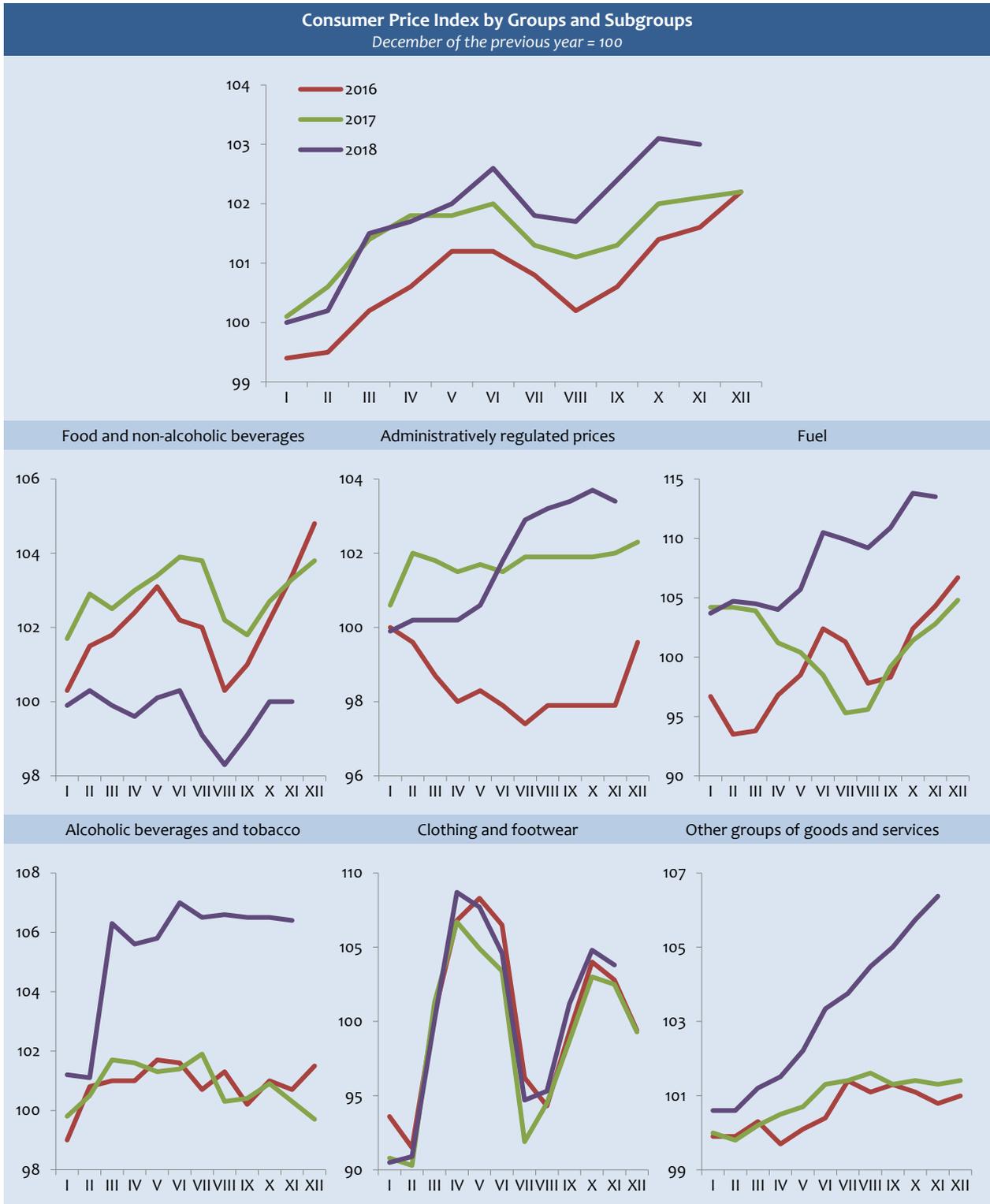
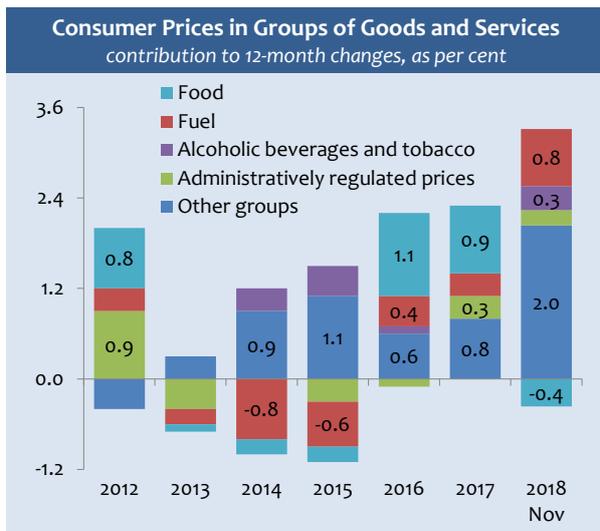


Figure 6.4



After a more rapid increase in post-crisis years, when inflation in the **European Union** was within 1.5% to 3%, in 2014-2016 the increase in prices was very moderate determined by rather weak economic development in the European Union, as well as by drop in world prices of food and oil. The annual average inflation in the EU in this period reached the highest level in 2014, when it was only 0.6 per cent.

Trends similar to those across the EU were observed in the Baltic countries. The most rapid inflation among the Baltic

countries in the post-crisis period was observed in Estonia, but the lowest – in Latvia.

As economic activities and therefore private consumption increase, as well as world prices are growing, inflation in the EU in recent years has grown as well. The annual average inflation was 1.7% in 2017, and 1.9% – in October 2018. Prices increased in all the main consumption groups, with the exception of communication. The increase in prices of services and energy had the biggest effect.

Figure 6.5

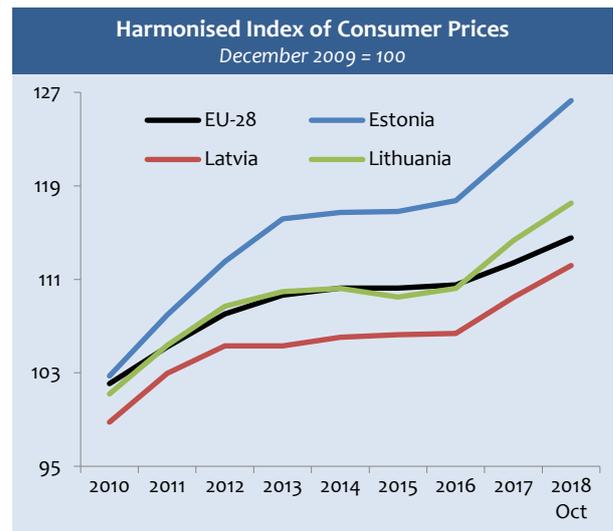
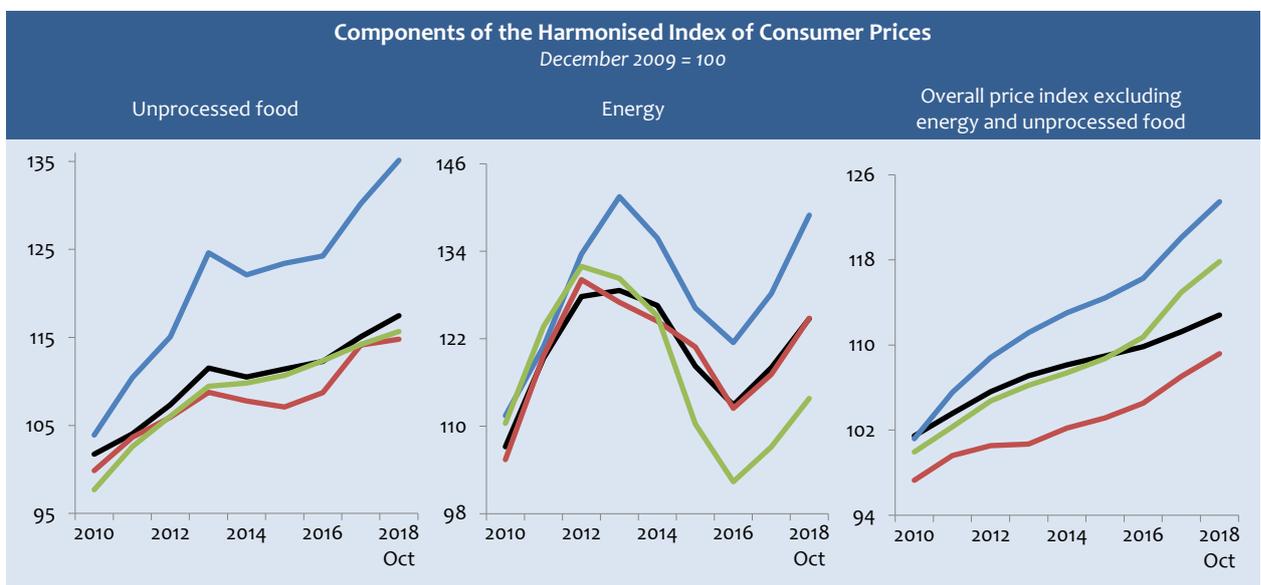


Figure 6.6



If we compare the Baltic countries, growth of the harmonised index of consumer prices has been most rapid in Estonia in recent years as well. In 2017, prices in Estonia and Lithuania increased in all main consumption groups, with the exception of communication, but in Latvia – in all groups, with the exception of clothing and footwear. The

increase in prices of services and food had the biggest effect in all the three Baltic countries. The increase in prices of alcoholic beverages and tobacco also had a big effect in Estonia and Lithuania.

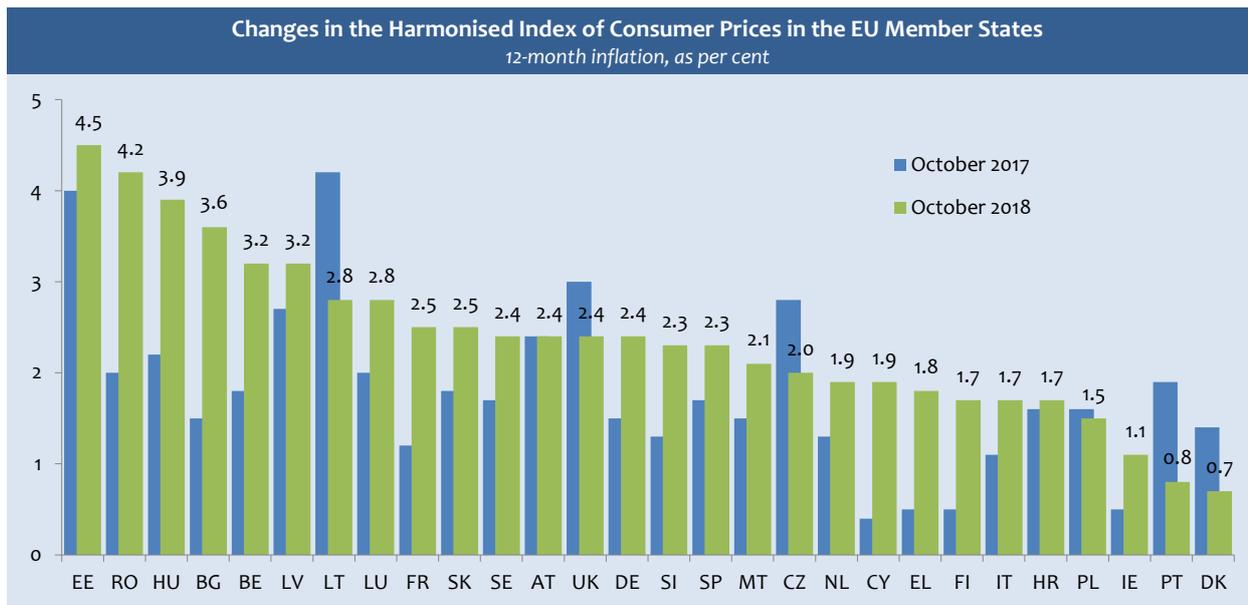
It should be noted that since 2010 Latvia has been having the lowest core inflation among the Baltic countries affected by a slower increase in private consumption than in the other countries and therefore slower increase in prices of services. Prices of alcoholic beverages and tobacco in Latvia also increased slower, because the equalisation of the excise tax with the EU level in Estonia and Lithuania is more rapid.

In the ten months of 2018, prices in Latvia increased in all main consumption groups, in Estonia – in all groups, with the exception of communication, but in Lithuania – in all

groups, with the exception of communication and food. The increase in prices of services and energy had the biggest effect in all the three Baltic countries.

In October 2018, compared to October 2017, the price level grew by 2.2% in the EU countries as a whole as well as in the Eurozone. Inflation increased most rapidly in Romania and Bulgaria, but prices fell more rapidly in Lithuania and Portugal. The highest inflation in October 2018 was in Estonia and Romania, but the lowest inflation was in Denmark and Portugal.

Figure 6.7



PRODUCER PRICES

After the rapid increase in 2010-2012, in 2013 and 2014 producer prices were growing very moderately, but in 2015-2016 reduced mainly due to the drop in prices in manufacturing.

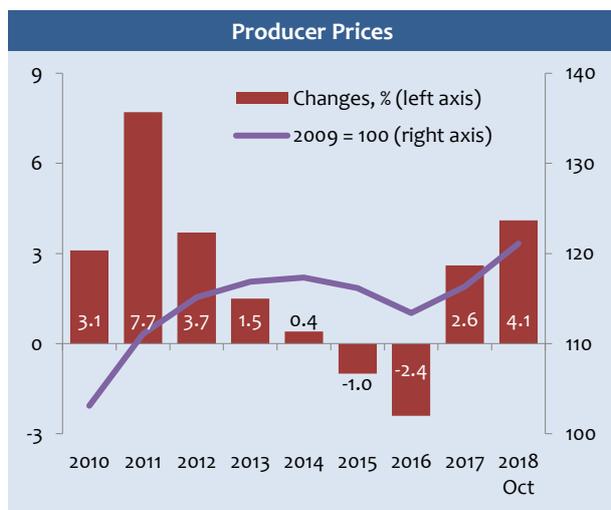
Producer prices saw a serious increase in 2017. The producer prices of production for domestic market and production for exports saw a similar increase – by 2.6% and 2.7%, respectively. Manufacturing had the biggest effect on the increase in prices.

The rapid increase in producer prices continued also in 2018. In October 2018, inflation in the industry was 4.1%. Inflation of production for domestic market was 5%, while that of production for exports – 3.3%. Producer prices increased in all industrial sectors. Manufacturing and electricity, gas, steam and air conditioning supply had the biggest effect on the increase in producer prices.

A similar trend has been observed in producer prices in manufacturing since 2010. In 2014-2016, producer prices in manufacturing were influenced by the economic situation in the EU and Russia and the drop in world prices of raw materials, in particular energy sources. In recent years, a rapid increase in prices has been observed in Latvian

manufacturing. In 2017 and in October 2018, inflation of products for domestic market was higher – 3.8% and 4.3%, respectively, than that of production for exports, which was 2.7% and 3.3%, respectively.

Figure 6.8



Slightly over 60% of the manufacturing products are being exported, therefore the overall dynamics of producer prices are largely affected by the fluctuations in producer prices of the production for exports. The prices of the production for exports, in their turn, are mainly determined by the price dynamics of the Latvian key export goods, including wood, metal products, and food, in global markets. It should be noted that global prices of energy and raw materials showed a rapid increase in prices in 2017 and in the ten months of 2018. The price of production for domestic market, in its turn, is affected by the domestic demand and increasing growth rates.

In terms of sectors, the most significant rise in producer prices in the manufacturing in 2017 was experienced in manufacture of food products, but in 2018 – in manufacture of wood. It should be noted that the world food prices increased (by 8%) during 2017. The increase in producer prices in manufacture of food products was more due to the increase in prices of production for domestic market, but for wood – more by the increase in prices of production for exports.

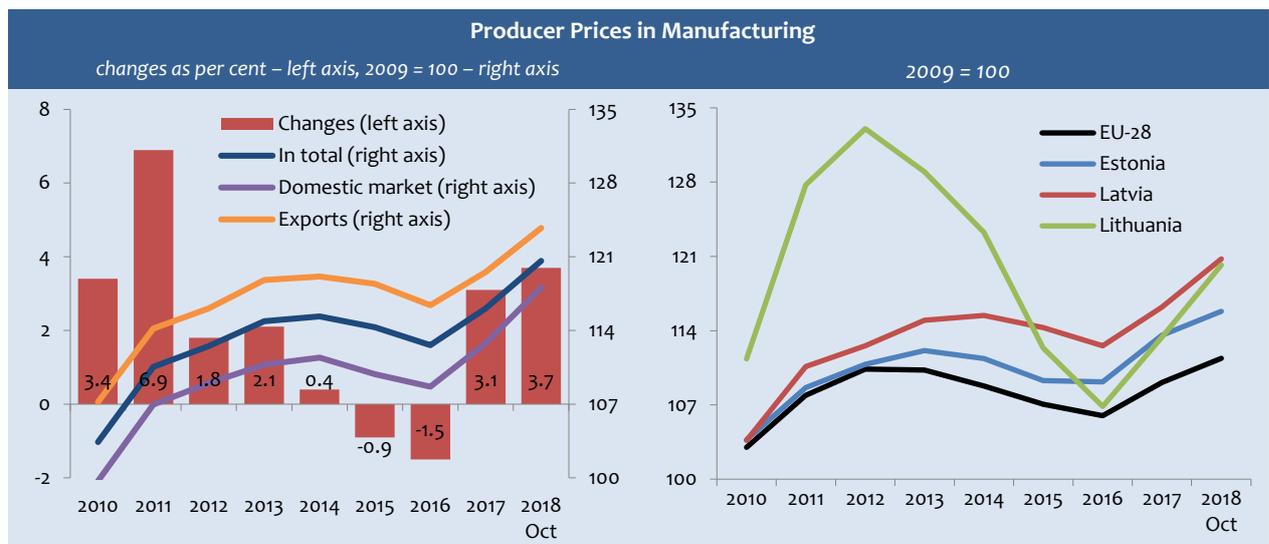
By contrast, both in 2017 and 2018, producer prices in manufacturing reduced in manufacture of computer, electronic and optical products. In 2018, a drop was observed also in manufacture of chemicals. In manufacture

of computer, electronic and optical products and manufacture of chemicals prices reduced for production for exports.

Producer prices in the EU reduced in 2013-2016. It was mainly influenced by a drop in the prices of food, as well as agricultural and industrial raw materials, to some extent determined by a decrease in the global demand, the deteriorating economic situation in other developed countries, as well as the slowdown of global trade growth and uncertainty about future fiscal consolidation in most developed countries. In 2014 and 2015, this was affected by the economic situation between the EU and Russia due to the crisis in Ukraine. As the economic situation improved and prices of raw materials increased, producer prices in manufacturing in 2017-2018 saw the most rapid increase since 2011 both across the EU and in all the three Baltic countries. If we compare EU countries, producer prices in manufacturing increased in all the countries. They increased most rapidly in Belgium, Lithuania and Greece.

If we compare the Baltic countries, producer prices in manufacturing in 2017 and 2018 increased most rapidly in Lithuania due to the increase in the oil refining sector, while average growth rates in Latvia and Estonia were similar.

Figure 6.9



FOREIGN TRADE UNIT VALUE INDICES

In the post-crisis period, the export and import unit value increased similarly, therefore the trade conditions did not change. In 2012, the trade conditions worsened, taking into account more rapid increase in the import unit value. The trade conditions improved and returned to the level of 2011 only in 2015.

Since 2016, the trade conditions have been improving sharply. The unit value index for exported goods exceeded the unit value index for imported goods by more than 3 percentage points. The import unit value in 2016 was mostly

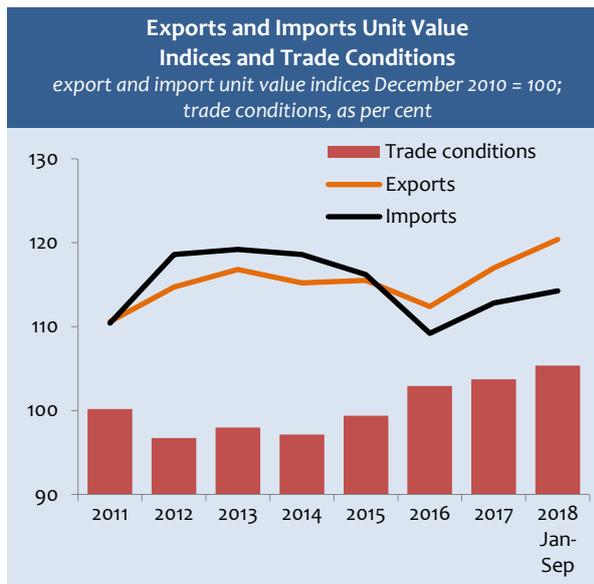
affected by a decrease in the unit value of coke and refined petroleum products and mining.

Exported products had changes of 4.2% and imported products – 3.3% in 2017 compared to the previous year. The value of both export and import unit in 2017 was mostly affected by an increase in the unit value of coke and refined petroleum products. In the nine months of 2018, the unit value of exported goods increased by 2.9% compared to the year before, while the unit value of imported goods – by 1.3%. The unit value index for exported goods exceeded the unit value index for imported goods by more than 5 percentage points. The average export unit value was mostly

affected by the increase in the unit value of wood and wood products, coke and refined petroleum products, basic metals, computer, electronic and optical products, as well as the drop in other non-metallic mineral products, chemicals and furniture.

The average level of import unit value was mostly affected by an increase in the unit value of coke and refined petroleum products, basic metals and beverages, while at the same time it was decreased by a drop in the value of computer, electronic and optical equipment and food products.

Figure 6.10



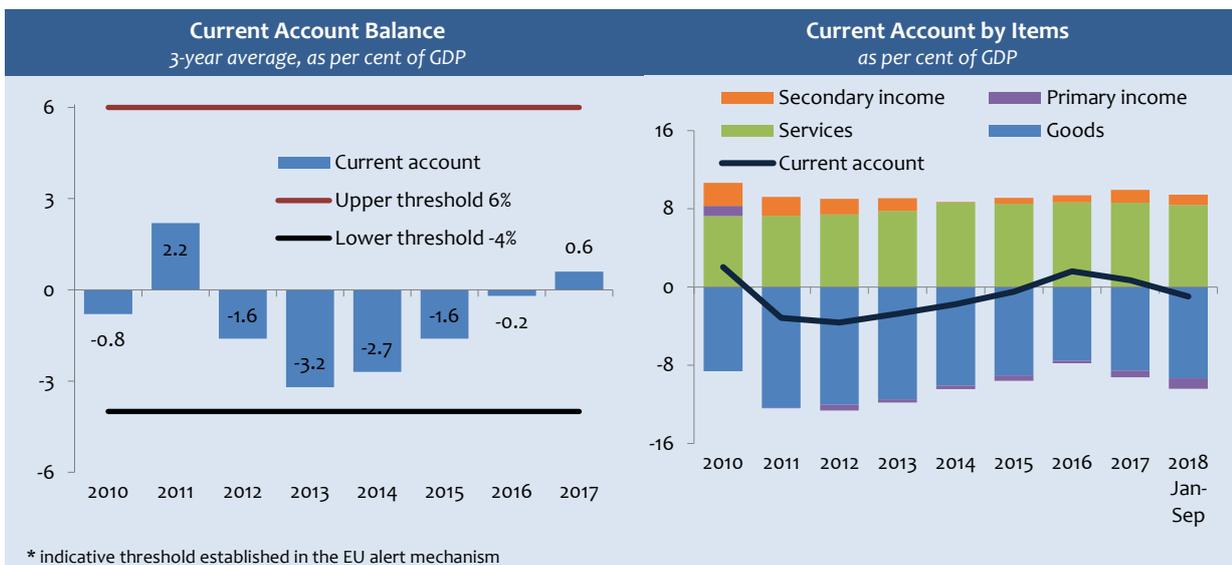
6.2. BALANCE OF PAYMENTS

CURRENT ACCOUNT

The current account of the balance of payments has been at a low level, which does not exceed the indicative thresholds determined in the alert mechanism of the EU, since 2010, and can be assessed as sustainable. The indicator of the current account balance is close to the level of balance also in our neighbouring countries, and annual fluctuations of the indicator are quite insignificant. On average, in the period

from 2010 to 2017 current account was in a moderate deficit – at the level of 0.9% of GDP. By contrast, in 2016 and 2017, the balance of the current account was in surplus – at the level of 1.6% and 0.7% of GDP, respectively. Positive balance was also present in the first half of 2018 reaching 1.7% of GDP. However, in Q3 of this year current account was in deficit of 5.7% of GDP and, in total, in the nine months of this year, the current account deficit reached the level of 1% of GDP.

Figure 6.11



The Latvian current account is characterised by high deficit of trade in goods and surplus of trade in services, and in smaller scope net flows of primary income and secondary income.

The condition of the Latvian current account is mainly determined by changes in the balance of external trade. Latvia is characterized by an external trade deficit, which increased in the years of rapid growth and decreased in the years of recession. Cyclic adjustments of the current account were largely determined by a significant decrease in import volumes. When the economy had stabilised, the import volumes also increased. By contrast, the export volumes of goods increased faster than the imports, and the balance of external trade improved. In recent years, dynamics of both exports and imports have become slower.

In the period from 2011 to 2016, external trade deficit was at the level of 10.4% of GDP on average. Since 2011, it reduced each year, which was mainly due to imports growing slower than exports. In this period of time, exports of goods at current prices increased on average by 7.7% annually and exceeded the pre-crisis level by 88% in 2016. By contrast, imports of goods grew by 7% on average annually and were by 14% higher than in 2007. External trade deficit reached 7.5% of GDP in 2016, which was considerably lower than prior to the crisis (in 2007 – 22.8%).

External trade deficit has been growing since 2017 largely fostered by a considerable increase in imports of goods, as domestic investments and household consumption were growing. In 2017, exports of goods at current prices were by almost 11% higher than a year before, while imports rose by 12.6%, and the negative balance of external trade reached the level of 8.5% of GDP.

Also in the nine months of 2018 the dynamics of imports of goods were more rapid than the dynamics of imports of goods. In comparison with the corresponding period in the previous year, exports and imports of goods (at current prices) increased by 5.7% and 6%, respectively. The dynamics of exports of goods were largely affected by the development of exports of machinery, appliances and electrical equipment, wood and wood products, as well as agricultural and food products. The export value of other groups of goods increased as well. By contrast, the increase in the value of import of goods was fostered by the increase in imports of machinery and appliances, iron and steel, wood and wood products, as well as vehicles. Since the export value of goods increased in a smaller amount than the import value, external trade deficit in the nine months of this year was at the level of 9.3% of GDP.

Table 6.2

Balance of Payments of Latvia per cent of GDP						
	2013	2014	2015	2016	2017	2018 Jan-Sep
Current account	-2.7	-1.7	-0.5	1.6	0.7	-1.0
Trade balance	-11.5	-10.1	-9.0	-7.5	-8.5	-9.3
Export	43.1	43.4	42.5	41.6	42.7	41.2
Imports of goods and services	54.5	53.4	51.6	49.1	51.2	50.5
Balance of services	7.8	8.6	8.5	8.7	8.6	8.4
Primary income	-0.3	-0.4	-0.6	-0.3	-0.7	-1.1
Secondary income	1.3	0.1	0.6	0.7	1.3	1.0
Capital account	2.5	3.2	2.8	1.0	0.8	2.0
Financial account	1.0	2.8	2.1	2.7	1.3	4.5
Direct investment	-1.6	-1.2	-2.4	-0.1	-0.1	-2.4
Assets	1.6	1.7	0.6	0.8	0.7	2.3
Liabilities	3.3	3.0	2.9	0.9	0.8	4.8
Portfolio investment**	-0.1	0.5	11.6	5.1	6.4	-7.4
Assets	0.1	6.1	9.7	7.0	5.7	-6.5
Liabilities	0.2	5.7	-2.0	1.9	-0.7	0.9
Other investment	1.0	4.1	-8.5	-2.8	-6.5	13.4
Assets	0.0	7.4	-11.0	1.1	0.1	1.9
Liabilities	-1.0	3.3	-2.5	3.9	6.6	-11.4
Reserve assets	1.7	-0.5	1.3	0.5	3.3	-0.2
Deviation	1.2	1.3	-0.3	0.1	-0.2	3.5

* portfolio investment and financial derivatives

The balance of services is positive in Latvia. In 2011-2016, the surplus of the balance of services was 8.1% of GDP on average. In 2017, dynamics of the imports of services were slightly more rapid than the dynamics of exports, which provoked a decrease in the surplus of the balance of services. In 2017, the exports of services at current prices were by 8%, whereas the imports – by 8.6% higher than a year before, and the balance of services reached 8.6% of GDP.

Imports of service rose faster than exports also in 2018. In the nine months of this year, the exports of services at current prices were by 7.1%, whereas the imports – by 10.1% higher than a year before, and the balance of services reached 8.4% of GDP (in the nine months of 2017 – 8.8% of GDP). Exports of services were positively affected by the increase in income from exports of air transport, travel and construction services. Exports of ICT services have increased in recent years. Imports of transport services, computer and information services, as well as other economic activity services contributed a lot to imports of services, while imports of financial services reduced. The positive balance of services covered the deficit of external trade of goods almost by 90% in nine months of this year.

Overall, it should be noted that, although weakening signs have appeared, Latvia has retained its competitiveness. Despite the rise in unit labour costs (ULC) of products, export volumes of goods and services keep increasing, and the share of Latvian exports in global markets is growing.

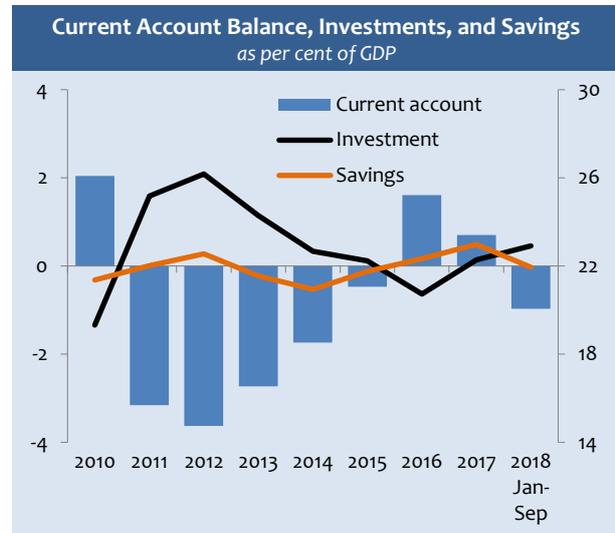
The status of the primary income account is largely affected by flows of income from direct investment. The primary income balance in the period from 2011 to 2016 was negative – at the level of 0.4% of GDP on average with relatively small fluctuations. The primary income balance was mainly due to changes to non-residents' investment income, as well as the inflow of EU funds. In 2017, the primary income deficit was 0.7% of GDP, while in the nine months of 2018 it rose to 1.1% of GDP due to the inflow of EU funds.

Changes in the secondary income and capital account are mainly due to flows of finances of the EU funds and contributions made by Latvia into the EU budget. The secondary income balance in Latvia is positive and in the period from 2011 to 2016 it was at the level of 1% of GDP on average. In 2017 and in the nine months of 2018, the secondary income account had a surplus – 1.3% and 1% of GDP, respectively. The capital account has also been positive for a long time. The capital account surplus has been 2.2% on average since 2011, including at the level of 0.8% of GDP in 2017. The positive balance of capital account increased considerably in the nine months of 2018 reaching 2% of GDP. Changes in capital account surplus are mainly related to changes in activities of acquisition of EU funds.

The large deficit of the current account in the pre-crisis years showed a significant imbalance between the domestic investment and accruals. The adjustment of crisis years have reduced the gap between the level of accruals and productivity. In the last three years, accruals have been 22.4% on average, but investments – at the level of 22% of GDP. A moderate deficit of the current account balance

indicates that there is a balance between the accruals and domestic investment.

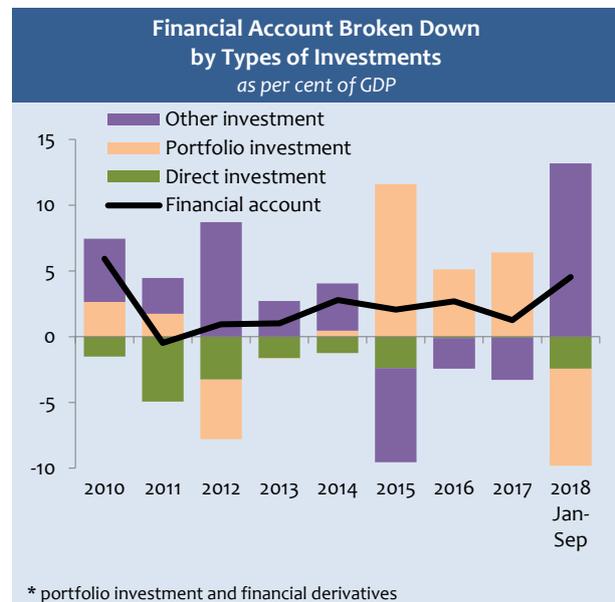
Figure 6.12



CROSS-BORDER FINANCIAL FLOWS

The global financial crisis influenced cross-border financial and capital flows significantly, causing major adjustments to the financial account of the balance of payments. Since 2010, the deficit of the financial account is decreasing. At the same time, the instability of financial flows is also decreasing.

Figure 6.13



In recent years the status of the financial account balance has been mainly affected by the public sector, that is, financial sector stabilisation measures, measures of the Bank of Latvia for restructuring of debts of the public sector within the scope of an extended asset acquisition

programme (EAAP). Fluctuations of the financial account were also affected by the drop in deposits of non-residents in Latvian credit institutions.

From 2011 to 2017, the balance of the financial account (assets minus liabilities) was generally positive – 1.5% of GDP on average, including 1.3% of GDP in 2017. Portfolio investment and other investment flows are still the main drivers of the financial account. Large changes in the Latvian balance of payments in the period from 2015 to 2017 were related to the increase in net outflow of portfolio investments. Moreover, net income from other investments increased as well. Furthermore, net inflow of derived financial instruments, which was previously insignificant, increased to almost 2% of GDP in 2017. Balance of payments data on cross-border flows show that in the nine months of 2018 assets in foreign countries and international liabilities reduced. On a net basis, funding was flowing out of Latvia

largely affected by the reduction in the balance of deposits made by non-residents in credit institutions.

The inflow of direct investment exceeds the outflow, while the balance of direct investment in recent years has been negative evidencing of inflow of foreign direct investment. From 2011 to 2017, the attracted FDI flows constitute 2.9% of GDP, including 2.4% of GDP in 2017. The dynamics of FDI flows remain positive also in 2018. In the nine months of this years, FDI flows reach 1.7% of GDP, which was twice lower than in the corresponding period of the year before (see Chapter 6.3).

The gross external debt of Latvia remained at a relatively high level. According to the data of the Latvian international investment balance, the gross external debt constituted almost 126% of GDP at the end of September 2018. Also, the gross external debt of the government reached 8619 million euro (29.9% of GDP).

6.3. FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) flows in the Latvian economy are growing. The volume of FDI raised in the last three years (2015-2017) was 2% of GDP on average, which is at a lower level than in the pre-crisis years (2000-2007).

The intensity of FDI flows in other Baltic countries is rather moderate. From 2011 to 2016, the average annual net inflow of FDI in the Baltic countries were almost twice smaller than in the years of rapid growth (2004-2007). In 2017, activities of foreign investors in the Baltic countries increased, and, compared to 2016, the volume of attracted FDI flows in the region generally increased by 98.2% reaching 2748.2 million euro. Most of FDI flows were in the Estonian economy (55%), while Latvia and Lithuania attracted 24% and 21% of the total FDI in the Baltic countries, respectively.

It should be noted that a long-term negative cycle of cross-border flows of investments is observed all over the world in general, which is caused by several factors, including growing geopolitical risks and political uncertainty. At the same time, there are structural changes in FDI models, which are related to the fact that the importance of labour costs as a competitive advantage and, therefore, also the attractiveness of emerging countries for foreign investors reduce under the influence of automation of production. Structural consequences of digital economy for cross-border flows of investments increase as well.

Figure 6.14

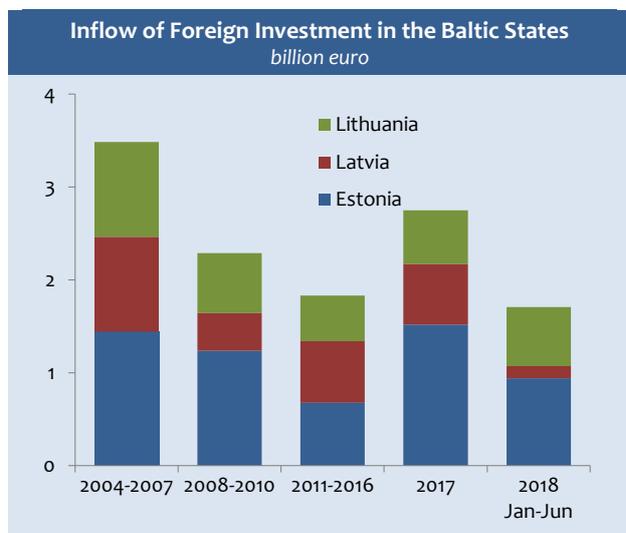
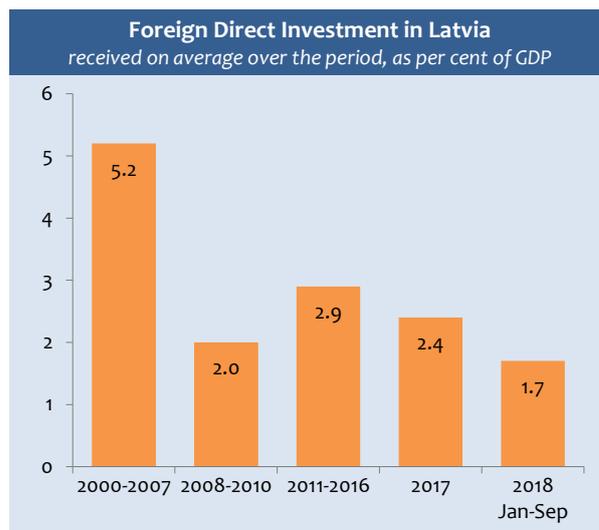
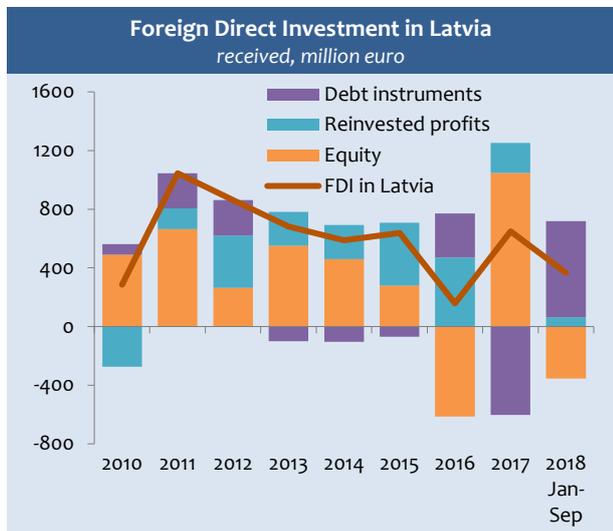


Figure 6.15



Dynamics of the flows of FDI in the Latvian economy are more moderate compared to the years of rapid growth. From 2011 to 2016, the volume of raised FDI was smaller almost by half than the annual average in 2004-2007.

Figure 6.16



FDI flows have been characterised by pronounced volatility in recent years. In 2017, Latvia attracted 650 million euro in FDI. FDI flows increased almost 4 times and reached 2.4% of GDP in comparison with 2016, which was by 1.8 percentage point more than a year before. This was mainly underpinned by extensive investments in share capitals of companies by non-residents.

High volatility of FDI flows is also observed in 2018. In Q1 2018, 105 million euro of FDI flowed into the Latvian economy retaining the average level of quarterly investments of the previous year, they amount only to 23 million euro in Q2 of the year (almost 6 times less than a

year before). Furthermore, in Q3 FDI flows were almost twice higher (237 million euro) than in Q1. The total volume of FDI attracted in the nine months of 2018 was 365 million euro, that is, twice less than a year before. There were higher flows in trade and real estate sectors.

According to the balance of international investment, the amount of FDI accrued in the economy of Latvia at the end of September 2018 reached 14.9 million euro (at the level of 52% of GDP). They increased by 3.1% during the year mainly due to extensive investment of Swedish and Estonian businesses in the Latvian national economy.

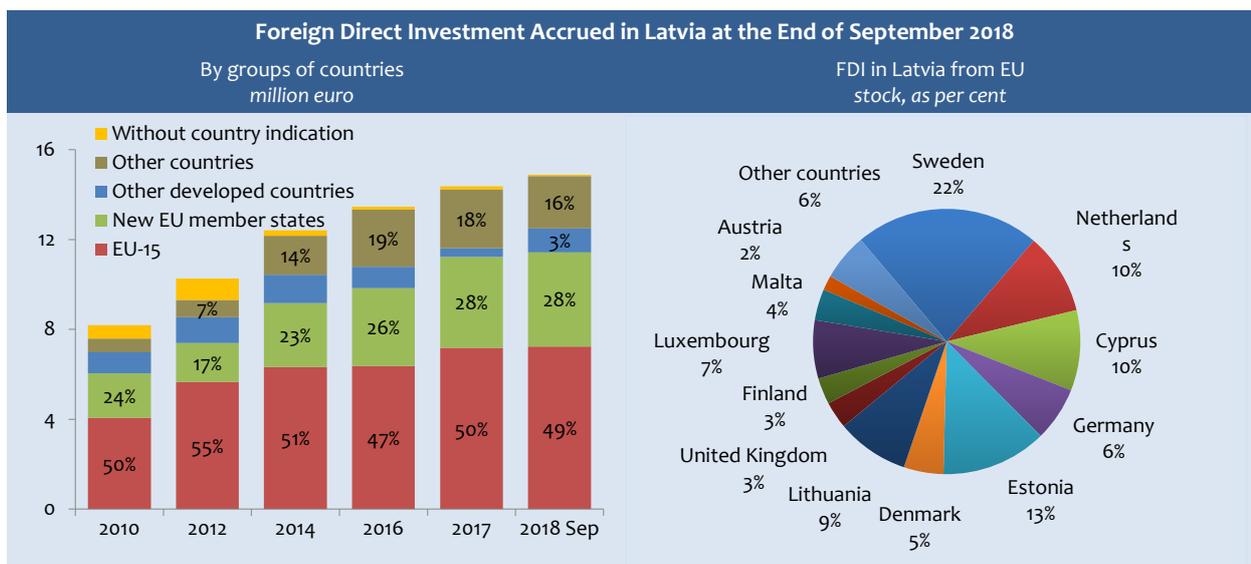
Investments from businesses from the EU countries dominate in the geopolitical structure of FDI accrued in Latvia. At the end of September 2018, FDI of the EU states constituted 77% of all accrued FDI, and almost 68% of this amount was constituted by the investment of the euro area countries.

Sweden is the major investing country in the economy of Latvia. At the end of September 2018, the investment of Swedish entrepreneurs constituted 17.2% of the total accrued FDI. It is mainly the investment in the financial intermediation. Since the end of 2010, the direct investment of Sweden has increased 2.4 times, including they have increased by almost 11 percentage points since the end of September 2017.

Investments of Russian investors in Latvia have considerably increased in recent years. Since the end of 2010, the accrued direct investment of Russia have increased 4.6 times and Russia was the second major investing country in the economy of Latvia at the end of September 2018 by accrued FDI.

Lithuanian and Estonian businesses also make big investments in the Latvian economy. At the end of September 2018, the direct investments accrued by the Baltic countries constituted almost 17% of the total accrued FDI.

Figure 6.17



Entrepreneurs from the Netherlands, Cyprus, Germany, Norway, Denmark and Luxembourg also make extensive investments. At the end of September of this year, the amount of investment by these countries constituted almost 33% of the total accrued FDI in the economy of Latvia.

Activities of Asian investors in Latvia are increasing. At the end of September 2018, the accrued FDI of Asian countries constituted 2.5% of the total FDI in the economy of Latvia, which was almost 10 times higher compared to the end of 2010.

Most of FDI was attracted in service industries. At the end of September 2018, the accrued FDI in the services sector constituted almost 75% of the accrued FDI in the economy of Latvia. It increased by 82.3% compared to the end of 2010, including by 3.1 per cent since the end of 2017.

Financial mediation, real estate and trade sectors clearly dominate in the structure of accrued FDI in the services industries. At the end of September 2018 investment of foreign investors in these sectors constituted 73% of

accrued FDI in services sectors (54.4% of total FDI in the Latvian national economy). Investments of non-residents in transportation and storage and in information and communication services have increased in recent years.

At the end of September 2018, the accrued FDI in manufacturing sectors constituted 25% of the total amount of accrued FDI in the economy of Latvia. They almost doubled compared to the end of 2010.

The amount of investment in the manufacturing has increased. From the end of 2010 to the end of September 2018, the amount of accrued FDI in the manufacturing increased by 74.5%, which was significantly influenced by large investment in the food industry, wood processing and manufacture of electrical equipment.

It should be noted that in the years of economic recession FDI flows in Latvian manufacturing were rather stable, however, Latvia still lags behind Lithuania in terms of FDI accrued in this sector.

Table 6.3

FDI by Sectors						
balances at the end of the period						
	million euro			structure as per cent		
	2010	2017	2018 Sep	2010	2017	2018 Sep
Agriculture	215	602	628	2.6	4.1	4.2
Manufacturing	1017	1636	1775	12.4	11.2	11.9
Other types of industry	386	700	719	4.7	4.8	4.8
Construction	487	588	674	6.0	4.0	4.5
Trade and accommodation	1040	2217	2486	12.7	15.2	16.7
Transportation and storage	346	871	851	4.2	6.0	5.7
Financial intermediation	2327	3524	3522	28.4	24.1	23.7
Real estate activities	843	2102	2183	10.3	14.4	14.7
Other services	697	1323	1077	8.5	9.1	7.2
Unclassified activity	824	1042	962	10.1	7.1	6.5
Total	8182	14605	14878	100	100	100

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 conducted by make it an important contribution to the improvement of the investment environment.

Investors Sentiment Index 2017 or the assessment of foreign investors working in Latvia for the potential of the

competitiveness of the Latvian economy was presented at the annual meeting of the Foreign Investors Council in Latvia with the government of Latvia in 2018.

The results of the survey of foreign investors evidences of a positive assessment of the Latvian investment environment in general. The investors noted that it has improved compared to 2016. However, there are shortcomings weakening the investment environment, for example, unfavourable demographic trends, labour availability trends, shortcomings in healthcare and in the court system. At the same time, investors note positive changes in the quality of business law, as well as reduction in uncertainty. Foreign investors recognise that although progress in the improving the investment environment has been reached, there is still potential for its improvement.

6.4. MONETARY INDICATORS

After the financial market turmoil at the end of 2008 and the beginning of 2009, monetary indicators of Latvia are gradually stabilising, and the banking sector is generally operating with profit, however, the development of crediting is still evaluated as weak, also deposit stock shrinks, but this is mainly affected by the decline of deposit stock of non-residents.

In Q2 2018, the performance indicators of all Latvian banks were in line with the regulatory requirements. The capitalization level of the banking sector remained at a high level. In Q2 2018, the average capital adequacy ratio of the banking sector reached 22.8% (the regulatory minimum is 8%). Return on assets (ROA)¹ of the banking sector has increased to 1.01% reaching the highest indicators in recent years, while the return on equity (ROE)² has declined to 8.14 per cent.

Bank profitability reduces, but it is still positive – banks operated with a profit of 236.1 million euro in 2017. In the said period, 10 Latvian banks and 4 branches of foreign banks operated with a profit (their market share in total assets of the banking sector – 92%).

