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ECONOMIC DEVELOPMENT OF LATVIA

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OPENING STATEMENT

Experts of the Ministry of Economics have prepared the current 2020 *Report on the Economic Development of Latvia.* The report assesses the economic situation, as well as forecasts the prospects of economic development.

2020 was full of challenges. The Covid-19 pandemic has had a strong and lasting impact on the socio-economic situation on a global scale. However, we can view the current situation as an opportunity to strengthen sustainability of our economy.

Until this autumn Latvia had managed to cope with the challenges posed by Covid-19 relatively well. One of the lowest Covid-19 infection rates in Europe were observed in Latvia. This was achieved due to effective and timely reaction on the part of the government. The impact of the Covid-19 pandemic on the economy was also comparatively smaller. However, since autumn we have faced a new outbreak of the Covid-19 pandemic. This means that we should not relax and should be vigilant.

Uncertainty about the impact of Covid-19 on economic development is still extremely high because it is unclear how long and widely the virus will continue to spread across Europe and globally. Specialists of the Ministry of Economy forecast a fall in GDP within 5-6% in 2020, while the economy will resume growth again in 2021.

I would like to note that Latvia has developed a clear strategy to overcome the crisis caused by the Covid-19 pandemic and has highlighted policy directions to strengthen its economy in the post-crisis period. At the end of May 2020, the government approved the Latvian economic recovery plan "Strategy for Latvia for Mitigation of the Consequences of the Crisis Caused by Covid-19" developed by the Ministry of Economics together with entrepreneurs, industry experts and organisations representing businesses.

To overcome the crisis, the strategy proposes to take three consecutive steps: to stabilise the economy in 2020, to refocus the economy in 2021-2022, and the growth phase would start from 2023.

During the stabilisation phase, a set of measures are being taken, first of all, aimed at stabilising the financial situation of the population and businesses in conditions of the Covid-19 crisis and limiting the spread of the virus in Latvia.

The re-orientation phase is intended for creating new opportunities for entrepreneurs and citizens, with an emphasis on innovation, digital transformation, lifelong learning and focusing on structural economic change by purposefully adapting state aid mechanisms.

Furthermore, in the growth phase a set of medium-term support measures are expected to be developed to transform the national economy based on the dynamic development of exports of goods and services, ensuring economic growth through productivity growth, automation, digital transformation, support for business growth and fast-growing industries and ecosystems.

The Strategy is regularly complemented by specific action plans in each of the five action lines: "Human Capital", "Innovation", "Business Environment for Export Capacity", "Access to Finance" and "Infrastructure". To mitigate the effects of the Covid-19 crisis, by 2023, it is proposed to provide public and private investment of 2.2 billion euro for the implementation of infrastructure projects.

To mitigate the effects of the Covid-19 crisis, entrepreneurs will also have a number of aid programmes available in 2021, as well as we have submitted a number of proposals for reforms under the European Recovery and Resilience Facility, contributing to transformation of the economy, productivity and digitalisation, the availability of housing, including rental housing, and energy efficiency.

The Ministry of Economics pays special attention to the promotion of export capacity. In Latvia, it is important to provide aid not only to already exporting companies, but also to create opportunities for new exporters by supporting companies in the internationally competitive industry and the promotion of their products on export markets.

Work is ongoing on a new instrument for overcoming the effects of the Covid-19 crisis to boost employment for exporting taxpaying companies and businesses in the tourism sector.

Support for all companies affected by government-imposed security measures to limit the Covid-19 virus is extended. The criterion of the decline in working capital over the last three months for the downtime allowance has been substantially changed, thus providing financial support to all those who are currently unable to work and receive remuneration due to the measures imposed by the government. Similarly, support for working capital is extended without setting a NACE code criterion. This will make it possible for entrepreneurs to "hibernate" and then continue their economic activity.

There are plans to create a "green corridor" to reduce bureaucracy and administrative processes for effective attraction of local and foreign investors. At the same time, measures will be developed, in cooperation with economic operators to reduce business costs to maintain export capacity.

Human capital plays an important role in promoting competitiveness. 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. Since the labour market is becoming increasingly variable, for the purposes of reducing the unemployment caused by the Covid-19 crisis it is necessary to move towards the establishment of a sustainable and functional adult education system. By 2023, 165 thousand people are planned to be involved in adult education.

The Employment Board consisting of three ministers – Minister of Economics, Minister of Education and Science and Minister of Welfare – ensures more harmonised cooperation between all the parties involved in anticipation of labour market changes and introduction of necessary anticipatory changes, thus enabling society to adapt to the expected changes in a more timely manner. Given the negative impact of the Covid-19 crisis on the labour market, in 2020, the work of the board focused on developing proposals for measures to overcome the Covid-19 crisis and economic recovery in support of adult education and employment.

In order to stimulate discussions and find the most effective solutions to boost productivity, the Ministry of Economics continues cooperation with the LV PEAK thinktank of the University of Latvia and the Tripartite Cooperation Sub-Council for Competitiveness and Sustainability (TCSCS). In 2020, TCSCS discussed industrial policy, upskilling of employees and other matters.

The EU Single Market, which was created more than 25 years ago to form an integrated, economic growth-oriented group of countries, is facing a historic challenge. Various restrictions imposed by Member States due to Covid-19, partly restored internal border controls, the withdrawal of the United Kingdom from the European Union, the disruption of international supply chains and other factors have an impact on the benefits of the EU Single Market, which seem to be self-evident in everyday life – travelling, working, learning, doing business freely. In all cooperation formats, the Ministry of Economic implements activities aimed at maintaining and sustaining the principles of the functioning of the EU Single Market in order to promote closer EU integrity, unity and competitiveness for further growth.

Latvia should be ready to embrace challenges related to the changes brought by Brexit, the withdrawal of the United Kingdom from the block of the EU countries. In this context, the Ministry of Economics continues to provide informative support to businesses and the population to help form 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.

Support programmes of the EU funds are successfully implemented, providing the opportunity to invest 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-paid jobs and increasing the quality of life.

In 2020, the government supported a number of proposals for the use of EU funds and additional state budget over-commitments for measures to overcome the crisis caused by Covid-19 and promote economic recovery, as well as to reduce the negative impact of Covid-19 on EU fund projects.

On 28 May 2020, the European Commission proposed to introduce an ambitious *Recovery Plan for Europe* to address the economic and social damage caused by the coronavirus pandemic, stimulate Europe's recovery and protect and create jobs. A significant part of the European recovery funding will be channelled to the *Recovery and Resilience Facility*, a new centrally managed budget programme of the European Commission. The aim of the mechanism is to support reforms and investments, particularly those related to the transition to the green and digital economy, and to mitigate the social and economic impacts of the crisis. The priorities of the Ministry of Economics under this facility include support for entrepreneurs for the development and digitisation of new products, energy efficiency solutions to achieve the objectives of the *National Energy and Climate Plan*, as well as the housing affordability reform.

The *Latvian Industrial Guidelines for 2021-2027* highlight the national approach to transformation of the economy into an innovative and knowledge-based economic model, using the development of RIS3 value chain ecosystems. It will be based on structured dialogue and coordinated action between all stakeholders (a network of private, public and academic cooperation partners), thereby promoting the development of new products and services, knowledge transfer in the national economy and increasing private investment in research and development (R&D).

Support programmes are implemented for the improvement of the national innovation system, the main support instruments of which ensure the promotion of cooperation between economic operators and the research sector for the implementation of joint projects. These include promoting commercialisation of research developments and other technology

transfer processes, including 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 development. 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. 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 are also strengthened.

It is important to emphasise the approach implemented by the Ministry of Economics, which results in identification on a national scale of value chains with high value-added potential. By mobilising the leading representatives of national-level industries, the academic sector and related line ministries and by ensuring their coordinated and strategic cooperation, integration of national-level value chains in global value chains in promoted. An integral part of the approach is its close link to the *Smart Specialization Strategy*, which allows to dynamically plan public investments, as well as develop knowledge-intensive products and services in the programming period 2021-2027.

The Ministry of Economics is actively involved in the development of the space industry. The most important event of this year in the field of space was Latvia's accession to the European Space Agency as an associated Member State. This means not only the access of Latvian businessmen and scientists to the knowledge base of the European space industry, but also the possibility for Latvia to make its contribution to international space missions and use a wider range of space data and technologies for future economic development of Latvia in different sectors – from medicine and agriculture to smart cities and energy.

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 2020 study* places Latvia on the 19th place among 190 countries. Also, Latvia holds the 6th place among EU Member States.

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.

In progress towards an excellent business environment Latvia has introduced the "Consult first" principle aiming to improve the mutual understanding between entrepreneurs and supervisory authorities, thus promoting the fulfilment of requirements rather than entailing 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.

Provision of a fair competitive environment is also considered to be an essential element in promoting competitiveness. A pressing topic in the competition policy is how to ensure equal and non-discriminating competition between public persons (for example, state or local government capital companies) and the private sector. To tackle with these challenges, "Amendments to the Competition Law" entered into force on 1 January 2020, which enable the Competition Council to address distortions of competition by public persons more effectively.

The Ministry of Economics is currently actively working on strengthening the financial and professional capacity and on capacity building of the Competition Council, including by strengthening the use of IT tools in the Competition Council. This will make it possible for the Competition Council to turn against the most severe distortions of competition, as well as to better reveal and fix signs of procurement cartels.

In 2020, due to the prudent and meaningful deployment of electronic processes and the development of the functionality of the construction information system, the restrictions introduced to combat the Covid-19 pandemic had a minimal impact on the development of the construction process and on the development of the construction sector.

Over the last years, a number of complex measures have been implemented in cooperation with the construction sector, which has enabled a significant improvement in the competitiveness of the sector. The reduction in the shadow economy was most influenced by the *General Agreement of the Construction Sector*, which entered into force on 3 November 2019. In February 2020, the establishment of a single electronic system for registration of working hours was completed, which collects data from electronic working time recording systems on the actual working time on the construction site, as well as data on contracts for construction works entered into within the scope of implementation of the specific construction concept.

There are intentions to create a support programme for the construction of affordable rental housing, which will not only contribute to housing affordability but also improve the mobility of the population by promoting competitiveness and productivity of employees. There are also plans to implement a support programme for the restoration or construction of social or local government rental housing, which will facilitate the affordability of quality housing for the poorest Latvian population.

There are also plans to ensure a fair balance between the interests of landlords and tenants with the assistance of the *Law on Rental of Living Spaces*, which has been developed and is in the Saeima waiting for its third reading.

The improvement of the housing guarantee programme continued in Latvia in 2020. Since the launch of the programme in 2014, it has helped more than 12.7 thousand families with 18.3 thousand children to get housing of adequate size and quality.

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

In the arrangement of the electricity mandatory procurement system (MPC) continues paying special attention to the supervision of power plants receiving state aid. 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 for end users of electricity. In 2021, MPC is expected to be reduced from the current fixed rate of 22,68 EUR/MWh to 17,51 EUR/MWh in 2021 and a further reduction in 2022 and 2023. The amount of funding for the reduction of MPC is projected to be at the level necessary to ensure that, according to the current forecasts on the costs of mandatory procurement of electricity in 2024, no additional state budget grant is required and a further reduction of MPC is ensured.

From 1 January 2020 energy policy administration functions, including supervision of MPC, started to be implemented by the State Construction Control Bureau, thus ensuring more effective control of the state aid system. In the field of law, on 15 February 2020, amendments to the *Electricity Market Law* entered into force, which, inter alia, provide for strengthening of control of the electricity producers receiving state aid in the form of mandatory procurement, a framework for prevention of overcompensation and recovery of the unjustifiably received state aid.

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 their dependence from Russian and Belorussian power supply systems and integrate them in the European Union electricity market. It is planned to implement this project by 2025.

The establishment of a single natural gas market on 1 January 2020 is considered to be an event unique for Europe and historical for the Latvian natural gas sector. This is the result of long-term cooperation that was rich in challenges among regulatory authorities, natural gas transmission system operators and ministries responsible for the sector of the Baltic countries and Finland. The initial participants of the single market area are Finland, Estonia and Latvia, but there are plans to develop the market providing benefits to all players, and also users, of this market, and other European Union Member States will be urged to join it.

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

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

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

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

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

Jānis Vitenbergs,
Minister of Economics

December 2020

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PART II. ECONOMIC POLICY PRIORITIES

ABBREVIATIONS, MEASUREMENT UNITS, AND SYMBOLS

Abbreviations

ALTUM	Joint Stock Company "Development Finance Institution Altum"
AMR	Alert Mechanism Report
BIF	Baltic Innovation Fund
BIM	Building Information System
BIS	Building Information System
CEF	Connecting Europe Facility of the European Commission
CF	Cohesion Fund
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CM	Cabinet of Ministers
CP	Competition Council
CPI	Consumer Price Index
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
EAAP	Extended Asset Acquisition Programme
EC	European Commission
EEA	European Economic Area
EIF	European Investment Fund
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
EU-28	European Union Member States after the enlargement on 1 July 2013
EU ETS	European Union Emissions Trading System
Eurostat	Statistical Office of the European Union
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FICIL	Foreign Investors Council in Latvia
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GHG	Greenhouse Gases
GWh	Gigawatt-Hour
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
IMI	Internal Market Information System
JSC	Joint Stock Company
LLC	Limited Liability Company
LPP	Legal Protection Proceedings
MIP	Macroeconomic Imbalances Procedure
MoE	Ministry of Economics
MoEPRD	Ministry of Environmental Protection and Regional Development
MoF	Ministry of Finance
MoJ	Ministry of Justice
MP	Mandatory Procurement
MPC	Mandatory Procurement Component
MWh	Megawatt-Hour
NCCB	State Construction Control Bureau
NDP2020	National Development Plan of Latvia 2014-2020
NDP2027	National Development Plan of Latvia 2021-2027
NIIP	Net International Investment Position
NPP	Nuclear Power Plant
NRP	National Reform Programme
NULC	Nominal Unit Labour Cost Index
OCTA	Mandatory Insurance of Civil Liability of Owners of Land Vehicles
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PJ	Petajoule
PPS	Purchasing Power Standard
R&D	Research and Development
REER	Real Effective Exchange Rate
RES	Renewable Energy Source
RIS3	National/regional research and innovation strategies for smart specialisation
ROA	Return On Assets
ROE	Return on Equity
SC	State Chancellery
SME	Small and Medium-Sized Enterprises
SMM	Small and Medium-Sized Merchants
SOLVIT	EU Internal Market Problem Solving System
SRDA	State Regional Development Agency
SRS	State Revenue Service
STEM	Science, Technology, Engineering and Mathematics
TFEU	Treaty on Functioning of European Union
TRIS	Technical Regulations Information System
TWh	Terawatt-Hour
UGSF	Underground Gas Storage Facility
ULC	Unit Labour Costs of Products
USA	United States of America
USD	US Dollar
VAT	Value-Added Tax
VUIS	Vulnerable User Information System

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

PART I. ECONOMIC DEVELOPMENT TRENDS

1. ECONOMIC DEVELOPMENT TRENDS: OVERVIEW

Stable economic growth in Latvia with its rates exceeding the EU average continued until the Covid-19 pandemic. From 2011 to 2019, GDP grew by 3.3% per year on average. In 2019, growth of the economy has become more moderate. GDP grew by 2.1% in 2019. The deceleration of growth rates was underpinned by both internal factors (the investments from EU funds have reached their maximum, developments in the financial sector, etc.) and external factors (revision of global trade relations, Brexit, slower growth in EU countries).

The Covid-19 pandemic has a considerable impact on the global and Latvian economy. In the first three quarters of 2020, GDP of Latvia has reduced by 4.3% compared to the three quarters of 2019. If we look at quarters, the biggest drop was observed in Q2, when the economy shrank by 8.9%. However, this is a comparatively good indicator, because the EU average drop in GDP in Q2 was 13.9%. In Q3, economic downturn rates reduced with Latvia's GDP falling by 2.6% and that of the EU – by 4.2%. Taking into account the worsening of the epidemiological situation, at the end of the year the general economic situation in the country continues to deteriorate. The situation also gets worse in Latvia's export markets and new restrictions may influence external demand and therefore our export capabilities. According to the assessment of the Ministry of Economics, **in 2020 Latvia's GDP might shrink by 5-6% compared to 2019**. Economic growth might resume in 2021.

Table 1.1

Latvia: Key Figures of Economic Development								
	2014	2015	2016	2017	2018	2019	2020f	2021f
Gross domestic product (at current prices, billion euro)	23.6	24.6	25.4	27.0	29.1	30.5	28.7	29.9
	changes, %							
Gross domestic product	1.1	4.0	2.4	3.3	4.0	2.1	-5.5	3.7
Private consumption	0.6	2.2	2.4	3.0	2.6	2.2	-12.7	9.5
Public consumption	3.5	2.7	2.5	3.4	1.6	2.6	2.5	2.7
Gross fixed capital formation	0.6	-2.0	-8.2	11.4	11.8	2.1	-2.1	2.3
Export	6.2	3.0	4.0	6.4	4.3	2.1	-6.7	3.8
Import	2.9	1.6	3.6	8.6	6.4	3.0	-7.0	4.2
Consumer prices	0.6	0.2	0.1	2.9	2.5	2.8	0.2	1.0
	as a percentage in relation to the GDP, unless indicated otherwise							
General government sector balance	-1.6	-1.4	0.2	-0.8	-0.8	-0.5	-8.0	-6.0
General government debt	41.6	37.1	40.4	39.1	37.1	37.0	50.0	52.0
Export-import balance	-2.9	-1.7	0.3	-0.6	-0.8	-0.8	0.7	-0.6
Changes in the number of the employed (15-74 years of age, % compared to the previous year)	-1.3	1.4	-0.0	1.5	1.5	0.1	-1.8	-0.3
Employment rate	59.1	60.8	61.6	62.9	64.5	65.0	64.2	64.3
Unemployment rate (unemployed, % of the economically active population, 15-74 years of age)	10.8	9.9	9.6	8.7	7.4	6.3	8.3	7.8
Changes in the average gross monthly wage, %	6.8	6.8	5.0	7.9	8.4	7.5	5.1	7.0

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

The Covid-19 crisis has had a significant impact on consumption. As employment and wages were growing, it has been growing stably in recent years. In 2019, the private consumption growth rate (2.2%) was close to the overall growth rate. The increase in unemployment and drop in income caused by the Covid-19 crisis in 2020 has reduced consumption of

households considerably – in the first three quarters of 2020, it was by 10.5% lower than a year before. The support measures implemented by the government to mitigate the negative effects of Covid-19 and largely funded at the expense of increasing the state budget deficit, have maintained a positive increase in public consumption. It was 2.4% higher in the three quarters of 2020 than a year before.

The Covid-19 crisis has had a relatively more modest impact on investments. In previous years, the increase in investment was largely driven by the use of EU funds. In 2019, investments from EU funds reached their peak in the current programming period, investment rates decreased showing an increase of only 2.1% (compared to 11.8% in 2018). In the three quarters of 2020 gross fixed capital formation volumes decreased by 0.7% compared to the corresponding period of 2019. Investment in housing, buildings and structures decreased by 3.3%, in machinery and appliances – by 5%, while investment in intellectual property products increased by 2.7%. Despite the Covid-19 crisis, net FDI flows attracted to Latvia in the nine months of 2020 amounted to 592 million euro, that is, by 58 million euro more than a year before, and reached 2.8% of GDP.

The Covid-19 crisis has a negative impact on exports of goods and services. Export growth has been slightly more rapid than overall economic growth in recent years. From 2015 to 2019 exports of goods and services increased by 3.1% on average every year. Exports of services increased even more rapidly – by 5.7%, indicating that the services sector is increasingly integrating into global markets, increasing its contribution to increasing the volume and value of Latvian exports. Still, growth rates started to slow in 2019, rising just by 2.1%. In 2020, the development of exports is greatly affected by Covid-19 restrictions on Latvian export markets and delays in raw material supply chains. In the three quarters of 2020 export volumes decreased by 4.8% compared to the three quarters of 2019. Export volumes of goods increased by 2,5%, while exports of services were 21,3% lower in the three quarters that in the relevant period a year ago. This was mainly underpinned by a significant drop in exports of tourism and transport services.

The deficit of the current account of the balance of payments has been low since 2011, which gives proof of the external balance of the Latvian economy. In 2019, current account had a small deficit of 0.6% of GDP. In the nine months of 2020 the current account condition was determined by the shock caused by the Covid-19 pandemic having different impacts on cross-border flows of goods, services and revenues and reflected in the current account surplus of 1.3% of GDP. Current account is expected to be balanced or have a small deficit also in the coming years.

Development trends across sectors vary considerably. Trade made the most significant contribution to economic growth in 2019 (increase by 4.2%). Rapid growth in 2019 was also observed in agriculture and forestry (by 12.3%), food service activities (by 11.2%), computer programming and advisory services (by 7.9%) and business services (by 6.3%). In the three quarters of 2020, under the influence the Covid-19 crisis accommodation and food service activities, and also arts, entertainment and recreation sectors have had the most significant drop in volumes, with a decline of 34.9% and 26.1% across the year, respectively. The Covid-19 restrictions also had a significant impact on aviation, land transport and rail companies. In the three quarters of 2020, the drop in transportation and storage services reached 15%. There was also a considerable decrease in volumes in financial and insurance activities, information and communication services and business services sectors. Agriculture and forestry, construction and public services were among the few sectors where growth persisted in the three quarters of 2020.

Fall in three quarters of this year was also observed in manufacturing (2.7%). Overall, although the decrease in volumes was observed in many sub-sectors, month-by-month data look optimistic. For example, compared to May, when only a few sectors were growing, in June-August, many sectors were already experiencing positive trends and overall in Q3 manufacturing still showed a slight growth (by 0.1%).

Since 2011, Latvia has returned to growth, and significant improvements have been achieved in its fiscal position. Budget has been with a small deficit in recent years. It was 0.6% of GDP in 2019. The Saeima approved the budget for 2020 with a deficit of 0.3% of GDP. However, **in 2020, under the influence of the Covid-19 pandemic the budget deficit has increased considerably – according to the estimates of the Ministry of Finance to about 8% of GDP.** The budget for 2021 was adopted with a deficit of 3.9% of GDP. The Ministry of Finance has made an assessment: if the negative macroeconomic development scenario is implemented, the budget deficit might reach 6% of GDP in 2021.

The average annual inflation was 2.8% in 2019 and it was slightly higher than in 2018. The increase in prices of services had a considerable effect on the level of consumer prices. **In 2020, average annual inflation is expected to be significantly below the level of 2019**, which will mainly be underpinned by the negative impact of the Covid-19 epidemic on economic development. A drop in prices was observed in the eleven months of 2020. In November 2020, compared to December 2019, consumer prices decreased by 0.4%. The annual average inflation in November was 0.4 per cent.

The introduction of the measures to restrict Covid-19 has a significant influence on the situation in the labour market. In recent years, the increase in economic activity contributed to the decline in unemployment and increase in employment. At the same time, the increase in the number of employees was moderate due to a reduction in the population capable of working. In 2019, the unemployment rate was 6.3%, thus approaching the pre-crisis unemployment rate of 2007, while the employment rate increased to 65 per cent.

Since mid-March 2020, when the Covid-19 restriction measures were introduced, the labour market situation has changed dramatically. The labour-intensive sectors – transport services/passenger transport, booking services of travel agencies and tour operators, accommodation and food service activities, arts and various cultural areas, sports centres and other sectors directly linked to the movement and assembly of the population – were most negatively affected. According to the data from the State Revenue Service, 229.5 thousand employees were employed in the sectors affected by the Covid-19 restrictions in Q3 2020, which make more than 1/4 of all employees in the national economy in the corresponding period. The negative effects of the Covid-19 pandemic on the labour market have so far been mitigated by the introduced state support measures, which have partly allowed both jobs and income of the population to be maintained. In Q3 2020, the number of employees decreased by 25 thousand or 2.7% compared to Q3 2019. Unemployment has also increased tangibly with the decline in population employment. In Q3 2020, the unemployment rate in Latvia was 8.4%, significantly exceeding the level of Q3 2019 – by 2.4 percentage points.

The impact of the Covid-19 epidemic on the labour market will depend to a large extent on the duration of restrictions related to the spread of coronavirus. In view of the shrinking economic activity due to Covid-19, the total number of employees is expected to fall by 1.8% in 2020 (by almost 17 thousand) compared to 2019, while the unemployment rate will rise to 8.3%. The labour market situation is likely to improve from the spring/summer season of 2021, with seasonal jobs increasing and the overall stabilisation of the economic situation.

The increase in wages has remained above 7% per year in the last three years. In 2019, the average gross wage reached 1,076 euro or 7.2% more than in 2018. Although average wages continued to rise in 2020, with labour market activity declining, growth rates have still become slower. The average monthly gross wage increased by 3.9% in Q2 2020 and by 5.9% in Q3 – increasing to 1,147 euro on average per month, which is still tangibly lower than in previous years.

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

The Latvian economic competitiveness is mainly based on technological factors, improvement of production efficiency, and innovation, to a lesser extent on cheap labour and low resource prices. In the medium term, Latvia's growth rates may reach a 4-5% increase per year. If growth in Europe weakens and measures to restrict the virus could endure, the pace of economic recovery might be slower.

2. GLOBAL ECONOMIC DEVELOPMENT

In the first half 2020, the **global economy** entered into a sudden downturn due to the Covid-19 pandemic with the most rapid decline in production since World War II. Strict restrictive measures were introduced around the world to prevent the spread of the COVID-19 pandemic, which significantly stifled much of the economy. The prospects for global growth are currently very uncertain. Global growth is expected to reduce by 4.3% in 2020 and increase by 4.6%[1] in 2021.

Table 2.1

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

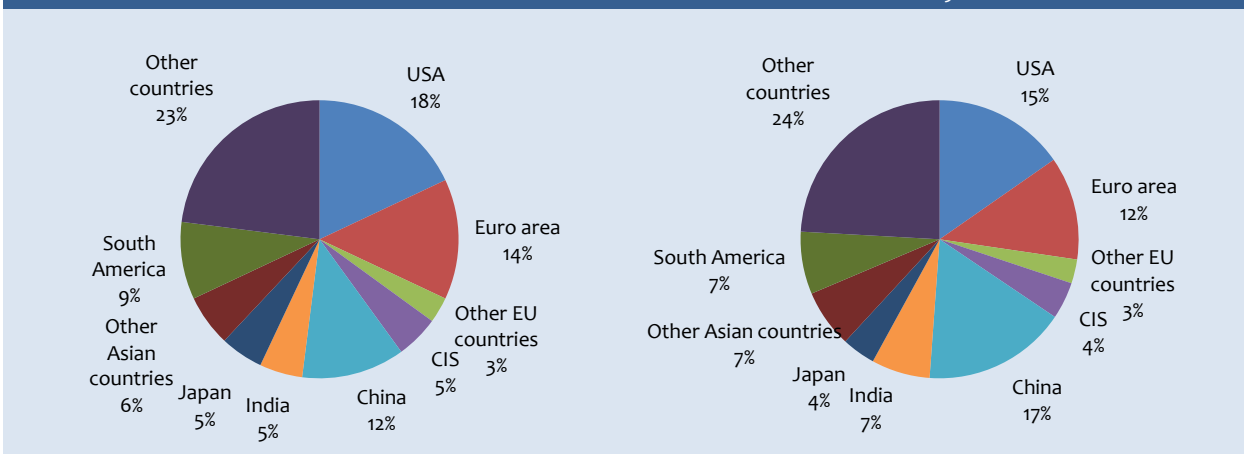
	2017	2018	2019	2020f	2021f
World including:	**3.7**	**3.5**	**2.7**	**-4.3**	**4.6**
USA	2.4	2.9	2.3	-4.6	3.7
Japan	2.2	0.3	0.7	-5.5	2.7
EU including:	2.8	2.1	1.5	-7.4	4.1
Euro area	2.6	1.9	1.3	-7.8	4.2
Russia	1.8	2.5	1.3	-4.2	2.0
China	7.0	6.7	6.1	2.1	7.3

Source: *European Commission – European Economic Forecast, Autumn 2020*
f – forecast

Thanks to strong private demand, improvements in the labour market and very supportive monetary policy and broad fiscal stimulus support, the economy of the **United States** began to recover relatively quickly after the collapse in April and May 2020. The global downturn and the economic development of major trading partners, as well as broader changes in value chains will have a significant impact on exports in the coming quarters. Private consumption and investment are expected to recover gradually. Although the economy will continue to recover in the coming quarters, uncertainty remains very high. The EC forecasts that overall economic growth of the United States will fall by 4.6% in 2020, while the economy will recover by 2021, with GDP rising by 3.7 per cent.

Figure 2.1

Breakdown of the Total Global GDP by Countries and Groups of Countries
by purchasing capacity parity, share in the global total, as per cent



Source: *The World Economic Outlook October 2020, International Monetary Fund*

[1] *European Commission. European Economic Forecast, Autumn 2020*

In China, where recovery is taking place after a sharp decline in Q1, growth is projected to reach 2.1% in 2020. Thanks to early pandemic control, targeted policy support and increased external demand for Chinese exports, manufacturing industry output and investment returned to the levels before the pandemic relatively quickly. Higher unemployment and lower household and corporate incomes in 2020 will reduce consumer demand, which is likely to recover more strongly only in 2021. The EC forecasts that growth rates will accelerate in China in Q4 2020 and in 2021.

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

Following negative growth in the first three quarters of 2020, economic activity in Japan has recovered in the second half of 2020, largely thanks to significant fiscal policy incentives, a comparatively successful Covid-19 pandemic restriction policy and growing external demand. Private consumption is expected to increase as private demand grows. It will also be promoted by the Tokyo Olympics, which will take place in summer 2021. Public consumption is expected to increase by continuing incentive measures, while private investment growth is likely to resume only in 2021. Exports of goods are also expected to continue to grow, although travel restrictions are likely to hamper a strong recovery of the tourism sector.

Table 2.2

Main Macroeconomic Indicators of the EU Member States
as per cent

	Real GDP			Inflation			Unemployment rate		
	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f
European Union	**1.5**	**-7.4**	**4.1**	**1.2**	**0.3**	**1.1**	**6.7**	**7.7**	**8.6**
United Kingdom	1.3	-10.3	3.3	1.8	0.9	2.3	3.8	5.0	7.3
Austria	1.4	-7.1	4.1	1.5	1.5	1.7	4.5	5.5	5.1
Belgium	1.7	-8.4	4.1	1.2	0.4	1.4	5.4	5.9	7.0
Bulgaria	3.7	-5.1	2.6	2.5	1.2	1.4	4.2	5.8	5.6
Czech Republic	2.3	-6.9	3.1	2.6	3.4	2.3	2.0	2.7	3.3
Denmark	2.8	-3.9	3.5	0.7	0.3	1.1	5.0	6.1	5.8
France	1.5	-9.4	5.8	1.3	0.5	0.9	8.5	8.5	10.7
Greece	1.9	-9.0	5.0	0.5	-1.3	0.9	17.3	18.0	17.5
Croatia	2.9	-9.6	5.7	0.8	0.1	1.2	6.6	7.7	7.5
Estonia	5.0	-4.6	3.4	2.3	-0.5	1.4	4.4	7.5	7.8
Italy	0.3	-9.9	4.1	0.6	-0.1	0.7	10.0	9.9	11.6
Ireland	5.6	-2.3	2.9	0.9	-0.5	0.3	5.0	5.3	8.9
Cyprus	3.1	-6.2	3.7	0.5	-0.9	0.9	7.1	8.2	7.8
Latvia	2.1	-5.6	4.9	2.7	0.3	1.3	6.3	8.3	8.0
Lithuania	4.3	-2.2	3.0	2.2	1.3	1.5	6.3	8.9	8.0
Luxembourg	2.3	-4.5	3.9	1.6	0.2	1.5	5.6	6.6	7.1
Malta	4.9	-7.3	3.0	1.5	0.8	1.3	3.6	5.1	4.7
Netherlands	1.7	-5.3	2.2	2.7	1.1	1.3	3.4	4.4	6.4
Poland	4.5	-3.6	3.3	2.1	3.6	2.0	3.3	4.0	5.3
Portugal	2.2	-9.3	5.4	0.3	-0.1	0.9	6.5	8.0	7.7
Romania	4.2	-5.2	3.3	3.9	2.5	2.5	3.9	5.9	6.2
Slovakia	2.3	-7.5	4.7	2.8	2.0	0.7	5.8	6.9	7.8
Slovenia	3.2	-7.1	5.1	1.7	0.0	0.9	4.5	5.0	4.8
Finland	1.1	-4.3	2.9	1.1	0.4	1.1	6.7	7.9	7.7
Spain	2.0	-12.4	5.4	0.8	-0.2	0.9	14.1	16.7	17.9
Hungary	4.6	-6.4	4.0	3.4	3.4	3.3	3.4	4.4	4.4
Germany	0.6	-5.6	3.5	1.4	0.4	1.4	3.1	4.0	4.0
Sweden	1.3	-3.4	3.3	1.7	0.6	0.8	6.8	8.8	9.2

Source: *European Commission – European Economic Forecast, Autumn 2020*
f – forecast

Economic prospects in **India** have deteriorated sharply. Output volumes in Q2 2020 experienced a record-high decline and fell 25.2% compared to the previous quarter, as one of the toughest restrictions in the world were introduced in the country. In view of the unfavourable epidemiological situation and the fact that monetary and fiscal space remains restricted, a significant economic downturn is expected in 2020. Meanwhile, in 2021, the recovery will be moderate also due to structural economic problems.

A number of indicators show that the **Euro area** economy has operated from 25% to 30% below its capacity during the strictest restrictions. The EC forecasts that the euro area economy will shrink by around 7.8% in 2020. Meanwhile, in 2021, the economy will recover reaching a 4.2% annual growth rate.

Germany's GDP reduced by 4.3% in the first half of 2020 compared to the first half of 2019. Although the relatively favourable epidemiological situation allowed Germany to be among the first EU countries that started to relax its restrictive measures, there was an unprecedented drop in economic activity in Q2 2020. Broad policy support is expected to persist and should help prevent massive loss of jobs and insolvency. The costs of the crisis budget will continue to pile up, but the fiscal deficit is expected to shrink already in 2021 and 2022.

Sweden's GDP fell 3.1% in the first half of 2020. Overall, economic growth is expected to reduce by 3.4% in 2020. Meanwhile, in 2021, the economy is expected to recover, with real GDP rising by 3.3%. The general government balance in 2020 will be with a deficit of 4% of GDP and will improve over the next few years as growth recovers and fiscal support is reduced. The public debt-to-GDP ratio is expected to stabilise at around 40% of GDP.

United Kingdom's GDP reduced by 6.2% in the first half of the year. Overall, the EC forecasts that GDP will reduce by 10.3% in 2020 and will increase by 3.3% in 2021. While private consumption is expected to contribute significantly to economic growth in 2021, the recovery of business investment will take longer because of the long-term effects of the pandemic and the need to adapt to the new, significantly less beneficial trade relations with the EU. Government debt is projected to be well above 100% of GDP in the coming years.

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

In **Russia**, the recession is slightly more moderate than in most other G20 countries. This is related to the recently restored macroeconomic system, which focuses on flexible exchange rates, as well as the relatively closed and static nature of the economy. Following the introduction of national-scale infrastructure projects at the beginning of the year, national investment stopped, with resources being redeployed for national consumption. In recent years, growth in Russia has been hampered by widespread ownership issues, the role of the energy sector and capital companies in the economy, barriers to SMEs, a general lack of competition, as well as the lack of economic openness and innovation. These structural challenges are likely to further curb economic growth in the current circumstances, where oil prices have fallen significantly and global demand remains weak.

In **Belarus**, the decline in growth rates in Q3 2020, compared to the previous quarter, was driven by higher agricultural output and a smaller fall in manufacturing. However, internal demand remains weak. The protests are likely to continue to have a negative impact on domestic activity and economic development. All of this shows no indications for an economic recovery in Q4.

A sharp economic downturn is expected in **Ukraine**. The economy is likely to return to growth only in 2021. Growth is expected to be driven by both external and internal demand as well as expansionary fiscal and monetary policies. The Covid-19 pandemic, the postponement of reforms as well as the shortcomings in the banking system will weaken economic growth prospects in the coming years.

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

Lithuania's GDP reduced only by 0.8% in the first half of 2020 compared to the first half of 2019. The EC forecasts that GDP in Lithuania will decline 2.2% in 2020. And then GDP will grow by 3% in 2021. Important economy stimulation measures have helped to keep jobs, but budget deficit and public debt have increased. Growth is expected to slow in the coming years due to the fragile international trade situation and moderate internal demand. Exports, including transport services, have been an important factor in Lithuania's economic growth over the past three four years. However, the unstable situation in international trade and the demands arising from reforms in the EU road transport sector are expected to slow growth prospects in the coming years.

Estonia's GDP decreased by 4% in the first half of the year. The EC forecasts GDP to fall by 4.6% in 2020, while GDP will grow by 3.4% in 2021, reflecting the base impact and the incentive measures already taken to boost investment and overall confidence. The unemployment rate rose in spring but has since stabilised. Deflation in 2020 reflects a significant drop in

energy and tourism-related prices. Fiscal stimulus measures will be implemented in 2021, maintaining an increased budget deficit, although Estonia's government debt burden is projected to remain the lowest in the EU.

Figure 2.2

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

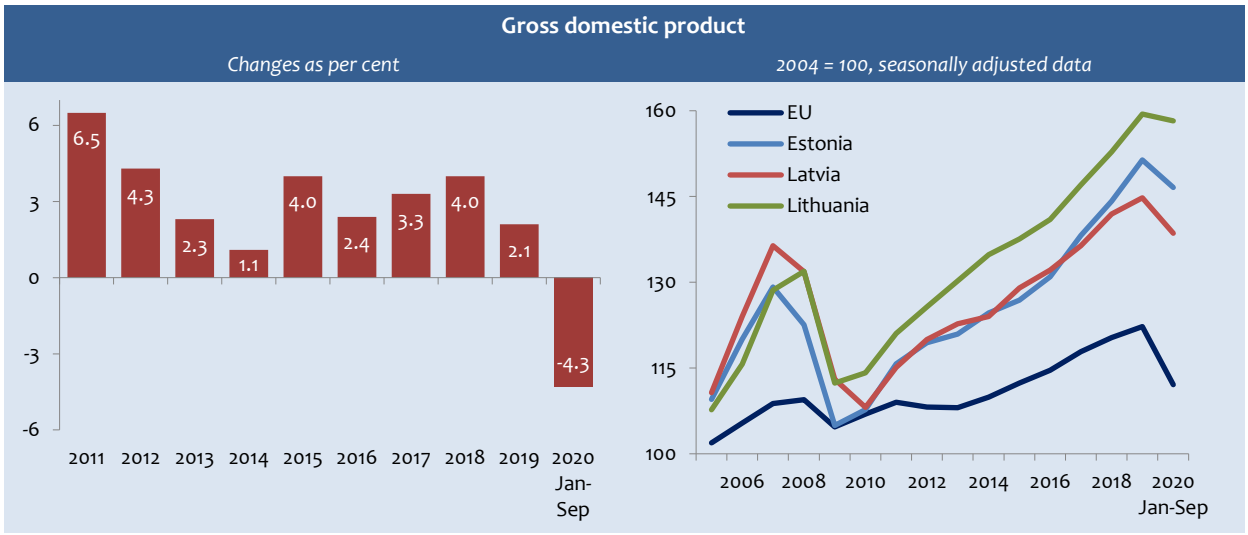
Source: CSB, *European Commission – European Economic Forecast, Autumn 2020*
f – forecast

3. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

3.1. DYNAMICS AND STRUCTURE

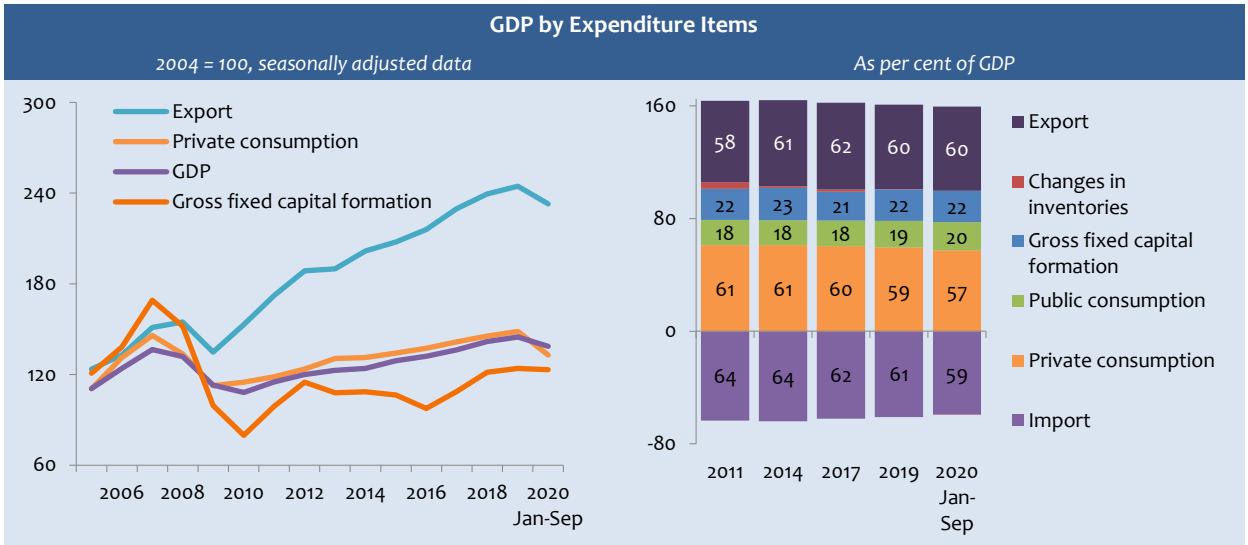
Since 2011, economic growth in Latvia has been one of the most rapid in the EU. In 2011-2012 it reached 5.4% per year on average. During the first years after the crisis, Latvia's economic growth was largely based on an increase in export volumes. In 2010-2012 the share of exports increased by 7 percentage points – from 54% to 61% of GDP. From 2013 to 2016, economic growth was slower due to different factors. Overall, GDP was growing by 2.4% per year on average during this period.

Figure 3.1



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

Figure 3.2

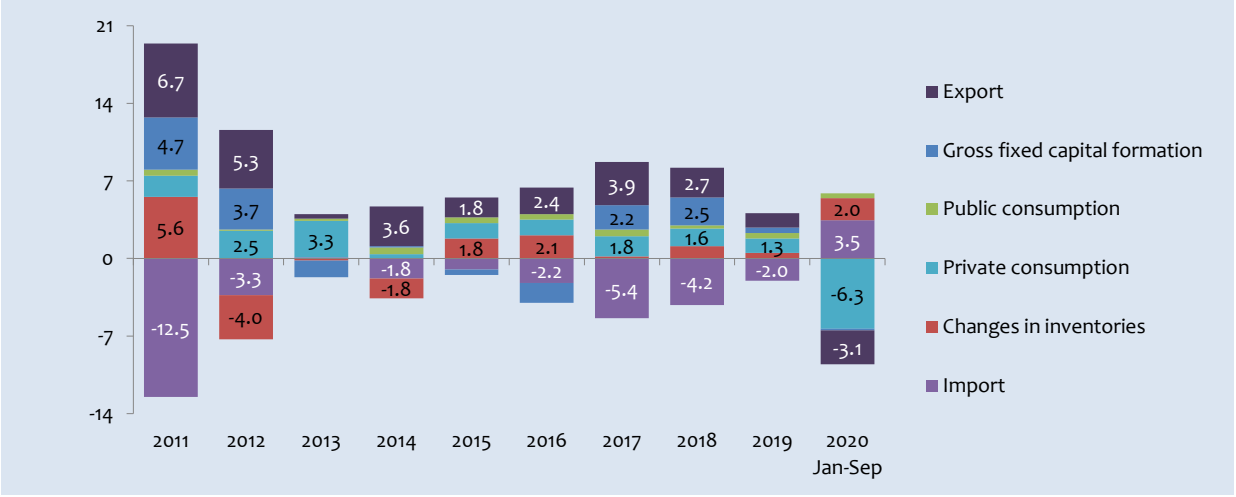


In 2017-2018, growth became more rapid. It reached 3.6% per year on average. The acceleration of growth was fostered by the improvement of the situation in the EU, the commencement of a new programme of the structural funds, increase in wages and employment. In this period, export, investments, private and public consumption were growing stably.

In 2019, growth of the economy was more moderate. GDP has grown by 2.1%. The deceleration of growth rates was underpinned by both internal factors (the investments from EU funds have reached their maximum, developments in the financial sector, changes in port management, etc.) and external factors (revision of global trade relations, *Brexit*, slower growth in the EU countries).

Figure 3.3

Contribution of GDP Expenditure Items to Changes
as percentage points



In turn, economic development in 2020 is mainly dependent on the negative effects of Covid-19. GDP fell by 4.3% in the three quarters of 2020 showing the steepest drop in the past decade. The fall in private consumption, which was affected by rising unemployment and falling incomes, had the biggest impact on the GDP reduction.

In the three quarters of 2020, Covid-19 restrictions on Latvian export markets and delays in raw material supply chains have affected exports of goods and services. A relatively moderate decline was seen in investment. Government consumption, on the other hand, continued to grow, mainly due to the government support measures to mitigate the negative effects of Covid-19.

In 2011-2019, growth in all the three Baltic countries was similar. It grew slightly faster in Estonia and Lithuania – by 3.9% and 3.8% per year on average, respectively, and by 3.3% in Latvia.

Table 3.1

GDP by Expenditure Items
compared to the previous year, changes as per cent

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 Jan-Sep
Gross domestic product	**6.5**	**4.3**	**2.3**	**1.1**	**4.0**	**2.4**	**3.3**	**4.0**	**2.1**	**-4.3**
Private consumption	3.1	4.3	5.6	0.6	2.2	2.4	3.0	2.6	2.2	-10.5
Public consumption	2.8	0.7	1.4	3.5	2.7	2.5	3.4	1.6	2.6	2.4
Gross fixed capital formation	24.1	16.0	-6.0	0.6	-2.0	-8.2	11.4	11.8	2.1	-0.7
Export	12.6	9.5	0.7	6.2	3.0	4.0	6.4	4.3	2.1	-4.8
Import	22.8	5.2	-0.1	2.9	1.6	3.6	8.6	6.4	3.0	-5.0

3.2. CONSUMPTION

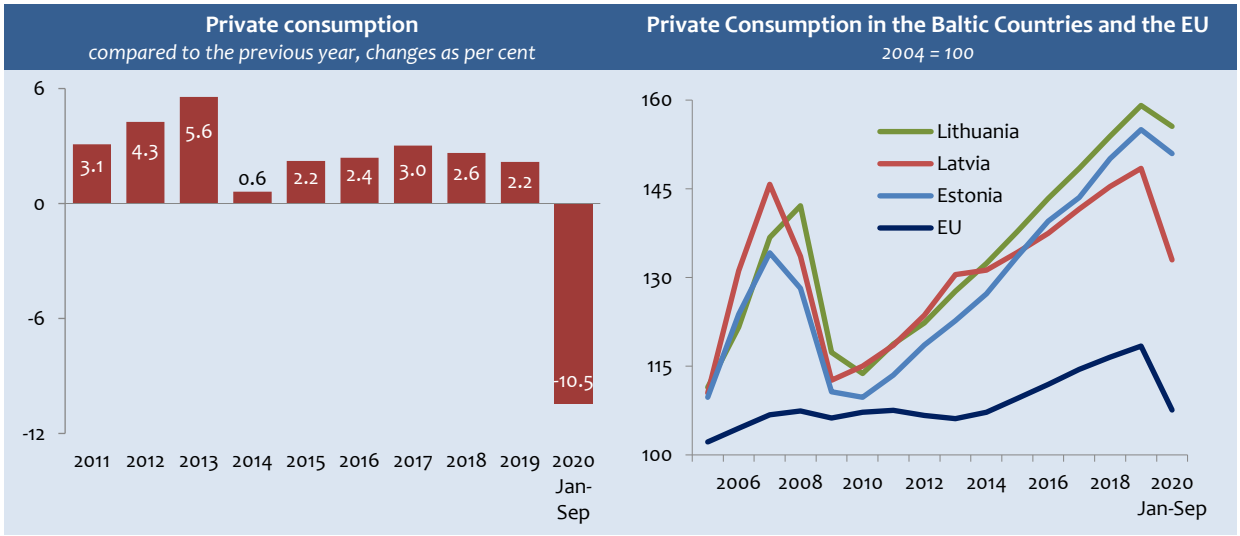
From 2011 to 2013, private consumption increased by 4.3% per year on average. Despite the improvement of the situation in the labour market and low inflation, the increase in volumes of private consumption similarly to economic growth were more moderate in 2014-2016. The increase in private consumption was only 1.7% 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 – by 2.8% per year on average secured by an increase in employment and a considerable increase in wages. Meanwhile, in 2019, a slower increase was underpinned by more moderate improvements in the labour market, although wage increase rates were still relatively rapid.

However, in the three quarters of 2020, due to the Covid-19 restrictions, private consumption reduced rapidly under the influence of shrinking expenses, growing unemployment and income reduction.

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

Figure 3.4



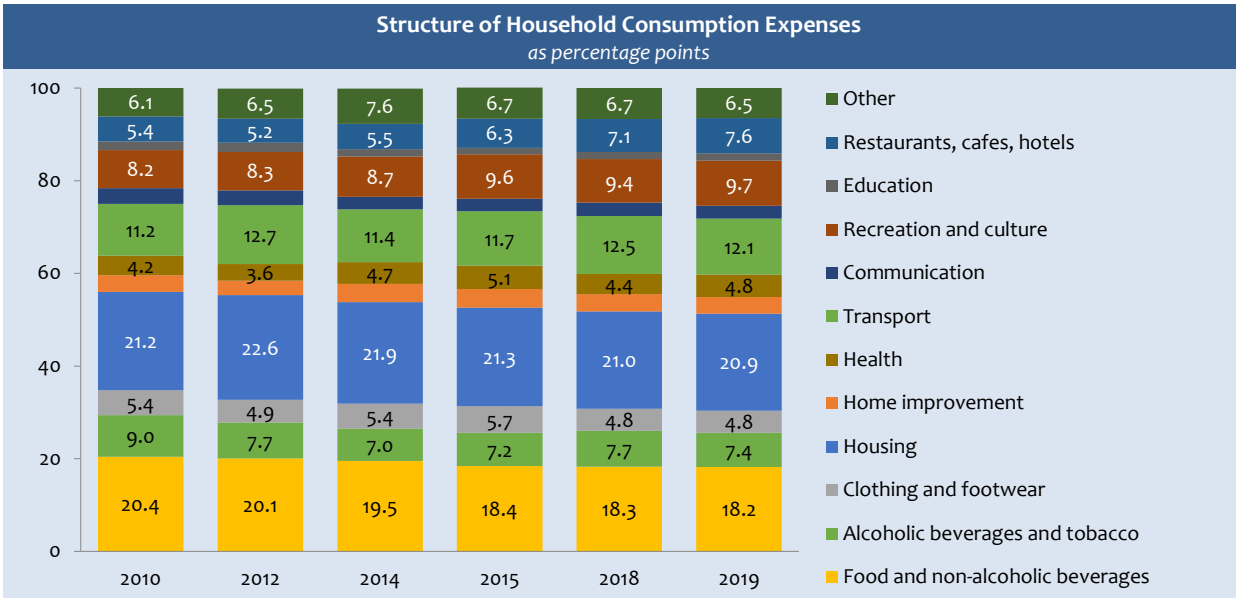
In the structure of household consumption, most of expenditure is on housing, expenditure on food is the second largest consumption group, while transport is the third priority. The share of expenditure on food, alcoholic beverages and tobacco, clothing and footwear, housing, communications and education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

Household expenditure in monetary terms also continued to increase. In 2019, compared to the previous year, expenditure increased in all main groups of expenditure with the exception of alcoholic beverages and tobacco, and home improvement. The increase in expenditure on restaurants, cafes and hotels, health, recreation and culture had the biggest effect. Expenditure on housing and utilities has increased only 1.3% during the year. The amount of expenditure on food, which is the second largest group of consumption expenditure, increased as well – by 2.3%. The third largest group of expenditure – transport expenditure increased by 2.1%. Recreation and culture were the fourth priority in household expenditure, where a rapid increase by 5.2% was observed due to the increase in expenditure on recreation and culture services.

In 2019, compared to 2010, household consumption expenditure increased in all groups of consumption expenditure with the exception of housing. Expenditure on transport and food, recreation, culture and restaurants, cafes and hotels made the largest contribution into the increase of consumption expenditure.