An increase in the Latvian **bank assets** was observed in late 2013, which was largely due to the upcoming introduction of the euro – people's cash savings in lats went into bank accounts. Consequently, the amount of cash in circulation significantly decreased and the use of non-cash means of payments significantly increased. However, when the euro replaced lats, the amount of cash in circulation increased significantly. Since the introduction of the euro, the growth of the amount of cash in circulation has been moderate, and no significant fluctuations are observed. At the end of September 2018, 4285.2 million euro were in circulation as cash, which is by 4.7% more in September of the previous year.

Since the beginning of 2016, the amount of assets of the banking sector has been increasing gradually. In Q2 2018, the assets amounted to 24.5 billion euro, which is by 15.2% more than a year before. The share of non-bank loans in total assets was 58% (for comparison – bank loans accounted for 65.5% of the bank assets in Q2 2011), while the proportion of securities shrank (7.5%).

Table 6.4

Monetary Indicators of the Latvian Banking System							
	2012	2013	2014	2015	2016	2017	2018 Sep
<i>at the end of the period, billion euro</i>							
Net foreign assets	0.9	1.2	-1.8	-3.6	-2.5	-3.6	-1.4
Net domestic assets	8.8	8.6	11.3	13.9	13.6	14.9	12.7
Credits to residents, including:	13.7	13.5	12.6	13.4	13.2	13.2	11.9
To the general government (net)	-1.3	-0.7	-0.5	0.5	0.01	0.1	-0.4
To enterprises and households	14.9	14.1	13.2	12.9	13.3	13.1	12.3
Other assets (net)	-4.9	-4.8	-1.3	0.5	0.3	1.8	0.8
Broad money M2X	9.6	9.8	9.4	10.3	11.1	11.4	11.3
Cash in circulation (without balances at banks' cash-desks)	1.5	0.7	3.7	3.8	4.0	4.2	4.3
Deposits of households and enterprises, including:	8.1	9.2	9.5	10.3	11.1	11.4	11.3
Overnight deposits (resident)	5.1	6.6	7.0	8.0	8.7	9.3	9.3
Deposits with agreed maturity	3.0	2.6	2.5	2.3	2.4	2.1	1.9
<i>compared to the respective period of the previous year, changes as per cent</i>							
Credits to residents, including:	-13.1	-1.4	-5.9	6.1	-0.8	-1.0	-6.0
To enterprises and households	-10.4	-5.3	-6.8	-1.7	2.9	-2.0	-4.8
Broad money M2X	4.5	2.0	-3.6	9.0	7.7	2.5	4.4
Cash in circulation (without balances at banks' cash-desks)	4.1	-56.6	461.0	2.6	4.5	4.0	4.7
Deposits of households and enterprises	4.5	13.2	-3.6	9.0	7.7	2.5	4.4

Source: Bank of Latvia

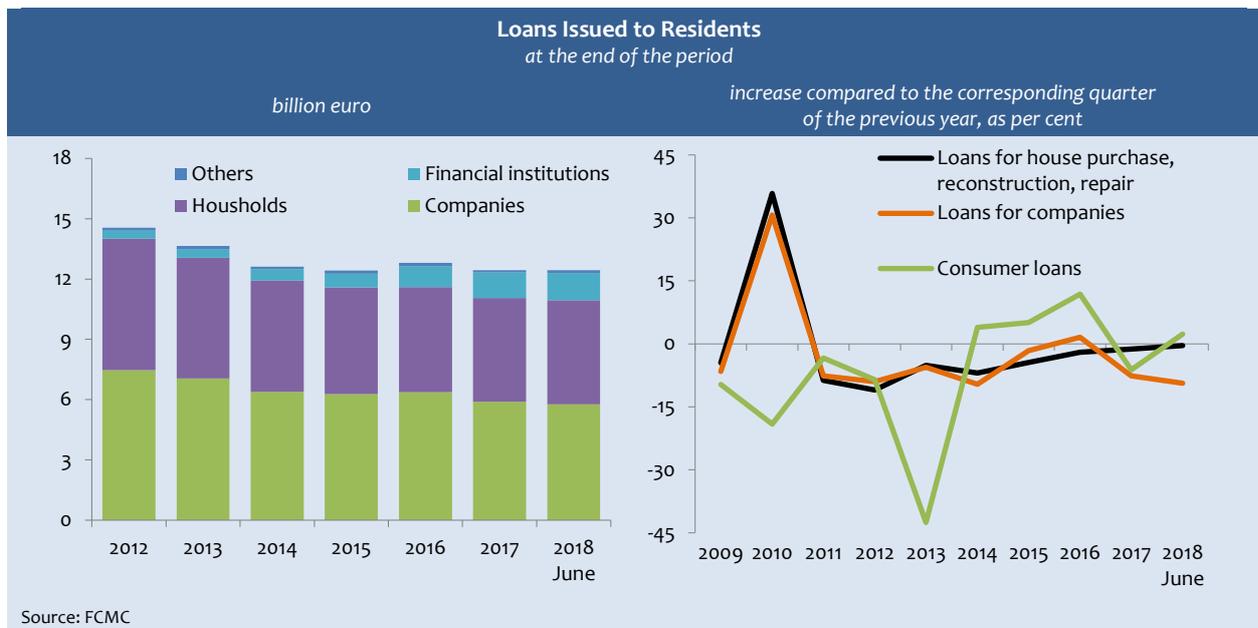
¹ ROA – profit/loss to assets ratio² ROE – profit/loss to capital and reserves ratio

* FCMC data are used further in the text

Loans granted to enterprises with the share of 46% in Q2 2018 still dominate the structure of credits granted to domestic enterprises and individuals, while the share of household loans was 42%. Most of the loans granted to households are loans for house purchase, reconstruction and repair.

Since 2009 the dynamics of the non-bank loans portfolio was negative, with the exception of 2016, when the loan portfolio of banks started to grow. The loan portfolio of banks has shrunk again since 2017. Banks are still cautious in the implementation of more active crediting. According to the FCMC data, outstanding amounts of non-bank loans decreased by 5.5% at the end of Q2 2018 compared to the corresponding period of the year before.

Figure 6.18



New crediting is developing unevenly – crediting of households is gradually recovering, while the development of crediting of enterprises is moderate. In Q2 2018, new loans for 622.8 million euro were granted in the banking sector in total, which was by 4.2% less than a year before.

Positive trends are observed in **crediting of households**, and an increase in issuing of new credits has been observed already since 2011, however, crediting of households is still evaluated as moderate. In Q2 2018, the amount of new loans granted to households increased by 14% and amounted to 30% or 187.5 million euro of the total amount of new loans granted. As income and therefore savings of households are growing, their creditworthiness improves. Therefore, the loans newly granted for house purchase is also gradually growing. Despite the improvement of the situation, household crediting is still hindered by insufficient household income for the first instalment, which usually ranges from 10 to 30% of the total amount of the credit. The support programme for acquisition of housing property, which provides loans for families with children for the house purchase or construction of housing property, can be evaluated positively. From 1 March 2018, the range of beneficiaries of the housing guarantee programme has been extended and also young specialists aged below 35 having no children as dependents and families with children up to 23 years of age (inclusive) can receive state support for acquisition of a home. In total, dynamics of household

credits are still negative, and the proportion of household credits in the total credit portfolio is shrinking.

Consumer loans newly granted are gradually growing. Borrowing consumption shrank sharply in the dynamics of the total credit portfolio in 2013 and at the beginning of 2014, and then a rapid increase followed. At the beginning of 2018, the development of consumer loans was positive.

Crediting of business is still developing unevenly. In 2013 and 2014, the loans newly granted to companies declined rapidly. Starting from 2015, positive trends were observed and the volume of loans newly granted to companies increased. In 2017, volumes of loans newly granted to companies declined by about 1/3. This was determined by the decline in the total volume of newly granted loans. In Q2 2018, new crediting of companies was by 2.5% smaller than in the corresponding period of 2017. It constituted only 28% or 175 million euro of the total amounts of new loans (41% – in Q2 2011), which generally evidences that businesses are still cautious in the implementation of new credit liabilities. There are also companies, which do not qualify for loans, because they are operating in the shadow economy. Crediting of business is also affected by the availability of funding from the European structural funds. Sectors like financial and insurance activities and real estate activities are newly credited the most among sectors of the national economy. An increase is also observed in crediting of agriculture.

Also, the dynamics of the total business credit portfolio are still negative.

In terms of volume, most of the credits by sectors were granted in real estate activities (28% of total loans granted)

and financial and insurance activities (13%), as well as manufacturing (10%). There was a relatively large share of credits in trade, accommodation and food services (12%).

Figure 6.19

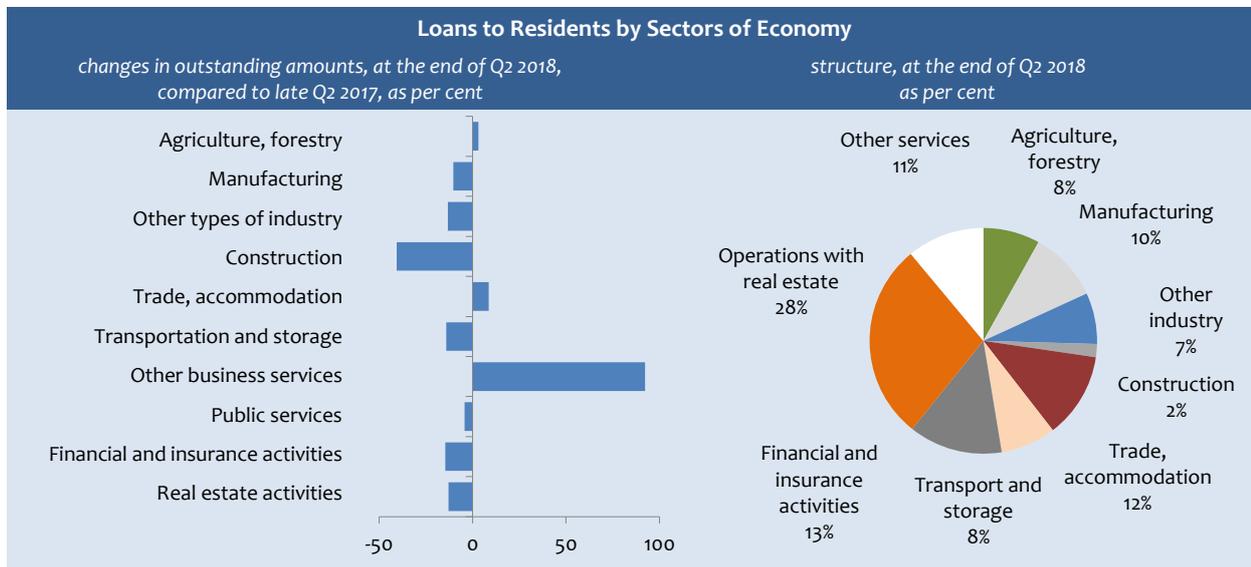
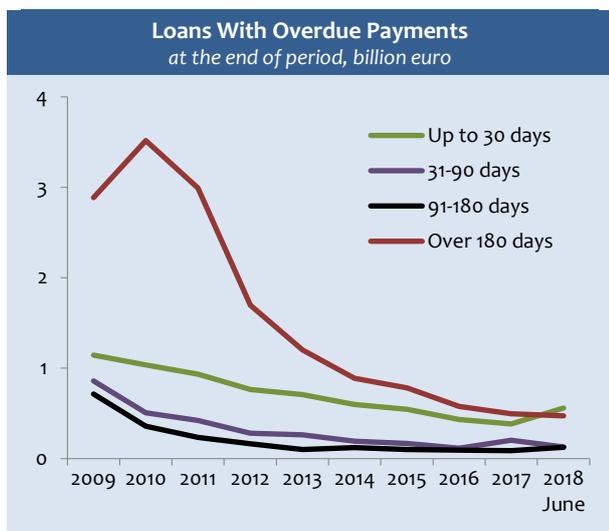


Figure 6.20



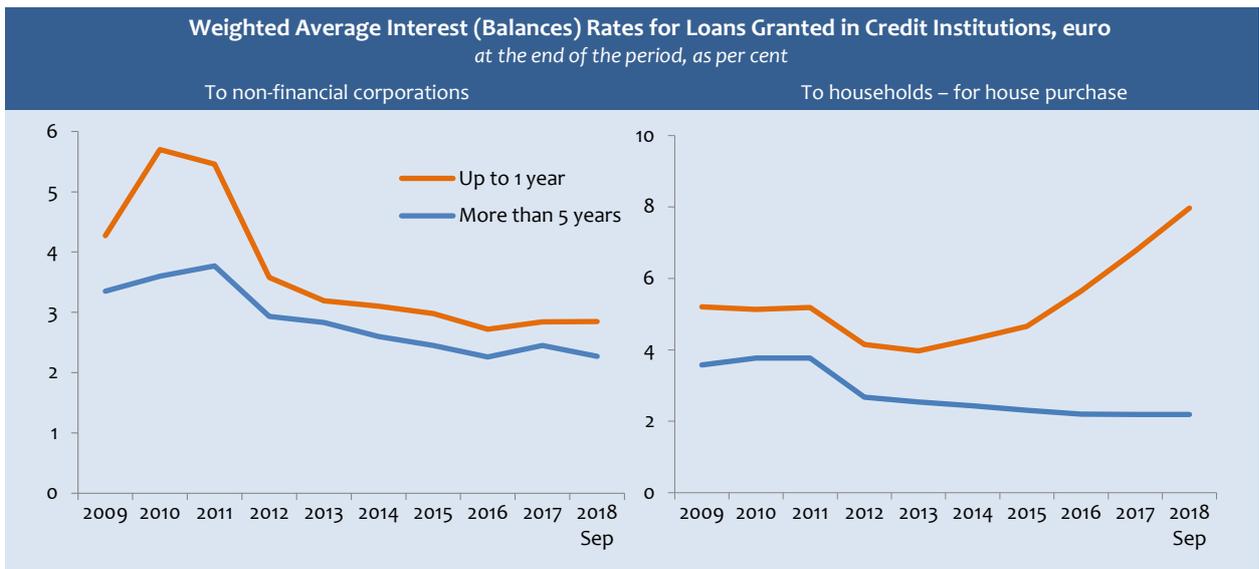
In 2009, the quality of the loan portfolio worsened considerably, and in Q2 2010 the highest indicators in loans with overdue payments was reached – the amount of loans with overdue payments in the total loan portfolio of banks was 28.6%. The quality of credit portfolio has been gradually improving since 2011, mainly due to improvement of the economic situation, as well as writing off of bad debts. In total, banks have written off credits for 84.5 million euro since the beginning of 2018, which is for 57.1% less than in the corresponding period of 2011. At the end of Q2 2018,

the amount of credits with a payment delay in the total bank credit portfolio was 9.1%, which was for 0.7 percentage points less than a year before, and it was one of the lowest indicators since late 2008. It is evaluated positively that the share of loans with more than 180 days overdue payments, had shrank from 16.7% in Q2 2010 to 3.3% in Q2 2018. At the same time, an improvement in the quality of loans is observed mainly in the segment of residents, while the share of loans with more than 90 days overdue payments, in the segment of foreign customers has increased.

The share of restructured loans and loans in a work-out process in the total loan portfolio of banks continues to decrease. At the end of Q2 2018, restructured loans and loans with overdue payments constituted 7.7% of the total loan portfolio (35.1% in Q2 2011). The volume of loans written off the balance sheets of banks shrank as well, yet writing off of credits does not mean that this stops the debt recovery process.

Long-term interest rates (on outstanding amounts) for loans granted to non-financial companies continue to decrease, and they reached the lowest point in recent years in September 2018 (2.27%). Short-term interest rates for non-financial companies also decrease, but their fluctuations are more pronounced. Also, the long-term interest rates (on outstanding amounts) for credits granted to households for house purchase have been decreasing since 2012 and fell to 2.19% in September 2018, which has been the lowest indicator in recent years, while the long-term interest rates of credits issued to households for acquisition of a home have continued to grow since the end of 2014.

Figure 6.21



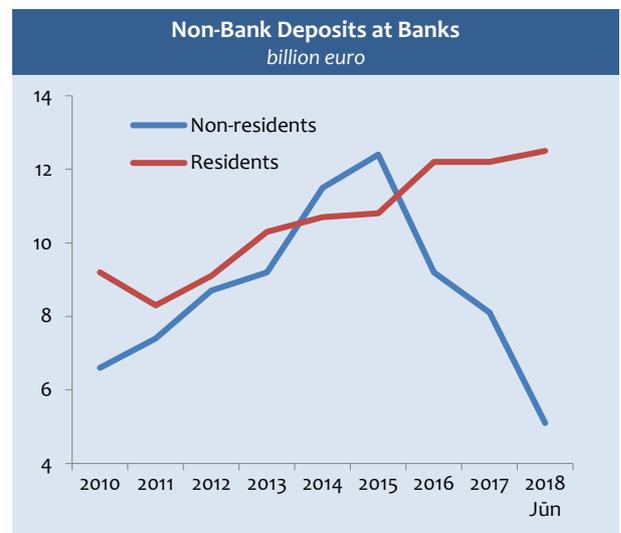
From 2010 to the end of 2015, **deposit stock** increased considerably. Deposit stock have been shrinking since the beginning of 2016, and in Q2 2018, deposits amounted to 17.5 billion euro, which was by 13.7% less than in the corresponding period a year before. Changes in the structure and in the dynamics of deposits were caused by the drop in volumes of deposits of non-residents. This was related to the self-cleaning process started by banks to reduce the volume of risky transactions – during this year one of the banks, whose business included a considerable share of non-residents, has started self-liquidation, while the second largest bank, which served non-residents, has refused from serving risky customers. As a result of these changes the share of deposits of customers declined from 53% in Q2 2015 to 29% in Q2 2018, of which 6.3% are the deposits of CIS countries, 12.1% – deposits of other EEA countries and 10.5% – deposits of other countries. The total volume of deposits of non-residents in Q2 2018 amounted to 5.1 billion euro, which is by almost 40% 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.

Non-resident deposit stock retain a positive increase, and in Q2 2018 it was by 4.2% higher than in the corresponding

period of the year before, reaching the historically highest indicator.

The majority of non-resident deposits are in euro (90.9%). Non-resident deposits have mainly been in euro since 2018.

Figure 6.22



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.

Since 2011, Latvia has returned to growth, and significant improvements have been achieved in the fiscal position (see Table 6.5 and Figure 6.23). General government budget deficit according to the European system of accounts reduced from 9.1% of GDP in 2009 to about 1.2-1.5% of

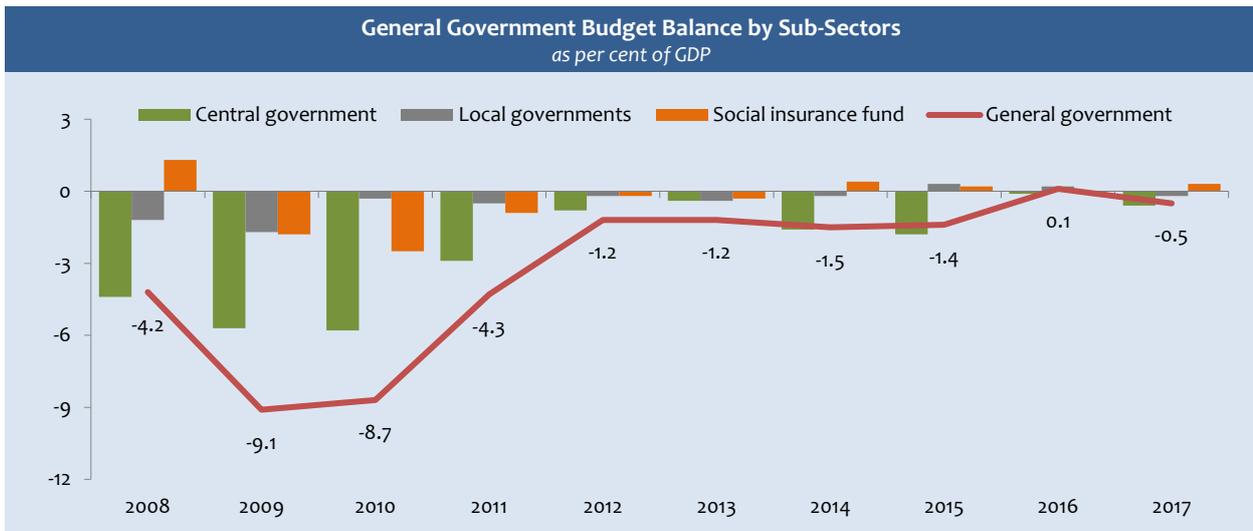
GDP in 2013-2015. In 2016, the budget had a surplus of 0.1% of GDP for the first time since 1998, but the budget had a small deficit of 155.7 million euro or 0.6% of GDP in 2017.

In 2017, the budget deficit was in central government and local government budgets. There was a surplus in the Social Insurance Fund (see Figure 6.23). The deficit in 2017 was lower than forecast in the budget law, where it was set as 1.1% of GDP. The lower level of deficit is explained by higher tax income, lower contributions to the EU budget, as well as lower than planned expenses on social benefits.

Table 6.5

General Government Budget					
	2013	2014	2015	2016	2017
Income, billion euro	8.3	8.6	9.0	9.3	10.1
as per cent of GDP	36.6	36.6	36.9	37.0	37.2
Expenditures, billion euro	8.6	9.0	9.3	9.3	10.2
as per cent of GDP	37.7	38.1	38.2	37.04	37.8
Balance, billion euro	-0.3	-0.4	-0.3	0.02	-0.2
as per cent of GDP	-1.2	-1.5	-1.4	0.1	-0.6

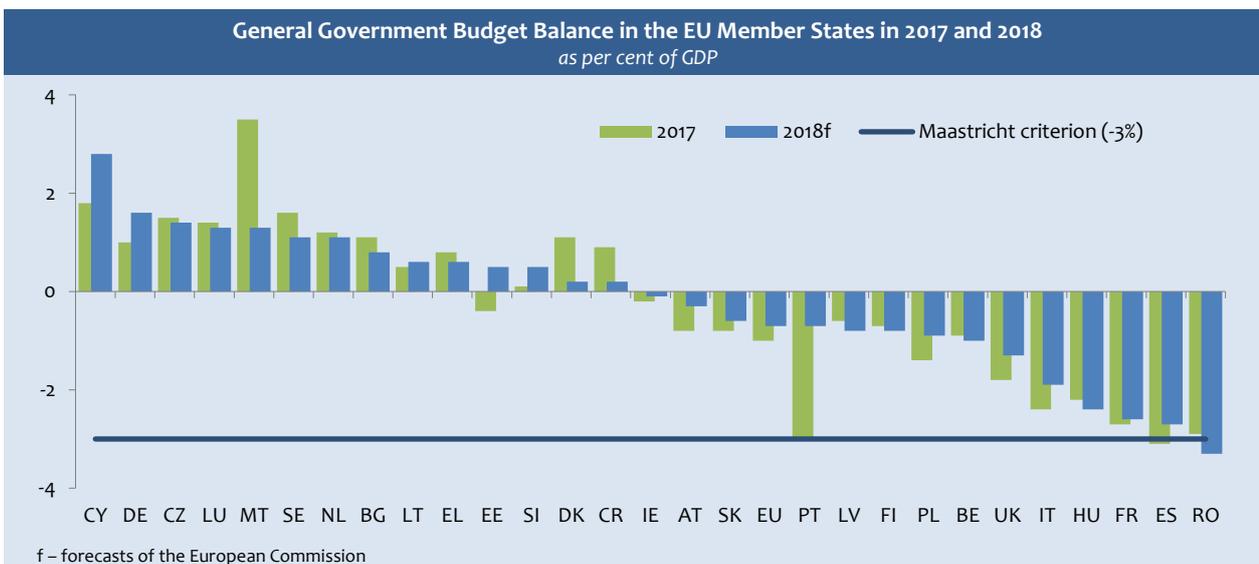
Figure 6.23



As it is seen on Figure 6.24, in 2017, the Latvian budget balance to GDP showed an average performance among all the EU countries. The overall situation of the EU in the budget is improving. The average level of budget deficit of the EU in 2017 was 1% of GDP (in 2016 – 1.7% of GDP, in

2015 – 2.3% of GDP). 13 EU countries had a surplus in the state budget in 2017. Budget deficit of only 2 countries (Spain and Portugal) was equal to or exceeded the Maastricht criteria, which is 3% of GDP.

Figure 6.24



According to the forecasts of the EC announced in the autumn of 2018, the budget situation in the EU will continue to generally improve in 2018 and 2019. The average level of budget deficit in the EU in 2018 is expected to be 0.7% of GDP, while in 2019 – 0.8%. The highest budget deficit in 2018 and 2019, which may exceed 3% of GDP, is expected in Romania.

The medium-term budget framework intends that the general government budget deficit is 1% of GDP in 2018, 0.9% in 2019 and 0.4% in 2020. In 2018, as well as in 2020, the fiscal security reserve of 0.1 % of GDP is anticipated. In the first half of 2018, there was a surplus in the government budget of 605 million euro or 4.4% of GDP, which is considerably more than in the first half of the previous years.

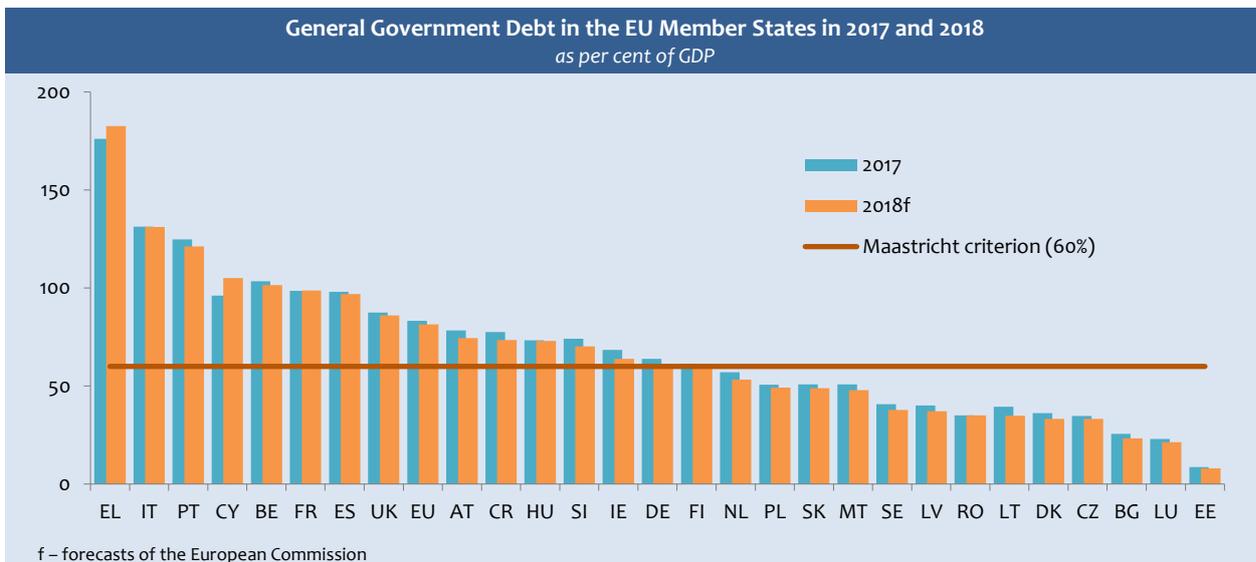
On 15 October 2018, the CM approved a draft state budgetary plan for 2019 if policy remains unchanged, it includes forecast income and expenses, which correspond to the latest macroeconomic forecasts and all the decisions adopted by the end of September. The budgetary plan

envisages the fiscal security reserve of 0.1% of GDP or 31 million euro. It is planned to reduce the general government deficit to 0.7% of GDP, and it ensures compliance with conditions of the Latvian fiscal discipline. The state budget for 2019 in its final version will be adopted by a new government, and it will be approved in Saeima.

The **general government debt** in Latvia is still one of the lowest in the EU (see Figure 6.25). It was 10807 million euro or 40% of GDP in 2017.

The average level of public debt in the EU in 2017 was 81.6% of GDP (in 2016 – 83.3% of GDP, in 2015 – 84.4% of GDP). In 15 EU member states, the public debt in 2017 exceeded the Maastricht criteria, which is 60% of GDP. The highest public debt to GDP in 2017 was detected in Greece, Italy, Portugal, Belgium, France, and Spain, whereas the lowest general government debt to GDP was registered in Estonia, Luxembourg, and Bulgaria. As indicated by the EC Autumn 2018 forecasts, the average level of public debt in the EU will slightly decrease in 2018 and also in 2019.

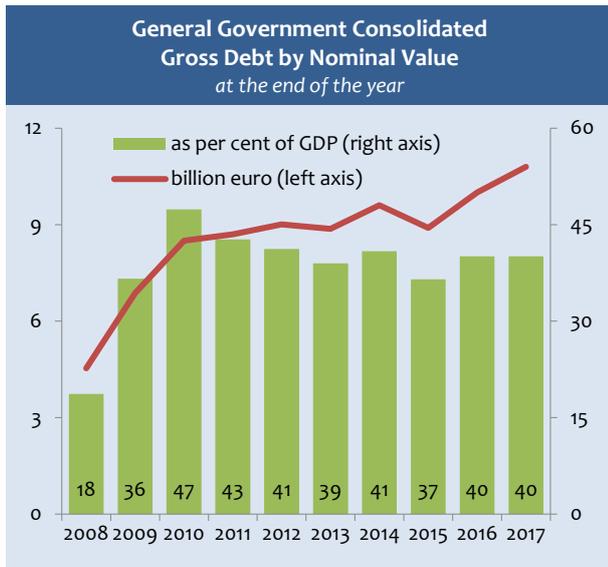
Figure 6.25



The general government debt in Latvia increased moderately until 2007. In order to provide funding for performance of financial liabilities, the general government debt started to grow rapidly starting from 2008, and it reached 8.4 billion euro or 46.8% of GDP at the end of 2010. Since the end of 2011, the general government debt has had a tendency to decrease. It was 10.8 billion euro or 40.0% of GDP in 2017 (see Figure 6.26). Government debt slightly reduced in the 1st half of 2018 and amounted to 10.4 billion euro.

By implementing well-timed 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, convincingly complying with the criteria concerning the amount of general government debt specified in the Maastricht Treaty.

Figure 6.26



6.6. BUDGET REVENUE AND EXPENDITURE

BUDGET REVENUE¹

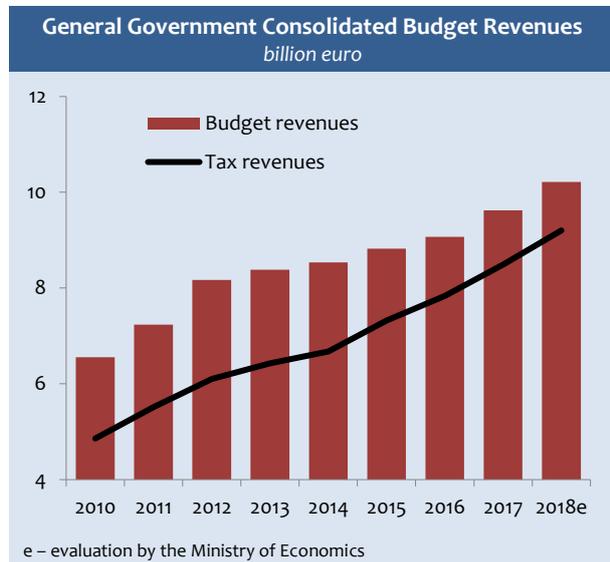
With the economic situation improving, the budget revenue has been increasing since 2011. From 2014 to 2017, the increase in **general government consolidated budget revenue** was more rapid than in 2011-2012. In total, budget revenue has grown 1.5 times since 2010. In 2017, budget revenues amounted to 9624.5 million euro or for 6.1% more than in 2016. Budget revenue continued to increase also in 2018 – an increase by 13.9% in the ten months compared to the corresponding period in 2017, and amounted to 9074.9 million euro.

Approximately 3/4 of all budget revenues consist of tax revenues. Tax revenue has been growing stably. The fastest growth was observed in 2012 affected by more tax collections.

In summer 2017 Saeima approved an extensive tax reform, which entered into force from 1 January 2018. The purpose of the Tax Reform is to ensure a stable and predictable tax policy until at least 2021 focussed on the growth of national economy and increase in welfare of the population, incl. reduction in income inequality, at the same time ensuring sufficient, predictable and qualitative tax income for financing of national and local government functions shifting the tax wedge away from labour towards consumption, environment and property taxes. The key measures implemented within the scope of the reform are oriented towards reducing the tax wedge of the labour force,

increasing income of low-earning employees and families with children.

Figure 6.27



Employment tax revenues are growing stably fostered by the average increase in gross wages in the country. Until 2015, the increase in employment taxes was moderate, while in 2016 it increased more rapidly, which was greatly influenced by the increase of the minimal wage in the country. In 2017,

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

employment tax revenues increased by 11% and continue to grow also in 2018 – by 10.5% to 4041.9 million euro in the ten months. Employment taxes account for more than a half of all tax revenues since 2016.

Within the scope of the tax reform, on 1 January 2018 the minimum wage increased from 380 euro to 430 euro, a progressive personal income tax system was introduced, a differentiated non-taxable minimum was increased in different groups of income and the tax relief for a dependent person was increased, as well as the rate of mandatory state

social insurance contributions was increased diverting these funds for financing of the healthcare sector, and other changes were made.

Personal income tax revenues have been growing since 2012 greatly affected by the improvement of the situation in the labour market. In 2017, personal income tax revenues amounted to 1692.9 million euro and grew by 10.7% compared to 2016. In 2018, the revenues continue to increase – by 1.7% to 1388.4 million euro in the ten months.

Table 6.6

	Budget Revenue as per cent of GDP									
	2010	2011	2012	2013	2014	2015	2016	2017	2018 Jan-Sep	
General government consolidated budget revenues	36.5	35.7	37.3	36.8	36.1	36.3	36.2	35.6	42.2	
I Tax revenues	27.1	27.2	27.9	28.2	28.3	30.1	31.3	31.4	31.6	
1. Indirect taxes	10.3	10.2	10.6	10.6	11.0	11.3	11.7	11.6	12.1	
– value-added tax	6.5	6.7	7.3	7.3	7.6	7.8	8.1	8.1	8.3	
– excise tax	3.6	3.4	3.2	3.2	3.2	3.3	3.4	3.4	3.6	
– customs duty	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	
2. Income taxes and property taxes	7.9	7.7	8.0	8.2	8.2	8.3	8.7	8.7	8.0	
– corporate income tax	0.9	1.4	1.6	1.6	1.5	1.6	1.7	1.6	1.3	
– personal income tax	6.3	5.6	5.7	5.8	5.9	5.9	6.1	6.3	5.7	
– real estate tax	0.7	0.8	0.8	0.8	0.8	0.8	0.9	0.8	0.9	
3. Social insurance contributions	8.2	8.8	8.7	8.6	8.6	8.7	8.4	8.4	10.8	
4. Other taxes	0.3	0.2	0.2	0.6	0.6	0.7	0.8	0.8	0.7	
II Other revenues	5.8	9.1	9.5	8.5	9.5	8.6	7.9	7.5	10.6	

Revenues from mandatory state social insurance contributions have been growing since 2011. They increased most rapidly in 2016 – 2544.6 euro or by 24.2% more than in 2015, which was largely affected by the introduction of the solidarity tax. Mandatory state social insurance contributions increased also in 2017, but not so fast as in the previous year – by 9.8% and continue to grow also in 2018.

Consumption tax revenues constitute a third of all tax revenues. Consumption tax revenues are growing. This is largely affected by an increase in private consumption and, therefore, an increase in retail turnover. In 2017, consumption tax income to the state budget grew by 7.9%. The increase continued also in 2018 – by 10.9% compared to the ten months of 2017, and was 2576.7 million euro.

Within the scope of the tax reform, from 1 January 2018 the application of reverse VAT payment procedure has been extended to include construction services, and this procedure has been introduced for deliveries of construction products, deliveries of electronic household appliances and electrical household appliances, deliveries of metal articles and related services, as well as deliveries of game consoles. The excise tax for alcoholic beverages and tobacco products has been raised with a timetable for gradual increase of its rates until 2020.

Value added tax revenue has been growing since 2010. In 2017, revenues amounted to 2187.8 million euro and grew by 8.4% compared to 2016, which was the fastest growth in the last five years. Value added tax revenues continued to increase also in 2018.

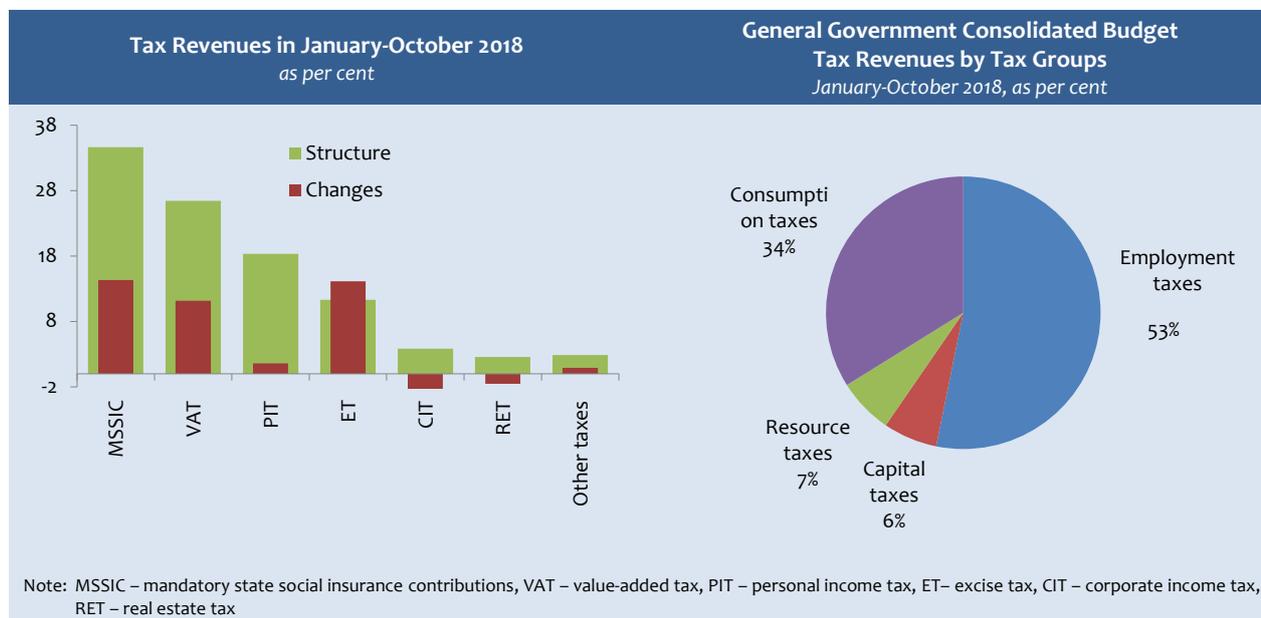
Revenue from the consumption share of the excise tax has been growing since 2011. In 2017, excise tax revenues amounted to 405.1 million euro, which is for 8.4% more than in 2016. The increase continued also in 2018.

Capital tax revenues are growing. The increase of capital tax revenues in the post-crisis period was largely affected by the low base effect, because corporate income tax revenues reduced considerably during the crisis as business activities narrowed and the number of insolvent companies increased. By contrast, the increase of the real estate tax rate during budget consolidation gave a comparatively smaller effect, because the share of this tax is comparatively low. The share in total capital tax revenues was 7.6% in 2017 with an increase by 2.2% compared to 2016. In 2018, tax revenues are declining and in the ten months amounted to 484.8 million euro, which is by 12.8% less than in the ten months of the previous year.

Within the scope of the tax reform, from 1 January 2018 the turnover threshold for payers of the microenterprise tax reduced, PET rates for different types of income were equalised, as well as a new corporate income tax payment procedure was introduced envisaging that the CIT rate is

20%, and it should be paid only from that part of profit, which is distributed or paid in dividends or also used for the purposes, which are not directly related to business development, and corporate income tax no longer applies to reinvested profit.

Figure 6.28



In 2011, revenues from corporate income tax resumed growth, however the revenues decreased by 2.1% in 2014. This was largely related to a reduction in tax payments and an increase in the amount repaid. Revenues have been growing again since 2015, however, not at such a fast pace as previously. In 2017, corporate income tax revenues increased by 1.4%. Corporate income tax revenues are declining in 2018 – an decrease by almost 19% in the ten months compared to the corresponding period in the previous year, and amounted to 292 million euro. So rapid decline was largely affected by changes in the corporate income tax payment procedure.

Real estate tax revenues have been growing homogeneously since 2009. Revenues increased by 3.8% and amounted to 228.2 million euro in 2017. Revenues slightly reduced in the ten months of 2018.

Resource taxes are the smallest group of taxes, which composed 6.2% of all tax revenues in 2017. Resource tax revenues resumed growth in 2011, and resource tax revenues increased by 4.4 per cent in 2017, compared to 2016.

The changes introduced within the scope of the tax reform as of 1 January 2018 increased the excise tax for fuel and introduced other changes.

Natural resources tax revenue has been generally growing since 2010. Natural resource tax revenues increased by 43.5% in 2017, compared to 2016, and amounted to 25.6 million euro. Natural resources tax revenues saw the most rapid increase in percentage. The rapid increase was

affected by changes in regulatory enactments, which entered into force from 1 January 2017. They extended the range of taxable objects and individual taxable objects, thus increasing tax rates. The revenues continued to grow in 2018.

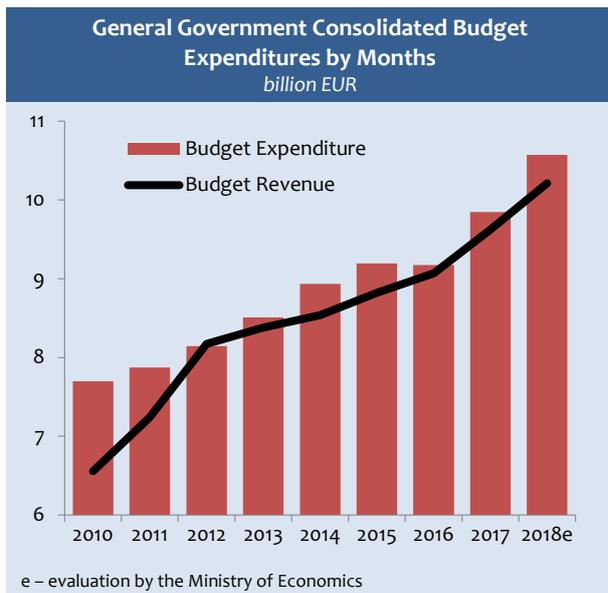
Starting from 2011, revenues from excise tax on oil products and natural gas have been generally growing. In 2017, the revenues amounted to 501.8 million euro – by 3% more than in 2016.

BUDGET EXPENDITURE

After an extensive cutting down of expenditure during the economic crisis, the **general government consolidated budget expenditure** has been gradually increasing since 2011, with the exception of 2016, when general government budget expenditure reduced by 0.3% compared to 2015. In 2017, total general government budget expenditure amounted to 9846.2 million euro, which is by 7.4% more than in 2016. General government consolidated budget expenditure continued to grow also in 2018 – they increased by 11.1% to 9074.9 million euro in the ten months.

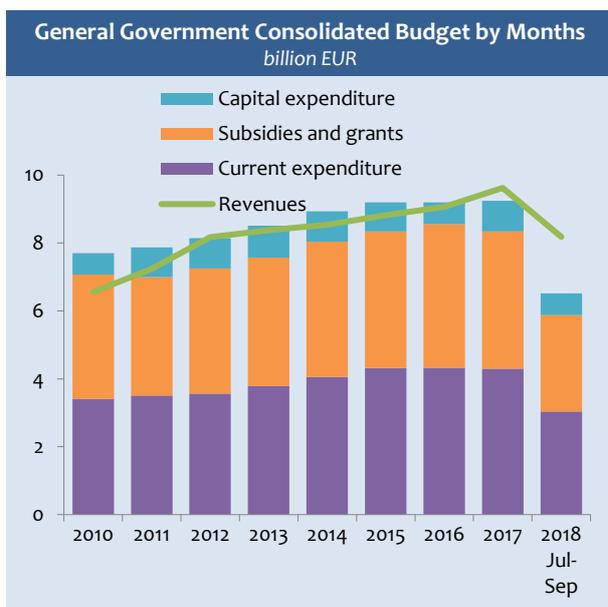
Expenditure on subsidies and grants has been generally growing since 2012. Expenditure on subsidies and grants increased by 2.7% in 2017, compared to 2016, and amounted 4720.4 million euro. In 2018, expenditure on subsidies and grants increases – by 10.8 in the ten months.

Figure 6.29



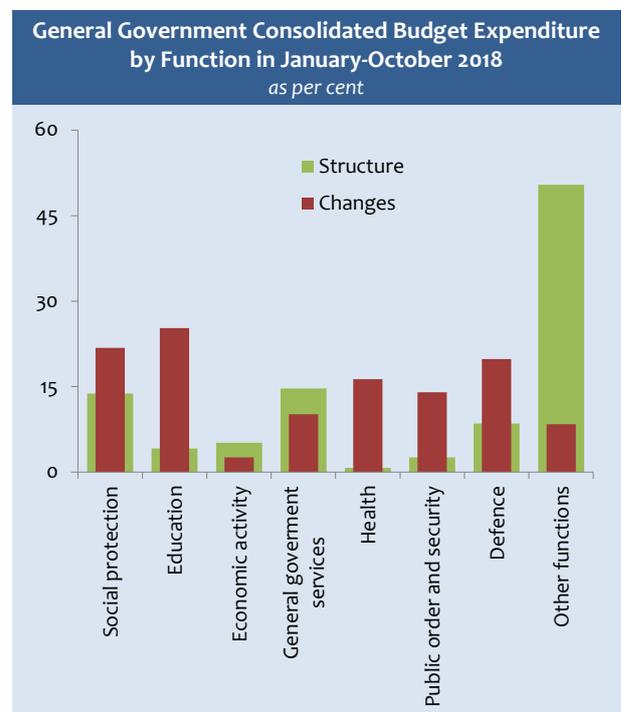
When cutting the budget expenditure during the crisis, **capital expenditure** was one of the first to be limited. From 2011 to 2013, capital investments increased due to active acquisition of the EU fund, but they have been decreasing since 2014 and reached the lowest level in the last 5 years in 2016 – drop by 25.3% compared to 2015. The reduction in capital expenditure is was mainly underpinned by the reduction of expenditure in local government budgets, where investments to ensure basic activity and for the implementation of EU funded projects reduced. Starting from 2017, capital expenditure has been growing and amounted to 1055 million euro, which is by half more than in 2016. The increase in capital investments continues in 2018 – by 33.1% compared to the ten months of 2017 and was 957.2 million euro.

Figure 6.30



Current expenditure was reduced most significantly during the crisis. To reduce the national general government consolidated expenditure, certain areas of public administration were optimised – cutting the number of employees and wages in ministries and public authorities, as well as reducing the number of state agencies and hospitals. These expenditures were reduced the most during the crisis. Current expenditure has been growing since 2013. It increased by 6.3% in 2017, compared to 2016, and amounted 5009.3 million euro. The increase was largely determined by the increase in the minimum wage. In 2018, current expenditure continues to grow and in the ten months of 2018 amounted to 4327.9 million euro, which is by 8.4% more than in the corresponding period of the previous year.

Figure 6.31



In accordance with budget expenditure by functional categories, the overall structure has not significantly changed in recent years. Social protection, education and economic activity contributed the most to the increase in expenditure.

In 2017, expenditure on defence, recreation and culture and management of local government territories increased most rapidly, while education and economic activity saw a more moderate increase.

6.7. PRODUCTIVITY AND COMPETITIVENESS

PRODUCTIVITY

Productivity growth rates in Latvia are also among the highest in the EU. Since 2011, they have grown by 14.7% (by 4% in EU-28). Dynamics more rapid than in the EU on average have contributed to the reduction of lagging behind of the productivity level of Latvia. However, in comparison with several developed countries of the EU, the productivity gap is comparatively large. In 2017, the productivity level in Latvia was only 46.8% (67.9% according to PPS) of the EU average, and this is one of the lowest indicators in the EU.

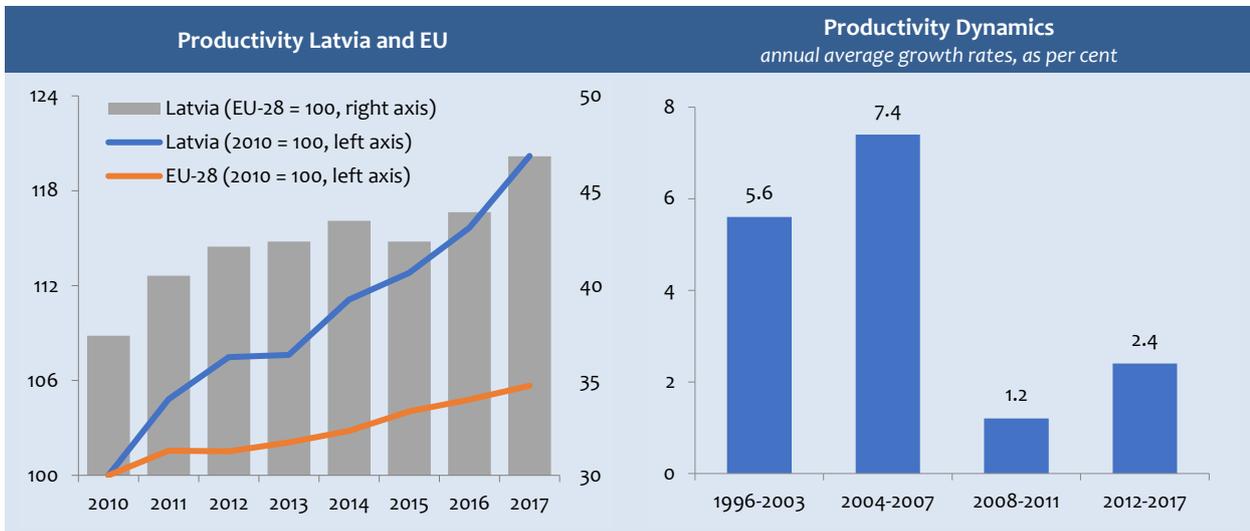
In the long-term view, the productivity dynamics become more moderate. Before the crisis (1996-2007), productivity of Latvia increased by 6.2% per year on average and was an important economic growth driver. The integration of the country in the EU Single Market had a positive impact on the productivity dynamics strengthening economic growth and accelerating the convergence process. In 1995-2007, the productivity gap among the EU countries narrowed by almost 25 percentage points. Productivity has been growing slower since 2008 – by 2% per year on average under the influence of cyclical and structural factors. In the first years of economic recession (2008-2009), productivity reduced 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 3 times slower than before the crisis (1996-2007). Despite the deceleration of the rates, productivity dynamics have been more rapid in Latvia than in the EU on average both in the national economy as a whole and across sectors.

Productivity is growing more rapidly in tradable¹ sectors. From 2011 to 2017, tradable sectors grew by 3.1% per year on average, non-tradable – by 1% per year. Trade and transport services sectors take leading positions by their annual productivity dynamics. Manufacturing has also made an important contribution to total productivity growth. In 2017, productivity of manufacturing was by 18% higher than in 2010.

In manufacturing the productivity level is lower than in the national economy on average. Clearly low productivity in manufacturing greatly explains the total low level of productivity in the Latvian economy. It should be noted that productivity in manufacturing exceeds the average indicator of the national economy in all EU Member States. The productivity level in manufacturing in EU countries is higher than in the economy on average by 17%, but in the old EU Member States (EU-15) – by 28%. By contrast, productivity of manufacturing in Latvia lags behind by almost 20% from the average national economy indicator.

Figure 6.32



Sectors with low value added dominate in Latvia. The share of the so-called high-tech sectors in manufacturing was 8.2% in 2016 (calculated according to added value). Although the share of high-tech sectors in manufacturing has been gradually growing since 2000, their effect on

productivity of the sector and total productivity is still insignificant in the Latvian economy.

The possibilities of increasing the productivity level of the Latvian industry are mainly related to its ability to carry out technological modernisation and innovation, to extend

¹ Tradable sectors: agriculture, forestry and fishing; industry (except construction); wholesale trade and retail trade; transportation, accommodation and food service activities

participation in global value chains, to increase qualifications of labour force and improve internal mobility of labour force across the country. The structural transformation of manufacturing and the entire Latvian economy also has considerable effects on higher value added and higher productivity activities.

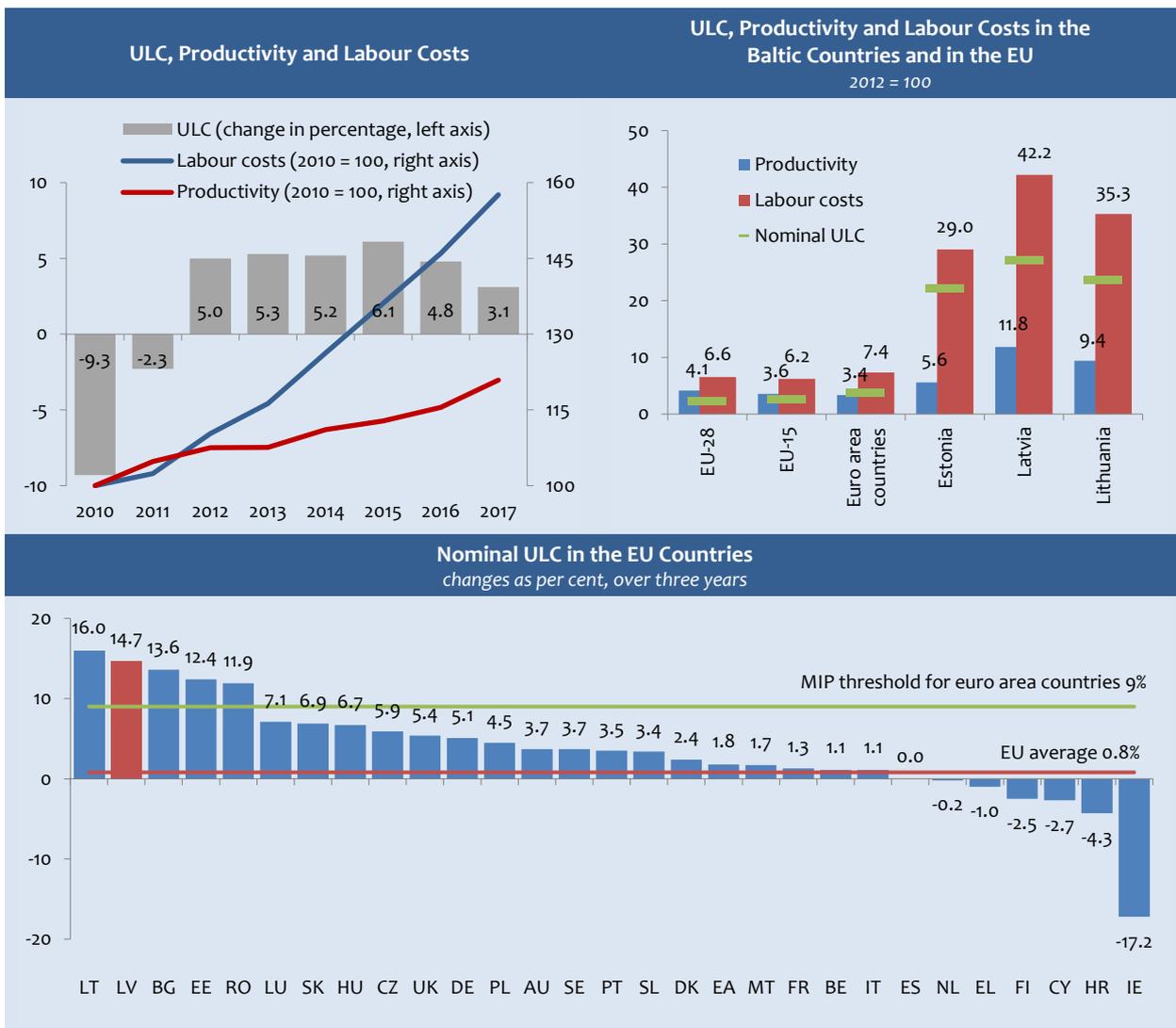
COST AND PRICE COMPETITIVENESS

Although Latvia is in one of the leading positions by productivity growth rates among the EU Member States, yet

wages have been growing faster than productivity, jeopardising competitiveness of Latvian businessmen in the field of costs. The increase in product unit labour costs (ULC)¹ also evidences of the risks of losses in cost competitiveness.

Wage is a significant cost competitiveness factor, therefore its rise should be balanced with a rise in productivity. Otherwise, the competitiveness in tradable sectors is lost, which does not result in a stable growth of total income or welfare.

Figure 6.33



In the pre-crisis years (2004-2007) wages of the employed increased almost five times faster than productivity, which also had a reflection in a rapid increase in product unit labour costs (ULC).

The serious adjustments to product and labour markets, created by the crisis in 2009-2011 bridged the gap between the dynamics of productivity and labour costs. A more rapid drop in labour costs in comparison with productivity in 2009

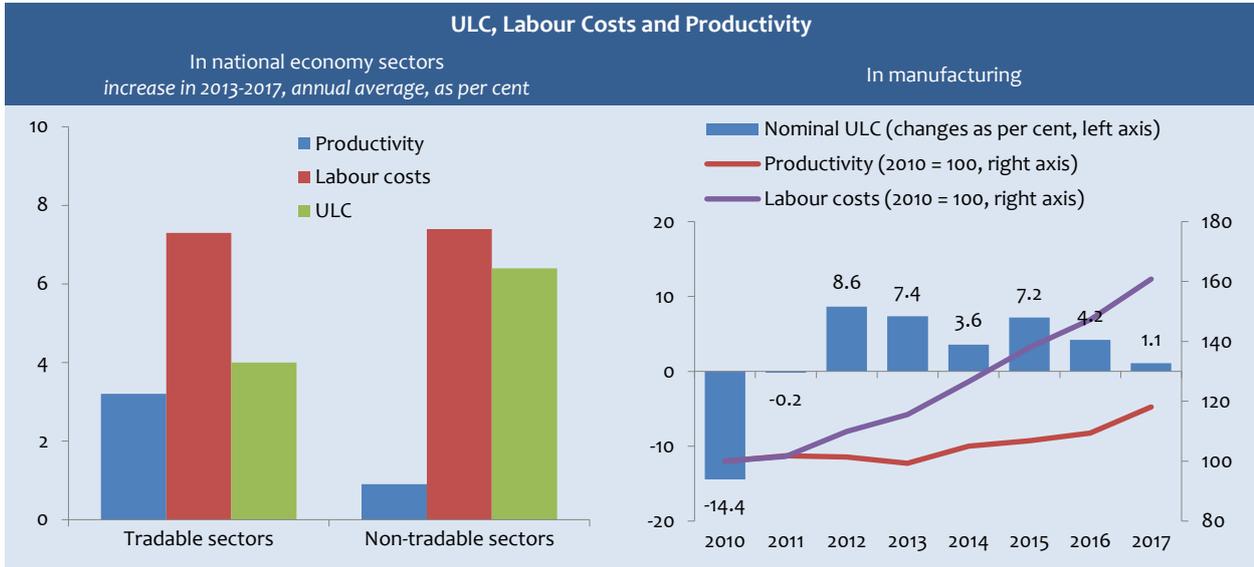
¹ ULC is a relationship between labour costs and productivity. If productivity is growing faster than the wages, then ULC is decreasing, which is an indication that competitiveness of state costs increases, and the other way around.

and a rise in productivity in 2010 and 2011 determined a decrease in ULC on average by 7.5% per year, which indicated an improvement in the cost competitiveness of the Latvian producers.

However, after the economic recovery ULC increased as well. In recent years, a particularly strong dynamics of nominal

ULC have been observed in all the Baltic countries, and the MIP threshold for this indicator has been exceeded. This was affected by a strong increase in wages and a comparatively more moderate increase in labour productivity. The competitiveness of Baltic producers is also adversely affected by slower wage increase rates in high income countries of the EU.

Figure 6.34



From 2013 to 2017, productivity rose on average by 2.4% per year on average, nominal unit labour costs increased by 7.4%, i.e., almost 3 times faster, and nominal ULC increased by almost 5% per year on average. Productivity grew slower than labour costs in the entire Latvian economy also in 2018.

A strong increase in labour costs is 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 evidences that a mismatch between labour demand and supply in the Latvian labour market increases.

Figure 6.35



Cost competitiveness reduction risks are observed in tradable and non-tradable sectors. Although the dynamics of labour costs in the last five years (2013-2017) in both

groups of sectors were very similar – they increase by almost 7.4% on average every year, however, productivity in tradable sectors increased more rapidly than in non-

tradable sectors – by 3.2% and 0.8%, respectively. Therefore, also the nominal ULC increase in tradable sectors was more moderate. Information and communication face the highest rise in ULC affected not only by the increase in labour costs, but also by the drop in productivity.

The gap between productivity and labour costs growth rates in manufacturing is more moderate than in the national economy on average, and it has slightly reduced in recent years, and the deceleration in annual nominal ULC growth rates is an evidence of this. Although in 2016 and 2017 labour costs grew slower than productivity in manufacturing, in a medium period of time annual productivity growth rates are still three times slower.

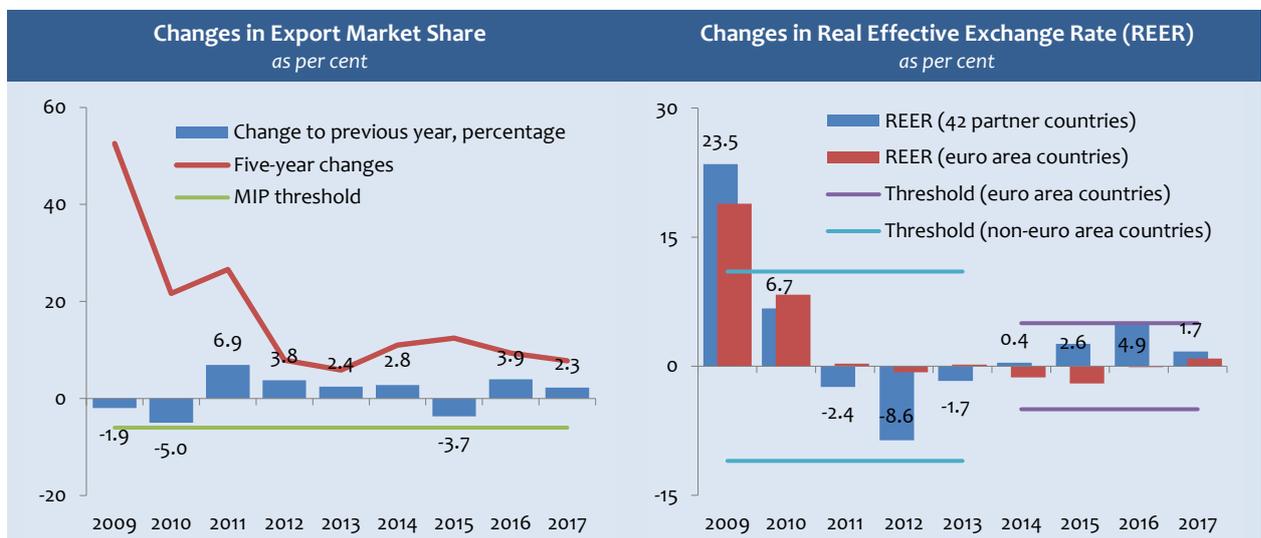
It should be noted that the labour costs dynamics in Latvian manufacturing exceeds EU average labour costs and nominal ULC growth rates almost twice. Taking into account that the EU countries are our main trade partners, such trends evidence of growth threats for reduction of cost

competitiveness. The competitiveness of Latvian producers in external markets is also adversely affected by slower wage increase rates in high income countries of the EU.

The share of Latvia in export markets is growing despite negative trends in the cost competitiveness indicator (ULC). Since 2013, the share of Latvian exports on global markets of goods and services increased by 7.8%, and this means that Latvia still retains its competitiveness in external markets. However, data about changes in the annual market share evidence that positive trends become increasingly more moderate.

The real effective exchange rate (REER) dynamics are rather moderate. The consumer price index (CPI) based REER to 42 trade partner countries has increased 1.7% in the last three years (2015-2017) (incl. to euro area countries – by 0.9%), which does not exceed the threshold set by MIP.

Figure 6.36



However, it should be noted that the increase in the export share along with the rapid increase in labour costs means that the increase in wages is compensated in prices only partially. The dynamics of the GDP deflator and the CPI-based REER evidence of that.

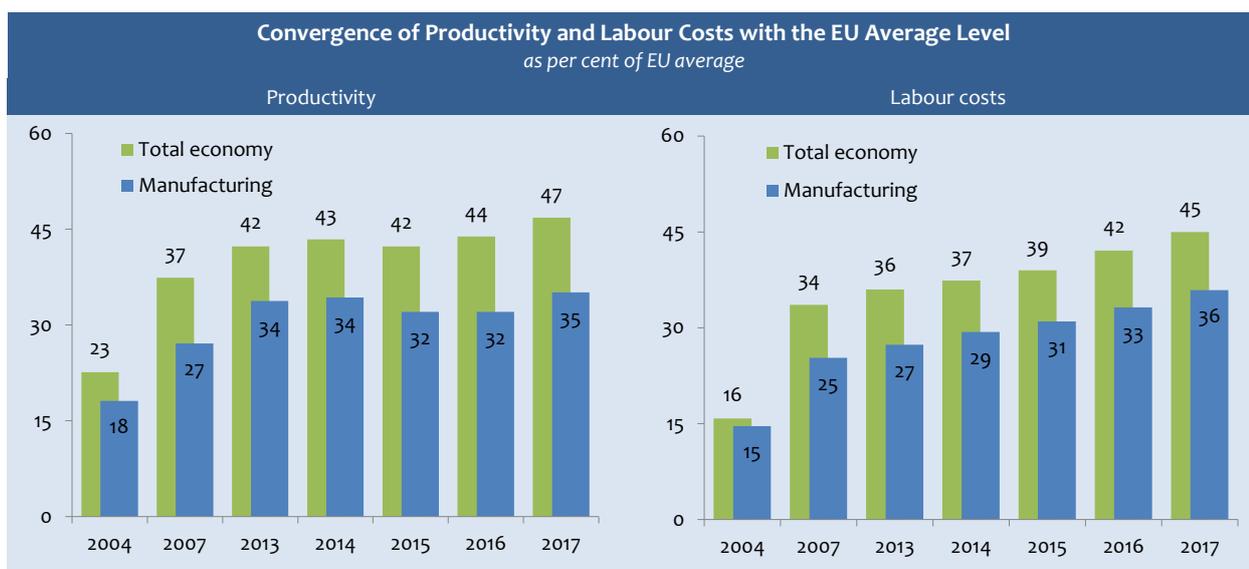
In Latvia, as well as in its neighbouring countries Lithuania and Estonia, the dynamics of price competitiveness (GDP deflator based REER) are growing slower than the cost competitiveness indicator (ULC-based REER) evidencing that the rise in labour costs affected the reduction in the cost-to-price ratio rather than are compensated completely in the rise in prices.

This means that the increase in labour costs, which is not compensated by a corresponding rise in productivity, may have a negative effect on the share of company's profits, which entrepreneurs will be forced to adjust to keep price competitiveness in external markets.

Trends in recent years show that as economic activities are growing, price and cost competitiveness indicators get worse, and wage convergence is one the most important factors here.

Labour costs in Latvia are one of the lowest in EU Member States. In 2017, labour costs per employed in the economy of Latvia were 39.2% of the EU average in total, whereas in the manufacturing industry – 29.8%. Since 2011, labour cost gap has decreased by almost 5 percentage points, while in terms of productivity index in the national economy fell by 6 percentage points in total, but in manufacturing – by 1.5 percentage point. Wage equalisation (convergence) is unavoidable, and this has to be taken into account. A more rapid growth in wages can be influenced by an increase in the minimum wage, entrepreneurs' wish to retain highly qualified workers, reduction of unemployment rate, etc. Therefore, strengthening of Latvia's competitiveness will largely depend on the ability to reduce the productivity gap.

Figure 6.37



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 21 November 2018, the European Commission published an **Alert Mechanism Report**¹ (AMR) 2019, which states that no macroeconomic imbalances have been stated in Latvia, although two indicators exceed the set limits or thresholds: net international investment position (NIIP) and nominal unit labour cost (NULC) index (see Table 6.7).

It is noted in the AMR that the current account of Latvia is balanced. Thanks to strong GDP growth negative NIIP has reduced, although it is still above the threshold. NULC mainly consist of foreign direct investment. Since 2014, the nominal unit labour cost index has been growing faster than the threshold, reflecting strong wage growth and a tight situation in the labour market. However, the impact of this process on external price competitiveness and the export performance has been limited so far, profit margins reduced slightly. It is expected that wage growth is expected to remain strong due to further tightening of the labour

market. This will reduce country's competitiveness and the growth prospects over the medium term. House price growth remains dynamic. While in 2017 house prices decelerated in comparison with 2016, they have accelerated again in the first half of 2018. Overall, credit growth has been subdued. Government and private debt are relatively low.

Indicators of the macroeconomic imbalance procedure (both the scoreboard 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 current account balance of Latvia has not exceeded the thresholds since 2010 and was positive in 2017. The countries, where the current account balance exceeds the upper threshold, are Germany, Malta, Netherlands and Denmark, and it exceeds the lower threshold in Cyprus and the United Kingdom. The rapid increase in Latvian GDP has left a positive impact on the current account. In this indicator Latvia was among the most rapidly growing EU-28 countries in 2017 (a higher increase was only in Romania, Ireland, Malta, Poland, Slovenia and Estonia).

¹ https://ec.europa.eu/info/publications/2019-european-semester-alert-mechanism-report_en

Table 6.7

Scoreboard of Indicators of the Macroeconomic Imbalance Procedure for Latvia									
	Thresholds	2010	2011	2012	2013	2014	2015	2016	2017
External imbalances and competitiveness									
Current account balance (as per cent of GDP, 3-year average)	-4%/6%	-0.8	2.2	-1.6	-3.2	-2.7	-1.6	-0.2	0.6
Net international investment position (as per cent of GDP)	-35%	-82.9	-74.4	-67.2	-66.4	-66.1	-63.5	-58.4	-56.3
Real effective exchange rate – 42 trading partners, HICP deflator (3-year changes)	±5%* & ±11%	6.7	-2.4	-8.6	-1.7	0.4	2.6	4.9	1.7
Export market share – % of world exports (5-year changes)	-6%	21.7	26.6	7.9	5.9	11.0	12.5	9.4	7.8
Nominal unit labour cost index (3-year changes)	9%* & 12%	-2.2	-21.0	-6.9	8.1	16.3	17.5	16.9	14.7
Internal imbalances									
Deflated house prices (y-o-y changes)	6%	-8.7	4.1	-0.4	6.5	4.3	-2.4	7.3	5.5
Private sector credit flow (as per cent of GDP, consolidated)	14%	2.5	-2.0	-2.1	0.9	-11.8	0.7	0.3	0.3
Private sector debt (as per cent of GDP, consolidated)	133%	134.0	115.3	97.9	92.6	96.2	88.9	88.0	83.5
General government gross debt (as per cent of GDP)	60%	46.8	42.7	41.2	39.0	40.9	36.8	40.3	40.0
Unemployment rate (3-year average)	10%	14.9	17.7	16.9	14.4	12.6	10.9	10.1	9.4
Total financial sector liabilities (y-o-y changes)	16.5%	-0.3	-4.1	5.2	5.2	10.4	12.2	5.8	6.1
New employment indicators									
Activity rate – as per cent of total population aged 15-64 (3-year changes)	-0.2 percentage points	0.4	-1.4	0.9	1.0	1.8	1.3	2.3	2.4
Long-term unemployment rate – as per cent of economically active population (3-year changes)	0.5 percentage points	7.2	6.9	3.3	-3.1	-4.2	-3.3	-1.7	-1.3
Youth unemployment rate – as per cent of economically active population (3-year changes)	2 percentage points	25.6	17.4	-4.8	-13.0	-11.4	-12.2	-5.9	-2.6
Source: MIP procedure indicators, Eurostat * – euro area countries									
Note: highlighted number exceed the limits or thresholds set in the alert mechanism									

The net international investment position of Latvia improved to -56.3% of GDP in 2017, however it still exceeds the threshold – -35% of GDP (see Figure 6.38). 12 more EU-28 countries are in a similar situation, where the indicator exceeds 100% of GDP in some of them (Cyprus, Greece, Ireland and Portugal). However, it is noted in AMR that the countries having NIIP slightly exceeding the threshold has incoming FDI as one of way of attracting foreign capital, which is evaluated positively, because this ensures sustainability of the debt. In 2017, FDI constituted 31.3% of the total attracted foreign capital in Latvia.

Since 2010, the real effective exchange rate of Latvia has been slightly exceeding the thresholds, but after its accession to the euro area also the thresholds intended for euro area countries. Of the EU-28, only Cyprus and Ireland have a real effective exchange rate above the threshold.

Latvia's export market share is steadily increasing, but after 2010 growth rates are no longer so fast. A reduction in the export market share exceeding the threshold in 2017 was observed only in Greece. In 2017, positive trends in the increase of the export market share in euro area countries slowed down, because the euro exchange rate increased.

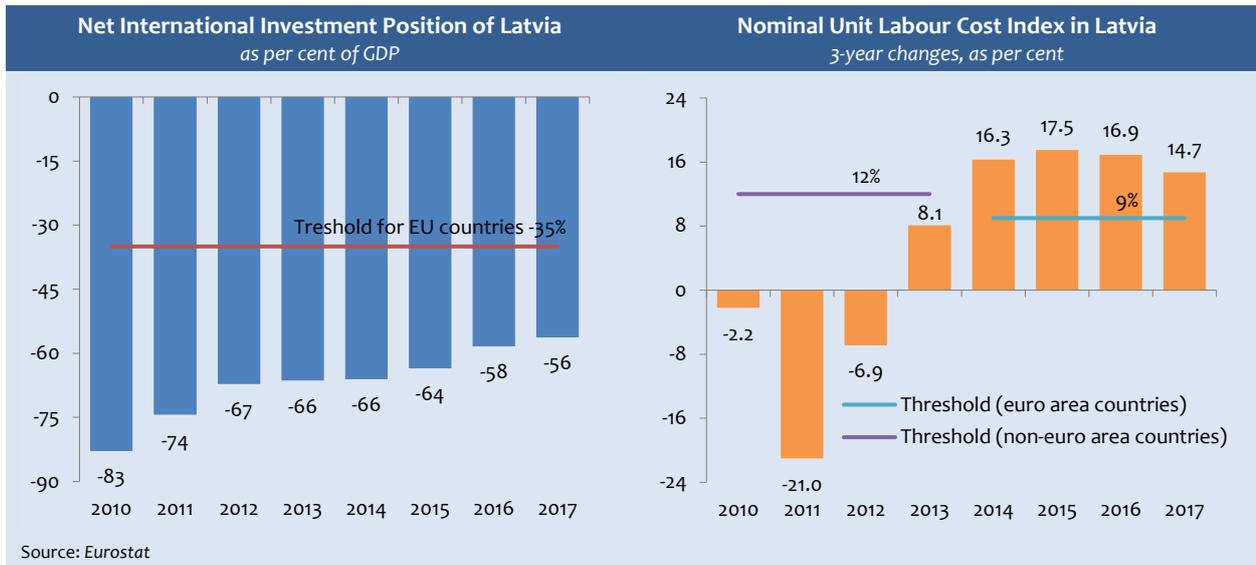
Since the accession of Latvia to the euro area in 2014, the nominal unit labour cost index exceeds the threshold set for euro area countries (see Figure 6.38). Other Baltic countries and Bulgaria are also in a similar situation. For more information on price and cost competitiveness, see section 6.7.

Internal imbalances are characterised by housing price deflation, private sector credit flows, private sector debt, general government debt, unemployment rates and total financial sector liabilities. After 2010, the house price index of Latvia exceeded the threshold in 2013 and 2016 (see Figure 6.39). Out of EU-28 countries, Ireland, Czech Republic, Portugal, Slovenia, Bulgaria and the Netherlands exceeded the house price index threshold in 2017.

The private sector credit flow of Latvia has not exceeded the threshold since 2010. In 2017, this indicator did not exceed this threshold in any of EU-28 countries.

The private sector debt exceeded the threshold in Latvia only in 2010. After 2010, the private sector debt continues to decrease. In 2017, this indicator exceeds this threshold in 12 of EU-28 countries.

Figure 6.38



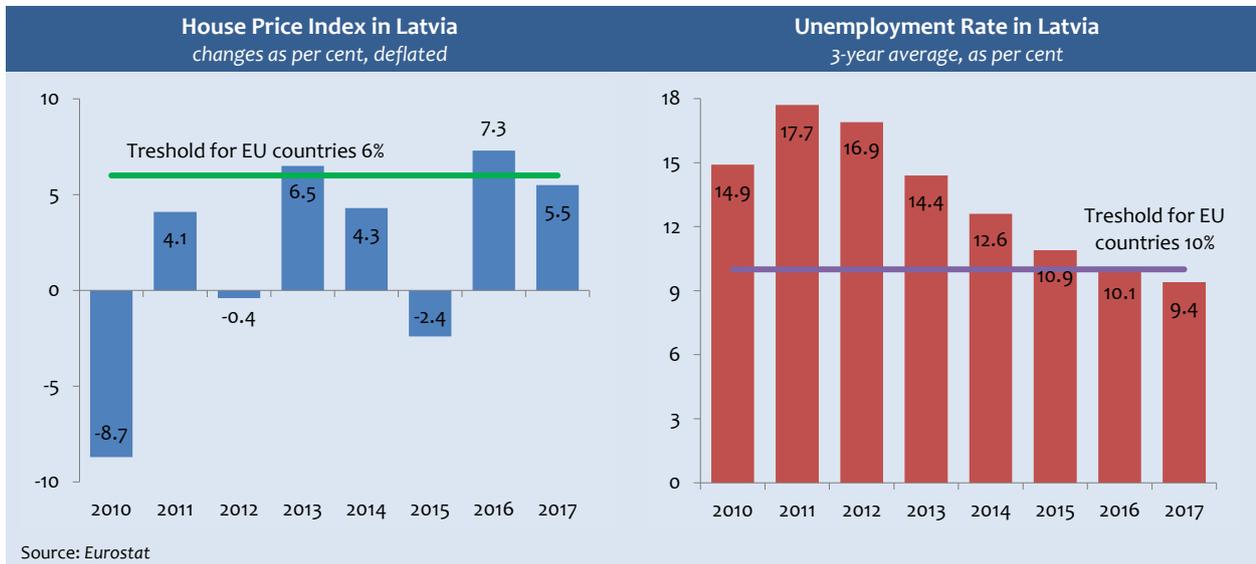
The general government debt of Latvia reached its highest level (46.8% of GDP) on 2011, however, it did not exceed the threshold. Then the debt has slightly reduced with small variations. In 2017, this indicator exceeds this threshold in 15 of EU-28 countries.

The 3-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 9.4% in 2017 (see

Figure 6.39). In 2017, out of EU-28 countries the 3-year average unemployment rate exceeded the 10% threshold in Greece, Spain, Croatia, Cyprus, Italy and France.

The increase in total financial sector liabilities in Latvia has not exceeded the set 16.5% threshold since 2010. In 2017, out of EU-28 countries, this indicator exceeded this threshold only in the Czechia.

Figure 6.39



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 long-term unemployment and youth unemployment rates in Latvia reached the highest level in 2010, but then reduced.

Similarly, the number of youths not in employment, education or training, was the highest in 2010. In 2017, long-term unemployment was 3.3% of the economically active population, youth unemployment was 10.3% of all the population aged 15-24, but 10.3% of youths aged 15 to 24 not in employment, education or training. Therefore, after 2012 long-term unemployment and youth unemployment indicators no longer exceeded the thresholds.

In 2017, out of EU-28 countries only Luxembourg had 3-year changes in percentage points in the long-term unemployment rate exceeding the threshold, but 3-year changes in youth unemployment did not exceed the threshold in any of EU-28 countries.

Three-year changes in percentage points in the economically active population level in Latvia exceeded the threshold in 2011, but then showed an increase. In 2017, only Luxembourg, Cyprus and Spain from EU-28 countries have exceeded the threshold.

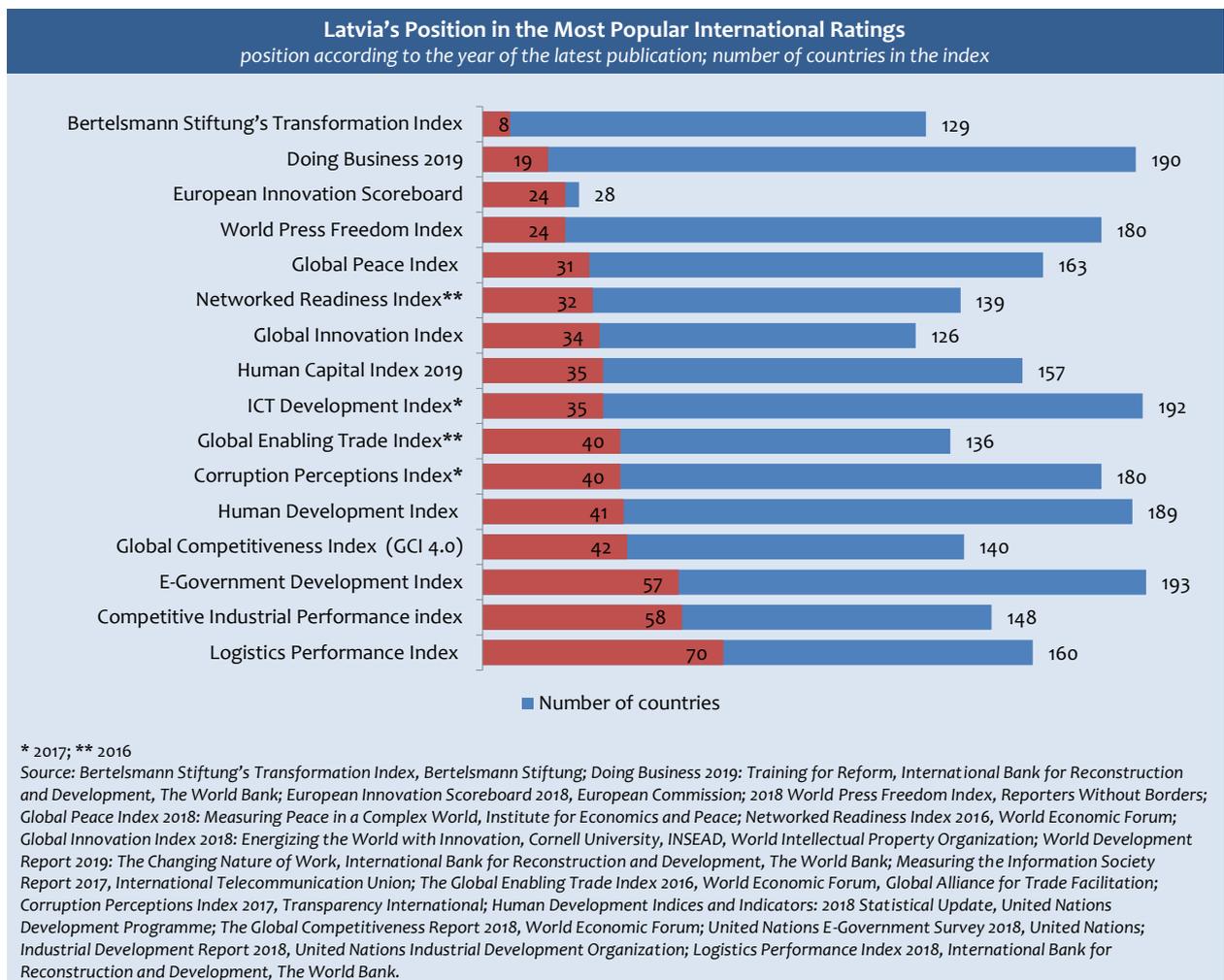
6.9. LATVIA IN INTERNATIONAL RATINGS

INDEXES

Ratings from the United Nations, the World Bank Group, the World Economic Forum and other organisations describe Latvia as a country that makes a lot of reforms to improve

its competitiveness, improving the business environment, human resources, ICT infrastructure, e-government, etc., while also providing free press and not endangering militarily other countries of the world.

Figure 6.40



In 2018, in the **Global Competitiveness Index (GCI)** created by the World Economic Forum (WEF) Latvia occupied the 42nd place among 140 countries of the world (Estonia – 32nd, Lithuania – 40th). 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 new GCI methodology was changed and is named GCI 4.0. The performance of the previous year was also recalculated according to it. It allows to evaluate the changes that have taken place during the year, which can be characterised by the evaluation (compared to the leading country) and by the change in the place during the year.

Having analysed the progress of Latvia in competitiveness by the evaluation, it should be concluded that the performance of Latvia in 12 pillars has improved or remained unchanged in 11 pillars and has slightly worsened only in one pillar (financial system), compared to the previous year. By contrast, by the occupied place, Latvia's

position has improved in 5 pillars (see Table 6.8). This means that in the areas, where, despite the improvement in the evaluation, the place of Latvia in the rating has deteriorated, other countries had more progress thus worsening the relative position of Latvia in the rating.

Table 6.8

Place of the Baltic Countries in GCI 4.0 2018				
	Latvia		Lithuania	Estonia
	place 2018	change in place compared to 2017	change in evaluation compared to 2017	place 2018
Total index	42	0	1.45	40
Environment				
Institutions	49	+3	+2.38	41
Infrastructure	47	+8	+2.76	44
ICT use	11	+6	+6.91	14
Macroeconomic stability	1	+28	+0.48	1
Human capital				
Health	76	0	+0.58	77
Skills	23	+5	+1.43	31
Markets				
Product market	49	-1	+0.96	53
Labour market	29	-2	+0.7	32
Financial system	94	-11	-0.7	76
Market size	94	-3	+0.68	76
Innovation ecosystem				
Business dynamism	47	-2	+0.49	44
Innovation capacity	52	-1	+0.67	42

Source: The Global Competitiveness Report 2018, World Economic Forum

The *Doing Business* survey by the World Bank group is an international, comparative rating of business environment, which annually measures entrepreneurship regulating administrative procedures and their application in various countries of the world.

In the competition among 190 countries *Doing Business 2019* Latvia occupies the 19th place as the year before. When evaluating the position among the EU countries, Latvia occupies one of the highest positions in the *Doing Business 2019* survey. Only Denmark (3rd place), the United Kingdom (9th place), Sweden (12th place), Lithuania (14th place), Estonia (16th place) and Finland (17th place) have a higher evaluation.

The creators of the *Doing Business 2019* study have used a new methodology and have therefore recalculated evaluations of indicators for the 3 previous years, however, have not specified places of countries. If we compare the evaluation of Latvia in 2019 and 2018, values of 8 groups of indicators have improved or remained unchanged, but the results of 2 groups of indicators have worsened (see Table 6.9). The assessment of "Paying taxes" has reduced, because tax rates changed, which reduce the profit of enterprises, but the assessment of "Registering property" has been reduced by the observation that information about deals with real estate became less accessible, because

statistical data about the number of land disputes in 2017 are not available.

In the **Transformation Index 2018** created by Bertelsmann Stiftung, which evaluates the quality of democracy, market economy and political governance, Latvia is placed 8th among 129 countries of the world (Estonia shares the 1st place, Lithuania is the 4th) having improved its performance by 2 positions compared to the result of 2016.

In the **European Innovation Scoreboard 2018** created by the European Commission Latvia is placed 24th among 28 EU countries, like a year ago (Estonia – 17th place, Lithuania – 20th place) and is included in the group of *moderate innovators* for the third year in a row. The following relative advantages of the Latvian innovation system were noted: innovation-friendly environment, finance and support, but relatively weaker areas are: innovators and firm investments.

In the **2018 World Press Freedom Index** created by the International Freedom of Expression Exchange organisation "Reporters Without Borders", in 2018 Latvia was ranked 24th (Estonia – 12th, Lithuania – 36th) among 180 countries of the world having moved up 4 positions compared to the result of 2017.

Table 6.9

Evaluations of Baltic Countries by Indicators in Doing Business 2019 in 2018							
	Latvia			Lithuania		Estonia	
	place	assessment	Changes compared to Doing Business 2018	place	assessment	place	assessment
Total index	19	79.59	0.33	14	80.83	16	80.50
Starting a Business	24	94.13	0.02	31	93.18	15	95.25
Dealing with Construction Permits	56	73.46	0.05	7	84.86	14	82.53
Getting Electricity	53	82.24	3.19	26	88.43	46	83.26
Registering Property	25	81.45	-0.42	3	92.96	6	91.02
Getting Credit	12	85.00	0	44	70.00	44	70.00
Protecting Minority Investors	51	63.33	0	38	66.67	83	56.67
Paying Taxes	13	89.74	-0.05	18	88.66	14	89.56
Trading Across Borders	26	95.26	0	19	97.83	17	99.92
Enforcing Contracts	20	71.66	0	7	78.80	13	74.34
Resolving Insolvency	54	59.60	0.5	85	46.87	47	62.51

Source: Doing Business 2019: Training for Reform, International Bank for Reconstruction and Development, The World Bank

In the **Global Peace Index 2018** created by the Institute for Economics and Peace, in 2018 Latvia was ranked 31st (Estonia – 33rd, Lithuania – 36th) among 163 countries of the world having moved up 1 position compared to the updated result of 2017.

In 2016, in the **Networked Readiness Index 2016** created by the World Economic Forum, which analyses the ability of countries to use ICT to increase competitiveness and welfare, taking into account the latest innovation trends, Latvia was placed 32nd among 139 countries of the world (Estonia – 22nd place, Lithuania – 29th place) improving its performance by 5 positions compared to the result of 2014.

In the **Global Innovation Index 2018** created by the Cornell University, European Institute of Business Administration and the World Intellectual Property Organisation Latvia was ranked 34th (Estonia – 24th, Lithuania – 40th) among 126 countries of the world worsening its performance compared to the result of 2017. The following indicators were emphasised as strengths of Latvia: ease of starting a business, pupil-teacher ratio in secondary education, compliance with environmental management system standards, ease of getting credit, females with advanced degrees, expenditure on research and development financed by abroad, growth rate of gross domestic product per worker by purchasing power parity, as well as increase in creative industry products.

In the new **Human Capital Index 2019** created by the World Bank group, which measures productivity of employees of the next generation to complete education and full health standard, in 2018 Latvia occupied the 35th place (Estonia – 29th, Lithuania – 37th) among 157 countries.

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 placed 35th among 192 countries of the world (Estonia – 17th place, Lithuania – 41st) improving its performance by 5 positions compared to the result of 2016.

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 among 136 countries of the world (Estonia – 14th place, Lithuania – 29th) improving its performance by a position compared to the result of 2014.

In the **Corruption Perceptions Index 2017** created by the International anti-corruption organisation *Transparency International*, Latvia was ranked 40st (Estonia – 21st, Lithuania – 38th) among 180 countries of the world improving its performance by 4 positions compared to the updated result of 2016. The increase was reached by slightly improving the index value.

In the **Human Development Index 2018** created by the United Nations Development Programme, which includes life expectancy, literacy, education level, GDP per capita and other indicators, in 2017 Latvia was ranked 41st (Estonia – 30th, Lithuania – 35th) among 189 countries of the world having moved up 2 positions compared to the updated result of 2016.

In the **E-Government Development Index** created by the United Nations Department of Economic and Social Affairs, which analyses the progress of using e-government, in 2018 Latvia was ranked 57th (Estonia – 16th, Lithuania – 40th) among 193 countries of the world worsening its performance by 12 positions compared to the result of 2016, although the index value in this period has increased.

In 2018, in the **Competitive Industrial Performance Index 2015** created by the United Nations Industrial Development Organization, which analyses the ability of industrial

enterprises of countries to produce and exports by transforming them competitively and structurally, Latvia was placed 58th among 148 countries of the world (Estonia – 50th place, Lithuania – 40th) improving its performance by one position compared to the Competitive Industrial Performance Index 2013 of 2016.

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 among 160 countries of the world (Estonia – 36th place, Lithuania – 54th) worsening its performance by 27 positions compared to the result of 2016. The performance was affected by the drop in the volume of transit freights, which reflected in timeliness of deliveries. On average, in the period from 2012 to 2018 Latvia occupied the 55th place in this index (Estonia – 36th, Lithuania – 43rd).

CREDIT RATINGS

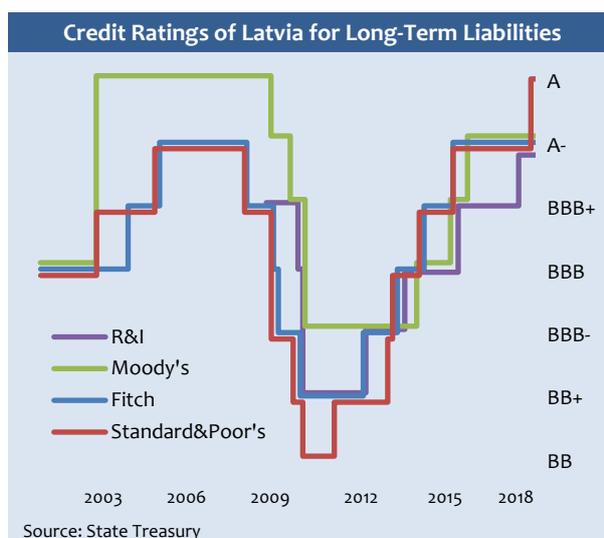
The credit rating of a country is the evaluation of its creditworthiness, which is an essential indicator for potential creditors and investors. The higher it is, the more beneficial terms of borrowing of financial resources are, which allows to reduce service costs of the state debt. The credit rating 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*, 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 early 2018, the Japanese credit rating agency *R&I* increased the credit rating of Latvia from BBB+ to A- retaining a stable future assessment. In September 2018, the credit rating agency *S&P Global* increased the credit rating of Latvia from A- to A setting a stable future assessment. *Moody's Investors Service* and *Fitch Ratings* reconfirmed credit ratings and future assessments of Latvia at the current level in 2018 (see Figure 6.41).

In September 2018, *S&P Global* noted that the increase in the credit rating level was facilitated by the successfully implemented fiscal policy of the state, which resulted in a moderate budget deficit. Thanks to the development of the construction sector and an increase in investments, Latvia has a potential to reach economic growth of 3% on average in the next 4 years. *S&P Global* also noted that liquidation of *ABL V Bank* and the measures implemented to reduce deposits of non-residents in the Latvian banking system do not threaten stability of the Latvian financial sector and have no considerable fiscal effect on the Latvian economy. The drop in deposits of non-residents in the Latvian banking sector has reduced external risks. *S&P Global* indicated that this might further increase the Latvian credit rating level, if net government debt reduced, state budget income increased faster than planned or economic growth was more rapid.

Figure 6.41



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

The credit rating of Estonia is two levels higher than the credit rating of Latvia and Lithuania. In 2018, the credit rating agency *Fitch Ratings* raised Estonia's credit rating, driven by factors such as the stable political environment and institutional governance, the low level of government debt, the balanced government budget, good economic growth rates. It also marks the execution of the government's political strategies and the strong banking sector.