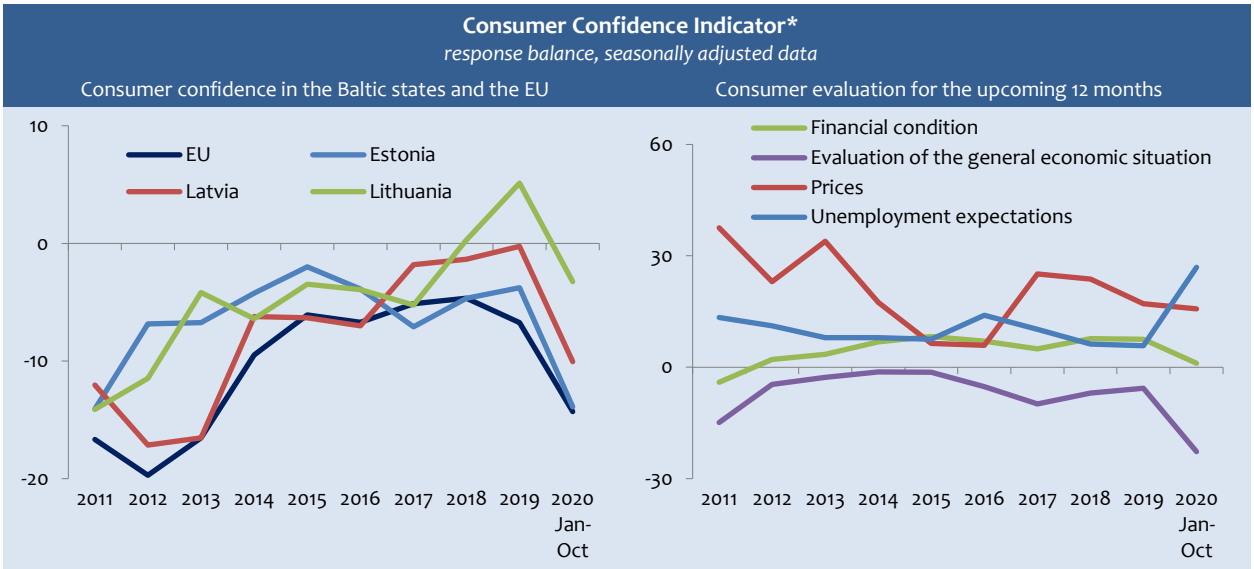
Since 2010, consumer confidence has generally improved although it has been volatile, but it is still negative. The most optimistic confidence level was reached in January 2018, when the indicator reached -1 points, the highest level in the last 10 years. Such an improvement in consumer confidence has been largely fostered by rapid economic growth in recent years. However, although the confidence has been generally improving, it lagged behind the average level in the European Union. It has finally exceeded the EU average only since December 2018 as consumer confidence has improved.

Figure 3.5



However, consumer confidence is worsening in 2020. At the beginning of the year, consumer confidence continued to improve as a result of 2019 trends, but with the announcement of the emergency situation in the country due to the Covid-19 crisis, it started to deteriorate in almost all indicator's positions, such as the financial situation of the family, the overall economic situation in the country, unemployment expectations, reaching the lowest level this April and May. Meanwhile, inflation expectations in these two months had reached their lowest level in the past three years. Starting from August, consumer confidence is beginning to gradually improve, but due to uncertainty in Latvia and in the world due to Covid-19, it may change at any time.

Figure 3.6



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

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 and until April 2020 reaching its historic low in the last three years – -9.2 points.

A growing trend in consumers' assessment of the overall situation in the country has been similar to the assessment of the financial situation of their families since 2010. A rapid increase has been observed until 2012, and in 2012 consumer

confidence stabilised at the same time sticking to the ascending trend. 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 emergency situation announced at the beginning of this year has dramatically reduced consumer optimism about that indicator, reaching its lowest level in the past decade (-47 points) in April.

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 or worsens, the consumers' assessment of the overall situation in the country and also of the financial situation of their families changes.

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 end of 2016. Since the middle of 2017, unemployment expectations have been generally declining, which is largely related also to the overall decline in the unemployment rate and an increase in employment. Unfortunately, as a result of this year's events, unemployment expectations of consumers have been growing rapidly as well, reaching 63.1 points, the highest level in the last ten years, in April. The expectations have slightly reduced in recent months, but because of the announcement of another emergency situation due to the second wave of Covid-19 they are expected to grow rapidly in the coming months.

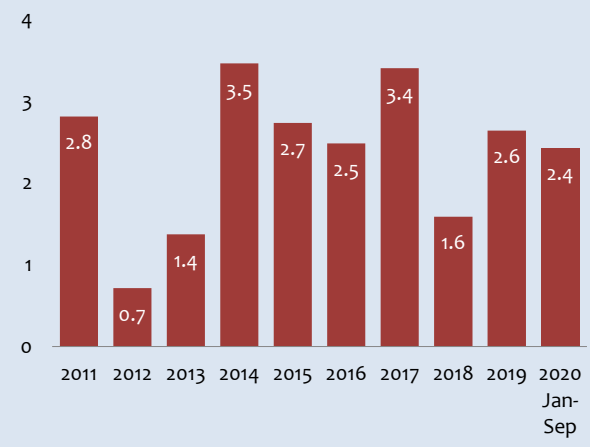
Consumers' inflation expectations had been growing rapidly until April 2011. Since the middle of 2011, inflation expectations have been very cyclical – in this way consumers responded to different changes, however, they have been generally declining. Since the middle of 2013 the drop has been very rapid reaching the level of -2 points in September 2016, the lowest since 2011. At the end of 2016, inflation expectations resumed growth until the middle of 2017. Since the end of 2017, inflation expectations have moderately reduced, largely under the influence of a slower rise in prices and high inflation in the previous years.

The events of 2020 – the announcement of the emergency situation due to Covid-19 – have not had any significant impact on inflation expectations and they generally show a descending trend.

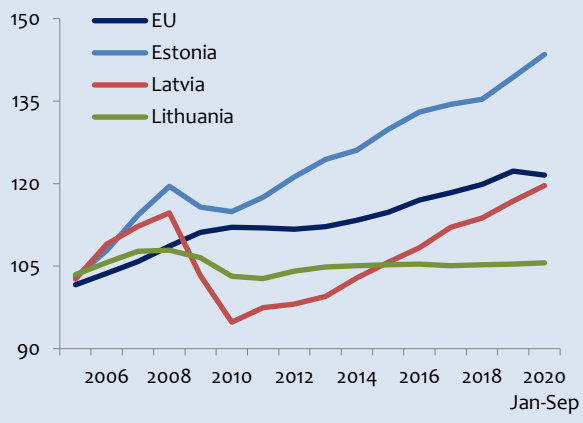
The increase in public consumption or the volumes of public services after the crisis was slow. The government's commitment to continue reducing the national budget deficit in 2012 and 2013 held back a rapid increase in expenditure. As budget income is growing, public consumption has been growing more rapidly since 2014. Overall, from 2011 to 2019, public consumption was growing by 2.3 per cent per year on average.

Figure 3.7

Public consumption
compared to the previous year, changes as per cent



Public Consumption in the Baltic Countries and the EU
2004 = 100



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.

Government consumption continued to grow also in the three quarters of 2020, mainly due to the government support measures to mitigate the negative effects of Covid-19.

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

3.3. INVESTMENT

Investment is an important contributor to Latvia's economic growth. The Covid-19 crisis caused a reduction in investment and trends in the coming years are uncertain. In the nine months of 2020, investment, compared to the corresponding period of the previous year, was 0.7% lower, showing a relatively small drop in investment activities. This was largely underpinned by a 1.8% increase in private investment while public investment was nearly 10% smaller than a year ago.

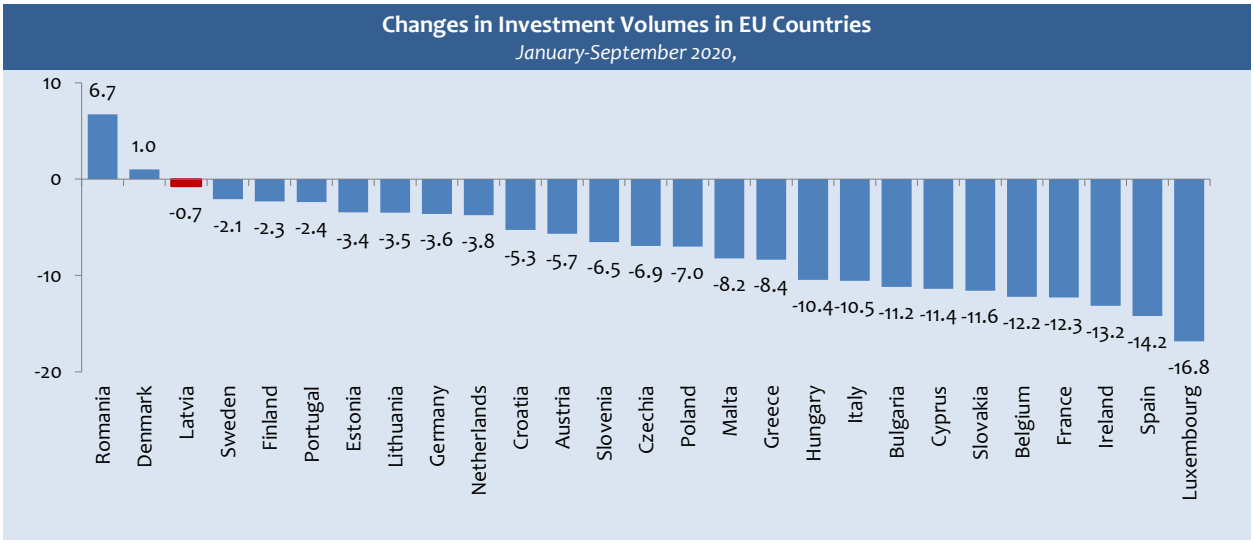
In the long term, investment activities in the Latvian economy are very volatile. They had been growing rapidly until 2007 influenced by the influx of foreign capital due to the Latvia's accession to the EU. Between 2004 and 2007, average investment in Latvia's economy accounted for 33% of GDP being one of the highest levels in EU countries.

Investment was hit hard by the global financial crisis. Investment volumes decreased over three years (2008-2010), reaching only 19% of GDP in 2010, the lowest level since 1998.

The recovery of investment after the crisis was relatively slow. Its annual growth rates have been generally more moderate than before the crisis since 2011. From 2011 to 2019 investment increased by 5% per year on average and amounted to 22% of GDP. Moreover, the investment dynamics were unstable: showing a rapid increase in 2011-2012 and a long weak investment period in 2013-2016.

The weak investment period has been overcome since 2017. Expenditure for gross fixed capital formation in 2017 and 2018 increased by 11.4% and 11.8%, respectively, which was much faster than in most of the EU Member States. A large amount of investment come from EU-funded public investment. Moreover, as the absorption of EU structural funds approaches its maximum level, the growth rate of investment activities is becoming increasingly more moderate and in 2019 the total fixed capital formation expenditure was only 2.1% higher than a year ago and accounted for 22.2% of GDP. Despite the increase of the last years, the level of investments is still considerably lower than in the years of rapid growth (2005-2007).

Figure 3.8



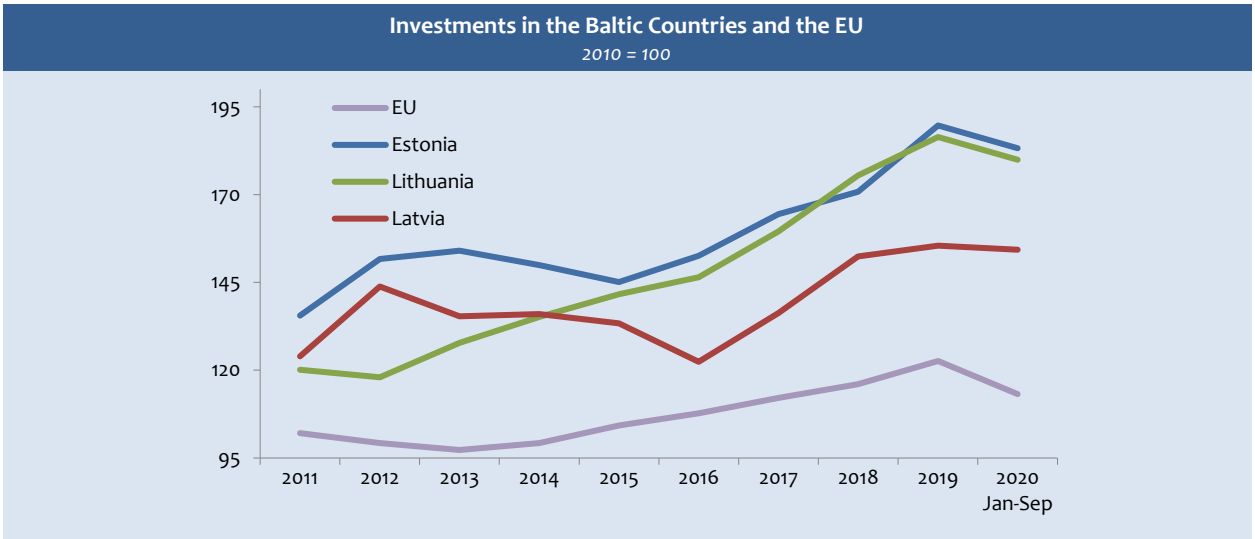
The low level of investment in recent years is mainly influenced by weaker activity of private investors than in years of rapid growth. The positive dynamics of private investment have only resumed since 2017 and in 2019 accounted for 17.3% of GDP, almost 11 percentage points less than before the crisis.

The funding for investments was mainly provided by entrepreneurs' own resources and EU structural funds, while lending remained very low for a long time. Despite comparatively low costs and growing demand, the credit-to-GDP ratio continues to shrink. According to the data of the Bank of Latvia, at the end of 2019, the balance of loans to non-financial corporations and households accounted for 40% of GDP, which is well below the level before the crisis. Private investment growth is also limited by low demand and high uncertainty.

The negative effects of the above-mentioned factors on investment are significantly reinforced by the crisis caused by the Covid-19 pandemic. According to data of the Bank of Latvia, in the eight months of 2020, the total amount of newly issued loans was 11.4% (including by 6.3% to non-financial corporations) smaller than in the corresponding period of the previous year. The credit portfolio-to-GDP ratio has fallen to almost 38.5% in the first half of 2020, reaching its lowest level since 2003. There is also an increase in the costs of issued loans. Lending costs are mainly rising in the segment of small and

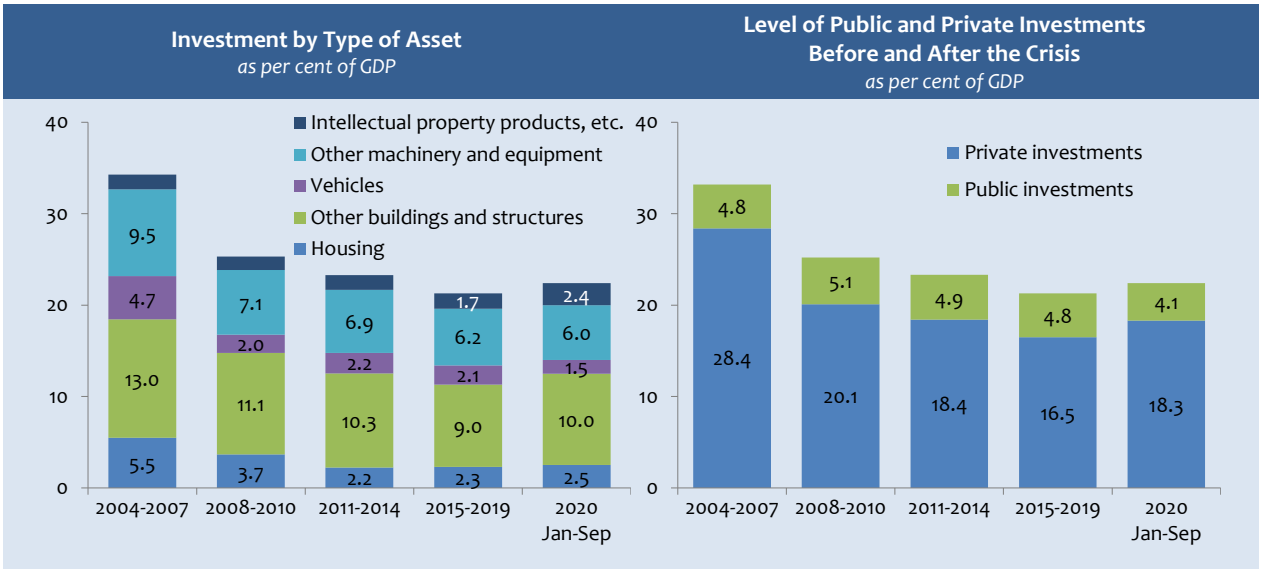
medium-sized enterprises. Several Latvian credit institutions have strengthened their credit standard, within the main reason being the deterioration of the overall economic situation, as well as the increased credit risks of borrowers (see also Section 6.4).

Figure 3.9



Public investments in Latvia remain at a high level and play an important role in the accumulation of the fixed capital. In the last five years (2015-2019), public investment increased on average by 5% per year and accounted for 1/5 of total investment in the Latvian national economy, which is one of the highest rates in EU Member States. The level and dynamics of public investment are strongly influenced by the cyclicity of the absorption of EU structural funds. In the nine months of 2020, public investment was nearly 10% lower than a year ago.

Figure 3.10



Most of investments have been made in construction assets. These mainly are investments in buildings and structures, which account for almost half of the expenditure on gross fixed capital formation. In the last five years (2015-2019) investments in buildings and structures have increased by 0.8% per year on average. The drop in these assets due to the global financial crisis was comparatively low, while the recovery after the crisis has been rather rapid. Overall, investment volumes remained at high levels during the crisis, largely secured by national economy heating measures. Investment in these assets has also not reduced due to the crisis caused by Covid-19. In the nine months of 2020, 3.2% more than a year ago was invested in buildings and structures.

In the total structure of investments (2015-2019), investments in housing accounted for a relatively small share of around 10-11%, i.e. 2% of GDP. They are mainly financed from bank loans, the reduction in which under the influence of the global financial crisis along with the increase in debt liabilities of the private sector determined also the drop in investments in these assets. Investment in housing also declined in 2020 during the Covid-19 crisis. In the nine months of this year, 3.3% less than a year ago was invested in housing construction.

Table 3.2

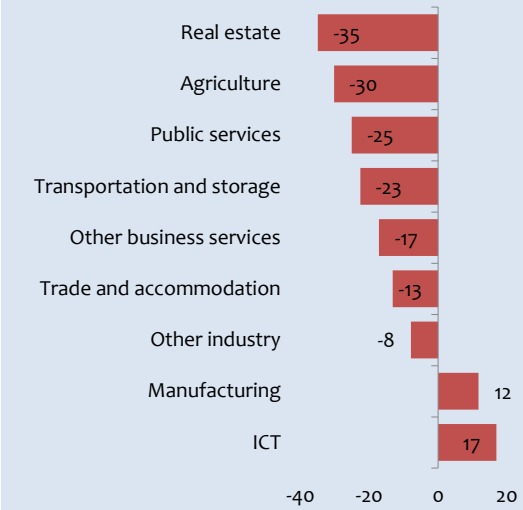
Gross Capital Formation	1995-2007	2008-2010	2011-2019	2017	2018	2019	2020 Jan-Sep
	annual changes, as per cent						
GDP	**7.4**	**-7.4**	**3.3**	**3.3**	**4.0**	**2.1**	**-4.3**
Gross capital formation	18.1	-24.4	6.6	9.9	15.8	3.5	6.7
– gross fixed capital formation	18.4	-21.5	5.0	11.4	11.8	2.1	-0.7
	as per cent of GDP						
Gross capital formation	27.9	25.8	23.9	22.1	23.8	22.4	22.0
– gross fixed capital formation	25.2	24.5	22.1	20.6	22.2	22.2	22.4
– changes in inventories	2.6	1.2	1.8	1.5	1.6	0.2	-0.4

Investments into machinery and appliances react sensibly to shocks and their recovery after the crisis is slower than in other assets. This is mainly due to weak lending, relatively high private debt and unfavourable market conditions, as well as low capacity utilisation. Since 2014, investment in machinery and appliances increased by 5% per year on average, but it was not sufficient to fully compensate for the drop in investment during the years of the crisis (2008-2010). In 2019, investments in machinery and appliances accounted for 8% of GDP and was almost by half smaller than the average volume in 2004-2007. In the nine months of 2020, investment in machinery and appliances reduced by 5% compared to the corresponding period of the previous year, including 22.4% less was invested in vehicles than a year ago.

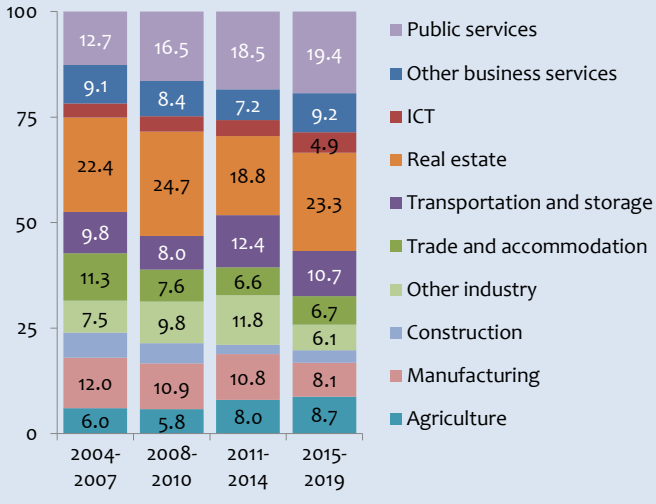
In the years of economic recession (2008-2010), investments in intellectual property assets reduced insignificantly, and in the following years their dynamics were moderate – 2% per year on average. Investments in intellectual property continued to grow also in 2020. They increased by 2.8% in the nine months of this year and accounted for 2.3% of GDP.

Figure 3.11

Non-Financial Investments by Sectors
*in the nine months of 2020, changes as per cent**



Structure of Non-Financial Investments by Sectors
as per cent



* calculated using the quarterly data, current prices

Investments in Latvia's economic sectors are unsustainable, and their volatility is affected by both the cyclicity of the absorption of EU structural funds and the adjustment of private sector investment plans in line with changes in market conditions. Investment levels declined across all sectors under the influence of the global financial crisis of 2008. There was

a particularly large drop in investment volumes in construction, trade, accommodation and food service activities. Investments fell rather moderately in such sectors as information and communication services, health and social care, mining and energy industries.

In the last five years (2015-2019) the intensity of investment was more moderate than before the crisis. Investments volume increased more rapidly in services sectors – by 3.2% per year on average, with the largest contribution from real estate activities, public administration, and information and communication sectors. In sectors manufacturing goods investments increased more moderately – by 1.4% per year on average. Overall, the investment intensity in the services sectors has been close to historical indicators since 2011, while in manufacturing sectors it was at a lower level.

The crisis caused by the Covid-19 pandemic has affected the services sectors the most. In the nine months of 2020, capital investments in services sectors were by 23% lower than a year ago. Investments in goods manufacturing sectors reduced by 13.3 per cent.

The level of investment in manufacturing was almost 12% higher than a year ago. Investment in information and communication services increased as well.

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

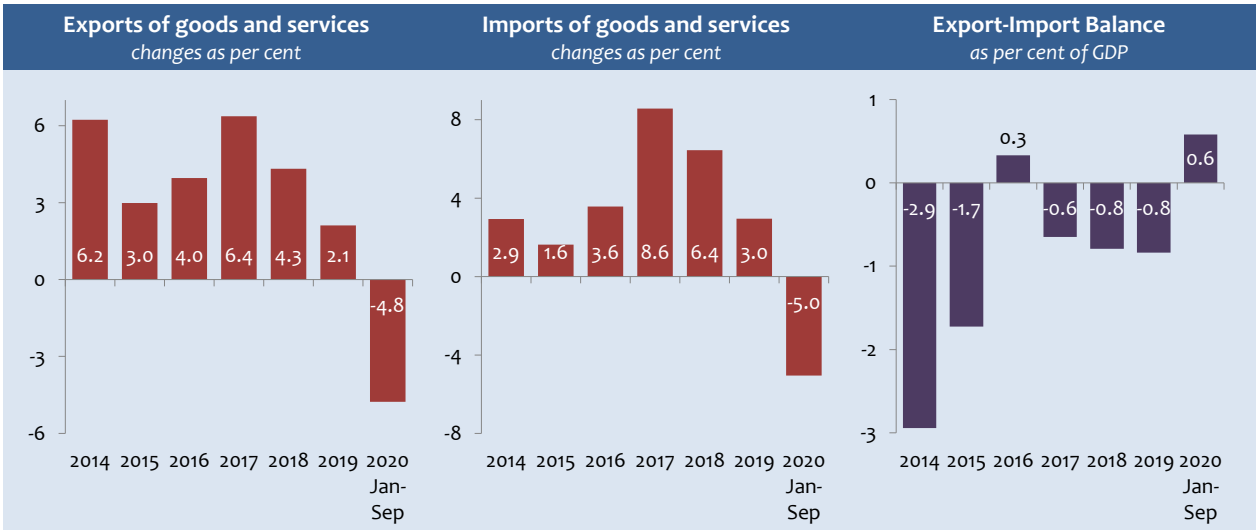
As a result of the economic crisis caused by Covid-19, investment is declining and the trends for the coming years are uncertain. Investment dynamics will continue to be influenced by uncertainty about the international environment, including the impact of the Covid-19 pandemic, as well as by a significant decrease in production capacity levels. Investment dynamics are also weakened by a low level of lending. In turn, the implementation of state support programs can become an important factor in increasing the dynamics of investment. Investment activities are expected to grow more rapidly after the launch of the Rail Baltics project.

3.4. EXPORTS AND IMPORTS

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 partner countries.

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

Figure 3.12



2020 will be marked in history books as the year of crisis caused by Covid-19, which affected virtually all economic indicators in all countries around the world, including Latvia. As exports are directly dependent on external demand, this crisis had a

significant impact on export volumes. In Q1 2020, export volumes increased mainly due to the achievements of January-February, while in March there was a sharp decline in rates following the beginning of the Covid-19 pandemic. In Q2, export volumes were already significantly lower than a year ago. Q3 2020 was marked by positive trends when the reduction in exports was significantly lower than Q2. However, as the second wave of the Covid-19 pandemic started in autumn, the situation with the further dynamics of exports has become uncertain.

The most important export markets for Latvia are EU countries, including Lithuania and Estonia. Exports to CIS countries, including Russia, make up a smaller share. Exports to other countries, to which the United Kingdom belongs since the first half of 2020, make up a slightly bigger share than exports to CIS countries.

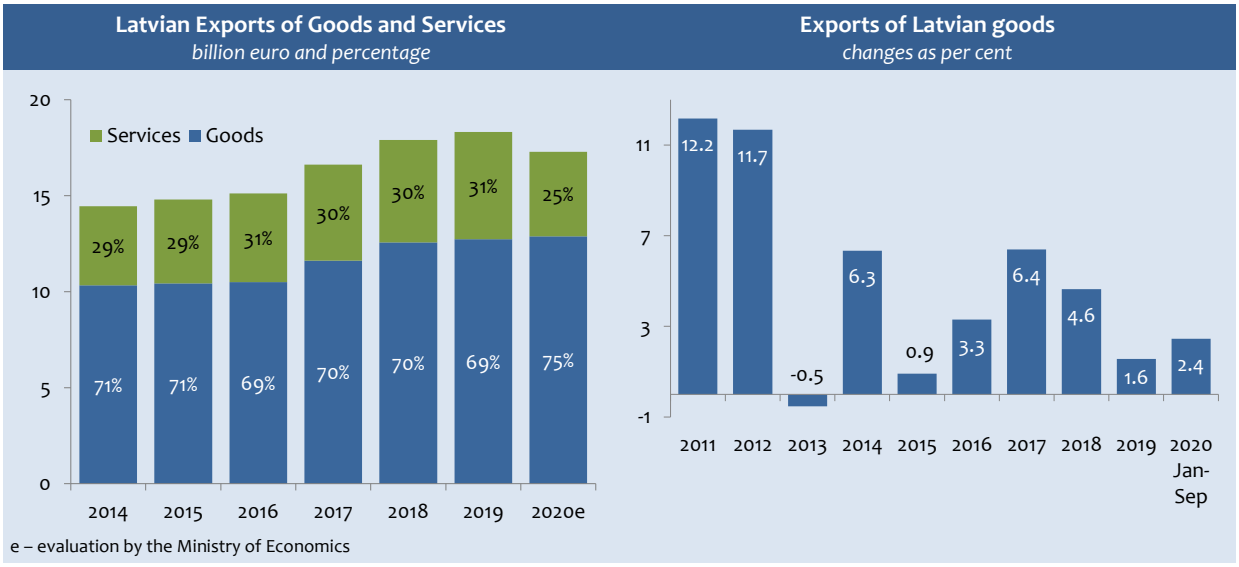
The main factors of development of imports of Latvian goods and services are increases in production volumes in manufacturing and in income available to households. Import volumes are growing considerably, as internal demand is growing. However, in 2020, when internal demand has dropped considerably, import volumes are significantly smaller than a year ago. Similarly, in 2020, import volumes are significantly affected by the reduction in investments and the import value of intermediate goods.

The export-import balance, after being clearly negative in 2012-2015, has balanced since 2016. In 2020, when import volumes are declining more rapidly than export volumes – in the three quarters they have reached historically the highest positive level.

EXPORTS

More than two thirds of Latvian export are composed of export of goods, while the rest is export of services. This proportion has not significantly changed in recent years. 2020 is an exception, because exports of services are declining much more rapidly than exports of goods under the influence of the Covid-19 crisis, therefore the export structure has changed in favour of exports of goods in 2020.

Figure 3.13



e – evaluation by the Ministry of Economics

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

2020 has been favourable neither for exports of goods nor for the overall economic development. Due to the Covid-19 crisis, in Q2, export volumes at constant prices were significantly lower than a year ago. However, growth of exports of goods in Q1 and Q3 exceeded 6 per cent in terms of annual growth.

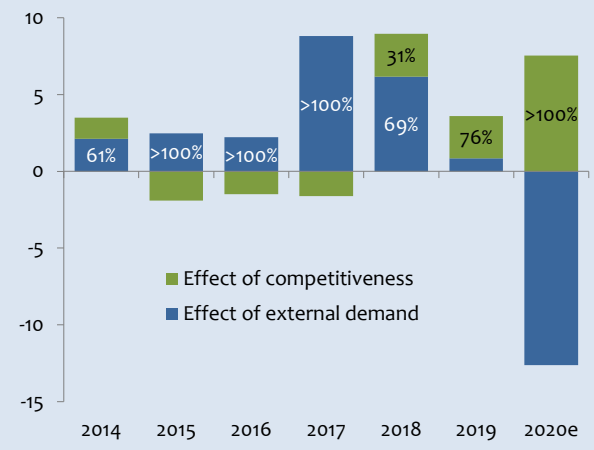
In 2017-2018, the development of exports of goods was positively influenced by changes in export prices. At current prices, exports increased by around 10% per year average. Export prices declined slightly in 2019 as external demand reduced. Similar trends are also observed in 2020. In the three quarters of the year, the export unit value has fallen by 1.6 per cent.

In 2014-2018, the increase in exports of goods was driven by external demand, with a low or even negative role of competitiveness in export growth. In 2019, however, Latvia's exports to EU countries were driven by a faster increase in the

competitiveness of Latvian companies. With external demand shrinking rapidly in 2020, the negative export development is partly compensated by the ability of entrepreneurs to compete on external markets.

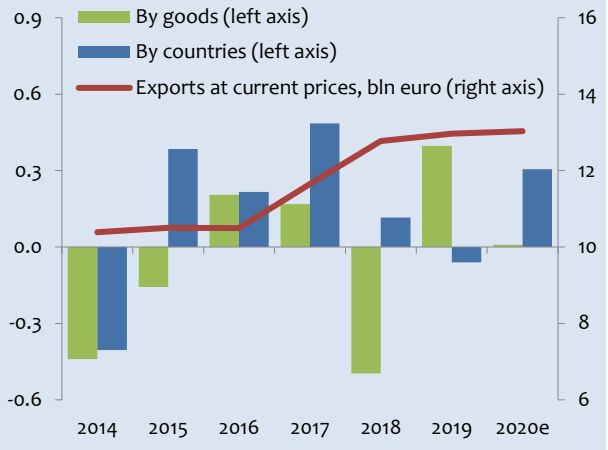
Figure 3.14

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



e – evaluation by the Ministry of Economics

Diversification of Exports of Latvian Goods
changes, percentage points



As major groups of goods such as wood and products of wood and agricultural and food products are growing faster, the diversification rate of export goods is deteriorating, while faster development of relatively smaller export groups improves this indicator. An improvement in the diversification indicator for goods was observed in 2015-2017. An opposite process was observed in 2018, when exports of wood and products of wood grew considerably due to the hopes of the United Kingdom to withdraw from the EU, which had a negative effect on the diversification indicator for goods. The indicator improved in 2019, when this effect had subsided. Diversification of exports of goods by groups of goods is not expected to change significantly in 2020.

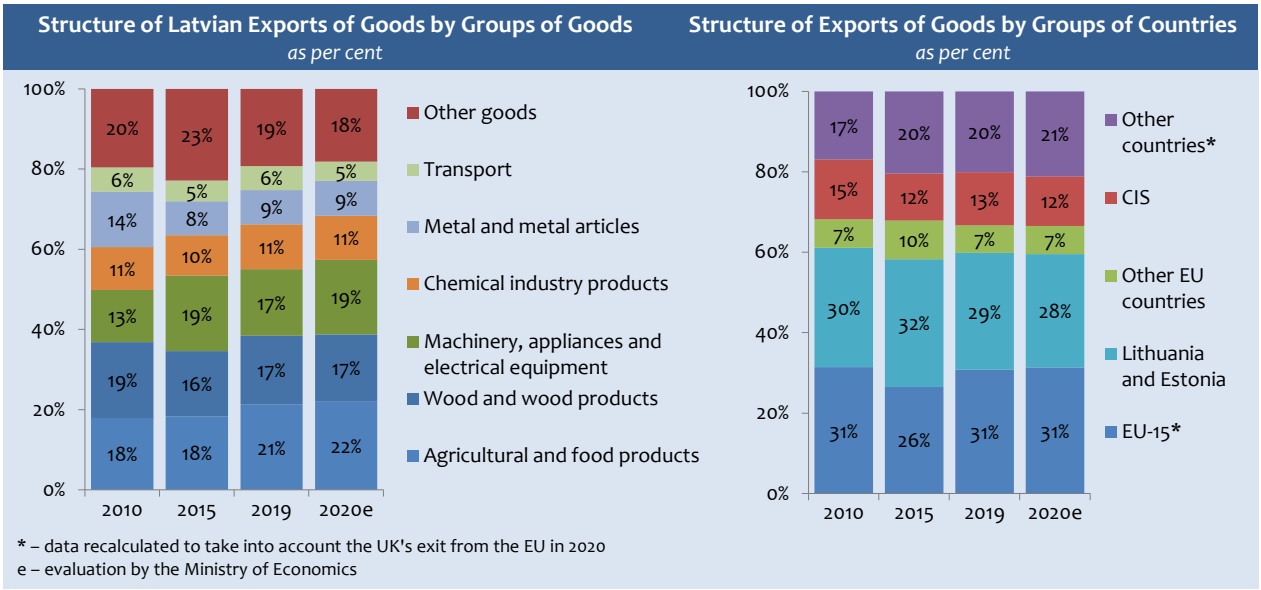
Table 3.3

Exports of Goods
at current prices, as per cent

	2019			2020 Jan-Oct		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**1.5**	**1.5**	**100**	**-0.3**	**-0.3**
Agricultural and food products	21.2	15.9	2.9	21.7	6.6	1.3
Mineral products	5.0	-12.9	-0.8	4.1	-20.1	-1.0
Chemical industry products	11.1	9.3	1.0	11.4	1.1	0.1
Light industry products	3.6	14.3	0.5	3.6	-1.1	-0.0
Wood and wood products	17.3	-1.6	-0.3	16.6	-6.6	-1.2
Metal and metal articles	8.5	-4.4	-0.4	8.5	-2.7	-0.2
Machinery, appliances and electrical equipment	16.5	-8.9	-1.6	18.6	13.9	2.3
Transport vehicles	6.3	-2.9	-0.2	4.9	-23.3	-1.5
Other goods	10.6	4.0	0.4	10.6	-0.2	-0.0

Diversification of exports of goods by countries improved in 2015-2018 evidencing of entering into new markets. In 2019, exports to larger partner countries (Estonia, Lithuania and Germany) have been growing slightly more rapidly, which has respectively worsened the diversification indicator. In 2020, diversification of exports by countries has improved. This is due to reductions in exports to a number of major partner countries, such as Russia, Lithuania, Sweden. Meanwhile, the share of exports to smaller partner countries in total exports is growing.

Figure 3.15



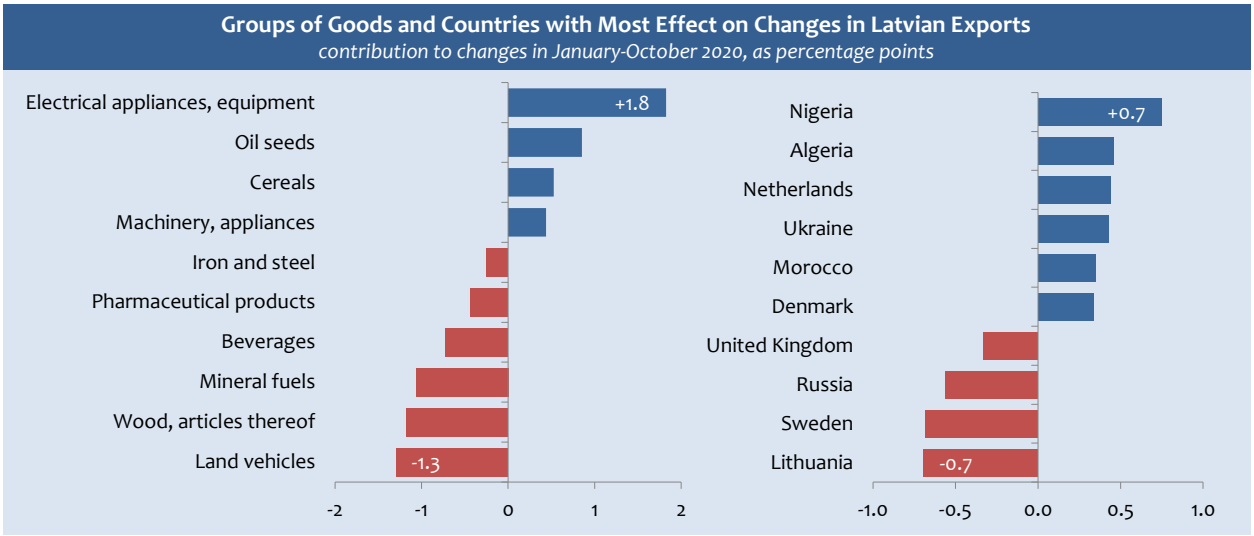
In 2019, the increase in exports was driven by the agricultural and food group, in particular the export value of cereal crops, oil seeds and beverages. Exports of electrical appliances and equipment, iron and steel articles, as well as pharmaceutical products also increased considerably.

In January-October 2020, the drop in export value was affected by the reduction in the export value of the largest groups of exports of goods – wood and wood products. The export value of land vehicles, mineral fuel and beverages reduced as well. On the other hand, exports of electrical appliances and equipment, oil seeds and machinery and appliances increased considerably.

In 2019, exports of goods to EU countries increased slightly faster than total exports – by 3.1%. Most of the increase was formed by growth in exports of agricultural and food products.

In January-October 2020, exports to EU countries decreased by 1.3%. The decline in exports was driven by a fall in the export value of vehicles, wood and its products and mineral products. It was partly compensated by growth in exports of machinery and appliances, agricultural and food products and goods of the chemical industry.

Figure 3.16



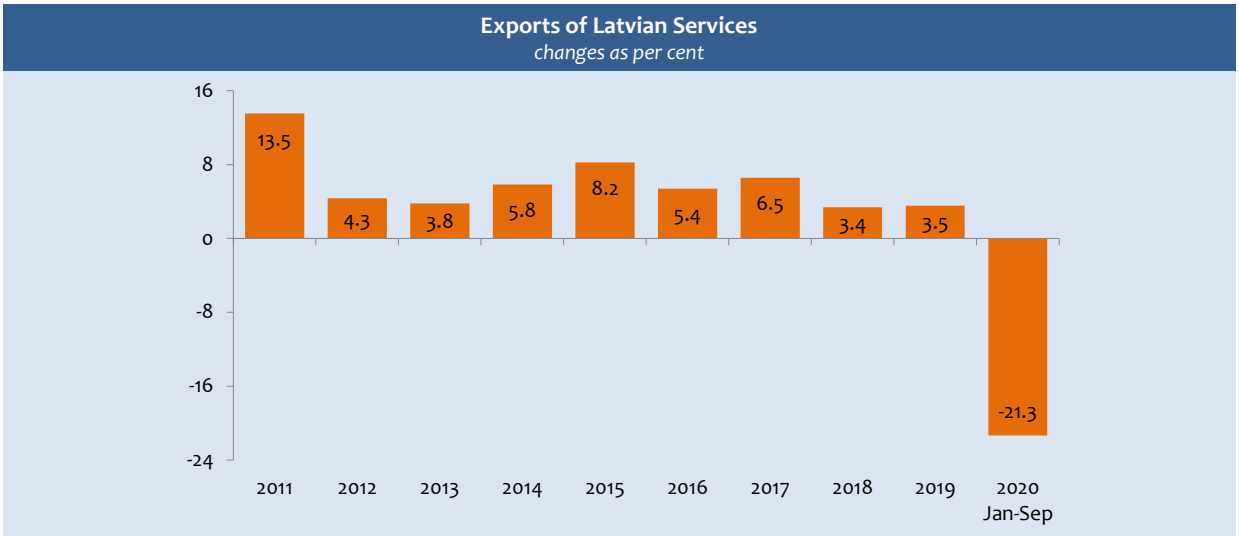
Exports of goods to CIS countries increased relatively rapidly (by 5.8%) in 2019 affected by exports of virtually all product groups, except metals and their products.

In the ten months of 2020, exports to CIS countries decreased by 2.8%. This was mainly due to the drop in the export value of goods of the chemical industry and agricultural and food products. In turn, exports of goods of the light industry and machinery and appliances increased.

Exports of goods to other countries, excluding EU and CIS countries, declined relatively sharply in 2019 – by 8.6%. This was mainly caused by a significant decrease in exports of machinery and appliances to the United States. However, exports increased by 6.3% in January-October 2020 significantly affected by the increase in export value of cereal crops.

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

Figure 3.17



In 2017, as growth resumed, export rates of goods and services were similar. The positive export balance also persisted in 2017.

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

In 2020, growth of exports of services is greatly affected by Covid-19 restrictions on travelling, food services activities and other service activities. Exports of services have reduced by 21.3% in the three quarters of the year. They declined particularly rapidly in Q2 and Q3.

Traditionally – until 2019 – about 40% of the exports of services had consisted of income from transport services. The last two years have not been successful for the export of transport services. In 2019, exports of transport services were similar to the year before, exports of sea and rail transport services declined, but the fall was compensated by exports of road transport services and services provided by other modes of transport. In the three quarters of 2020, exports of services provided by all modes of transport declined significantly.

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

In the three quarters of 2020, exports of construction services and other economic activities increased significantly. However, overall, this increase has not significantly contributed to total exports of services.

About two-thirds of total exports of Latvian services are traditionally linked to EU countries, and their share in total exports of services increases every year.

Exports of services to EU countries grew at a faster pace in 2019 than total exports of services. In 2019, transport services (road and air transport) as well as travel accounted for the largest share of exports of services to EU countries.

Table 3.4

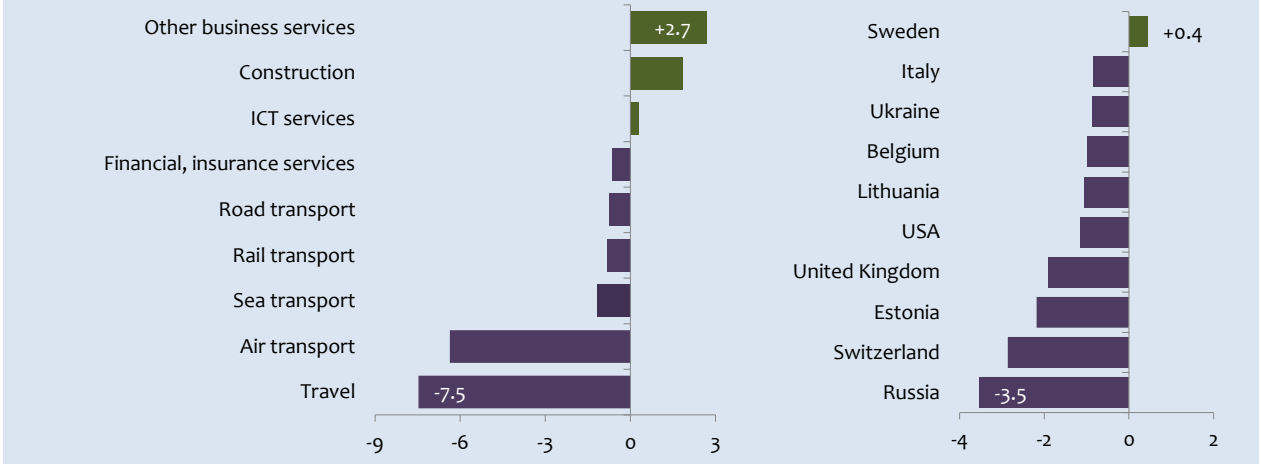
Export of Services
at current prices, as per cent

	2019			January-September 2020		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**4.8**	**4.8**	**100**	**-21.2**	**-21.2**
Transport services, including:	38.1	0.5	0.2	31.8	-36.2	-14.2
– sea transport	5.9	-16.5	-1.2	5.2	-34.5	-2.2
– air transport	9.6	1.5	0.2	3.3	-74.9	-7.8
– rail transport	5.3	-12.2	-0.8	3.5	-49.3	-2.7
– road transport	16.0	12.6	1.9	18.5	-7.8	-1.2
– other transport services	1.4	16.9	0.2	1.3	-22.2	-0.3
Travel	16.2	1.2	0.2	10.9	-48.5	-8.1
Other services, including:	45.7	10.1	4.4	57.3	2.4	1.0
– construction services	5.7	21.6	1.1	8.1	25.2	1.3
– financial and insurance services	3.4	-39.3	-2.3	3.1	-31.5	-1.1
– ICT services	15.1	8.6	1.3	18.7	-2.9	-0.4
– other business services	20.0	26.2	4.4	26.1	9.3	1.7
– other services	1.4	2.7	0.0	1.3	-29.3	-0.4

In the three quarters of 2020, exports of services to EU countries have decreased by 12.6%. The value of all groups of exports of services declined, except exports of construction, other economic activities and ICT services.

Figure 3.18

Services Items and Countries with Most Effect on Changes in Latvian Exports
contribution to changes in January-September 2020, as percentage points, at current prices



IMPORTS

Import rates of Latvian goods and services have been declining in recent years – from 8.6% in 2017 to 3% in 2019. In the three quarters of 2020, under the influence of the Covid-19 crisis, imports similarly to exports have reduced considerably – by 5 per cent.

The increase in **imports of goods** at current prices in 2019 amounted to 2% being considerably less than a year ago. This was essentially due to reduction in the import value of machinery and appliances and refined petroleum products.

In the ten months of 2020, due to the Covid-19 crisis, imports of goods at current prices have been significantly lower than a year ago. The largest positive contribution to the increase in imports of goods was from groups of electrical appliances and equipment, agricultural goods, weapons and ammunition and chemical products and made-up textile articles.

In 2019, imports from EU countries at current prices increased significantly faster than total imports of goods – by 4.9%. In the ten months of 2020, the reduction in imports of goods from EU countries has also been lower than in total imports of goods. The decrease was affected by a drop in the import value of vehicles and mineral fuels.

Table 3.5

Imports of Goods
at current prices, as per cent

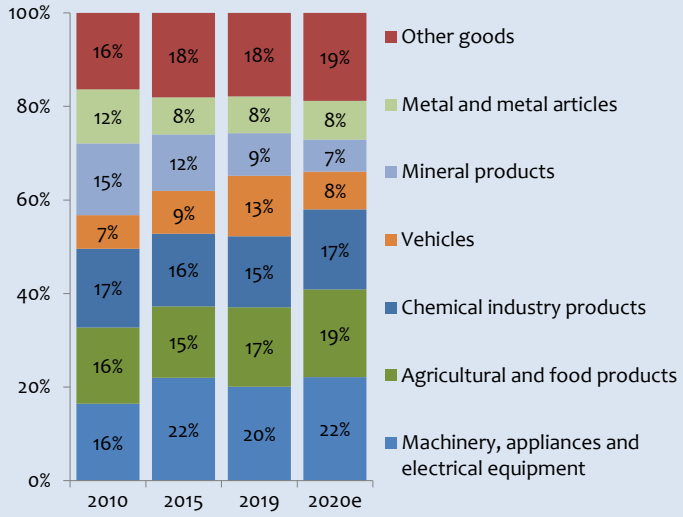
	2019			2020 Jan-Oct		
	structure	changes	contribution to the changes	structure	changes	contribution to the changes
Total	**100**	**0.8**	**0.8**	**100**	**-8.1**	**-8.1**
Agricultural and food products	16.9	6.4	1.0	18.8	4.0	0.7
Mineral products	9.1	-15.5	-1.7	6.9	-33.6	-3.2
Chemical industry products	15.2	7.0	1.0	17.0	1.5	0.2
Light industry products	4.9	13.1	0.6	5.3	-1.3	-0.1
Wood and wood products	3.6	-1.1	0.0	3.9	-2.2	-0.1
Metal and metal articles	7.8	-6.5	-0.5	8.2	-5.4	-0.4
Machinery, appliances and electrical equipment	20.1	-6.9	-1.5	22.3	4.6	0.9
Vehicles	12.9	11.7	1.4	8.0	-39.5	-4.9
Other goods	9.5	6.8	0.6	9.6	-2.4	-0.2

Imports from CIS countries at current prices decreased significantly in 2019 – by 11.5%. They were mainly affected by a sharp reduction in imports of mineral products and metals and their products. Also in the ten months of 2020, with a significant decrease in the import value of mineral products, total imports of goods from CIS countries decreased by 15.1 per cent.

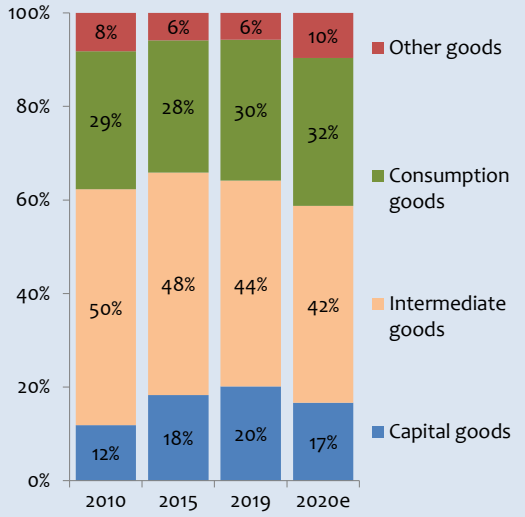
In the group of other countries, except EU and the CIS countries, imports decreased by 10.4% in 2019 significantly affected by imports of machinery and appliances. The reduction was partially compensated by imports of aircraft, parts thereof from Canada. Also in the ten months of 2020, imports of goods from other countries decreased by 14.5 per cent, partially due to the base effect.

Figure 3.19

Structure of Imports of Goods by Groups of Goods
as per cent



Structure of Imports of Goods by the Classification of Broad Economic Categories
as per cent



e – evaluation by the Ministry of Economics

In the structure of imports of goods in terms of their end use, imports of capital goods had been slightly growing until 2019. However, their share shrank again in 2020 under the influence of Covid-19. The share of intermediate goods in total imports reduces, mainly due to the reduction in the import value of fuel.

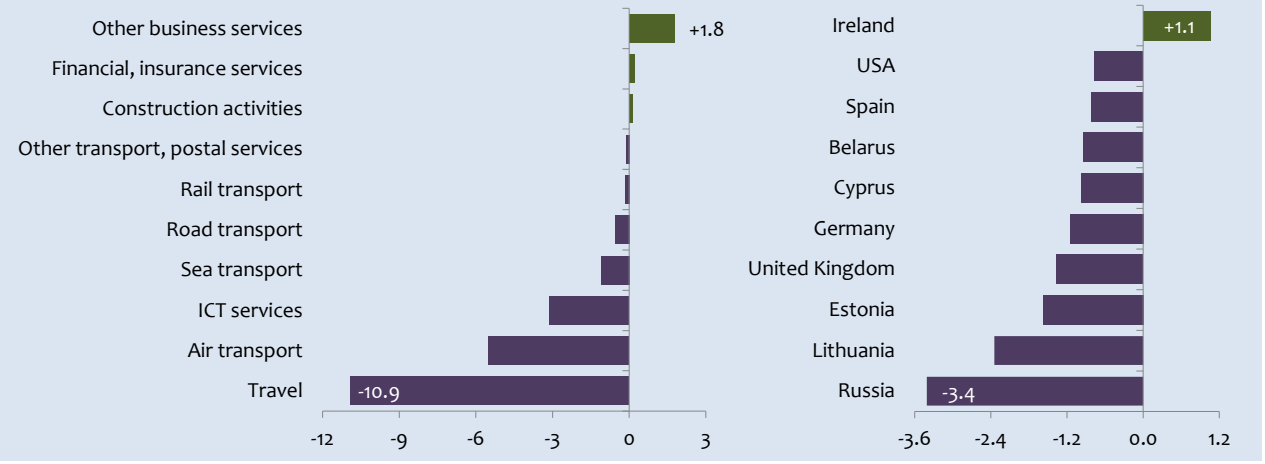
Growth of **imports of services** was similar to growth of exports of services in 2019 – 4.8%. Imports of services related to brokering were growing more rapidly. Imports of transport services also increased considerably, while imports of financial services reduced. In January-September 2020, imports of services decreased by 18.2%. This was mainly caused by a reduction in all service items except for imports of brokering, financial and also construction services. Imports of travel and different types of transport services have reduced considerably.