Table 6.10

Credit Ratings of the Baltic Countries for Long-Term Liabilities in 2018			
	Moody's Investors Service	S&P Global	Fitch Ratings
Estonia	A1/Stable	AA-/Stable	AA-/Stable
Lithuania	A3/Stable	A/Stable	A-/Positive
Latvia	A3/Stable	A/Stable	A-/Stable

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

In turn, in 2018 the credit rating agency *Fitch Ratings* kept the credit rating of Lithuania for long-term liabilities at A-level, but improvement its future assessment from stable to positive. This was fostered by factors like balanced economic growth, where no overheating signs are observed, relatively low government debt level, incoming investments, successfully implemented tax policy, stable institutional governance and successful fiscal policy, which ensured budget surplus in 2017.

7. LABOUR MARKET

7.1. EMPLOYMENT AND UNEMPLOYMENT

Along with the increase in economic activities, visible improvements in the labour market can be observed – unemployment continues to fall and the employment rate increases. Meanwhile At the same time, challenges arise demographic trends and labour market regional disparities rises, which limit the attraction of new employees in more rapidly growing sectors and economically stronger regional centres. It should be taken into account that the low base effect in the labour market has been lost – labour force participation and employment indicators have reached their historically highest levels, therefore, the possibilities to attract labour force from the economically inactive part of the population have almost gone.

On the other hand, economic growth in recent years has been largely based on productivity increase, therefore, the job growth has overall remained moderate and in line with labour supply trends.

Since mid-2010, the **number of employed** has been gradually increasing. According to the labour force survey data the number of employed has grew by 44.1 thousand or on average of 6.3 thousand per year from 2010 to 2017. This was largely affected by the increase in economic activities in the economy – since 2010, GDP has increased by almost 1/3. In total, 920.1 thousand people aged 15 to 74 were employed in Q3 2018, which was by 1.9% more than in the corresponding period of 2017.

At the same time, it should be noted that the number of employed in 2017 was still by 15.4% (162.6 thousand) less than in 2007.

Figure 7.1

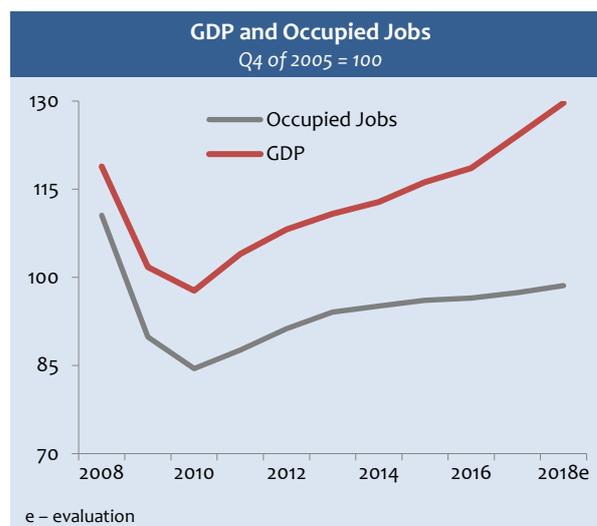
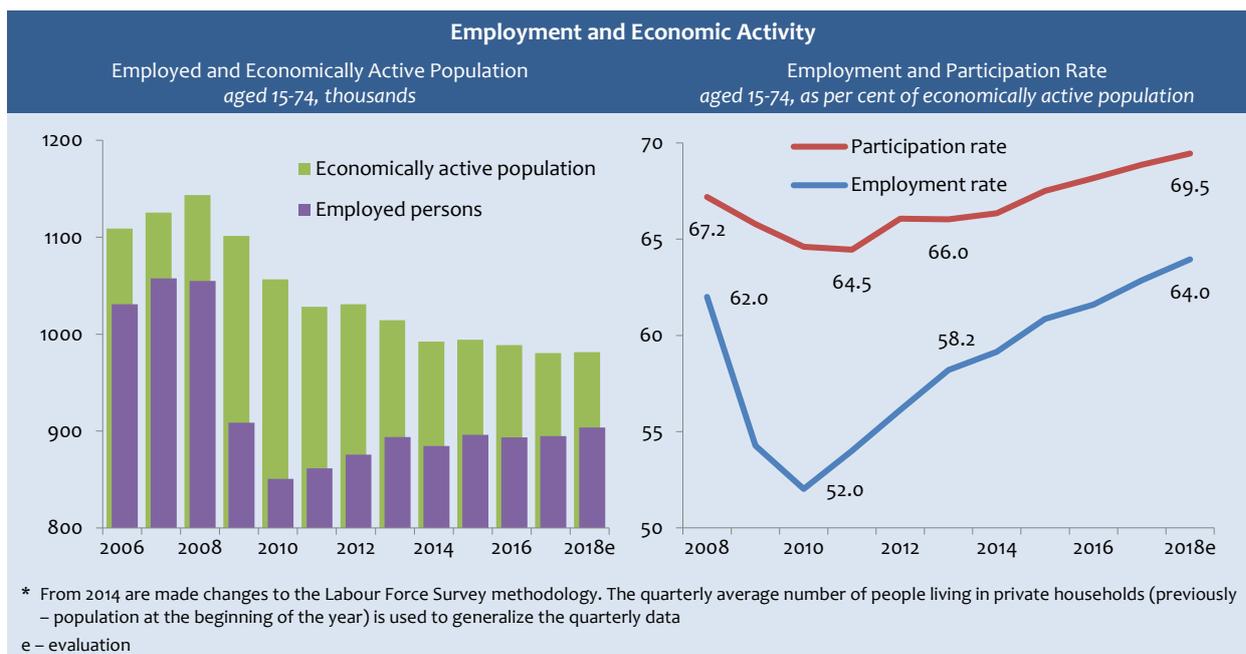


Figure 7.2



* From 2014 are made changes 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

Despite that the number of employed still lags the pre-crisis level, the employment rate has reached its historically the highest level – in Q3 2018 65.3% of the population aged 15 to 74 were employed, which is by 3.2 percentage points higher than in the corresponding period of 2007.

The increase in the employment rate is mainly attributed to the drop in the number of working age population compared to the number of the employed. Since 2007, the population aged 15 to 74 has reduced by more than 300 thousands. In Q3 2018, there were 1409.6 thousand people in private households, which was by 10.4 thousand less than a year before.

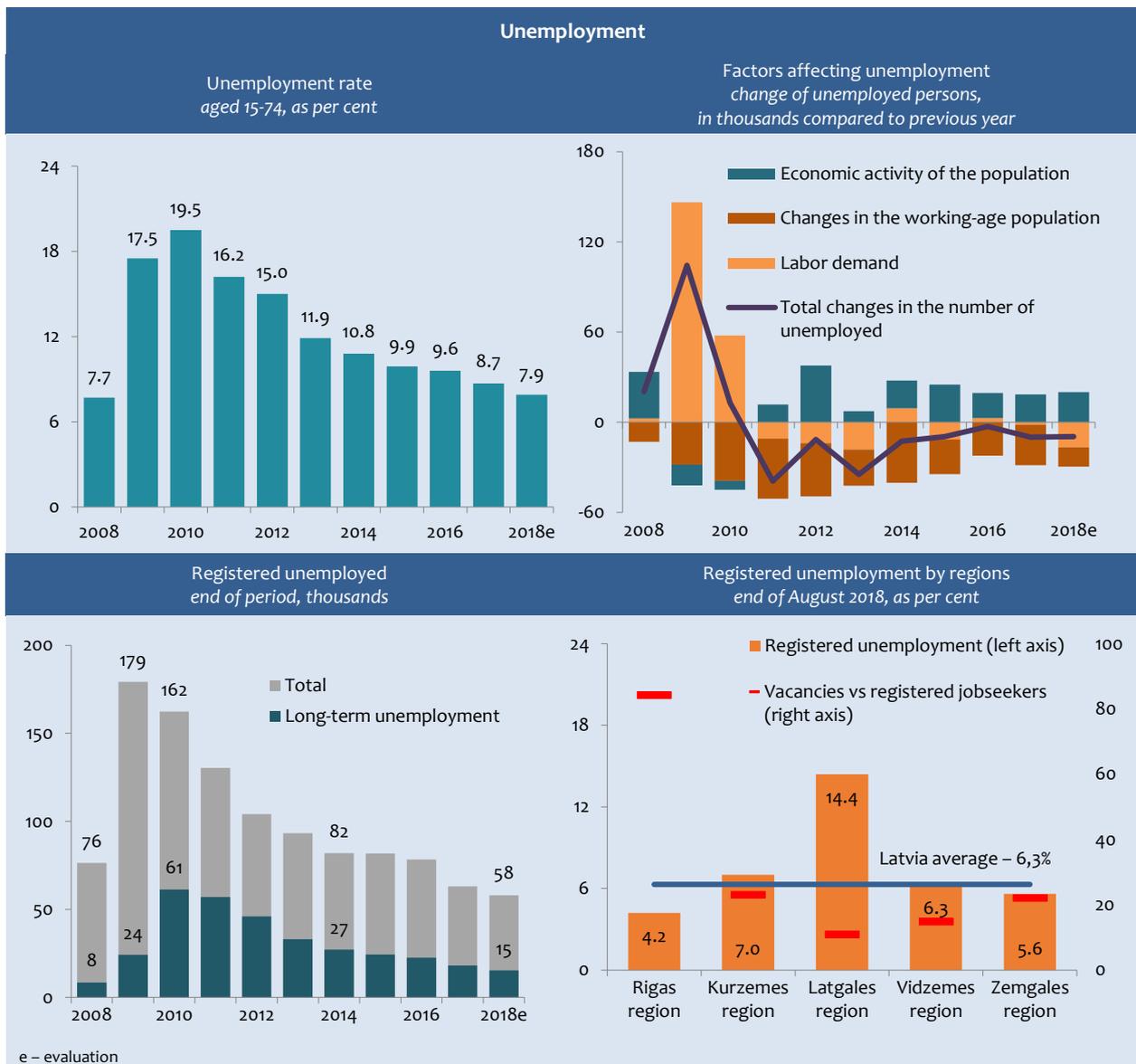
At the same time, the demographic trends also affect the decline of economically active population or potential labour supply. Since 2010, the economically active population aged 15 to 74 has reduced by about 70 thousands. The dynamics

of the economically active population were seriously affected by demographic trends – decline of working age population and changes in the age structure of the population.

Meanwhile, the negative impact of demographic trends on labour supply was reduced by the increase in economic activity of the population. Similarly, to the employment rate, the economic activity of the population has reached the highest level ever – 70.2% in Q3 2018.

Since 2010, the **unemployment rate** has decreased by almost 12 percentage points. In Q3 2018, the unemployment rate in the age group 15-74 was 7%. In Q3 2018, the number of the unemployed persons decreased to 68.8 thousand, which was by 15.3 thousand less than in the corresponding period of 2017.

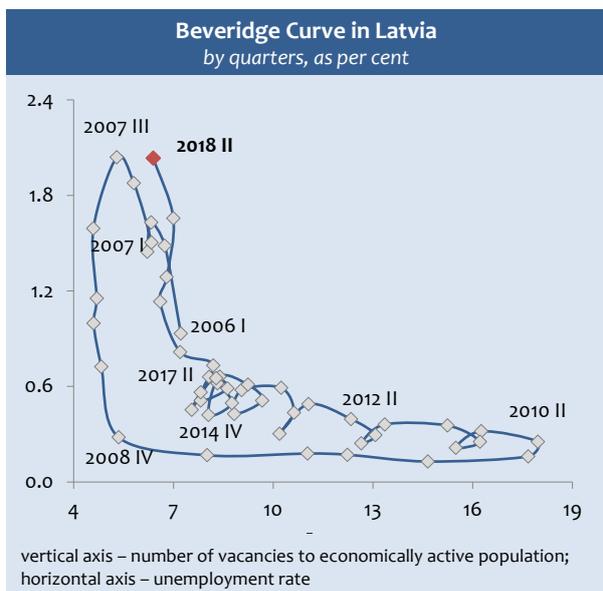
Figure 7.3



Unemployment reduced in the previous years due to labour demand – the increase in employment of the population and demographic trends – the reduction in the economically active population.

Although the demand side has been a significant labour marketing driver in the past 2 years, though its effect on unemployment decrease has been overall limited, because of relatively moderate increase in new jobs – only about 2/5 of the drop in unemployment in the last 5 years can be explained by demand factors. About 60% of the unemployment drop has been determined by the declining economically active population, which in turn has been fostered by demographic trends.

Figure 7.4



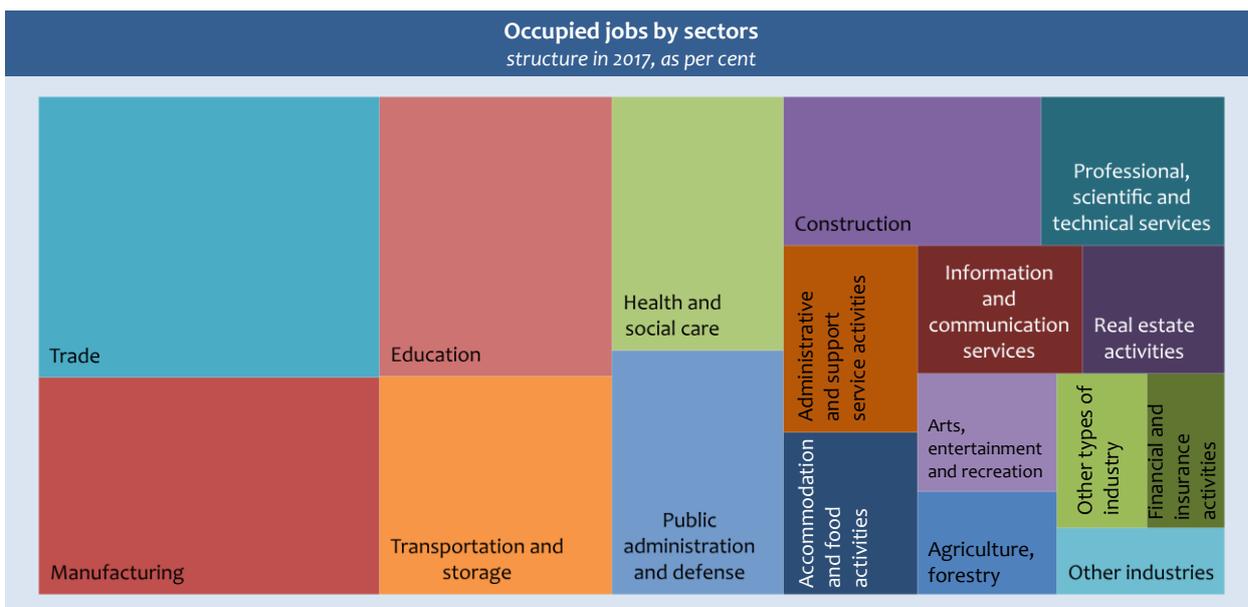
Even though the unemployment rate has reduced by more than half in the last six years, it still remains higher than in the neighbouring countries – the unemployment rate in Q3 2018 was 5.2% in Estonia, and 5.9% in Lithuania. A more rapid drop in unemployment is still hindered by regional labour market disparities – registered unemployment rate in the Latgale region is more than three times higher than in the Riga region.

Although the uneven distribution of labour resources and vacancies by regions is currently one of the most notable labour market risks, though it is not the only one. Challenges rise also the high share of long-term unemployed people – still more than 1/4 of registered unemployed persons have been out of employment longer than a year. It has to be taken into account that a high long-term unemployment rate may lead to an increase in structural unemployment, namely, the longer these people are unemployed, the greater the risk them to lose their professional skills and abilities. Moreover, there is a risk that part of the current unemployed might have problems to find a job in the future, because their skills might not meet the needs of labour market, considering the structural changes within sectoral labour demand.

It should be noted that also the shift of the Beveridge curve to the right is indicating to a structural problem in the labour market – despite the increase in vacancies, the share of job seekers in the labour market remains high.

At the same time, it must be taken into account that the match of labour demand and supply is not only affected by skills mismatches, but also the wages levels, which not always met the expectations of job seekers. Therefore, there remain vacancies, although the unemployment rate is high.

Figure 7.5



Along with the increase in economic activity since the middle of 2010 an increase in the number of jobs has been observed in almost all economic sectors, with the exception of the financial services sector, where the number of occupied jobs has reduced.

The highest increase in the number of jobs was in ICT services and construction, which together made ¼ of the total increase in the number of occupied jobs in the period from Q3 2010 to Q3 2018. At the same time, taking into account centralisation and digitalisation of financial services, the number of occupied jobs in the financial services sector has reduced by 14% or 2.7 thousand jobs. Insurance services have seen the most rapid decline in jobs in the financial services sectors, where the number of jobs has reduced by 38 per cent.

It should be noted that similar trends were observed also in 2018 – more than 2/3 of the increase of occupied jobs in Q3 2018 has been provided by construction and ICT services.

The number of occupied jobs in the construction sectors increased by 3.3 thousand or 5.3% in Q3 2018, compared to the corresponding period of 2017. In Q3 2018, the number of occupied jobs in the sector reached 65 thousand.

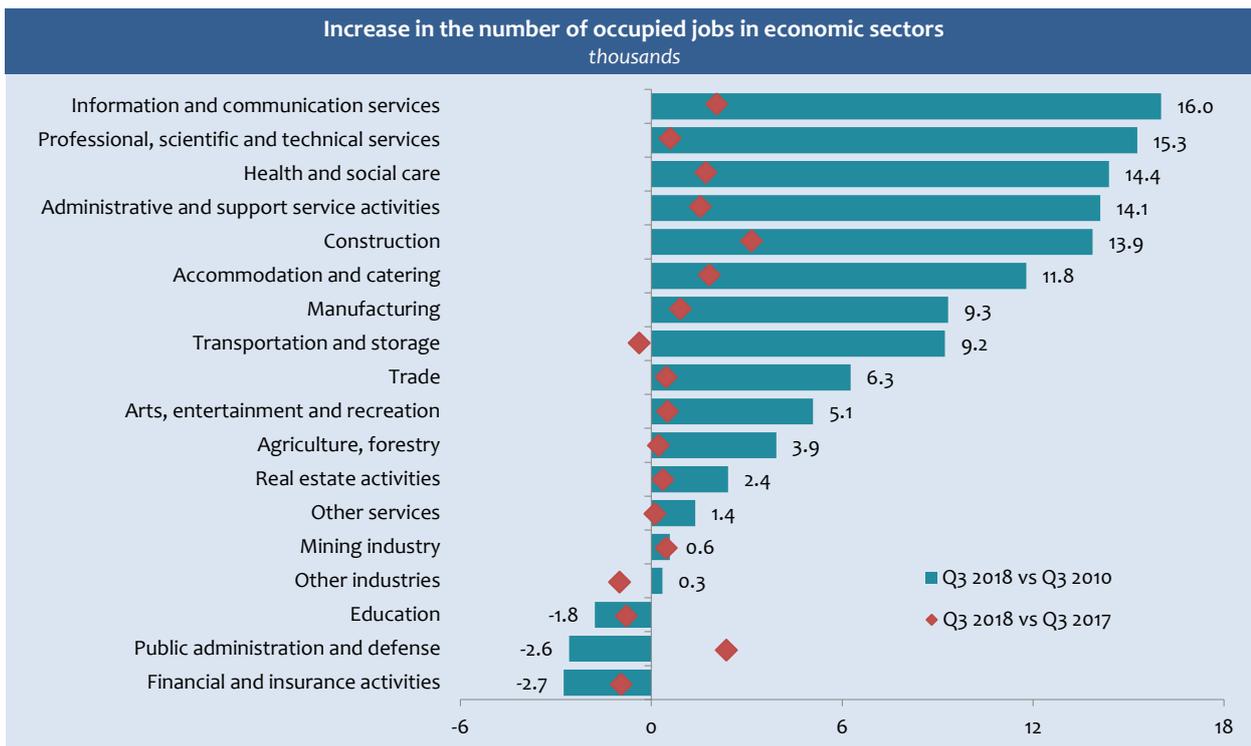
Also, a rapid increase in jobs continued in ICT services, where the number of occupied jobs increased by 2.1 thousand in Q3 2018. The number of jobs mainly increased thanks to the growing labour demand in computer programming and information technology service activities.

At the same time, the largest drop in jobs was in public administration and other industries. The number of jobs in the private sector still continues to grow rapidly. After a 30% decline during the crisis, since 2010 the number of jobs in the private sector has increased by almost one fourth.

Meanwhile, there has been a relatively slow increase in the number of jobs in the public sector, where the number of occupied jobs has grown only by slightly more than 2%. A more rapid increase in the number of occupied jobs in the public sector was observed in 2014, when the number of occupied jobs increased by 1.5%, compared to 2013.

A relatively moderate labour demand increases in past years can be observed in manufacturing. Although growth of the industry has been closing to 6% per year since mid-2016, the number of occupied jobs grew only by 0.7% per year on average. Thereby the growth of the sector has been largely based on productivity increase.

Figure 7.6



7.2. WAGES

Along with the activity increase in labour market, also the wage growth has resumed since the end of 2010. In Q3 2018, the average gross wage reached 1006 euro, which

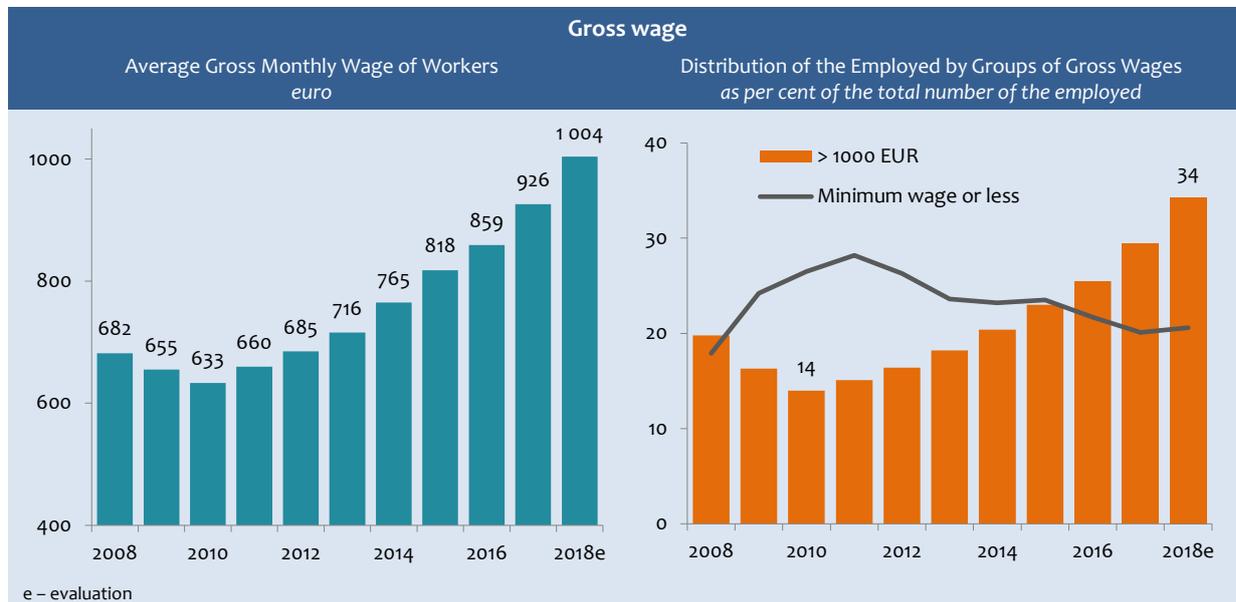
was by 8% more than in the corresponding period of 2017. It should be noted that the increase in wages has been above 5% in the last four years, despite the fact that the

average unemployment rate in the period has been close to 10 per cent.

Wage growth has been supported by stable labour productivity growth in previous years, which has also been

partly passed on to wages. Since 2010, labour productivity has been growing by 2.8% per year on average. Meanwhile, GDP at current prices per 1 employed has been growing by about 5% yearly.

Figure 7.7



It should be noted that a positive trend is observed also in wage structure. Despite the fact that the minimum wage has grown rapidly in the previous years – by almost 70% (from approximately 256 euro in 2010 to 430 euro in 2018), nevertheless the share of the employed receiving the minimal wage or less has reduced by 6 percentage points. Furthermore, the share of the employed receiving more than 1000 euro has increased by 20 percentage points in this period. These were about 1/3 of all the employed in Q3 2018.

Since 2010, wages have increased in both the private and public sector. At the same time, an increase in the private sector has been tangibly more rapid in recent years. This was largely related to different labour demand dynamics among sectors. The number of jobs occupied in the private sectors has grown by almost 17%, but in the public sector – only by 1.2 per cent since 2011.

In 2018, budget amounting to more than 90 million euro was diverted to the increase of wages of medical personal. Thus, the average gross wage in health and social work activities increased by more than 15 per cent in Q3 2018, compared to the corresponding period of 2017.

In Q3 2018, wages grew in all sectors of the economy, however wage dynamics were uneven. The most rapid increase in wages was observed in health and social work activities followed by industry, accommodation and food

activities. The slowest increase was in the financial sector – wages in the sector increased by 0.4% in Q3 2018. Financial and ICT services sectors still had the highest wages, while accommodation and food service activities had the lowest wages.

Figure 7.8

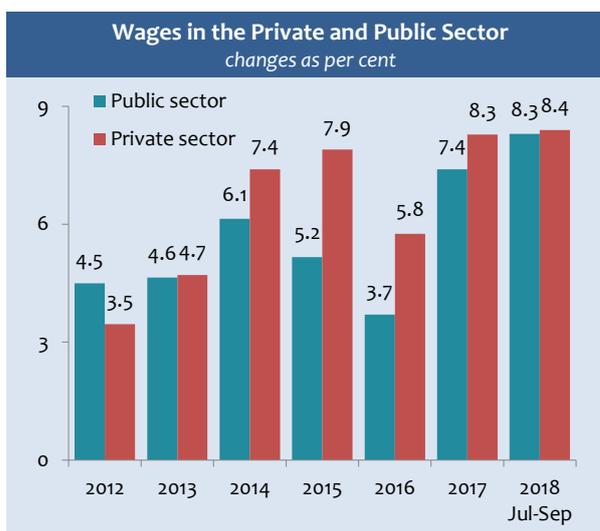
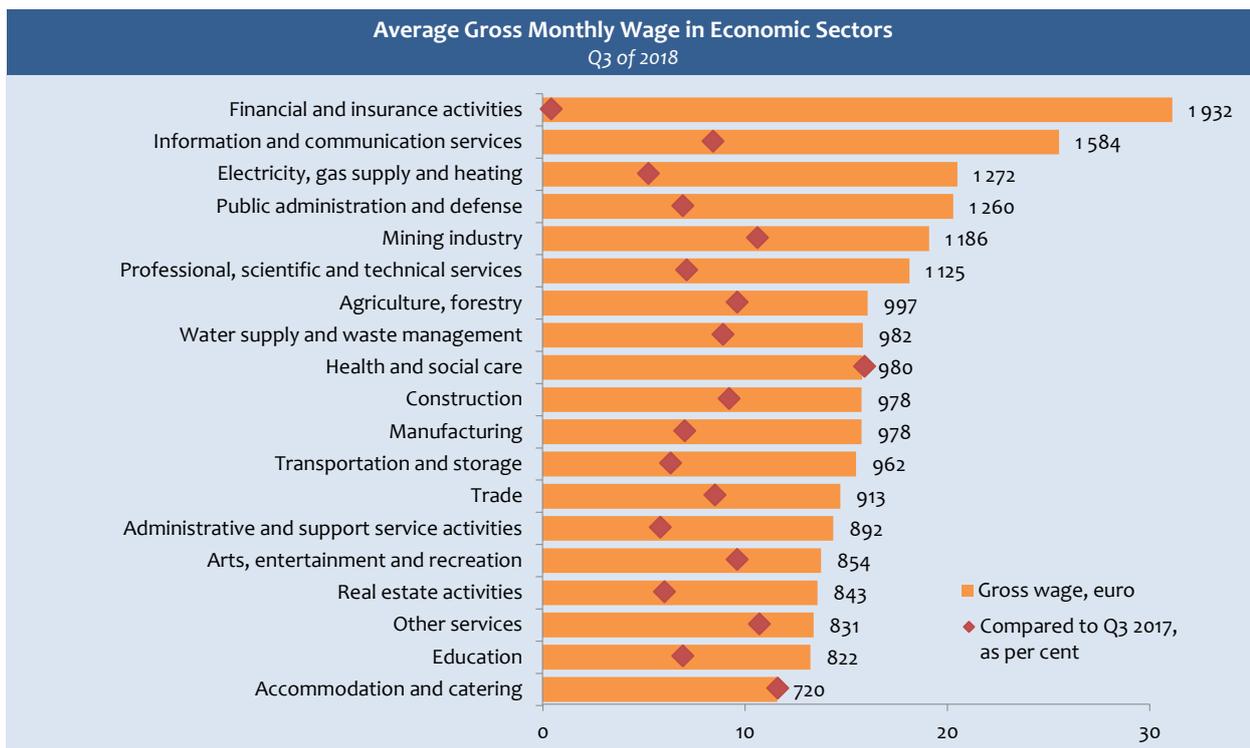


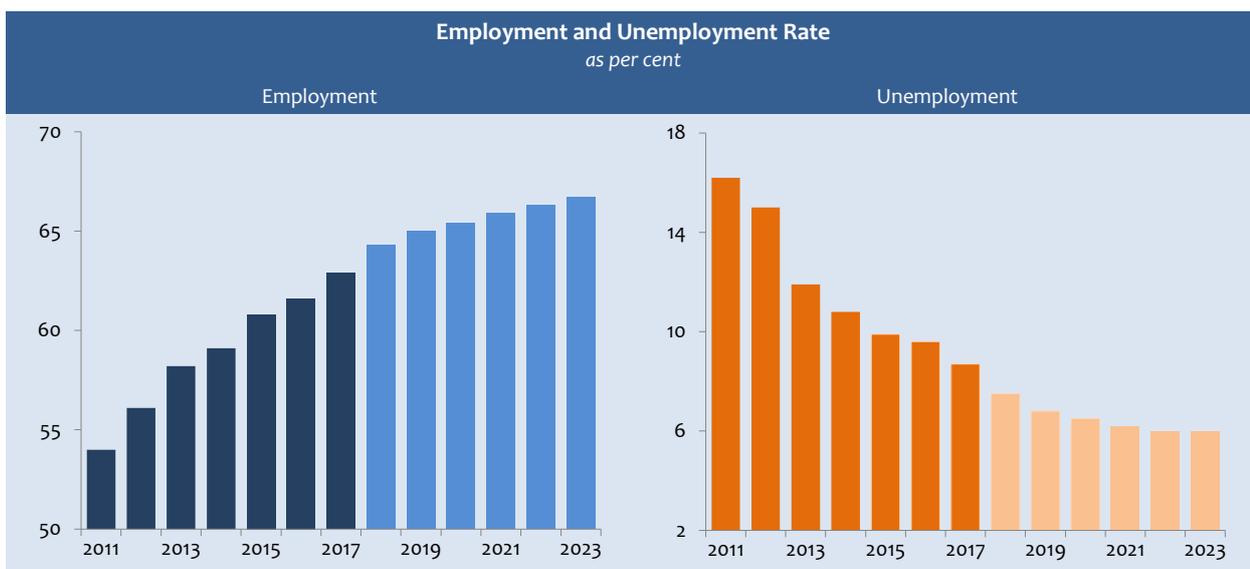
Figure 7.9



7.3. LABOUR MARKET FORECASTS

The labour market forecasts until 2023 are prepared in accordance with the medium-term economic growth forecasts (see Chapter 5).

Figure 7.10



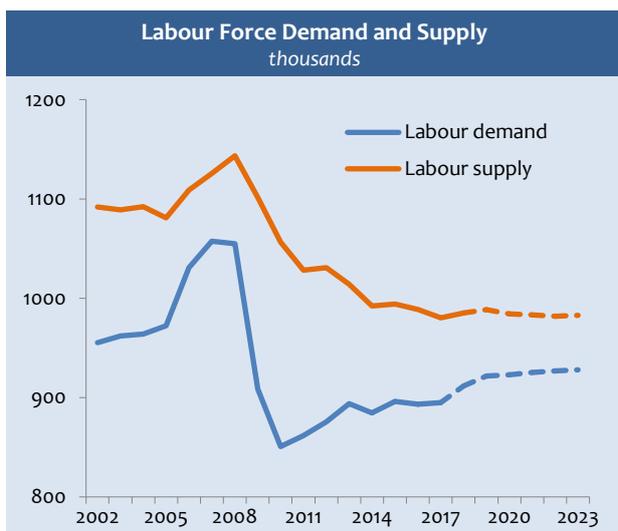
The increase in economic activity is expected to improve the situation in the labour market in the next years – employment will increase and unemployment will decrease, which, in turn, will stimulate further increase of wages. Meanwhile, along with unemployment decrease, the labour shortage problem will become more visible, which will be aggravated by the unfavourable demographic trends. Employers must consider that it is becoming more difficult and more expensive to retain current employees and recruit new employees.

In 2019, the number of the employed will grow slower than in 2018, however, the increase will still remain relatively rapid exceeding the average indicator of the last five years. Overall, the number of the employed in 2019 might grow by 1.1% or 10 thousand compared to 2018. In total, the average number of employed in 2019 could reach 922 thousand, while the employment rate could increase to 66%. At the same time, the unemployment rate will fall below the 7% level and will get close to 6.8% in 2019. In turn the number of job seekers will drop by almost 7 thousand, compared to 2018 – to an average of 67 thousand in 2019.

Improvements in the labour market are expected also after 2019, when employment growth becomes slower as the growth will be mainly determined by the increase in productivity. Similarly, the negative demographic trends/aging workforce, regional disproportions of the labour market, as well as mismatch between labour demand and supply will hinder a more rapid employment growth.

It is expected that the number of employed will increase by approximately 16 thousand in 2023, compared to 2018. Thus, the number of employed could reach 928 thousand in 2023, while the share of employed in the population aged 15-74 years could increase to almost 67 percent.

Figure 7.11

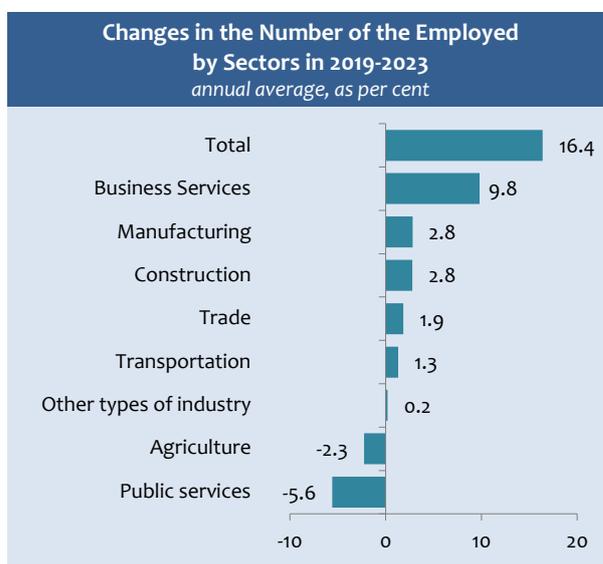


Unemployment will also continue to fall in the medium term, and the problem of labour shortage will become more pronounced. In total, unemployment rate could get close to

6% by 2023. In 2019, demand factors – an increase in new jobs – will still be a serious incentive for the drop in unemployment. By contrast, after 2019 unemployment trends will be more affected by the decline in labour supply. Despite an active increase in economic activity rate, the economically active population might shrink by 2.4 thousand in 2019-2023. This will be largely affected by the drop in working age population, as well as ageing of labour force and leaving of the labour market. According to the forecasts of the Ministry of Economics, the number of people aged 15-74 might decrease by almost 53 thousand by 2023.

On sectoral level the most significant employment increase in 2019 will remain in construction, which will be largely affected by the momentum started in 2018. Though the new job increase will be overall slower than in 2018, as the construction volumes will most likely stabilize.

Figure 7.12



An labour demand increase is expected also in other domestic demand oriented sectors, which will be partially fostered by an increase in household income. In 2019, the total number of people employed in trade might increase by almost 3 thousand or 0.7%, while in business services – by 2.4 thousand or 1.2%. ICT services sectors will still have the highest increase in jobs in the business services sector.

It should be noted that the role of domestic-demand-oriented sectors in the labour market will continue to increase in the coming years. Growth of the tradable sectors will be mainly based on the increase in productivity, which is crucial for ensuring competitiveness, therefore the growth of employment in these sectors will be slower.

Until 2023, the most significant increase in the number of employed will be observed in the commercial services sector, in the manufacturing industry and construction.

At the same time, a drop in the number of employed is expected in the primary sector – mainly in the agriculture and forestry, as well as the public services. Decrease in labour demand in the agricultural sector is mainly

attributable to efficiency enhancement of the industry – formation of farmers’ cooperatives and large farms, introduction of systematic production organisation,

introduction of more complex technological solutions in the production process.

7.4. EMPLOYMENT POLICY

The creation of more jobs of better quality is one of the main goals of the EU employment policy, also defined in the *Europe 2020 strategy* (see Chapter 8.1). Governments of countries are primarily responsible for employment and social policy. The EU funding supports and complements their attempts. On 21 November 2018, the European Commission published a *Draft Joint Employment Report* (see Box 7.2), which analyses the current situation in the EU employment area.

The quantitative aim set by Latvia within the context of implementing the *EU 2020 strategy* is to achieve employment rate of 73% in the age group 20-64 by 2020. The target for 2020 was reached back in 2016. In 2017, the employment rate in age group 20-64 reached 74.8 per cent.

Economic growth is expected to further boost the employment increase, however, the growth rate might slow down as the growth will be mainly determined by the increase in productivity. Furthermore, the increase in employment rate will be partially affected by the decline in the number of working-age population.

LABOUR MARKET CHALLENGES AND POLICY DIRECTIONS

Taking into account negative demographic trends, the main Latvian labour market and also economic challenges are related to ageing of the labour force and shortage of labour force (employees with relevant qualifications) in all economic sectors. Shortage of working hands can become a factor hindering the growth in the future. The labour market forecasts show that labour force availability matters become increasingly more topical (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, tangible 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 in 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 have the biggest number of job seekers. Registered unemployment rate in the Latgale Region is still almost four times higher than in the Riga Region, which has more than 4/5 of all vacancies. In the coming years, the regional disparities can significantly 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 and Regional Governments.

In order to foster changes in the labour market providing specialists required for economics and, thus, contributing to growing economy, in 2016, an Employment Board was established consisting of three ministers (ministers of economy, education and science, and welfare). The goal of this Board is to coordinate inter-departmental cooperation in planning, implementation, and monitoring of labour market reform, thereby reducing the disproportion in the Latvian labour market. The Employment Board has paid special attention to the matters of investment in human capital and the development of skills of labour force (in particular, low qualification labour force). The Board has agreed to include in the priority re-arrangements:

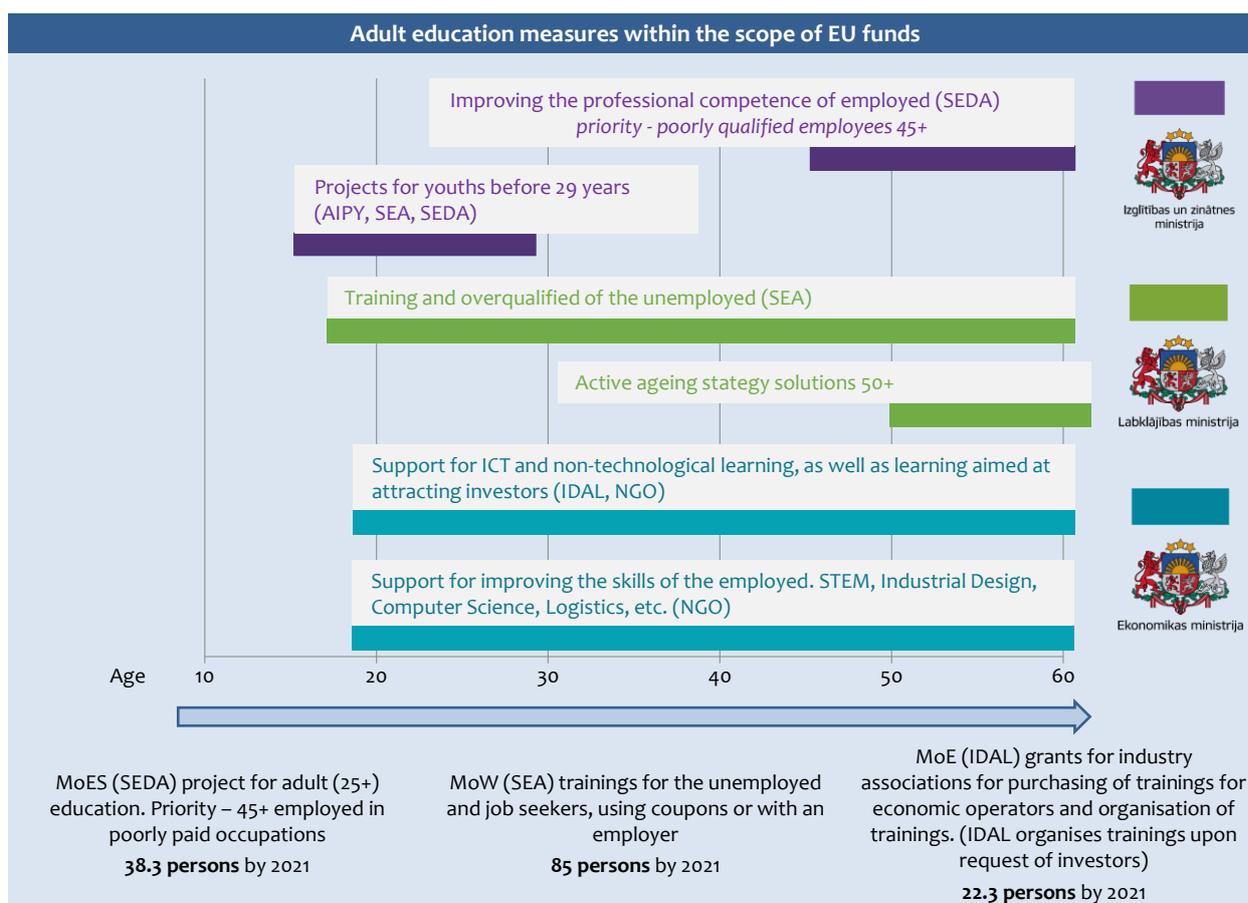
- creation of a sustainable and comprehensive education system;
- modern and qualitative general education;
- increase of the number of students in STEM directions;
- more active involvement of employers in the creation of education supply;
- improvement of skills and employment of youths.

ADULT EDUCATION

Taking into account that changes in formal education give a tangible effect in the long-term, adult (labour force) education also plays a big role in the reduction of labour market mismatches, when available labour force is shrinking. Although the involvement of the population in adult education is gradually increasing, it is still twice lower than the target set in Latvian policy planning documents – to reach that 15% of the population aged 25 to 64 are involved in adult education measures by 2020.

Since 2017, the employed have the possibility to increase their professional competence and competitiveness by applying to studies within the EU funds adult education programmes *Improving the professional competence of employees* implemented by the State Education Development Agency. Almost 9 thousand persons started studies in the first two application rounds. The 3rd application round closed in September 2018, where more than 11 thousand people applied for training. In this round, most of applications were received for training in the ICT sector, transportation and logistics sectors and food and beverage service activities. It is planned to announce the next application round in the first half of 2019.

Figure 7.13



The Ministry of Economics has developed a state support programme to train employees of companies and improve their skills for introduction of technological and non-technological innovations (trainings ordered for employees by employers):

- *Support for employed learning (technology learning).* Support is provided for training of persons employed with a merchant. The aim of this measure is to provide the merchants 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 ERDF funding is 18 million euro. In spring 2016, 10 projects of the first selection round implemented by the largest sectoral associations were approved. These associations represent manufacturing subsectors, the ICT sector or accommodation and food service activities sector. The period for implementation of the first selection round is until 31 December 2022. By 1 November 2018, 9123 non-unique persons employed with 554 merchants have been trained. It is planned to start the second selection round in 2019;
- *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 merchants, by raising the employees' qualifications and skills in ICT areas, to provide merchants 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 in the country. The ERDF funding is 6.9 million euro. 3 projects implemented by the LCCI, LICTA, and IDAL, the were approved in 2016. The period for implementation of the programme is until 31 December 2020. By 1 November 2018, 2490 non-unique persons employed with 614 merchants have been trained.

Furthermore, 52.6 thousand people in total were involved in the activities for improvement of skills implemented by the State Employment Agency (SEA) for the unemployed and job seekers in 2017.

The provision of a qualitative supply of education to adults plays a crucial role for vocational education institutions and also higher education institutions and employers.

INTERNAL LABOUR MOBILITY

In order to promote the availability of labour force in the territories with higher economic activity, an offer to support construction of rental housing is being drafted. The purpose is to ensure the availability of high-quality housing for the population with average income. The programme would also provide additional support for the return of the people, who have emigrated from Latvia, taking into account that the matter of a place of residence is one of the most important, when deciding on returning.

Apart from that since March 2018 the attraction of qualified labour force to regions has also been facilitated by the state support available to young highly-qualified specialists 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 employment measures.

SMART IMMIGRATION

The shortage of highly qualified specialists, which is currently experienced by a number of companies, particularly in manufacturing and ICT sectors, is hindering Latvia's economic growth, growth in business productivity and attraction of investments, and 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, therefore, the ministry in cooperation with other institutions is implementing activities to promote smart migration (see Box 7.1).

The aim of the smart migration policy is to promote the attraction of highly qualified professionals from third countries. It should be emphasised that these measures 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.

Box 7.1

Measures for Attraction of Highly Qualified Labour Force from Foreign Countries

A number of activities were implemented in 2017 and 2018 with the aim to satisfy the demand of the Latvian economy for qualified professionals from third countries.

- The so-called *List of Occupations* was drafted and approved by the Cabinet of Ministers, which includes 237 specialities or occupations, in which the process of registration of work permits for third country nationals is accelerated:
 - the lower minimum remuneration criterion is applied to the foreigner who wishes to receive an EU Blue Card (special type of work permit introduced at the EU level). Namely, the minimum remuneration shall not be lower than the average gross wage in Latvia in the previous year multiplied by factor 1.2 (factor 1.5 is used for other occupations);
 - the period of notification about a vacancy, which the employer should submit to the State Employment Agency before inviting a foreigner, reduced from a month to 10 working days.

Box 7.1 continued

- Incentives for receiving an EU Blue Card have been set. Rules for Residence Permits have been amended providing that in the future an EU Blue Card may be issued to third country nationals also if the person does not have higher education (document certifying higher education), but has at least five years of professional experience in the specific speciality or sector, where he or she will be employed in Latvia. This procedure applies only to those foreigners, who will be employed in the occupations included in the first or second major group of the Classification of Occupations (“Managers”, “Professionals”). However, the procedure does not apply to regulated occupations such as medical doctors, pilots, engineers, etc.
- Attraction of foreign (third country) students studying in Latvia to the Latvian labour market. In accordance with the data of the Ministry of Education and Science, in 2017 more than 7,5 thousand foreign students (without short-term mobility students) studied in Latvian higher education institutions, and this number tends to grow. It provides the possibility to attract qualified labour force to the Latvian labour market, which is already located and has partially integrated in Latvia. Amendments to the Immigration Law entered into force in 2018, which inter alia provide that:
 - students (in Bachelor programmes) are allowed to work 40 h per week during holidays (no more than 20 h per week during studies);
 - students of Master/doctoral programme are allowed to work with any employer;
 - the period of stay, during which holders of Bachelor degree can search for a job after completion of studies was extended to 4 months, but for holders of Master/doctoral degrees – to 9 months.

At the same time, it is provided that the temporary residence permit of a student, who is a third country national, is annulled, if the student does not show sufficient progress in studies for 2 years in a row.

- A temporary residence permit for founders of start-ups – in 2017, the Saeima approved proposals of the Ministry of Economics for amendments to the Immigration Law, which, inter alia, provided for a new temporary residence permit reception procedure for founders of start-ups (a temporary residence permit is issued for 3 years).
- In order to ensure the development of the ICT sector and satisfy the demand of other sectors for ICT specialists, the work on studying potential solutions for the creation of an ICT university or study programme in Latvia has started.

REMIGRATION

One of solutions for the reduction of shortage in labour force 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.

From 2019, the *Diaspora Law* will enter into force, which, inter alia, sets specific measures for promotion and support of remigration.

A targeted remigration support measure is a network of five regional remigration coordinators created by MoEPRD in 2018 in cooperation with planning regions, providing one regional coordinator in each planning region. Potential remigrants have the possibility to receive free of charge a 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. Furthermore, in 2018 remigrants had the opportunity to participate in the competition of projects for starting or developing a business in Latvia. The amount of funding available in each planning region in 2018 was 36 thousand euro, while the maximum amount per project was 9,000 euro. In total, 9 projects received a business support grant in 2018.

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, Tele2 movement *Latvija strādā*, the work and information portal *YourMove.lv* has been created, 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:

- measures to increase competitiveness;
- training measures – vocational training, retraining and improvement of professional skills, training with an employer, acquisition of non-formal education;
- paid temporary public service jobs;
- measures for certain groups of persons (subsidised jobs);
- measures for starting a business or self-employment;
- measures to foster youth employment, including within the Youth Guarantee;
- activation measures for long-term unemployed;
- support for regional mobility.

During the economic crisis, the demand for active employment measures was growing also due to a

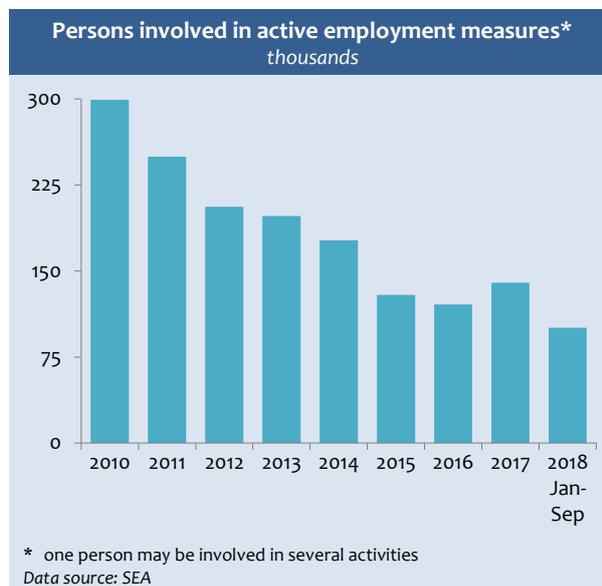
considerable increase in unemployment. Almost 300 thousand people were involved in the active employment measures in 2010. When the market situation has improved, the involvement in active employment measures has reduced. In 2017, 139.7 thousand people were involved in active employment measures (one person may be involved in several activities).

At present, special attention is paid to those population groups, for whom it is most difficult to return to the labour market and who need special support to promote their economic activity and inclusion in the labour market. These are long-term unemployed, youths not in education or employment, unemployed of preretirement age, people with disability.

Improvements to active labour market policy tools and the support provided to the unemployed are provided for in the *Inclusive Employment Guidelines 2015-2020*. The measures included in the guidelines focus on the creation of an inclusive labour market, making full use of the human potential of Latvia, also by reducing the social consequences of unemployment, supporting the return of unemployed people to the labour market and keeping the people at risk of social exclusion in the labour market for as long as possible, as well as improving the quality of jobs.

Labour market support measures to retain working capacity of elderly working people (aged above 50) are also developed.

Figure 7.14



Box 7.2

EU Employment Policy

On 21 November 2018, the EC published a **Draft Joint Employment Report** together with other European Semester documents for 2019 (see Chapter 8.1). The Report provides an annual overview of key labour market and social development trends in Europe as well as policies implemented by Member States in these areas in line with the Guidelines for the Employment Policies. In addition, it includes an evaluation of Member States' performance and progress in relation to the Social Scoreboard set up in the context of the European Pillar of Social Rights. The European Pillar of Social Rights was established as an inter-institutional Proclamation by the European Parliament, the Council and the European Commission on 17 November 2017. It identifies principles and rights in 3 areas: 1) equal opportunities and access to the labour market, 2) fair working conditions, and 3) social protection and inclusion.

The EC admits in the Joint Employment Report 2019 that Europe is making progress regarding the Social Scoreboard. New jobs are created resulting in a higher employment level in the EU. Unemployment has returned to its pre-crisis level, but still remains relatively high in individual Member States (Greece, Spain, Italy, Croatia and Cyprus).

Household incomes continue rising in almost all EU Member States. The share of people at-risk-of-poverty the share of people decreases markedly.

However, despite the above-mentioned achievements, part of society still face difficulties in integration into the labour market and improving their social condition. Employment increases in the group of women, older people and highly qualified people. By contrast, the employment rate of people with low qualifications and youths is still lower than the pre-crisis level. Migrants and disabled also face problems with inclusion in the labour market. It is positive that the share of young people not in employment, education or training has returned to the pre-crisis level.

Ensuring access to a quality and inclusive education and training system enables younger generations to integrate into the labour market. Rapid development of technologies and related transformations in labour markets crucially require reskilling and upskilling of the working age population.

Unemployment benefits of adequate amount, reasonable duration, accessible to all workers and accompanied by effective activation measures are key to support jobseekers. Also, effective active labour market policies and Public Employment Services are crucial to ensure well-functioning and inclusive labour markets.

EU Member States continue taking measures to modernise social protection systems, strengthening coverage and adequacy of benefits and services.

Demographic change and rising life expectancy present the pension, healthcare and long-term care systems with a clear need to adapt. Therefore, EU Member States need to focus their attention on improving access to quality healthcare and long-term care, together with increasing their effectiveness.

A well-functioning social dialogue is a key element. It helps strengthening social cohesion and reducing conflicts in the society, to the mutual benefit of workers, employers and governments. Therefore, the involvement of social partners in the preparation and implementation of reforms is important, because it helps to improve community participation and responsibility for reforms being implemented and eventually lead to better socio-economic outcomes.

PART II. ECONOMIC POLICY PRIORITIES

8. LATVIA'S INTEGRATION IN THE EU ECONOMIC AND STRUCTURAL POLICIES

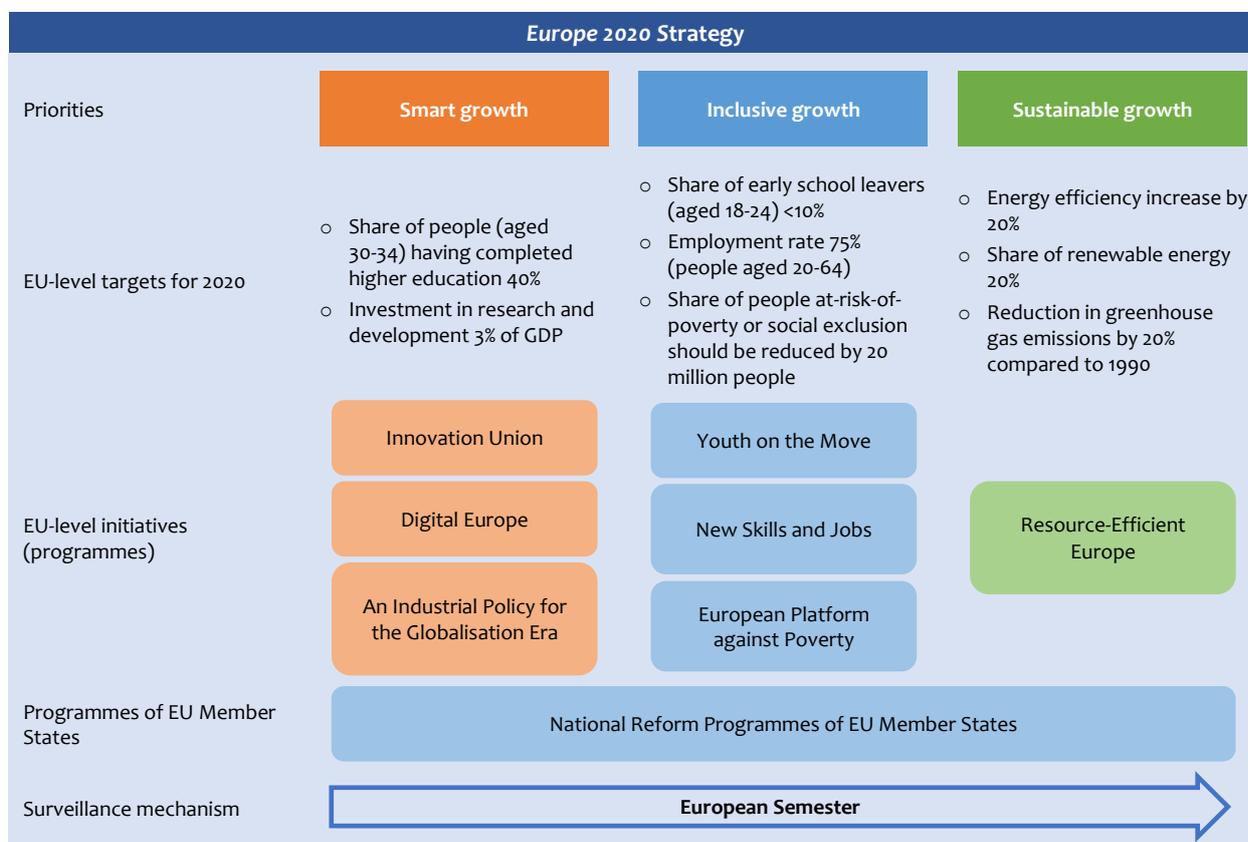
8.1. EUROPEAN SEMESTER

On 3 March 2010 the European Commission (EC) published a communication *Europe 2020: strategy for smart, sustainable and inclusive growth* (hereinafter – *Europe 2020 strategy*). On 17 June 2010 the European Council officially approved the *Europe 2020 strategy* and its key elements (see Figure 8.1): EU-level quantitative targets for 2020, Integrated Guidelines (are developed according to the Articles 121 and 148 of the *Treaty on the Functioning of the European Union*, which contains key economic and employment policies, as well as serves as the basis for the development of the *National Reform Programmes* of EU Member States). On the basis of the adopted *Europe 2020 strategy*, EU Member States are obliged to prepare every

spring and to submit until the mid-April to the EC their *National Reform Programmes* along with the *Stability or Convergence Programmes* (prepared and implemented for the fulfilment of requirements of the *Stability and Growth Pact*).

Based on the multilateral surveillance of both programmes, which is performed at the EU level, the EC may give a policy warning, if the economic policy of any EU Member State fails to comply with the EU *Integrated Guidelines* and objectives set at the EU level. The national reform programmes are linked also to the EU funds, because a large part of the measures is co-financed from the EU funds.

Figure 8.1



In order to ensure the implementation of the *Europe 2020 strategy* and abovementioned national programmes of EU Member States, as well as provide annual recommendations

to the EU Member States, an annual EU economic policy implementation supervision cycle – the European Semester – was introduced on 1 January 2011 (see Figure 8.2).

Figure 8.2

European Semester Process							
European Semester: Partnership between the EU and Member States							
	November-February	March	April	May	June	July	September-October
<i>European Commission</i>	Annual Growth Survey and Alert Mechanism Report Publication of recommendations for the euro area	EC Reports on EU Member States		EC proposal for EU Council's recommendations to EU Member States			EU-level review
<i>European Council / EU Council</i>	Discussions				Discussion of recommendations	Approval of recommendations	
<i>European Parliament</i>	Discussions						
<i>Member States</i>			Approval and submission of National Reform Programmes and Stability or Convergence programmes to the EC				National level decisions

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.

On 21 November 2018, the EC published the *Annual Growth Survey 2019* along with other documents, namely, the *Alert Mechanism Report*, the *Draft Joint Employment Report* – see Chapter 7.4 and the *EC proposals for EU Council recommendations to the euro area*. In the abovementioned documents the EC evaluates the economic situation in the EU, progress towards the targets of the *Europe 2020 strategy* and offers economic policy priorities for the next year. These documents serve as a basis for further

discussions between the EU Member States and the EC at different meetings of the EU Council.

Similarly to the reports of previous years, also the *Annual Growth Survey 2019* (see Box 8.1) reviews the economic and social situation in Europe and sets political priorities for the EU as a whole. It is concluded that economic growth in the EU continues, ensuring the creation of jobs and reduction of the poverty level. This positive growth is fostered by the structural reforms implemented by the EU Member States, investments and responsible fiscal policy, as well as such European-level initiatives as the implementation of the *Investment Plan for Europe*.

Box 8.1

Annual Growth Survey 2019

The EC recognises in the Annual Growth Survey 2019 that not all the EU citizens feel an improvement of the situation despite a strong economic growth. Lower economic growth is forecasted in the nearest years, because global uncertainty and risks are growing. Some EU Member States still face problems with financial sustainability and debt levels. In some EU Member States, the unemployment rate is still high, and the level of household income is lower than in the pre-crisis period. Some countries also face the lack of skills necessary for the labour market. The EC shows that productivity and digitalisation growth rates across the EU are still slow. The ageing process of the population, the impact of digitalisation on labour markets, climate change and unsustainable use of natural resources are among long-term challenges of the EU. Additional risk factors for slower growth include a faster tightening of monetary policy in the US, which may have a negative effect on financial stability in emerging markets, as well as geopolitical tensions affecting global trade and persisting uncertainties associated with the UK's exit from the EU (Brexit).

Against this background, the EC believes that the EU and EU Member States should focus on three main priorities in the European Semester 2019:

- 1) delivering high-quality investment;
- 2) focusing reforms efforts on productivity growth, inclusiveness and institutional quality;
- 3) ensuring macroeconomic stability and sound public finances.

In the *Alert Mechanism Report 2019* the EC analyses the situation in the EU Member States based on set of indicators and thresholds (see Chapter 6.8). If the situation in any EU Member State exceeds the threshold set for any indicator, the EC should carry out an in-depth analysis and publish an *In-Depth Review*.

In the *Alert Mechanism Report 2019*, the EC identified 13 EU Member States (Bulgaria, Croatia, Cyprus, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, Greece and Romania), where macroeconomic imbalances are observed. By February 2019, the EC is planning to prepare in-depth reviews about these countries in order to understand, which of them have and which do not have macroeconomic imbalances (see Chapter 6.8, which analyses Latvia according to the Alert Mechanism Scoreboard indicators).

The *EC proposal for EU Council's recommendations for the euro area* contains five recommendations. According to the EC, the euro area countries should take action, individually and collectively within the Eurogroup, in the period 2019-2020 to deepen the EU Single Market, to improve the implementation of the fiscal policy for the purposes of

reducing debt levels and promoting investment, to strengthen the labour market (incl. reduce the tax burden for labour, strengthen the efficiency of the education system and active labour market measures), to continue the process of creation of the Banking Union (for example, to achieve the operation of the Single Resolution Fund and implement other EU-level initiatives), to achieve progress in completing the deepening of the Economic and Monetary Union, as well as to strengthen the international role of the euro currency. At present, this EC proposal is being discussed in different EU Council formations, and it is planned to approve the recommendations for the euro area at the European Council's meeting in March 2019.

Annual *Country Reports* which are published at the end of February are another important element of the European Semester (see Box 8.2). In these reports, the EC reflects its evaluation of the situation in each EU Member State, progress of implemented structural reforms and EU Council recommendations. These reports are being used by the EU Member States in the development of their national programmes.

Box 8.2

EC's 2018 Country Report Latvia

The 2018 Country Report Latvia evaluates the development and prospects of the Latvian economy taking into account the Annual Growth Survey which was published by the EC on 22 November 2017 and started the European Semester of 2018. The 2018 Country Report Latvia also reviews the policy response since the mid-2017, notably as regards the progress achieved by the country in the implementation of the country-specific recommendations adopted by the EU Council in 2017.

Latvia has made some progress in addressing the EU Council's recommendations of 2017. Some progress was achieved on reducing the tax wedge on low-income earners and on improving tax compliance. Some progress was also made as a result of setting efficiency targets, by increasing the provision of public healthcare services and by updating vocational education curriculum. Progress has been limited on preventing conflict of interest in public administration and on improving the adequacy of the social safety net.

The 2018 Country Report Latvia also identified problems and challenges:

- tax cuts are expected to provide employment and investment incentives, but restrict resources for public services;
- the education system faces a challenge to consolidate resources while improving quality and efficiency;
- facilitating labour market inclusion of the long-term unemployed remains difficult, notably in rural areas;
- adequacy of social benefits remains low and results in a high share of people at risk of poverty and still high-income inequalities;
- the increase in healthcare financing is expected to satisfy some of the critical needs but newly adopted access restrictions risk worsening health outcomes;
- rapidly rising labour costs raise some concerns about Latvia's price competitiveness;
- Latvia's productivity growth has been solid, but its innovation performance is average;
- Latvia has taken steps to reduce the burden of energy subsidies on electricity consumers, but challenges remain;
- Latvia's business environment is generally favourable, although the judicial system and public procurement continue to pose challenges;
- the upcoming public administration reform aims at increasing the quality and efficiency of the central administration, however, local authorities and state-owned enterprises are outside the scope of the reform, limiting its overall effectiveness;
- corruption remains a challenge for the business environment but strengthening functional independence of the anti-corruption office is a positive step.

In accordance with the European Semester's process (see Figure 8.2), every year EU Member States should prepare and by mid-April submit to the EC national programmes (the *National Reform Programme*, *Stability* or *Convergence Programme*).

The *National Reform Programme of Latvia for the Implementation of the Europe 2020 strategy* (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 prepares and submits to the EC Progress Report on the Implementation of the NRP of Latvia.

The NRP of Latvia describes the medium-term macroeconomic scenario, main macro-structural bottlenecks of Latvia and key measures for eliminating them, as well as national targets of Latvia for 2020 in the context of the *Europe 2020* strategy and key measures for achieving them.

Latvia's aim is to promote growth and jobs, by ensuring the annual growth of GDP in the medium term by 4-5% and employment rate of 73% by 2020.

The NRP of Latvia reflects quantitative targets of Latvia for 2020 in the context of the *Europe 2020 strategy* (Latvian quantitative targets). These have been set taking into account the medium-term development scenario of the Latvian economy, as well as targets of the *Sustainable Development Strategy of Latvia – Latvia 2030*, and are reflected also in the *National Development Plan 2014 – 2020* (NDP2020), which was approved by the Saeima on 20 December 2012.

According to the quantitative targets of Latvia, the plans for 2020 are to achieve an employment rate of 73% among the population aged 20-64, to increase investments in research and development (R&D) to 1.5% of GDP, to increase the share of population having acquired tertiary education to 34-36%, to reduce the share of early school leavers to 10%,

to reduce the share of persons at risk of poverty to 21%, to increase the share of renewable energy sources in gross energy consumption to 40%, etc.

According to the European Semester's process, the Cabinet of Ministers approved the seventh *Progress Report on the Implementation of the NRP of Latvia* (hereinafter – Progress Report) and the *Latvia's Stability Programme for 2018-2021* on 10 April 2018. Both documents were submitted to the EC on 15 April 2018.

The Progress Report contains an updated medium-term macroeconomic scenario described in the NRP of Latvia, evaluates the progress of Latvia in addressing the EU Council's recommendations adopted in 2017, provides a detailed description of the NRP policy directions, including national quantitative targets of Latvia in the context of the *Europe 2020 strategy* (see Table 8.1), and reflects information on the use of EU funds.

Table 8.1

Progress Towards the Achievement of Latvia's Targets in the Context of the Europe 2020 Strategy			
	2016	2017	2020
Employment rate (population aged 20-64, as per cent)	73.2	74.8	73.0
Investment in research and development (R&D), as per cent of GDP	0.44	0.51	1.5
Tertiary education (share of population aged 30-34 having completed tertiary education, as per cent)	42.8	43.8	34-36
Share of early school leavers aged 18-24, as per cent	10.0	8.6	10.0
Share of people at-risk-of-poverty, as per cent	21.8	22.1	21.0
Energy efficiency (energy savings compared to 2008, Mtoe)	0.47	..	0.67
Share of renewable energy in the final consumption of gross energy, as per cent	37.2	..	40.0
Total greenhouse gas emissions, Mt CO ₂ equivalent	12.1	12.1	12.2

When evaluating the national programmes submitted by the EU Member States and their implementation, on 23 May 2018 the EC published proposals for EU Council's recommendations to the EU Member States, which were

approved at the European Council on 28-29 June 2018 (see Box 8.3). The European Semester has been completed after the adoption of the EU Council's recommendations at the end of June 2018.

Box 8.3

The EU Council's country-specific recommendations for Latvia 2018

The following recommendations are made for Latvia for 2018-2019:

- Achieve the medium-term budgetary objective in 2019, taking into account the allowances linked to the implementation of the structural reforms for which a temporary deviation is granted. Reduce taxation for low-income earners by shifting it to other sources, particularly capital and property, and by improving tax compliance;
- Improve the adequacy of minimum income benefits, minimum old-age pensions and income support for people with disabilities. Increase the labour market relevance of vocational education and training, and foster upskilling of low-skilled workers and jobseekers. Increase the accessibility, quality and cost-effectiveness of the healthcare system;
- Strengthen the efficiency of the public sector, in particular with regard to local authorities and state-owned enterprises. Strengthen the accountability of public administration by protecting whistle-blowers, preventing conflicts of interest and following-up on the results of the ongoing assessment of past insolvency proceedings.

The measures planned by the government for the fulfilment of EU Council's recommendations and targets of the *Europe 2020 strategy* are included in the government's action plan. EU Council's recommendations for Latvia serve as an important element when setting national priorities,

formulating necessary reform and policy activities, as well as successfully implementing *National Reform Programme of Latvia* and *Latvia's Stability Programme*.

It should be noted that the *National Reform Programme of Latvia* and the *Latvia's Stability Programme* are being

implemented in close cooperation with the EC. The progress of the implementation of both programmes is discussed regularly in bilateral meetings. The Ministry of Economics will continue monitoring the implementation of measures addressing the NRP of Latvia and Council 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 within the Europe 2020 strategy* for 2019.

8.2. USE OF EUROPEAN UNION STRUCTURAL FUNDS AND THE COHESION FUND

As an EU Member State, Latvia benefits from financial assistance coming from the EU's structural funds (SF) and the Cohesion Fund (CF), which are tools for the implementation of the EU's regional cohesion policy.

2014-2020 PROGRAMMING PERIOD

Within the scope of the 2014-2020 programming period of the EU Funds of the cohesion policy, in August 2018 the European Commission (EC) approved the documents submitted by Latvia about the management and control measures taken in 2017 to declare investment expenditure of EU Funds. The EC similarly evaluated the efficiency of the Latvian management and control system of the EU Funds also in 2016. Intensive work on project selections and conclusion of investment contracts is ongoing. The projects are implemented in all areas and all Latvian regions. The challenge for 2018 is reach the interim targets set in the operational programme.

In accordance with the MoF assessment, the investment from the EU funds increased GDP growth in 2017 by 2%, which is considerably more than in the previous year. In 2017, the investments within the scope of the 2014-2020 programming period of the EU Funds amounted to 404 million euro compared to 225 million euro in 2016¹. A higher flow of investments from the EU Funds has a multiplier effect on the total investment activity in the country.

Investment projects of the EU Funds for the total amount of 3.1 billion euro (69%) of the total "envelope" of the EU funds of 4.4 billion euro have been approved by 1 October 2018. There was a considerable increase in project approvals in September 2018 – 23 million euro in August, and 63 million euro in September in areas like information and communication technologies, environment and territorial development (reuse, recycling and regeneration of waste), as well as tertiary education (ensuring effective governance in higher education institutions). The amount of concluded contracts is also growing – 7 million euro in August, 22 million euro in September, already 38.8 million euro in the first half of October, mainly in the area of competitiveness of small and medium-sized merchants (public infrastructure for business), environment and territorial development

(adaptation to climate change), transport infrastructure to improve regional mobility, as well as in the area of tertiary education (to reduce fragmentation of study programmes).

Along with the intensity of real implementation of projects, EC interim payments of 668.6 million euro were received in Latvian state budget revenues by mid-October 2018 for expenditure on investment projects, i.e., already 15% of the total "envelope" of 4.4 billion euro.

Along with the payment application cumulatively for 745.7 million euro for investments with support of the EU Funds submitted to the EC on 28 September 2018, Latvia has fulfilled the annual cumulative target of payment applications of the EU Funds for 2018 by exceeding the target set in the operational programme for 2018 by 16%. Therefore, Latvia does not risk losing part of the allocated EU Funds for not achieving the target for 2018, and MoF also does not state such a risk in the future².

PROGRESS TOWARDS THE IMPLEMENTATION OF ACTIVITIES IN THE COMPETENCE OF THE MINISTRY OF ECONOMICS

Within the EU funds programming period 2014-2020, MoE is responsible for 20 different support measures with the total funding from the EU Funds amounting to 759.3 million euro in three priority axes:

- research, technological development and innovation;
- competitiveness of the small and medium-sized enterprises;
- shift towards a low-carbon economy in all sectors.

Total public funds for all MoE measures amount to 907.2 million euro, and by the end of 2017 the selection and implementation of projects has started in all the measures under responsibility of MoE. The implementation of projects for 575.4 million euro or 75.6% from the funding available from the EU funds started in 2018. In turn, 141.6 million euro were actually paid to implementers of projects from 2014 to 2018 (see Table 8.2).

¹ Informative report on progress in investments of the European Union Funds of the Cohesion Policy until 30 June 2018 and monthly operative information for August 2018 http://www.esfondi.lv/upload/oo-informativie-zinojumi/fmzin_230818_es_fondi.pdf

² Monthly report on the status of implementation of investments from the EU Funds (operative information). The informative report is available on the website of the EU funds: www.esfondi.lv/zinojumi-Ministru-kabinetam.

Table 8.2

Progress of the Implementation of Activities in Competence of the Ministry of Economics as at 31 October 2018				
Priority directions	Measures	Share from the EU Funds in 2014-2020 mln euro	Total payments made mln euro	Paid to beneficiaries % of total allocation
1. Research, technological development and innovation	1.2.1.1. Support for development of new products and technologies within the competence centres	64.3	19.3	28.2%
	1.2.1.2. Support for improvement of technology transfer system	34.5	1.1	3.3%
	1.2.1.4. Support in introduction of new products into production	60.0	2.9	4.9%
	1.2.2.1. Support for employed learning	18.0	4.0	20.9%
	1.2.2.2. Innovation motivation programme	4.8	1.1	22.0%
	1.2.2.3. Support for ICT and non-technology learning, as well as learning aimed at attracting investors	6.9	0.9	11.9%
3. Competitiveness of the small and medium-sized enterprises	3.1.1.1. Loan guarantees	44.8	12.2	27.1%
	3.1.1.2. Mezzanine loans	7.0	1.8	26.3%
	3.1.1.4. Microcredits and start loans	4.0	1.3	31.7%
	3.1.1.5. Support for investment into the creation and reconstruction of production facilities and infrastructure	50.5	7.8	14.6%
	3.1.1.6. Regional business incubators and an incubator for creative industries	27.9	3.1	8.9%
	3.1.2.1. Risk capital	32.2	10.2	31.7%
	3.1.2.2. Technology accelerator	13.0	4.1	31.7%
	3.2.1.1. Cluster programme	6.2	2.3	36.1%
3.2.1.2. International competitiveness	51.5	23.7	46.0%	
4. Shift towards a low-carbon economy in all sectors	4.1.1. Energy efficiency of manufacturing enterprises	25.7	4.7	16.9%
	4.2.1.1. Promoting the increase in energy efficiency of residential buildings	150.0	33.1	22.1%
	4.2.1.2. Promoting the increase in energy efficiency of public buildings	97.9	4.5	4.5%
	4.3.1. Energy efficiency of district heating	60.0	3.5	5.4%
Total		759.3	141.6	18.6%

In 2018, conditions for the implementation of programmes were improved, for example, the conditions for the implementation of the *Technology Transfer Programme* for effective provision of innovation support vouchers and to ensure functioning of the fund for commercialisation and patenting of research results, as well as to extend the start-up support ecosystem, the technology transfer programme was extended with activities promoting participation of start-ups in exhibitions, conferences, trade missions, as well as direct visits to the potential investor or cooperation partner in foreign countries. Similarly, a number of amendments were made to regulations of activity 4.2.1.1 and activity 4.2.1.2 to improve the progress in the implementation of these programmes.

In response to high demand, addition funding was found in the *Programme for Promotion of International Competitiveness*, as well as to resolve insufficiency of supply of industrial zones and premises, as well as additional 25 million euro of ERDF funding were diverted to the second round of the *Industrial Premises Programme* (it is planned to announce the selection round at the beginning of 2019).

In 2018, the second round of selection of project applications for activity 1.2.1.4 "Support for putting new products in production" aiming to promote an increase in productivity and competitiveness of merchants by developing and introducing new products and technologies into production, as well as increasing investment of the private sector into research, development and innovation (ERDF 37.7 million euro), as well as round 4 of activity 1.2.1.1 "Support for development of new products and technologies within competence centres" were announced, where 37.6 million euro are available, incl. 12 million euro for the implementation of intersectoral cooperation research projects. Second rounds were also announced in the priority axis "Shift towards a low-carbon economy in all sectors" in activity 4.2.1.2. "Promoting the enhancement of energy efficiency of public buildings" (ERDF 29.5 million euro), SO 4.1.1 "Promoting effective use of energy resources, reduction of energy consumption and a transition to RES in the field of manufacturing" (CF 15.4 million euro) and SO 4.3.1 "Promoting the energy efficiency and use of local RES in district heating" (CF 18.2 million euro).

PROPOSAL OF THE EUROPEAN COMMISSION FOR 2021-2027 PROGRAMMING PERIOD

On 2 May 2018, the EC published the communication “*A Modern Budget for a Union that Protects, Empowers and Defends*”, which marked the EC’s vision of the new EU’s multiannual budgetary framework for 2021-2027. According to the EC, it is necessary to start discussions on a new EU’s multiannual budgetary framework in a timely manner than ever before in order to ensure as fast transition as possible from the current EU’s multiannual budgetary framework, which will complete in 2020, to the next one, which will start on 1 January 2021, thus preventing the so-called “funding gap” between both periods, which has a negative effect on the development of EU Member States. By publishing the abovementioned communication on a new EU’s multiannual budgetary framework after 2020, the EC also wanted to simplify the work of the new EC, which will start its work after the European Parliament elections in May 2019.

The EC believes that procedure of the new EC budget after 2020 will be simplified, more flexible and this will generally be an EU budget with a greater focus on main priorities and measures with EU’s added value. The EC also wants to reinforce the link between the EU budget and the European Semester and the fulfilment of the EU Council’s recommendations (see Chapter 8.1).

When preparing the EC’s communication on the multiannual EU budget after 2020, the EC took into account current EU’s challenges. One of the challenges is the UK’s exit from the EU (Brexit), which was one of the biggest net contributors to the EU budget. The EU is also currently facing several other challenges: technological changes, demographic changes and population ageing process, climate change, unemployment rate in the EU, in particular among youth, new security threats, refugee crisis and worsening of the geopolitical situation.

In the new multiannual EU budget after 2020 the EC offers considerable changes to the *Cohesion Policy*, which is very important for Latvia. For instance, the EC offers to divert 11.3 billion euro from the Cohesion Fund to the Connecting Europe Facility (CEF) to finance different transport, digital and energy infrastructure projects, which have European added value, for the improvement of cross-border infrastructure.

Distribution criteria of the Cohesion Fund will be also supplemented, where apart from the main GDP per capita criterion the EC offers to take into account also the youth unemployment rate, the effect of climate change and the criterion of reception/integration of refugees. The EC offers to increase co-financing rates for the EU Member States to reinforce their responsibility for Cohesion Fund investments, as well as encourages to pay a particular attention to the specifics of more distant and less populated territories.

The **European Social Fund (ESF)** will also be strengthened and reformed within the scope of the Cohesion Policy. It is planned that 100 billion euro or 27% of the total cohesion policy investments will be available for it. Support will be available for the reduction of youth unemployment, reskilling and upskilling of employees, social inclusion and reduction of poverty. In the new period of the EU Funds after 2020, this fund will be called ESF+ and will merge the ESF, the Youth Employment Initiative, the Fund for European Aid to the Most Deprived, the Employment and Social Innovation Programme and the Health Programme.

The EC believes that the new EU budget should be closer linked to strengthening of the Economic and Monetary Union². For this purpose, the EC offers a new **Reform Support Programme** with total funding of 25 billion euro. Its purpose will be to provide technical and financial support to the EU Member States for the implementation of reforms, and it will be separate but complementary to the future European Structural and Investment Funds (ESIF)³.

The Reform Support Programme also includes a *Reform Delivery Tool* aiming to provide support to all the EU Member States in the implementation of key structural reforms in the context of the European Semester (see Chapter 8.1), for example, reforms related to the product and labour markets, reforms in education, tax system, capital market development, as well as reforms to improve the business environment, human capital and the efficiency of public administration.

The Reform Support Programme will include also the *Convergence Facility*, to support those EU Member States, which have not introduced the euro yet, in introducing the single currency of the EU. If the EU Member States do not take necessary measures to introduce the euro by 2023, the allocations intended for the Convergence Facility will be redirected to the Reform Delivery Tool. The participation of the EU Member States in all the three abovementioned reform support programmes is planned to be voluntary, and the EU Member States will be still completely responsible for the implementation of the reforms.

The **European Investment Stabilisation Function** will be another important element of the new EU budget in accordance with the EC’s proposal. The purpose of the function will be to mitigate the effects of macroeconomic shocks in the euro area during the crisis. The EC offers to guarantee loans up to 30 billion euro from the EU budget. The loans will be available to the EU Member States, which strictly comply with the criteria set for fiscal and economic policies. This stabilisation function will ensure also an interest rate subsidy to provide budgets of the EU Member States with the necessary funding to retain their investment level. The subsidy is planned to be funded from contributions of the euro area countries.

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

² In June 2015 the Five Presidents’ Report (President of the European Commission, President of the Euro Summit, President of the Eurogroup, President of the European Central Bank and President of the European Parliament) on Completing Europe’s Economic and Monetary Union was published. It is planned in several stages until 2025, where one of them is related to the establishment of the Economic and Fiscal Union, incl. the

establishment of the Structural Reform Support Programme and closer link of the EU multiannual budgetary framework to the process of strengthening of the Economic and Monetary Union. More information: http://europa.eu/rapid/press-release_IP-17-5005_lv.htm.

³ ESIF includes the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund.

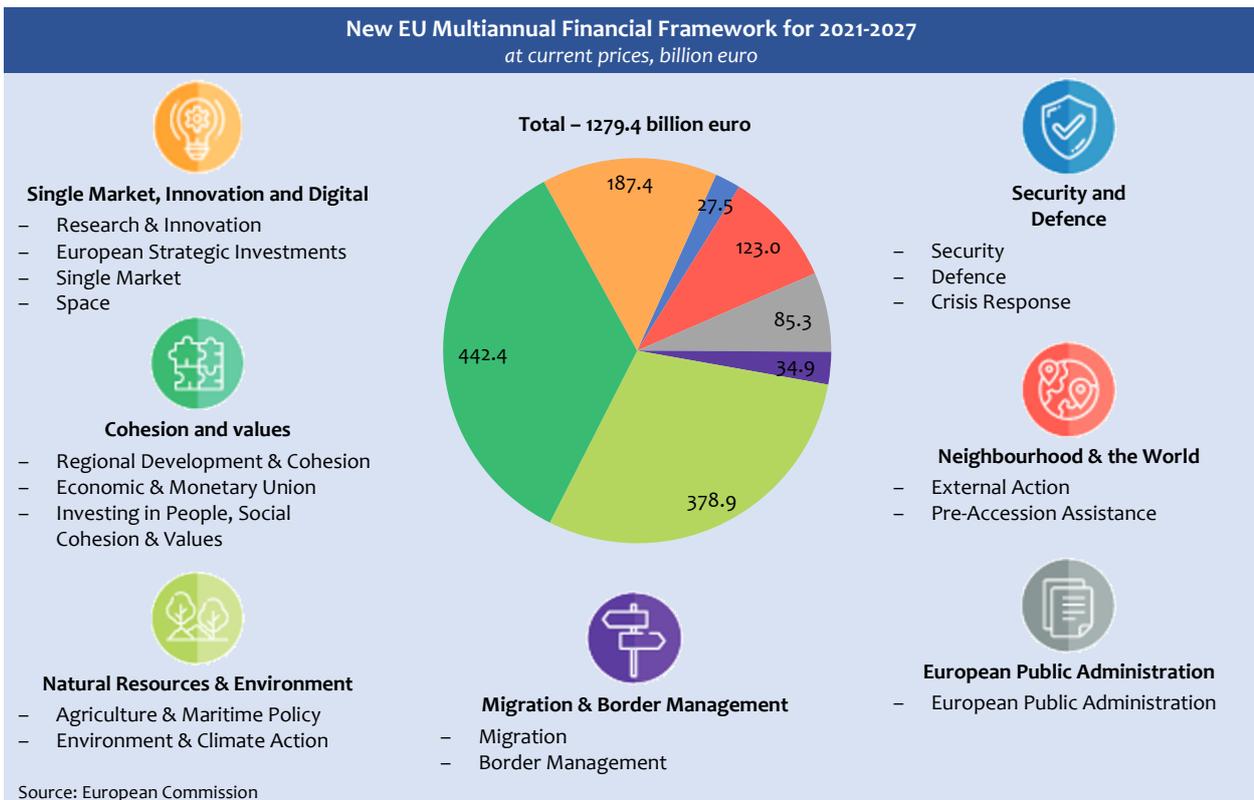
The EC believes that over time the European Investment Stabilisation Function might be supplemented with other sources of financing outside the EU budget, for example, an insurance mechanism financed from voluntary contributions of the EU Member States, the European Stabilisation Mechanism and the prospective European Monetary Fund. The European Investment Stabilisation Function will be available also to those EU Member States, which are outside the euro area, if they make contributions to this function.

According to the EC, current levels of financing will have to increase in the new EU budget in order to ensure funding for new priority instruments and programmes. Therefore, the EC offers to reduce funding allocations to the Common

Agricultural Policy and the Cohesion Policy to free financial resources for the new programmes and priorities. As a result, as emphasised by the EC, the new EU budget will put a greater emphasis on the areas with higher European rather than national added value. Against this background, total liabilities in the EU budget for 2021-2027 might amount to 1279.4 billion euro or 1.114% of the gross national income of the EU-27 countries, which is similar to their current amount in the EU budget for 2014-2020 in real terms.

Figure 8.3 reflects the EC’s proposal regarding the total amount of funding broken down by EU budget programmes and priorities in 2021-2027.

Figure 8.3



The EC offers to modernise and simplify the current **own resources system** and diversify sources of income. For instance, apart from current sources of income from customs taxes and contributions of EU Member States to the EU budget based on total national revenues, the EC proposes to simplify the VAT-based own resources.

The EC also offers to establish a stronger link between the EU budget financing and EU policies by introducing a new “basket” of own resources consisting of the share of income from the Emissions Trading Scheme (to allocate 20% of income from the scheme to the EU budget), the revised Common Consolidated Corporate Tax Base and contributions of EU Member States, which are calculated on the basis of the amount of non-recycled plastic packaging waste.

In accordance with the EC’s calculations, the new own resources system would provide on average 22 billion euro

per year or about 12% of total revenues of the EU budget. This new own resources system will help to divert funding for new priorities and reduce contributions of EU Member States based on their gross national income.

According to the **initial opinion of Latvia** about the EC’s proposal for the new multiannual EU budget after 2020 Latvia does not support the offered reduction of funding for the Cohesion Policy and the Common Agricultural Policy. Latvia believes that the EU still needs to promote economic, social and territorial cohesion, to equalise the welfare level between less developed and developed EU regions, as well as equalise direct payments in agricultural sector. Latvia appreciates the EC’s proposal to increase funding for research, innovation and the Connecting Europe Facility (which also includes support for the *Rail Baltica* project).

It should be noted that along with publishing of the EC's communication on the multiannual EU budget after 2020,

discussions have started between the EC and EU Member States, as a result of which the initial EC's proposal will change.

8.3. EU SINGLE MARKET

The EU Single Market unites 31 country (28 EU Member States and 3 countries of the European Economic Area (EEA) – Norway, Iceland and Liechtenstein) having over 500 million 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. After a long and coordinated work within the EU, 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, the population was provided the possibility to live, work and study in other Member States, a possibility was found to introduce a single currency, as well as many other benefits were provided.

This year, the EU Single Market celebrates its 25-year anniversary. Since 1993 Europeans have experienced that their rights are developing on a daily basis: a harmonised period of withdrawal in case of online purchases, a two-year legal warranty period all over Europe, protection when travelling by plane, train or bus. The euro is one of the achievements of European integration. It is the single currency of 19 of 28 EU Member States, i.e. of 338.6 million people⁶. It helps to conveniently travel throughout the EU, compare prices of different products or make purchases in European online shops without currency exchange.

The EU Single Market continues to improve and adapt in the rapidly changing modern world to promote sustainability, development of the EU's economy and the welfare of its population. In 2015, the EC adopted two strategies – the *EU Single Market Strategy*⁷ and the *EU Digital Single Market Strategy*⁸, which set out necessary action for further reinforcement and improvement of functioning of the EU Single and EU Digital Single Market. Both strategies provide multiannual targets, which need to be implemented at the EU level and which directly affect the market development and competitiveness of all EU Member States in different sectors.

The digital single market is one of the most promising and challenging areas of progress, creating potential efficiency gains of EUR 415 bln⁹. It opens new opportunities to boost the economy through e-commerce, while at the same time facilitating administrative and financial compliance for businesses and empowering customers through e-government. Market and government services developed within the digital single market are evolving from fixed to mobile platforms and becoming increasingly ubiquitous, offering access to

information and content anytime, anywhere and on any device (ubiquitous commerce and ubiquitous government). These advances call for a regulatory framework that is conducive to the development of cloud computing, borderless mobile data connectivity and simplified access to information and content, while safeguarding privacy, personal data, cybersecurity and net neutrality. The digital single market has the potential to improve access to information, to bring efficiency gains in terms of reduced transaction costs, dematerialised consumption and reduced environmental footprint, and to introduce improved business and administrative models. More e-commerce generates tangible benefits for consumers, such as rapidly evolving new products, lower prices, more choice and better quality of goods and services, as a result of cross-border trade and easier comparison of offers.

In accordance with Articles 34-36 and 49-62 of the *Treaty on the Functioning of the European Union* (TFEU), the Ministry of Economics supervises and coordinates the freedom of provision of goods and services and the right to do business in Latvia. It is also competent to identify legal provisions which may potentially or actually hinder the use of freedoms of the EU Single Market, including by evaluating pending laws and regulations.

An electronic *Single Market Centre* has been established on the website of the Ministry of Economics (https://www.em.gov.lv/lv/eiropas_savieniba/es_vienota_tirgus_centrs/) for better governance of the EU Single Market providing all the information on the EU information and aid 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 on freedom of provision of goods and services. The Ministry of Economics has also created an online questionnaire using which one can report on barriers to business 24 h a day (https://www.em.gov.lv/lv/eiropas_savieniba/zino_par_skersliem/).

The **technical regulations notification procedure** serves as a preventive, uniform 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 drafts prepared by other EU Member States, which might potentially affect that

⁶ https://europa.eu/european-union/about-eu/money/euro_lv

⁷ Upgrading the Single Market: more opportunities for people and business COM(2015) 550 final, 28.10.2015

⁸ A Digital Single Market Strategy for Europe COM(2015) 192 final, 06.05.2015

⁹ <http://www.europarl.europa.eu/factsheets/lv/sheet/43/visparejais-vienota-is-digitalais-tirgus>

economic operator's product exports or cross-border provision of information society services. The information on draft technical regulations notified by Member States is freely available in the database of the Technical Regulations Information System (TRIS) <http://ec.europa.eu/growth/tools-databases/tris/iv/search/>, where draft technical regulations can be viewed in Latvian. If any 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.

To ensure administrative cooperation between EEA's national regulatory authorities, the EC has created an **Internal Market Information System** (IMI). The IMI allows to contact responsible authorities of the countries of the European Economic Area 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 matters according to respective EU laws and regulations. Hence, the applicant is free from bureaucratic barriers in the resolution of different cross-border matters in the EU Single Market.

The Ministry of Economics is the national coordinator of the IMI system in Latvia. Today, the IMI system in Latvia is operating in the area of *Services Directive (2006/123/EC)*, *Professional Qualifications Directive (2005/36/EC)*, *Posting of Workers Directive (96/71/EC)*, *Patients' Rights Directive (2011/24/EU)*, and *Regulation on the cross-border transport of euro cash by road (1214/2011)*, in the area of *Directive on the return of cultural objects unlawfully removed (2014/60/EU)*, *European Professional Card Directive (2005/36/EC, 2013/55/EU)* and *Commission Implementing Regulation 2015/983*, *Regulation for Non-Road Mobile Machinery (2016/1628)*, *General Data Protection Regulation (2016/679)*, *Public Documents Regulation (2016/1191)*, pilot drafts in the area of *Commission Implementing Decision on train drivers' licences (2014/89/EU)*, *E-Commerce Directive (2000/31/EC)* and *Public Procurement Directive (2014/24/EU and 2014/25/EU)*.

The *Services Directive* obliges Member States to inform about services which can cause significant harm to human health, life and the environment, therefore, the IMI system has an *Alert mechanism* which ensures cooperation between supervisory authorities for risk prevention. 111 Latvian authorities are registered in the IMI system in different areas – 59 authorities deal with the services, 27 – professional qualifications, 8 – posting of workers, 5 – patients' rights, 1 – e-commerce, 2 – train drivers' licences, 32 – public procurement (one authority can deal with several areas). In 2016, a *European Professional Card* in the IMI system was created within the scope of *Directive 2013/55/EU* which is issued to those representatives of regulated professions who want to pursue the same profession in another EU Member State or EEA Member State. From 2017, requests *regarding EU type-approvals for non-road mobile machinery* are processed under *Regulation 2016/1628*. From 2018, information requests and notifications are processed in the

cross-border context under the *General Data Protection Regulation 2016/679*. From 2018, a register of public documents has been created within the scope of *Regulation 2016/1191* enabling to view typical documents issued in other Member State and examples of forged documents, while from February 2019 information requests in the area of public documents will be processed.

From January to October 2018 Latvia sent 78 information requests to other Member States within the IMI system: 56 in professional qualifications area and 12 on public procurements. Latvia received 310 information requests: 292 in professional qualifications area, 11 in the positing of workers area.

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 activities of public authorities in case of incorrect application of EU law. In situations, when a resident or a entrepreneur is harmed by wrongful decisions taken by responsible authorities of other Member States, the *SOLVIT Centre* operates as a free problem-solving tool. There are *SOLVIT Centres* in each EU Member State (and also in Iceland, Norway, Liechtenstein). From January to October 2018 the Latvian *SOLVIT Centre* received 28 complaints as a Home Center on problems of Latvian citizens in the EU countries and 18 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. The Latvian *SOLVIT Centre* most frequently solves cases of individuals related to social benefits and issue of residence permits, cases of businessmen 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, the requirements of laws and regulations are analysed regularly and recommendations for required changes are prepared to reduce an administrative burden on undertakings in cooperation with non-governmental organisations and national regulatory authorities. Administrative barriers and procedures are reviewed by respectively removing or simplifying requirements for issue of permits, licences, certificates, certifications and other documents, as well as creating the possibility to carry out the necessary procedures electronically.

The **"tacit consent"** principle is one of the tools promoting modernisation of public administration, to reduce delays in decision-making by authorities, costs and unfavourable consequences to small and medium-sized enterprises. This principle defines that in case a responsible institution fails to make a timely decision on the application for a permit, it shall be considered that the service provider has received the permit and is entitled to start service provision.