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

Figure 3.20

Services Items and Countries with Most Effect on Changes in Latvian Imports

contribution to changes in January-September 2020, as percentage points



4. CONTRIBUTION OF SECTORS

4.1. DYNAMICS AND STRUCTURE

In 2009-2010, as labour costs declined, competitiveness of Latvia's producers improved, thus stimulating the growth of exports and the development of tradable sectors. The structure of the economy has changed. In 2008, tradable sectors (agriculture, forestry and fishery, industry, transport services) accounted for only 26.7% of total value added, but in 2010 the share of these services reached 33.1%. In 2019, the share of these sectors slightly shrank to 27.4%. In 2019, compared to 2010, the share declined in all sectors except construction, business services and public services.

The analysis of economy structures from other perspective shows that in 2019 producing sectors (agriculture, forestry and fishery, industry and construction sectors) accounted for 25.6%, but services sectors – for 74.4% of total value added. Compared to 2010, the share of producing industries has reduced in all sectors except construction.

Table 4.1

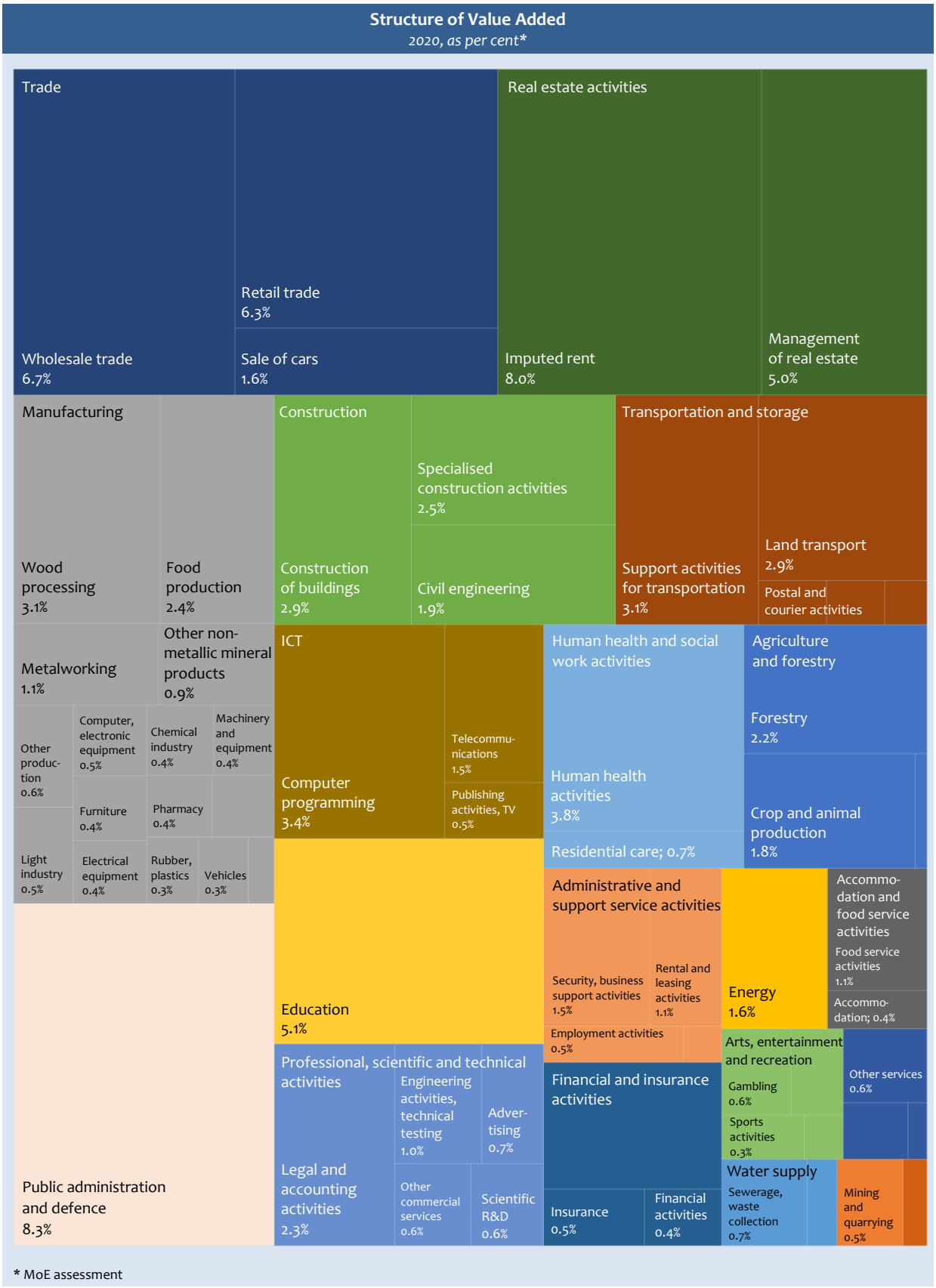
Structure of the Economy
by value added, %

	2000	2005	2008	2010	2016	2019	2020 Jan-Sep
Agriculture, forestry and fishing	5.0	4.2	3.3	4.5	3.7	4.2	4.8
Manufacturing	15.2	12.9	10.7	13.4	11.6	11.9	12.1
Other industry	4.2	3.1	3.4	4.8	4.3	3.0	2.9
Construction	7.0	6.8	10.2	4.9	5.3	6.5	6.7
Trade, accommodation and food service activities	15.6	18.4	16.0	17.7	16.6	16.5	15.9
Transportation and storage	11.9	12.3	9.3	10.4	9.1	8.3	7.3
Other business services	23.8	27.3	30.3	28.3	33.2	32.7	32.5
Public services	17.3	15.1	16.9	16.0	16.2	16.9	17.8
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**

In the main export sector – manufacturing, growth rates in 2010-2012 were significantly higher than the total economic growth, and the sector became the main driving force of the economy. In other tradable sectors, (e.g., the export-oriented commercial services, transportation and storage), growth after the crisis also resumed faster than in other economic sectors. In 2011-2013, the construction sector, which experienced the largest decline during the crisis, was growing relatively fast.

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

Figure 4.1



* MoE assessment

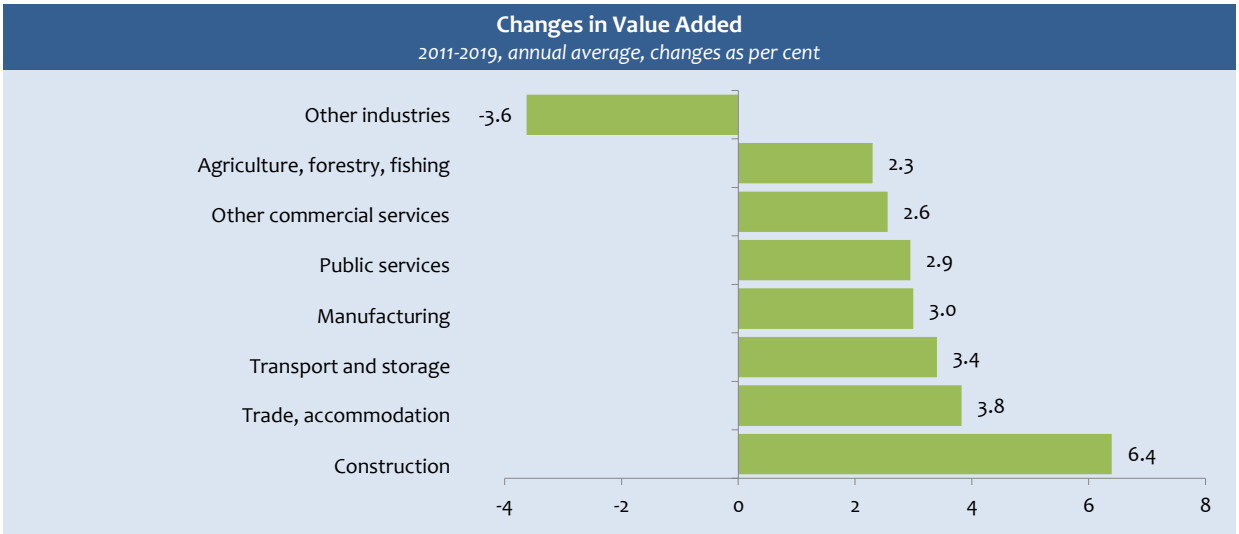
Since 2010, when GDP dropped to the lowest level in the last ten years, it has been growing by 3.3% per year on average and now exceeds the pre-crisis level. Growth in Latvia continued also in 2019, but economic growth has become more moderate. The increase in trade and public services had the biggest effect on growth. However, GDP is declining in 2020 under the influence of the Covid-19 crisis.

Table 4.2

Development Trends of Sectors
change compared to the corresponding period of the year before, %

	2016	2017	2018	2019	2020 Jan-Sep
Gross domestic product	**2.4**	**3.3**	**4.0**	**2.1**	**-4.3**
Agriculture, forestry and fishing	-4.3	1.8	-3.6	12.3	1.9
Mining and quarrying	-2.8	9.1	9.1	-4.6	6.3
Manufacturing	1.7	6.7	7.6	2.1	-2.7
Food industry	1.8	5.2	-2.9	-0.7	-1.6
Light industry	2.1	7.6	-0.8	-2.6	-12.0
Wood processing	8.0	2.1	4.5	0.0	1.4
Paper industry and publishing	3.6	4.5	-3.7	5.7	2.7
Chemical industry	10.7	11.4	7.0	3.9	-1.9
Manufacture of other non-metallic mineral products	11.6	11.1	1.3	-2.1	-2.2
Metalworking	5.4	12.0	3.6	13.5	-6.3
Manufacture of electrical and optical equipment	12.6	15.8	12.1	11.3	6.3
Manufacture of machinery and equipment	8.5	21.5	7.0	-1.9	-5.9
Manufacture of vehicles	-2.9	22.8	7.3	-7.7	-21.2
Other industries	0.8	4.3	-1.8	2.8	-14.5
Electricity, gas, steam and air conditioning supply	17.5	-2.1	-38.7	-4.4	-4.6
Construction	-9.6	14.6	12.5	2.2	2.8
Construction of buildings	-11.1	22.4	25.6	7.8	3.2
Civil structures	-25.7	30.0	11.6	1.0	-4.6
Trade	4.5	2.5	4.0	4.2	-2.7
Retail trade	2.3	4.3	3.8	2.4	1.7
Transportation and storage	1.7	6.4	4.0	-2.7	-15.0
Transport of freight by railway	-14.1	-8.4	12.5	-15.8	-44.9
Freights transhipped in ports	-9.3	-2.0	6.9	-5.7	-29.7
Transport of freight by road	1.3	7.0	12.8	-3.8	-4.3
Accommodation and food service activities	4.4	9.3	7.6	8.3	-34.9
Information and communication	5.0	8.6	9.7	1.0	-6.5
Financial and insurance activities	-0.2	-17.1	-3.1	-15.2	-5.2
Real estate activities	1.6	-1.6	2.4	1.4	-1.9
Other commercial services	3.9	4.5	2.8	6.3	-3.5
Public administration and defence; compulsory social security	1.5	3.8	2.8	2.0	1.4
Education	1.1	4.3	3.0	2.9	0.4
Human health and social work activities	1.2	4.3	9.3	9.6	1.0
Arts, entertainment and recreation	5.0	5.1	6.1	5.7	-26.1

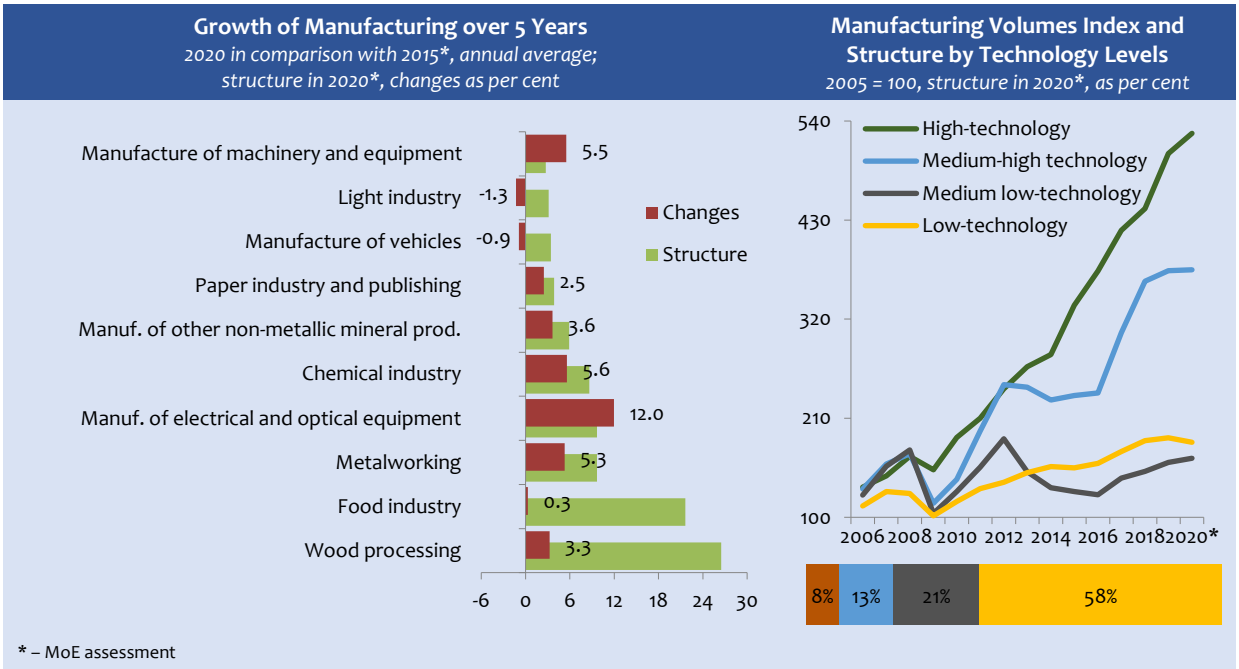
Figure 4.2



4.2. MANUFACTURING

In recent years, this sector has made an important contribution to total economic growth. Year 2014 was a year with the negative sign for manufacturing affected by trends in foreign markets – slower economic growth in the EU, as well as the economic crisis in Russia.

Figure 4.3



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

Year 2017, when production volumes increased by 8%, was one of the most successful years in the development of manufacturing. The development of food industry and manufacture of electrical and optical equipment made a considerable

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

Table 4.3

Structure of Manufacturing and Development Trends of Sectors in January-October 2020

%

	Output structure	Structure of occupied posts*	Share of exports in the sales of the sector	Changes in production volumes
Manufacturing – total	**100**	**100**	**66.1**	**-2.7**
Manufacture of food and beverages	21.6	19.3	38.6	-1.6
Light industry	3.1	9.3	83.1	-11.6
Wood processing	26.5	20.1	72.6	1.8
Paper industry and publishing	3.9	4.3	66.7	2.6
Chemical industry and related industries	8.7	7.2	73.3	-4.2
Manufacture of other non-metallic mineral products	5.9	5.3	51.5	-2.7
Manufacture of metals and metal articles	9.7	10.4	68.2	-6.7
Manufacture of electrical and optical equipment	9.7	5.0	89.6	8.1
Manufacture of machinery and equipment	2.7	3.3	84.7	-5.4
Manufacture of vehicles	3.4	3.3	90.0	-19.2
Other manufacturing industries	4.8	12.4	67.6	-14.4

* data on the first half of 2020

Year 2020 is full of challenges for manufacturing, similarly to the economy as a whole. Before Covid-19 – in January-March – manufacturing volumes decreased by 3.6%, mainly in the woodworking and chemical industries because of the drop in volumes/base effect. When the Covid-19 crisis hit, manufacturing volumes declined by 10.4% in April-May, which is likely to result in a reduction in the sector's annual volumes. During this period, production volumes decreased in all sub-sectors of the industry – more rapidly in the food industry. Meanwhile, in the second half of the year – in June-October – more and more sub-sectors show positive increases and sector volumes are overall only slightly below previous year's levels during that period. Production volumes of woodworking and electrical and optical equipment manufacturing grew more rapidly during this period.

In 2017-2018, as producer prices were growing, stable growth was observed also in turnover of manufacturing. The turnover increased for products sold on the domestic market and abroad. Manufacturing turnover in 2019 also increased stably, but slower. Slightly more products were sold on the domestic market.

In the ten months of 2020, manufacturing turnover increased by 0.1%. The turnover of the domestic market decreased by 2.3%, which was offset by an increase in export sales by 1.3%. Chemical, metalworking and electrical and optical sub-sectors contributed to the increase the most.

Every year, around two-thirds of all products are exported. Over five years, the share of exported products has increased by more than 2 percentage points. The industries with the share of exports in sales above 85% are manufacture of vehicles, electrical and optical equipment and machinery and equipment. Slightly less than 85% of export sales are attributed to the light industry. Traditionally, most of the food industry's products are sold in the domestic market.

More than 70% of products produced in manufacturing are sold in markets of the EU countries. Similar volumes are sold in markets of CIS and other countries. The share has not changed significantly in recent years. It should be noted, in the ten months of 2020 the share of EU countries and CIS countries in the export structure of manufacturing products has slightly increased, while the share of third countries has declined.

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

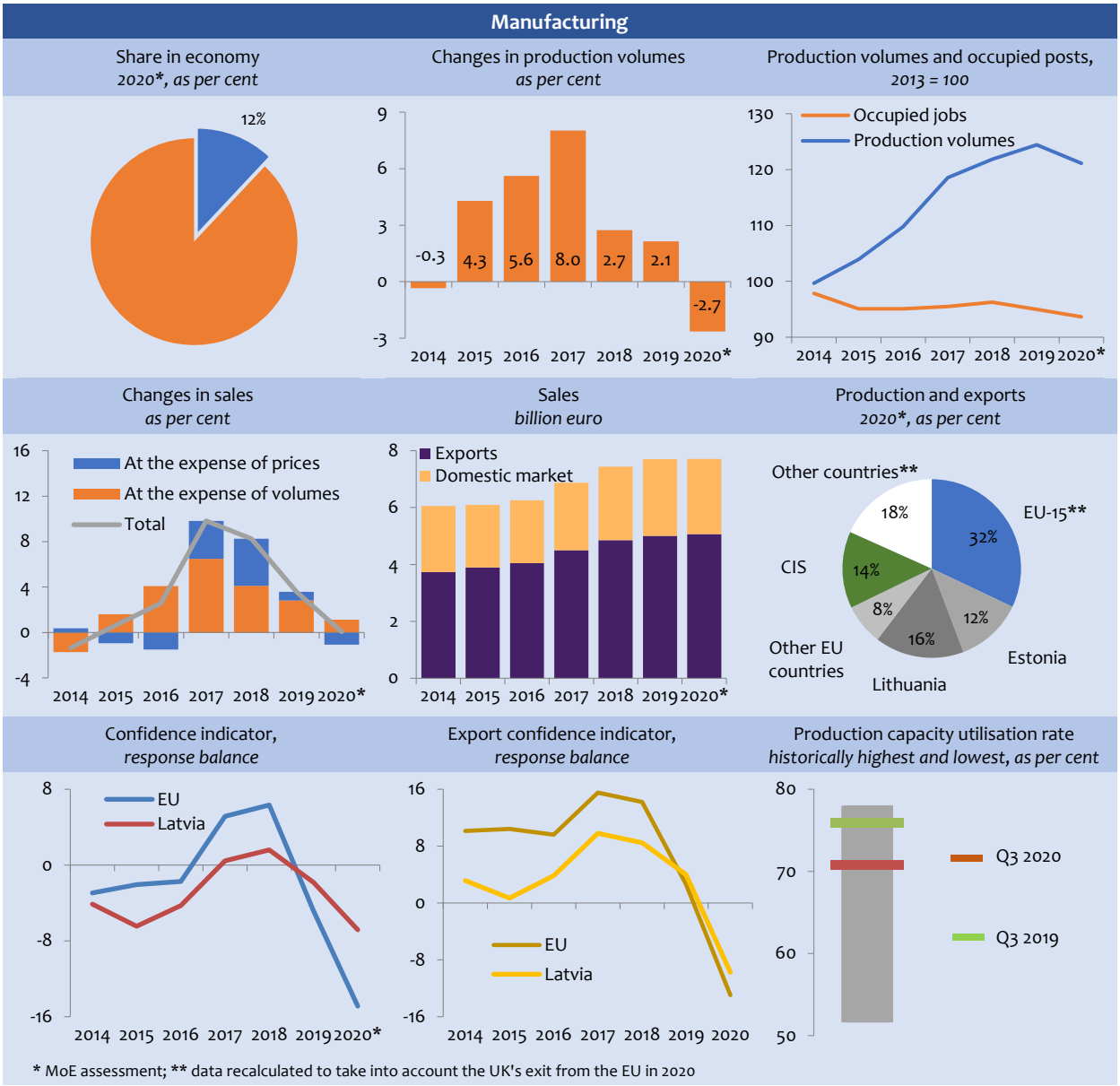
Also in the first half of 2020, the number of occupied posts in manufacturing has increased by 2.3%, which is the biggest drop since 2015. This was largely affected by the reduction in the number of jobs in light industry and woodworking. The negative effects were partly offset by an increase in labour demand in metalworking, electrical and optical equipment, as well as in the food industry.

Confidence indicator of the manufacturing industry slightly improved in 2018, but reduced in 2019. Meanwhile, during the ten months of 2020, confidence in the industry has had highly negative trends. Confidence of manufacturers deteriorated particularly rapidly under the influence of Covid-19 – in April-June. The decline in confidence was observed in all sub-sectors of the manufacturing industry. In the ten months of the year, the confidence indicator has generally decreased more rapidly in the light industry, manufacture of other non-metallic mineral products and machinery and equipment sub-sectors.

The export confidence indicator was strongly positive until 2018. In 2019, producers already looked at export prospects more cautiously, but still with a positive sign. Totally opposite trends are observed in Q2 and Q3 2020, when export prospects are highly negative.

Until 2019, production capacity levels in the manufacturing industry tended to grow, exceeding the level of 76% in 2019. The adjustments were introduced by the Covid-19 crisis, when manufacturing capacity levels decreased to the level of 2015 and amounted to 71.5% in Q3 of the year.

Figure 4.4



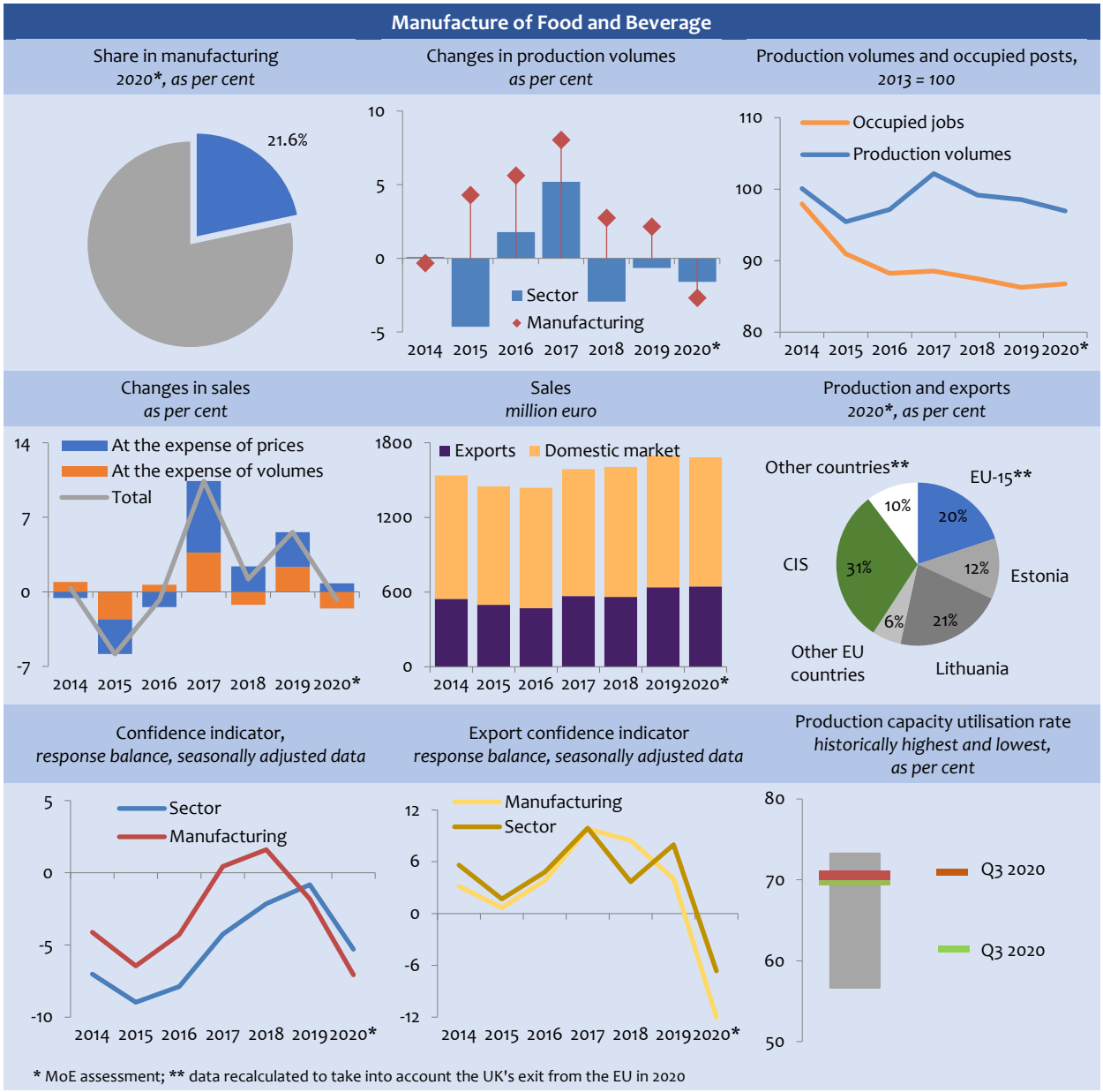
Manufacture of food and beverages is the second largest manufacturing sector in terms of both the output and the number of occupied posts. The sector sells less than 40% of its output in external markets. The embargo on food products imposed by Russia in 2014 affected the development of the sector significantly, when the share of products exported to markets of CIS countries declined from 43% in 2014 to 29% in 2020. However, CIS countries are still the largest outlet for products of the industry.

In 2019, production volumes of manufacture of food products slightly shrank, while production volumes of manufacture of beverages increased. Production volumes in both sub-sectors have also decreased in the ten months of 2020.

As producer prices of food products increased, in 2019 the turnover of the sector increased as well. Turnover was growing moderately for the products sold on the domestic market, while volumes of exported products increased more rapidly. In the ten months of 2020, sales of the sub-sector have remained broadly at the same level as in the previous year.

In recent years, the number of occupied posts in the food industry has been dropping. Compared to 2015, the number of occupied posts in the sector has reduced by 0.8 thousand jobs. The confidence indicator of the industry has been clearly negative since 2015. It was above the general confidence level of manufacturing only in 2019. Similar trends in industry confidence remain also in 2020. The production capacity utilisation rate in the food industry is slightly lower than in manufacturing on average.

Figure 4.5

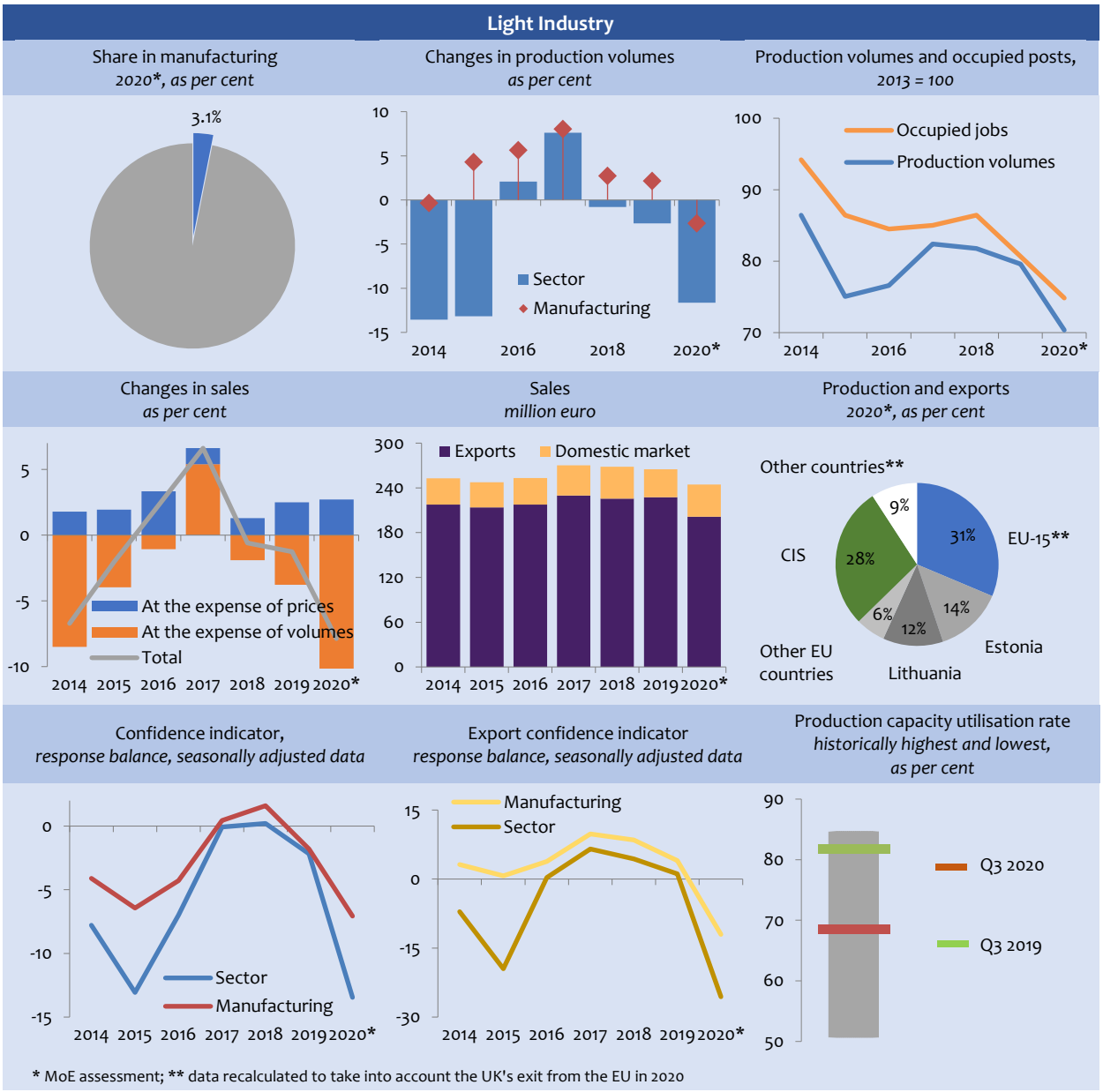


Light industry is considerably affected by global trends, and in conditions of the open EU labour market the sector cannot rely on advantages of cheap labour force like East Asia does. A considerable reduction in production volumes was observed in the sector in 2014-2015. The sector has recovered since 2016. In 2019, volumes of industry slightly shrank under the effect of the reduction in volumes of manufacture of wearing apparel. Volumes of manufacture of wearing apparel and textiles continued to reduce also in the ten months of 2020.

In 2019, sales volumes of the sub-sector slightly reduced, mainly affected by the drop in sales volumes in the domestic market. By contrast, in the ten months of 2020, as sales of exported products have reduced, total volumes of products are also considerably smaller than a year ago.

Since 2014, the number of occupied posts in the sector has reduced by 1.7 thousand. The confidence indicator significantly improved in 2018 reaching a positive industry development vision. However, this indicator has worsened considerably in 2019 and, in particular in the three quarters of 2020. Until 2019 the capacity utilisation rate of the industry has been one of the highest in manufacturing and exceeded the 80% mark. In 2020, it reduced and amounted to 68.5% in Q3. Taking into account the large share of exports in sales of the sector, its development is closely related to changes in demand and competitiveness in the external markets.

Figure 4.6



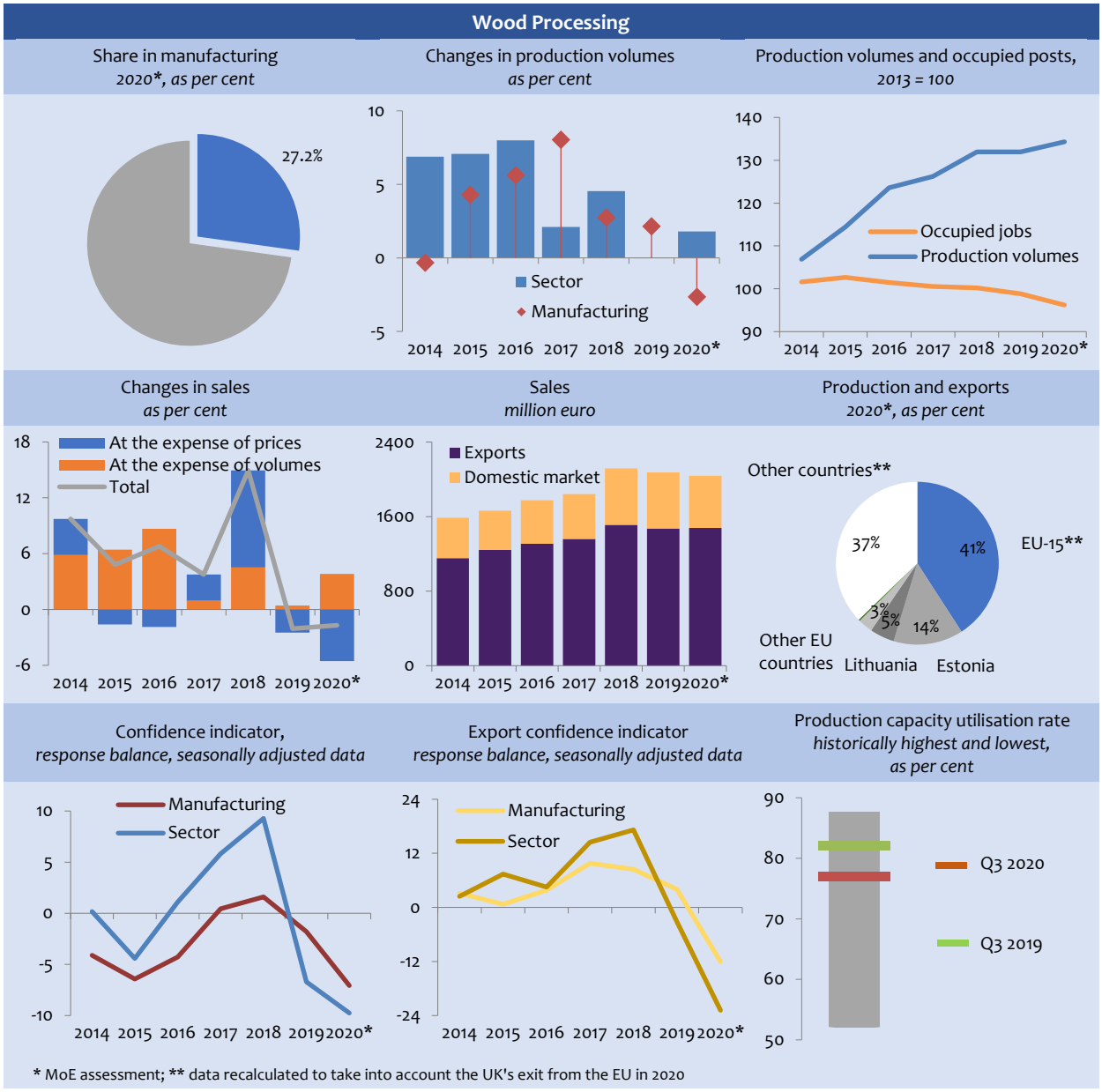
Wood processing is the largest manufacturing sector of Latvia. It accounts for more than 1/4 of the total manufacturing output. Recent years have been successful for the sector, including 2018, when output volumes exceeded average manufacturing rates. In 2019, the output of the sector remained at the level of the previous year, and in 2020 it continued to grow.

In 2018, prices of producers in wood processing increased sharply significantly affecting the increase in turnover of the industry. By contrast, in 2019 and in the ten months of 2020 sales of products of the industry slightly reduced.

Wood processing is a strongly export-oriented sector. Its exports amount to almost one third of all the products exported by the industry. EU-15 countries have traditionally been the export market of this sector. Turnover increase rates became much slower in 2019. This is related both to *Brexit* and expansion of fir bark beetles in Europe, thus leading to surplus of wood processing products, which, in turn, has significantly affected producer prices. Similar sales trends preserved in the sector also in 2020.

Despite stable industry growth, the number of occupied posts in the sector gradually reduces, which evidences of the rise in productivity of the industry. Until 2018, confidence indicators of the industry had traditionally been considerably above the average level in manufacturing. Both in 2019 and 2020, as sales of products were shrinking, confidence of producers reduced as well. In 2020, future export opportunities are also evaluated similarly. The capacity utilisation rate of the industry has slightly shrank during the year, however, it still remains at a relatively high level.

Figure 4.7



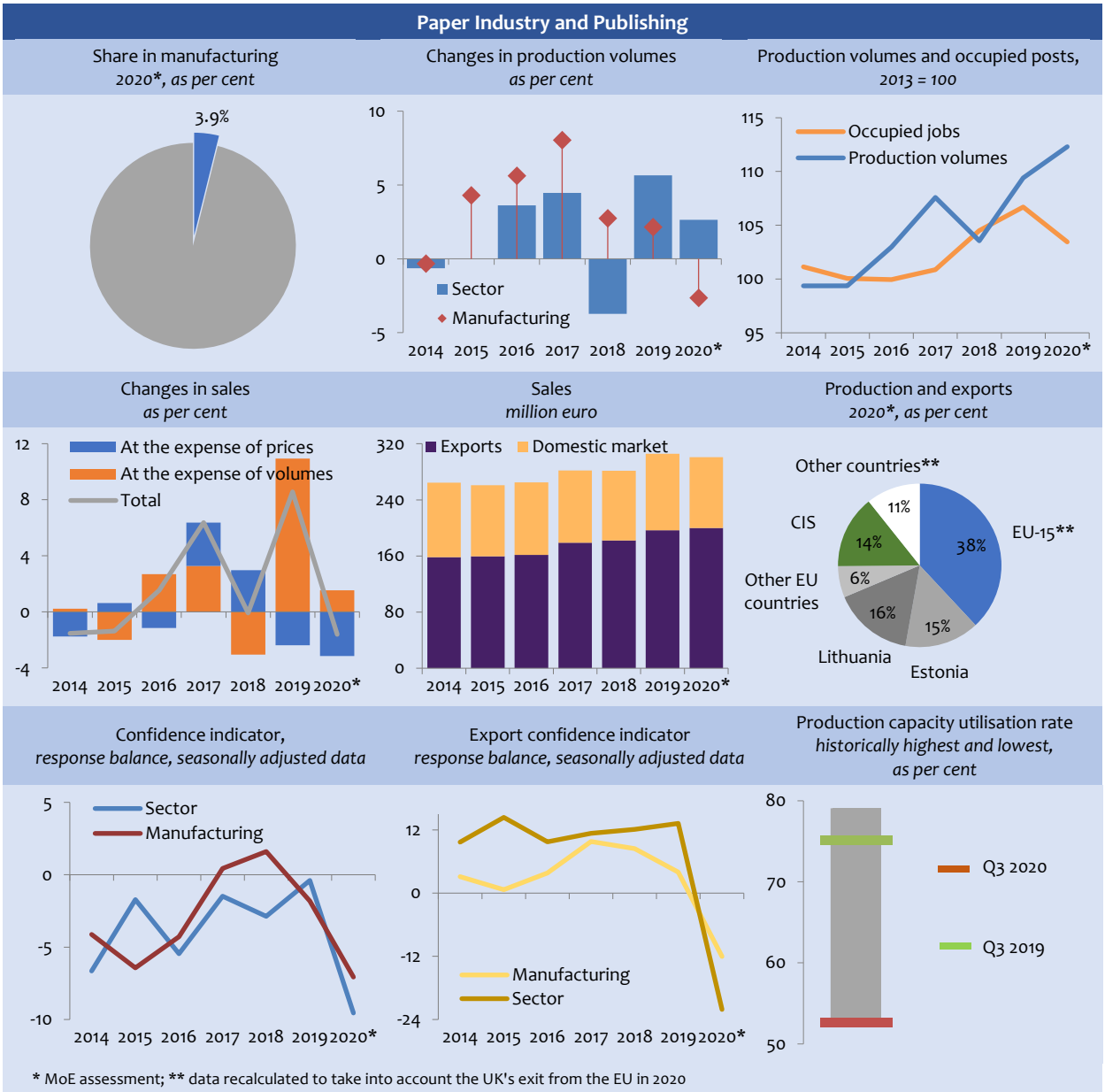
The *paper industry and publishing* is gradually reorienting from the domestic market to export markets. In 2019 and in the ten months of 2020, about two thirds of the production were exported.

Recently, production volumes in the industry have been volatile. After the fall in 2018, growth of the sector in 2019 and 2020 was positive. By contrast, in the ten months of 2020, volumes of the industry have been growing affected by significant growth of the publishing sub-sector.

The turnover of the industry has been growing in recent years. More rapid growth of sales in the sector was observed in 2019 equally facilitated by an increase in exported products and products sold on the domestic market. The EU countries are the main outlet for the products of the sector.

Until 2019, the number of occupied posts in the paper industry and publishing has also been growing more rapidly than in manufacturing on average. However, the number of occupied posts has slightly shrank in the first half of 2020. In recent years, the confidence indicator of the sector has been rather negative, although future export opportunities of the sector until 2019 had been evaluated positively. This indicator reduced considerably, more rapidly than in other manufacturing sub-sectors, in Q2 2020. Until 2019, the capacity utilisation rate of the industry in the paper industry and publishing sub-sector had traditionally been similar to the average in manufacturing, but it shrank considerably in 2020.

Figure 4.8

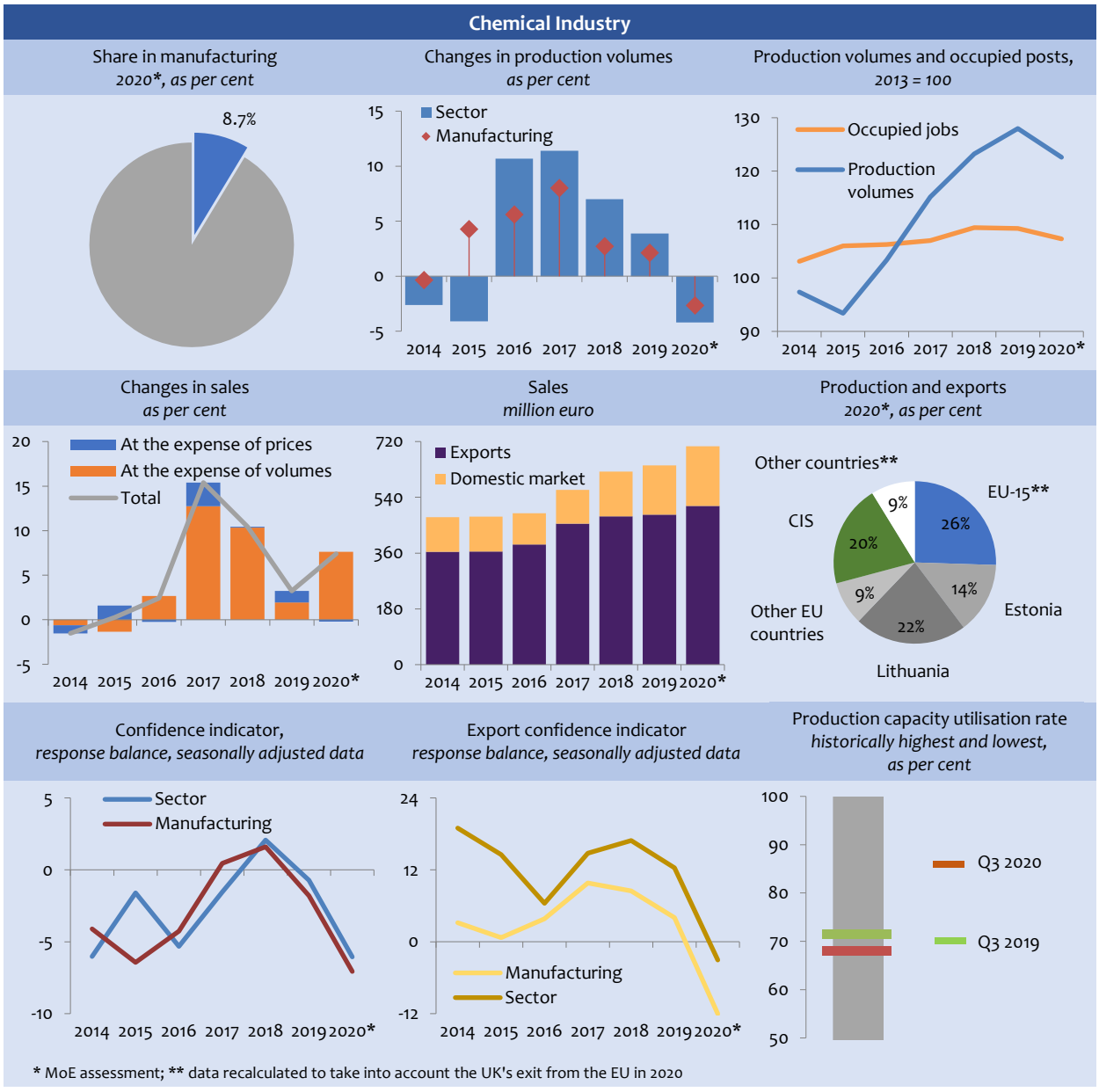


Years 2016-2018 were successful for the ***chemical industry***, which is explained by the improvement of the economic situation in trading partner countries as considerable part of chemical industry products are exported. Year 2019 was also successful for the chemical industry, although its growth rates have slightly slowed down. In the ten months of 2020 growth of the sub-sector has been slightly above zero level, but its output reduced slower than in manufacturing on average.

In 2017 and 2018 sales volumes of the industry grew considerably. The rates of sales volumes remained comparatively rapid also in 2019. An equally rapid increase in these years was affected by the increase in volumes of exported products and in volumes of products sold in the domestic market. Sales volumes continue to grow also in the ten months of 2020. More rapid growth in sales was observed in the domestic market and more moderate in exports.

The number of occupied posts in the chemical industry increased until 2018, but slightly reduced in 2019. However, the number of occupied posts has slightly shrank also in the first half of 2020. Although this sector's confidence is negative, this indicator is still one of the most optimistic in the industry as a whole. Similarly to other industry sub-sectors, this year export opportunities in the chemical industry are also evaluated cautiously. It should be noted that the production capacity utilisation rate is close to the average indicator in manufacturing.

Figure 4.9



* MoE assessment; ** data recalculated to take into account the UK's exit from the EU in 2020

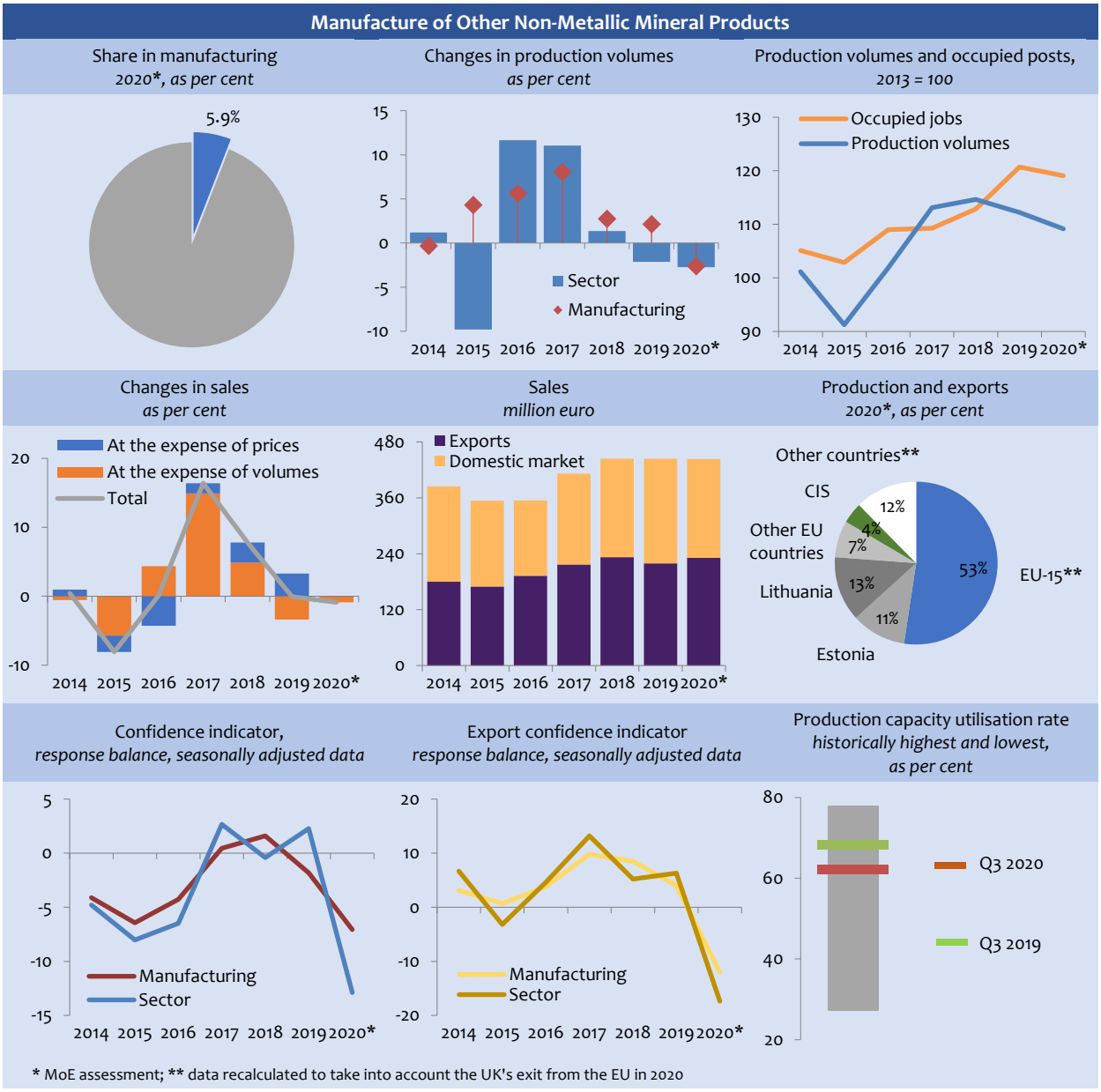
Manufacture of other non-metallic mineral products is closely related to the demand of the construction sector. Sharp growth was observed in the sector in 2016-2017. As the demand for products of the sub-sector reduced, growth of the sector in 2018 was more moderate. In 2019 and in the ten months of 2020 production volumes of other non-metallic mineral products have slightly reduced.

In 2017-2018, sales of products also increased a little bit more rapidly than production volumes of the industry. Sales turnover grew at a similar pace in the domestic market and export markets. In 2019, similarly to the ten months of 2020, sales of products of the industry were similar to those a year ago. In the ten months of 2020, sales volumes declined in the domestic market, but increased in the export market.

The number of occupied posts in the industry has increased comparatively rapidly in recent years, by 7% in 2019. By contrast, in the first half of 2020, the number of occupied post in manufacture of other non-metallic mineral products was slightly lower than a year before.

The confidence indicator of the sector has been volatile recently. In 2020, confidence of the sector is evaluated negatively. The evaluation of export opportunities has also been weak in recent years. The capacity utilisation rate has reduced in recent years and in 2020 was one of the lowest in manufacturing.

Figure 4.10



* MoE assessment; ** data recalculated to take into account the UK's exit from the EU in 2020

In recent years, the ***metalworking*** sector has contributed significantly to the total growth of the manufacturing. Growth rates of the sector were more moderate in 2018, yet they were still above the average level of the industry. By contract, the ten months of 2020 were not favourable for the sector similarly to other manufacturing sub-sectors.