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 annually.

Targeted reforms and close cooperation with the business community has enabled Latvia to achieve high results in international ratings, namely, the World Bank's *Doing Business 2019* rating Latvia is placed 19th among 190 countries. In the assessment of the business-friendly environment, Latvia is ranked 7th among the EU member states, which is by one position higher than in the previous year giving way to Finland (12th place), Estonia (16th place), Lithuania (14th place), Sweden (12th place), United Kingdom (9th place) and Denmark (3rd place) (for details see section 6.9).

On 15 March 2015 the CM approved the current version of the *Business Plan* and its purpose is "simple and high-quality services in business: more e-services", and includes 46 measures, which have effect also on Latvia's indicators in the World Bank's *Doing Business* study.

The current version of the Business Plan took into account not only the proposals made by ministries and organisations representing businesses, but also included measures arising from the results of the study conducted by the State Chancellery in 2015 "Study on administrative procedures for drafting reports and the opportunities in reducing administrative burden", as well as those measures are continued, which were included in the updated version of the Business Plan for 2014-2015.

On 1 November 2018 MSS accounted a new version of the *Business Plan*. The focus of measures has changed in this version in response to the challenges in the business environment (see Box 9.1).

Box 9.1

Main accents of the Action Plan for Improvement of the Business Environment announced by MSS on 1 November 2018

Considering the challenges related to international competitiveness, as well as the problems identified by businesses, it is necessary to move forward with the cycle of reforms and to implement long-term oriented economic development activities, thus creating a competitive business environment in Latvia, which is evaluated accordingly by investors. At the same time, special attention is drawn to promotion of innovation, human capital and protection of investor rights, which are important components of a developed business environment.

Basic principles included in the Business Plan: customer-oriented public administration, digitalisation of services, competitiveness of the tax system, openness of the business environment, legality, promotion of innovation.

The plan includes 12 sections important for the business environment:

1. Starting a business.
2. Construction process.
3. Registering property.
4. Protecting minority investors.
5. Accountancy and taxes.
6. Trading across borders – customs.
7. Enforcing contracts.
8. Getting electricity.
9. Restructuring.
10. Human capital.
11. Digitalisation and accessibility of state services.
12. Promoting Innovation.

The plan includes 47 activities with the following institutions responsible for their fulfilment within the set deadlines: MoE, MoF, MoJ, MoW, MoT, MoEPRD, MoH, MoA and subordinate institutions.

The Business Plan for the next period has been drafted by discussing the activities in the *Business Plan* working group approved by the Minister of Economics, which includes representatives from state institutions, as well as organisations representing businesses. There were 7 working groups in the process of drafting of the plan, which individually reviewed all the sections included in the Plan. In parallel, a separate working group was created for drafting of the innovation section, because this section was newly created. There were 4 separate working groups for the development of the innovation section, and it was presented to the full working group at the last working group of the Plan. In addition, the draft Plan was published on the MoE website for public consultation along with its submission to MoE for announcement.

DIALOGUE WITH BUSINESSES

The Ministry of Economics is constantly maintaining a dialogue with businesses. The first and the main instrument of implementation of the dialogue is involvement of businesses in drafting of the *Action Plan for Improvement of the Business Environment*. The MoE in cooperation with sectoral ministries and the Employers' Confederation of Latvia, Latvian Chamber of Commerce and Industry, Foreign Investors' Council in Latvia constantly take care of the development and implementation of measures for the improvement of business environment. At the same time, the opinion of each company is taken into account and submitted challenges are evaluated in the process of drafting of the *Action Plan for Improvement of the Business Environment*.

Another important measure in the dialogue with businesses are visits to companies, during which MoE listens to the challenges submitted by businesses, studies each visited company and thus gets a better idea of real needs of businesses and the possibilities to provide different support to businesses.

REDUCTION OF BUREAUCRACY

The Business Plan provides for several measures to reduce bureaucracy for small companies. The regulation for the microenterprise tax (MET) and the regulation for patent fees were improved in 2017 within the scope of implementation of these measures.

Although, initially there were discussions on the review of the MET regime, MoE proposed to keep the MET regime applying a simple and understandable tax payment solution and a uniform tax rate of 15% of turnover. The MET regime will keep serving as a support for starters of business and companies with small annual turnover (from 2018 the permissible turnover is equal to the VAT registration threshold – 40,000 per year).

At the same time, the new regulation intended social guarantees for employees diverting 80% of the microenterprise tax paid by the payer of MET to the state budget to the account for mandatory state social insurance contributions. Moreover, a possibility is envisaged for employees to join the state social insurance voluntarily, including this information in the employment contract. To prevent unfair competition, the *Micro-Enterprise Tax Law* already envisaged restrictions, and SRS will continue to control them. In addition, from 2019 it is intended that an employee may be at the same time employed by only one microenterprise.

The patent fee payment regime was improved by keeping the possibility to use this regime in certain professions, as well as envisaging a reduced patent fee regime for persons with disability of group I and II and setting a single amount of the patent fee – 50 euros and 100 euros, respectively.

In order to seek new solutions for more convenient payment of taxes, work is ongoing on the introduction of a single

account for all tax payments, as well as simplified tax payments from an account in a credit institution. The State Tax Policy Guidelines 2018-2021 include the task to introduce a voluntary solution for taxpayers, who pay the tax from turnover – an economic activity income account. It is necessary to find a technical solution for mutual cooperation between commercial banks and the tax administration for automatic calculation and charging of the tax. A simplified tax payment solution has been introduced in Estonia since 2018. Thus, when evaluating the possibility of implementation of a 0% “bureaucracy” model in tax payments, the simplified solution introduced by Estonia in payment of taxes should be evaluated. MoE is actively discussing the potential solution pilot project, for example, in the business involving carriage of passengers.

ENHANCEMENT OF TAX SYSTEM

An absolutely new CIT regulation was introduced since 1 January 2018, which envisages a 0% rate for reinvested profit. Therefore, the calculation and payment of CIT is postponed until income is distributed, applying a 20% rate at the time of distribution of profits from the gross income to be distributed.

The above-mentioned changes in the tax policy will promote investments of companies in development, as well as economic growth in the country in general. It is expected that the corporate income tax of 0% for reinvested profit will improve financial indicators of companies and promote an increase in equity (retained earnings). At present, many companies have small or negative equity. Insufficiency of equity prevents companies from attracting external funding, increasing their creditworthiness. Investments create new opportunities for increasing competitiveness of companies. Therefore, it is expected that as the tax policy changes, the turnover, profit and productivity of companies increases. This will promote issuing of loans by commercial banks. Therefore, faster economic growth, increase in exports and increase in competitiveness are expected.

MOTIVATION OF FAIR BUSINESSES

In order to create all the preconditions for closer cooperation between taxpayers and the tax administration, on 22 May 2018 CM approved the *Conceptual report on functioning of the In-Depth Cooperation Programme and its development model*, which provides for significant improvement of the current programme, thus fostering a modern approach and at the same time concentrating the resources of the state on taxpayers with higher risk of non-payment of taxes. The Conceptual Report provides for the following improvements:

- segmentation of customers into 3 levels – Bronze, Silver and Golden level intending to receive financial and non-financial support measures for fair businesses. The offered proposal intends to extend the current number of participants from 75 to 2000 by including small and medium-sized enterprises;

- extended range of advantages: fair taxpayer's visibility mark (faster service), reduced requirements (less bureaucracy), partnership (special status, which enables, for example, to participate in the SRS advisory council);
- simplification of programme administration and supervision: proposal to automate the inclusion of participants in the programme on the basis of SRS risk management system data;
- extension of the programme: it is intended that also other institutions will submit proposals for extension of support activities of the programme.

By introducing the offered solution, popularising of the status of a reliable taxpayer will be fostered, which will serve as a motivation tool for taxpayers and as a marketing tool in the establishment or strengthening of business relationships. International research also confirms that in-depth cooperation programmes are mutually beneficial for taxpayers and tax authorities. Benefits are related to simplified administration and lower costs of administration of taxes (audit) and for taxpayers (for fulfilment of liabilities).

IMPROVEMENT OF THE INSOLVENCY REGULATION

Taking into account the importance of this area for successful development of the national economy, the process of improvement of the insolvency regulation is at the centre of attention of the *Business Plan*. On 31 May 2018 the Saeima adopted Amendments to the Insolvency Law aimed at more effective dispute resolution procedure, an Electronic Insolvency Registration System, the change of the name and updating of functions of the Insolvency Control Service, more simplified procedure for determination of forgery of documents, for effective sale of thing belonging to a company, improvement of the regulation of the legal protection proceedings. The amendments entered into force on 1 July 2018.

Further actions in the insolvency area are related to information of the society about the regulation, in particular, paying attention to popularisation of legal protection proceedings.

INTRODUCTION OF THE "CONSULT FIRST" PRINCIPLE IN PUBLIC ADMINISTRATION

In order to move towards excellent business and change mutual cooperation and promote mutual understanding of duties to be performed between supervisory authorities and businesses, in 2017 MoE started the "Consult first" initiative.

The purpose of the "Consult first" principle is to achieve mutual understanding between businesses and supervisory authorities to ensure that businesses, first of all, know and understand their duties, and, second, fulfil them fairly. The implementation of the principle will allow to reach a better result in observation of regulatory enactments and therefore fair competition in the market, thus creating a stable business environment favourable for investments.

Guidelines on the application of the "Consult first" principle have been developed in cooperation with supervisory authorities, recommending best practice examples to promote efficiency and customer-oriented activities in institutions.

On 15 June 2017 23 Latvian institutions, the Prime Minister and the Minister of Economics signed a cooperation memorandum¹⁰ committing to introduce the "Consult first" principle in the work of Latvian supervisory authorities. The implementation of the "Consult first" principle is impossible without participation of all the parties involved, therefore, also the four largest business organisations, by signing the cooperation memorandum, committed to improve the culture of business and to promote voluntary fulfilment of the applicable regulations among their members.

In order to ensure the effective implementation of the "Consult first" project, as well as to fulfil the tasks intended in the *Action Plan for Improvement of the Business Environment*, at the end of 2017 the Ministry of Economics drafted an institution evaluation methodology to be able to evaluate progress of supervisory authorities in introduction of the "Consult first" principle in the next years on a regular basis. According to the drafted evaluation methodology, surveys of customers of authorities, a self-assessment of institutions and evaluation by experts will be organised, which will help to evaluate success of institutions in introduction of the "Consult first" principle. The first results for evaluations of institutions will be presented in the first half of 2019.

¹⁰ Cooperation memorandum on the implementation of the "Consult first" principle https://em.gov.lv/files/ministrija/konsultevispirms/KV_memorands_A4_final_15.06.pdf

DIGITALISATION OF THE BUSINESS ENVIRONMENT

The information necessary for business is available electronically, as well as e-services are available in one place on the State Services portal www.latvija.lv¹¹.

The Portal fulfils the functions defined in the *Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market, 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 providing relevant services in the Member state.

The Portal is also included in the EU Single portal of contact points “EU-GO” on public services available in EU Member states to those companies, which provide services.¹²

The main principles of operation of the Portal are defined in the *Information Society Development Guidelines for 2014-2020*¹³, and the legal regulation is stipulated in several CM regulations.

Problems with functionality of the Portal:

- at present the population and companies face a challenge when they need to find relevant, up-to-date and understandable information online, as well as to unambiguously identify and find necessary services (e-services). This process is often time-consuming and complicated or even impossible. If such information is available from institutions, it is not always available electronically, and most frequently it is organised according to the administrative competence of institutions rather than from the point of view of the population and companies (integrating services of different institutions and fulfilling the situation of the individual completely);
- at national level Latvia does not have a single contact point (business portal) to obtain information on business by its operation cycles – starting of business, requirements during operations of the company and closing, consultations about law, exports, support, taxes, permits, etc. Informative business environment is fragmented, part of information is available from IDAL, part from MoE, the Register of Enterprises, the State Revenue Service and on other websites. It should be taken into account that a single contact point covers only part of the functionality necessary to support businesses.

In the context of identified challenges MoEPRD in cooperation with MoE and other public authorities have started work on 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.

Therefore, in order to foster the improvement of functionality and content of the business section of the Portal, SIA “PricewaterhouseCoopers” at the assignment of MoE has developed a study “Concept of the business section of Portal www.latvija.lv. Evaluation of the current situation and future development proposals”, which provides strategical proposals for the development of the business section of the Portal. The proposals from the study have been submitted to MoEPRD, as well-organized discussions with entrepreneurs on necessary improvements and proposals made in the study. In Q1 2019 it is planned to organise a design thinking workshop on the development of content of the business section of the Portal using the study conducted by SIA “PricewaterhouseCoopers” as a basis.

¹¹ The content of the portal is structured in two sections – for the population and for companies. Information and services are grouped into thematic blocks. Information about life situations, interinstitutional information and functionality in the section for the population is coordinated by the SRDA in cooperation with institutions involved, but the section for companies – by the Ministry of Economics.

¹² The “EU-GO” portal is a tool, using which those who want to start business in any of EU Member states, may conveniently find information about conditions for starting business of the relevant country and to settle administrative formalities in the selected country electronically.

¹³ More information: <https://likumi.lv/doc.php?id=260931>

10. INNOVATION AND NEW TECHNOLOGIES

The main goals and directions of Latvian industry, innovation and R&D until 2020 are set in several policy planning documents – *National Development Plan of Latvia 2014–2020*, *National Industrial Policy Guidelines 2013–2020*, as well as *Guidelines on Research, Technology Development and Innovation for 2014–2020*.

An important precondition for transition to innovative economy is strengthening of the Latvian innovation system by eliminating its deficiencies and facilitating mutual cooperation between all subjects of the innovation system – businesses, science and education, as well as financial and legislative systems.

The main challenges for the improvement of the innovation system are:

- weak cooperation between the business sector and science – insufficient use of the creative and intellectual capital in the creation of innovations, comparatively low innovation capacity and knowledge absorption capacity in the business sector, as well as lack of new and progressive innovation and research-based jobs;
- weak commercialisation potential of research results – shortage of employees in science and research, a poorly developed and fragmented science and research infrastructure, as well as small number of laboratories with modern equipment for the implementation of projects with a technological orientation.

Important directions in promotion of innovation and new technologies are:

- establishment of a knowledge transfer system supporting innovation;
- creation of start-ups;
- creation and support of competence centres;
- promotion of digitalisation (*Industry 4.0*);
- development of strategic ecosystems.

ESTABLISHMENT OF A KNOWLEDGE TRANSFER SYSTEM SUPPORTING INNOVATION

The Investment and Development Agency of Latvia, which at the same time ensures the establishment of a Single Technology Transfer Centre, is a central element, a mediator in the ecosystem of innovations, which promotes 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. It is important to ensure wider use of research results funded from public resources in the creation of new products and services in the private sector through technology transfer.

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 by providing them support in the development of new or significantly improved products or technologies.

By now 40 projects for commercialisation of ideas (in the area of food, medicine, pharmacy, agriculture, information and technologies) and 19 innovation voucher projects (learning and development toys and mobility devices, as well as technological solutions for enhancement and improvement of different national economy areas) have received support within the scope of the *Technology Transfer Programme*. It is planned to continue these activities to support economic operators and research organisations in 2019.

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 3 years the Ministry of Economics and the bodies subordinated to it have been actively working on the creation of uniform supply for the start-up ecosystem. The Latvian start-up ecosystem has become more visible also in the international context. Every year at least 5 local events and festivals with international coverage bring together start-ups and their representatives.

On 1 January 2017 the *Law on Aid for the Activities of Start-up Companies* entered into force giving a clear signal to entrepreneurs, society and policy makers that start-ups are an important source of innovation in the national economy, as well as they promote the attraction of investments, foster the creation of new business models, development of talents and strengthen the venture capital sector.

A representation of Latvia in the Silicon Valley started its work in February 2018 serving as a networking place and an investor attraction point. In 2018, 72 start-ups received support from IDAL for participation in exhibitions, conferences and direct visits in foreign countries, and it is planned that this support will be received by another 28 start-ups.

In 2018, 3 acceleration funds (Overkill Ventures, BuildIT and the Commercialisation Reactor) started to work with each of the funds having ERDF funding of 5 million euro of the total funding of 15 million euro.

An important element in the use of support programmes is their popularisation for the international range of interested persons. For these purposes, an informative portal for start-ups, StartupLatvia.eu, was opened in June 2018. This portal offers a comprehensive overview of support or "Welcome Pack" available to start-ups in Latvia and general information about the state and activities of the ecosystem.

The private sector shows big interest and support initiatives for financial technology or fin-tech start-ups. A combined Swedbank and Start-up Wise Guys fin-tech accelerator for financial technology start-ups started to function at the beginning of 2018. Furthermore, on 4 September 2018 the innovation centre of SEB banka and the SEB Venture Capital new venture capital investment programme kicked-off in Baltic start-up companies. Seeing this growing interest to fin-tech companies in the private sector, the BA School of Business and Finance and the Riga Technical University have created a study programme, which is unique for the Baltics and Eastern Europe and will prepare programming engineers with deep knowledge in finances.

In 2018, the Latvian start-up community twice had an opportunity to meet at the forums organised by the Ministry of Economics and the Latvian Start-up Association Startin.lv. The first such forum was organised at the beginning of 2018, where the development, opportunities and challenges of the start-up ecosystem were discussed together with representatives of start-ups, public, private and academic sector, as well as practical suggestions for improvement of further cooperation and improvement of support were obtained. The second forum was held in September 2018, where cooperation opportunities, the cooperation potential and challenges were discussed together with representatives of the start-up ecosystem, large industry enterprises and government bodies. Representatives of the entire ecosystem, including such state institutions as the Register of Enterprises, Office of Citizenship and Migration Affairs, MoE, IDAL and MoEPRD participated in the forum. It is planned to continue similar activities also in 2019.

Two X-industry hackathons were organised in 2018 in cooperation with the Latvian IT cluster, which contributed to intersectoral cooperation among tech industry companies, corporations and experienced mentors, which are vitally important nowadays due the development of digital business.

It is planned that the work on promotion of cooperation between start-ups and state capital companies will continue, thus creating mutually beneficial solutions to increase innovation capacity. It is planned to continue to strengthen cooperation with representatives of the start-up ecosystem and organisations representing them to promote public awareness of the role of start-ups in the innovation system. MoE has started to draft an informative report "On examples and prospects of use of the blockchain technology and further actions to promote the development of the area", and it is planned that the first pilot projects in cooperation with SRS and the Register of Enterprises might be implemented in 2019.

CREATION AND SUPPORT OF COMPETENCE CENTRES

The European Commission indicates in its report "*Latvian Research Funding System*"¹ that among the EU-funded programmes, the competence centres are the most successful instruments promoting innovation in Latvia at the moment. Competence centres unite companies and scientific institutions, where the purpose of cooperation is to develop products and processes.

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 an international and intersectoral platform.

By 1 November 2018 the number of completed researches within the CC programme aiming to create a new innovative product or improve properties of an existing product was 71. The co-funding of companies involved in the CC programme in R&D project as at 1 November 2018 was 16.9 million euro. 138 companies have received support in total to introduce new products and technologies. As at July 2018, 291 new jobs, incl. those employing scientific employees in the public sector, were created within the scope of the CC programme. More than 230 master and doctoral students are involved in the implementation of projects. 108 scientific articles were published in journals indexed in international databases (Scopus, Web of Science).

It is important to continue activities of the CC programme, which have demonstrated an important and positive impact on the achievement of RIS3 goals. The activities supported within the activity have improved cooperation of scientific institutions with economic operators increasing innovation

¹ <https://rio.jrc.ec.europa.eu/en/library/specific-support-latvia-final-report-%E2%80%93-latvian-research-funding-system>

capacity. Taking into account good functioning and the indicators achieved the programme, within the scope of the fourth selection round (from January 2019 to December 2021) MoE is planning to promote cooperation with similar organisations, for example, clusters, cluster associations, associations to ensure the establishment of an intersectoral platform and create new innovations and technologies as a result of cooperation.

One of goals of the fourth round is to promote the creation of a CC cooperation network in the international environment. MoE has put forward several tasks within the fourth round, for example, to ensure closer cooperation between different sectors, to share the information and knowledge obtained, to promote international cooperation between scientific institutions and economic operators.

PROMOTION OF DIGITALISATION (INDUSTRY 4.0)

Within the scope of *Industry 4.0 concept* Latvia is currently starting the digitalisation process at the level of industry. In recent years, this process has been introduced and has already helped to improve production processes in several largest industrial enterprises helping them to become more productive, for example, AS Dobeles dzirnavnieks, AS UPB, SIA Peruza. *Industry 4.0 concept* is based on the use of digital solutions for the development of innovations and technologies.

In cooperation with the German-Baltic Chamber of Commerce and Industry the Ministry of Economics has started in-depth talks with the German leading manufacturers of smart technologies and services (SAP, Siemens, Bosch, Phoneix Contact, Weidmuller) to promote cooperation with Latvian businesses. By now matters have been discussed about cooperation in the context of *Industry 4.0 concept*, to raise productivity of Latvian manufacturers cooperation in the area of research and services on IoT (*Internet of things*) and Artificial Intelligence. Companies get increasingly more interested in developing the industry process using advantages of data and opportunities offered by automation.

A comprehensive national business digitalisation strategy has not been drafted in Latvia yet. However, the Ministry of Environmental Protection and Regional Development and the Latvian Information and Communications Technology Association have drafted a cooperation memorandum agreeing on joint goals and cooperation in the process of digital transformation of Latvia and for the development of data-based society and state for Latvia to achieve an economic breakthrough and strengthen competitiveness of the state internationally.

The need for introduction of digitalisation in Latvia is defined by the Latvian National Development Plan for 2014-2020, Operational Programme "Growth and Employment for 2014-2020", Information Society Development Guidelines for 2014-2020". In the globalised and digitalised world the competitive power of a country depends more and more on

creative ideas, which have been transferred into innovative products, technology and services. Observing the development directions specified in the above-mentioned, in continuing to develop new technologies and innovations, Latvia will increase competitiveness of the business environment, will create new jobs, as well as will promote production of new high value-added products and services.

Taking into account the guidelines of the EC and European scale, Latvia focuses attention also on integration of new technology solutions for integration in Latvian production companies. Latvia keeps focusing on promotion of digitalisation and improvement of existing solutions, enabling manufacturing companies to cooperate with developers of smart technologies, mainly ICT companies, ensuring the latest available technologies and data processing opportunities.

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 together with IDAL are implementing pilot projects in three development areas such as biomedicine, smart city technologies and smart materials. Pilot projects are implemented according to the uniform methodology, where the main task is to identify employees of the ecosystem in the area of biomedicine, smart city technologies and smart materials. The Latvian leading design thinking experts are involved in the fulfilment of the task to ensure observation of interests and correct interpretation of all the stakeholders.

The business ecosystem is a network of interrelated companies, for example, suppliers and distributors, who interact, mainly supplementing or supplying main components creating value in their products or services. On 31 May, 1 June and 11 October 2018 design workshops were organised within the scope of the pilot project, which united representatives of the academic, public and private sector, who, using design thinking methods, jointly identified the potential of development of the relevant ecosystem and possibilities to jointly develop new products and technologies within the scope of the relevant platform.

Three ecosystems were identified and the need for cooperation between members of the ecosystems was initiated as a result of the pilot project. In order to continue the work and develop these ecosystems regardless of independently functioning sets (clusters), which would be able to take the leading role in the European research and innovation environment in the defined period of time and

would be able to attract investments from European Union funds, strategic approach to the development of such ecosystems is necessary. On the basis of competence and international experience of the Ministry of Economics, a uniform ecosystem development approach has been created, according to which ecosystems of biomedicine, smart city technologies and smart materials are developed.

A unified approach envisages setting of the initial ecosystem development point and reaching of the ecosystem

development point through different activities (regular meetings, identification of targets and activities, determination of future projects and partners, defining and testing of the business model, takeover of good practices, etc.), where it is able to function independently promoting cooperation (triple helix), attracting funding (public and private), as well as ensure the increase in importance of Latvia in the area of innovations at the international level.

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 European Regional Development Fund (hereinafter referred to as ERDF) funding for financial instruments intended in the 2014-2020 programming period of EU funds forms 101 million euro. In addition to this funding, the development financial institution "Altum" (hereinafter referred to as 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 million euro, as well as external funding of indicatively 36.15 million euro (venture capital and for ensuring 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.

LOAN GUARANTEES

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, are implemented in the 2014-2020 programming period of EU funds within the scope of *Activity 3.1.1.1 "Loan guarantees" of 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"*.

The programme has been functioning since June 2016 and by 14 August 2018 337 guarantees amounting to 55 million euro were issued, which evidences of constantly high demand for such financial instruments.

In April 2018, the list of supported sectors was extended, and, taking into account large interest of economic operators in receiving the guarantees, by amendments the total funding of the support programme was increased by 24.3 million euro, incl. (earlier the ERDF funding amounted to 20 million euro):

- additional funding of 22.8 million euro was assigned for guarantees to small and medium-sized economic operators;
- additional funding of 1.5 million euro was assigned for guarantees to large economic operators (earlier up to 1.2 million euro were intended for these guarantees).

PORTFOLIO GUARANTEES

On 12 September 2017 a new state aid programme, portfolio guarantees, was approved. Within it aid in the form of guarantees for the loans issued by credit institutions for investments, financing of working capital as well as financial leasing with a period from 1 to 10 years is available. Banks will be able to use a portfolio guarantee for investment and working capital loans and leasing in the amount up to 250 thousand euro. The aid programme will be implemented by ALTUM, which in the process of open selection has selected and concluded agreements on portfolio guarantees to promote crediting of small, medium-sized and large economic operators with 3 credit institutions, which will be able to grant loans within the scope of available funding with a state guarantee to companies themselves, without direct involvement of ALTUM. 7.8 million euro of repaid public funding are available for issuing of the guarantees. The process of selection of credit institutions ended in June 2018, and since Q3 2018 the credit institutions have started issuing loans with a state guarantee.

PARALLEL LOANS

The *Parallel Loan Programme* is implemented in the 2014-2020 programming period of EU funds is implemented 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 the problem of 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 by 31 July 2018 7 loans for 1.3 million EUR have been issued, 10 loans for 2.6 million EUR have been granted and 9 agreements for 2.5 million EUR have been concluded.

On 12 July 2018 MSS announced amendments to CM Regulations No. 469 "Regulations on Parallel Loans to Improve Competitiveness of Economic Operator", which intend to simplify the parallel loan programme and extend the area of operation: current sector restrictions of the programme were reduced, for example, it will further be possible to finance wholesale, equipment rent, electricity, heat supply and other projects. The conditions of repayment of the principal amount of parallel loans were improved – repayment of the part of the loan is adapted to the specifics and cash flow of each project regardless of the grace period applied by the commercial bank. These regulations are currently being coordinated.

MICROCREDITING AND LOANS FOR STARTERS OF BUSINESS

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 will be introduced in the form of direct financial instruments, and it is planned to introduce microcrediting in the form of direct and indirect 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 million EUR were issued in the 2007-2013 programming period of EU structural funds and the Cohesion Fund, 27.74 million EUR of which were loan amounts and 3.05 million EUR were grant interest for 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, while the maximum loan amount is 150 thousand EUR. 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.

In January 2018, amendments to CM Regulations No. 328 "Regulations on Microloans and Start Loans" were adopted, by which up to five years old starters of economic activity will be able to apply for start loans; other amendments were made as well, which have a favourable effect on the range of potential beneficiaries of the aid.

In April 2018, amendments to CM Regulations No. 328 "Regulations on Microloans and Start Loans" were approved, by which the ERDF funding (8 million euro) available within the aid programme was updated, replacing it with repaid public funding. 350 start loans for a 7.4 million euro and 113 microloans for 1.4 million euro have been closed by 31 July 2018.

VENTURE CAPITAL INSTRUMENTS

Venture capital instruments are available in the 2014-2020 programming period of EU funds within the framework of *activity 3.1.2.1 "Venture capital" of the Specific Objective 3.1.2 "To increase the number of start-ups" of the Operational Programme "Growth and Employment"*.

Continuing the experience of the 2007-2013 programming period of EU structural funds and the Cohesion Fund and taking into account market development trends, it is planned to offer several venture capital instruments, which will be introduced through financial intermediaries selected in a public procurement procedure.

SEED, START AND GROWTH CAPITAL FUNDS

The programmes are intended for investments in innovative companies with a rapid growth potential. Seed and start capital investment are intended for companies in their early stage of development, where traditional funders refrain from investing due to high risk. Growth capital investments will be made in already operating companies for their further development. Seed capital, start capital and growth capital investments may be in the form of an investment in equity of the capital or in the form of quasi-equity. Conditions of the programme have been approved, the selection of financial intermediaries has ended. Taking into account the attraction of private co-funding, the first investments in companies are expected at the end of 2018.

TECHNOLOGY ACCELERATORS

The programme is implemented in the 2014-2020 programming period of EU funds within the framework of *activity 3.1.2.2 "Technology accelerators" of the Specific Objective 3.1.2 "To increase the number of start-ups" of the Operational Programme "Growth and Employment"*.

The programme is intended for innovative start-ups for the creation and development of a business idea, company or product to promote their growth and competitiveness, in particular for technological and industrial projects. Pre-seed funding for the establishment of a company, consultations and development, research, evaluation and approval of a product will be provided in the amount up to 50 thousand euro, and seed funding – to companies, which have successfully passed the pre-seed investment stage, for further growth, for the development of a product and economic activity model – up to 250 thousand euro. Conditions of the programme have been approved, the process of selection of financial intermediaries within the scope of the public procurement procedure has ended, agreement with financial intermediaries have been concluded and the funds have started to function. 3 acceleration funds started the implementation of acceleration programmes in the second half of 2018, as well as the first seed investments in companies have been made.

BUSINESS ANGELS CO-INVESTMENT FUND

The programme is implemented in the 2014-2020 programming period of EU funds is implemented within the framework of *activity 3.1.1.3 "Business Angels Co-investment Fund" 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"*.

Initially, it was intended to implement the programme in cooperation with EIF, however, a refusal was received from EIF on 21 November 2016 justifying it by poor development of the network of business angels in Latvia and therefore insufficient demand in the market. In order to promote activities of business angels and provide alternative financial solutions for funding of commercial banks in the market, on 17 March 2016 a cooperation agreement was concluded between ALTUM and the association Latvian Business Angel Network, within the framework of which the funding of ALTUM and business angels is combined providing opportunities to business starters to receive funding or receive it in a larger amount, when there is insufficient co-funding and security for the loan in a commercial bank. Five co-investment agreements on the ALTUM's part of funding amounting to 144.5 thousand EUR were concluded within the scope of the pilot project, which form 4.8% of the ALTUM budget available in the cooperation programme – 3 million EUR.

In addition, financially extensive venture capital investments for programmes of EU structural funds are also offered by the **Baltic Innovation Fund (BIF)**. BIF is an innovative investment initiative of the Baltic scale, which was created to increase the availability of private and venture capital funding to companies in Baltic countries. BIF finances and administers venture capital and start capital funds, which make early and growth stage venture capital investments on the Baltic scale into small and medium-sized enterprises, the investments amount from 3 to 15 million EUR per company. At present, BIF has 5 active venture capital funds, and 20 venture capital investments amounting to 96.5 million EUR are made within them.

11.2. SUPPORTING ACCESS TO FOREIGN MARKETS

To achieve Latvia's "economic breakthrough" described in the *National Development Plan* and to successfully implement the goals included into the *National Industrial Policy Guidelines*, on 17 June 2013 in accordance by CM Decree No. 249 the *Guidelines for Promotion of Export of the Latvian Goods and Services and Attraction of Foreign Investment for 2013-2019* were approved and respectively updated on 14 March 2017.

The guidelines are aimed to promote competitiveness of the economy of Latvia in the open product (goods and services) and capital markets fostering the increase in high and medium-high technology branch products in Latvian export and focusing on foreign demand-oriented sectors when attracting FDI.

Latvian exporters have access to a wide range of direct services for export support, which include consultations on issues related to export, among them consultations on foreign markets, specific trade requirements and searching for business partners. Also, seminars about export skills and informative seminars about external markets are organised, also identification and promotion of export and investment projects is implemented.

20 IDAL representations are operating for the purposes of resolution of economic matters and for provision of support to Latvian businesses, which within the scope of their competence promote export sales and attraction of investments in the most prospective sales markets for Latvian goods and services – United States, United Arab Emirates, Belarus, Denmark, France, Italy, Japan, Kazakhstan, Russia, China (Beijing, Shanghai), United Kingdom, Lithuania, Netherlands, Norway, Poland, Singapore, Finland, Germany, Sweden. These representative offices provide support for the Latvian commercial companies in creating and maintaining business contacts, and for implementation of external marketing activities, and also provide consultations on market requirements of respective foreign countries.

IDAL provides support to enterprises in taking external marketing measures, by encouraging Latvian enterprises to participate in international exhibitions using national stands, as well as by organising trade missions and participation of enterprises in foreign visits of the highest state officials of the state.

IDAL also provides direct export supporting services for enterprises, which include general consultations, information seminars on external markets and organization of external trade matters, as well as on sectoral market review, research, and information report preparation. Business forums, trade missions and individual business visits with potential cooperation partners abroad are being organized.

To strengthen and extend economic, industrial, scientific and technical cooperation, including creation of favourable conditions for cooperation between economic operators, Latvia has concluded agreements on economic cooperation with Armenia, United Arab Emirates, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Russia, Kuwait, China, Moldova, Turkmenistan, Tajikistan, Ukraine, Uzbekistan, Turkey. An Intergovernmental Commission or a United Commission was established to ensure functioning of these agreements. Their agenda includes matters of bilateral economic cooperation, which are topical for both contracting countries at the level of governments and businesses in areas like industry, travel, transport,

pharmacy, agriculture, financial services, communication, professional training, investment policy, technology and innovation, etc.

In December 2015, the implementation of the EU funds measure for 2014-2020 *Building the International Competitiveness* was launched. The aim of this measure is to build the sectoral competitiveness on the international level by supporting businesses and conquering foreign markets, ensuring operation of Latvian Foreign Economic Representative Offices, and developing Latvia's international competitiveness in the priority sectors of tourism. In this activity merchants are provided with extensive support for implementation of external marketing activities and entering external markets – support for participation in exhibitions, conferences, seminars with a stand, trade missions, state visits organised by IDAL, as well as assessment of conformity of production units and products with requirements of the particular target market.

For the fourteenth year in row the Investment and Development Agency of Latvia in cooperation with the Ministry of Economics organise the *Export and Innovation Award*. The purpose of the contest is to demonstrate the awareness and to award Latvian businesses, which achieved good results in manufacturing of new and export-capable products, supply of the domestic market with high quality home-made products, the implementation of innovations and the development of industrial design.

Joint Stock Company "Development Financial Institution "Altum"" (hereinafter referred to as Altum) also supports exporting companies enabling exporters to receive insurance (guarantees) of export transactions, thus protecting against foreign buyer's insolvency or lengthy non-payment by selling goods or providing services against deferred payment.

Since 2009 state aid totally guarantees export transactions to third countries, and from the first half of 2017 also to EU countries in the amount exceeding 155 million EUR, and 84 businesses have received this aid for 273 transactions in total. Several considerable changes have been made to promote the availability of this programme to a wider range of exporters over the last two years: the maximum amount of the export credit guarantee per one buyer has increased from 1 to 2 million EUR, requirements to exporters have been simplified, as well as from April 2017 Altum has been issuing export credit guarantees for transactions to EU and individual OECD countries, if the company meets the guarantee issuing criteria. Forecasts for the period until 2023 evidence that by supporting up to 150 companies, the guaranteed amount of export transactions might reach up to 30 million EUR per year.

11.3. FOREIGN INVESTMENT ATTRACTION POLICY

To achieve Latvia's "economic breakthrough" described in the *National Development Plan* and to successfully implement the goals included in the *National Industrial Policy Guidelines*, in 2013 the Ministry of Economics drafted the *Guidelines for Promotion of Export of the Latvian Goods and Services and Attraction of Foreign Investment for 2013-2019*. These guidelines were amended in March 2017. They described the priorities and actions to attract foreign direct investment (FDI) to export-oriented industries.

The FDI attraction policy is aimed at boosting the competitiveness of Latvia as an investment-friendly environment, taking into consideration the key aspects for investors: national macroeconomic indicators, the business environment – the simplicity of bureaucratic procedures and a stable tax policy, the availability of appropriately qualified workforce, market potential, the availability of the necessary infrastructure, the offered support instruments and incentives. It is important to attract foreign investment in sectors that allow for a change in the structure of the economy in favour of external demand-oriented¹ sectors, especially those that are defined as medium-high and high technology sectors².

FDI is an essential precondition for further growth of Latvia's economy. It enables Latvian producers not only to use additional financial capital, but also promotes acquisition of different manufacturing and management skills, creates new jobs, provides an opportunity to use new technologies and preconditions for technology transfer, promotes the state integration in the international trade and the involvement of companies in the chains of production sales. The inflow of FDI has a positive impact and development in other sectors, such as medicine, education, infrastructure.

The attraction of foreign investment should focus be based on the geographically close neighbouring countries where Latvia is recognized and no additional resources have to be invested for informative activities; on economically stable and developed countries where the development potential and needs of economy sectors are appropriate for Latvian perspective cooperation opportunities; as well as on countries with globally largest investment outflows – USA, France, Germany, United Kingdom, Japan, China, Russia, India.

Attraction and promotion of FDI is broken down into four main processes – strategy and planning (creation of the national investment policy, setting of goals, investment promotion structure, positioning of competitiveness, targeted analysis of sectors), promotion of interest (marketing and approaching companies), servicing (project

management) and provision of investment services (aftercare and improvement, monitoring of services).

Both the Ministry of Economics and the Investment and Development Agency of Latvia (IDAL) play important roles in attracting FDI in Latvia. The Ministry of Economics develops the foreign investment strategy and planning, as well as carries out proactive investment attraction by developing and generating strategically important investment projects. Proactive actions are implemented as a priority when working with companies included on the *Fortune 500* list, as well as in the area of the global business services centre (GBSC). An analysis of target industries is initially carried out and the strategic advantages of Latvia are identified and summarised, which are then further highlighted when preparing an offer for potential investors, using proactive tools like centres:

- addressing potential investors during international visits of high-level officials;
- sending individual-tailored letters and marketing materials to potential investors to deploy consider creating representative offices in Latvia, using valuable information obtained from Latvia's representative offices and embassies in their respective countries, as well as the information obtained from interviews with representatives regarding each company's objective and vision.

The activities of IDAL are focused towards servicing high-quality incoming investment projects and active operation in attracting investment projects through addressing potential investors, as well as providing aftercare services of investment projects. IDAL and its representative offices abroad provide assistance and necessary information to foreign investors, for example, in relation to the implementation of investment projects in real estate areas/special economic zones and investment promotion, as well as contact with relevant authorities at the request of investors and helps to resolve investor challenges (see Box 11.1).

In order to compete successfully on the investment attraction market and improve the progress of local and foreign investment projects which are important for the state, starting from 2010 the IDAL implements the investment attraction methodology *POLARIS process*, which provides a unified and coordinated conduct of ministries, municipalities, infrastructure companies and public companies in implementation of strategically important local and foreign investment projects, as well as involvement of the private sector, universities and scientific institutions.

¹ External demand-oriented sectors – agriculture, extractive industry, manufacturing industry, transport and storage, information and communication services.

² Medium-high and high technology sectors – manufacturing of pharmaceutical products, computers, electronic, optical equipment, aircraft and its equipment, and medical instruments, as well as

manufacturing of chemical substances, weapons, electric equipment, mechanisms and working machines, automobiles, ships, railway and other types of transport (excluding aircraft) and repairs and installation of equipment and devices (NACE version 2 20, 25.4, 27, 28, 29, 30 (excluding 30.3), 33)

The process is focused on eight priority sectors of investment attraction¹.

Taking into consideration the limited resources, the development of FDI in 2019 aims at focus activities on a small number of target countries (Nordic countries, Germany, United Kingdom) and individual target sectors (wood industry, life sciences, greentech, information technologies, including creation of global business service centres, as well as metalworking and mechanical engineering).

Depending on the area and activities, additional information and support also comes from the sectoral associations, the

Employers' Confederation of Latvia and the Latvian Chamber of Commerce and Industry, investment bankers, auditing companies, sworn advocates, consulting companies, etc.

Important marketing activities for investment attraction are regular international visits of high-level officials. Over the last few years high-level officials from the Ministry of Economics have made visits and met with potential investors in countries of vital cooperation to Latvia, like the United Kingdom, Poland, Germany, Finland, the United States of America, South Korea, Japan and China.

Box 11.1

Activity of the Investment and Development Agency of Latvia in servicing and attraction of investment projects

Servicing of incoming investment projects in 2017 was quite extensive – 353 requests for investment information were processed. Overall, 191 meetings / visits to potential investors were arranged, of which 131 meetings / visits to potential investors abroad, and 60 of them were visits to investors within the scope of post-servicing. In total, work has been carried out with 251 foreign investors, both preparing proactive investment offers for 72 foreign investors and working with 110 potential investment projects, and follow-up activities were carried out for 70 foreign investors.

In 2017, 26% of all projects were related to sectors, which cannot be included in any of the POLARIS sectors. IT is the second most important sector, constituting 11%, followed by Life sciences services (9%). Logistics/transport, services centres, metalworking and mechanical engineering constitute a significant contribution, 7% in each by the number of projects.

In total, 53% of potential investors the IDAL worked with in 2017 came from European countries. 82% of all potential investors from 2017 came from countries having representative offices of IDAL, the leading countries being the United Kingdom (10 projects or 9%), China and Germany (9 projects or 8% each). The United States of America with 8 projects or 7 per cent came next.

If all the positive decisions made in 2017 are implemented completely, the expected gain will consist of an investment of 120.75 million euro and creation of at least 1524 new jobs in total. Foreign investors served by IDAL, who have decided to start or extend their activity in Latvia in 2016-2017, have paid 15,502,750 euro in the state budget as taxes administered by SRS.

With IDAL support, in the 9 months of 2018 15 companies made positive decisions to implement investment projects in Latvia. If the investment intentions are implemented completely, the expected gain will consist of an investment of 221.5 million euro and creation of up to 1773 new jobs in total.

Information for 28 investors on potential 168 offers of 33 local governments relating to real estate as potential investment objects has been prepared in cooperation with local governments within the scope of 41 POLARIS process cooperation agreements concluded in 2017.

Until 2019 the most important activities within the scope of the IDAL business strategy in the POLARIS process focus on the preparation of more qualitative offers by local governments and strengthening of cooperation mechanisms among the parties involved in the POLARIS process drawing more active attention to investment attraction measures aimed at increasing the scope of investment:

- in manufacturing by increasing the scope of investments in machinery and equipment, as well as intellectual property products;
- in projects, where non-financial assets provide higher return;
- the purpose of which is to invest in infrastructure objects;
- by investing in productivity-enhanced projects.

The changes introduced within the scope of the tax reform as of 1 January 2018 introduced a new procedure of payment of corporate income tax (CIT). Since the beginning of 2018, the CIT rate is 20%, however, it should be paid only on the part of profit, which is distributed or paid in dividends or used for the purposes, which are not directly related to business development, while the reinvested profits are no longer applied to CIT. 0% CIT rate for reinvested profit is an important incentive for foreign investors assessing locations fit for investments.

At the beginning of 2017, the *Law on Aid for the Activities of Start-up Companies* or the Start-up Law was launched, Latvia became the first country in the world to have such a law focusing on support of start-ups. The purpose of the law is to promote the development of start-ups in Latvia and thus to promote the development of innovative commercial activity and research in the private sector, as well as the commercialization of research. Start-ups play a key role in boosting Latvia's economic growth and fostering value-added manufacturing and innovations, and foreign investors often show interest in the start-up eco-system in the

¹ Metalworking, mechanical engineering, electronics; woodworking (high value-added subsectors); manufacture of food products; transit and logistics; information technologies; healthcare; life sciences (pharmacy,

biotechnologies in the area of human health, veterinary and agricultural biotechnologies); and greentech.

country. In order to further promote the development of Latvian start-ups, the representation of Latvian start-ups was opened in the Silicon Valley at the end of 2017.

Other challenges characterising the future direction of foreign investment attraction and economic development policy relate to demographic and human capital development, a dynamic increase in production productivity and competitiveness growth, closer integration of Latvian

companies in global value chains, the development of the financial sector and effective public administration.

In addition to the already achieved results, the stakeholders, including the Ministry of Economics, are actively working on current development projects. The largest development projects include the creation of an ICT school, the creation of the Liepaja industrial park, participation of Latvia in Expo 2020 and promotion of development of global business services centres in Latvia (see Box 11.2).

Box 11.2

Development projects

ICT school

Information and communication technologies (ICT) is becoming an important precondition for the development and competitiveness of different economic sectors in the global market. Considering the overall trends in ICT, the level of ICT competence should be increased in the public and private sectors. However, forecasts show that a shortage of ICT specialists will grow in the coming years. Therefore, it is a state-level priority to extend information technology (IT) development capacity – to create an ICT school in Latvia. Currently, the Ministry of Economics is working to develop the ICT school as an internationally recognised higher education institution, which prepares 2500-3000 IT graduates every year. The school is scheduled to open by 1 September 2020.

Expo 2020

On 5 December 2017, the Cabinet of Ministers supported Latvia's participation in the international exhibition Expo 2020 Dubai, which will take place in Dubai, United Arab Emirates from 20 October 2020 to 10 April 2021. The Ministry of Economics was designated as the responsible institution, at the same asking other ministries, in accordance with their competence, to provide the necessary support for the Ministry of Economics. The Cabinet of Ministers also expressed its support to the Latvian Chamber of Commerce and Industry (LCCI) as the organiser of Latvia's participation. According to the assignment given by the Cabinet of Ministers, on 14 November 2018 the Ministry of Economics and LCCI signed an agreement on delegation of the public administration assignment – to organise Latvia's participation in Expo 2020 Dubai – to LCCI.

LCCI has already started performing this task in order to attract the exhibition's visitor's attention to the Latvian exposition and to provide them with attractive, interactive and innovative experience capable of addressing and engaging in exposition activities. The exhibition's motto is "Connecting Minds by Creating the Future", with the sub-topic being "Opportunity, Mobility and Sustainability". Latvian pavilion will be located in the "Mobility" sector. According to the initial LCCI vision it is planned to create a mobile exposition. Namely, the parts of the exposition, which can be moved, would be made in Latvia and then transported to the United Arab Emirates.

Development of global business service centres

Global business services centres (GBSC) are playing an increasingly important role in the economic growth of the Central Europe and the Baltic region. With the help of GBSC, international companies create an extensive range of business support functions in cities with competitive business environment and available human capital: data processing, accounting, finances, human resources, customer service, etc. The sector is also growing in Latvia, currently employing more than 8,000 specialists in such GBSC like SEB, DNB, Circle K, Tele2, Cabot Corporation and Evry. The Ministry of Economics continues to promote growth of the sector in a targeted way. The interests of GBSC are identified through interviews with industry specialists, by organising sessions and workshops for managers of these centres, thereby providing an understanding of the challenges facing the growing sector.

The Ministry of Economics also plays a notable role in the creation and implementation of the Memorandum concluded in April 2018, where six stakeholders – local government, public authorities and sectoral associations – have committed to build targeted cooperation in the development, growth and creation of new jobs. To promote Latvia as the destination for GBSC, the state has been represented in international GBSC events and conferences, regularly maintaining relations with international business consulting companies, which are often responsible for selecting the location of GBSC for their large clients. These and other targeted activities of the Ministry of Economics to improve the operational environment of the sector help existing GBSC to expand, as well as increase the possibility of entrance of new GBSC players.

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 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 users 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, energy efficiency improvement measures have been carried out.

The matter of increasing competitiveness of Latvian energy costs has been particularly topical in the energy sector since the beginning of 2017 paying particular attention to the promotion of competition in the natural gas supply sector, as well as the reduction of the burden of the electricity producers support mechanism or the electricity mandatory procurement component on the society.