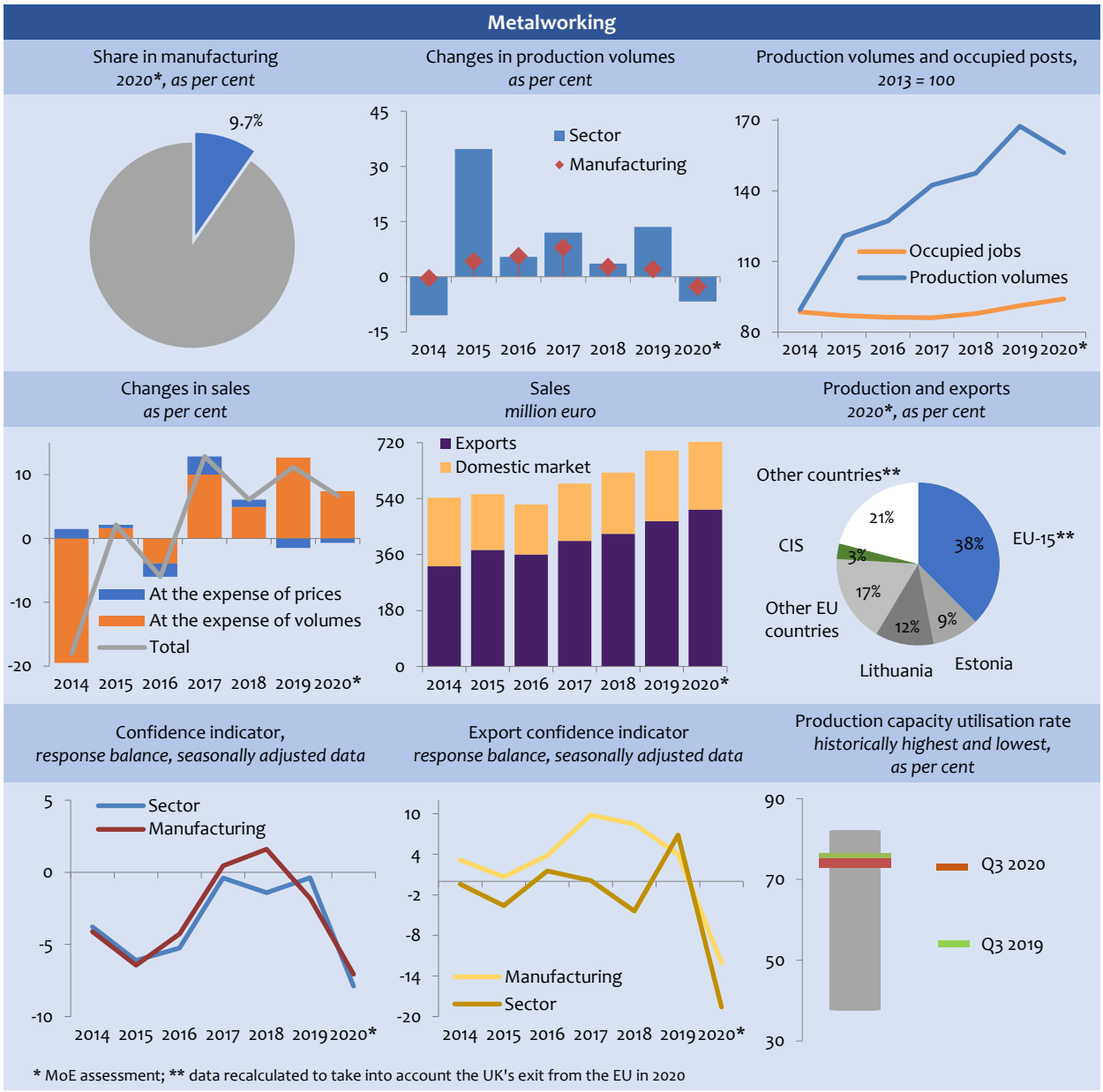
Since more than two thirds of the products produced by the sub-sector are exported, it should be noted that manufacture of basic metals and articles thereof is significantly affected also by competitiveness of the EU steel manufacturing sector on the global market, which has worsened in recent years. The EU countries are the main outlet for the products.

Sales volumes of the sector have been growing rapidly in recent years, including in the ten months of 2020. Volumes of products sold in the domestic market and exported products are growing equally rapidly.

The number of occupied posts in the metalworking industry also increased in 2017-2019. Their number continued to increase also in the first half of 2020.

The confidence indicator of the metalworking sector in 2020 is similar to the general indicators of the industry. Future export opportunities are also evaluated similarly. Capacity utilisation in metalworking is slightly above the average in manufacturing.

Figure 4.11



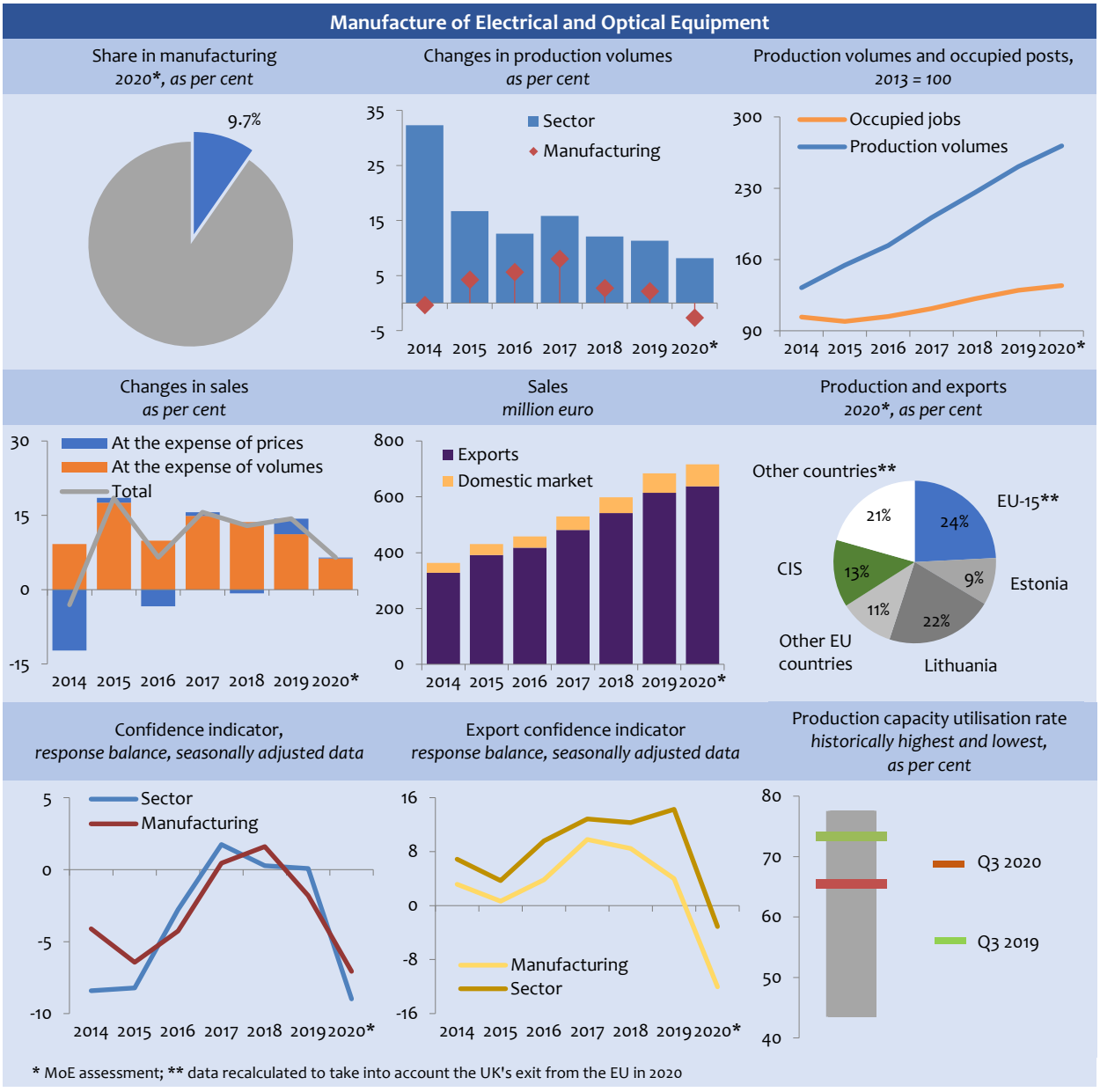
Manufacture of electrical and optical equipment in recent years has been the most rapidly growing manufacturing sector. Industry growth rates have been considerably higher than in manufacturing on average. Due to growth of the industry, its share in manufacturing is growing year on year. Production volumes of the sector continued to grow rapidly also in 2020.

Despite fluctuations in producer prices, sales volumes of the industry are also growing stably. The development of the sector is closely related to external demand, about 90% of the production of the said industry is exported. Sales of products increased more rapidly in the domestic market and more moderately in exports.

Although most of the industry's growth is ensured by the rise in productivity, the increase in the number of jobs has also been comparatively rapid in recent years. In 2017-2018 the sub-sector secured half of the increase in the number of occupied posts in manufacturing. The number of jobs was growing stably also in 2019 and in the first half of 2020.

The confidence indicator of manufacture of electrical and optical equipment is improving every year, however, in 2020 it is negative, while its future prospects are evaluated positively. Export opportunities of the sub-sector are estimated as relatively optimistic. The output of the sector had been growing rapidly until 2019, the capacity utilisation rate was close to its all-time high, however, it reduced considerably in 2020.

Figure 4.12



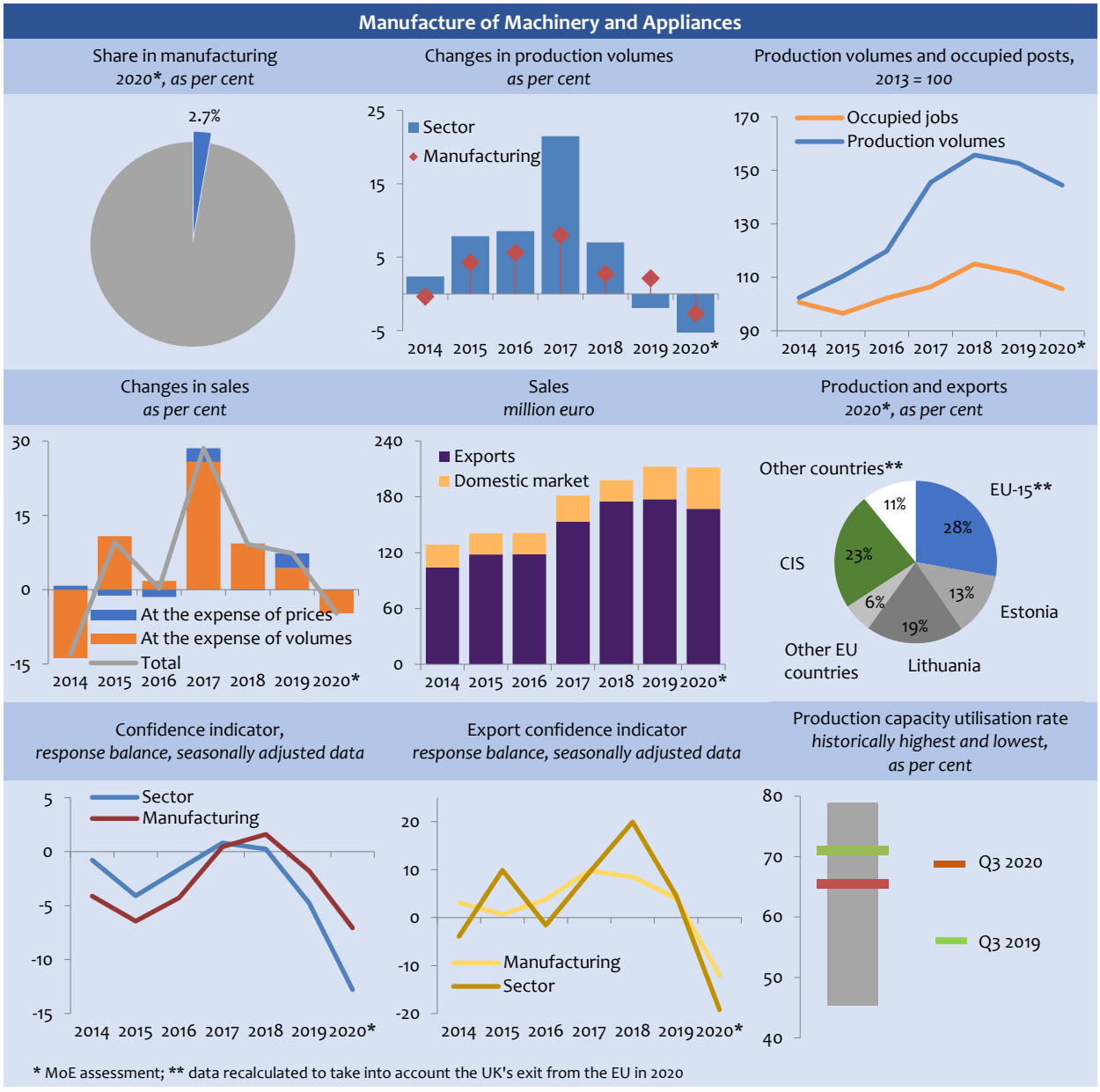
Growth rates in ***manufacture of machinery and equipment*** in 2015-2018 were considerably above the average level in manufacturing. Clearly rapid growth was observed in 2017. When external demand reduced in 2019 and in the ten months of 2020, growth rates of the sub-sector have become negative.

In recent years, growth in sales volumes in the sub-sector has been more rapid than output. In 2019-2020, sales volumes were growing particularly rapidly in the domestic and more moderately in exports. However, it should be noted that about 90% of the production of the said industry is exported. The EU countries are the main outlet for the products, although considerable part of products are sold also in CIS countries.

The number of occupied posts in the sector increased in 2017-2018, when it secured a big share of the increase in the number of occupied posts in manufacturing in total. However, the number of occupied jobs in the sub-sector slightly shrank in 2019 and in the first half of 2020.

The development of the sector has been evaluated negatively in recent years, in particular in 2020. Export development potential is also not evaluated optimistically in 2020. In recent years, the capacity utilisation rate has been slightly below the average level in manufacturing.

Figure 4.13



* MoE assessment; ** data recalculated to take into account the UK's exit from the EU in 2020

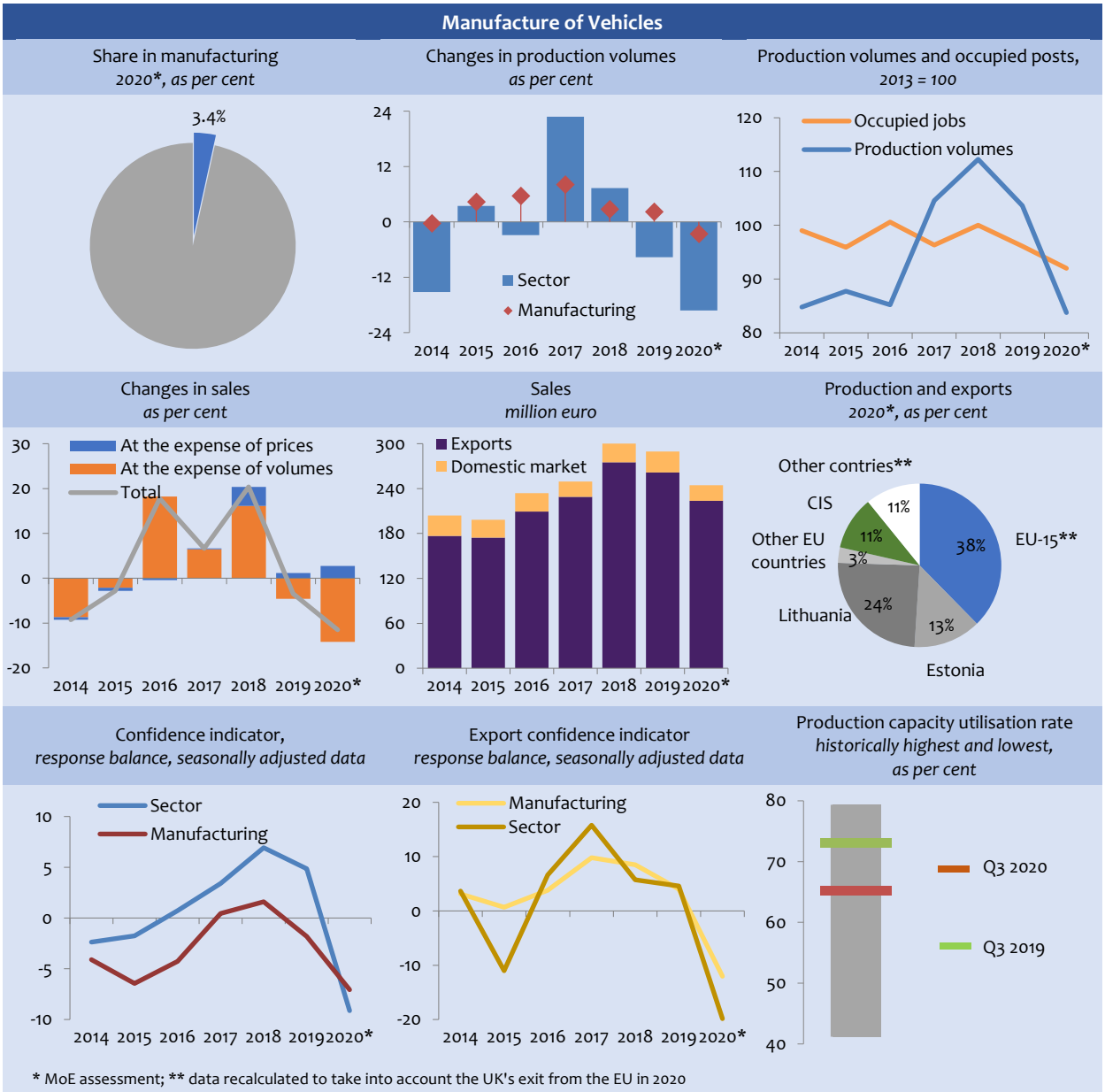
Manufacture of vehicles is clearly focused on external markets – more than 90% of products of the industry are exported. Since the industry largely depends on new orders, it is characterised by very pronounced fluctuations in production volumes.

Comparatively rapid growth of the sub-sector was observed in 2017-2018, when external demand increased. This was considerably affected by the increase in production volumes of cars and trailers. However, production volumes of the sub-sector declined in 2019. Year 2020 is also not successful for the industry due to the general situation in European automotive sector. Latvian companies mainly produce parts, and manufacture of vehicles in Europe has been one of the sectors that was hit most severely.

Sales volumes of the sector also grew comparatively rapidly in 2017-2018. In 2019 and in the ten months of 2020 production volumes and sales reduced.

The number of occupied posts in manufacture of vehicles has not significantly changed in recent years, which means that growth in the industry is mainly based on the increase in productivity. In 2020, the confidence indicator of the industry is negative, however sector development opportunities have been evaluated as increasingly more optimistic in recent months. The export capacity indicator of the sector also experiences similar trends and is markedly positive in Q2 2020. The capacity utilisation rate is slightly below the average in manufacturing.

Figure 4.14



4.3. OTHER INDUSTRIES

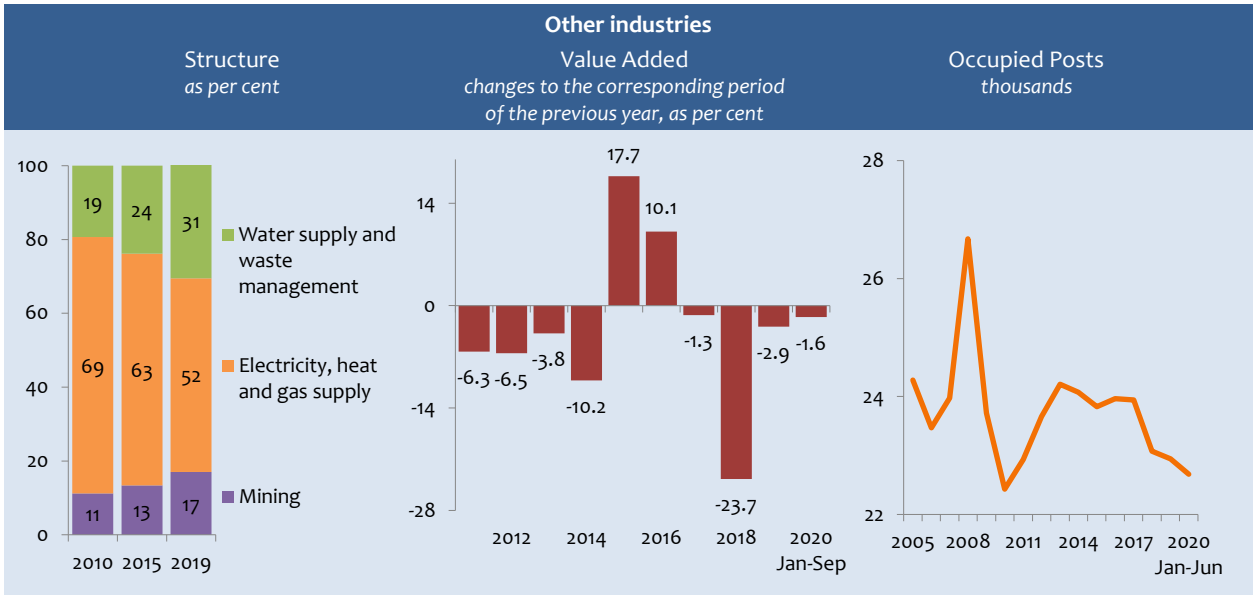
Electricity and gas supply dominate in the structure of **other industries** (mining and quarrying; electricity, gas, steam and air conditioning supply; water supply, sewerage, waste management and remediation activities). After the increase in 2015-2016, the share of other industries in the total value added has been declining since 2017. The dynamics in sales volumes in electricity and gas supply sectors is related to weather, as amounts of electricity and heat produced depend on it.

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

In 2017-2019, a rapid decline was observed in volumes of other industries being particularly rapid in 2018 under the influence of a drop in electricity and gas supply. The amount of electricity generated by hydropower plants and cogeneration plants, and gas supply to consumers reduced considerably under the effect of warm and dry weather. At the same time, the share of the mining industry increased fostered by a rapid increase in peat extraction volumes. In the three quarters of 2020 production volumes of other industries reduced compared to the respective period of the previous year. This was underpinned by a decline in electricity generation and supply, and by a decline in gas supply.

The number of occupied posts in mining and quarrying is growing, while in other industries it is shrinking.

Figure 4.15



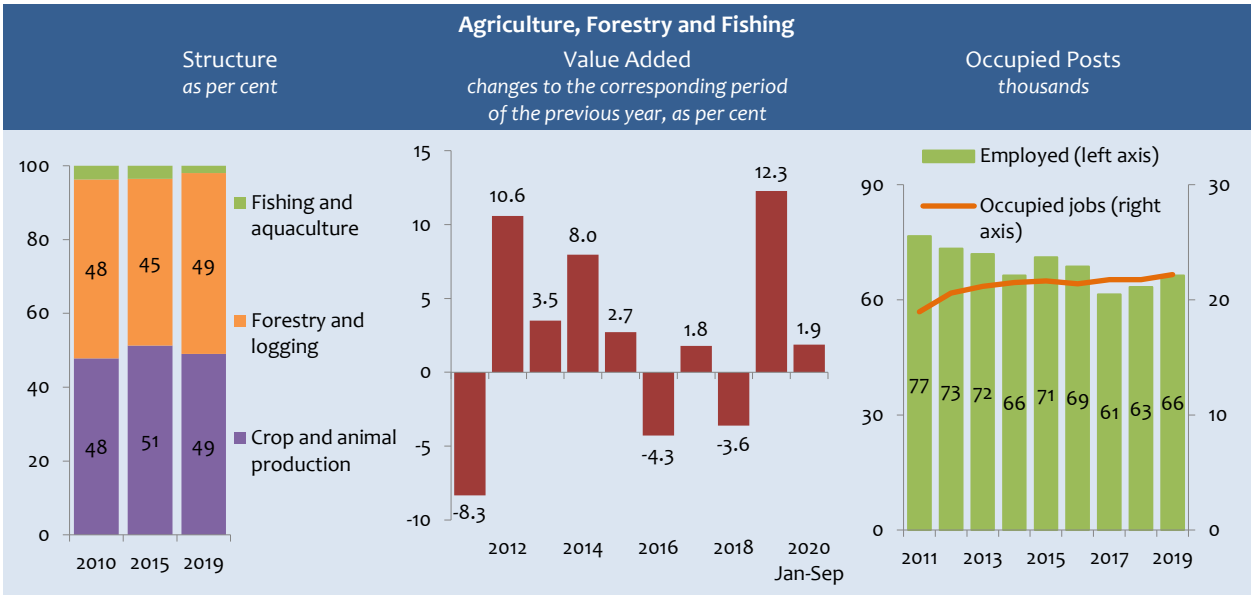
4.4. AGRICULTURE, FORESTRY AND FISHING

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

In 2014-2015, despite Russia's embargo on food imports, there was rapid growth in agriculture and forestry fostered by the historically highest harvest of crops. In 2016, volumes of the industry shrank sharply due to the drop in crop production volumes.

In 2017, growth was observed in the sector due to the increase in forestry volumes. Volumes of cut wood increased and forest renewal volumes increased sharply. After a decline over the previous three years, average purchase prices of logs in Latvia increased in 2017. The increase in volumes of agriculture was modest due to unfavourable weather. The number of exported livestock and pigs in animal production increased despite the effect of the African swine fever.

Figure 4.16



In 2018, volumes of the industry shrank sharply, underpinned by a rapid decline in production volumes in agriculture. Crop production saw the lowest total crop harvest in the last five years and the lowest average crop harvest in the last seven years. It was significantly affected by a long draught period, as well as a considerable reduction of areas of winter sowing due to incessant rains in autumn 2017. Animal production volumes remained unchanged in 2018. The number of farmed animals reduced, while an increase was observed in the number of poultry. Despite the decline of the total number, the number of exported live cattle increased. A small increase was observed in meat production volumes, but milk and egg production volumes declined. At the same time, prices of agricultural products increased considerably in 2018 caused by the increase of prices in crop production due to smaller harvest. Meanwhile, the average purchase price of meat and milk reduced, but the price of eggs remained unchanged.

Furthermore, in 2018, a more rapid decline in the entire industry was compensated by a significant increase in forestry volumes, when amounts of cut wood increased considerably. Afforestation of lands not used in agriculture was growing rapidly. Average purchase prices of logs continued to increase in Latvia.

In 2019, very rapid growth was generally observed. The increase was mainly underpinned by growth in agriculture, where volumes of products increased by 20.2%. This increase was underpinned by an increase in crop production volumes – in 2019, Latvia had the highest total crop harvest in its history. The achievement of the record-high crop harvest was significantly affected by good yields as well as by the increase in crop farming areas. The weather also had a positive effect on the growing of vegetables in the open field.

Animal production volumes reduced by 1.4% in 2019. The number of farmed live cattle remained at the level of the previous year, while an increase was observed in the number of pigs and poultry. The number of exported live cattle decreased, while exports of live pigs increased. Production volumes of meat and eggs showed an increase, while dairy production decreased slightly, affected by a drop in the number of dairy cows.

At the same time, in 2019, prices of agricultural products slightly increased due to the increase in prices of animal products. The average price of meat increased by 8.1%. In animal production, the largest increase in the purchase price was for pork – by 18.4%, reaching 1,608.67 euros per tonne, which was the highest price since 2014. The average purchase price of milk increased, but the price of eggs reduced. Crop production prices declined in 2019, the average purchase price of grain decreased to 158.24 euros, or by 6%, and global markets also showed a trend of declining grain prices. In contrast, potatoes and vegetables saw a significant increase in prices.

In 2019, growth in forestry continued. Volumes of cut wood increased by 4%, but forest renewal volumes increased much more rapidly – by 9%. After an increase over the previous two years, in 2019, average purchase prices of logs in Latvia reduced. They reduced for logs of both coniferous and deciduous trees.

In three quarters of 2020 volumes of the industries have generally slightly increased. Production volumes increased in agriculture and reduced in animal production. A minor increase in volumes was observed in forestry, while in fishing production volumes decreased.

In recent years, the number of the employed and occupied posts in the industry has been growing and has already exceeded the pre-crisis level. Occupied posts increased more rapidly, which means that labour force on wages is still used more in the industry. The number of jobs reduced in the first half of 2020 under the influence of Covid-19, affected by their rapid decline in forestry.

4.5. CONSTRUCTION

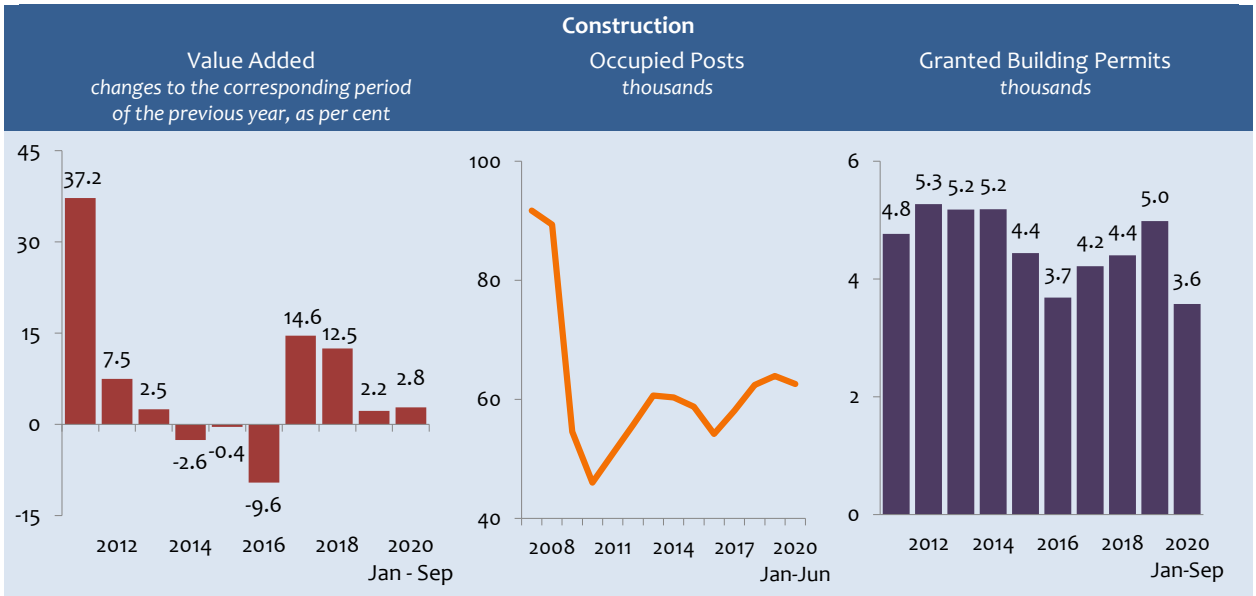
Growth of **construction** is largely subject to cyclical fluctuations. Production volumes dramatically declined during the crisis; industry output shrank more than twice in the period from 2008 to 2010.

The demand for services of the industry resumed growth in 2011. The recovery of the construction sector was largely driven by active acquisition of the EU structural funds. Along with the increase in internal demand, the development of the sector was positively affected by the ability to reorient to external markets during the crisis. In 2011, the volume of construction products outside Latvia exceeded the indicator of 2008 more than five 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 orders and the European Union structural funds. The annual increase in the average volume of construction products 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 building permits.

The development of the construction sector ceased for the next two years. It can mainly be attributed to the transition period of the EU structural funds, when investments in construction declined. 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 building permits in these years.

Figure 4.17

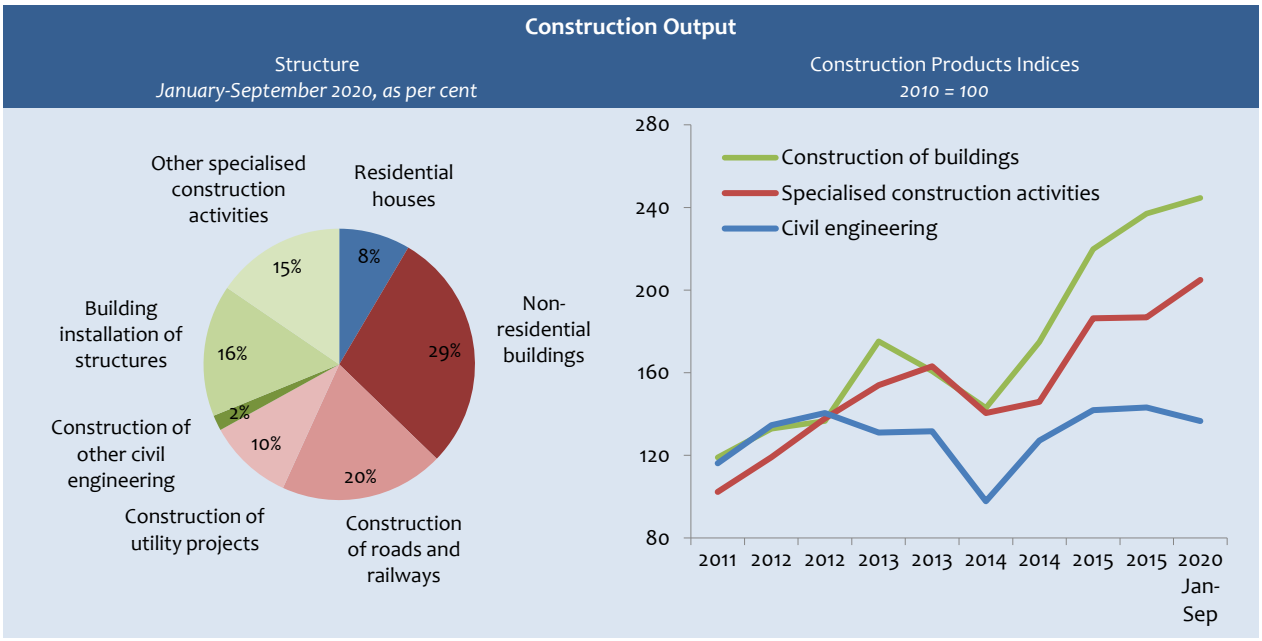


The construction sector resumed its growth in 2017 after a two-year break. Rapid growth was observed in 2017-2018. In this period, the average increase in production volumes of the industry was 20.3% per year. Industry development drivers were the increase in intensity of implementation of projects of EU structural funds after a transition period, as well as the inflow of private investments for construction of large construction objects.

Volumes of products significantly increased in all main groups of construction. The increase in construction of buildings made the biggest contribution, which was 24% on average in 2017-2018. The annual average increase rate in civil engineering was 20.8%, while in specialised construction activities – 15.9 per cent.

The construction sector continues to grow in 2019, yet at a lower rate than in the last two years. Volumes of construction products were by 2.9% higher than in 2018, and were affected by the base effect or the high results reached as a result of rapid growth in the previous years. The affecting factors are completion of large private construction projects and the flow of investments from EU structural funds, which has reached its maximum.

Figure 4.18



In 2019, construction volumes increased in all main groups of construction with the biggest contribution coming from the increase in volumes of construction of buildings.

Year 2020 started with warm winter, and favourable weather conditions resulted in very good indicators in Q1. In the following quarters, the industry felt the effects of Covid-19. The decline in private investment caused by the economic downturn has stalled construction development – both in Q2 and in Q3, construction volumes actually remained at the level of the corresponding quarters of the previous year. Taking into account good growth rates of Q1, in 2020 the overall dynamics of the construction sector remain positive.

The increase in construction activities was also seen in the increase in the number of granted building permits since 2016. The decline in economic activity and investors' caution are reflected more tangibly in the dynamics of this indicator in 2020. 3576 building permits were granted in the three quarters of 2020, which is 10.7% less compared to the corresponding period of 2019. This was mainly due to a reduction in the number of building permits granted for the construction of private houses. The intended floor space has decreased more rapidly, with a decline by 17 per cent during this period.

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. Since 2017, at least 1/10 of the volume of construction products were exported. In the three quarters of 2020, export capacity has been maintained, and 14.2% of all construction works were carried out outside Latvia.

In the last two years, the development of the industry has affected the prices of services provided by builders. The index of construction costs has been growing more rapidly since 2017 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. Although increase rates of construction costs has slowed down considerably in 2020, wages remain the main cost increasing factor.

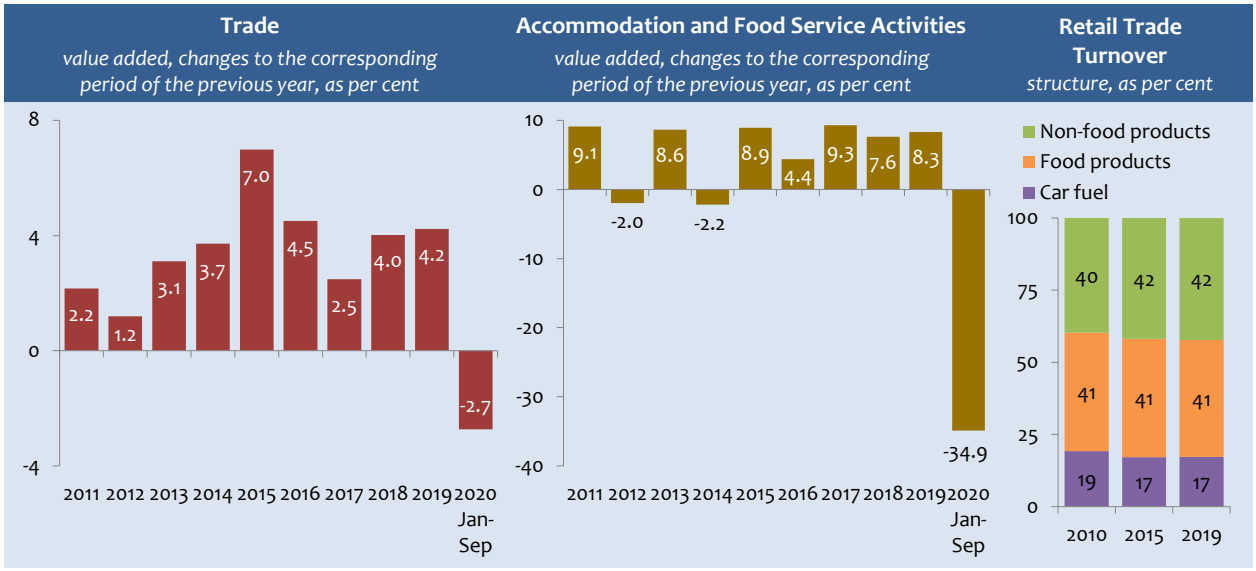
The construction was actively attracting employees in the period before the crisis. In 2005-2007, the number of occupied posts increased by almost 30 thousand reaching 91.7 thousand. During the economic recession, the number of persons employed in the sector was significantly adjusted reducing almost twice.

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

4.6. TRADE, ACCOMMODATION AND FOOD SERVICE ACTIVITIES

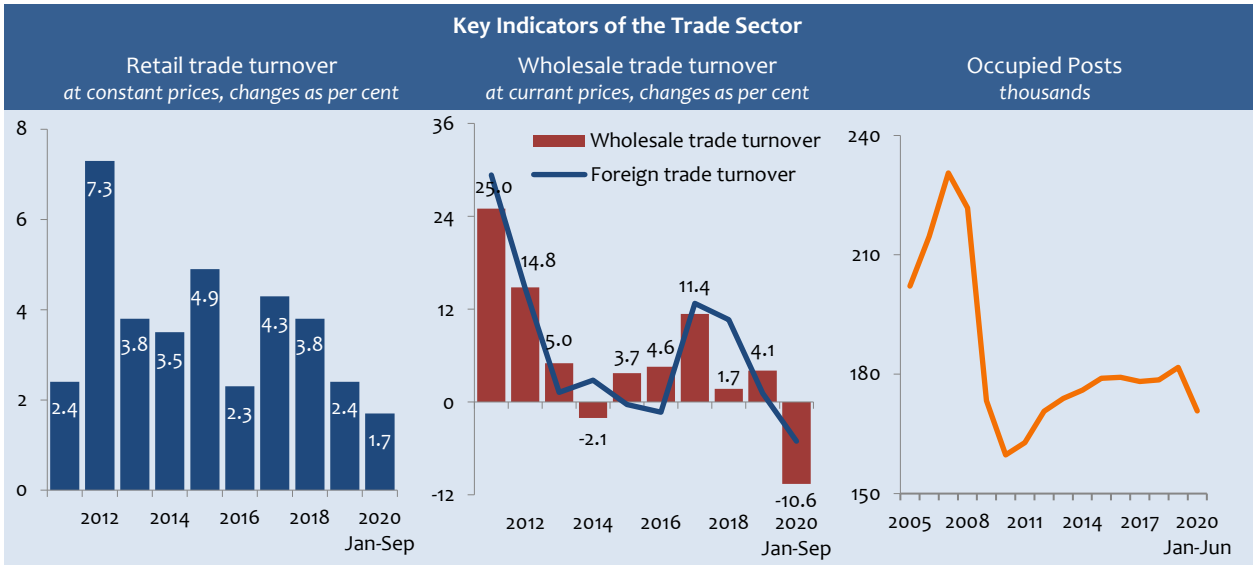
Trade dominates in **trade, accommodation and food service activities** – about 90%. Volumes of services provided in the sector have been growing since 2010. The trade sector was positively influenced by an increase in private consumption and retail turnover. Furthermore, accommodation and food service activities positively affected the development of the tourism sector.

Figure 4.19



Although retail trade turnover was growing rapidly, general growth in trade was very moderate in 2010-2012. In 2013-2019, growth in the entire sector was very rapid. In this period, growth rates of both trade and accommodation and food service activities were rapid – by 4.1% and 6.4% per year on average, respectively. The increase in wages and improvements in the labour market ensured growth of retail turnover, which increased by 3.6% per year on average. The dynamics of the total retail trade turnover were most seriously affected by the increase in non-food retail trade volumes, while in the group of automotive fuel and food products retail volumes increased equally rapidly. The dynamics of the retails sector were affected by external trade activities.

Figure 4.20



Growth of the sector continued in 2019. It has been more rapid than that observed in the previous years. In 2019, volumes in trade grew by 4.2%, while in accommodation and food services activities – by 8.3%. Retail trade turnover increased slower – by 2.4% in 2019. The largest rise was observed in volumes of retail trade of non-food products, which account for 55% of total retail trade. Wholesale trade turnover at current prices increased by 4% 2019, despite weak foreign trade activity.

In the three quarters of 2020, the volume of services provided in trade, accommodation and food services activities has reduced rapidly. The trade sector was negatively affected by the decline in private consumption, rising unemployment and falling incomes caused by Covid-19. It reduced by 2.7% in the three quarters of 2020. Retail trade turnover increased by only 1.7% in the nine months of 2020. Retail volumes of food products and fuel increased, while those of non-food products saw a decline. Meanwhile, the wholesale trade turnover at current prices reduced by 10.6%. Accommodation and food service activities were particularly negatively influenced by the strict measures introduced to restrict the spread of the virus. In three quarters of 2020, volumes of the industry reduced by 34.9 per cent.

The largest share of occupied posts is in trade, but it has shrank in recent years with jobs growing faster in the accommodation and food services activities sector. In the first half of 2020, due to the effects of Covid-19, the decline in the number of jobs has been observed in both sectors, being particularly rapid in accommodation and food service activities.

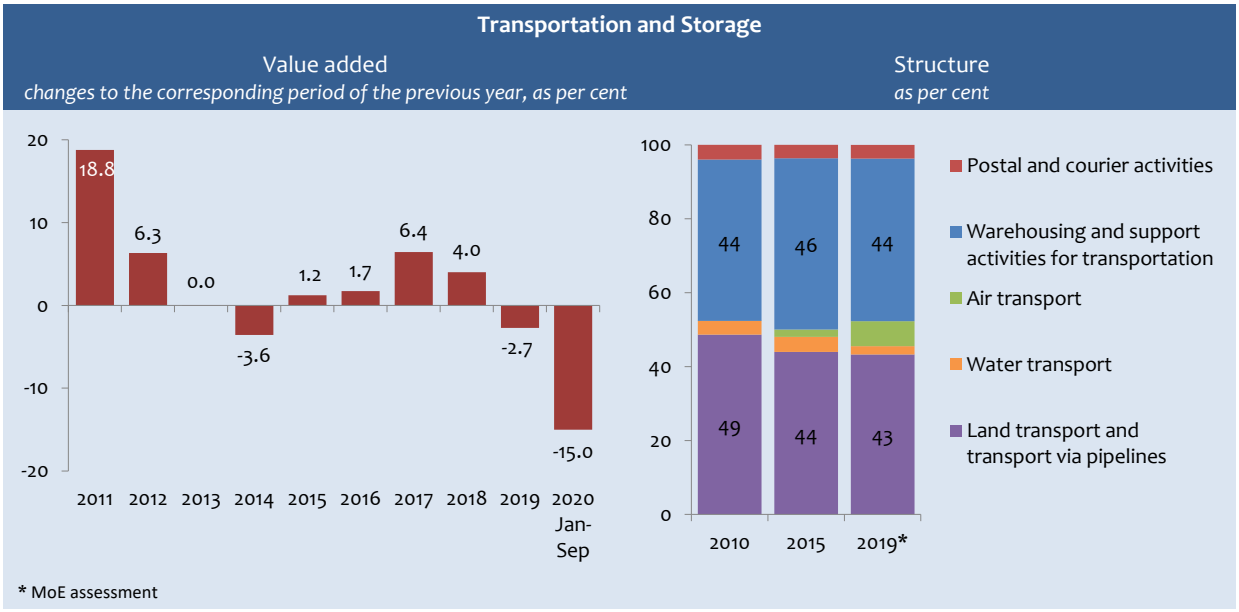
4.7. TRANSPORTATION AND STORAGE

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

After a sharp increase in the post-crisis period, volumes of the sector experienced a small increase in 2013-2016 – 0.2% per annum on average. Among other things, it was primarily affected by the decline in transit freight transport, mainly due to the Russian transport policy and growing competition. Since the end of 1990s, Russia has been forwarding the goals to develop its own transportation infrastructure to be independent from transit countries.

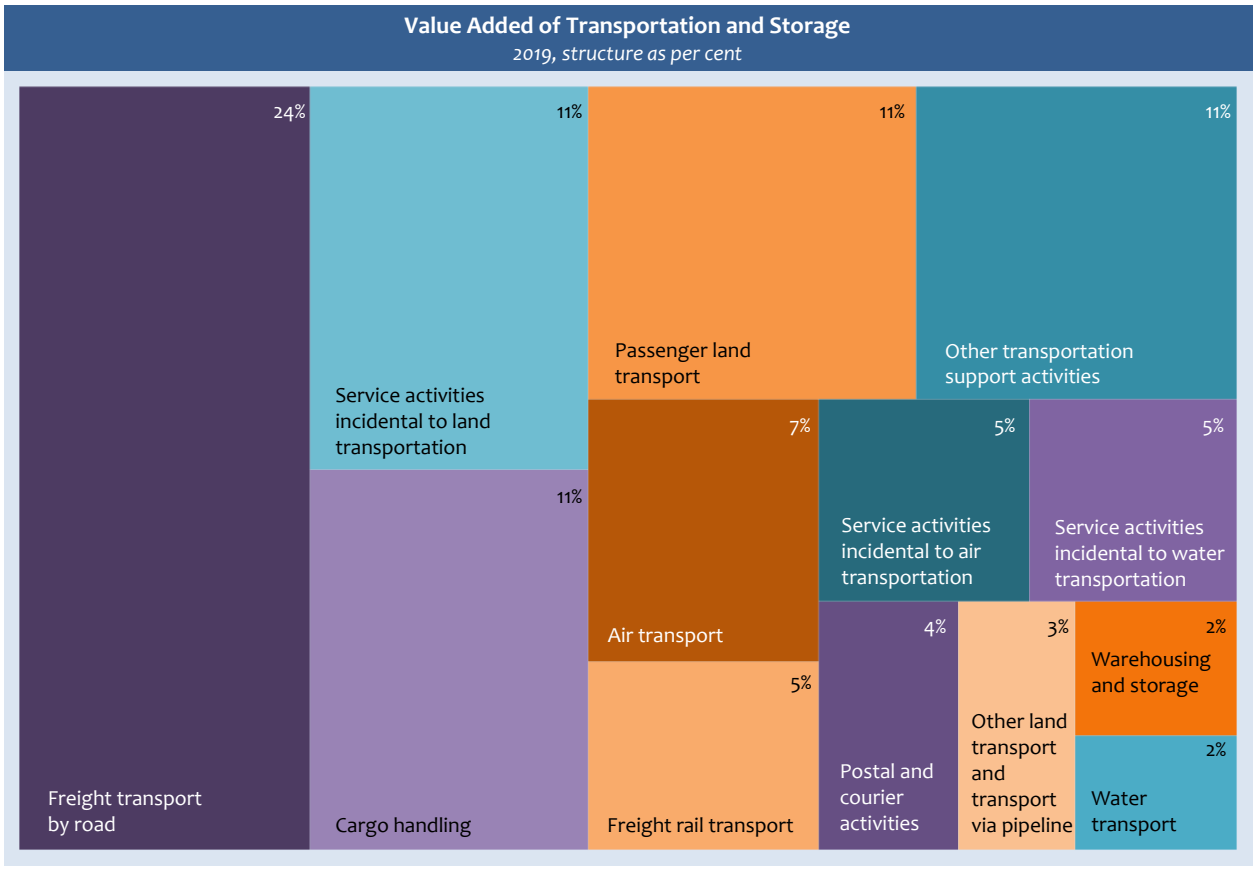
In 2017, the increase in volumes of the sector was the fastest since 2011. Despite the drop in transit freights by railway and in ports, growth of the sector was fostered by the increase in freight transport by road, as well as the increase in the number of passengers in the airport and seaports. Rapid growth was also observed in 2018. Passenger and freight transportation by all modes of transport increased.

Figure 4.21



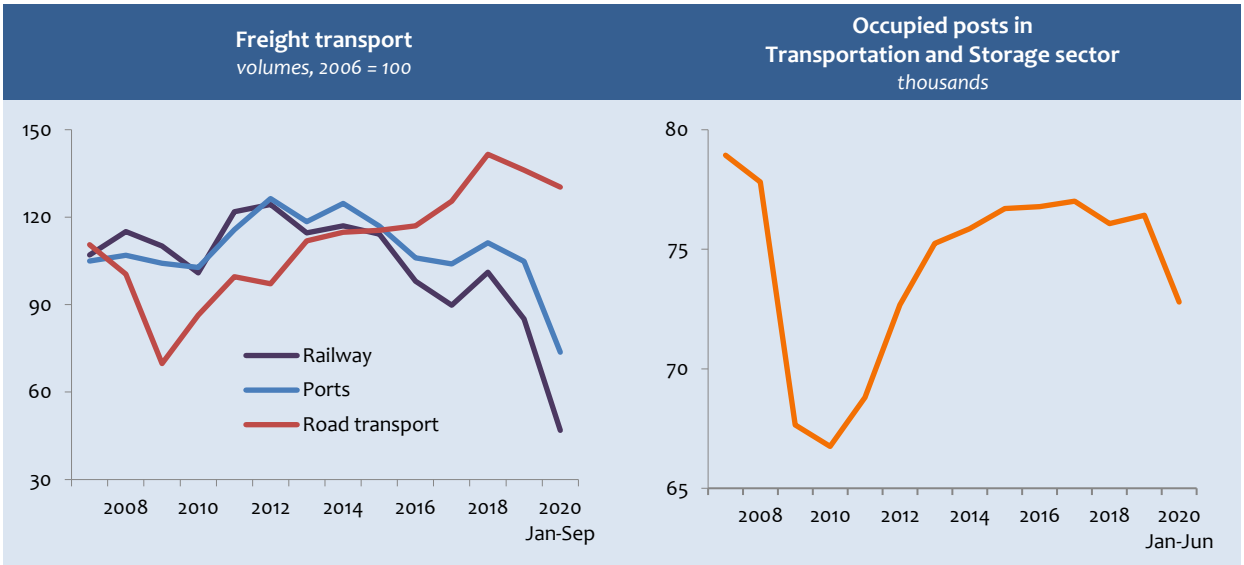
In 2019, volumes of the sector reduced underpinned by a drop in freight transport and warehousing and support activities for transportation. Freight transport reduced in all modes of transport, while carriage of passengers increased by 8% and postal and courier activities – by 18 per cent.

Figure 4.22



In three quarters of 2020, volumes of the industry reduced. The Covid-19 restrictions had a significant impact on aviation, land transport and rail companies. A sharp drop in transit freights was seen in railways and ports, while road freight volumes, due to an increase in inland freight volumes, declined more slowly. Passenger transport reduced in all modes of transport. The most rapid reduction in passenger numbers was in air transport – by 69.6%, passenger numbers in ports reduced by 51.2% and in road transport by 38.9 per cent.

Figure 4.23

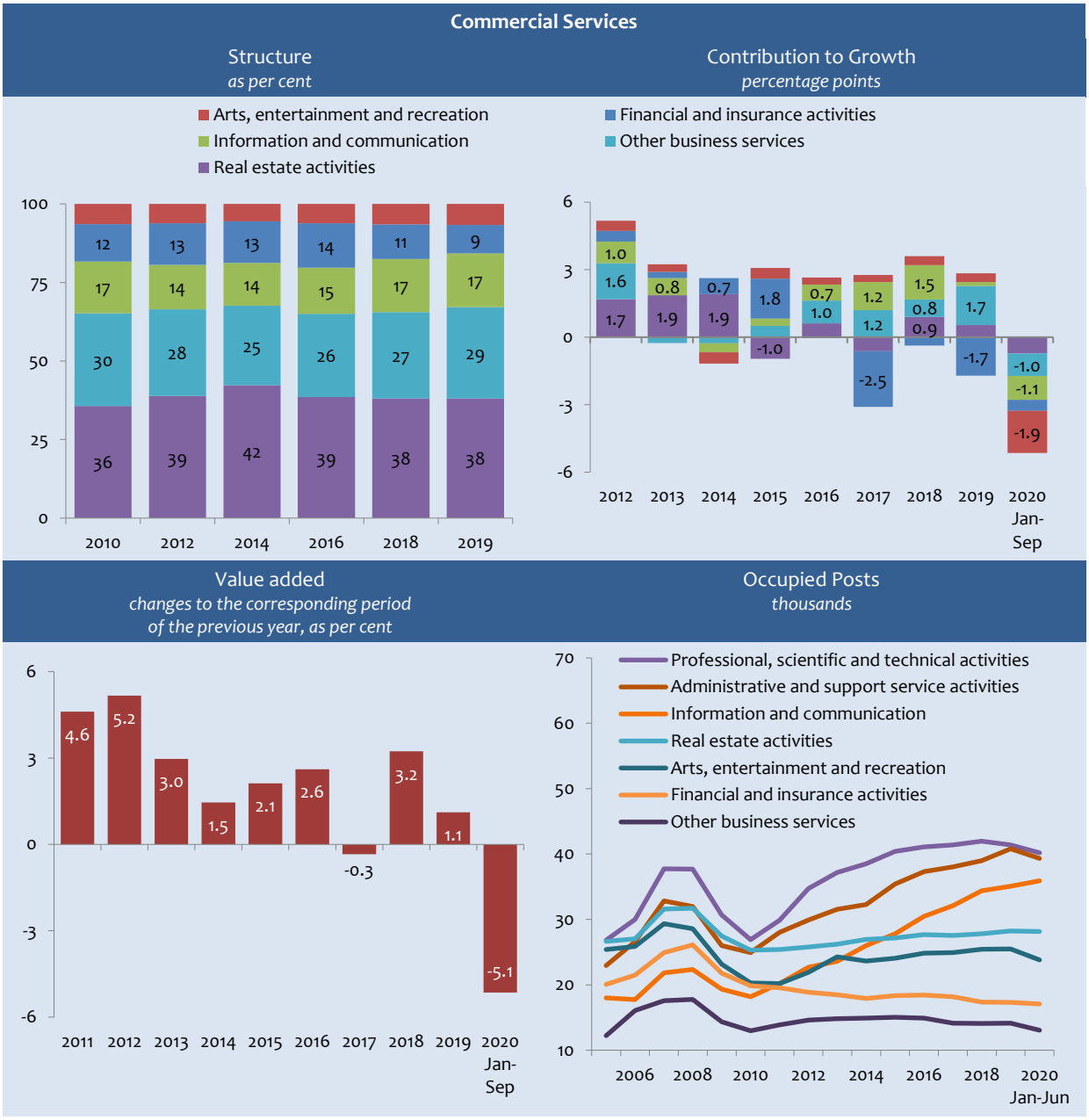


The biggest share of occupied posts in transportation and storage is in land transport and transport via pipeline and warehousing and support activities for transportation, where it increased in 2019 after the rapid decline in jobs in 2018. However, in the first half of 2020, under the effects of the Covid-19 crisis, the number of occupied posts reduced in all transportation and storage sub-sectors. The sharpest decline in the number of occupied posts has been in air and water transport sectors.