ELECTRICITY MARKET

The full liberalisation of electricity market was completed on 1 January 2015. According to the amendments to the *Electricity Market Law* of 18 September 2014, households, just like legal users, shall freely choose a trader, agreeing on the price of electricity. Implementing the provisions of the amendments to the *Electricity Market Law* of 18 September 2014, a support instrument for protected users was introduced as of 1 January 2015 along with full opening of the electricity market.

Under the EU third legislation package on the energy market, one of the factors ensuring the optimal functioning of the electricity market is separating the network services from the production and trade activities. Electricity transmission and distribution system operators were legally separated through restructuring the vertically-integrated energy supply merchant, shares of which are owned by the Ministry of Economics – Latvenergo AS. According to the electricity trade register of the Public Utilities Regulation Commission (hereinafter referred to as the Regulator), 33 traders were registered for sale of electricity as of 21 November 2018. On 1 January 2012, Augstsprieguma tīkls AS started operating outside the Latvenergo Group as

an independent transmission system operator. Augstsprieguma tīkls AS is responsible for development of the transmission network, security of electricity transmission, stability of the power grid and quality of electricity and ensures it according to technical and economic requirements and modern technologies. The Ministry of Finance is the shareholder of Augstsprieguma tīkls AS. Assets of the transmission system are owned by Latvijas elektriskie tīkli AS, subsidiary of Latvenergo AS, which started its operation on 1 April 2011. As of 1 January 2015, all employees servicing the high-voltage network are working at Augstsprieguma tīkls AS. As of 1 July 2007, functions of the electricity distribution system operator are performed by Sadales tīkls AS, independent subsidiary of Latvenergo AS. Sadales tīkls AS ensures the supply of electricity to more than one million facilities of electricity users, covering 99% of the territory of Latvia with its service. In total, there are 11 distribution system operators working in Latvia. The main requirements for the distribution service quality are laid down in the CM *Rules on Public Power Supply Network Voltage Requirements* of 4 October 2011, which provides for mandatory application of the EU standard LVS EN 50160:2010 Voltage Characteristics of the Public Electric Supply Networks adopted in Latvia.

Full integration of electricity markets of Latvia, Lithuania and Estonia in the EU common market, both joining the Nordic electricity market and ensuring sufficient interconnections, is an important goal not only for the Baltic countries, but also at the EU level. Historically, the electricity transmission networks of Estonia, Latvia, and Lithuania are tightly integrated into the transmission networks of Belarus and Russia and are operating in a parallel, synchronous mode with them. Operational activities of the power systems are determined by the BRELL agreement entered into between the transmission systems of Belarus, Russia, Estonia, Latvia, and Lithuania. Internal electricity trading of Russia and Belarus, as well as other countries of the Commonwealth of Independent States, fluctuations and failures of their power system modes 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.

The Latvian bidding area of electricity exchange Nord Pool (NP) started its operation on 3 June 2013. Currently, NP bidding areas are opened in all three Baltic States – Estonia, Lithuania, and Latvia; and electricity trade is carried out in a uniform and consistent manner throughout the Baltic Sea region. The NP Latvian open electricity bidding area and the introduced ELSPOT day-ahead market for trading power

enables market participants to submit their quotes for transactions that will take place the following day. The next step in development of the electricity market in Latvia was the establishment of ELBAS intraday market. ELBAS market was successfully opened in Latvia on 10 December 2013. 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 ELSLOT 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 transfer capability, and transparent energy price that the market participants can rely upon.

Efficient **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 NP Estonian and Finnish bidding areas. Although the implementation of this project potentially improves the situation of ensuring the integration of Estonian and Finnish power systems, and liquidity of the Estonian and Finnish bidding areas, it does 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 NP 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 interconnection “LitPol Link” stage 1 with transmission capacity of 500 MW started its operation at the end of 2015. In addition, the Lithuanian-Swedish interconnection “NordBalt” with transmission capacity of 700 MW was established.

Before 2016 there were considerable pronounced price differences in Latvian-Lithuanian trading regions in comparison with Estonian-Finnish trading regions. Since the NordBalt cable started operation in 2016, there have been advancement to equalisation of prices in trading regions of the Baltic and Scandinavian region. This resulted in the reduction of the electricity prices in the Latvian-Lithuanian trading region.

In the coming years, one of planned priorities is also the development of electricity transmission infrastructure, which will promote closer integration of Latvia in the electricity market of the Latvian integration region. The project Kurzemes loks is implemented with the same goal, which provides for the construction of a 330 kV overhead high-voltage power line in the western part of Latvia, in order to eliminate the lack of options for increased-power connections, to ensure the development of wind farms and to increase the security of electricity supply in Kurzeme. The first stage of Kurzemes loks includes the construction of a

330 kV high-voltage line, connecting the 330 kV substation “TEC-1” of Riga with the substation “Imanta”; line construction works, including inspections, were completed on 25 September 2013. The second stage of Kurzemes loks includes construction of a 330 kV high-voltage line Grobiņa-Ventspils; design phase started in 2010, and the works were finished in 2014. The planned total length of the new 330 kV electric lines of Kurzemes loks is about 330 km, capacity – 800 MW, costs – around 220 million euro, half of which will be covered under the EC co-funding programmes. It is planned to complete the third, final stage of Kurzemes loks by the end of 2019.

Construction of the third Latvian-Estonian interconnection is also a strategically important, which will allow eliminating the existing transmission network overload and increasing the available transmission capacity of the Latvian-Estonian interconnection. The project of the third Latvian-Estonian interconnection will significantly improve the security of energy supply in the cross-section between Estonia and Latvia, as well as the power systems of both countries, ensuring an efficient power transmission corridor between the Baltic and Nordic power systems. Total costs of the third Latvian-Estonian interconnection are approximately 172.7 million euro. The total planned costs of the project in the territory of Latvia (from the 330 kV substation Riga CHP-2 to the Estonian-Latvian border) are approximately 102 million euro. In November 2014, European co-funding of 65% was granted for the construction of the third Latvian-Estonian interconnection from the Connecting Europe Facility funds. Currently, the environmental impact assessment of the project is being implemented, and the study of the planned line is being conducted. It is planned to launch the connection of the said interconnection by 2020.

In 2013, both projects – the third stage of Kurzemes loks and third Latvian-Estonian interconnection – were included in the 1st list of the European Projects of Common Interest (PCI). The PCI list is updated every two years. Accordingly, the two projects were also included in the EC’s 2nd list (2015) and the 3rd list of PCI (2017). Regulation No 347/2013 of the European Parliament and of the Council prescribes that the products included in the list of Projects of Common Interest not only may qualify for the support of the EU financial instruments, but also benefit from fast and efficient authorization procedures, while respecting the environmental assessment and protection standards. Overall, the 3rd list of PCI also includes the following projects important for the Latvian power supply infrastructure:

- internal line between Ventspils, Tume, and Imanta (Stage 3 of Kurzeme Ring);
- interconnection between Latvia and Estonia Kilingi-Nemme (EE) and Riga TEC-2 (LV) (3rd interconnection of Estonia-Latvia);
- internal line from Riga TEC-2 to Riga HPP;
- interconnection Tartu (EE) – Valmiera (LV);
- Aspects for inclusion of Baltic countries in the electric power grid of Continental Europe.

An important priority for the next years is integration of the power supply system of the Baltic States for operation in synchronous mode with the electricity systems of Continental Europe. Research results were presented at the meeting of high-level group of the Baltic energy market interconnection plan (BEMIP) on 14 September 2018, which evidenced that the synchronisation scenario, which envisages synchronisation with the existing LitPol link 1 and a new undersea direct current (HVDC) interconnection between Poland and Lithuania, is the safest and the most effective synchronisation scenario. On 19 September 2018, operators of the Baltic transmission system submitted an official letter to the operator of the Polish transmission system asking to contact the ENTSO-E Continental Europe Regional Group with an application to extend the synchronous zone of Continental Europe to include Baltic countries. On 21 September 2018 the Polish TSO submitted this application to the ENTSO-E Central Europe Regional Group. On 9 October 2018, this application was discussed at the meeting of the regional group. During the meeting a Baltic project working group for resolution of technical matters in the process of further advancement of the synchronisation process was created. The next meeting of the Central European Regional Group will be held at the end of 2018, which is planned for receiving a mandate for the Baltic project working group to start preparing a Connection Agreement for synchronisation of power grids of Baltic countries with power grids of Continental Europe, which includes both legal and technical aspects. The preparation of the agreement will require approximately 6 months.

When characterising actual operation of the electricity market in 2017, several positive trends should be noted – with active competition and favourable climatic conditions, **wholesale prices** in Baltic countries and Scandinavia in 2017 experienced a significant drop reaching 34.68 EUR/MWh in the Latvian region, which is the lowest annual average price since accession of Latvia to the Nord Pool Spot exchange. At the same time, it is important to note that despite the drop in prices, Latvian electricity producers were largely capable to keep their competitiveness, and the amount of electricity produced in Latvia in 2017 exceeded the amount consumed, amounting to 7.3 TWh of electricity, which was mainly due to climatic conditions, which contributed to competitiveness of Latvian combined heat power plants in the first 3 months of 2017, as well as high output of hydro power plants in Q4 of the year.

In 2018, the electricity market experienced considerable changes, and, as the availability of hydro resources in Scandinavian countries and the Baltics reduced, when prices of carbon dioxide emissions quotas increased, as well as due to the influence of more rapid air temperature fluctuations, the average electricity price has experienced a drastic increase in Baltic and Scandinavian countries reaching 48.94 EUR/MWh in 10 months of 2018. Production of electricity at hydroelectric power plants has reduced considerably in 2018 under the influence of hydrological conditions, however, this could still be largely compensated by the increase of output of thermal power plants, which was mainly underpinned by the increase of competitiveness in the market. In 10 months of 2018, Latvia produced 5.44 TWh of electricity in total or

about 90% of all the amount of electricity consumed in this period.

At the same time, the positive trend in 2018 were growing electricity consumption rates – about 6.02 TWh of electricity were consumed in ten months of 2018, which was about 1.8% or 0.106 TWh more than in the corresponding period of 2017. The increase in electricity consumption in 2018 is mainly related to general economic growth in Latvian economy.

NATURAL GAS MARKET

Latvian natural gas supply system is not connected to the EU's common natural gas supply system. Historically, until 2017, Latvia received natural gas from Russia only, but, along with the launch of operations of the Klaipeda LNG terminal at the beginning of 2015, Latvia has access to gas supply from Lithuania. Since the end of 2017, the share of different sources of delivery in natural gas supplies has experienced significant short-term fluctuations, and, although most of annual supplies are still made from Russia, in individual periods (for example, several weeks in May 2018) Latvian consumption was also fully secured by deliveries from the Lithuanian natural gas transmission system.

The only natural gas field in the Baltic region is located in Latvia – Inčukalns Underground Gas Storage Facility (UGSF) with the total volume of 4.3 billion m³, including the active natural gas volume of approximately 2.3 billion m³. The total natural gas consumption in 2017 was 1208 million m³. The major consumers of natural gas were the CHPPs of Latvenergo AS and heating companies. Approximately 65% of the natural gas used in Latvia is consumed in Riga region.

Since April 2017 the natural gas market has been fully liberalised, and 11 natural gas traders, in total, were actively working in the Latvian natural gas market in October 2018. In order to promote the development of competition and independence of operators of the transmission and distribution system, a legally separated natural gas transmission and distribution system operators were established as a result of reorganisation of the historical natural gas monopoly Latvijas Gāze AS – Conexus Baltic Grid AS and GASO AS. To reduce social tension, a gradual opening of the market is planned for household users, 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, in 2019 household users will retain the user status and the possibility to buy natural gas according to the tariffs set by the regulator, rather than the market price.

Wholesale prices of natural gas in the Baltic countries were historically higher than the EU average, however, according to the data of the European Commission, the prices have

considerably equalised since Q4 2017, and their level has set at an equivalent or lower level than in other EU countries¹.

According to the terms, information about the spare capacity of the transmission system and Inčukalns underground gas storage facility available on the market is publicly available on the website of Conexus Baltic Grid AS and is updated on a regular basis. In order to ensure uninterrupted operation and proper technical condition of the natural gas transmission system and storage facility, Conexus Baltic Grid AS is obliged to control the quality of gas entered into and discharged from the system, to keep relevant records and balance the natural gas transmission system, while the market participants wishing to transport natural gas are obliged to ensure the compliance of the natural gas, biogas, and gas produced from biomass, as well as liquefied natural gas converted to its gaseous form, to be entered into the transmission system with the natural gas quality characteristics established by the Cabinet of Ministers, as well as obliged to comply with the established operating modes and natural gas transportation schedule.

Further diversification of supplies 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 the most important future priorities on the natural gas market. In order to improve security of natural gas supplies in the Baltic region and to create an effective market, it is planned to implement the following projects:

- interconnection GIPL of the Lithuanian-Polish natural gas supply systems;
- regional LNG terminal project;
- Estonian-Finnish interconnection Balticconnector;
- modernisation of the Incukalns Underground Gas Storage Facility, where it is planned to modernise equipment and wells of the storage facility, as well as to considerably improve flexibility of operations of the storage facility.

12.2. PROMOTING ENERGY EFFICIENCY

The Latvian government has set² energy efficiency targets to be reached by 2020:

- the indicative national energy efficiency target – the primary energy savings in 2020 – 0.670 Mtoe (28 PJ);
- the annual saving target of 1.5% of average energy supplied to final customers – final energy savings in 2020 – 0.213 Mtoe (8.9 PJ) and total cumulative final energy savings in 2014-2020 – 0.85 Mtoe (9897 GWh);

- the annual renovation target of 3% of the state-owned building total floor area (maximum estimates – 678.5 thousand m²).

Energy savings for the final customers are promoted through financial support programmes for energy efficiency of residential, public and industrial buildings and public lighting. The measures taken by the obligated parties of the energy efficiency obligation scheme and the measures identified in mandatory energy audits and introduced by companies also play an important role in advancement to state energy efficiency targets (see Box 12.1).

Box 12.1

Energy efficiency of companies in Latvia

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 electricity consumption above 500 MWh 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 22 November 2018, 727 Latvian companies have conducted an energy audit, have introduced a certified energy management system according to ISO 50 001 or have respectively supplemented their existing environmental management system. As a result of the audit, the companies have identified the possibilities for improvement of their buildings, and for 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.

¹ https://ec.europa.eu/energy/sites/ener/files/documents/quarterly_report_on_european_gas_markets_q2_2018.pdf

² Energy Sector Development Guidelines 2016-2020 <http://polsis.mk.gov.lv/documents/5499>

By implementing energy efficiency measures in the final energy consumption and energy transformation sector, Latvia's primary energy consumption trend corresponds to the reaching of the target set for 2020. The primary energy savings as at 2016 were 0.679 Mtoe, including 0.671 Mtoe for end consumers of energy and 8 ktoe – in electricity transmission and distribution.

However, new annual energy savings lag behind the planned trend. The measures implemented in the 2014-2020 period by 2016 will allow to cumulate savings of 2060 GWh, which is about 1/3 of the necessary saving. Therefore, in 2019, it is planned to improve the energy efficiency monitoring system, as well as to propose additional measures to reach the target.

In 2018, EU Member States agreed that they should increase energy efficiency by 32.5% by 2030. Therefore, each

Member State should contribute to reaching of this target, as well as apply the horizontal principle "energy efficiency first" in its development planning.

The co-funding from EU funds intended for support measures for the implementation of energy efficiency measures in the 2014-2020 EU funds programming period is 333 million euro (see Figure 12.1). Support programmes for improvement of energy efficiency in multi-apartment houses, public or state-owned buildings, production buildings, as well as in centralised heating systems have been implemented since 2016. 656 project applications for funding from funds amounting to 190 million euro have been submitted within the scope of these support programmes since 2016 (see Box 12.2).

Box 12.2

Support Programmes for Improvement of Energy Efficiency

Energy efficiency programme for multi-apartment buildings:

- 403 projects requesting ERDF funding of 65 million euro were submitted to the Development financing institution Altum;
- 152 positive decisions on granting of grants were taken;
- the implementation of 26 project has completed, 98 projects are being implemented, incl. at the construction stage;
- 8 Altum loans for 1.3 million euro were issued;
- 79 guarantees for 11 million euro were granted.

Average indicators of projects:

- the average energy consumption reduction in homes – 67%;
- the annual average energy consumption for a renewed house – 54 kWh/ m².

Annual energy saving in submitted projects:

- annual consumed heating energy reduction - 24.3 MWh/ m²;
- annual CO₂ reduction – 412 thousand tons.

Energy efficiency programme for public buildings:

- 90 project applications requesting ERDF funding of 56.6 million euro were received;
- the implementation of 4 projects requesting ERDF funding of 0.8 million euro has been completed;
- the total area of state-owned buildings, which will be renewed within projects – 115,162 m²;
- the annual average energy consumption of the buildings after a year of implementation of the project – 110 kWh/ m².

Energy efficiency programme for manufacturing industry:

- 56 project applications requesting Cohesion Fund funding of 14.5 million euro were submitted;
- 24 agreements for Cohesion Fund funding of 6.2 million euro were concluded;
- the implementation of 8 projects for Cohesion Fund funding of 3.1 million euro has been completed;
- 32 projects are still under evaluation.

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

- annual energy savings – 84 GWh;
- installed capacity of renewable energy sources (heating boilers + solar collectors) – 9 MW;
- annual CO₂ reduction – 6.6 thousand tons.

Energy efficiency programme for district heating system:

- 107 project applications requesting Cohesion Fund funding of 53.6 million euro were received;
- 88 agreements for Cohesion Fund funding of 44.7 million euro were concluded;
- the implementation of 1 project for Cohesion Fund funding of 116 thousand euro has been completed;
- 32 projects are still under evaluation.

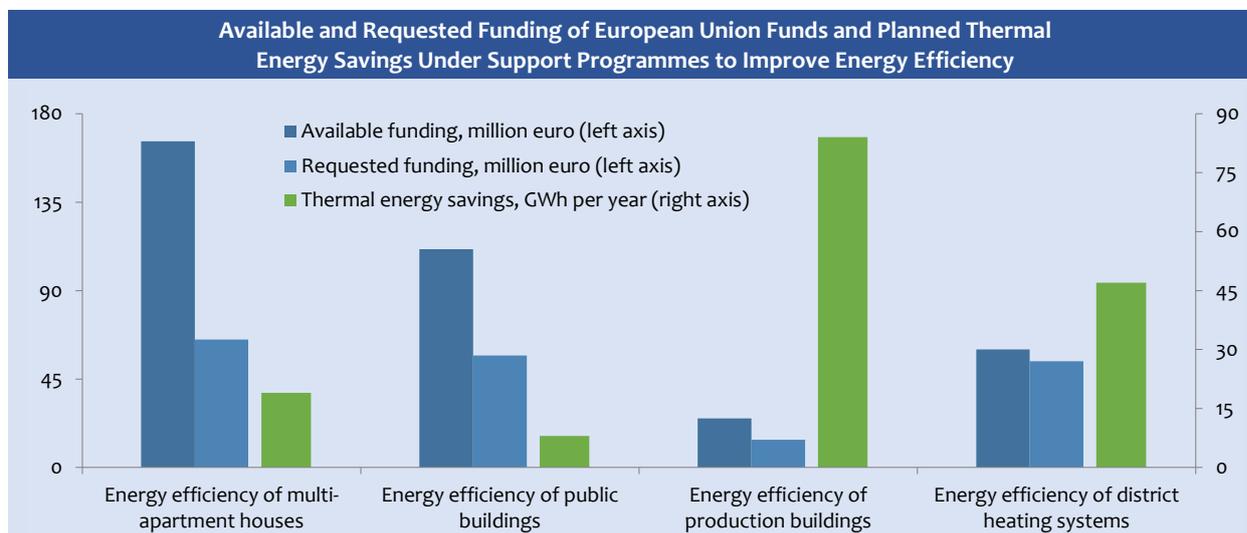
The following indicators will be achieved within the framework of approved projects:

- additional installed capacity of renewable energy sources – 5.4 MW;
- reconstructed production capacity– 215 MW;
- reconstructed heating networks – 60 km;
- annual reduction in heating energy losses in reconstructed heating networks – 47 GWh;
- annual CO₂ reduction – 142 thousand tons.

Support programmes for improvement of energy efficiency provide an important contribution to the achievement of Latvian energy and energy efficiency targets (see Figure 12.1). It is planned that the received project applications will provide consumed energy saving of at least 158 GWh per

year. It should also be mentioned that not all the available funding was requested within the scope of projects submitted for the support programme, therefore, the planned saving will increase along with the number of submitted projects.

Figure 12.1



12.3. ENERGY FROM RENEWABLE SOURCES

The *National Reform Programme of Latvia for the implementation of Europe 2020 strategy* (see section 8.1) sets national targets to achieve a 40% share of renewable energy in the gross final energy consumption and a 10% share in the final energy consumption in the transport sector in 2020.

In 2014, share of renewable energy in gross energy consumption reached 38.65%, which was the highest indicator so far, while in 2016 it reduced to 37.16%. In the transport sector it has decreased from 3.92% in 2015 to 2.76% in 2016.

Fuel wood (firewood, fuel chips, pellets, etc.) is the renewable energy source used the most commonly in Latvia (hereinafter referred to as RES). However, its share in RES consumption has reduced by 4.4 percentage points in five years, reaching 74 per cent in 2017.

The consumption of biogas keeps growing (gas from waste landfills, sewerage sludge gas, other biogas) – it increased by 44.7% over five years reaching 3.9 PJ in 2017. In 2017, Latvia produced 5,461 GWh of electricity from RES, and the amount produced from RES increased by 56.8% in comparison with 2016. Hydro power plants (HPP) produced 4381 GWh, but wind power plants 150 GWh. The increase in electricity production last year was most affected by high output of HPPs, which is explained by untypically high amount of precipitation and large inflow of water to

Daugava. Electricity produced at biomass power plants and cogeneration plants increased from 215 to 525 GWh and at biogas cogeneration stations – from 288 to 405 GWh over five years.

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.

The Ministry of Economics is constantly reviewing and searching for solutions for the improvement of the existing support mechanism, and its policy has been aimed at the reduction of the mandatory procurement component (MPC) for end users of electricity. In the period from 2014 to 2017, MPC was kept at the level of 26.79 EUR/MWh, while from 1 July 2018 it has reduced to 22.68 EUR/MWh.

In order to promote competitiveness of energy-intensive manufacturing companies at export markets, from 2017 industry companies are entitled to reduced participation in the MPC payment.

The Ministry of Economics has been gradually promoting the development of self-consumption of electricity by improving the NET accounting system created on 1 January 2014¹, which is now offered to household for production of electricity for their own needs from RES, for example, using solar panels or wind turbines for this purpose. The NET system enables to transfer excessive electricity produced to the power grid and use it, when necessary.

RENEWABLE ENERGY IN TRANSPORT

In order to promote an increase in renewable energy share in the transport sector, amendments to *the Law on Pollution* entered into force on 6 March 2018, which oblige fuel suppliers to reduce the life cycle greenhouse gas emission per one supplied transport energy unit by 2020 by 6% compared to the level of 2010. On 25 September 2018, Cabinet Regulations No.597 "Procedure of calculation and reporting of the amount of transport energy life cycle greenhouse gas emissions and its reduction" were adopted.

The Draft Law on Transport Energy is drafted to promote the use of alternative fuels in transport and the development of alternative fuel infrastructure by strengthening

supervision of the transport energy market and promoting public awareness of available and usable transport energy types, as well as foster sustainable economic development and limit climate change.

RENEWABLE ENERGY SOURCES USE TARGETS BY 2030

A binding 32% RES share target for 2030 is set at the EU level, which should be reached by all countries, making their contribution, and national targets cannot be smaller than for year 2020. Latvia along with other EU Member States should ensure 14% RES shares in energy consumption in the transport sector in 2030. Moreover, the share of modern biofuels should constitute 0.2 percentage points of this target in 2022, and 3.5 percentage points in 2030. Furthermore, the share of first-generation biofuels (produced from raw materials intended for food) in 2030 should not exceed the level of 2020 by more than 1 percentage point in the respective Member State and should in no way exceed 7 percentage points of the RES share in transport.

12.4. REDUCING GREENHOUSE GAS EMISSIONS

Climate has changed faster over the last decades in the history of instrument meteorological observations, and it is expected that the temperature will increase even faster in the 21st century having a bigger effect on the society in general and different sectors and national economy sectors.

Individual policies in national economy sectors are implemented to reduce greenhouse gas emissions (hereinafter referred to as GHG) in Latvia – promotion of use of renewable energy sources, improvement of energy efficiency, promotion of electrical mobility, measures to reduce the use of fossil fuels, extraction and use of biogas, etc. (see Box 12.3).

According to the GHG inventory of 2018 for years 1990-2016² and the approximate GHG inventory for 2017³ Latvia's total GHG emissions from 1990 to 2016 and until 2017 reduced by 57.3% and 57.4%, respectively, while in the period from 2005 to 2016 and in 2017 Latvia's total GHG emissions reduced by 1.3% and 1.6%, respectively. Latvia's total GHG emissions in 2016 amounted to 11,306.39 kt CO₂ eqv, but approximate GHG emissions in 2017 – 11,275.43 kt CO₂ eqv.

In 2016, GHG emissions from non-ETS activities dominated in the Latvia's total GHG emissions – 80.6%. The approximate share of GHG emissions of non-ETS activities in Latvia's total GHG emissions in 2017 is even higher –

81.8 %. GHG emissions generated by Latvian ETS operators amounted to 2,197 kt CO₂ eqv. in 2016, and 2,049.8 kt CO₂ eqv. in 2017, or 19.4% or 18.2%, respectively, of Latvia's total GHG emissions.

The GHG emissions dynamics of non-ETS activities (see Figure 12.2) currently evidences of an increase in emissions – 5.9% increase in 2005-2016 and an increase by 7.2% in 2005-2017. Overall, until 2017 Latvia was within the annual targets set for non-ETS activities in the *Effort Sharing Decision*. Latvian ETS operators had reduced their GHG emissions by 23% before 2016 and by 28.2% before 2017, in comparison with 2005, thus significantly exceeding the Latvian national ETS emissions reduction target for 2020.

In 2016, the energy sector was the largest source of GHG emissions, creating 64% of Latvia's total GHG emissions. Most of emissions from fuel combustion are generated by the transport sector – 44.2%. Emissions of the energy sector reduced by 62.7% in 2016 in comparison with 1990, and by 10 percent in comparison with 2005.

Agriculture is the second largest emissions sector in the Latvian GHG inventory, which generated 23.6% of Latvia's total GHG emissions in 2016. Non-ETS emissions from waste management constituted 6.4% of the total GHG emissions in 2016.

¹ Evaluation and proposals for improvement of the net electricity system https://em.gov.lv/lv/nozares_politika/atjaunojama_enerģija_un_kogeneracija/statistika_un_petijumi/

² http://cdr.eionet.europa.eu/lv/eu/mmr/arto7_inventory/ghg_inventory/envwu6qfa/

³ http://cdr.eionet.europa.eu/lv/eu/mmr/arto8_proxy/envw07vaw/

Box 12.3

Reducing GHG Emissions in Latvia

Latvia’s political goals in terms of climate relate 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 broken down into two parts – the activities included in EU Emissions Trading System (hereinafter referred to as EU ETS) and the activities not included in EU Emissions Trading System (hereinafter referred to as non-ETS). Common targets set by the EU:

- EU ETS operators should jointly reduce the amount of GHG emissions by 21% until 2020 and by 43% by 2030 (in comparison with the amount of GHG emissions of EU ETS operators in 2005);
- the total amount of non-ETS GHG emission within the EU should reduce by 10% by 2020 and by 30% by 2030 (in comparison with the amount of GHG emissions of non-ETS operators in 2005).

The organisation of fulfilment of the **EU-ETS target** is responsibility of the European Commission. ETS operation conditions have been approved for the fulfilment of this target and responsibility of operators has been set with EU regulations. Measures for reduction of the amount of GHG emissions of 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.

Non-ETS GHG emissions reduction target fulfilment liabilities are shared by all EU Member States, incl. Latvia. For the period from 2013 to 2020 the target of each EU Member State and its fulfilment conditions are expressed with the so-called *Effort Sharing Decision*, and for the period from 2021 to 2030 – with the so-called *Effort Sharing Regulation*.

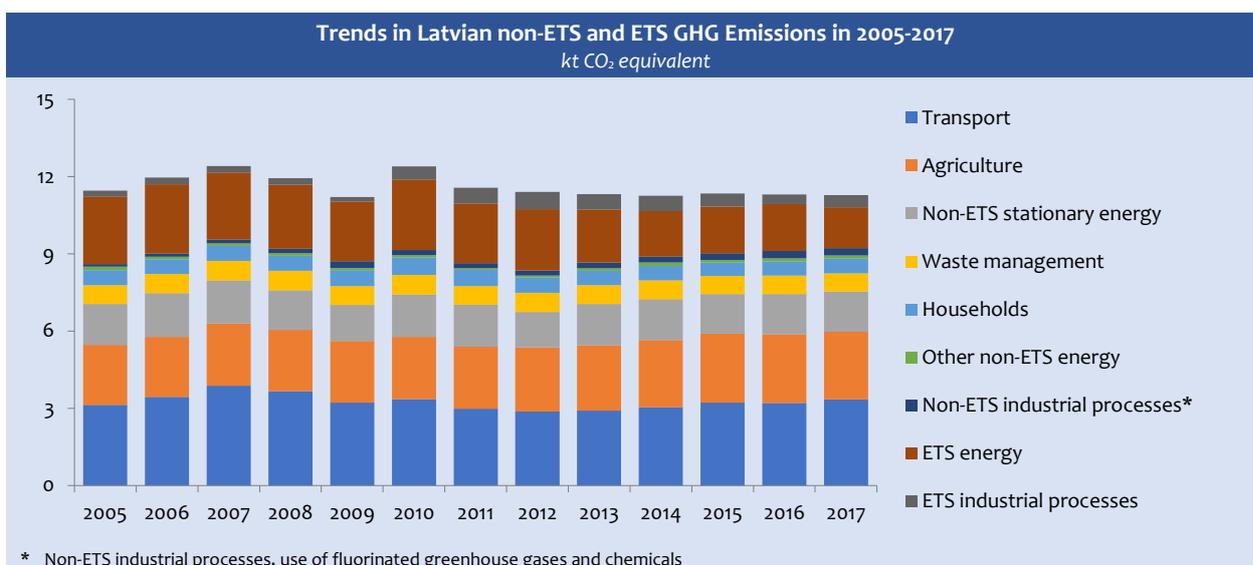
In the period from 2013 to 2020 Latvia is allowed to increase the amount of Latvia’s non-ETS GHG emissions by no more than 17 percent.

In the period from 2021 to 2030 Latvia should reduce GHG emissions from non-ETS activities by 6% in comparison with 2005. The total target of the period is broken down into annual binding targets.

At present, Latvia is drafting the *National Energy and Climate Plan 2021-2030*, which will set the main action policies and measures for the fulfilment of GHG emissions reduction targets, as well as in other dimensions of the energy union, which also affect the volume of GHG emissions – ensuring of the share of renewable energy sources and fulfilment of energy efficiency improvement targets.

At the same time, MoEPRD is drafting the *Low-Carbon Development Strategy of Latvia 2050*, the Ministry of Transport is preparing an *Evaluation of scenarios of implementation of alternative fuel infrastructure* to determine the most effective measures, which would, among other things, ensure also a reduction in GHG emissions from transport activities, while the Ministry of Agriculture has drafted the *Bioeconomy Strategy of Latvia*.

Figure 12.2



¹ In accordance with Proposal for a Regulation of the European Parliament and of the Council on the Governance of the Energy Union, amending Directive 94/22/EC, Directive 98/70/EC, Directive 2009/31/EC, Regulation (EC) No

663/2009, Regulation (EC) No 715/2009, Directive 2009/73/EC, Council Directive 2009/119/EC, Directive 2010/31/EU, Directive 2012/27/EU, Directive 2013/30/EU and Council Directive (EU) 2015/652 and repealing Regulation (EU) No 525/2013

13. CONSTRUCTION POLICY

A new *Construction Law* entered into force in the **construction sector** on 1 October 2014, the purpose of which was to create a contemporary and modern legal regulation for the construction process, as well as to foster opportunities of society to cooperate in decision-making, ensuring balanced protection of the initiator of construction and protection of public interests. At the same time, Cabinet regulations related to the new construction regulation were approved, which considerably change the procedure of construction, making a special emphasis on the process of organisation of construction works and responsibility of the parties involved. Several important changes were included in the construction regulations, which would allow to organise and ensure the construction process faster, more effectively and with more responsibility, at the same time fostering security and quality.

State control in construction was resumed in 2014. The State Construction Control Bureau (SCCB) was established pursuant to provisions of the *Construction Law*, which ensures control of construction works by the state and commissioning of structures, for example, new public buildings, where more than 100 persons will stay at once, in case of construction and reconstruction. SCCB is competent to control the use of public buildings and granting independent practice rights in expertise.

The construction sector itself is involved in the development of construction regulation and arrangement of the construction sphere. A **Latvian Construction Council** was established under MoE, where 15 representatives of non-governmental organisations representing the construction sector, as well as responsible ministries and the Latvian Association of Local and Regional Governments are delegated¹.

A cooperation *Memorandum for combatting shadow economy in the construction sector, as well as for improvement of the sector and promotion of development* between responsible members of the Cabinet of Ministers and representatives of the construction sector (hereinafter referred to as the Memorandum) was signed on 31 May 2016. The Memorandum contains priority tasks for 2016–2018. It not only defines specific measures, but also serves as a certification of interest of the parties involved in the arrangement of the sector. The most important areas, on resolution of which the parties agreed by signing the Memorandum, is the need to take controlled measures to increase production volumes, especially for export, reduce shadow economy, increase competitiveness, as well as improve security and quality in construction. The most important task set in the Memorandum is to conclude a *Collective Agreement on minimum wage levels in construction professions*. It is expected that the Collective Agreement will enter into force in 2019. The Collective

Agreement envisages a significant increase in minimum wages in the construction sector. In October 2018, the Partnership of Latvian Construction Entrepreneurs collected the necessary number of signatures for the conclusion of **the Collective Agreement** in the construction sector, envisaging to set the minimum gross wage of 780 euro in construction. Provisions of the Collective Agreement become binding for the entire sector in 6 months of their official publication in *Latvijas Vēstnesis*.

In fulfilment of the tasks included in the Memorandum:

- electronic registration of working hours in construction was introduced in 2017. This is applicable not only to public procurements, but also to construction of new structures of the third group or any construction works costing 1 million or more. The introduction of electronic registration of working hours of workers employed on a construction site will provide objective information to controlling authorities on the hours worked on the construction site by workers. In combination with the Collective Agreement on minimum wage rates for persons employed in groups of professions in construction it becomes the most effective tool for combatting shadow economy;
- On 17 May 2017, the Latvian Construction Council approved the code of conduct for the sector and created an Ethical Commission for the Construction Sector, has drafted guidelines for evaluation of the most economically advantageous tender in public procurements for construction works, design and combined design and construction works;
- An extensive *Building Information System Development Project* was started in 2017 with a transition to a completely electronic construction administrative process.

In 2017, the Latvian Construction Council approved the *Construction Sector Development Strategy 2017-2024*, which combines interests and needs of the sector and public administration, as well as sets goals and priority measures of the sector for balanced development of the sector. The main task of the strategy is to determine a uniform policy for sustainable and competitive development of the Latvian construction sector.

In order to achieve the development vision of the Latvian construction sector, the Latvian Construction Council has defined strategic development goals for the sector:

- to reduce bureaucracy in construction regulation, reducing by 50% the total process period and

¹ The Latvian Construction Council is an advisory organisation, the purpose of activity of which is to make proposals for draft laws and regulations and draft policy planning documents, as well as draft EU international

laws and regulations affecting the construction sector according to community's interests. The Latvian Construction Council also provides feedback to participants of the construction process.

- digitalising solutions, thus ensuring more effective construction process;
- to triple productivity of the sector to reach the average indicator of TOP 10 EU Member States;
 - to increase turnover of the construction sector from current 1.5 billion EUR per year to up to 3 billion EUR per year;
 - to improve the system of education and professional qualification of construction specialists achieving that
- highly qualified specialists are available in each construction profession;
- to improve the quality of construction services at the same time creating a single system of quality management.
- Significant improvements have been made in the normative regulation of the construction process in recent years, paying considerable attention to the reduction of administrative burden (see Box 13.1).

Box 13.1**Improvements in the normative regulation of the construction process**

Amendments to the *Construction Law* entered into force in 2017, which simplified making of changes in the construction concept. By these amendments it was defined that the only changes, which are prohibited, are changes to the main type of use of the structure, and it was also defined that only changes to the location of the structure, scope of construction and the façade solution, as well as additional structures should be coordinated with the construction board. Other changes do not need coordination with the construction board. The procedure of coordination of deviations and alternative solutions was also updated, defining institutions and cases, when deviations and alternative solutions can be coordinated.

On 1 March 2017 amendments to Cabinet Regulations No. 529 of 2 September 2014 “Construction Regulations for Buildings” entered into force. The cases, when construction concept documentation was not necessary were supplemented, for example, when the outer door of the building is changed, when external stairs and porches are renewed, when façade finishing, and roofing is painted and in other specified cases such construction works will not require a separate coordination with the construction board. The regulations also envisage in which cases the construction of a seasonal building may be performed without construction concept documentation, other easements are intended.

On 6 June 2017, Cabinet Regulations No.253 of 9 May 2017 “Construction Regulations for Separate Engineering Structures” entered into force, which, unlike in the previous respective construction regulations, provide that in order to commission a structure, no cadastral measurement file is requested, it is permitted to use the existing topographic information in designing, as well as construction of individual structures outside the public space has been simplified.

On 24 November 2017 amendments to Cabinet Regulations No. 156 of 25 March 2014 “Procedure of market surveillance of construction products” entered into force, which allowed using in construction works of prestressing steel, which obtained an assessment of conformity with the standard of Member States of the European Economic Area and meet the minimum requirements set in the regulations, thus each such batch does not require an evaluation of such prestressing.

In accordance with the National implementation plan of *Eurocode* standards, a transition to *Eurocode* standards is ensured in designing of building structures from 1 June 2015. Overall, 58 *Eurocode* basic standards, amendments and supplements to the standards have been translated and registered in the Latvian National standard, as well as eight Latvian construction standards for designing of building structures have also been issued.

In 2017 and 2018 construction standards in the area of energy efficiency, fire safety, water supply and sewage were reviewed. In order to promote multi-storey wooden construction, amendments to the Latvian construction code LBN 201-15 “Fire Safety of Structures” were approved to promote the use of wooden construction products in construction of new buildings, increasing the floor level mark of the highest floor of the structure to 18 m (earlier up to 8 m) and construction of up to 6-storey (previously up to 3-storey) new residential and public buildings. These amendments entered into force on 1 May 2017. Construction codes for heating and ventilation of residential and public buildings, as well as construction climatology are recast.

In order to ensure the evaluation of competence of construction specialists according to the new construction regulation and supervision of independent practice in engineering research, designing, management of construction works and construction supervision, order was issued in accordance with the requirements of regulatory enactments, which delegated these functions to eight institutions for verification of competence of construction specialists. On 20 March 2018, the Cabinet of Ministers approved new regulations No.169 “Rules of Evaluation of Competence of Construction Specialists and Supervision of Independent Practice”, which considerably improve the regulation in the area of certification of construction specialists, criteria for practical work experience requirements to candidates for a certificate of a construction specialists were defined, the procedure of maintenance of an independent practice was updated, the criteria for warning, suspension and annulment of the sphere of effect of the certificate were clarified, the requirements was set for the construction specialist to maintain in force the existing agreement with the National standardization institution on subscription of necessary Latvian national standards, which are necessary for the fulfilment of daily duties.

From 2019, the National standardization institution Latvijas Standarts SIA will provide construction specialists with a reading room with standards with access to standards without an additional fee, authorised online reading of Latvian standards in 24/7 regime on www.lvs.lv from any internet connection and any device: computer, smartphone, tablet.

Box 13.1 continued

On 12 April 2016, Cabinet Regulations No.211 “Rules of classification of construction merchants” were adopted to ensure an open, unified system for the evaluation of providers of construction services for public funding and selection of performers of construction works with a professional classification corresponding to the construction concept. Professional abilities and competences, financial and sustainability indicators, including violations in professional activity, if any, will be taken into account in the process of classification. The classification of construction merchants will be one of tenderer selection criteria in public procurements.

In order to ensure an effective construction process, amendments to the construction regulation were developed and entered into force in 2018, which reduce the administrative burden, introduce digitalised solutions, accelerate the time for coordination of the construction concept. The new LBN 202-18 “Presentation of construction concept documentation” set requirements in relation to electronic preparation of the construction concept, ensuring uniform requirements to presentation of construction documentation in writing and in an online form as structured data, introducing digital circulation of construction concept documentation. Amendments to general and special construction regulations have been developed and adopted in order to remove obstacles in the electronic process of coordination of construction concepts.

In order to foster the implementation of projects of structural funds to increase energy efficiency of multi-apartment residential buildings and renewal of these buildings, as well as to simplify the construction process and reduce the administrative burden, Cabinet Regulations No.529 “Construction regulations for buildings” of 2 September 2014 were amended in 2018. The period, during which construction can be implemented after an acceptance by the construction board in the façade certification card or a note in the construction permit on the fulfilment of designing conditions was extended to 5 years. Earlier, this period was three and two years.

In order to improve control of use of buildings, amendments to LBN 405-15 “Technical inspection of structures” were made in 2018, which set out an obligation to the performer of technical inspection in case of additional duties, if insufficient mechanical strength and stability of the building is indicated in the technical inspection report. The construction specialist or the construction merchant, who ensures technical inspection of a structure, will have the duty to inform the construction board, the institution fulfilling functions of the construction board by submitting a technical inspection report of the building.

Amendments to the *Construction Law* have been prepared, which affect several matters such as:

- allocation of responsibility and competence – it is envisaged to amend competence of the construction board and the SCCB, as well as to clearly define responsibility of each member of the construction process. It is intended to introduce the tacit consent principle;
- insurance – it is planned to revise and introduce an effective insurance mechanism to protect interests of third parties, as well as improve insurance of participants of the construction process;
- building technicians will keep their rights (without time restrictions) to conduct an engineering research, manage construction works and carry out construction supervision, while construction engineers (first level higher education) will conduct engineering research. It is also planned to extend the restrictions set for education, allowing to use the modular education system;
- it is planned to clarify the regulation with regard to persons, which should register in the Register of Construction Merchants – acousticians, restorers, as well as other changes to improve the construction regulation.

Significant improvements have been reached in recent years in the area of **digitalisation of the construction sector**.

On 31 December 2015 the ERDF project “Development of a construction information system” was completed, which initially merged several registers of the construction sector. The *Building Information System Development Project* was started in 2017, which intended to improve examination and coordination of construction concepts and construction projects,

ensuring electronic coordination with the parties defined in regulatory enactments, improvement of supervision of the construction process, supervision of use of buildings, improvement of reports and information analytics modules, improvement of management of data of construction merchants and construction specialists, and so on.

On 1 July 2018, stage 1 of the *Building Information System Development Project* and the functionality of electronic coordination and acceptance of construction proposal and construction concept documentation, which provides the possibility to coordinate the entire construction concept from the application to the commencement of construction works electronically, considerably reducing the deadlines ensuring reception of different coordinations in parallel. An electronic process will also allow to track the stage of the concept, thus making the process transparent.

In order to foster full transition to an electronic process, a new functionality was developed in the Building Information System in 2018, which will allow the proposer of construction to “move” from a paper process to an electronic process at any stage of the construction process. Thus, also the processes, which were stated on paper, can be continued electronically.

At the same time, MoE has prepared amendments to the *Construction Law*, which envisaged a transition to an electronic process of coordination of construction proposal and construction concept starting from 2019. It is intended that the local government will be able to use binding regulations to set a transition period for the implementation of an electronic construction concept coordination process in its territory, however, no longer than one year. The *Saeima* was adopted in the 1st reading on 1 November 2018.

At the same time, within the framework of the *Building Information System Development Project* work is ongoing on

further improvements – improvement of functionality for control of construction works, commissioning of the structure. It will be possible to submit necessary documents for commissioning of a structure and receive reports from responsible authorities in the Construction Information System.

Within the scope of the *Building Information System Development Project* by 31 December 2019 it is planned to considerably improve functionality of the system to support the process of supervision of the process of certification of construction specialists and independent practice of certified construction specialists. The CIS will be able to get information from higher education institutions, provide certification bodies with information on construction files of construction specialists, as well as information about complaints on certified construction specialists and violations stated in their operations, it is intended that it will be possible to read practice data from logs of construction works, improve information selection options, as well as improve the reminder functionality to support the process of supervision of construction specialists.

Within the scope of round 2 of the ERDF project for the development of BIS it is planned to extend CIS functionality to improve BIS in such a way that it would serve as a single platform for management of the lifecycle of any structure from the concept to the end of use, as well as would lay a stable foundation for the implementation of **Building Information Modelling (BIM)** processes in Latvia, providing a necessary platform from the state information system.

The Ministry of Economics and the State Construction Control Bureau are working with construction boards of local governments introducing electronic construction processes, as well as provide them with necessary support.

In order to promote the quality of construction and productivity of the sector, make construction predictable in terms of costs and time, work has started on the BIM implementation “roadmap”, where the main priorities are drafting of standards and guidelines initially concentrating on the development of construction projects for public procurements in BIM, and improvement of competences of construction specialists in work with digital tools. BIM is a process, in which a digital three-dimensional structure is created with added information about its elements, therefore, all the parties involved, including the contracting authority, the designer and the construction merchant, will be able to see from the very beginning of development of the construction project, what the final result will be, this will allow to notice and pay attention to errors in the project before construction starts, to calculate the necessary amount of construction materials more accurately, which may result in a reduction of total costs of construction materials and the amount of waste during construction, which makes BIM one of the most efficient tools for the development of environmentally friendly and sustainable construction. BIM models may also be used in management and maintenance, as well as supervision of buildings, because the information available in the BIM model simplifies performance of these activities, as well as reduces their costs considerably.

The **functional analysis of the structure of classification of the construction sector** has been carried out in cooperation with the Sectoral Expert Council of the Construction Sector (SEC) in accordance with European Qualification Framework – within the scope of the EU funds project “Development of a sectoral qualifications system and improvement of the efficiency and quality of vocational education”. A review of professions of the construction sectors, including a review of regulated professions, has been carried out and the *Map of construction professions* has been created in accordance with professional qualification levels. The Latvian Construction Council representing the largest bodies for certification of construction specialists, having studied the functional analysis of the structure of qualifications of the construction sector and having discussed it with SEC representatives, has concluded that standards on regulated professions are incomplete, outdated and no longer meet the EU qualification requirements. In order to promote the improvement of education programmes of education institutions involved in the preparation of specialists in regulated professions of the construction sector and improvement of qualifications of specialists, support to professional organisations in drafting of standards on new professions will be provided by the sector in the coming years.

The first study on **expected changes in the labour market and costs of construction materials in the construction sector** in Latvia was carried out in 2018. As a result of combined statistical and expert evaluation forecasts it was concluded that the total volume of construction products will increase by 14.09% per year on average and construction costs will increase by 4.31% per year on average in the period from 2018 to 2022. The main factors, which, in the experts’ opinion, will affect the total increase in construction costs in the period of the forecasts, are the volume of construction products, the level of wages of labour force in EU countries in the construction sector, the annual average electricity price in the country. Such studies will also be carried out in the next years to provide forecasts on changes in costs of labour force and construction materials.

In order to create a sustainable quality monitoring system of services in the Latvian construction sector, which would create an objective system of quality measurements in the process and all sub-processes of the construction sectors, the first study for the development of the *Methodology for the index of quality and measurements in the Latvian Construction sector* and for the preparation and testing of a survey tool (questionnaire) was carried out in 2018 to further learn in a systematic matter opinions of participants of the sector, summarise conclusions, draft justified proposals for improvements and constantly improve the quality and efficiency of the construction regulation and processes. The results of the monitoring system will create a new opportunity for service providers in the sector to compare the quality of their individual services with quality levels of stages of processes in the sector and will promote improvements in competitiveness of service providers, as well as will provide a deep insight in progress of each stage of the construction process. Quality measurements in accordance with the drafted methodology will be carried out on a regular basis.

14. HOUSING POLICY

At present, one of the most pressing challenges in the housing policy area in Latvia is ensuring housing affordability. The opportunity to live in a qualitative home for affordable prices would have to be perceived as the fundamental need, and this is one of the most important factors in reaching several social policy goals, including promotion of equal opportunities, social integration and mobility.

In their studies, OECD emphasize that well-functioning housing market fosters labour mobility, which, in turn, ensures effective distribution of human resources and workplaces within the labour market.¹

The Latvia's current housing facilities are considerably outdated, which increases their maintenance costs, and if income of households does not increase, its renewal prospects become even more remote. 45% of all the multi-apartment buildings in Latvia were built before 1941, and 53% of all the Latvia's residential facilities were built in 1961-1992, while the share of new multi-apartment residential houses built after 1993 is only 2%.² 2.9 million m² of living spaces were built in 2010-2016. At present, the renewal of multi-apartment residential facilities in Latvia is very slow, only 0.2% of the total number of apartments are built during a year (1.06 million m²). The largest share is observed in Pierīga – 1.64 million m² (56.2%) and in Rīga – 0.65 million m² (22.2%), while other regions show low activity.

Currently there is lack of rental housing in economically active regions due to long-term shortage of funding.

The main directions for resolution of the situation are:

- promotion affordability of rental housing to households;
- drafting of a legal framework for rental and amendments to the Civil Procedure Law;
- implementation of a housing support programme for acquisition of housing.

AFFORDABILITY OF RENTAL HOUSING TO HOUSEHOLDS

In accordance with Eurostat data, only 7.9 percent of the population in Latvia in 2017 rented an apartment for a market price.

In order to determine the availability of rental apartments in a building meeting construction and energy efficiency requirements, in 2018 the Ministry of Economics conducted a market survey aiming to learn costs of 50 m² apartment

for a household. It showed that the number of cases, when real estate developers offered apartments in a new rental project, was very limited, for example, several real estate developers do not offer rental apartments in new projects. In order to rent a 50 m² apartment paying utility and management payments households must cover costs of 450-530 euros.

Households total expenditure on housing should not exceed 30 % of its disposable income. In accordance with the survey and calculations made by the Ministry of Economics, for a household to be able to rent an apartment meeting construction and energy efficiency requirements, observing the above-mentioned proportion of costs for housing in the available income, household income would have to be starting from 1600 euros.

In OECD member states, the average indicator of household expenses on housing from total household income was 23%.³ Assuming that housing expenses should not exceed 30% of household income⁴, in accordance with the survey and calculations done by the Ministry of Economics, 80% of households are denied the possibility to rent a housing meeting construction and energy efficiency requirements, because their income is lower than 1600 euros per month. In addition, it should be taken into account that income of 50% of households in Latvia does not exceed 700 euros per month, so half of Latvian households would have to double their monthly income to be able to rent a housing that meets construction standards and energy efficiency requirements.

The availability of affordable housing is also emphasized in OECD Economic Survey about Latvia, where in comparison to the average in OECD countries, Latvia is one of the lowest indicators regarding welfare of citizens, especially in two categories: income and the availability of rental housing. Also, Latvia has the highest share of population whose net income is below the poverty threshold, therefore, many households with low income are insufficiently provided with housing.⁵

It should be pointed out that at present, the private sector is not interested to invest in construction of rental housing, because, taking into account high construction costs and the investment pay-off period expected by the developer, the rent in newly constructed housing exceeds the average rent payment level in the local government and payment capacity of the population living in regions. It is clearly demonstrated by the above-mentioned statistics on about the area of the newly built apartments from 2010 to 2016, where 78.4% of the newly built apartments, by floorspace, are constructed in Rīga and Pierīga.

¹ D.Andrews, A.Caldera Sanchez, A.Johansson. OECD Economics Department Working Papers No. 836 "Housing Markets and Structural Policies in OECD countries", (2011)

² State Cadastral Information System

³ Affordable Housing database - HC1.1 HOUSING-RELATED EXPENDITURE OF HOUSEHOLDS

⁴ Alice Pittinii, HOUSING AFFORDABILITY IN THE EU Current situation and recent trends (2012) CECODHAS

⁵ OECD survey on Latvia (2017) <http://www.oecd.org/economy/surveys/Latvia-2017-OECD-economic-survey-overview.pdf>

Construction of multi-apartment housing considerably lags Estonia and Lithuania in terms of private investments. 1155 apartments were built in Latvia in 2017, while three and a half times more or 4307 apartments were built in Estonia and 4024 apartments were built in Lithuania. In other EU Member States, for example, in the Netherlands, France, United Kingdom and Spain, the share of public investments in promotion of the availability of housing exceeds 1% of GDP. About 6 million EUR (~0.02% of GDP) per year are invested in promotion of availability of housing in Latvia.

Although population growth since 2010 can mainly be observed in Pierīga, an important factor is domestic migration of citizens, which, despite the fact that it reveals a general tendency for citizens to move from regions to Riga or from Riga to Pierīga, also shows regional migration tendencies – the migration of citizens between the regions. The very limited availability of rental housing and the high expenditure on housing are one of the main causes for emigration of the population abroad and inability to keep labour force in Latvia.

In light of the foregoing, on 2 October 2018, Cabinet of Ministers issued a protocol decision to support the development and implementation of the housing support program, which anticipates a long-term (30 years) loan issued by the Treasury of the Republic of Latvia to municipal limited liability company with low interest rate, which can be fixed for 5,10, or even 30 years.

Support would be provided with an objective to eliminate the market failure of insufficient supply of high quality and affordable rental housing for households, whose net income at the time of grant provision does not exceed EUR 30,000 a year and that fall under the following target groups – qualified specialists in fields stated in the municipality's development program, specialists that perform a job related to state or municipality function provision, in which a shortage of qualified specialists has been confirmed, or households with one or more children.

Higher affordable housing availability will facilitate, both nationally and regionally, the attraction of new performers of economic activity and private individuals to real economic activity and residence in Latvia on a national and regional scale. An increased entrepreneurial activity and the creation of new workplaces is stated in Regional Policy Guidelines for 2013-2019. Also, other objectives included in the policy guidelines are the promotion of the accessibility of workplaces and services and the improvement of service quality and accessibility. Also, the criteria in support program for households with one or more children is closely linked to the demographic situation in Latvia and the necessity to grant support to new families. Business development and creation of new jobs is also emphasised in the *Regional Policy Guidelines 2013-2019*, setting fostering of business development and creation of jobs, promotion of jobs and accessibility of services, as well as improvement of the quality and availability of services in territories as one of tasks. Furthermore, the criterion related to households with one or more children is closely related to the demographic situation in Latvia and the need to provide support to young families.

DRAFTING LEGAL FRAMEWORK ON RESIDENTIAL TENANCY AND AMENDMENTS TO THE CIVIL PROCEDURE LAW

The currently existing residential tenancy regulation is outdated, it has been in force since 1993.

Currently, residential housing is not being constructed for the purpose of renting it. This is related to the lessor's risks, which arise from the regulation currently in force. These risks, at the same time considering that a tenant may be removed from living spaces only based on legal action, increase the costs of construction of rental housing for potential developers so much (increasing also the potential rent) that it is not profitable to build rental housing right now. Therefore, one of the priorities of the Ministry of Economics in 2017 was to draft a new legal framework for residential tenancy, the purpose of which was to promote construction of rental housing and affordability of housing, ensuring a fair balance between interests of lessors and tenants.

The draft law "Law on Residential Tenancy" would require to register all tenancy agreements in the land register for the purposes of ensuring acquisition of information about concluded tenancy agreements, which can be used to resolve disputes between tenants and lessors, and also to fight underground economy, as well as provides that a tenancy agreement will be binding for the acquirer of the living space, if it is registered in the land register.

To provide better protection of the interests of tenants, the draft law stipulates that the lessor would be able to increase the rent only when the tenancy agreement sets out the principles and procedures for raising the rent, for example, linking the raise with the average annual inflation, planned expenditures, or periodically raising the rent. Similarly, the law envisages the principle that members of the family will no longer enjoy permanent right to use the living space and are not severally liable for the obligations arising from the tenancy agreement.

To fight underground Economy the new "Law on Residential Tenancy" draft law demands all tenancy agreements to be registered in Land Register, thus ensuring publicly available and reliable information on concluded transactions that will protect both tenants and new owners of real estate. It is important to emphasize that registration of a tenancy agreement in the Land Register will be free of charge, thus avoiding any additional costs to the lessor or tenant. Simultaneously, registration of a tenancy agreement in the Land Register will allow to eliminate fictitious rental agreements as well as to protect honest tenants in the event of a change of lessor.

Compared to the current law, significant changes are intended regarding the term of the tenancy agreement – from now on, the tenancy agreement can no longer be concluded for an indefinite period. Namely, the tenancy agreement will be entered into only for a finite period of time, and, upon expiry of the term, the tenant will be obliged to vacate the living space, unless a new tenancy agreement is concluded with the tenant. In the context of the term of

the agreement, it should be noted that, as before, a tenant, without giving a reason, will be able to terminate the agreement by notifying the lessor in advance. The lessor will still be able to withdraw from the agreement only in cases and within the time limits provided for in the law.

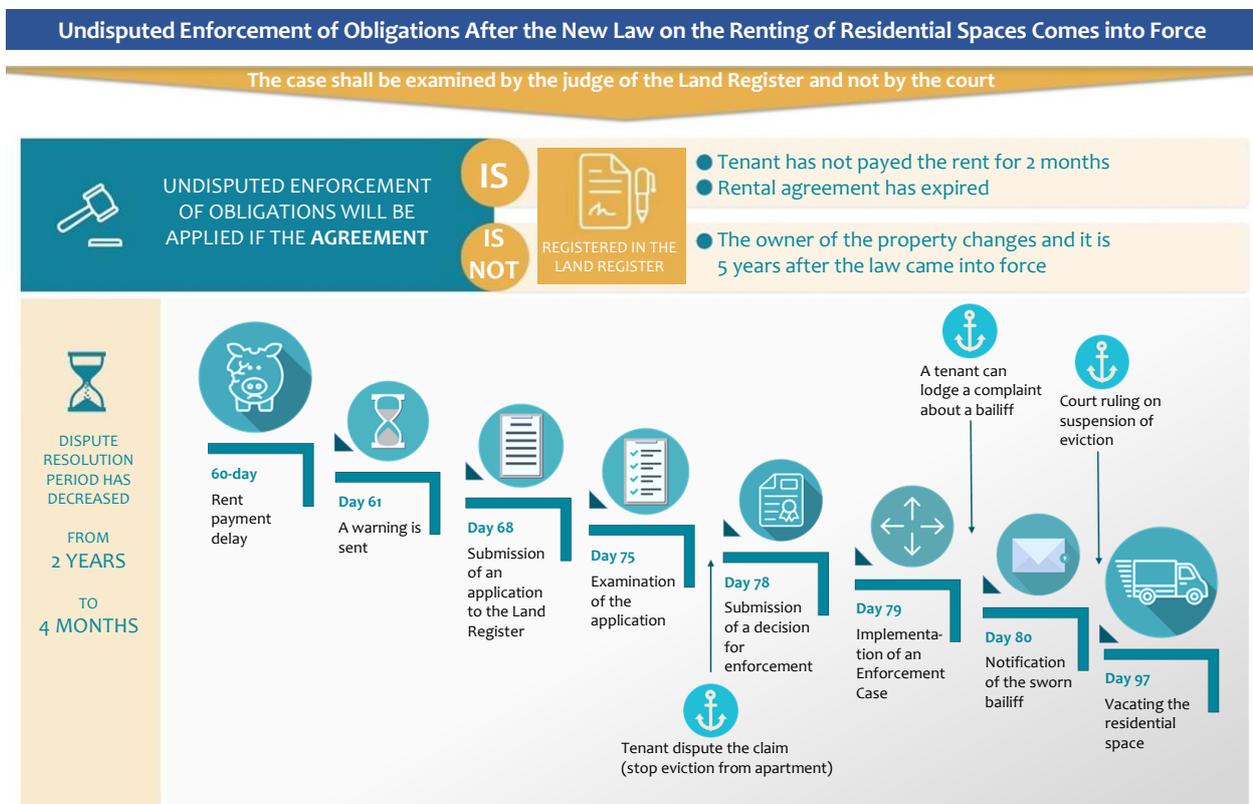
Considering the significant differences between the new regulation and the current law, the draft law provides for a transitional regulation. Accordingly, tenancy agreements that were concluded prior to the entry into force of the new law will have to be registered in Land Register within 5 years from the entry into force of the said law.

At the same time, for the purposes of drafting the draft law "Law on Rental of Living Spaces" amendments related to the new draft law are made to the *Civil Procedure Law*, which will considerably accelerate resolution of disputes between

the tenant and the lessor and reduce the costs involved, intending to set the procedure of unconditional forced fulfilment of liabilities in the amendments, when the tenancy agreement is over, or when there is a rent debt and tenancy rights are registered in the land register, as well as if real estate, in which living spaces are rented, is alienated during the effective period of the tenancy agreement, but tenancy rights are not registered in the land register. At the same time, such a solution will significantly reduce the risks for potential investors to invest in the construction of new rental housing.

Figure 1 explains the new approach to resolution of disputes between tenants and lessors related to the amendments in the *Civil Procedure Law*.

Figure 14.1



HOUSING ACQUISITION SUPPORT PROGRAMME

In order to simplify the possibility for families with children to secure the first instalment for the loan for acquisition or construction of housing, in accordance with Cabinet Regulations No.443 of 5 August 2014 "Regulations on Public Aid for Acquisition or Construction of a Residential Space" Joint Stock Company "Altum Development Financial Institution" issues sureties to persons, who live together with and care for at least one minor child.

The programme has a significant impact on the market of mortgage loans – in 2016 housing sureties were used for up

to 50% of the volume of newly issued credits for acquisition of a home, repair and reconstruction.

Important work was carried out in 2017 in the promotion of availability of housing, considerably significantly increasing the range of people who have access to sureties for the first instalment of housing purchase or construction.

The housing **Acquisition Support** programme has been highly appreciated by the population so far helping families with children to secure the first instalment for the loan for acquisition or construction of housing. During the three years of functioning of the programme, it has helped about

8000 families with 11,530 children to get housing of appropriate size.

In 2017, the programme was extended by making amendments to the law "On Aid in Resolution of the Apartment Matter", which entered into force on 1 January 2018, as well as by drafting Cabinet Regulations No. 95 of 20 February 2018 "Regulations in State Aid in Acquisition or Construction of Living Spaces". The amendments to the law provided that not only families with children, but also

persons younger than 35 and having higher or vocational education will have the possibility to get a surety for the first instalment for the loan for acquisition or construction of housing. More than 200 sureties have been granted to young specialists by now. It was also defined that the surety for families with children will be available to families with, who live together with and care for a child, who has not reached the age of 24, thus extending this group of the population, which can receive aid from the programme.

15. TOURISM POLICY

Tourism policy in Latvia is designed to promote the development of domestic and international tourism, by increasing the competitiveness of the tourism industry and export of tourism services.

The statistical indicators of tourism summarised by CSB present evidence that development trends of this industry in Latvia are positive. This is confirmed by both annual indicators and also their assessment over the longer period of time (see Box 15.1).

Box 15.1

Tourism development indicators in Latvia

In 2017, the number of border crossings by foreign travellers has increased by 53% in comparison with 2010, and their number has doubled since 2005. In 2017, foreign travellers crossed the Latvian border 7.7 million times, which is by 13.7 % more than in the previous year. In 2017 foreign travellers spent 691.9 million euro – by 46.7 million euro or 7.2 % more than in 2016. In 2017, Latvia was visited by 1.9 million overnight travellers, which is by 8.7 % more than in 2016 and by and they spent 533.9 million euro, which is by 12.5 % more than in 2016. The total number of nights spent in 2017 increased by 1% compared to the previous year and reached 8.9 million nights. The average duration of the stay was 4.5 nights. 43.7% of foreign travellers, who visited Latvia for tourism purposes, came for recreation, 34% – visited friends or relatives, but 22.4% came on a business trip.

2.6 million of travellers used accommodation services in Latvia in 2017, incl. 1.8 million were foreign travellers, which is by 13% more than in the previous year. More than half of all the foreign guests came from Russia, Germany, Lithuania, Estonia and Finland.

In year 2018 data on bed occupancy rate present noticeable trend of increasing occupancy level in total, although the number of hotels thus rooms increases year on year. Significant seasonal fluctuations are still being observed. The highest rate of hotel room occupancy in 2017 was in July, in the hotels of Latvia in general – 65.4%, and in Riga – 74.1%.

In year 2018 growing trends for other statistical data in tourism industry of Latvia are observed. In the third quarter of 2018, Latvian tourist accommodations served 1.03 million guests, which is by 6.5% more than in the same time of period in 2017. Compared to the corresponding period of the last year, the number of nights spent by guests has increased by 5.3% and has reached 1.95 million. The average duration of the stay of guests in tourist accommodations was 2 nights.

In 2017, tour operators operating in Latvia served 484.6 thousand travellers, of which 130.6 thousand travelled to Latvia, 325.1 thousand travelled outside Latvia, while 28.9 thousand used services of tour operators within borders of Latvia.

On 1 July 2014, a medium-term tourism policy planning document *Latvian Tourism Development Guidelines 2014-2020* was adopted, where MICE tourism (meetings, incentives, conferences, and exhibitions), wellness tourism, nature tourism, culture tourism, and creative industries were established as the strategic forms of tourism.

Sustainable development of Latvian tourism, contributing to increase the competitiveness of tourism services in foreign markets, has been set as the objective of the tourism policy development. The policy results and performance indicators to be achieved are:

- an increase in the number of foreign overnight travellers;
- an increase in the average occupancy (bed occupancy) rate of accommodation establishments outside the busy summer season (except for June-August);
- an increase in the daily average expenditure of a foreign overnight traveller;
- an increase in the total annual expenditure of foreign overnight travellers.

Main lines of action:

- to ensure the recognition of the Latvian tourism offer in the target markets, especially through modern means of communication;
- to promote the improvement of the quality of tourism products, also by ensuring a better regulatory framework of the industry and support both to the tourism businesses and product consumers;
- to promote the development of competitive tourism products, supporting the development of new, innovative tourism products with higher value added, by developing an infrastructure for the growth of tourism, promoting the formation of regional tourism clusters and inclusion of the Latvian tourism product into the common tourism offer of the Baltic Sea Region.

The *Interim Evaluation for 2014-2016 of the Implementation of Latvian Tourism Development Guidelines 2014-2020* identified problems, and it was discovered that it is necessary to create new tourism products with higher value to increase competitiveness and quality of them. By creating new and more interesting products, Latvia will ensure that the tourist will stay longer and will spend more also in regional territory of Latvia.

Tourism industry challenges in Latvia are also related to the promotion of local tourism and cooperation among providers of tourism services and organisations to ensure the development of a qualitative supply, particularly in regions. Business tourism ensures the demand for tourism services outside the active tourism season, therefore it is important to ensure visibility of Latvia as a business tourism destination, which is still comparatively low compared to competing destinations.

The *Tourism Marketing Strategy 2018-2023* was developed in 2018, which defines priority target markets and tourism products, as well as defines activities to achieve set tourism policy targets. In order to strengthen visibility of Latvia as a tourism destination, to promote the development of sustainable tourism and inflow of valuable tourists, different type of marketing and communication activities had been implemented in set target markets – marketing campaigns, visits of media representatives and tour operators to Latvia, participation in travel exhibitions and other similar events in the tourism industry the availability of information about Latvian tourism offer is ensured, including in the digital environment and in several languages.

By implementing marketing activities, the biggest challenge are new marketing communication tools. Since 2016, IDAL has been implementing the project “Promotion of international competitiveness of Latvia in tourism” by performing marketing activities in foreign countries and providing support to tourism industry representatives for participation in exhibitions and conferences in foreign countries. In 2017-2018, the Latvian tourism offer was popularised at 300 different events in 25 countries, incl. in distant markets – China, Japan and South Korea, where joint activities of Baltic countries are implemented. During the implementation of the project, support for participation in different events abroad (exhibitions, incl. the Latvian national stand, seminars and conferences) was provided to 40 legal entities, 7 associations and 14 local governments.

Measures for promotion of local tourism and development of products are also implemented – trainings for representatives of the tourism industry on the development

of products, quality of services, as well as tourism conferences and a new tourism product competition are organised. In 2018, a local tourism promotion campaign devoted to the celebration of Latvia’s century. The purpose of the campaign was to invite the local population to visit less known, special, unordinary tourism sites and objects in Latvia and to share experiences with other persons.

In 2018, the total amount of funding (state budget funds, ERDF co-funding, as well as funding for the implementation of the project EDEN) for tourism marketing was 3.47 million euro.

According to the conclusions included in the Interim Evaluation for 2014-2016 of the Implementation of Latvian Tourism Development Guidelines 2014-2020 significant changes in trends are observed in the tourism sector, and therefore several action lines are set on the basis of which it is planned to draw up the planning document for the next period (2021-2027).

Taking into the consideration the above mentioned the Ministry of Economics is planning to continue the development such action lines as:

- development of new tourism products;
- promotion of local tourism;
- analysis of impact of the sharing economy on the tourism industry;
- development of business incl. MICE and health tourism; development of tourism clusters.

In the current planning period tourism marketing and IDAL’s activities will be continued by organising more extensive activities in high priority target markets – Russia, Germany, Lithuania, Estonia, Finland, Sweden and Norway, making an emphasis on specialised tourism events for industry representatives. Education events for tourism business representatives and communication activities for local tourists about tourism offer will be continued.

16. COMPETITION POLICY

Free and fair competition creates the opportunities, which are willingly used by companies and consumers by acquiring goods of higher quality for a lower price, as well as having choice in the diversity of supply. It has become the foundation for the general economic competitiveness increase, promotion of efficiency of operations and innovation of businesses, as well as increase of public welfare. The goals of the competition policy is to protect free and fair competition, promote its development in all national economy areas among market players, create new and innovative products, prevent that public persons interfere with free competition.

The Competition Council (the CC), which is subordinated to the Ministry of Economics, is responsible for the

implementation of the competition policy in the country. There is also cooperation with competition supervisors and international organisations of other states, thereby participating in formation of the international competition policy and using the information and experience shared by other states for efficient protection of competition in Latvia.

The CC investigates and prevents infringements of the Competition Law, controls market concentration, monitors that state and municipal normative acts do not create unjustified obstacles for free and fair competition among companies, and educates the society, thereby promoting its understanding about competition rights and contributing to intolerance towards distortion of competition.

Box 16.1

The Most Pressing Challenges in the Latvian Competition Policy

Keeping effective protection of competition in conditions of shortage of resources. In conditions of shortage of human and financial resources, in order to prevent a reduction in efficiency of operations, it is necessary to search for more effective solutions in exposing and preventing distortions of competition. According to the CC's observations, the number of particularly severe violations of the Competition Law – cartels – has not reduced in the last three years. Also, the number of cases, when competition is distorted by public administrative bodies, is significant. Competition gives rise to the occurrence of new goods and services, new solutions, which not only benefit consumers, but may also affect the market indirectly, structurally changing market operation principles and creating new more innovative commercial activity aspects. This may endanger traditional market functioning principles at the same time creating opportunities for new and more effective companies to develop in the market. In such conditions, any artificial competition restrictions in regulatory enactments are not acceptable, unless they are justified by other important public benefits. In order to tackle with these challenges, solutions need to be sought in instruments like prioritisation of competition problems and application of alternative solution (without initiating a case), closer cooperation with partners in discovering violations (distortions in competition not covered by the *Competition Law*), improvement of regulatory enactments setting sufficiently discouraging sanctions for distortions of competition, proactive actions in identification of distortions of competition in priority sectors.

Actions of public administrative bodies. Due to different factors, markets may function inefficiently, and competition may not be a sufficient instrument to align the supply and the demand, including in provision of services important for the company (utility services, health and social work activities, museums and higher education institutions, etc.). In such cases, it is permissible that an entity operating in the public sector (state/local government company) starts providing the service. Companies owned by the public sectors were established historically and continue to conduct commercial operations in Latvia. It is not prohibited, but the public administrative bodies involved in commercial activities, need to conduct a careful analysis of the market situation and the potential effect of their commercial activity on competition, because belonging to the public sector may create considerable advantages and an unequal competition environment in comparison with a private company. This reduces competitiveness and private companies wish to invest, and they may even be in danger. Effective competition does not develop in such conditions. According to the facts collected by the CC, public administrative bodies and their companies often get involved in commercial activities ignoring potential consequences for competition. However, the CC has no sufficient tools to eliminate their negative effect on competition. The CC also has no sufficient tools to prevent distortions of competition, which may be caused by public administrative bodies, when they implement their governance functions.

Society's insufficient understanding and knowledge about competition. Despite the fact that the Competition Law as a tool for protection of free competition has been in use in Latvia for over 25 years, the society still has incomplete and misleading ideas about goals of the competition policy, functions, tasks and work methods of the CC, etc. Involvement in natural economic processes, which are an integral part of functioning of a free market, is often expected from an institution, incl. by regulation of prices and particularly protecting local companies from competition with foreign companies. The results of the public opinion poll conducted by the CC in 2018 show that the level of knowledge and understanding of the society about competition matters is low. For example, 15% of businessmen disagree that market players are prohibited to agree on prices, and 57% do not know, what a leniency programme is, i.e. the opportunity for a market player involved in a cartel to voluntarily report its involvement in the cartel to the CC, cooperate in investigation of the violation and get an exemption from the penalty, as well as get an exemption from disqualification from public procurements. Low level of understanding and knowledge, misleading ideas about the importance of competition and application of the Competition Law mean that the society cannot recognise violations of Competition Law, fight them and report to the CC, as well as the society is still tolerant to such harmful phenomena like price and market sharing cartels, and often expect from the CC, for example, the creation of policies for specific industries, regulation of prices and supervision of organisation of tenders.

In accordance with priorities of the competition policy, which are set according to the most pressing challenges in the competition policy (see Box 16.1), the CC strategy defines the following tasks:

- exposure and prevention of significant competition infringements and market distortions, preclusion of adverse impact of market concentration;
- creation of understanding of market participants and public administrative bodies about free and fair competition, competition policy and culture.

EXPOSURE AND PREVENTION OF SIGNIFICANT COMPETITION INFRINGEMENTS AND MARKET DISTORTIONS, PRECLUSION OF ADVERSE IMPACT OF MARKET CONCENTRATION

The ability of the institution to adequately and proportionately prevent violations, when investigating the most severe violations, in applying penalties and legal obligations, in reaching individual and joint preventive effect are important for the improvement of the competition environment. The practical experience of the institution proves that the number of the most severe violations of the Competition Law, in particular, the violation involving a cartel agreement, does not reduce (see Table 16.1).

Thanks to the CC's educational activities, the CC often receives reports from organisers of procurements on potential cartels. The CC prioritises these situations in accordance with the *Case Prioritising Strategy* introduced by

the CC without initiating violation proceedings in less important cases but using the warning procedure after a market research. In this way, explanatory work on a potential violation of the *Competition Law* is carried out with market players, who might be *prima facie* involved in a cartel.

Table 16.1

Number of Stated Prohibited Agreements (Cartels) and Number of Warnings			
	2016	2017	2018
Number of stated prohibited agreements (cartels)	3	4	3*
Number of cases on cartels, when the CC used the warning procedure, number of persons warned (in brackets)	6 (21)	5 (15)	7 (36)
Total	9	9	9
Source: the CC; * forecast			

Despite the fact that the CC educates enterprises also about the Leniency Programme, applications of market players within the Leniency Programme are received quite rarely. In order to encourage market players to use the Leniency Programme and explain its use, in 2018 the CC published the *Guidelines on the Use of the Leniency Programme*, as well as popularises it in its lectures and seminars. One of cases of procurement cartels, when confession was received within the scope of the Leniency Programme, is a cartel of stage equipment (see Box 16.2).

Box 16.2

Cartel of stage equipment

The CC started the investigation of the case in May 2015 after one of the companies involved in a prohibited agreement at its initiative, within the scope of the Leniency Programme, reported a potential violation to the institution. The company revealed to the CC information about the cartel among distributors of sound, light and stage equipment, in which they exchanged information about participation in public procurements.

When investigating the case, the CC had learned that the violation was implemented in the period from 2009 to 2014. The cartel agreement distorted competition in procurements of capital companies of the Ministry of Culture, local governments of cities and municipalities, and cultural institutions.

Nine other merchants participated in the prohibited agreement apart from the company, who reported this to the CC, – SGS Sistēmas SIA, Diogens Audio SIA, Kompānija NA SIA, PRO 1 STAGE SIA, AJV grupa SIA, Audio AE SIA, 3S SIA, SGM SIA and SOLAVI SIA. These companies implemented the violation mainly in two ways – encouraging competitors not to submit their tenders and encouraging other competitors to submit fake tenders to ensure the necessary number of tenderers in a procurement and selection of a specific company. Therefore, there was no competition among these companies, and organisers of tenders were misled, receiving tenders, which were not prepared in conditions of true competition.

The company, which used the opportunities provided by the Leniency Programme and was the first to report the prohibited agreement to the CC, received full exemption from the penalty and from a years-long ban to participate in public procurements. At the same time, taking into account that Diogens audio SIA cooperated with the CC during the investigation and provided information at their own initiative, the CC decided to reduce the fine applied to this company. A settlement agreement was concluded with SOLAVI SIA and SGM SIA that they were committed not to appeal the CC decision in a court in the part related to the stated violation and received a reduction of the imposed penalty.

The CC applied a total penalty of 373,083 euros to the companies.

This was the third prohibited agreement discovered in Latvia based on a report within the Leniency Programme. The Leniency Programme allows any company, which is or was involved in a prohibited agreement, to refuse from further illegal activity and distortion of a fair competition environment. To get a full exemption from the penalty, the company involved in a cartel should be first to report to the CC at its initiative and submit evidences of the violation, parties involved, etc.

The CC has also developed its analytical skills and approach to investigation of complicated violations related to an abuse of the dominant position. For example, in 2016, the CC stated an abuse of the dominant position in actions of Knauf SIA, manufacturer of gypsum plasterboards and other products. Knauf SIA developed and applied to its customers – retailers of construction materials – a scheme of loyalty discounts, the purpose of which was to create a string economic motivation not to purchase gypsum plasterboards and other products from competing suppliers. Thus, Knauf SIA has built an artificial barrier for entry of competitors to the Latvian market and limited choice of consumers.

Over the last three years, the CC has been actively fighting the distortions of competition caused by public administrative bodies, by supervising actions of public administrative bodies in accordance with provisions of Section 88 of the *State Administration Structure Law* and by

evaluating discrimination, which public administrative bodies used against market players (see Box 16.3). In 2015, the CC published the *Competition Evaluation Guidelines for State and Local Government Decision-Makers*, and a separate structural unit was established for this task in the middle of 2018. At the same time, it should be noted that the supervision implemented by the CC is not considered to be effective and productive, because the institution is only entitled to provide a non-binding opinion. The institution still does not have sufficient authorisations to fight competitive neutrality violations of public administrative bodies, thus the CC cannot provide considerable benefits to the society in these matters, cannot ensure market development and innovation meeting the goals and tasks of the *Competition Law*. It is necessary to strengthen the CC's authority to fight against distortions of competition by public administrative bodies. In September 2018, the acutely necessary amendments to the law were transferred for review to the *Saeima*.

Box 16.3

Competition neutrality

In its practical experience, the CC has often faced competition restrictions created by local governments and their capital companies. In most cases, the cause of such restrictions was failure to observe the principle of competition neutrality: local governments, using their public power advantages, without any justification provide privileges to their capital companies. They are often in a dominant position and provide fundamental services to the society (water management, housing administration, etc.), as well as have extended their activity to related markets, thus complicating provision of these services by the private sector. The CC indicates that this unjustifiably denies consumers free choice of service provider according to the quality and price. It should be emphasised that in five cases – in Aizkraukle, Olaine, Tukums, Dobeles and Ventspils – the institution has stated restrictions unjustifiably created by capital companies of local governments to private sector companies to provide water meter installation and replacement services. After negotiation procedures, the CC has managed to eliminate the restriction allowing businessmen from the private sector to install and replace the meters in the future.

The CC has also addressed to the Riga City Council and Rīgas satiksme SIA regarding the application of 20% discount to holders of *Riga resident's card* for paying for parking places in certain areas of Riga. The discount is received only when holders of *Riga resident's card* are using an electronic money account, which is maintained by a capital company indirectly owned by the municipality. The CC has concluded that in this way the local government provided unjustified advantages to the capital companies it owned directly or indirectly, at the same time creating significant distortions of competition and limiting opportunities of consumers to choose the most convenient method of payment, because this discount was not available to customers of the private service provider Mobilly SIA, although its customers were also holders of *Riga resident's card*.

The CC emphasises that according to the principle of competition neutrality or non-discrimination, discounts should be received by all owners of the *Riga resident's card* regardless if provider of payment services is a local government or private company. This would ensure equal and fair competitive opportunities to other payment service providers. However, the Riga City Council has not eliminated this violation of competition neutrality.

The CC's market research or **market surveillance** may provide a considerable contribution to identification of distortions of competition. The CC has been actively using market surveillance in its practices to evaluate and remove barriers and restrictions in specific markets, protect principles of competition and prevent the inclusion of restrictions deforming competition in regulatory enactments (or achieve that they are cancelled). Over the last three years, through market surveillance the CC has studied problems of competition in areas such as purchases of fresh milk, supplies of natural gas, distribution of medicinal products, technical inspection of vehicles (see Box 16.4), telecommunication services, etc. Sectors important for the national economy, where obstacles to the development of

fair competition are potentially seen, are considered to be a priority. The CC also prioritises involvement in supervision of sectors, where liberalisation and market opening activities have started or are implemented (for example, electricity, natural gas trading, etc.). Monitoring may be proposed at the CC's initiative according to the set priorities regarding sectors, and also based on warning signals received from the society. After market surveillance, the CC informs the authorities responsible for the sector about stated problems in the regulatory framework, lack of regulation or excessive regulation, as well as proposals for their settlement, as well as organises and participates in discussions on solving these problems.

Box 16.4**Technical inspection services**

The basic technical inspection service is control of technical condition of the vehicle. The inspection also includes the duty to supervise payment of penalties and taxes, validity of the driver's licence and restrictions, etc., which is considered to be a function of the state. Having studied the market situation and experience of other countries, the CC has stated that state unjustifiably denies private companies' involvement in the vehicle technical conditions control market – checking of technical condition of vehicles to participate in traffic.

Unjustified state restrictions created considerable competitive advantages for current market players, at the same time considerably distorting competition and delaying market development. Road Traffic Safety Directorate (RTSD) acts on the basis of the guidelines provided by the Ministry of Transport (MoT), conditions of which are not proportionate and make involvement of new players in the market almost impossible. If the creation of new stations would be considered, advantages are primarily guaranteed to RTSD and their accredited companies rather than all market players have equal opportunities.

Competition is also negatively affected by the fact that accredited companies do not compete among themselves for customers, because each of them has a specific territory, where it can provide its services. Therefore, this creates equivalent consequences for the most severe violations of competition – market sharing. This, in turn, limits free choice of service providers by consumers. At the same time, accredited companies are protected from the pressure of competition, because their contracts with RTSD are extended automatically. Therefore, neither these companies nor new market players can compete for the provision of the services in the specific stations during the next period of the contract completely excluding any opportunity for competition.

The competition restrictions caused by the existing system model have a negative effect on direct service providers – consumers. Only in conditions of free competition consumers may get prices, which are competitive and reflect the real market situation. In conditions of a closed market, costs of technical control have grown by 50 – 60% for consumers over the last ten years. They are one of the highest if comparing to other EU countries and the highest in the Baltic countries. Consumers also face considerably limited availability of the service. Over 700 thousand vehicles are registered in Latvia. From them 30% are located in Riga, which has only one technical inspection station. That is 20 times less than in conditions of an open market. Taking into account that RTSD decides on the number and locations of stations, consumers have difficulties with the availability of the service and it does not meet the needs of the demand. In addition, high prices of the service and low availability to consumers incur other costs in the form of time spent. The experience of other countries evidences that on an open market consumer may choose the best service provider in terms of price and availability, as well as receive additional services, which are included in the price, for example, a repeated free control, card wash, flexible working hours, etc. Latvian consumers do not have the possibility to receive different competitive benefits.

In order to eliminate unjustified involvement of the state in the technical condition control market, remove restrictions of competition and negative effect on consumers, the CC proposes to open this market to free competition. The institution is offering the state to keep the function of accreditation and supervision of these companies and entrust the provision of the service to the private sector – car care centres and repair shops, which could at the same time identify and prevent defects in a vehicle and perform technical control. The CC denies assumptions that traffic safety would reduce on an open market. Namely, the experience of other EU Member States and European Court of Justice confirm that traffic safety does not depend on the market model. It depends on the implementation of an effective state supervision mechanism and supervision.

The operational policy used by RTSD, which is included in MoT Guidelines, is contrary to the EU law and contains indications of a violation of the Treaty on the Functioning of the European Union (TFEU) – abuse of the dominant position. For Latvia to comply with the EU law and ensure conditions of free and fair competition, the CC has sent to the responsible authority – MoT – a letter encouraging it to submit the necessary plan of action and measures.

It is no less important to control changes in the market structure, which occur due to **mergers of market players**. When analysing mergers, the CC is evaluating if structural changes do not deform competition in the relevant market. The CC provides premerger consultations, has drafted guidelines¹ to ensure a uniform and transparent approach to the review of merger reports and simplify preparation of the report for market players, as well as evaluates the merger transactions importance for the national economy and how it affects the market. In several cases, the CC prevented negative consequences to competition and consumers, imposing binding obligations on members of the merger or even prohibiting the merge. For example, in 2017 the CC set binding conditions for the telecommunication company Bite UAB, when it took control of the MTG group. These binding conditions ensured non-discriminating attitude when distributing popular TV programmes on

different platforms and providing advertising services, as well as application of justified discounts to TV operators in sale of TV programmes. In other merger case in 2017, the CC prohibited a merger, as a result of which the retail company Rimi Latvia SIA would obtain the right to use spaces in the *Domina Shopping* trade centre. The ban of this transaction prevents excessive concentration of t/c "Rimi" shops in Riga.

After the decision was taken, feedback was received by asking submitters of the report to provide their opinion to the quality of the CC's work and improvements in its work. The CC will further ensure a flexible approach to the evaluation of mergers by consulting participants of the merger before notification and by evaluating submitted reports.

¹ Guidelines for preparation of reports on mergers of market players, 2016.

CREATION OF UNDERSTANDING OF MARKET PLAYERS AND PUBLIC ADMINISTRATIVE BODIES ABOUT FREE AND FAIR COMPETITION, COMPETITION POLICY AND CULTURE

In order to forward competition protection and competition policy development ideas effectively – to eliminate violations,

to reduce tolerance to several violations of the Competition Law, discriminating actions of public administrative bodies and other distortions of competition, it is important to promote public awareness of the competition culture. Therefore, it is necessary to educate the society about the importance of the Competition Law and work of the CC. The CC uses tools like lectures, seminars, informative campaigns, games, participation in discussions, etc. also cooperating with partners to educate the society (see Box 16.5).

Box 16.5

Education of society

A successful model of interinstitutional cooperation is the CC's initiative of 2017 to cooperate with the Corruption Prevention and Combating Bureau (CPCB) and the Procurement Monitoring Bureau (PMB) to conduct a cycle of seminars for organisers of procurements and tenderers in 2017 and 2018. Taking into account a wide spectrum of procurement topics, the three institutions educate about matters in their competence (the CC – about prohibited agreements, PMC – on principles of fair competition when preparing procurement regulations, and CPCB – about risks of corruption).

The cycle of seminars already took place in ten Latvian cities (Liepaja, Ventspils, Kuldīga, Bauska, Jelgava, Jurmala, Daugavpils, Rezekne, Jekabpils and Valmiera). 481 persons have been educated, the majority of which (369) were organisers of procurements. The final seminar was held in Riga in November 2018.

In order to ensure active actions according to the challenges identified in sectors, the CC implemented several educational measures also independently. Namely, based on adopted decisions and/or identifiable indications of potential violations, the CC educated organisers of procurements about prohibited agreements of companies in cultural and defence areas. Thus, in 2018, the CC educated employees of the Ministry of Culture and the Ministry of Defence, who are responsible for the organisation of procurements. At seminars, the institution educated about the importance of fair competition principles and thought how to recognise matches in applications of tenderers, which may have evidence of a prohibited agreement.

In its turn, the internationally widely known strategic roleplay "Mafia" adapted by the CC should be highlighted as an untraditional educational activity. During the game participants (six fair businessmen, three cartel members and the CC role) should achieve that their team wins, arguing the involvement of the opponent in prohibited actions and proving that their actions are fair. The game "Cartel" was organised for the first time in 2018, at the Conversation festival LAMPA educating about 40 persons.

At the same time, the results of the public opinion poll organised in 2018 shows that most of respondents believe that the CC is informing the society insufficiently, at the same time evaluating seminars as less important source of information. Respondents believe that internet (apart from the website of the institution ww.kp.gov.lv), social media, TV, radio and press are important channels for distribution of educational materials. However, seminars purposefully prepared for participants of a particular sector are evaluated as most successful for discussion between the CC and market players than non-specialised seminars.

NEXT STEPS

The future intention of the CC is to improve regulation to retain market players from prohibited agreement and to eliminate distortions of competition caused by public administrative bodies. The institution is also planning to improve the regulatory framework in relation to responsibility of officials for violations of the *Competition Law*, as well as cooperate in the advancement of the draft regulatory framework for the area of supervision of activities of public administrative bodies to introduce an effective

process of prevention of such distortions and the right to set legal obligations.

The CC is planning to continue the "Consult first!" policy, incl. to consult companies about the application of the competition regulations and to take individual preventions using the warning method about violations of the *Competition Law*. On the basis of the priorities set by the institution, the CC is planning to ensure the improvement of research methods, incl. using also good practices of other countries and use the approach focusing on the resolution of impact of competition problems in market research and merger cases. The CC is also planning to ensure consultation of companies before mergers, as well as to consult public administrative bodies and supervise their activities in the area of its competence.

In strengthening public awareness of free and fair competition, the competition policy and culture, the CC is planning to increase the number of educational activities, which are intended for a specific audience. The institutions regulating the sector and non-governmental organisations should become partners in education of the society. The CC has also planned to publish educational materials using modern communication channels and solutions.

17. 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. In order to ensure that the rights are respected, it is important to ensure the implementation of the consumer rights protection policy in different directions. While 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 considered, when determining 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.

The consumer rights protection policy is implemented in such a way to provide consumers with high level of security in many areas, including withdrawals from defective goods from the market. It is important for a consumer to have the opportunity to receive legal protection, if regulations are applied incorrectly.

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 accordance 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 smart decisions at every step in this fast daily life. Considering the popularity of e-commerce, as well as the challenges created by the digital market, it is necessary to continue strengthening protection and information of consumers. Taking into account the rapid market 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.

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 Consumer Rights Protection Centre (CRPC), a body subordinated to the Ministry of Economics, takes care of protection of consumer rights. The *CRPC Operational Strategy for 2017-2019* sets the mission of CRPC – to protect rights and interests of consumers, to provide the population with the possibility to live health and safe life, be convinced that goods and services are safe, to enable to exercise consumer rights effectively, as well as to ensure participation and awareness of the society about consumer rights and interests. CRPC acts as support to the formation of a fair business environment.

CONSUMER RIGHTS PROTECTION CENTRE

The CRPC is the main authority supervising the enforcement of laws and regulations regarding consumer protection, and the goal of its operations is to ensure efficient protection of consumer rights and interests. In order to ensure that the CRPC is performing its functions, the CRPC implements activities related to monitoring of the consumer rights (in the field of protecting consumers' economic interests and supervising the implementation of 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.

In 2018 the following areas were set as a priority for supervision regarding the protection of consumer rights by CRPC: supervising commercial practices implemented by crediting service providers, evaluating lender's practice regarding the consumer's ability to repay the loan and distributing consumer crediting advertisements, as well as supervising commercial practices and contract terms in recreational parks for children and teenagers, in the area of autonomous services and electronic communications, as well as supervising provision of true information about the price in shops and in the electronic environment, social networks and on dating portals.

CRPC continues the licencing 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, as well as issuing of licences to travel agents and operators has started.

Currently in preparation are several studies and situational evaluations, guidelines in the priority areas are drafted and updated, supervision has begun regarding the regulation for

prevention of money laundering and terrorist financing, with regard to credit providers and out-of-court debt services.

Box 17.1

Activities of the Consumer Rights Protection Centre in 2018

The CRPC provided consumers, legal entities and institutions with 29,159 consultations in the ten months of 2018. The number of provided consultations reduced by 11% compared to the ten months of 2017. By contrast, the number of provided consultations reduced by 12% compared to the first ten months of 2016. When asking for advice, consumers most often inquired about issues related to their rights, if a product of low quality is purchased or a service of low quality is received. Most of the questions are about actions in the cases, when shoes, electrical appliances, mobile phones, as well as other goods not meeting provisions of the agreement are purchased, or also about problems with airline services, travel services, distance contract services and electronic communication services. Consumers also contacted regarding individual disputes regarding matters, which are not in competence of CRPC, for example, rental and utility services.

The CRPC received 2953 consumer complaints in the first ten months of 2018 illustrating that the number of complaints received has increased by 4% in comparison with the first ten months of 2017. Consumers most frequently complain about purchased products which do not meet provisions of the agreement and services which do not meet provisions of the agreement.

Consumers also frequently complain about purchased footwear, electrical appliances and mobile phones which do not meet provisions of the agreement. Most frequent complaints about services were complaints about airline services (883 complaints). Many complaints have also been received about electronic communication and travel services.

In the first ten months of 2018 there has been 188 proceedings initiated on violations of the collective interests of consumers, incl. proceedings about implemented commercial practices and terms given in 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 appropriately or without specifying the information laid down in regulatory enactments, or inappropriately implementing other rights or duties arising from regulatory enactments or contacts.

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 the Consumer Rights Protection Centre with the European Commission's support. In the ten months of 2018, 449 consultations were provided to consumers and merchants on cross-border problems within the EU and 343 complaints were examined on cross-border problems within the EU. People have turned to ECC Latvia mainly – 49% of all the received complaints – in relation to airline services, cross-border on-line purchases – 32%, car tourism services – 4 percent.

In 2018, the following priority axes are set for **market surveillance** by the CRPC: improvement of safety and compliance of goods and services in such fields as construction products, electrical appliances, machinery,

explosive equipment, toys and goods safe for children, personal protection equipment, radio and telecommunication terminal units, recreation services, procedure on indication of prices and correct determining of weight, measure and purchase price. A project for inspection of dangerous equipment – surveillance of elevators – is also implemented. Supervision projects in state metrological supervision are implemented in priority areas like non-automatic weighing instruments and water meters, as well as control of pre-packaged products in companies.

In the 10 months of 2018 the CRPC carried out 795 market supervision inspections, 66 metrological supervision inspections in companies, where measuring instruments are used and in companies distributing measuring instruments. 47 inspections were carried out in metrological supervision of pre-packaged products and 83 inspections – in supervision of dangerous equipment.