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 and support service activities, arts, entertainment and recreation).

Figure 4.24



Sharp growth was observed in commercial services in 2011-2013. Volumes of the services grew by 4.2% per year on average. They increased in all the main commercial services sectors, with the exception of financial and insurance activities.

In 2014-2016, volumes of commercial services sectors were growing; however, they were more moderate than in the post-crisis period. However, in 2017, volumes of services in commercial services sectors essentially remained unchanged, affected by a rapid decline in volumes of financial and insurance activities triggered by the reduction of non-resident business volumes in Latvia, the decline of the number of employed, and merging of banks.

In 2018, volumes of services in commercial services sectors grew very rapidly. The increase was primarily based on growth in information and communication sector. Also, in 2019, growth in commercial services sectors continues, albeit at a slower pace than in 2018. The largest effect came from the increase in volumes of professional, scientific and technical activities and administrative and support service activities, while volumes of financial and insurance activities reduced.

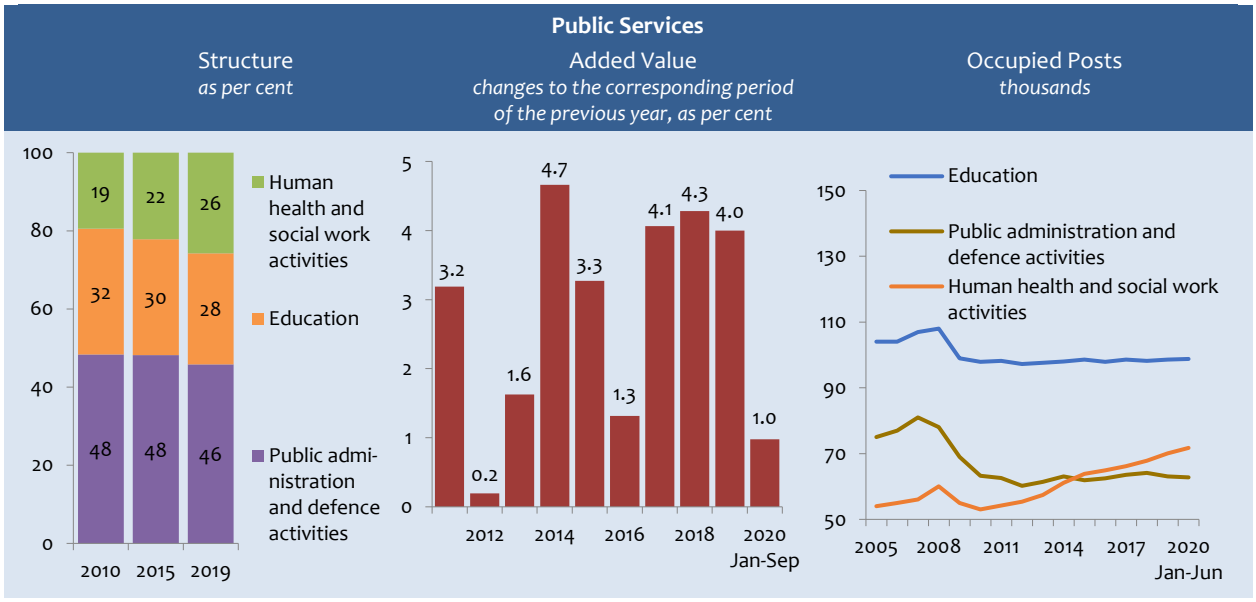
In the three quarters of 2020 volumes of commercial services reduced rapidly in all sectors under the influence of the Covid-19 crisis. The drop in service volumes in arts, entertainment and recreation had a major impact due to the strict measures introduced to limit the Covid-19 pandemic. In other sectors,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

The largest share of occupied posts has been in professional, scientific and technical activities, administrative and support service activities and information and communication sectors, which had the most rapid increase in the number of occupied posts in recent years. In the first half of 2020, the number of jobs declined across all commercial services, excluding information and communication and real estate activities. They declined most sharply in art, entertainment and recreation.

4.9. PUBLIC SERVICES

Public administration and defence activities dominate in the structure of **public services** (public administration and defence activities, education, health and social work activities). The government's commitment to continue reducing the national budget deficit in the post-crisis period held back a rapid increase in expenditure. In 2012, volumes of public services essentially remained unchanged under the influence of the drop in volumes in public administration and defence activities. With the government expenditure increasing, a steady growth has been observed in the public services sectors since 2013. A slower increase was observed in 2016, when only public administration and defence activities had a stable rise in volumes. The sector continued to grow rapidly also in 2017-2019.

Figure 4.25



Overall, in 2011-2019, volumes of public services increased by 2.9% per year on average. The most rapid increase was observed in health and the slowest – in public administration and defence activities. Consumption on the increase of defence capabilities of the state, health and education has increased considerably in recent years.

In the three quarters of 2020, public services were also negatively affected by the Covid-19 crisis. Total volumes of services increased by 1% compared to the corresponding period of the previous year. Volumes of public administration and defence activities increased by 1.4%, volumes of health and social work activities – by 1% and volumes of education services – by 0.4 per cent.

Education has the highest share of occupied posts, while public administration and health have an equal share. In recent years, the fastest growth of jobs was observed in health. In the first half of 2020, a rapid increase in the number of jobs was observed in health, while the number of jobs in public administration continued to reduce.

5. ECONOMIC DEVELOPMENT FORECASTS

ECONOMIC DEVELOPMENT IN 2021[1]

Like everywhere across the world, in 2021, similarly to 2020, economic development and usual lifestyle in Latvia will be significantly affected by the spread of the Covid-19 virus and the epidemiological safety measures for its containment. The sectors related to the gathering and servicing of people – mainly retail, accommodation and food service activities, transport services, arts, entertainment and recreation – have been hit by the Covid-19 crisis particularly severely. The most optimistic expert assessments regarding a possible "V-type" crisis management scenario have failed, as the numbers of infected people started growing in autumn 2020 and new measures to limit the spread of the virus had to be introduced. As the epidemiological situation deteriorates, in Q4 2020, economic growth rates are expected to slow down again and may reach a 7-8% year-on-year drop. Overall, GDP could fall by 5.5% in 2020.

The decisions taken by the government in December 2020 to restrict access to services in the first weeks of 2021 will have a significant impact on the overall economic activity. Further developments will heavily depend on public's reaction and compliance with the restrictions imposed. When morbidity rates fall, the restrictions will be also gradually eased, and the economy will return to growth. The main risks to growth in 2021 that are worth to mention are the effectiveness of support measures to maintain economic capacity, the capability and capacity of the healthcare system to fight the Covid-19 crisis, and the likelihood of a third wave of Covid-19. Meanwhile, the development of the Covid-19 vaccine and the planned start of vaccination as soon as possible are positive signals.

In 2021, private consumption is expected to recover relatively rapidly fostered by wage increases and resumed employment in several services sectors, which were affected by the Covid-19 restrictions the most, in the second half of the year. Private consumption could grow by 9.5% in 2021, making a significant contribution to economic growth.

The Covid-19 crisis is affecting investment and its dynamics trends in the coming years are uncertain. Investment activities in 2021 will be influenced by uncertainty about the international environment, including the impact of the Covid-19 outbreak, as well as by a significant decrease in production capacity levels. Investment dynamics are also weakened by a low level of lending. The implementation of state aid programmes can become an important factor in increasing the dynamics of investment. Total investments are expected to increase by 2.3% in 2021.

The epidemiological situation and the imposition of strict restrictions in export partner countries have a negative impact on external demand and therefore Latvia's export capabilities. Services sectors (tourism, air transport) have suffered considerably more dramatically, while the impact of restrictions on exporters of goods has been more temporary and the recovery from the shock caused by Covid-19 has been faster. Taking into account the low base effect, the growth rates of services exports in 2021 could be more rapid than the rise in exports of goods and total exports of goods and services could reach 3.8% in 2020.

The dynamics of sectors will be largely influenced by their ability to resume growth following the cancellation of Covid-19 restrictions. Like in the first wave of the crisis, industries exporting goods, mainly manufacturing, will be the first to reach pre-crisis levels. Production volumes in manufacturing are projected to rise by 4% in 2021.

In 2021, relatively good growth rates are expected in the IT sector. Stable growth is also expected in the sectors related to private consumption and domestic market-oriented sectors – retail trade and other commercial services.

In 2021, growth is also expected in agriculture and forestry, which has been relatively successful in overcoming the Covid-19 pandemic in 2020. The construction sector will also keep growing in 2021, but more moderately than in previous years. Faster growth in construction volumes will be limited by slower growth in private investment and the timely launch of the new investment programming period of the EU funds. Growth in sub-sectors might be very variable, as road construction rates in 2021 could, for example, be more rapid than in the whole construction.

In view of the significant drop in volumes in 2020, relatively rapid growth rates are expected in the most heavily affected sectors – trade, accommodation and food service activities, transport services, arts, entertainment and recreation. At the same time, these sectors will not reach the level of 2019 in 2021, and certain sectors, in particular aviation and tourism sectors, may need several years to reach pre-crisis levels.

The Ministry of Economics forecasts that overall economic growth can reach 3.7% in 2021. However, it should be noted that there is still very high uncertainty about future developments in both the spread of the virus and economic development. If restrictions continue longer, it is not excluded that the impact of Covid-19 on economic activity and financial markets could

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

be stronger and longer and may lead to slower economic recovery in 2021. At the same time, there are also positive risks that successful vaccination will lead to a faster economic recovery in the region and also in Latvia.

DEVELOPMENT PERSPECTIVES FOR 2022-2027

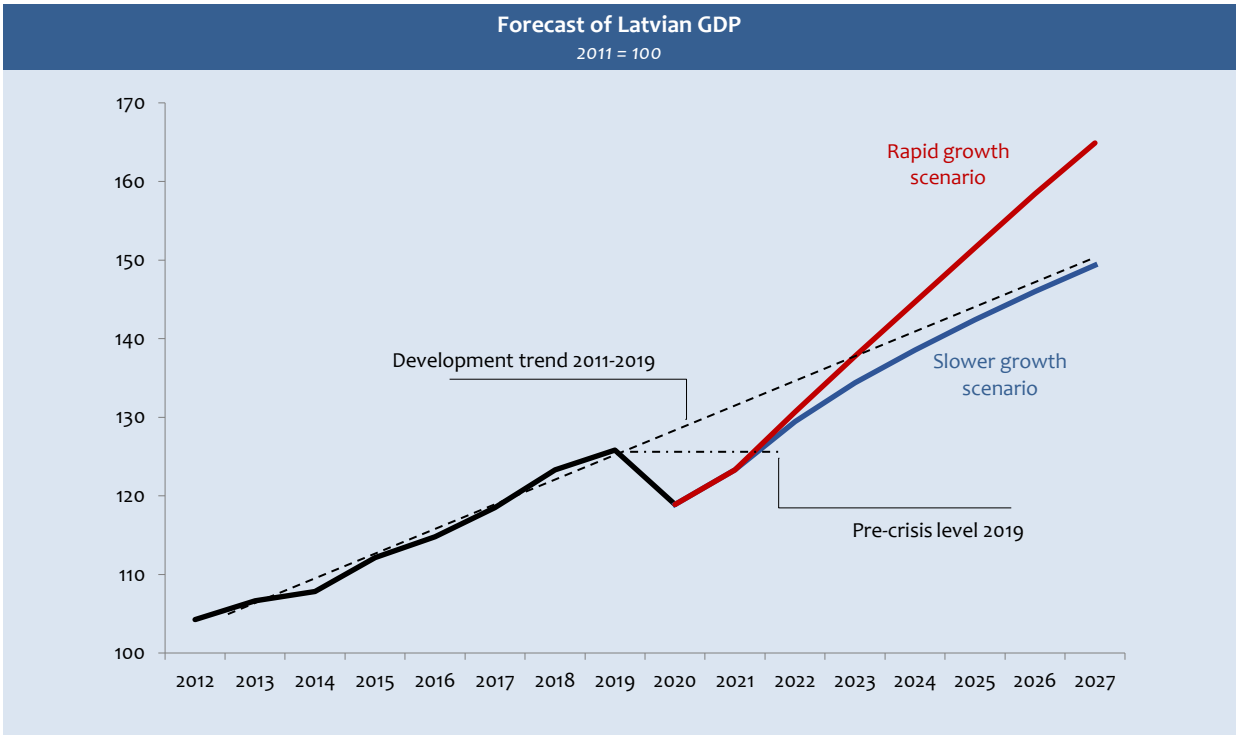
The Covid-19 crisis has contributed to changes that are likely to stay after the pandemic. For example, the increasing use of e-commerce and other digital solutions, remote forms of work, etc., increasingly localised global value chains, etc. Covid-19 and the new industrial revolution changes the configuration of international production. Progress is being made towards shorter value chains and localisation of production. This opens up wider opportunities for Latvia to integrate into international production networks, including higher value-added activities.

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

Scenarios of slower and more rapid or target growth are developed for the medium term until 2027. Basic assumptions of the scenarios are based on different trends of global economic development over the medium term, the efficiency of the structural policy implemented by Latvia and the ability to embrace the opportunities and advantages brought by Covid-19 and the development of technology.

The main growth driver of the Latvian economy is income from exports and the extension of export possibilities, the ability to get integrated in the production chains with higher value-added products and to create more qualitative final products. In the medium term, more rapid development is expected in the sectors, which are able to boost their productivity through overcoming the technological lag, introduction of new digital solutions, modernisation of production and investments, investments in human capital, research and innovation in developing new products and services, and other factors of the supply side.

Figure 5.1



The slower growth scenario is based on the assumption that the process of economic transformation is slow, the transition to a higher value-added economy will be gradual. In the scenario of slower growth, annual export growth rates for 2022-2027 might be around 3.5% per year on average. Private consumption and investments will grow relatively slowly. By contrast, annual average GDP growth rates in 2022-2027 might be 2.8%.

The medium-term scenario of more rapid growth foresees a larger increase in investment volumes, which contributes to the introduction of state-of-the-art technologies, the development of new products and services, and the wider use of digital

solutions and improving the efficiency of processes. Investments in human capital in the development of new skills will play an important role in the medium term, providing productive sectors with the workforce needed for growth. In this scenario, GDP growth rates can reach 5% on average per year in the medium term.

Table 5.1

Forecast of GDP by Expenditure Items
changes, as per cent

	Fact		Forecasts			
	2017	2018	2019	2020	2021	2022-2027 annual average
Gross domestic product	**3.3**	**4.0**	**2.1**	**-5.5**	**3.7**	**2.8 .. 5.0**
Private consumption	3.0	2.6	2.2	-12.7	9.5	2.9 .. 4.8
Public consumption	3.4	1.6	2.6	2.5	2.7	2.5 .. 2.8
Gross fixed capital formation	11.4	11.8	2.1	-2.1	2.3	3.2 .. 6.2
Exports	6.4	4.3	2.1	-6.7	3.8	3.5 .. 6.0
Imports	8.6	6.4	3.0	-7.0	4.2	3.6 .. 6.2

In the more rapid growth 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 so much related to extensive building of material-intensive production volumes, but to the use of newer technological processes, etc. More rapid 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, including private investments, should increase more rapidly.

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

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

Table 5.2

Forecast of GDP by Sectors
changes, as per cent

	Fact		Forecasts			
	2017	2018	2019	2020	2021	2022-2027 annual average
Gross domestic product	**3.3**	**4.0**	**2.1**	**-5.5**	**3.7**	**2.8 .. 5.0**
Agriculture, forestry	1.8	-3.6	12.3	1.9	2.0	2.5 .. 3.5
Manufacturing	6.7	7.6	2.1	-3.4	4.0	3.2 .. 6.0
Other industry	-1.3	-23.7	-2.9	-1.7	1.1	1.8 .. 2.5
Construction	14.6	12.5	2.2	1.1	1.3	3.3 .. 6.0
Trade, accommodation	3.2	4.4	4.7	-10.7	7.6	2.9 .. 4.9
Transport and storage	6.4	4.0	-2.7	-17.5	6.0	2.0 .. 4.0
Other business services	-0.3	3.2	1.1	-6.2	3.5	3.2 .. 5.5
Public services	4.1	4.3	4.0	1.0	1.5	2.4 .. 3.4

6. ECONOMIC STABILITY AND COMPETITIVENESS

6.1. PRICES

CONSUMER PRICES

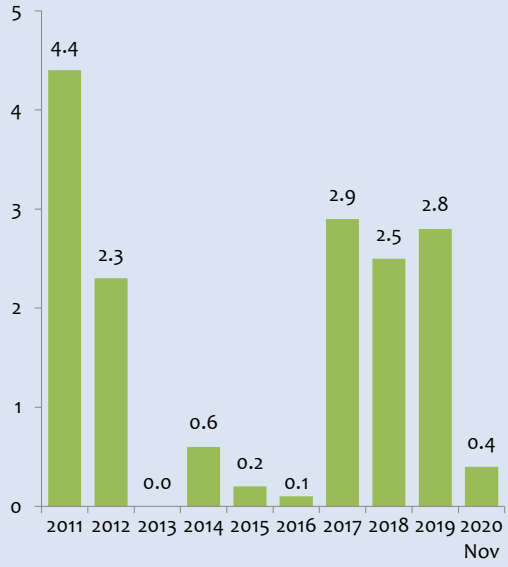
After the deflation caused by the crisis, consumer prices started to grow again in 2011. External factors started to affect the total price level increasingly more seriously. In 2011-2012, the increase in consumer prices in Latvia was determined by the increase in world prices of food and oil. The increase in prices was also underpinned by internal factors such as the increase in administrated 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, food services and outpatient services saw the most rapid increase.

In 2017-2019, a rapid increase in prices was observed. The level of consumer prices was affected by the increase in world prices of food and oil. The increase in prices of services also had a considerable effect on the level of consumer prices.

Figure 6.1

Consumer prices

Annual average changes
as per cent



Changes by Months, *as per cent*

		compared to the previous month	*compared to the respective month of the previous year*	*annual average*
2019	July	-1.0	2.9	3.0
	August	0.2	3.2	3.0
	September	0.1	2.6	3.0
	October	0.4	2.3	2.9
	November	-0.3	2.1	2.8
	December	-0.2	2.3	2.8
2020	January	0.4	2.2	2.7
	February	0.1	2.3	2.7
	March	0.3	1.4	2.6
	April	-0.5	0.0	2.3
	May	-0.4	-0.6	2.0
	June	0.2	-0.7	1.6
	July	0.2	0.5	1.4
	August	-0.5	-0.2	1.2
	September	0.0	-0.3	0.9
	October	0.0	-0.7	0.7
	November	-0.3	-0.7	0.4

A drop in prices was observed in the eleven months of 2020. In November 2020, compared to December 2019, consumer prices decreased by 0.4%. The annual average inflation in November was 0.4 per cent.

The main factors affecting prices in Latvia in 2020:

- the decrease in prices of fuel due to the drop in world oil prices affected the decrease in prices in the eleven months of 2020 the most. Fuel prices in Latvia decreased by 14.4% in January-November reducing the overall level of consumer prices by 0.8 percentage points. In November 2020, world oil prices decreased by 32% compared to December 2019 affected by the rapid drop in oil prices in March, when they reduced by 55% to 22 USD per barrel within a month. The decline continued in April – the price of Brent oil reduced by 21% on average within a month and dropped up to 19 USD per barrel in the second half of the month, while the price of WTI oil, due to the inability to store stocks, reduced to a negative value. The drop in oil prices was influenced by the reduced demand for energy sources due to the Covid-19 pandemic, as well as the crude oil price war between Saudi Arabia and Russia. The situation has changed due to the relaxation of the measures to restrict the spread of Covid-19 and the agreement concluded by the Organization of the Petroleum Exporting Countries (OPEC) and its partners for the reduction of oil extraction, when oil prices in May-August increased again reaching 46 USD per barrel. Although oil prices slightly reduced in September-October mainly due to concerns about demand, as increasingly more countries introduced quarantine measures due to Covid-19, they increased again rapidly in November getting close to 50 USD per barrel due to hopes for a successful Covid-19 vaccine and restoration of the demand for energy sources;
- the drop in prices of heat, gas, electricity and solid fuel has a big lowering effect, which together lowered the total level of consumer prices by 0.7 percentage points. The drop in prices of heat and natural gas was affected by the reduction in world oil prices. Since April the price of heat reduced every month except September and November in total in the eleven months dropping by 12.3%. Prices of heat experienced the most rapid drop in August due to the reduction of the tariff in Riga. Furthermore, natural gas tariffs were reduced on January 1 and July 1 and in the eleven months the prices of natural gas reduced by 16.7% in total. The price of electricity reduced as well – by 2.8% due to the highest output of hydroelectric power plants and the drop in demand due to the Covid-19 crisis;
- the increase in prices of services by 1.2% have the biggest increasing effect increasing the overall level of consumer prices by 0.4 percentage points. The biggest impact came from the increase in prices for outpatient services as dental services became more expensive, patient's contributions to a general practitioner increased from 1 January 2020 and prices of services of medical specialists increased, as well as prices catering services and recreational and cultural services (attendance of cinemas, theatres and concerts, television subscription fees, participation in recreational activities and sporting events) increased. In turn, the sharpest drop was in transport and accommodation services due to the impact of Covid-19 restrictions and motor vehicle insurance;
- the increase in prices of food affected by a more rapid increase in prices at the beginning of the year and the unusual increase in July. Food prices have increased by 1.2% in the eleventh months increasing the total level of consumer prices by 0.3 percentage points. The increase in prices of bread and cereal crops, dried meat, chocolate and other sweets, fresh fruit and coffee had the biggest increasing effect, while potatoes, pork and fresh vegetables had a decreasing effect. Changes in food prices are largely determined by the world price fluctuations. After the rapid drop in world food prices in February-May, which was mainly influenced by the reduction in demand due to the Covid-19 pandemic, they increased in June-November and in November reached the level of December 2014. The most rapid increase was observed for vegetable oils, affected by shrinking global stocks and strict import demand, and cereal prices rising very rapidly in August-October driven by strong global demand, concerns about production opportunities in the southern hemisphere and dry weather conditions, which have adversely affected crops in many parts of Europe, North America and the Black Sea region. Meanwhile, the most rapid drop in prices was observed for meat, with prices declining in all months of the year. Pork prices declined due to the decline in product output in Germany due to the Chinese import restrictions imposed on Germany, prices of beef reduced due to weak demand in the United States, while the drop in prices of poultry was affected by low demand from China and Saudi Arabia;
- the prices of alcoholic beverages and tobacco products increased by 1.9% as a result of the increase in the rate of excise duty, which increased the overall price level by 0.2 percentage points. The increase in prices of cigarettes and alcoholic beverages had the biggest influence in this group.

Overall, in 2020, the average annual inflation could be close to zero. Consumer prices will continue to fall in the coming months due to persistent low demand due to the measures to limit the spread of the virus. When the pandemic gives up, consumer prices will stabilise and in 2021, the average annual inflation will be higher than that observed in 2020. At the same time, it will still be determined by world price fluctuations.

Figure 6.2

Goods and Services with Most Effect on Changes in Consumer Prices
contribution to 11-month changes in November 2020, as percentage points

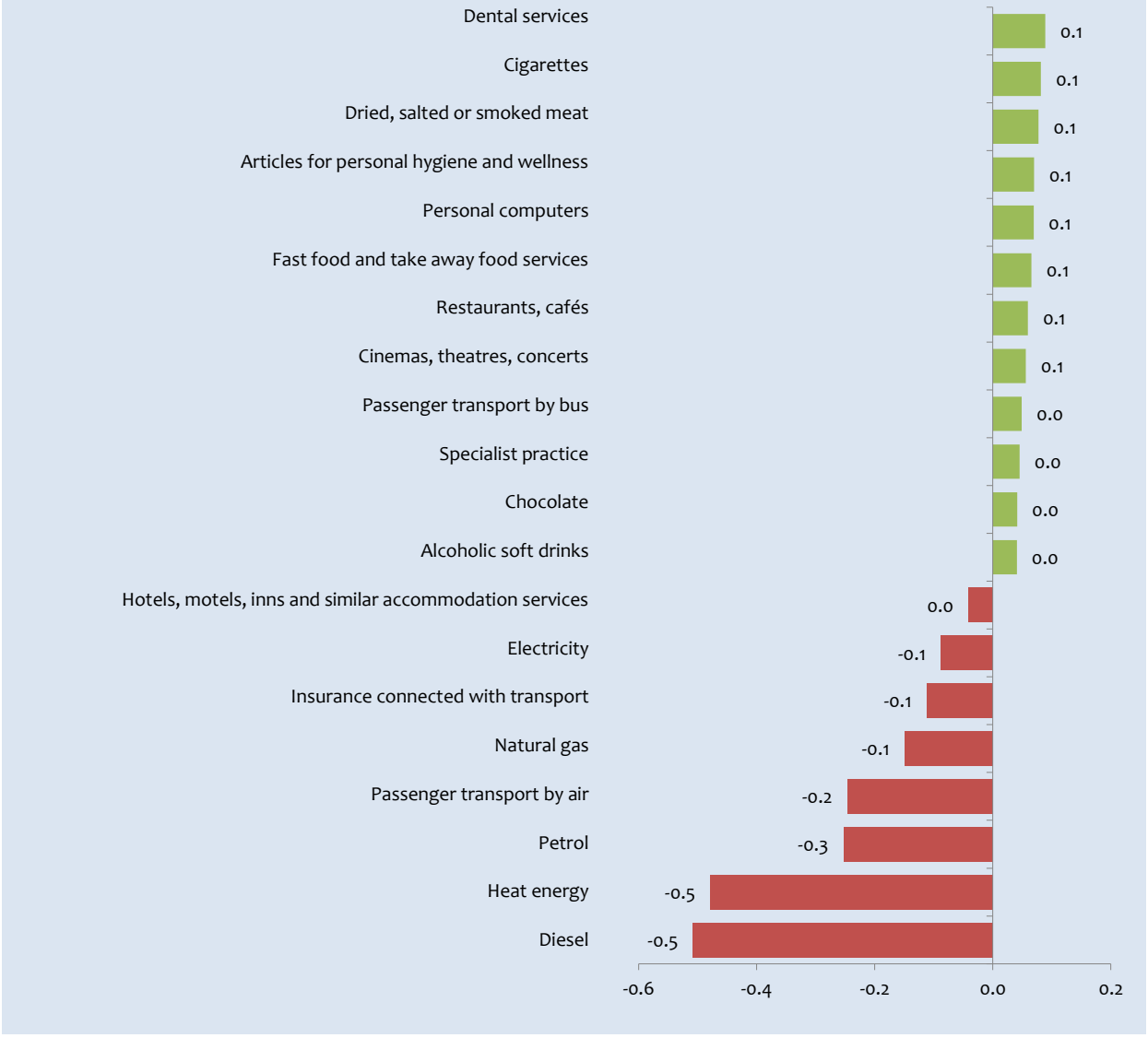


Figure 6.3

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

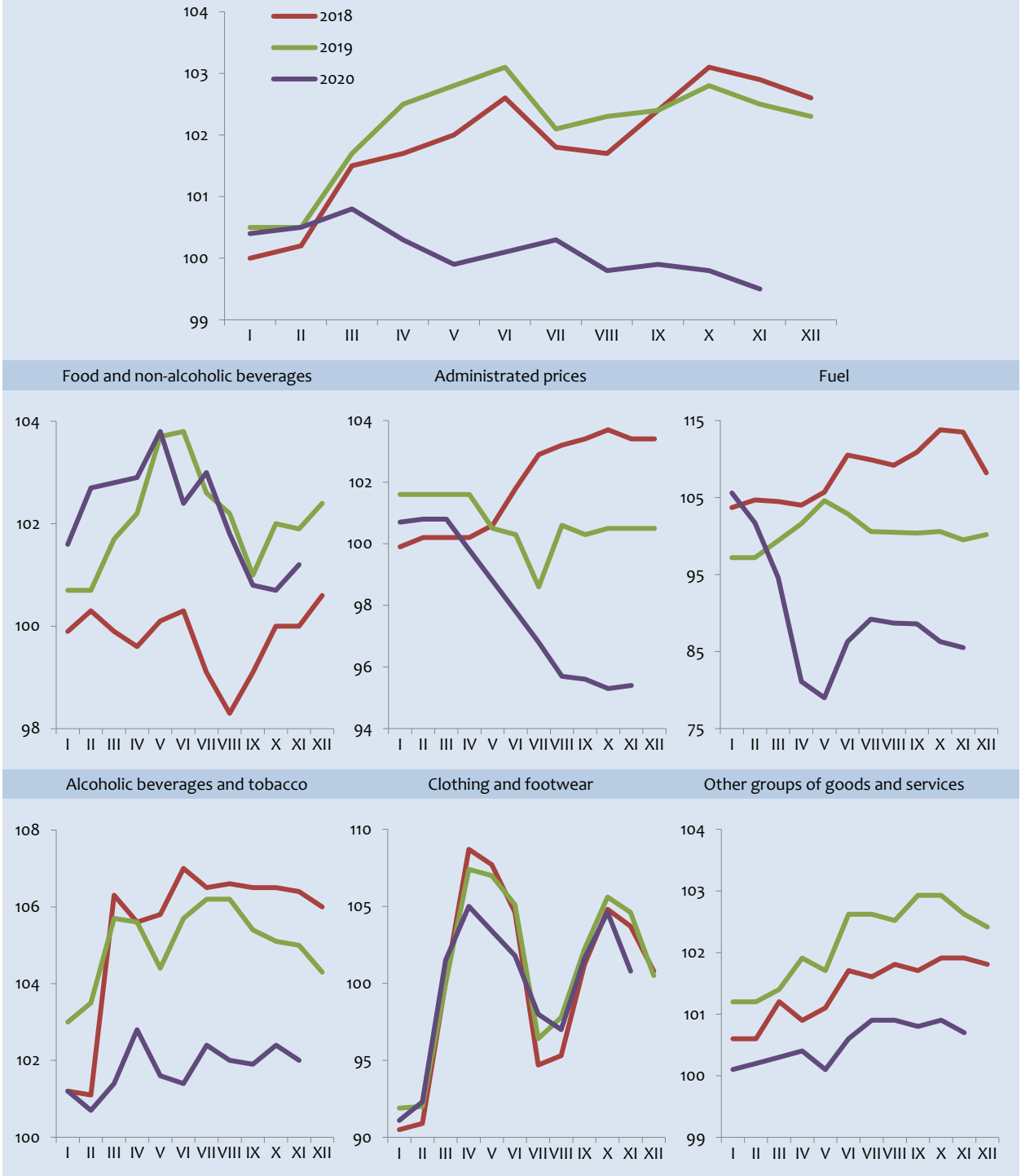
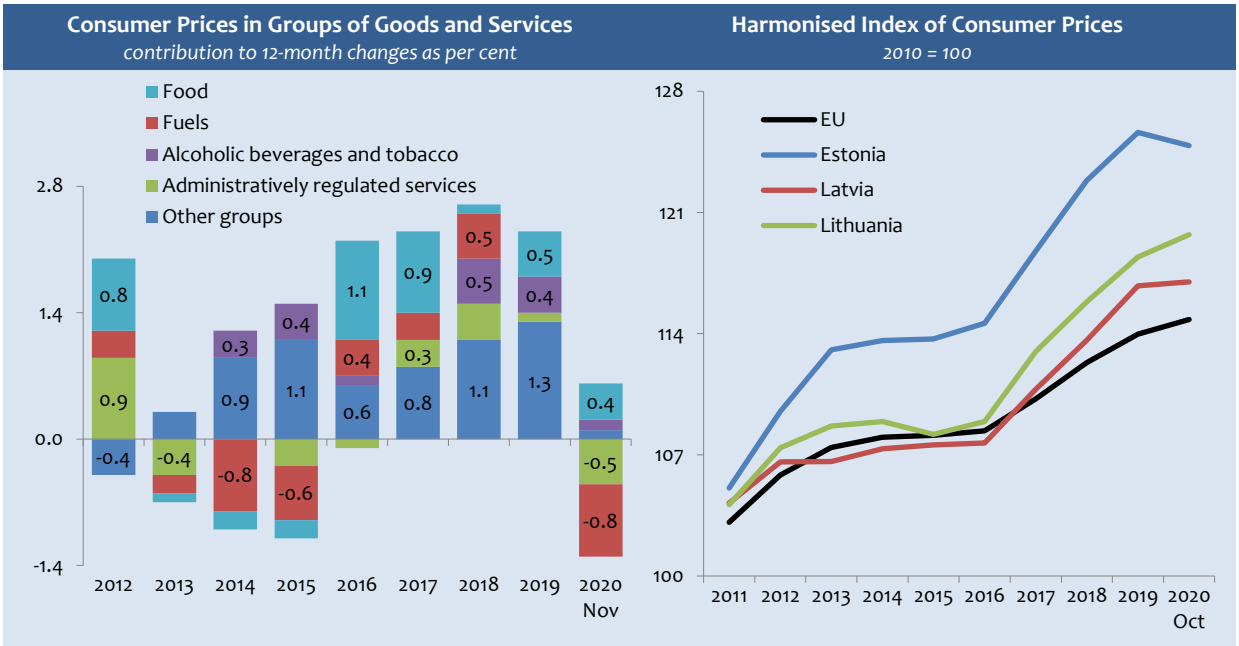


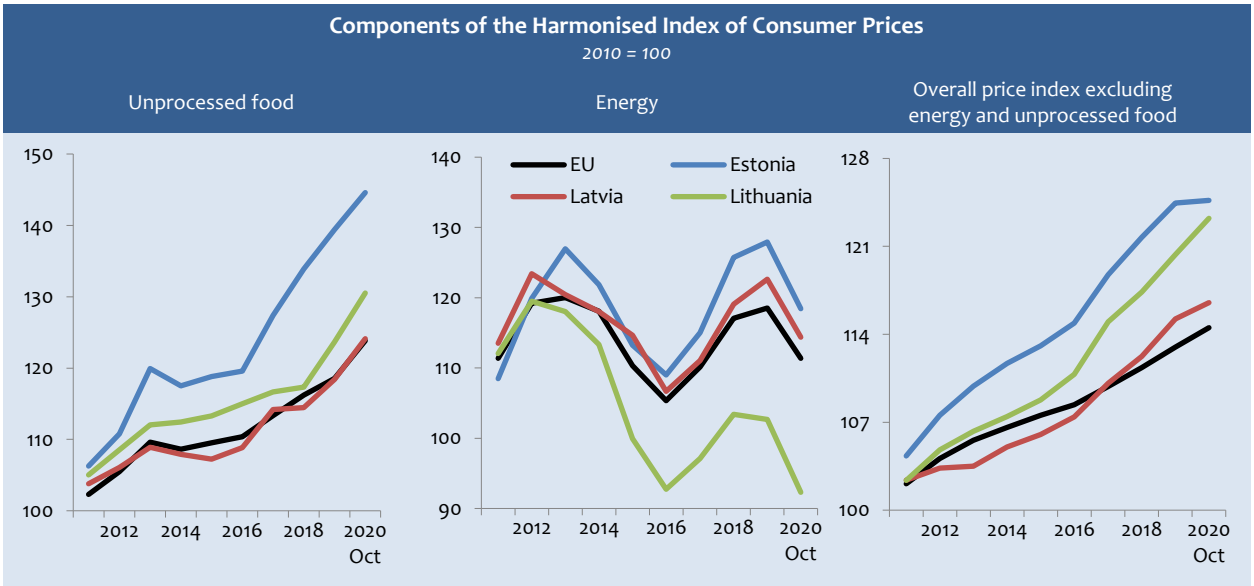
Figure 6.4



After a more rapid increase in 2011-2013, when inflation in the European Union was within 1.5% to 3.1%, in 2014-2016 the increase in prices was very moderate determined by rather weak economic development in the European Union, as well as the drop in world prices of food and oil. The annual average inflation 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 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 average annual inflation was 1.7% in 2017, 1.9% in 2018 and 1.4% in 2019. Prices increased in all the main consumption groups, with the exception of communication. The increase in prices of services had the biggest effect. The increase in energy prices had a big effect in 2017-2018, but it significantly reduced in 2019. However, prices are reducing in 2020 under the influence of Covid-19. In October 2020, annual average inflation in the EU was 0.9%. The increase in prices of services and food, and the drop in prices of energy and non-food products had the biggest effect.

Figure 6.5



If we compare the Baltic countries, in 2017-2018 the harmonised index of consumer prices grew more rapidly in Estonia, but in 2019 – in Latvia. In 2019, prices in Estonia and Lithuania increased in all main consumption groups with the exception of communication, in Lithuania prices reduced also for clothing and footwear, but in Latvia – prices increased in all groups. 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 Latvia and Lithuania.

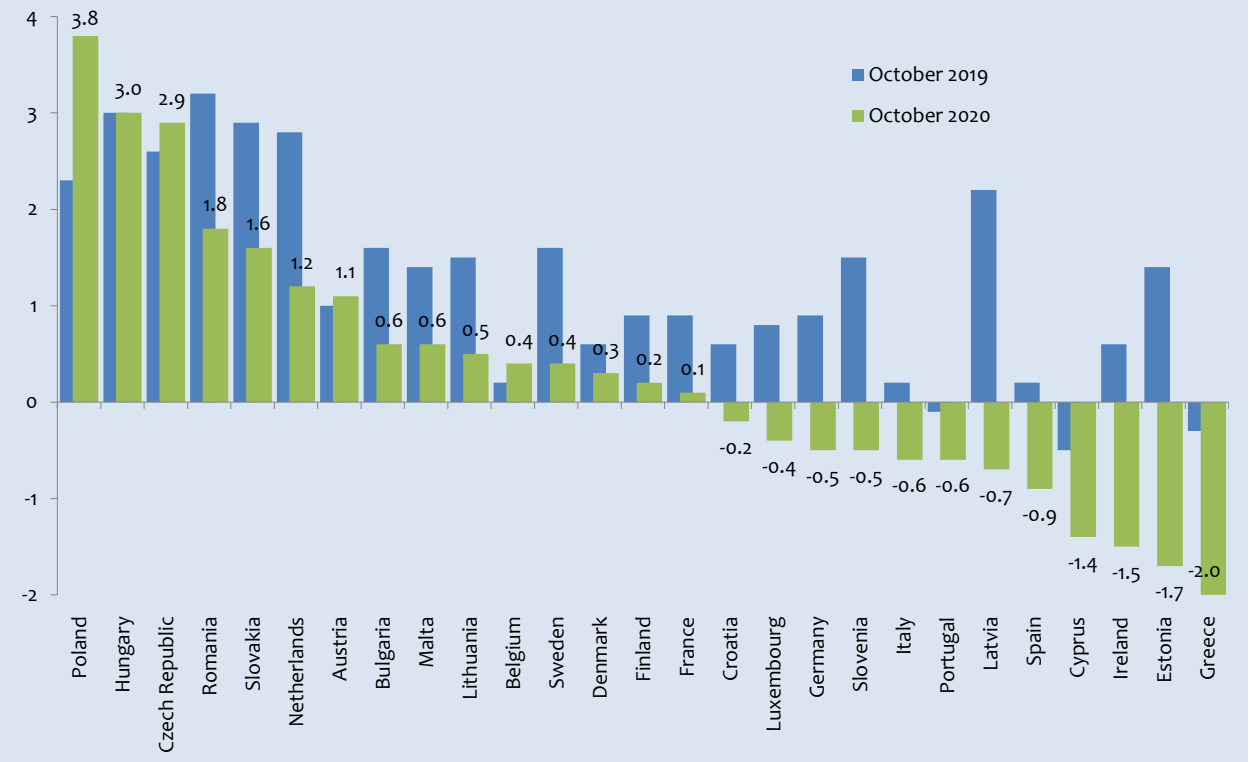
It should be noted that since 2011 Latvia has been having the lowest core inflation among the Baltic countries affected by a slower increase in private consumption than in the other countries and therefore slower increase in prices of services. Prices of alcoholic beverages and tobacco in Latvia also increased slower, because the equalisation of the excise tax with the EU level in Estonia and Lithuania is more rapid. Only in 2018-2019 prices of alcoholic beverages and tobacco in Latvia were growing more rapidly.

In October 2020, annual average inflation was the highest in Lithuania affected by a significant increase in prices of services. In Latvia and Estonia, the increase in prices of services also had a considerable effect, but the drop in prices of energy and the increase in prices of food had the biggest effect. In Estonia, the increase in administratively regulated prices and prices of alcoholic beverages and tobacco also had a big effect.

In October 2020, compared to October 2019, the price level grew by 0.2% in the EU countries, but reduced by 0.3% in the Euro area. Inflation increased most rapidly in Poland, Czech Republic and Belgium, but prices fell more rapidly in Estonia, Latvia, Ireland and Slovenia. The highest inflation in October 2020 was in Poland, Hungary and Czech Republic, but deflation was observed in Greece, Estonia, Ireland and Cyprus.

Figure 6.6

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

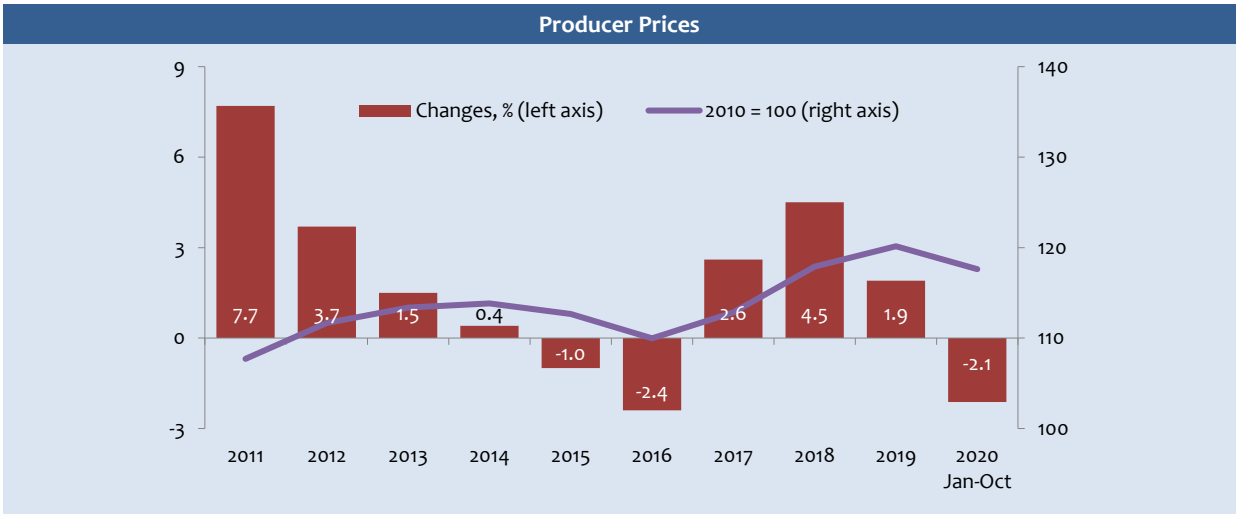


PRODUCER PRICES

After 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. Furthermore, as prices in manufacturing increased, a significant increase in producer prices was observed in 2017-2018.

The rise of producer prices slowed down in 2019. In 2019, the producer prices of products sold on the domestic market increased by 4%, while the producer prices of exported products remained unchanged. Electricity, gas, steam and air conditioning supply had the biggest effect on the increase in producer prices.

Figure 6.7



A drop in producer prices was observed in 2020. In January-October 2020, prices of industrial producers shrank by 2.1% compared to the relevant period of the year before. Prices of production for domestic market reduced by 3.1%, while prices of production for exports – by 1.2%. Producer prices reduced in all industrial sectors. Electricity, gas, steam and air conditioning supply and manufacturing had the biggest effect on the drop 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. A sharp increase of prices was observed in 2017-2018, but it slowed down in 2019. In 2019, prices of production for domestic market increased by 2.1%, while prices of production for exports remained unchanged. Furthermore, in January-October 2020, compared to the previous year, the decline in prices of production for domestic market and for exports in manufacturing was similar – 1.2% and 1 percent, respectively.

Slightly more than 60% of the manufacturing production is exported; therefore the overall producer price dynamics of the industry are largely affected by the fluctuations in producer prices of production for exports. The prices of production for exports, in their turn, are mainly determined by the price dynamics of the Latvian key export goods, including timber, metal products, and food, in global markets. It should be noted that a small drop was observed in world prices of energy sources and raw materials in 2019, but they reduced sharply under the influence of the Covid-19 crisis in the first half of 2020. The price of production for domestic market, in its turn, is affected by the domestic demand and slowdown of growth rates.

In terms of sectors, the most significant rise in producer prices in manufacturing was experienced in manufacture of food products both in 2019 and in the ten months of 2020. It should be noted that in 2019 world food prices also increased rapidly, but in the ten months of 2020 they remained unchanged, when, despite the effects of the Covid-19 pandemic, strong demand persisted. The increase in producer prices in manufacture of food products in 2019 was determined by the increase in both prices of production for domestic market and prices of production for exports, while in 2020 – by the increase in prices of production for exports only.

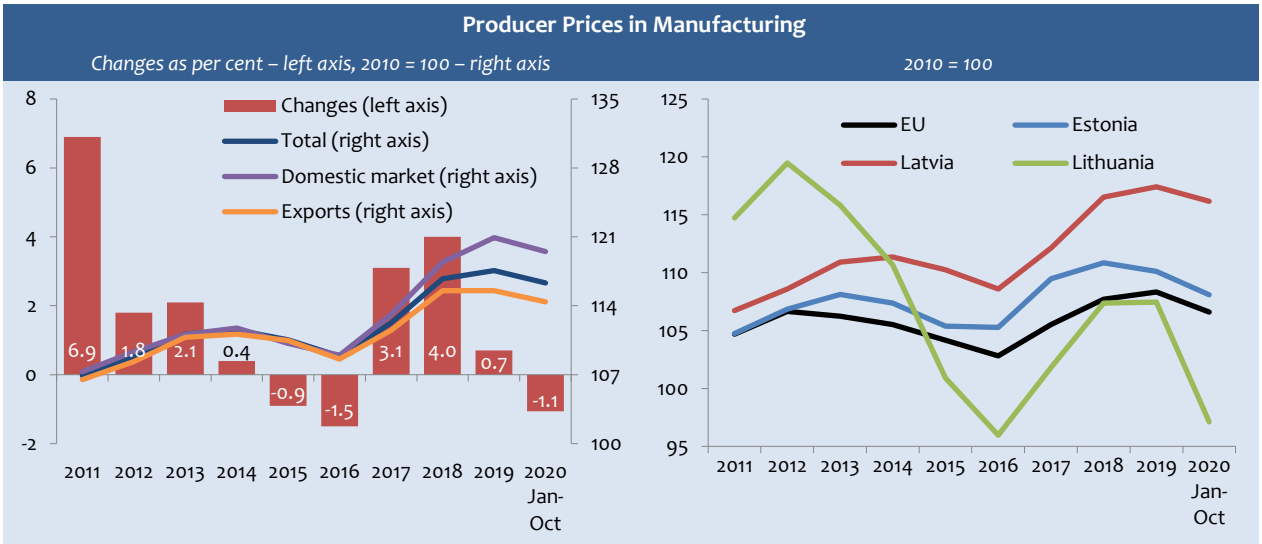
Furthermore, the most meaningful drop in producer prices in manufacturing in 2019 and in January-October 2020, compared to the relevant period of the previous year, was in wood processing, where the drop in prices of production for exports had effect in 2019, and the drop in both prices of production for domestic market and prices of production for exports in 2020. It should be noted that after the increase in the previous years, in 2019 and in the first half of 2020 average purchase prices of logs reduced.

Producer prices in the EU reduced in 2013-2016. They were 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. The rise of producer prices slowed down in 2019 mainly due to the drop in world energy prices and slowdown of global economic growth. Furthermore, producer prices reduced in 2020 under the influence of fluctuations in supply and demand of energy sources and raw materials due to the Covid-19 pandemic. If we compare the EU countries, in January-October 2020, compared to the relevant period of the previous year, producer prices in

manufacturing reduced in all countries, except Hungary, Cyprus, Malta, Romania, Czech Republic and Denmark. The reduction was the most rapid in Greece, Lithuania and Ireland.

If we compare the Baltic countries, in 2020, producer prices in manufacturing reduced in all the three countries. They have shrunk the most rapidly in Lithuania – by 9.6%. A small decline in these prices was observed in Estonia and Latvia – by 1.8% and 1.1 percent, respectively.

Figure 6.8

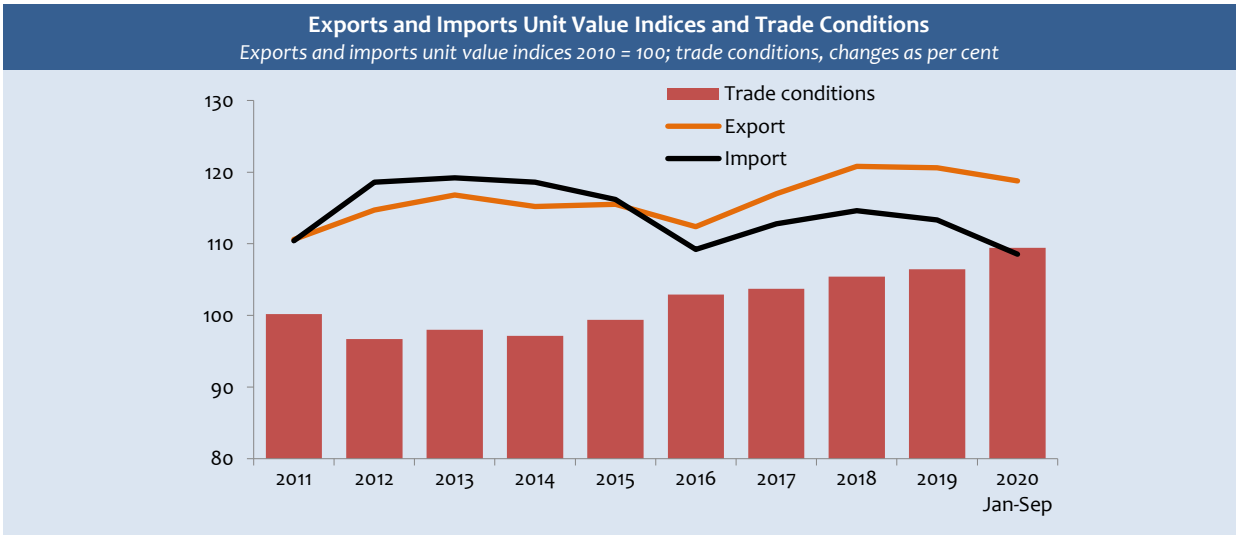


FOREIGN TRADE UNIT VALUE INDICES

In 2012-2014, trade conditions worsened, and the import unit value increased more rapidly than the export 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 drop in the import unit value of coke and refined petroleum products and mining had the biggest effect in 2016, and an increase in the export and import unit value of coke and refined petroleum products in 2017. In 2018, the increase in the export unit value of wood and its products and in the import unit value of coke and refined petroleum products had the biggest effect.

Figure 6.9



In 2019, trade conditions continued to improve and the unit value index for exported goods exceeded the unit value index for imported goods by more than 7 percentage points. In 2019, the export unit value reduced by 0.2%, but the import unit value reduced more rapidly – by 1.1%. The export unit value was mostly affected by the drop in the unit value of wood and

products of wood, while the import unit value – by base metals and coke and refined petroleum products. In January-September 2020, the unit value of exported goods reduced by 1.5% compared to the relevant period of the year before, while the unit value of imported goods – by 4.2%. The unit value index for exported goods exceeded the unit value index for imported goods by more than 11 percentage points. The average export unit value was mostly affected by the decrease in the unit value of wood and products of wood, base metals, coke and refined petroleum products, and forestry and logging products, as well as the increase in the unit value of agricultural and hunting products, food, motor vehicles and clothing.

The drop in the unit value of coke and refined petroleum products, mining, base metals, chemical substances and chemical products had a decreasing effect on the average import unit value, while the increase in value of motor vehicles, other finished products, food and basic pharmaceutical products had an increasing effect.

6.2. BALANCE OF PAYMENTS

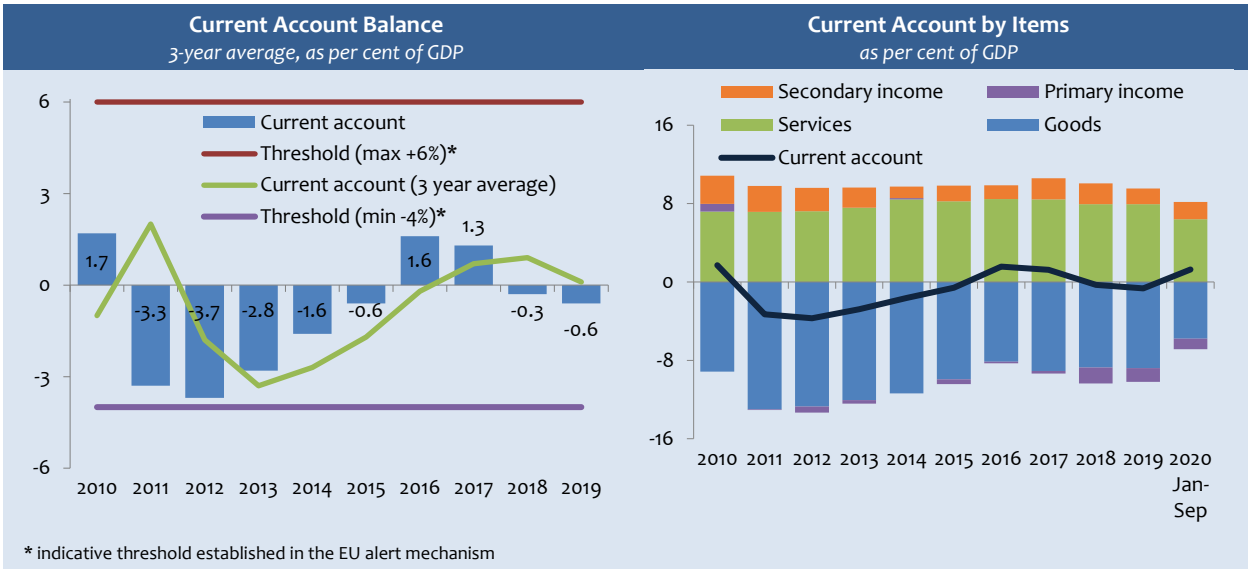
CURRENT ACCOUNT

Latvia as a small open economy is sensitive to external shocks, which have a reflection in the condition of its current account. In recent years, the current account of the balance of payments was close to the level of balance evidencing that the Latvian economy has become considerably more resilient since the global financial crisis. Since 2010, the current account does not exceed the indicative thresholds set in the EU Alert Mechanism and is evaluated as sustainable.

In the period from 2015 to 2019, the average current account balance was positive – 0.3% of GDP. The annual fluctuations of the current account are moderate, yet the general trend was turned downwards – from surplus of 1.6% of GDP in 2016 to deficit of 0.6% of GDP in 2019.

In the nine months of 2020 the current account condition was determined by the shock caused by the Covid-19 pandemic having different impacts on cross-border flows of goods, services and revenues and reflected in the current account surplus of 1.3% of GDP.

Figure 6.10



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 current account is mainly determined by changes in the balance of external trade.

In the last five years (2015-2019) the external trade deficit has been 8.9% of GDP on average. In 2019, compared to 2015, external trade deficit reduced by almost 1 percentage point and reached 8,8% of GDP. This was mainly due to imports growing slower than exports. During this period, exports of goods at current prices increased by 4.3% per year but imports of goods increased on average by 3.4% per year on average.

External weakening of trade flows has been observed in recent years. It was mainly affected by the uncertainty in the external environment and the drop in external demand. The export dynamics of goods in 2019 were more moderate than a year before (increased by 1.3%) reflecting gradual weakening of external demand. The dynamics of exports of goods were positively influenced by exports of agricultural and food products. Exports of electrical appliances and equipment, iron, and steel articles, as well as pharmaceutical products increased considerably. The rates of increase in imports were also slower compared to the previous year (increased by 2%).

The measures to reduce the spread of Covid-19 pandemic had a strong negative impact on trade intensity in 2020. In the nine months of this year the export value of goods was only 0.8% higher than a year ago, but the import value reduced by 6.2% and trade deficit was 5.8% of GDP (9.1% of GDP in the nine months of 2019).

Table 6.1

Balance of Payments of Latvia
as per cent of GDP

	2015	2016	2017	2018	2019	2020 Jan-Sep
Current account	**-0.6**	**1.6**	**1.3**	**-0.3**	**-0.6**	**1.3**
Trade balance	-9.9	-8.1	-9.1	-8.7	-8.8	-5.8
Export	42.5	41.4	43.1	43.1	41.8	44.6
Import	52.4	49.5	52.2	51.8	50.6	50.4
Balance on services	8.2	8.5	8.4	7.9	8.0	6.4
Primary income	-0.5	-0.2	-0.3	-1.6	-1.4	-1.1
Secondary income	1.6	1.4	2.2	2.1	1.6	1.8
Capital account	**2.8**	**1.2**	**1.0**	**1.8**	**1.5**	**1.8**
Financial account	**2.5**	**3.5**	**2.1**	**2.9**	**1.1**	**6.1**
Direct investment	-2.5	-0.3	-1.9	-2.2	-2.9	-1.8
Assets	0.5	0.9	1.8	-0.9	0.2	0.6
Liabilities	3.0	1.2	3.7	1.3	3.1	2.4
Portfolio investment**	11.7	5.3	6.6	-4.1	-1.7	13.5
Assets	9.6	7.1	5.9	-3.6	1.0	12.5
Liabilities	-2.1	1.8	-0.7	0.5	2.7	-1.0
Other investment	-8.0	-2.0	-6.0	9.6	5.9	-7.3
Assets	-10.2	1.9	0.8	-1.1	-0.2	-0.2
Liabilities	-2.3	3.8	6.7	-10.7	-6.1	7.0
Reserve assets	1.3	0.5	3.3	-0.4	-0.3	1.7
Deviation	**0.3**	**0.7**	**-0.2**	**1.4**	**0.2**	**3.0**

* portfolio investment and financial derivatives

The balance on services is positive in Latvia. In 2015-2019, the surplus of the balance on services was 8.2% of GDP on average. In 2019, imports and exports of services at current prices increased almost at equal rates – by 4.8%, slightly slower than a year ago. Although the growth rates of imports of services remained comparatively high, imports in absolute terms amount only to half of exports of services thus ensuring a stable surplus in the balance on services – 8% of GDP. Exports of services in 2019 were largely supported by the increase in transport, information and communication technology and other economic activity services. Trade mediation related import services made a considerable contribution to the increase in imports of services. Imports of ICT and transport services increased considerably, while imports of financial services reduced.

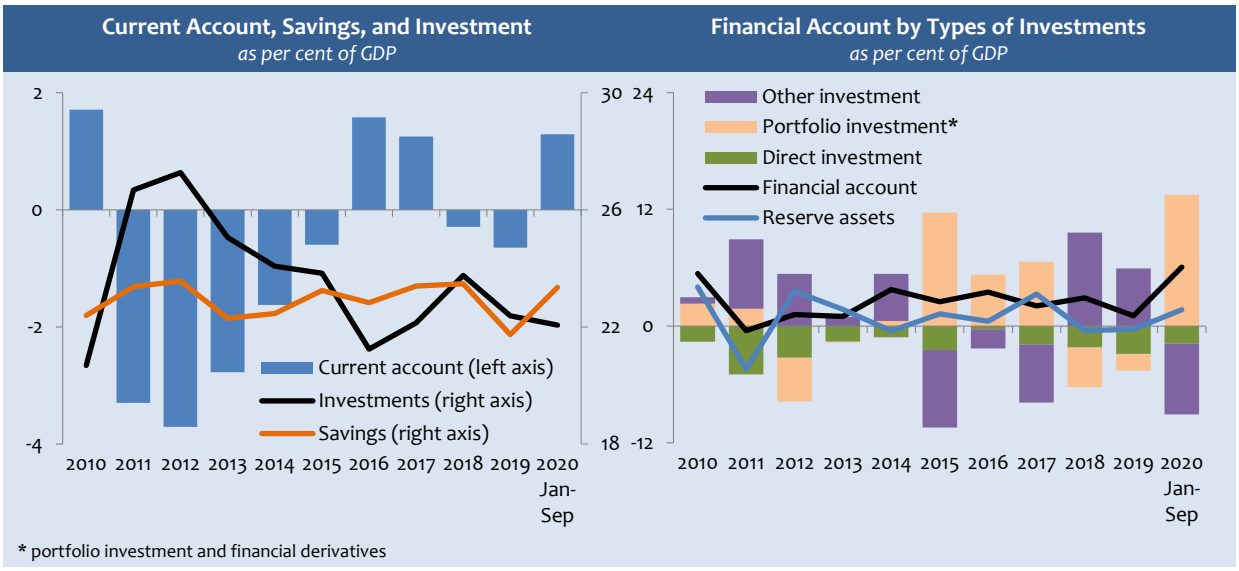
The shock caused by Covid-19 influences cross-border trade of services stronger than trade of goods. In 2020, the dynamics and balance of services reduced significantly. In the nine months of 2020 exports and imports of services at current prices, were smaller than a year ago – by 21.2% and 19.8%, respectively, and the surplus of the balance on services reduced reaching 6.4% of GDP. The reduction in cross-border flows of services was significantly influenced by movement restrictions and cautious attitude of the population to leisure and business trips, which determined the drop in the value of trips and air and road transport services.

The primary income balance in the last five years (2015-2019) has been negative – 0.8% of GDP per year on average with relatively small fluctuations mainly underpinned by changes in non-residents' investment income, as well as inflow of EU

funds. In 2019, the primary income deficit reached 1.4% of GDP, while in the nine months of 2020 it reduced to 1.1% of GDP due to the reduction of foreign investment earnings.

The condition of the secondary income and capital account is significantly affected by flows of EU funds, as well as Latvia's contributions to the EU budget. The secondary income balance in Latvia is positive and in the period from 2015 to 2019 it was at the level of 1.8% of GDP on average. In 2019 and in the nine months of 2020, the secondary income account had a surplus – 1.6% and 1.8% of GDP, respectively. The inflow of EU structural funds dominates in the capital account. Since 2015, the average current account surplus has been 1.6%, including 1.5% of GDP in 2019. In the nine months of 2020, the positive balance of the capital account is slightly higher than a year ago, reaching 1.8% of GDP. Changes in capital account surplus are mainly related to changes in EU funds uptake activities.

Figure 6.11



The condition of the current account balance proves that savings and domestic investments are balanced. Over the last five years (2015-2019) savings have been 22.7% of GDP on average, but investments – 22.9% of GDP. In the nine months of 2020 the current account surplus was determined by an increase in the level of savings and a decrease in investments.

CROSS-BORDER FINANCIAL FLOWS

The status of the financial account balance was 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.

In the period from 2015 to 2019, assets generally increased more than liabilities and the financial account balance (assets less liabilities) was positive – 2.4% of GDP on average. In the nine months of 2020, Latvia's assets abroad increased more than liabilities, and the financial account balance remained positive reaching the level of 6.3% of GDP.

The increase in Latvia's assets abroad was largely determined by portfolio investments of the Bank of Latvia and the credit institutions sector. Meanwhile, the Bank of Latvia had a bigger increase in external debt liabilities.

In recent years, the direct investment balance has been negative evidencing of inflow of foreign direct investments.

The foreign gross debt of Latvia has slightly increased. According to the data of the Latvian international investment balance, the gross external debt constituted almost 125% of GDP at the end of September 2020. Also, the gross external debt of the government reached 10456 million euro (36% of GDP).

The status of the balance of payment accounts in the near future will be determined by the spread of the Covid-19 pandemic and the scope and duration of the restrictions imposed for combatting it.

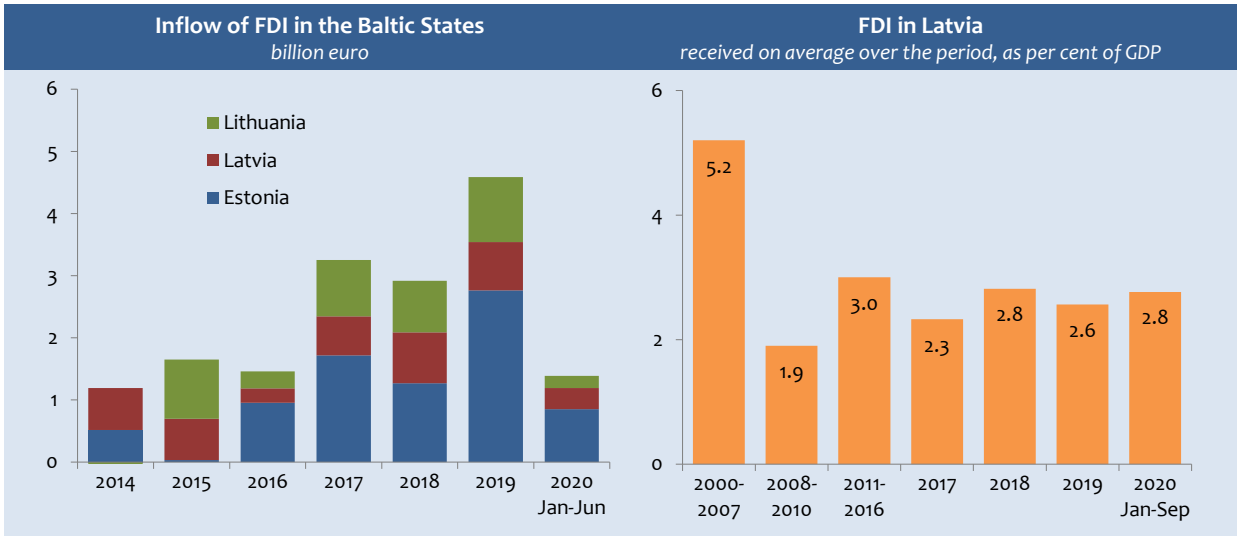
6.3. FOREIGN DIRECT INVESTMENT

Intensity of foreign direct investment (FDI) flows in Latvia, as well as in other Baltic countries is moderate. This is explained by the instability of the global economy and increased geopolitical risks. Covid-19 pandemic restrictions also become a significant obstacle to cross-border flows of investments. The UN World Investment Report[1] published in 2020 estimates that global FDI will decrease by up to 40% in 2020 compared to the level of 2019, and this will bring FDI below 1 trillion US dollars for the first time since 2005. FDI is projected to decrease by a further 5-10% in 2021 and to initiate a recovery in 2022, but the long-term upward trend of FDI cross-border flows is possible only at very positive expectations.

In the last five years the net flows of FDI attracted to the Baltic countries amounted annually to almost 3% of GDP being at a half lower level than in the years of rapid growth (2004-2007). Since 2017, foreign investors' activity has increased, where most of FDI flows were in the Estonian economy.

In the nine months of 2020, the Baltic countries have together attracted net FDI flows of almost 1.4 billion euro, and Latvia attracted 23% of all FDI in the Baltic States, Estonia – 68% and Lithuania – 10%.

Figure 6.12



It should be noted that a long-term negative cycle of cross-border flows of investments is observed all over the world, which is caused by several factors, including growing geopolitical risks and political uncertainty. At the same time, structural changes in FDI models are taking place under the influence of the industrial revolution Structural consequences of digital economy for cross-border flows of investments increase as well.

Even though FDI in the economy of Latvia are growing, quarterly FDI flows are characterised by pronounced volatility.

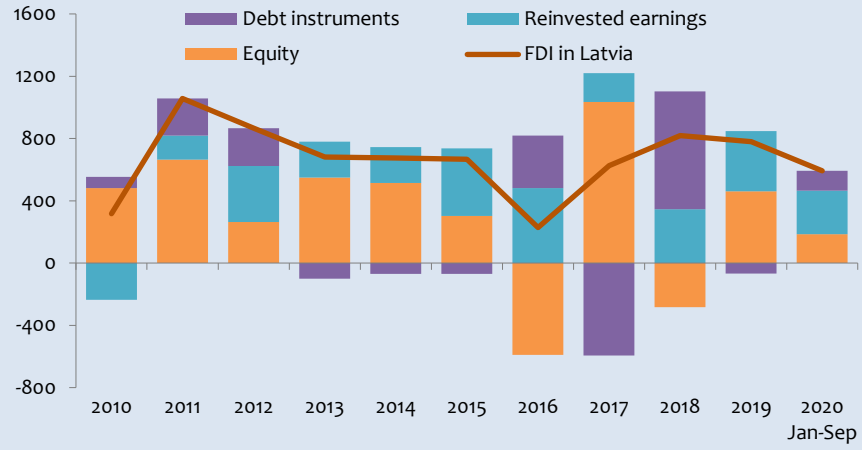
In 2019, Latvia attracted 781 million euro in FDI. FDI flows reduced by 4.8% compared to 2018, reached 2.6% of GDP and were at a slightly lower level than a year ago. Manufacturing, real estate and financial sector had the biggest FDI flows. In terms of countries, the largest flows of investments came to Latvia from Estonia and Germany.

Net FDI flows attracted to Latvia in the nine months of 2020 amounted to 592 million euro, that is, by 58 million euro more than a year before, and reached 2.8% of GDP. The increase in FDI volumes was largely determined by debt instruments as liabilities towards sister companies increased and claims to direct investors reduced. Investments of non-residents into equities of companies registered in Latvia and reinvested profits increased as well, but at a smaller rate than in the relevant period of 2019. Investors from Lithuania, Sweden and United Kingdom were the most significant investors. Extensive investments were made in financial services and manufacturing.

[1] World Investment Report 2020. United Nations Publications, New York 2020 https://unctad.org/system/files/official-document/wir2020_en.pdf

Figure 6.13

FDI in Latvia
net inward flows, million euro



The amount of FDI accrued in the economy of Latvia at the end of September 2020 reached 16.5 billion euro (55% of GDP). It increased by 4% compared to the end of 2019 mainly due to the increase in investments in financial and insurance services, manufacturing, as well as professional, scientific, and technical activities.

Investments of businesses from the EU countries dominate in the geopolitical structure of accrued FDI and they amounted to 76% of the total FDI accrued in the Latvian national economy at the end of this September.

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

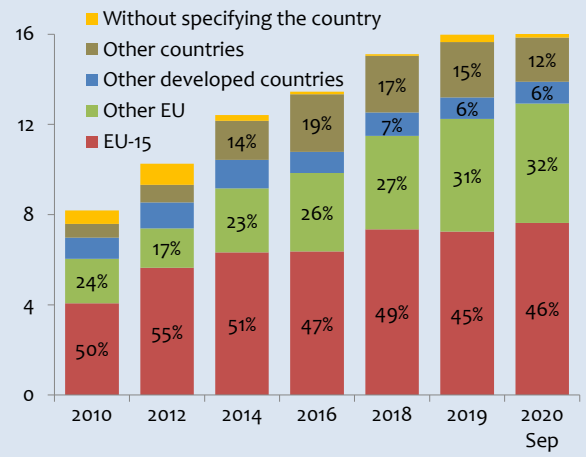
Since 2013, investments of Russian investors in Latvia increased significantly. At the end of September 2020, the accrued direct investment of Russia was 2.5 times higher than in 2013, and Russia was the third major investing country in the economy of Latvia by accrued FDI.

Investments of Lithuanian and Estonian businesses make almost one fifth of accrued FDI in Latvia. It should be noted that activities of Latvian businessmen in the Baltic neighbouring countries are much more moderate.

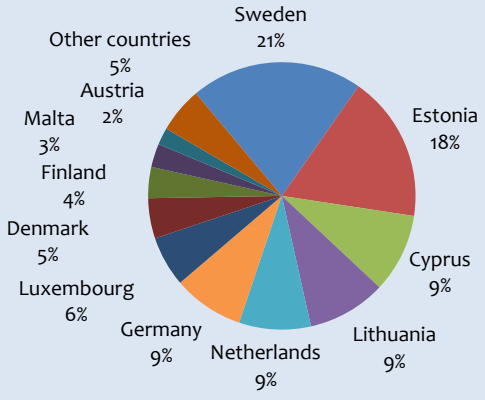
Figure 6.14

Stock of FDI in Latvia

By groups of countries
million euro



FDI of the EU States
as per cent of EU FDI in Latvia



Most of FDI is attracted in service industries. At the end of September 2020, the accrued FDI in the services sector constituted 77% of the accrued FDI in the economy of Latvia. It increased by 25% compared to the end of 2015, including by 4.5 per cent since the end of 2019.

Almost 74% of accrued FDI in service industries are investments in financial intermediation, real estate, and trade activities. Investments of non-residents in transportation and storage and in information and communication services have increased in recent years.

At the end of September 2020, the accrued FDI in manufacturing of goods amounted to 23%. Almost 12% of total accrued FDI were invested in manufacturing and mainly concentrate in traditional sectors. Only one fifth of accrued FDI in manufacturing were invested in high-technology and medium-high technology sectors evidencing of low attractiveness of these activities for foreign capital. Since the end of 2015, the amount of FDI accrued in manufacturing has increased by 26% considerably affected by significant contributions in wood processing, manufacture of electrical equipment, manufacture of vehicles, and manufacture of metal articles.

It should be noted that Latvia still lags behind Lithuania and Estonia in terms of FDI accrued in manufacturing.

Table 6.2

FDI in Latvia by Sectors
position at the end of the period

	million euro			*structure, as per cent*		
	2011	2019	2020 Sep	2011	2019	2020 Sep
Agriculture	263	647	659	2.8	4.1	4.0
Manufacturing	1 113	1 848	1 927	11.9	11.6	11.6
Other industry	386	665	695	4.1	4.2	4.2
Construction	482	565	524	5.2	3.5	3.2
Trade and accommodation	1 329	2 639	2 640	14.3	16.6	15.9
Transportation and storage	400	802	732	4.3	5.0	4.4
Financial intermediation	2 534	3 786	4 055	27.2	23.8	24.5
Real estate activities	1 109	2 653	2 680	11.9	16.7	16.2
Other services	688	1 243	1 406	7.4	7.8	8.5
Unclassified activity	1 019	1 079	1 235	10.9	6.8	7.5
Total	**9 323**	**15 927**	**16 553**	**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 it make an important contribution to the improvement of the investment environment.

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

The implementation of the initiative would ensure a faster actual inflow of private investment into the Latvian economy, thereby improving the volume of attracting foreign direct investment in 2021 and creating additional at least 1000 new high value-added jobs in the coming years.

The proposal provides for the availability of public services, which are related to the implementation of private investments and taking of decisions according to their competence in a priority order and within a time period which is at least half shorter than that specified in the regulatory enactments regulating the relevant field of provision of the service, as well as the delegation to the Cabinet of Ministers to determine the procedures by which such projects are to be directed and the relevant criteria for identification of such projects.

There are also intentions to stipulate administrative procedures (delegated to the Cabinet of Ministers) directly within the framework of the crisis regulation, which can be organised remotely, thereby maximising the speed of implementation of

the investment projects already launched in Latvia, by activating and making full use of all resources available for the economy in the short and medium term.

6.4. MONETARY INDICATORS

The banking sector as a whole is operating with profit, but it has declined significantly, largely due to the negative impact of the Covid-19 pandemic on the economy, including the banking sector. The development of crediting is still evaluated as weak – crediting of business is developing unevenly, while crediting of households has positive signs. Volumes of deposits are growing. The negative impact of Covid-19 on the banking sector was mitigated by state aid measures such as guarantee schemes and the moratorium on fulfilment of liabilities. Uncertainty in the banking sector remains relatively high as well.

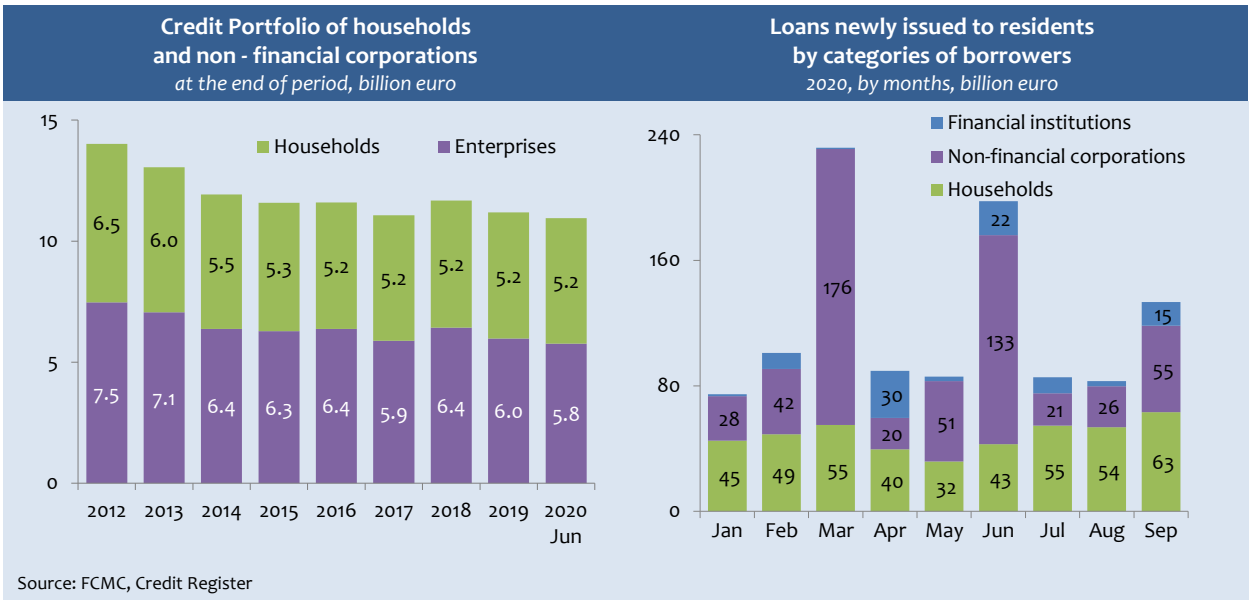
In accordance with the information from FCMC, **bank profitability reduces**, but it is still positive – banks operated with a profit of 40.3 million euro in the first half of 2020, which is by about 70% less than in the corresponding period of the previous year. Banks' profits were largely affected by concerns about the further development of Covid-19, which led to a preventive build-up of savings by banks. In total, 13 banks and 3 branches of EU banks operated in Latvia. The capitalization level of the banking sector remained at a high level. In Q2 2020, the average capital adequacy ratio of the banking sector reached 24.53%. Return on assets (ROA) of the banking sector[1] decreased significantly and amounted to 0.36%. Return on equity (ROE)[2] fell almost threefold during the year and amounted to 3.2% (1.3% in the EU).

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. At the end of September 2020, 4871.3 million euro were in circulation as cash, which is by 10% more in September of the previous year.

The increase in banking sector's assets until the end of 2015 (31.9 billion euro in Q4 2015) was followed by a decrease in assets. Since Q3 2018, there has been an increase in assets, and in Q2 2020, bank's assets amounted to 23.3 billion euro, which was 6% more than a year ago. The share of non-bank credits in total assets shrank and amounted to 56%, while the share of debt securities increased to 15 percent.

Banks are still cautious in the implementation of more active crediting. According to the FCMC data **outstanding amounts of loans to non-banks** decreased by 4.1% at the end of Q2 2020 compared to the corresponding period of the year before.

Figure 6.15



Source: FCMC, Credit Register

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

Dynamics of the total household loan portfolio are positive. Most of the loans granted to households are loans for acquisition of a home, reconstruction and repair.

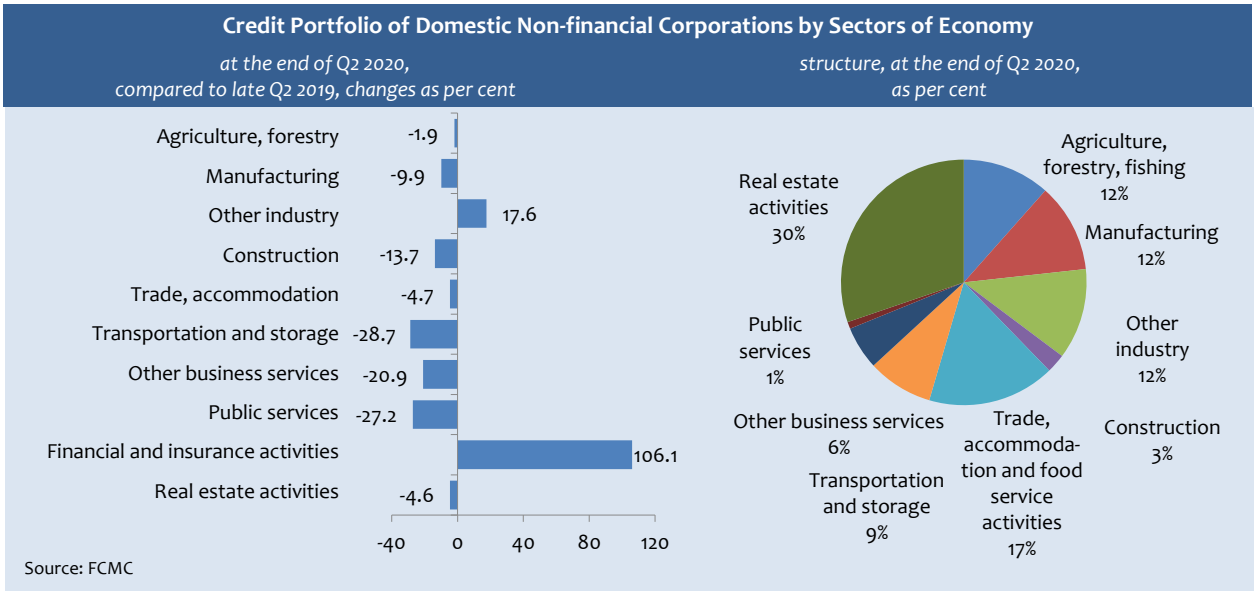
Business crediting is still developing unevenly, and the dynamics of the total business credit portfolio are still negative. In accordance with FCMC data the volume of credits issued to non-financial corporations shrank by 7% in Q2 2020 compared to the corresponding period of the previous year. There are also enterprises, which do not qualify for credits, because they are operating in the shadow economy. Sectors like real estate activities and trade, accommodation and food service activities are credited the most among sectors of the national economy. However, the decline in the volume of issued credits is observed in most of sectors.

New crediting is developing moderately. Positive trends are observed in household crediting, and since April 2020, the amount of newly issued credits for the purchase of consumer goods has grown rapidly. This could be related to the beginning of the Covid-19 crisis, when part of the population lost their income due to downtime in several sectors. The volume of newly issued credits for acquisition of housing has also slightly increased. Similarly as before, housing crediting is still hindered by insufficient household income for the first instalment. Given the uncertainty of the current economic situation, the population is generally cautious about creating new credit liabilities and tries make savings rather than take new financial liabilities.

The development of business crediting is uneven. According to the data of the Credit Register, newly issued loans amounting to 55 million euro were newly issued in September 2020. Most new loans were issued in trade and financial and insurance activities.

Figure 6.16

Credit Portfolio of Domestic Non-financial Corporations by Sectors of Economy



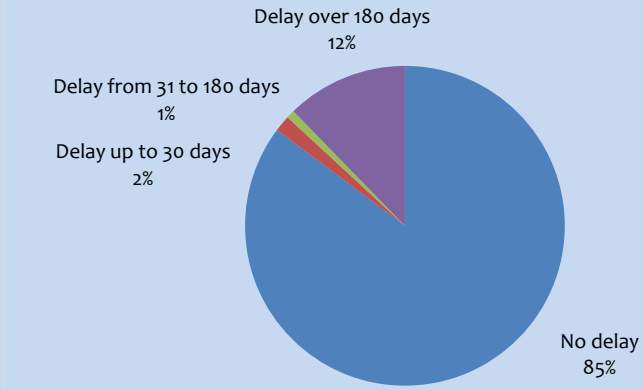
Source: FCMC

In 2009, the quality of the credit portfolio worsened considerably, and in Q2 2010 the highest indicators in loans with overdue payments was reached – almost 1/3 of loans had overdue payments. 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 accordance with the Credit Register statistics (data as at 09.2020) the amount of liabilities with overdue payments in the total credit portfolio of banks was 15%. Given the continued uncertainty surrounding the Covid-19 pandemic, the quality of the credit portfolio is expected to worsen.

Overall, in Q2 2020, half of the loans to non-bank customers subject to review measures were non-performing loans, and their share is declining (to compare, 77% in Q2 2019). According to the FCMC information, at the end of Q2 2020, the moratorium (credit holidays) was applied to 11,554 loans for the total amount of 1,168 million euro, which was 8.9% of the total credit portfolio. This protected some borrowers from insolvency. The largest share of concessional loans is in the arts and leisure sector and accommodation and food service activities. However, it should be noted that the moratorium does not discharge of assumed liabilities and interest payments. With the end of support, the risks associated with the credit burden could increase.

Figure 6.17

Structure of Overdue Payment Days
by liability balance share, at the end of the period, billion euro

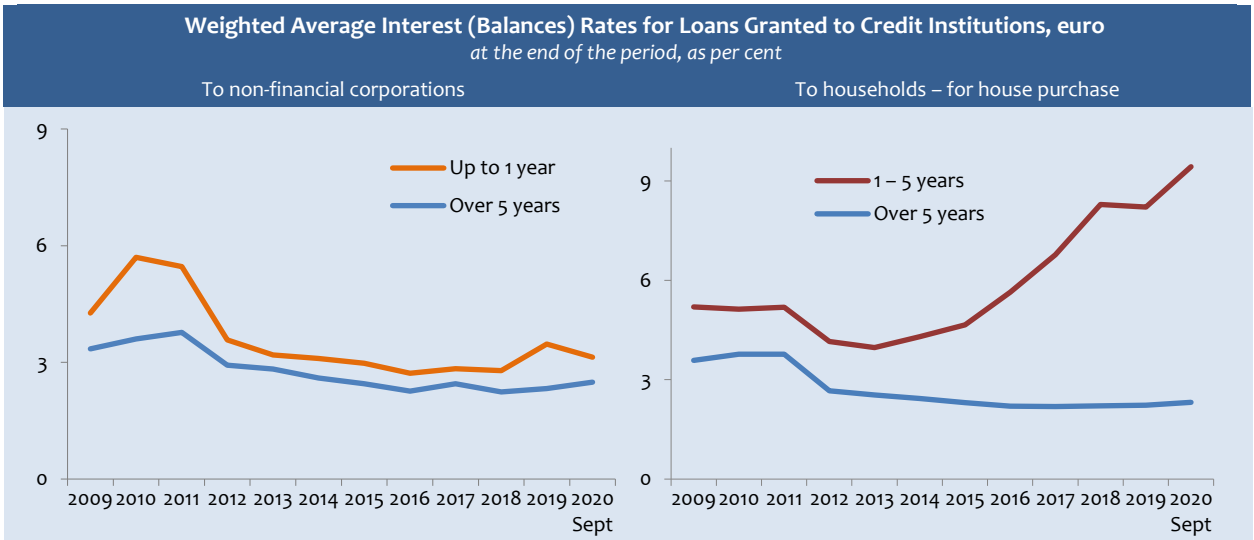


Source: Credit Register statistics, data as as September 2020

Long-term **interest rates** (on outstanding amounts) for credits granted to non-financial companies are almost unchanged and amount to 2.5% in September 2020. Short-term interest rates (up to 1 year) for non-financial corporations slightly reduced and in September amounted to 3.1%. Long-term interest rates (on outstanding amounts) for credits granted to households for house purchase have been slightly decreasing since 2012, however, a small increase has been observed since 2017 and the interest rate increased to 2.32% in September 2020. Short-term interest rates (1-5 years) on loans to households for house purchase continue to grow and reached 9.43% in September, the highest indicator in the last 10 years.

Figure 6.18

Weighted Average Interest (Balances) Rates for Loans Granted to Credit Institutions, euro
at the end of the period, as per cent



Source: Bank of Latvia

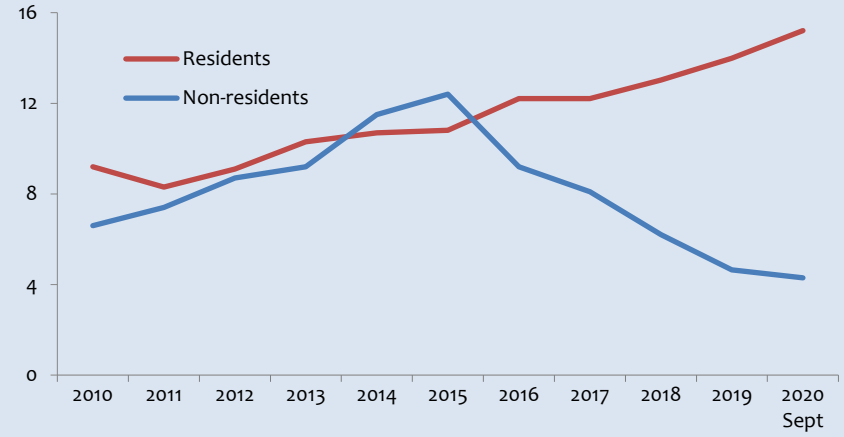
From 2010 to the end of 2015, **volumes of deposits** increased considerably. The credit portfolio of banks have been shrinking since early 2016. Volumes of deposits still continued to decline in Q1 2020, but in Q2 2020, deposits amounted to 19.5 billion euro, which was by 6% more than in the corresponding period a year before. Changes in the structure and in the dynamics of deposits were caused by the rapid drop in volumes of deposits of non-residents. The share of deposits of foreign customers (customers from other EU countries and other counties) had shrank from 53% in Q2 2015 to 22% in Q2 2020. The total volume of deposits of non-residents in Q2 2020 amounted to 4.2 billion euro, which is by almost 19% 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.

Volumes of non-resident deposits retain a positive increase, and in Q2 2020 they were 15.2 billion euro, which is by 16% higher than in the corresponding period of the year before.

Figure 6.19

Non-Bank Deposits at Banks
billion euro



Source: FCMC

6.5. FISCAL POLICY AND PUBLIC DEBT

The fiscal policy of Latvia is focused on ensuring sustainable economic growth and implementation of a responsible fiscal policy in line with the conditions of the fiscal discipline.

Since 2011, Latvia has returned to growth, and significant improvements have been achieved in the fiscal position (see Table 6.3 and Figure 6.20). General government budget deficit according to the European system of accounts reduced from 9.6% of GDP in 2009 to 1.4% of GDP in 2015. In 2016, the budget had a surplus of 0.2% of GDP for the first time since 1998, but in 2017-2018 the budget had a small deficit of 0.8% of GDP. In 2019, the general government budget deficit amounted to 0.5% of GDP.

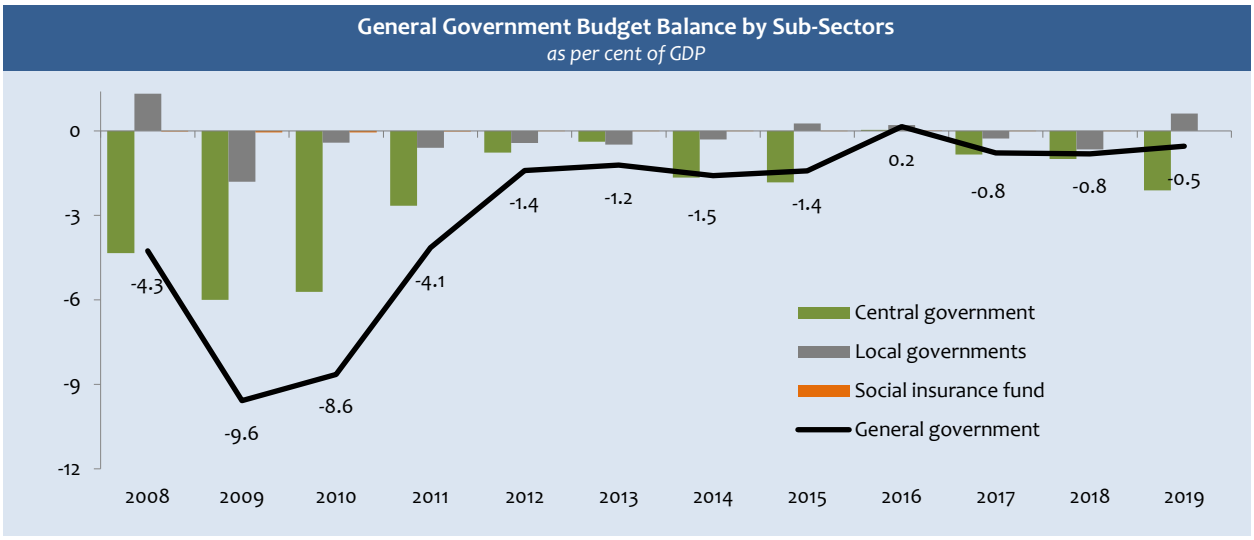
Table 6.3

General Government Budget

	billion euro					*as per cent as of GDP*				
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Revenue	9.1	9.5	10.2	11.2	11.5	37.2	37.5	37.9	38.5	37.9
Expenditure	9.5	9.5	10.4	11.5	11.7	38.7	37.4	38.7	39.4	37.9
Balance	-0.35	0.04	-0.02	-0.24	-0.17	-1.4	0.2	-0.8	-0.8	-0.5

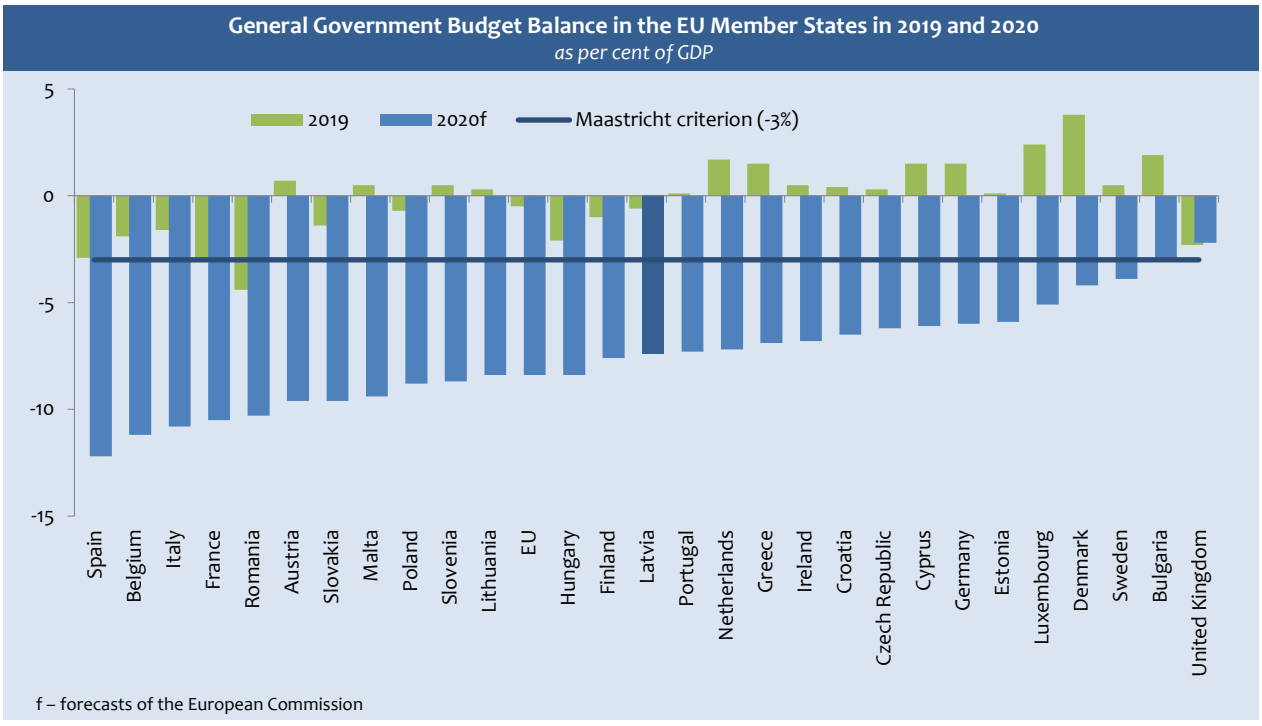
In 2019, the central government budget had a deficit, while the Social Insurance Fund budget was balanced. There was a surplus in the local governments budget (see Figure 6.20).

Figure 6.20



As it is seen on Figure 6.21, in 2019, the Latvian budget balance to GDP showed an average performance among all the EU countries. Overall, in recent years, until the Covid-19 pandemic budgets of EU countries tended to improve. The average level of budget deficit of the EU in 2019 was 0.5% of GDP (in 2018 – 0.4% of GDP, in 2017 – 0.8% of GDP). 17 EU countries had a surplus in the state budget in 2019. Budget deficit of only two countries (Romania and France) was equal to or exceeded the Maastricht criterion, which is 3% of GDP.

Figure 6.21



The Covid-19 pandemic has had a significant impact on EU countries' fiscal policies at least in 2020 and 2021. The general escape clause of the EU Stability and Growth Pact has been activated to overcome the effects of the Covid-19 pandemic crisis allowing EU Member States to increase the general government deficit of 2020 as needed to mitigate the economic damage caused by the Covid-19 pandemic. The EU State aid rules also allow financial support to businesses.

In accordance with the EC's forecasts in autumn 2020, the average level of budget deficit in the EU is expected to be 8.4% of GDP, while in 2021 – 6.1%. The highest budget deficit in 2020, which may exceed 10% of GDP, is expected in Romania, Belgium, Spain, France and Italy.

The Saeima approved the budget for 2020 with a deficit of 0.3% of GDP. However, in 2020, under the influence of the Covid-19 pandemic the budget deficit has increased considerably – according to the estimates of the Ministry of Finance to about 8% of GDP.

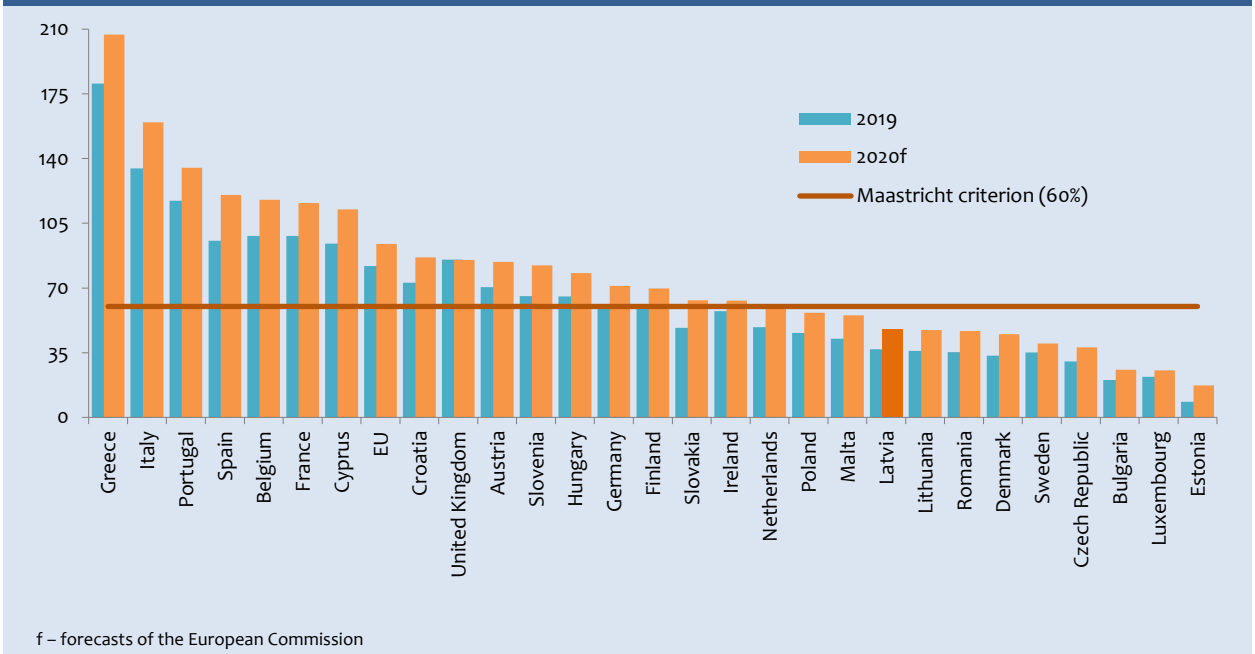
The budget for 2021 was adopted with a deficit of 3.9% of GDP. The Ministry of Finance has made an assessment – if the negative macroeconomic development scenario is implemented, in 2021 the budget deficit might reach 6% of GDP.

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

The average level of public debt in the EU in 2019 was 77.6% of GDP (in 2018 – 79.5% of GDP, in 2017 – 81.5% of GDP). In 11 EU member states, the public debt in 2019 exceeded the Maastricht criterion, which is 60% of GDP. The highest public debt to GDP in 2019 was detected in Greece, Italy, Portugal, where it exceeded 100% of GDP. The smallest general government debt to GDP was registered in Estonia, Bulgaria and Luxembourg. As indicated by the EC forecasts for autumn 2020, the average level of public debt in the EU will increase to 93.9% of GDP in 2020 and to 94.6 percent in 2021, due to the effects of the Covid-19 pandemic.

Figure 6.22

General Government Debt in the EU Member States in 2019 and 2020
as per cent of GDP



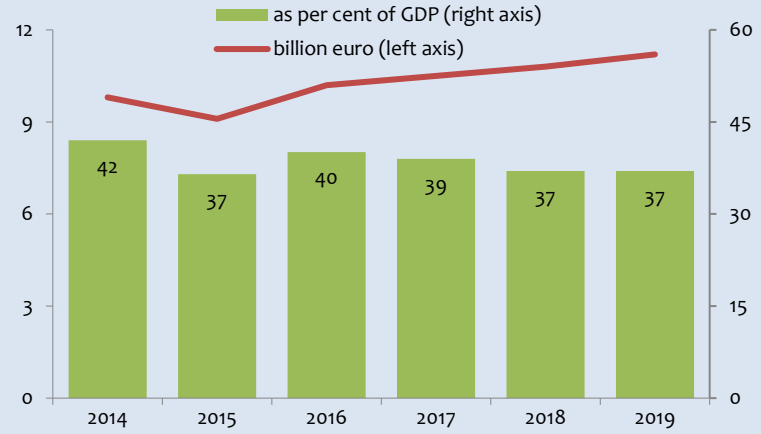
f – forecasts of the European Commission

Until 2007, public debt has been growing in Latvia moderately. In order to provide funding for performance of financial liabilities, the general government debt started to grow rapidly starting from 2008, and it reached 8.5 billion euro or 47.3% of GDP at the end of 2010. Since the end of 2011, the general government debt has had a tendency to decrease. It was 11.2 billion euro or 36.9% of GDP in 2019 (see Figure 6.23). At the end of Q2 2020, government debt amounted to 12.9 billion euro. In 2020, due to the Covid-19 pandemic, public debt is projected to be close to 50% of GDP.

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 6.23

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



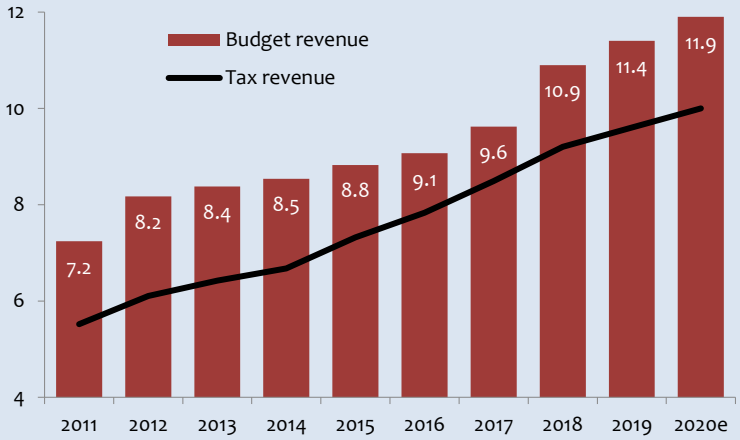
6.6. BUDGET REVENUE AND EXPENDITURE

BUDGET REVENUE[1]

Since 2011, as the economic situation has improved, the budget revenues have increased. From 2010 to 2019, **consolidated general budget revenue** increased 1.7 times. In 2019, budget revenues amounted to 11.4 billion euro (i.e., by 4.9% more than a year ago). Furthermore, in January-October 2020, budget revenue slightly lags behind the respective period of 2019 – a reduction by 1.2% (or 9.3 billion euro) in the ten months has been observed. The decline can primarily be attributed to the declared emergency situation in the country as a result of the Covid-19 crisis.

Figure 6.24

General Government Consolidated Budget Revenues
billion euro



e – evaluation by the Ministry of Economics

Approximately 3/4 of all budget revenues consist of tax revenues. 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 focussed on the growth of national economy and increase in welfare of the population, incl. reduction in income inequality. At the same time, the reform aims to ensure 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

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

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.

In 2011-2019 (as the most rapid increases in tax collection have been observed), tax revenue has been growing stably. In 2020, tax revenue has declined in almost all tax categories.

In recent years, **employment taxes** account for approximately a half of all tax revenues. In 2020, revenue from employment taxes due to the Covid-19 crisis has declined.

In 2012-2019, personal income tax revenue has increased, primarily affected by the improvement of the situation in the labour market. However, in 2020, personal income tax revenue has been declining – in January-October 2020, the revenue has decreased by 2.7%, predominantly affected by the related Covid-19 restrictions.

Table 6.4

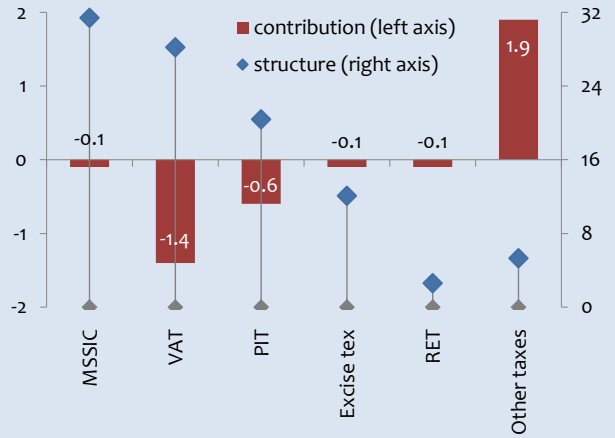
Budget Revenue
as per cent of GDP

	2015	2016	2017	2018	2019	2020 Jan-Sep
General government consolidated budget revenues	**35.9**	**35.8**	**35.7**	**37.3**	**31.0**	**38.6**
I Tax revenues	**29.8**	**30.9**	**31.5**	**31.5**	**31.7**	**28.3**
1. Indirect taxes	11.2	11.5	11.6	12.1	12.3	12.2
– value-added tax	7.8	8.0	8.1	8.4	8.7	8.4
– excise tax	3.2	3.4	3.4	3.5	3.5	3.6
– customs duty	0.2	0.2	0.2	0.2	0.2	0.2
2. Income taxes and property taxes	8.2	8.5	8.7	7.7	7.2	7.5
– corporate income tax	1.6	1.7	1.6	1.0	0.1	0.7
– personal income tax	5.9	6.0	6.3	5.9	6.3	6.0
– real estate tax	0.8	0.9	0.8	0.8	0.7	0.8
3. Social insurance contributions	8.3	8.3	8.4	8.7	9.2	9.3
4. Other taxes	2.1	2.5	2.8	2.9	2.9	-0.7
II Other revenues	**6.1**	**4.9**	**4.2**	**5.8**	**5.8**	**10.3**

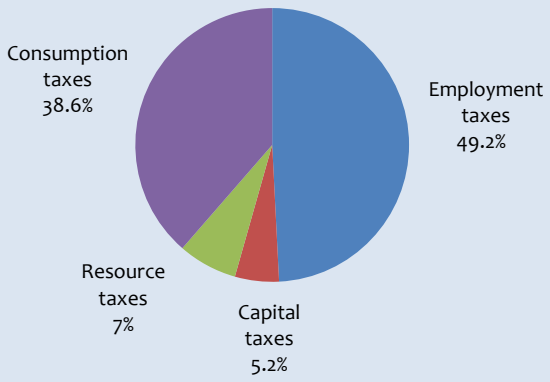
In recent years, similar growth dynamics have also been observed with regards to mandatory state social insurance contributions. In January-October 2020, mandatory state social insurance contributions declined by 0.2%.

Figure 6.25

Tax Revenues in January-October 2020
structure as per cent; contribution to changes, compared to January-October 2019, as percentage points



General Government Consolidated Budget Tax Revenues by Tax Groups
January-October 2020, structure as per cent



Consumption tax revenue constitute slightly more than a third of all tax revenue. In recent years, consumer tax revenue has increased due to the rise in private consumption and, consequently, the increase in retail turnover. In 2020, consumer tax revenue has been declining – in January-October 2020, compared to the corresponding period last year, the revenue has decreased by almost 3%.

Within the scope of the tax reform as of 1 January 2019 the excise tax for alcoholic beverages and tobacco products has been raised with a timetable for gradual increase of its rates until 2020. Changes in VAT and excise tax areas have been made since the beginning of 2020.

In 2010-2019, value added tax revenue increased. However, in January-October 2020, the value added tax revenue, primarily due to the Covid-19 crisis, has declined by 4.7%.

Since 2011, revenue from the consumption part of the excise tax has increased. In contrast to other taxes, the consumer portion of excise duty revenue continued to increase – in January-October 2020, it rose by 8.1%.

Capital tax revenues increased until 2017. The increase in the post-crisis period was largely affected by the low base effect, because corporate income tax revenues declined 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 entailed a comparatively smaller effect, as the share of this tax is relatively low. Since 2018, the capital tax revenues have decreased. The reduction in 2018 and 2019 was underpinned by the changes made within the tax reform in the field of corporate income tax. However, in 2020, the capital tax revenue has been increasing– in particular, in January-October 2020, it has increased by almost 64%.

Within the scope of the tax reform, from 1 January 2018 a new corporate income tax payment procedure was introduced, envisaging that the corporate income tax rate at 20% should be paid only from that part of profit, which is distributed or paid in dividends, or used for the purposes, which are not directly related to business development; additionally, corporate income tax no longer applies to reinvested profit. Corporate income tax revenue declined as a result of the reform in 2018 and 2019. However, in 2020, corporate income tax revenue has been growing rapidly– - in January-September 2020, the amount of income has increased almost sevenfold ,compared to the corresponding period last year.

In January-October 2020, real estate revenue declined by 3.1%.

Resource taxes constitute the smallest group of taxes, composing merely 6-7% of all tax revenues in recent years. In 2020, the resource tax revenue has been declining – in January-October 2002, it decreased by 2.5%.

Since 2011, natural resources tax revenue has been growing. The natural resource tax revenue continued to increase also in 2020 – in January-October 2020, it rose by 11.6%.

In 2011 to 2019, revenue from excise tax on oil products and natural gas was increasing. In January October 2020, revenue from the excise duty on oil products and natural gas has declined by 3.4%.

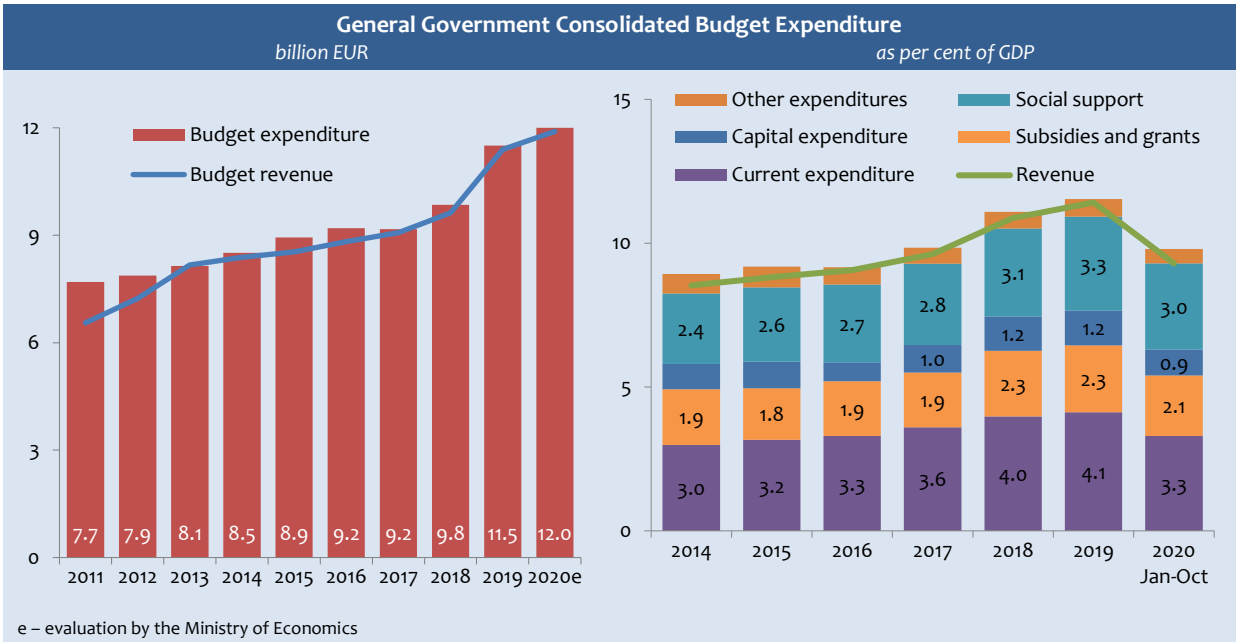
BUDGET EXPENDITURE

Since 2011, after an extensive cutting down of expenditure during the economic crisis, the **general government consolidated budget expenditure** has gradually increased (barring 2016, when general government budget expenditure slightly declined). In 2019, general government consolidated budget expenditure increased by 3.9%, reaching11.5 billion euro. In January-October 2020, general government consolidated budget expenditure has increased by 8.2%, amounting to 9.7 billion.

Since 2016, **expenditure on subsidies and grants** has been growing. In January-October 2020, expenditure on subsidies and grants has increased by 23.5%.

In recent years, **capital expenditure** has increased. However, in January-October 2020, capital expenditure due to the Covid-19 crisis declined by 1.6%.

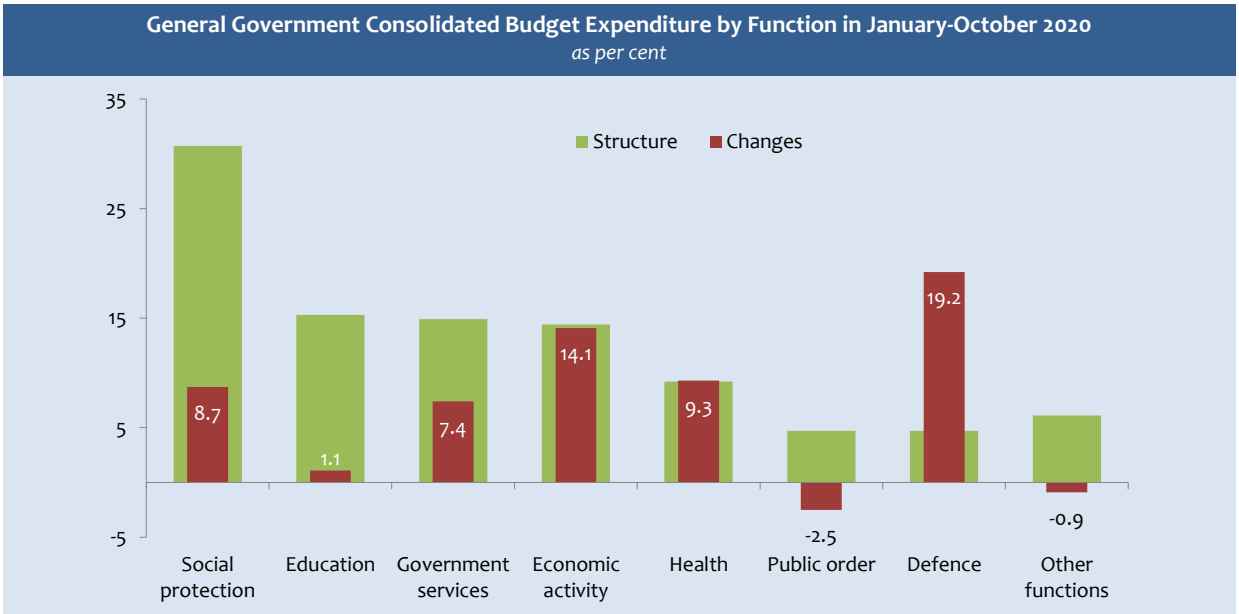
Figure 6.26



Since 2013, **current expenditure** has increased. In 2019, it rose by 3.5%. Also, in January-October 2020, current expenditure increased by 1.5%.

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 2019, expenditure on health increased. However, expenditure on recreation, culture and religion, management of local government territories, and economic activity declined.

Figure 6.27



6.7. PRODUCTIVITY AND COMPETITIVENESS

PRODUCTIVITY

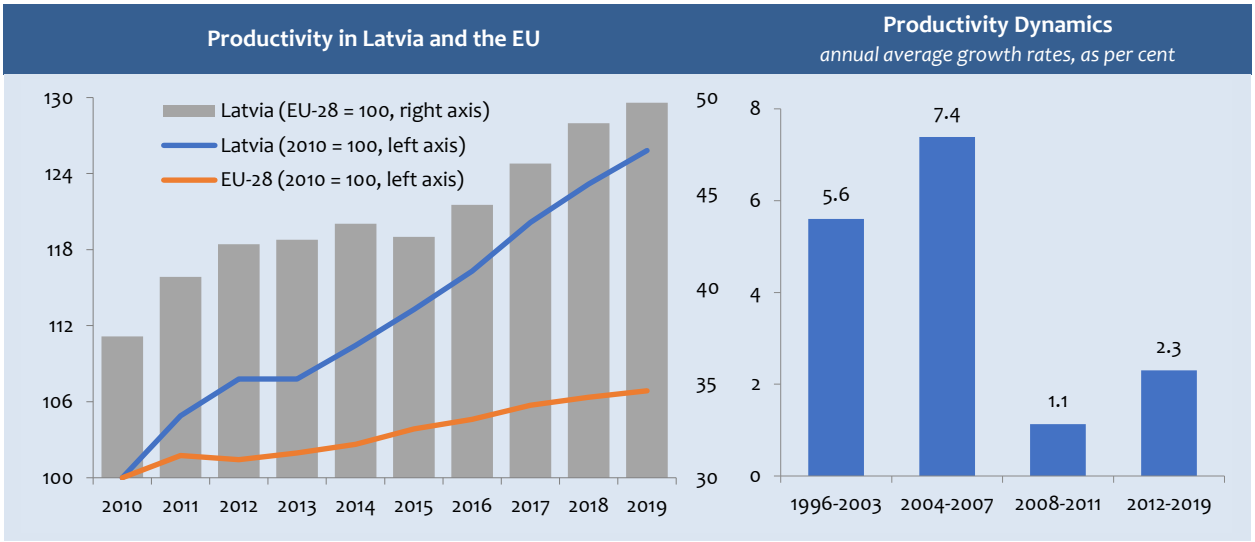
Long-term economic growth of Latvia is supported by productivity growth. Productivity has been growing by 14% per year in the last five years (2015-2019), i.e. almost 3.5 times more rapidly than in the EU on average. Overall, in 2019, GDP per employed in the Latvian national economy reached 49.8% (almost 70% according to PPS) of the EU average and the productivity gap has reduced by 6.4 percentage points since 2014.

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

The global financial crisis influenced not only the decline in economic activities, but also productivity dynamics. From 2008 to 2019 productivity was growing slower – by 2% per year on average. Productivity dynamics slowed down 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, it is still more moderate than before the crisis. Productivity has been growing by 2.6% per year on average in the last five years (2015-2019), (almost 2.5 times slower than in 1996-2007 on average).

Productivity was growing more rapidly in tradable sectors – by 3.5% per year on average in 2015-2019, while it increased by 1.4% per year on average in non-tradable sectors. Transportation and storage, manufacturing and trade have made the biggest contribution to total productivity increase in the national economy. Dynamics were positive also in other sectors, except financial intermediation, where productivity was at a 23% lower level in 2019 compared to 2014.

Figure 6.28



In 2020, the Covid-19 pandemic has brought a global strong and lasting impact on the socio-economic situation. Like in nearly all countries around the world, in 2020, due to the Covid-19 pandemic, the economy of Latvia is in recession and the labour market has been significantly affected. This also affects productivity, of course. However, its impact on productivity is unclear. In Q2 2020, which was the quarter worst-hit by the Covid-19 crisis so far, productivity in Latvia increased in terms of the number of hours worked. On the other hand, it decreased in terms of the number of employees. In the nine months of 2020, productivity in the Latvian economy (per employee) was at a 2.4% lower level than in the period concerned a year ago. Productivity in tradable sectors fell by 3.8% driven mainly by a drop in output in the trade, accommodation and transport services sectors. The negative impact of these sectors on productivity dynamics was partly offset by productivity growth in manufacturing and agriculture. In non-tradable sectors, in the nine months of 2020 productivity decreased by 1.3%, with the largest contribution from the information and communication sector.

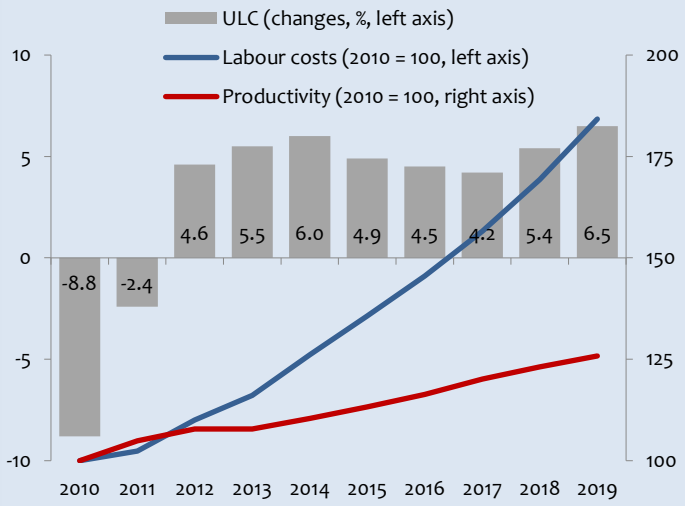
In times of high uncertainty, it is difficult to fully assess the impact of the Covid-19 pandemic on the future productivity dynamics. In the short term, productivity fluctuations lead to adjustments in product, labour and capital markets in response to measures to combat the pandemic and to stabilise the economy. In turn, the impact of the Covid-19 pandemic on long-term productivity trends will largely determine change in business models and consumer behaviour. It is clear that changes are taking place, for example, the degree of digitisation (e-services, remote work, etc.) is significantly increasing, but there is still great uncertainty about permanence of these changes and their impact on long-term productivity trends. Structural changes in Latvian economy towards higher value-added activities and knowledge-intensive industries will also greatly determine the positive dynamics of productivity.

COST AND PRICE COMPETITIVENESS

Labour costs are growing faster than productivity. Over the last five years (2015-2019), labour costs have increased by 46.1%, or almost three times faster than productivity. As a result, nominal unit labour costs (ULC) increased significantly - by 28.2%. This indicates growing risks of declining competitiveness of Latvian entrepreneurs.

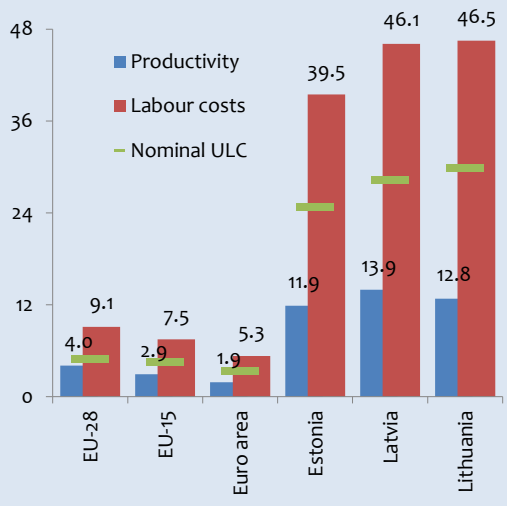
Figure 6.29

ULC, Productivity and Labour Costs in Latvia



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

2019 compared to 2014, as per cent



Statistical data shows that in years of economic growth the gap between productivity and labour costs is widening, while in recession it is getting smaller. The growth rates of workers' wages in 2004-2007 were almost five times higher than those of productivity dynamics indicators, which also had a reflection in a rapid increase in product unit labour costs (ULC).

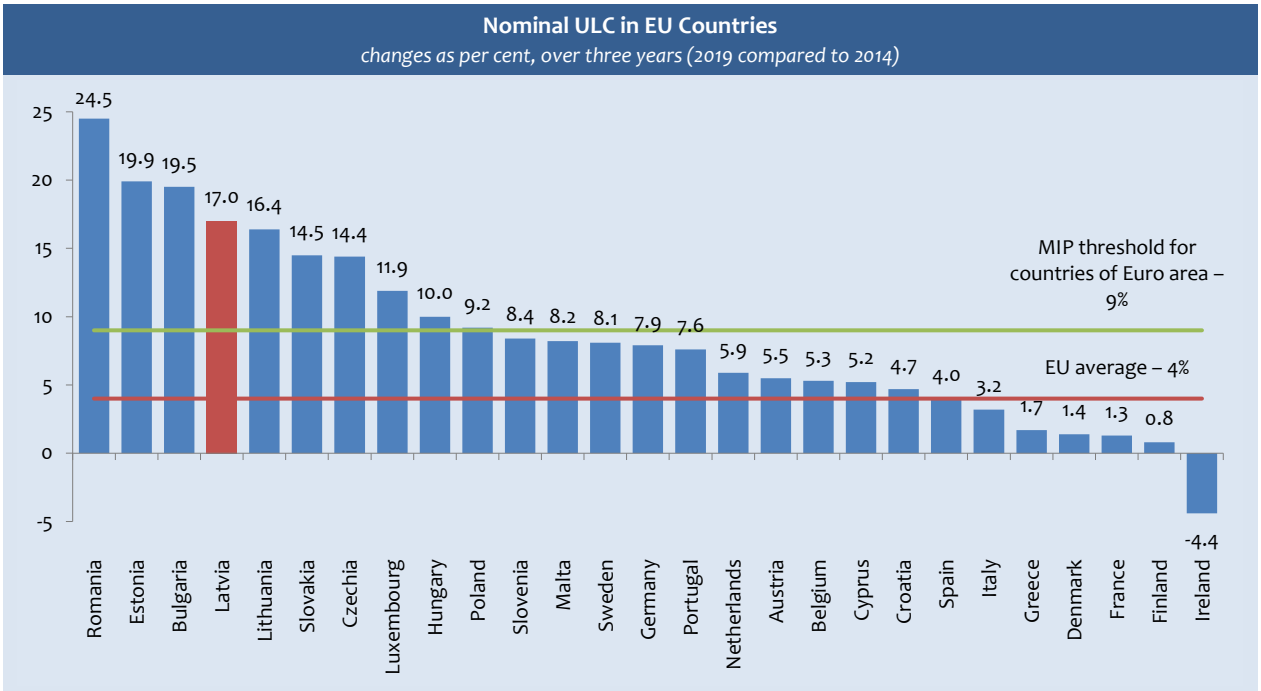
Meanwhile, the serious adjustments to product and labour markets created by the global financial crisis in 2009-2011 bridged the gap between the dynamics of productivity and labour costs. A larger drop in labour costs compared to productivity in 2009 and productivity growth in 2010 and 2011 resulted in an average annual decrease in ULC of 7.5%, contributing to an improvement in the competitiveness of costs of Latvian producers.

However, after the economic recovery ULC increased as well. Particularly strong dynamics of nominal ULC have been observed in recent years. In 2019, the ULC rose 6.5%, driven by a nearly 4-fold faster increase in labour costs compared to productivity growth.

In the last three years (2017-2019), a particularly rapid increase in ULC has been observed in all the Baltic countries. Nominal ULC increased by 17% in Latvia, by 19.9% in Estonia and by 16.4% in Lithuania – much more rapidly than in the EU on average (4%) and the threshold (9%) set for this indicator in the EU Alert Mechanism (MIP) has been significantly exceeded.

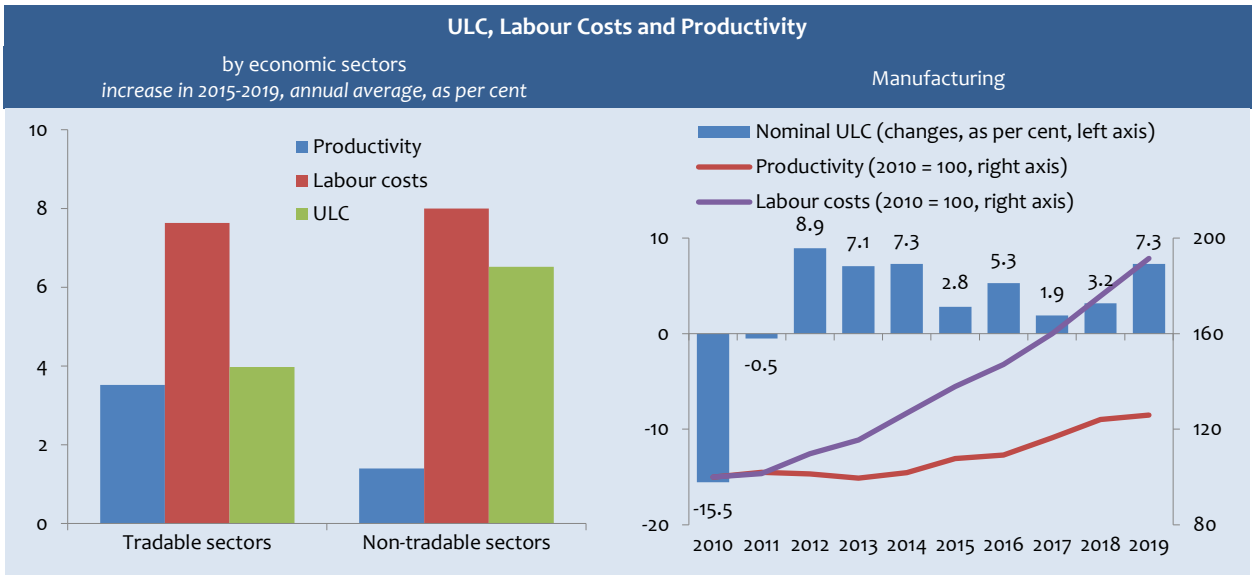
Before 2019 the increase in labour costs was affected the both by wage convergence processes in the integrated EU labour market and more tense situation in the domestic labour market. The falling unemployment rate and the growing number of vacant jobs evidenced of a mismatch between labour demand and supply increase in the Latvian labour market.

Figure 6.30



Cost competitiveness reduction risks are observed in tradable and non-tradable sectors. Although the dynamics of labour costs in the last three years (2015-2019) in both groups of sectors were very similar – they increased by almost 7.5% on average every year, productivity in tradable sectors still increased twice more rapidly than in non-tradable sectors – by 3.2% and 1.8%, respectively. Therefore, also the nominal ULC increase in tradable sectors was more moderate. Financial services, as well as energy and water supply and public utilities faced the highest rise in nominal ULC affected not only by the increase in labour costs, but also by the drop in productivity. There was also a large increase in nominal ULC in the field of information and communication.

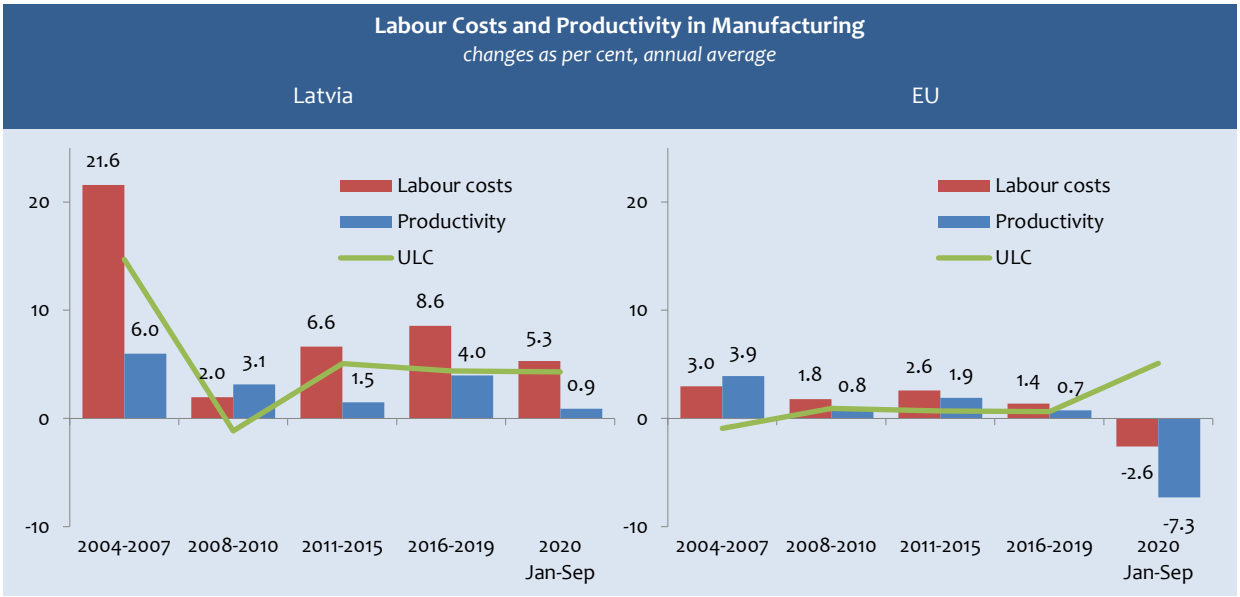
Figure 6.31



The shock related to Covid-19 has a stronger impact on adjustments in the goods market than in the labour market. In the nine months of 2020, labour costs continued to rise – by 4.6%, while productivity fell by 2.3%, boosting nominal ULC by

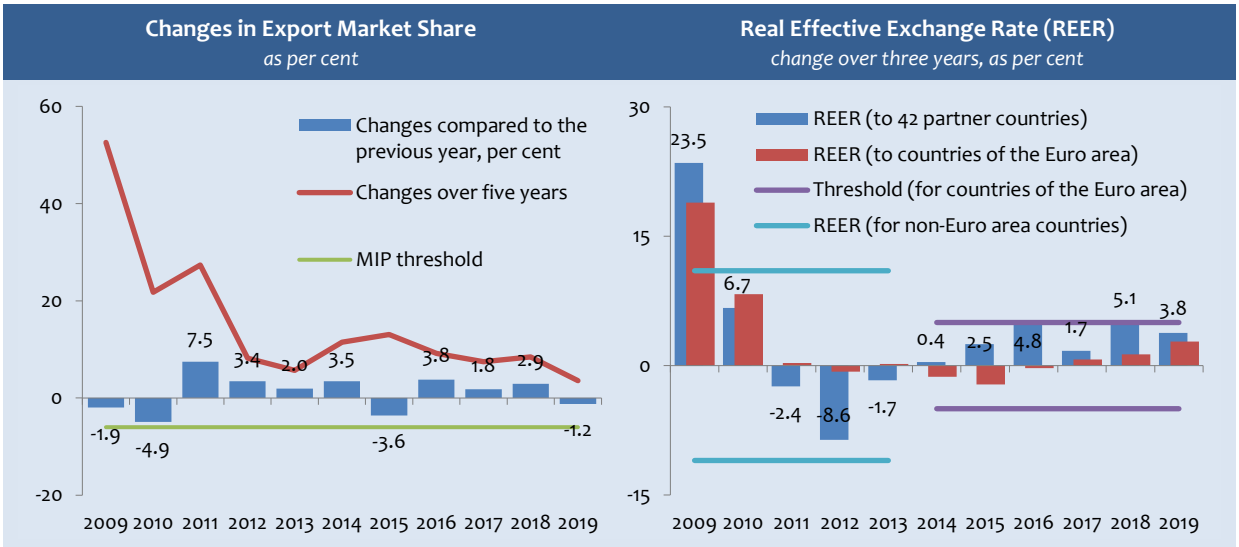
7%. In the near future, the dynamics of productivity and labour costs will be largely determined by measures to combat the Covid-19 pandemic and boost economic activity.

Figure 6.32



In manufacturing the gap between productivity and labour costs increase rates is slightly more moderate than in the national economy on average. However, annual changes in nominal ULC are rather volatile being mainly affected by factors on the goods market, while labour costs show stable upward dynamics. Labour costs in manufacturing have been growing two times faster than productivity in the last two years (2015-2019). In the nine months of 2020 both productivity and labour costs have increased by 0.9% and 5.3%, respectively, compared to the corresponding period of the previous year, increasing nominal unit labour costs of products by 4.3%. This is an evidence that under the influence of the measures to restrict the Covid-19 pandemic the changes in the number of the employed matched the reduction in manufacturing volumes, but labour costs in companies in manufacturing sectors increased. Furthermore, across the EU the average manufacturing output reduced almost three times more than the number of the employed and productivity in the nine months of this year was at a 7.3% lower level than a year ago. Moreover, labour costs reduced as well, yet much more moderately than productivity, and ULC increased by 5.1 percent.

Figure 6.33

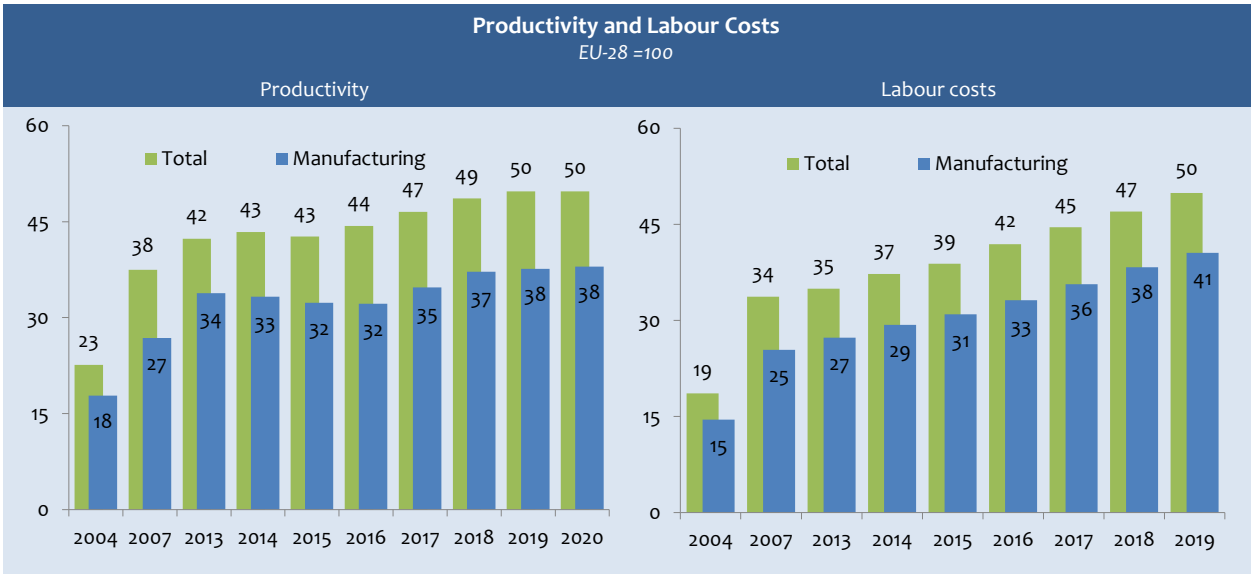


The labour costs dynamics in Latvian manufacturing exceeds significantly EU average labour costs and nominal ULC growth rates. Taking into account that the EU countries are our main trade partners, such trends reduce the competitiveness of Latvian producers in the field of costs. The competitiveness of Latvian producers in external markets is also adversely affected by slower wage increase rates in high income countries of the EU.

Negative trends in cost competitiveness indicators start to reflect also in the dynamics of the Latvian export market share. Although the share of Latvian exports on global markets has grown by 3.6% on average in the last five years, annual changes still evidence that positive trends become increasingly more moderate. In 2019, the global market share of exports of Latvian goods and services reduced by 1.6%, while that of Estonia and Lithuania – by 2.5% and 6.8 percent respectively.

The real effective exchange rate (REER) dynamics are rather moderate. The consumer price index (CPI) based REER to 42 trade partner countries has increased by 3.8% in the last three years (2017-2019) (incl. to euro area countries – by 2.8%) and has almost reached the threshold set by MIP. However, it should be noted that the increase in the export share along with the rapid increase in labour costs means that the increase in wages is compensated in prices only partially.

Figure 6.34



In the long term, 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.

Labour costs in Latvia are among the lowest in the EU Member States. In 2019, labour costs per employed in the Latvian economy were almost 50% of the EU average in total, whereas in the manufacturing industry – 38%. Compared to 2015, in 2019, the labour cost gap has decreased by 11 percentage points, while in terms of productivity index in the national economy fell by 7 percentage points in total, but in manufacturing – by 5 percentage point.

The wage convergence process is more rapid than productivity convergence and increases the risk of reduction in cost competitiveness even more. Therefore, strengthening of Latvia's competitiveness will largely depend on the ability to reduce the productivity gap.

6.8. ALERT MECHANISM

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

On 18 November 2020, the European Commission published an **Alert Mechanism Report**[1] (AMP) 2021, 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 6.5).

Table 6.5

List of Indicators of the Macroeconomic Imbalance Procedure for Latvia

	Thresholds	2012	2013	2014	2015	2016	2017	2018	2019
External imbalances and competitiveness									
Current account balance (% of GDP, 3 year average)	-4%/6%	-1.8	-3.3	-2.7	-1.7	-0.2	0.7	0.9	0.1
Net international investment position (% of GDP)	-35%	-68.0	-67.3	-65.5	-61.7	-55.8	-53.1	-46.5	-41.7
Real effective exchange rate – 42 trading partners, HICP deflator (3 year % change)	±5%* & ±11%	-8.6	-1.7	0.4	2.5	4.8	1.7	4.9	3.7
Export market share – % of world exports (5 year % change)	-6%	8.2	5.7	11.5	13.0	9.1	7.4	8.5	3.6
Nominal unit labour cost index (3 year % change)	9%* & 12%	-6.8	7.7	17.0	17.3	16.2	14.2	14.7	17.0
Internal imbalances									
Deflated house prices (% y-o-y change)	6%	-0.2	6.8	4.6	-2.8	6.3	5.6	6.4	5.8
Private sector credit flow (as % of GDP, consolidated)	14%	-2.4	-0.6	-4.6	-0.8	2.5	2.7	-0.2	1.5
Private sector debt (as % of GDP, consolidated)	133%	95.8	90.0	82.3	78.4	78.4	75.7	69.8	67.1
General government sector debt (as % of GDP)	60%	42.2	40.0	41.6	37.1	40.4	39.0	37.1	36.9
Unemployment rate (3 year average)	10%	16.9	14.4	12.6	10.9	10.1	9.4	8.6	7.5
Total financial sector liabilities (% y-o-y change)	16.5%	5.4	5.7	10.9	13.3	4.7	6.2	-3.5	4.6
New employment indicators									
Activity rate – % of total population aged 15-64 (3 year % change)	-0.2 percentage points	0.9	1.0	1.8	1.3	2.3	2.4	2.0	1.0
Long-term unemployment rate – % of economically active population (3 year % change)	0.5 percentage points	3.3	-3.1	-4.2	-3.3	-1.7	-1.3	-1.4	-1.6
Youth unemployment rate – % of economically active population (3 year % change)	2 percentage points	-4.8	-13.0	-11.4	-12.2	-5.9	-2.6	-4.1	-4.9

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

The AMR analysis is based on data up to 2020. Unlike previous years, forecasts and short-term data for 2020 have been used to characterise the situation of the latest AMR, as many positive trends in the reduction of macroeconomic imbalances either stopped or changed direction under the influence of the Covid-19 crisis. Debt levels and unemployment rates started to rise. Investments and economic activity started to decline. At the same time, wage growth slowed and private consumption declined, while household savings increased. The housing market started to cool. Although trends were similar in all EU-28 Member States, the effects of the Covid-19 crisis varied. Countries with high debt levels before the crisis were the hardest hit.

It is noted in the AMR that Latvian current account has a small deficit (3-year average is positive), but NIIP, which mainly reflects government debt and FDI, continues to improve, although it still exceeds the set threshold. Unit labour costs continued to grow relatively rapidly in 2019, driven by significant increases in wages. However, wage increases are no longer expected to be so rapid under the effects of the COVID-19 crisis. The real effective exchange rate remained broadly unchanged after the previous year's strong rise. Export market share declined for the first time in 4 years (5-year average is positive). Corporate and household debt remains moderate, although it is projected to rise with GDP falling in 2020. While lending to non-financial firms increased in 2019, it is projected to decline significantly in 2020. House price growth remained high in 2019, slightly below the threshold, but is expected to slow as a result of the COVID-19 crisis. The banking sector was in a financially stable position in the crisis, where both capital and liquidity ratios exceeded the EU average. When

[1] https://ec.europa.eu/info/publications/2020-european-semester-alert-mechanism-report_en

government support measures end, the amount of non-repayable loans, which has been relatively low in Latvia until now, is expected to increase.

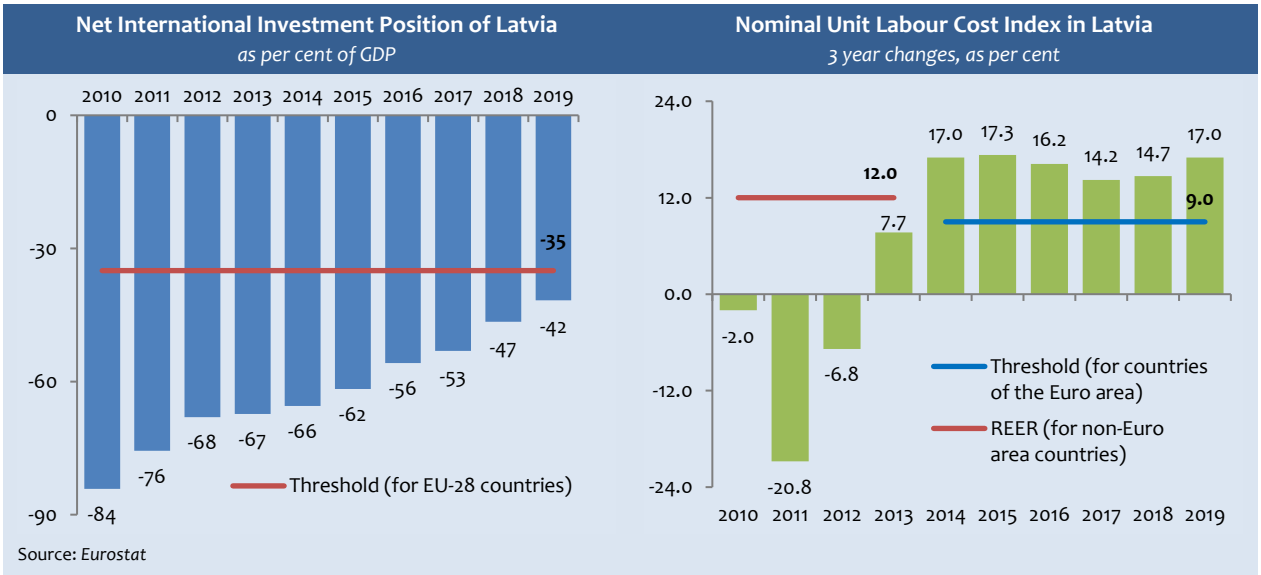
Indicators of the macroeconomic imbalance procedure (both the primary list and the auxiliary list) have been selected so as to better and faster warn about potential macroeconomic imbalances, as well as help to characterise the processes ongoing in the economy.

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

The current account balance of Latvia has not exceeded the thresholds since 2010 and has been positive since 2017. The countries, where the 3-year average current account balance in 2019 exceeded the upper threshold, were the Netherlands, Germany and Denmark, and the lower threshold was exceeded in the United Kingdom and Romania. The increase in Latvian GDP has left a positive impact on the current account.

The net international investment position of Latvia improved to -41.7% of GDP in 2019, however it still exceeds the threshold – -35% of GDP (see Figure 6.35). 11 more EU-28 counties are in a similar situation, where the indicator exceeds -100% of GDP (Ireland, Greece, Cyprus, 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 2019, FDI constituted 34.7% of the total attracted foreign capital in Latvia.

Figure 6.35



Source: *Eurostat*

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. Out of EU-28 countries, only the real effective exchange rate of Estonia exceeded the upper threshold in 2019.

Until 2019, Latvia's export market share increased steadily. A slight decrease was observed in 2019, which has not yet significantly affected the positive 5-year average. In 2019, the average 5-year decline in export market share from EU-28 countries was observed in Belgium, Italy, the United Kingdom, Germany and France, but it did not exceed the threshold.

Since the accession of Latvia to the euro area in 2014, the nominal unit labour cost index exceeds the threshold set for euro area countries (see Figure 6.35). In 2019, the threshold was exceeded also by such countries of the euro area like Estonia, Bulgaria, Lithuania, Slovakia and Luxembourg and non-euro area countries like Romania and Czech Republic. For more information on price and cost competitiveness in Chapter 6.7.

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

After 2010, the house price index of Latvia exceeded the threshold in 2013, 2016 and 2018 (see Figure 6.38). Out of EU-28 countries, Hungary, Portugal, Croatia, Luxembourg, Poland, Czech Republic and Slovakia exceeded the house price index threshold in 2019.

The private sector credit flow of Latvia has not exceeded the threshold since 2010. In 2019, this indicator did not exceed this threshold in any of EU-28 countries.

The private sector debt approached the threshold in Latvia only in 2010. After 2010, the private sector debt continues to decrease. In 2019, this indicator exceed this threshold in 11 of EU-28 countries.

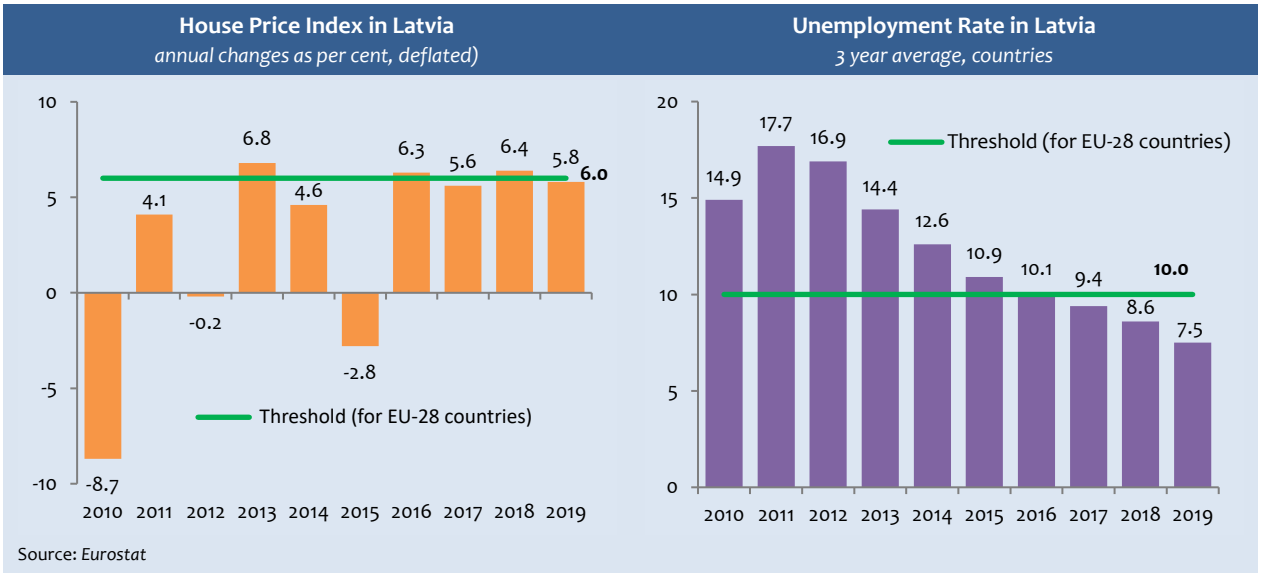
The general government debt of Latvia reached its highest level (47.3% of GDP) on 2010, however, it did not exceed the threshold. Then government debt reduced to 36.9% in 2019 with small variations. In 2019, this indicator exceed this threshold in 12 of EU-28 countries.

The increase in total financial sector liabilities in Latvia has never exceeded the set 16.5% threshold. In 2019, this indicator did not exceed this threshold in any of EU-28 countries.

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

The three-year average unemployment rate in Latvia exceeded the 10% threshold from 2010 to 2016. It reached the highest value in 2011, but then reduced. It was 7.5% in 2019 (see Figure 6.36). In 2019, out of EU-28 countries the 3-year average unemployment rate exceeded the 10% threshold in Greece, Spain and Italy.

Figure 6.36



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 2019, long-term unemployment was 2.4% of the economically active population, youth unemployment was 12.4% of all the population aged 15-24, but 7.9% 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 2019, none of EU-28 countries had 3 year changes in percentage points in the long-term unemployment rate, and 3 year changes in youth unemployment did not exceed the threshold either.

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 2019, out of EU-28 countries, this indicator exceeded this threshold only in Spain.

6.9. LATVIA IN INTERNATIONAL RATINGS

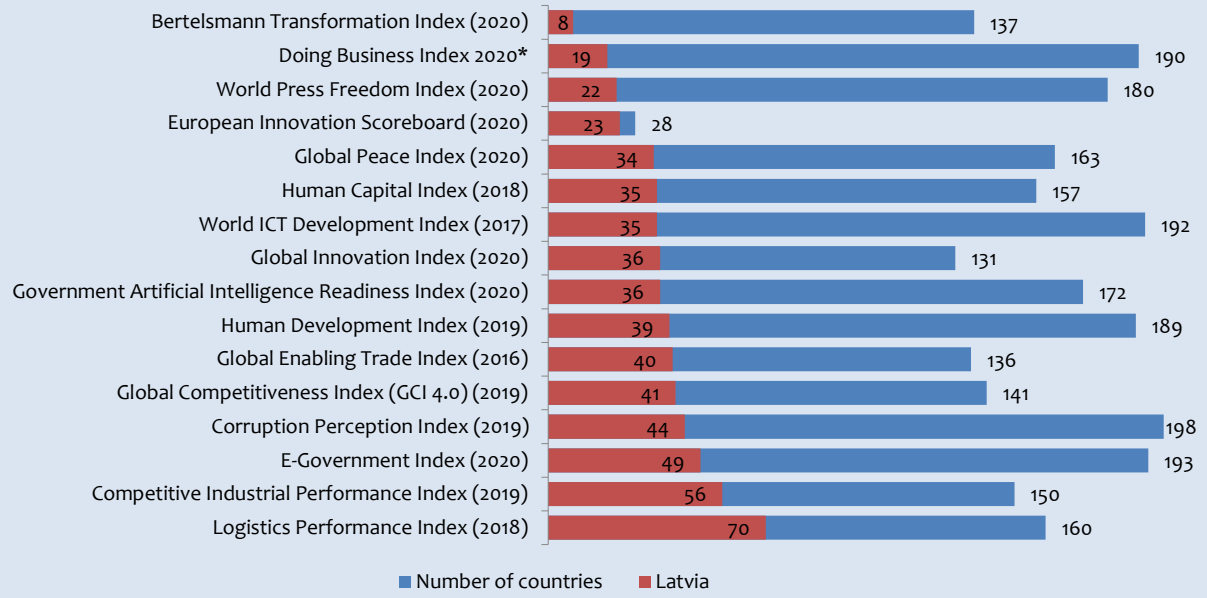
INDEXES

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

The indexes have been arranged starting from the highest place reached (see Figure 6.37), but their descriptions are broken down into main thematic groups.

Figure 6.37

Latvia's Position in the Most Popular International Ratings in 2020
position according to the year of the latest publication; number of countries in the index



* published in 2019

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

Comprehensive indexes

In 2019, in the new **Global Competitiveness Index (GCI 4.0)** of the World Economic Forum Latvia occupied the 41st place among 141 countries of the world (Estonia – 31st place, Lithuania – 39th place) having moved up one position compared to the evaluation of 2018. 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 9 pillars (the evaluation of the "Financial system" pillar improved the most affected by the evaluation of SME funding and venture capital availability), and worsened in 3 pillars (in the "Health" pillar the most affected by reduction in the healthy life years). By contrast, by the occupied place, Latvia's position has remained unchanged or improved in 8 pillars (see Table 6.6). At the same time, it should be noted that despite the improvement in the evaluation, the place obtained in "Market size" and "Innovation capacity" pillars has worsened, because progress of other countries was more rapid.

Table 6.6

Place of the Baltic Countries in GCI 4.0 2019					
	Latvia			Lithuania	Estonia
	place 2019	*change in place compared to 2018*	*change in evaluation compared to 2018*	*place 2019*	*place 2019*
Total index	**41**	**+1**	**+0.7**	**39**	**31**
Environment					
Institutions	47	+2	+1.4	34	21
Infrastructure	43	+4	+2.9	39	45
ICT use	15	-4	-0.7	12	16
Macroeconomic stability	1	0	0	1	1
Human capital					
Health	84	-8	-2.0	85	52
Skills	22	+1	+1.8	24	15
Markets					
Product market	47	+2	-1.2	58	29
Labour market	28	+1	+0.5	24	19
Financial system	85	+9	+3.6	75	52
Market size	95	-1	+0.4	76	99
Ecosystem of innovation					
Business dynamism	40	+7	+1.6	45	27
Innovation capacity	54	-2	+0.4	42	34

Source: The Global Competitiveness Report 2019, World Economic Forum

In the **Human Development Index 2019** created by the UN Development Programme, which includes life expectancy, literacy, education level, GDP per capita and other indicators, in 2018 Latvia was ranked 39st (Estonia – 30th, Lithuania – 34th) among 189 countries of the world improving its performance by 2 positions compared to 2017.

Indexes characterising institutional environment

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

In the **Corruption Perceptions Index 2019** created by the International anti-corruption organisation *Transparency International*, Latvia was ranked 44st (Estonia – 18th, Lithuania – 35th) among 198 countries of the world worsening its performance by 3 positions compared to the result of 2018.

In the **2020 World Press Freedom Index** created by the International press and freedom of expression organisation "Reporters Without Borders", in 2020 Latvia was ranked 22nd (Estonia – 14th, Lithuania – 28th) among 180 countries of the world having improved its rank by 2 positions compared to the result of 2019.

In the **Global Peace Index 2020** created by the Institute for Economics and Peace, in 2020 Latvia was ranked 34st (Estonia – 30th, Lithuania – 36th) among 163 countries of the world having moved up 1 position compared to the result of 2019.

Indexes characterising ICT development

In the **Global ICT Development Index 2017** created by the International Telecommunications Union, which provides comprehensive information on the assessment of the condition of the ICT market, including infrastructure development (mobile and fixed) and government policy, Latvia was placed 35th among 192 countries of the world (Estonia – 17th place, Lithuania – 41st). In the latest publication for 2018 the total index is no longer determined.

In the **E-Government Survey** created by the UN Department of Economic and Social Affairs, which analyses the progress of using e-government, in 2020 Latvia was ranked 49th (Estonia – 3rd, Lithuania – 40th) among 193 countries of the world improving its performance by 8 positions compared to the result of 2018.

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

Indexes characterising business environment

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. The issuing of the *Doing Business* Index in 2021 was postponed for an indefinite period of time, which the audit of data is performed, because many countries had provided false information.

In the competition among 190 countries *Doing Business 2020* 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 2020* survey. Only Denmark (4th place), the United Kingdom (8th place), Sweden (10th place), Lithuania (11th place) and Estonia (18th place) have a higher evaluation.

The creators of the *Doing Business 2020* study have used a new methodology, and have therefore recalculated evaluations of indicators for the 4 previous years, however, have not specified places of countries. If we compare the evaluation of Latvia in 2020 and 2019, values of 9 groups of indicators have improved or remained unchanged, but the result of 1 group of indicators had worsened (see Table 6.7). The evaluation of the "Paying Taxes" index has reduced, because the ration of paid taxes and social contributions has reduced compared to company profits.

Table 6.7

Evaluations of Baltic Countries by Indicators in *Doing Business 2020*

	Latvia			Lithuania		Estonia	
	place	*assess-ment*	*change in assessment compared to Doing Business 2019**	*place*	*assess-ment*	*place*	*assess-ment*
Total index	**19**	**80.3**	**0**	**11**	**81.6**	**18**	**80.6**
Starting a Business	24	94.1	0	34	93.3	14	95.4
Dealing with Construction Permits	56	73.5	0	10	84.9	19	82.6
Getting Electricity	61	82.3	+0.1	15	92.9	53	83.3
Registering Property	25	82.3	0	4	93.0	6	91.0
Getting Credit	15	85.0	0	48	70.0	48	70.0
Protecting Minority Investors	45	68.0	0	37	70.0	79	58.0
Paying Taxes	16	89.0	-0.7	18	88.8	12	89.9
Trading Across Borders	28	95.3	0	19	97.8	17	99.9
Enforcing Contracts	15	73.5	0	7	78.8	8	76.1
Resolving Insolvency	55	59.6	+0.2	89	46.7	54	60.1

* The results of *Doing Business 2019* have been recalculated based on *Doing Business 2020* methodology
Source: *Doing Business 2020, International Bank for Reconstruction and Development, The World Bank*

In 2020, in the **Competitive Industrial Performance Index 2017** created by the UN 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 56th among 150 countries of the world (Estonia – 48th place, Lithuania – 40th) improving its performance by 2 positions compared to 2015.

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).

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). On average, in the period from 2012 to 2018 Latvia occupied the 55th place in this index (Estonia – 36th, Lithuania – 43rd).

Indexes characterising innovation environment

In the **Global Innovation Index 2020** created by the Cornell University, European Institute of Business Administration and the World Intellectual Property Organisation Latvia was ranked 36th (Estonia – 25th, Lithuania – 40th) among 131 countries of the world worsening its performance by 2 positions compared to the result of 2019. The following indicators were noted as strengths of Latvia: pupil-teacher ratio in secondary education, tertiary enrolment, compliance with environmental management system and quality management principles standards, ease of getting credit, females with advanced degrees, growth rate of gross domestic product per worker by purchasing power parity, ICT services exports, as well as increase in creative industry products.

In the **European Innovation Scoreboard 2020** created by the European Commission Latvia is placed 23rd among EU-28 (Estonia – 11th place, Lithuania – 19th place) and is included in the group of *moderate innovators* for the fifth year in a row. Finance and support, employment and impacts innovation-friendly environment are Latvia's strongest innovation dimensions. Innovators, attractive research systems and impact on sales are the weakest innovation dimensions.

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

CREDIT RATINGS

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

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

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

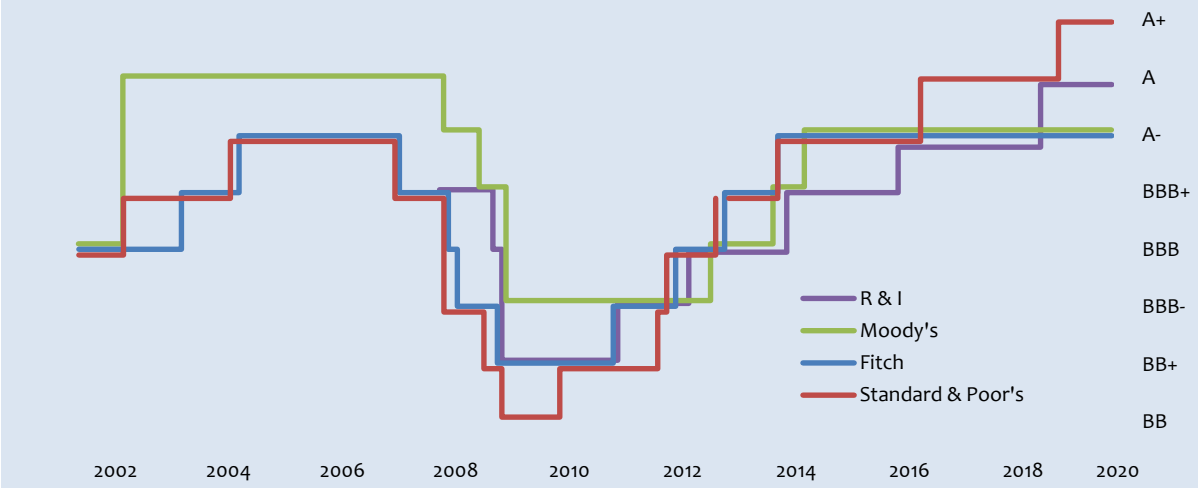
In February 2020, the international rating agency *S&P Global Ratings* increased the credit rating of Latvia from "A" to "A+", which is historically the highest credit rating set for Latvia. In August 2020, the agency confirmed that Latvia corresponds to "A+" level with a stable outlook. Other rating agencies did not change their assessment in 2020. Only *Fitch Ratings* reduced its assessment from stable to negative in April, but restored it from negative to stable in October (see Figure 6.38).

In February 2020, the international rating agency *S&P Global Ratings* indicated in its assessment that Latvia has conducted prudent fiscal policies, maintaining a low fiscal deficit and reducing public debt, has undertaken fiscal consolidation, created a fiscal space that would allow it to respond to external shocks, strengthened the financial sector, which allows financial stability to be ensured, thereby demonstrating the ability to implement effective policies. In August 2020, the rating agency appreciated the operational and effective behaviour of the Latvian government in restriction of the distribution of Covid-19 in Latvia and taking significant measures to support the economy. The tight fiscal discipline before the Covid-19 crisis has allowed maintaining sufficient fiscal flexibility to support the economy. According to the agency's assessment, the support measures implemented by the Latvian government and the recovery of major trading partner economies will contribute to the return of Latvia's economy to the level of 2019 by mid-2022, allowing for a reduction of the fiscal deficit and a stabilisation of the level of government debt in the coming years. The fragmentation of political parties has not been an obstacle to

decisions of strategic importance. At the same time, the agency emphasised that low population income levels and long-term demographic challenges remain major obstacles to raising the credit rating.

Figure 6.38

Credit Ratings of Latvia for Long-Term Liabilities



Source: State Treasury

In October 2020, the international rating agency *Fitch Ratings* pointed out that the Covid-19 crisis had a limited impact on Latvia's economy and public finances due to effective and operational support measures to mitigate the consequences of the Covid-19 outbreak and the resilience of the Latvian economy to external shocks. The agency also forecast that GDP will resume growth in 2021, boosted by the recovery of external demand and domestic consumption. The tourism and transport sectors will recover more slowly, but Latvia's flexible labour market could soften the negative impact of the pandemic.

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

Table 6.8

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

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

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

The credit rating of Estonia is 1-2 levels higher than the credit rating of Latvia and Lithuania. In 2020, all three international rating agencies kept Estonia's credit rating at the existing level. Only the assessment of the outlook has been changed. In February *S&P Global Ratings* increased its outlook from stable to positive but moved it back from positive to stable in August. At the beginning of the year, *S&P Global Ratings* believed that Estonia could be resilient to external shocks, as well as Estonia showed good economic growth results and its current account was in surplus. However, in August, the agency saw high risks to economic growth, which will also be affected by the situation in the main Estonia's trading partner countries.

In January 2020, rating agency *Fitch Ratings* increased Lithuania's rating from "A-" to "A" level changing future outlook from positive to stable. The agency appreciated Lithuania's stable economic growth and tight fiscal policy. In February 2020, the rating agency *S&P Global Ratings* also increased its credit rating from "A" to "A+" keeping a stable outlook. The agency noted Lithuania's stable real GDP growth, the low level of general government debt, cautious fiscal policy, fiscal surplus, positive net migration in 2019, wage increases and the strong banking sector. Then, during the year, none of the rating agencies changed their ratings and outlooks.

7. LABOUR MARKET

7.1. EMPLOYMENT AND UNEMPLOYMENT

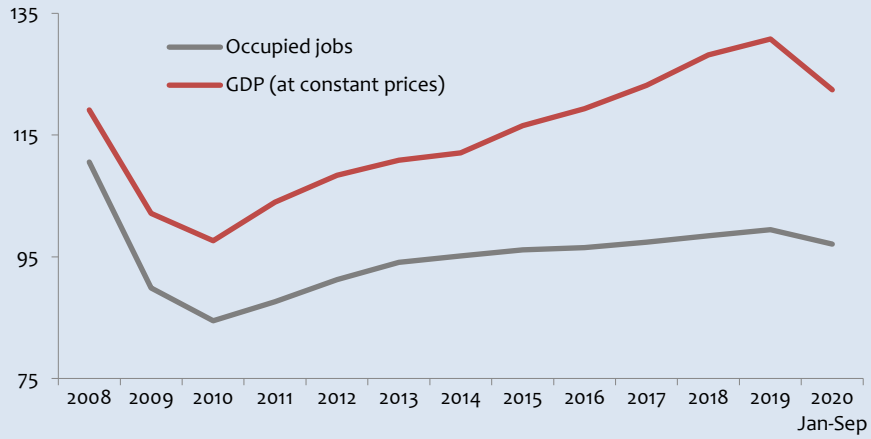
In 2011-2019 (after the financial crisis of 2008), Latvia saw stable economic growth, which has also brought tangible improvements to the labour market in previous years. During this time, the population employment rate increased by around 1/4 (by 13 percentage points) – from 52% in 2010 to 65% in 2019, with an average increase of 1.4 percentage points annually, while the unemployment rate fell 3 times – from 19.5% in 2010 to 6.3% in 2019.

Like for most countries of the world, also for Latvia year 2020 came with new challenges caused by the Covid-19 pandemic and the resulting restrictions. Although overall, Latvian economy and labour market are not strongly dependent on the sectors directly affected by the Covid-19 crisis (tourism, accommodation and food service activities, international passenger transport/air and water transport – the share of employees employed in these sectors in Latvia in 2019 was the fifth lowest among the EU-27 countries), it should be noted that the restrictions introduced and the global drop in demand affect almost all areas of the national economy, and labour-intensive sectors the most, thus covering a broad share of the labour market. According to the data from the State Revenue Service, 229.5 thousand employees were employed in the sectors affected by the Covid-19 restrictions in Q3 2020, which make more than 1/4 of all employees in the national economy.

Figure 7.1

GDP and Occupied Posts

2005 = 100



Despite the relatively large share of the labour market affected by the Covid-19 crisis, the economic shock of the pandemic and the effects of the restrictions on population employment have so far been significantly more moderate. In Q3 2020, the number of employees decreased by 25 thousand or 2.7% compared to Q3 2019. At the same time, compared to the previous quarter, the number of employees actually remained unchanged – an increase by 0.1% or 0.7 thousand. The employment rate among the population aged 15-74 was 64.3%, which was 0.2 percentage points higher than in Q2, but 1.3 percentage points lower than the year before. A total of 892.8 thousand people were employed in Q3 2020.

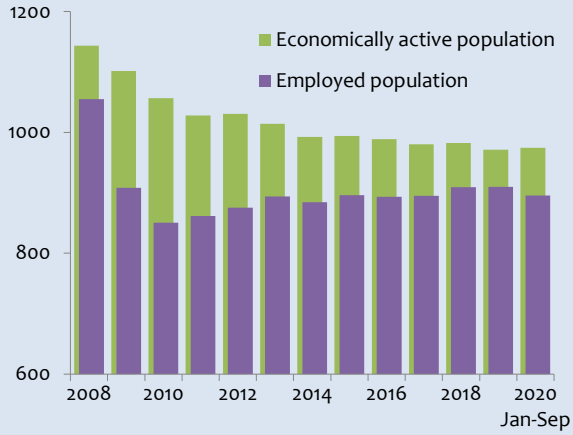
The negative effects of the Covid-19 pandemic on the labour market have so far been mitigated by the introduced state support measures, which have partly allowed both jobs and income of the population to be maintained. It should be noted that from 12 March to 30 June over 55 thousand employees and self-employed received a downtime allowance. More than half of them represented sectors such as trade, accommodation and food service activities, manufacturing, and professional, scientific and technical activities.

Although some of the jobs have so far been maintained, it should be noted that the reduction in real employment of the population is significantly higher. In Q2 2020, the average number of hours worked decreased by 9.3% compared to the corresponding period of the previous year. Load of employees has decreased the most in the food service activities and accommodation (56% drop in the number of hours worked) and in transport services (decrease of 12.8% in the number of hours worked).

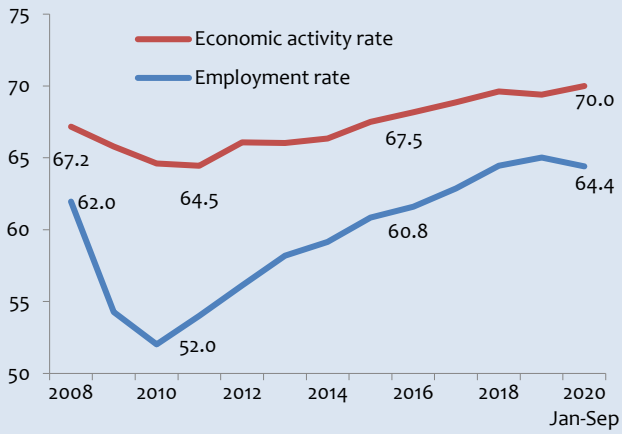
Figure 7.2

Employment and Economic Activity of the Population

Employed and Economically Active Population
aged 15-74, thousands



Employment and Participation Rate
aged 15-74, as per cent of economically active population



* 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

It should be noted that public intervention measures can only compensate the fall in economic activity in the short term, therefore, if economic activity remains at low levels for a long time, the impact of the crisis on the labour market can also increase.

Despite the decline in total economic activity in the national economy, the participation rate of the population in the labour market remained high – more than 2/3 (70.1%) of all population aged 15-74 were employed or were in search of employment in Q3 2020. For the second quarter, the participation rate of the population is at the level of 70.1%, which is the highest rate of economic activity of the population in Latvia in the last 20 years, that level was previously reached only in Q3 2018. It should be noted that the overall economic activity of the population has increased during the crisis – the participation rate in Q3 2020 was 0.2 percentage points higher than in the corresponding period a year before.

Although participation of the population in the labour market remained high, the number of economically active people (labour supply) continues to fall. Overall, the number of economically active population decreased to 974.2 thousand in Q3 2020 and was 2.5 thousand less than in the corresponding period a year ago. Decrease in the number of economically active population is mainly influenced by the negative dynamics in the number of the population capable to work.

The Latvian labour market has long been affected by negative demographic trends, thereby affecting both the total labour supply and the number of employees. The population in private households aged 15-74 decreased by 9.1 thousand (0.7%) in Q3 2020 compared to Q3 2019.

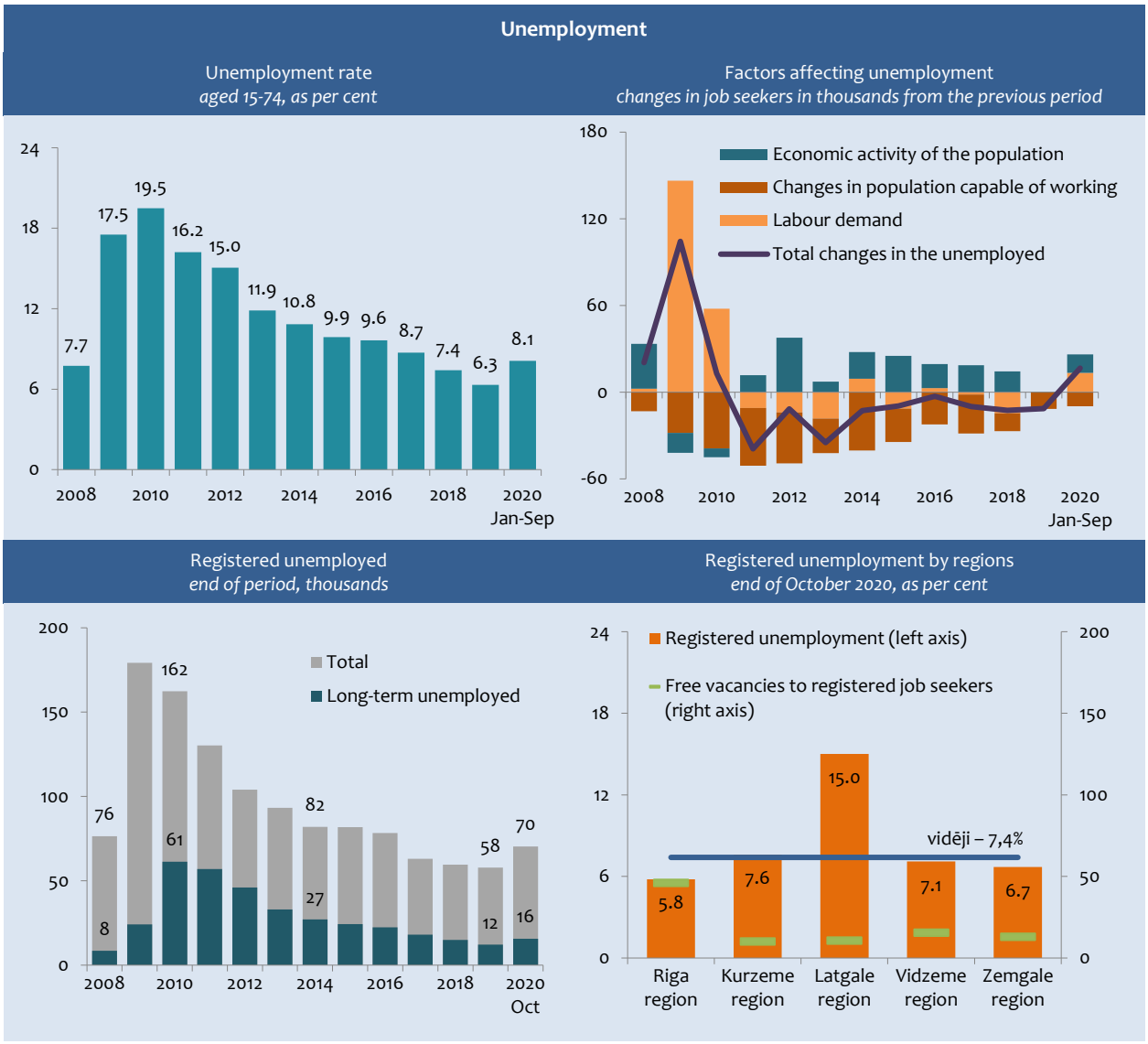
Unemployment has also increased tangibly with the decline in population employment. In Q3 2020, the unemployment rate in Latvia was 8.4%, which is slightly lower than in Q2 2020 – by 0.2 percentage points, but still significantly above the level of Q3 2019 – by 2.4 percentage points. In total, in Q3 2020, the unemployment rate was the highest since Q3 2017 and 81.4 thousand people were in search of a job.

The increase in the number of job seekers has been driven by both the decline in labour demand/population employment and the increase in the economic activity of the population – increased participation in the labour market. It should be noted that nearly half of the increase in the number of job seekers in the three quarters of 2020 has been attributed to the increase in economic activity of the population.

The current crisis has accelerated economy digitalisation trends and job automation, thereby increasing the productivity potential of the labour force on the one hand, while on the other hand changing the demand structure for skills in the labour market – skill needs in individual specialties may vary significantly from what they were a year before the crisis. It should be taken into account that skills demand and supply mismatches can contribute to increased structural unemployment.

It should be noted that in Q2 and Q3 2020 the number of job seekers increased more rapidly than the number of vacancies decreased compared to the total labour supply/economically active population in the corresponding period (see Beveridge curve), therefore, despite the increase in free labour resources, a relatively high number of unoccupied jobs/vacancies remained in the labour market.

Figure 7.3



Similarly, structural problems may be exacerbated by considerable regional differences in the labour market, as well as by the rise in long-term unemployment, which may hinder the faster recovery of the labour market in the future.

Although the regional differences in the labour market have slightly levelled during the crisis, the unemployment rate, for example in Latgale region, is still twice as high as the average in Latvia and almost 3 times higher than in the Riga Region, which together with the low geographical mobility of the labour force, increases the risks of structural unemployment.

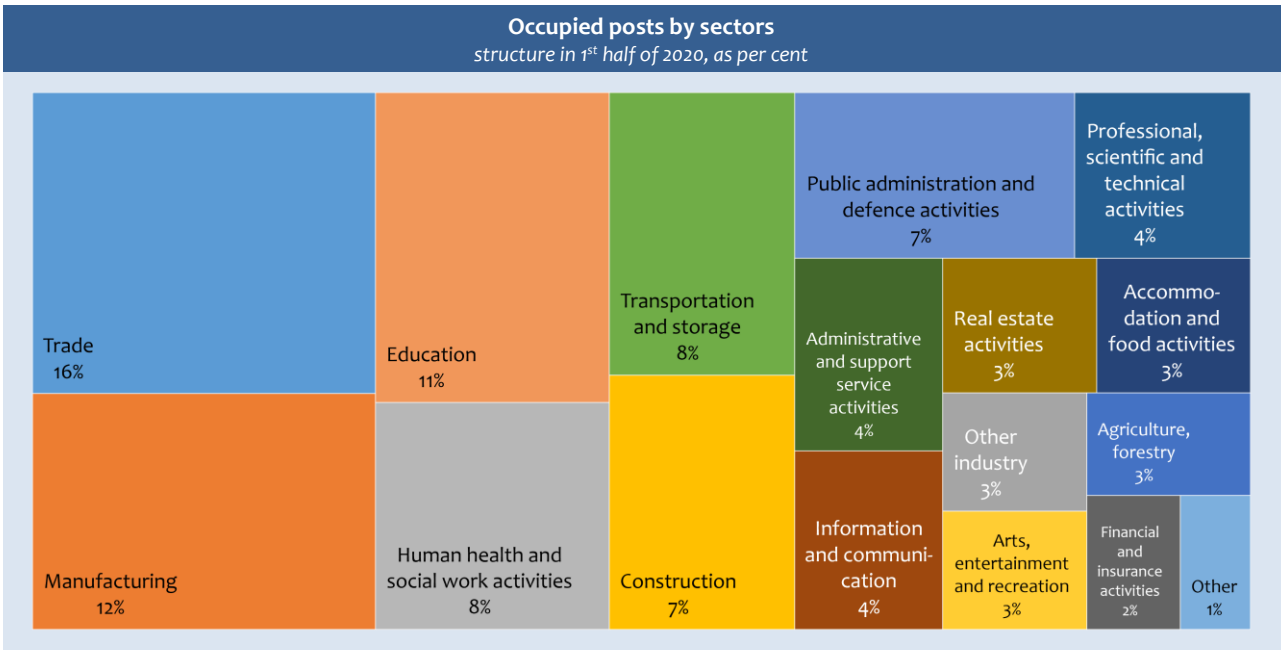
Risks that structural unemployment may increase are also caused by the growing share of long-term unemployed – still more than 1/5 of registered job seekers do not work longer than a year. High long-term unemployment can cause an increase in structural unemployment, namely, the longer these people are unemployed, the greater the risk of losing skills and abilities, and the more difficult it is to adapt to new labour market needs. There is a high risk that some of the unemployed may have problems finding jobs that match their skills in the coming years, since recovery in the sectors directly affected by the Covid-19 crisis might be relatively slow, but in sectors where job opportunities can potentially be developed, skills previously acquired will not necessarily be required.

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

Overall, the unemployment rate in Latvia in Q2 2020 was the fifth highest among the EU-27 (1.9 percentage points above the EU-27 average), sharing the position with Lithuania (8.6%), while lagging behind Estonia by 1.7 percentage points

(7.1%). However, it should be noted that Estonia, compared to Latvia, also maintained significantly lower unemployment rates before the crisis period, for example, the unemployment rate in Estonia reached 3.9% in Q3 2019, while it was 6% (2.1 percentage points higher) in Latvia, so the unemployment gap between countries has even decreased during the Covid-19 crisis period.

Figure 7.4



With the economy expanding and labour demand growing, the number of occupied posts has also increased significantly over the last 10 years. Between Q2 2010 and Q2 2020, the total number of occupied posts increased by 105.7 thousand or 13.6%. There was a significant increase in jobs in human health and social work activities (by 18.7 thousand), information and communication (by 17.2 thousand) and construction (by 16.3 thousand). Meanwhile, the biggest job cuts were observed in financial services.

At the same time, the decline in economic activity caused by the Covid-19 pandemic has introduced some adjustments to the dynamics of occupied posts. At the end of Q2 2020 the number of occupied posts decreased by 4.5% or 41.6 thousand jobs, compared to the corresponding period of 2019, reducing by 882.6 thousand jobs, which is close to the indicator of Q2 2016.

Approximately half (22.4 thousand jobs) of the total job cuts were in the sectors directly affected by the Covid-19 crisis (accommodation and food service activities; transport services; arts, entertainment and recreation services, as well as administrative and support service activities), where the most significant reduction has been in accommodation and food service activities – by 10.1 thousand jobs or 26.6%, compared to Q2 of the previous year – by 2.1 thousand (-28.7%) in accommodation and 8 thousand (-26.1%) in food service activities, respectively.

Although the Covid-19 crisis has affected most areas of the economy, labour demand in certain sectors in Q2 2020 continued to grow. In view of the increased demand for remote work, training solutions and tools, the number of occupied posts has increased in information and communication services by 656 jobs or 1.9% (mainly in computer programming and information services segments) compared to Q2 of the previous year. There was also a substantial increase in occupied posts in human health and social work activities – by 1,441 jobs (2.1%).

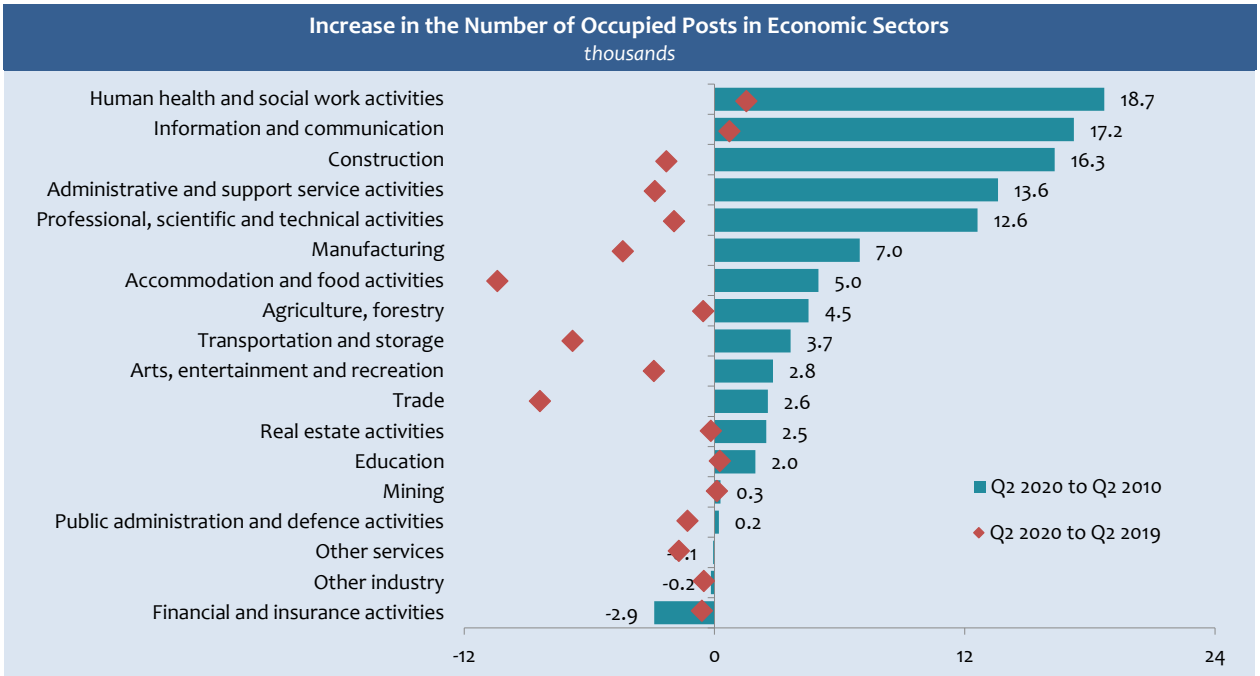
The most significant job cuts in Q2 2020 were observed in the private sector – by 35.7 thousand or 5.6%, so the number of occupied posts in the private sector has now returned to the levels of 2014-2015, comparing quarterly 2 indicators over recent years.

Overall, the Covid-19 crisis has affected less the public sector – the number of occupied posts has fallen by 5.9 thousand or 2%. The largest job cuts in the public sector has been in transportation and storage, public administration and arts and entertainment.

At the same time, differences in the number of occupied posts and in the dynamics of employees (according to the labour force survey, the number of employees in Q3 2020 decreased by 25 thousand, compared to Q3 2019) are a partial indication of an increase in the share of shadow economy/unregistered employment in Latvia during the Covid-19 pandemic. It should

be noted that the statistics on the number of occupied posts do not take into account companies with fewer than 50 jobs, and therefore the total reduction in jobs might be significantly higher than 41.6 thousand Labour force survey data cover also unregistered employment.

Figure 7.5



7.2. WAGES

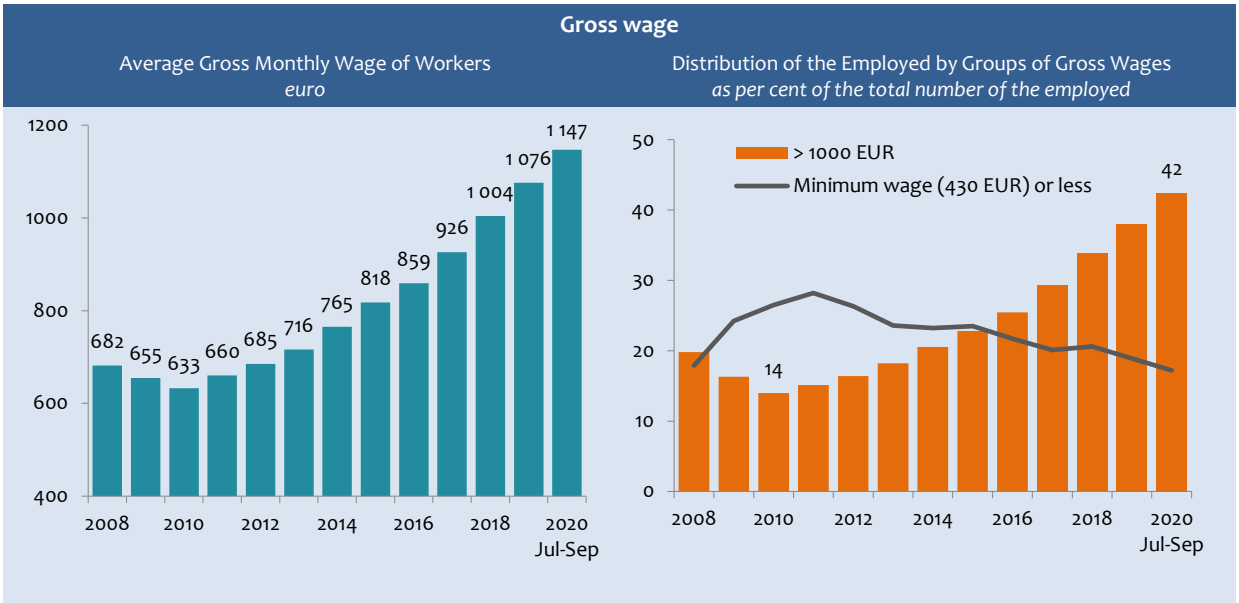
Since the end of 2010, there has been a steady increase in wages in Latvia, driven by both the increase in labour demand and by the narrowing of labour market supply – a decline in the population capable of working. Labour productivity growth has partly secured an increase in wages. Between 2010 and 2019, wages increased by an average of 6.1% a year.

Although average wages continued to rise in 2020, with labour market activity declining, growth rates have still become slower. The average monthly gross wage increased by 3.9% in Q2 2020 and by 5.9% in Q3 – increasing to 1 147 euro on average per month, which is a considerable increase, but it is still tangibly lower than in 2018 and Q3 2019, when average gross salary growth was 8.1% and 7.6%, respectively. The increase in wages has been above 5% per year in the last four years. The average gross wage grew by 7.2 per cent in 2019, and by 8.4 per cent in 2018.

It should be noted that a large part of the increase in wages was determined by the already relatively high base effect at the end of 2019 and in Q1 2020 (1 100 euro), when labour market activity still remained high. Compared to Q1 2020, the average monthly gross wage increased by 1.6% in Q2 and by 2.7% in Q3 compared to Q2. Similarly, the increase in average wages has, in part, been fostered by a reduction of the share of lower-paid jobs in the labour market, taking into account the significant job cuts both in accommodation and food service activities and in the retail sector, where average wage levels have so far been significantly lower than the economy average.

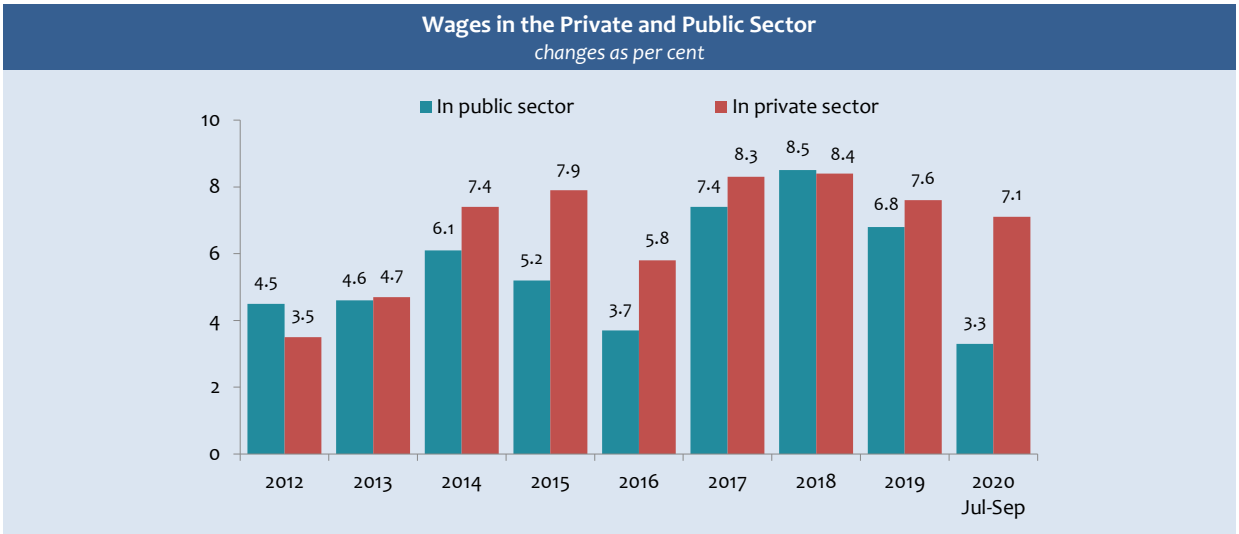
In Q3 2020, the average wage slowed in both private and public sectors, yet in the private sector wage growth was more than twice more rapid than in the public sector. In the public sector, the average monthly gross wage in Q3 2020 increased by 3.3% and 7.1% in the private sector compared to Q3 2019. It should be noted that 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. In 2011-2019, the number of posts occupied in the private sector grew by 20.2%, but in the public sector – only by 1.3 per cent.

Figure 7.6



A positive trend is still observed in the waging structure. Although the minimum wage has grown rapidly in the previous years – by almost 70% (from 256 euro in 2010 to 430 euro in 2020), nevertheless the share of the employed receiving the minimal wage or less has reduced by 9.3 percentage points. Furthermore, the share of the employed receiving more than 1 000 euro has increased by 30 percentage points in this period. In Q3 2020, more than 2/5 of all the employed had a gross wage above 1 000 euro.

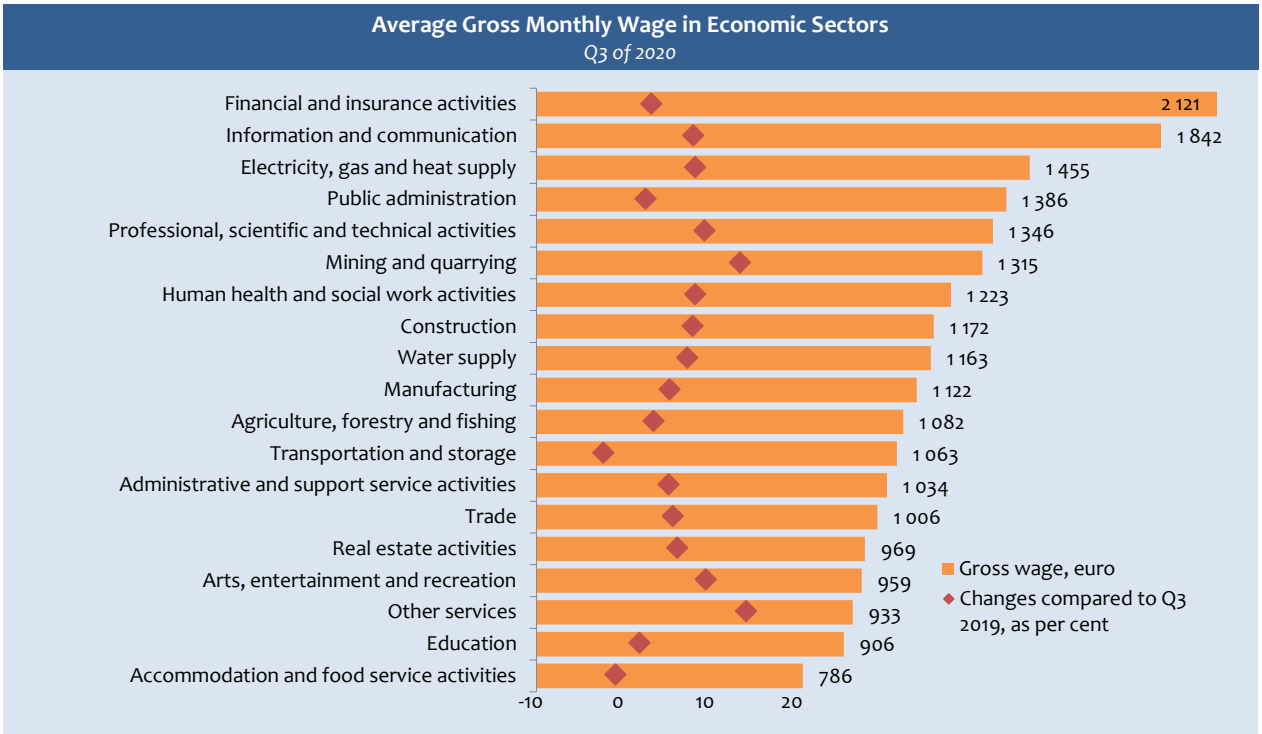
Figure 7.7



Despite the decline in economic activity, in Q3 2020, wages continued to rise in most sectors of the economy. The most rapid increases were observed in other services, mainly in repair of computers and personal and household goods (17.9%) and in activities of membership organisations (12.8%), as well as in mining and quarrying – an increase by 14.1 per cent.

At the same time, the most significant decrease in the average gross wage was observed in transportation and storage (by 1.7%) and in accommodation and food service activities (by 0.3%). The highest wages in Q3 2020 were still in financial services – the average gross monthly wage was 2 121 euro.

Figure 7.8



7.3. LABOUR MARKET FORECASTS

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

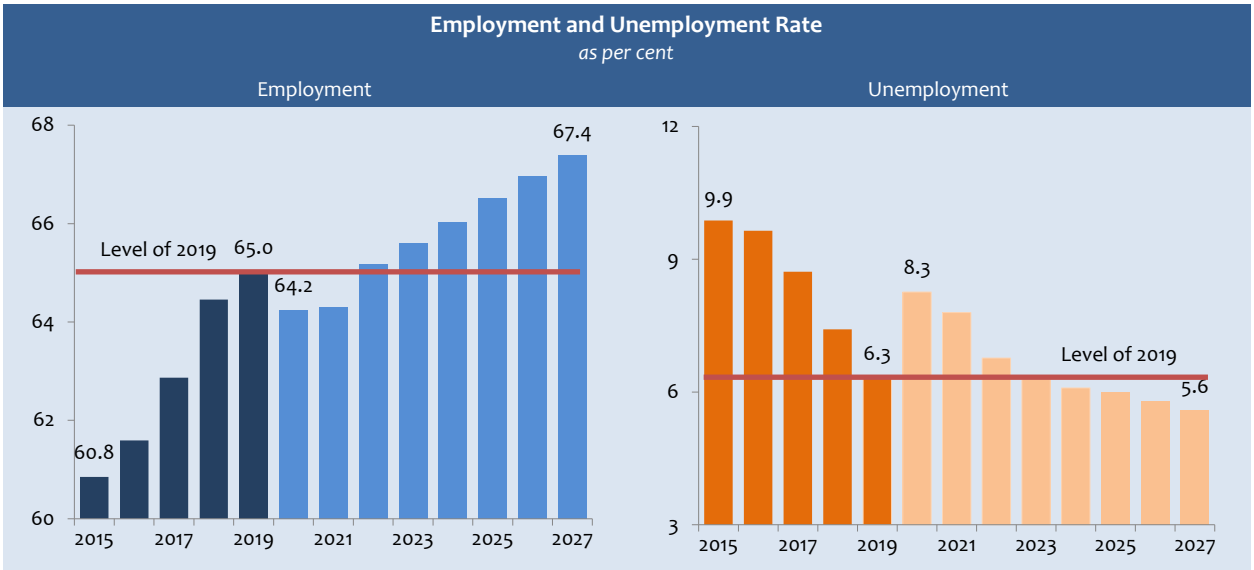
In view of the shrinking economic activity due to the Covid-19 crisis, the total number of employees is expected to fall by 1.8% in 2020 (by almost 17 thousand) compared to 2019, while the unemployment rate will rise to 8.3%. The labour market situation is likely to improve from the spring/summer season of 2021, with seasonal jobs increasing and the overall stabilisation of the economic situation. A tangible increase in employment could be observed in the second half of 2021 – the number of employees might rise by 1.2% in the second half of 2021 compared to the corresponding period of 2020, but despite that the average number of employees in 2021 will remain 0.3% lower than in 2020, taking into account the high base in the first half of 2020. Overall, the employment rate among the population aged 15-74 will fall to 64.2% in 2020 (0.8 percentage points lower than in 2019) and will settle at 64.3 per cent in 2021.

The unemployment rate is expected to fall to an average of 7.8% in 2021, while the number of job seekers could fall by around 5 thousand compared to 2020, and could generally fall to 75 thousand in 2021.

It should be noted that a key prerequisite for the stabilisation of the labour market situation is the gradual cancellation of the restrictions introduced and the recovery of economic circulation. It should be noted that the uncertainty surrounding the recovery of the global economy still remains high, so the availability of the new vaccine is a key milestone, both in Latvia and in other countries in the European Economic Area, with which Latvia has the closest economic ties.

Overall, the relative employment and unemployment indicators could return to the levels of 2019 around the end of 2022/early 2023, but the number of employees in absolute terms is likely to remain below pre-crisis levels in the coming years, taking into account both the demographic processes – less working age population in the labour market and the need for higher labour efficiency – economic growth will not be as much based on employment growth as on labour productivity.

Figure 7.9

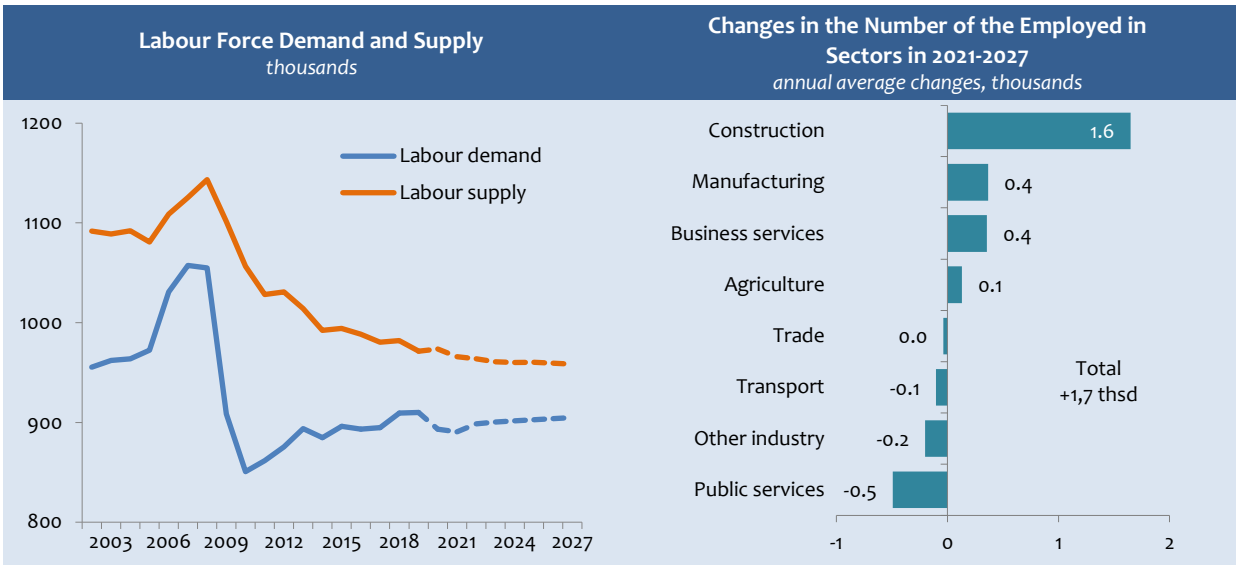


The labour market situation is likely to change significantly starting from 2023, when labour shortages can become more pronounced, taking into account running out labour resources and the gradual restoration of labour demand. In 2023, the unemployment rate could fall to an average of 6.2% (0.1 percentage points lower than in 2019), while the employment rate would reach 65.4% (0.4 percentage points higher than in 2019). Overall, the unemployment rate is expected to fall to 5.6% by 2027, while the employment rate is expected to rise to 67.4 percent.

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

According to demographic forecasts of the Ministry of Economics for 2020, the Latvian population might decrease by approximately 65 thousand by 2027, compared to the beginning of 2020. The most significant reduction in population will be observed among people of working age. The population aged 15-64 is expected to fall by nearly 90 thousand or more than 7% by 2027, which will also have a negative reflection on the overall labour supply.

Figure 7.10



Overall, the economically active population might reduce by 1.3% or 13 thousand by 2027, compared to 2019. At the same time, the negative impact of demographic trends on labour supply will be reduced by the increase in economic activity of the population. By 2027, the population participation rate in the labour market could reach 71.4 per cent.

In view of the ageing trend of the labour force in the medium term, the main job opportunities will be created by replacement demand.

The existing crisis has limited economic activity in most areas of the national economy, particularly affecting those sectors directly linked to population movement and assembly, such as passenger transport, travel agencies and tour operators, accommodation and food service activities, different areas of entertainment, art and culture. It should be noted that the recovery of these sectors will not be rapid and some of them will probably not return to pre-crisis levels. It is expected that the number of employees in transportation and storage in 2027 could still be 5 thousand less than the average of 2019. Meanwhile, the number of employees in accommodation and food service activities could return to the level of 2019 only around 2027, while in art, and entertainment – around 2025.

The number of the employed is also expected to reduce considerably in the coming years in public services sectors, mainly in public administration and education. Overall, the number of employees in the public services could fall by 3.4 thousand by 2027 compared to 2020.

In view of the trends in job automation, from 2023 the number of employees could also gradually decrease in the trading sector, taking into account increasingly broader entry of self-service cash register systems as well as other automated trading solutions in the sector.

At the same time, changes in population habits introduced by the crisis not only narrow individual activities, but also create new opportunities and needs in the labour market. The less affected sectors are expected to recover more quickly and will be the main driver for the economy to nearest years.

The most significant increase in labour demand until 2027 could be seen in the construction sector, which will be largely secured by the implementation of major investment projects such as *Rail Baltica*, the construction of the National Concert Hall in Riga. Overall, the number of employed in construction might increase by more than 11.5 thousand by 2027, compared to 2020.

An increase in the number of employees in the coming years might also be observed in manufacturing. Overall, the number of employed in manufacturing might increase by slightly more than 2.6 thousand by 2027, compared to 2020. At the same time, it should be noted that overall, the increase in the number of employees in traditional tradable sectors will remain slow, because growth of sectors will mainly be based on the productivity increase, which plays a decisive role in ensuring competitiveness.

Labour demand will also continue to grow in commercial services, in particular professional, scientific and technical services and information and communication services. Overall, the number of employees in commercial services could increase by 2.5 thousand by 2027.

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.

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 2019, the employment rate in age group 20-64 reached 77.4 per cent.

The decline in economic activity caused by the introduction of restrictions due to the Covid-19 pandemic in the world and in Latvia since March 2020, as well as the long-term uncertainty of the situation have a negative impact on the labour market. In summer 2020, after the first wave of Covid-19, the situation in the labour market improved. However, another surge of Covid-19 at the end of the year and the restrictions imposed to overcome it pose new challenges for the labour market. State aid measures aimed at businesses and the population, which slow down the negative effects of the crisis, play an important role in maintaining the activity of the labour market and overcoming the Covid-19 crisis. The support mechanisms put in place, such as downtime support and wage subsidy support, help companies to keep jobs during emergencies and protect people from total loss of income, which is particularly important in the sectors directly affected by the crisis. In order to reduce the negative impact of the restrictive measures imposed during the Covid-19 crisis, support is provided to socially vulnerable population groups, including the unemployed (unemployment benefit has been introduced, temporary employment has been extended to 4 months without losing unemployment status, employment support measures have been extended, etc.). At the same time, in order to overcome the crisis more effectively, one of the priorities is the development of human capital – the training support and supply available to the population and businesses has been expanded, adapting them to the new situation.

MEDIUM-TERM AND LONG-TERM LABOUR MARKET CHALLENGES AND POLICY DIRECTIONS

For a long time now, the main challenges of the Latvian labour market and also economic challenges, taking into account the negative demographic trends, are related to the aging of labour force and the shortage of labour force (properly qualified employees) (see Chapter 7.3 for information on labour market forecasts).

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, in particular in Latgale. Regional disparities hinder the 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, the Employment Board composed of three ministers (of economics, education and science and welfare) that was created in 2016 continues work. The goal of this Board is to coordinate inter-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). Given the negative impact of the Covid-19 crisis on the labour market, the work of the council in 2020 will focus on developing proposals for measures to overcome the Covid-19 crisis and economic recovery in support of adult education and employment. Almost all measures have been supported and the necessary additional funding has been provided.

The *Strategy for Latvia for Mitigation of the Consequences of the Crisis Caused by Covid-19* approved by the Cabinet of Ministers envisages the use of opportunities created by the crisis for the transformation of the Latvian economy in favour of the development of exports of knowledge-intensive goods and services. Society and the economy need the right skills to reorient. The strategy provides for the creation of a functional adult education system for reducing the share of poorly qualified persons, developing continuous skills, abilities and competences and changing the socio-economic paradigm – the introduction of the concept of lifelong learning. The goal is to involve 165 thousand people in adult education by 2023. Public investment in human capital development is expected to focus on sectors with high export potential (STEM sectors), with a special focus on developing the digital skills of the population and businesses. Measures already taken to control the spread of the Covid-19 virus and the challenges associated with it have contributed to the automation and digitisation of many processes. In order to achieve the results defined in the strategy in the field of human capital development, a working group has been established with extensive involvement of state institutions, NGOs and representatives of the private sector.

ADULT EDUCATION

7.4% of the Latvian population aged 25 to 64 years were involved in education in 2019, which is a 2 times lower indicator than the target in Latvian policy planning documents – to reach 15% by 2020.

Taking into account that changes in formal education give a tangible effect in the long-term, adult learning has an important role to play in reducing labour market disparities and in overcoming the economic crisis caused by the Covid-19 pandemic and its containment measures. Providing export-capable industries and companies relatively less affected by the Covid-19 crisis with the necessary human resources would facilitate the recovery and transformation of the Latvian economy. Training available to the population and businesses has been expanded as part of the Covid-19 crisis support mechanisms.

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. Since the beginning of the project, the training has been implemented in four application rounds, as well as in one distance training round, which was announced in addition in summer of 2020 to mitigate the negative consequences of the Covid-19 crisis. The 5th application round closed in October 2020, where more than 20 thousand people applied for training. Most applications were received in ICT and manufacture of electronic and optical equipment and in the business sector, where educational programmes were offered for the first time. In this round, educational institutions should start training by the end of February 2021.

In total, by October 2020, more than 34 thousand people had started training employees, including 8.2 thousand employees within the distance learning round. 23 thousand persons have already completed their education. Overall, 55 thousand unemployed are planned to be involved in the project by the end of 2023.

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

- *Support for employed learning (technology learning)*. The aim of this measure is to provide the 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 planned ERDF funding is 18 million euro, contracts have been concluded for 14.7 million euro. In spring 2016, 10 projects of the first selection round implemented by the 10 largest sectoral associations were approved. These associations represent manufacturing subsectors, the ICT sector and accommodation and food service activities sector. By Q4 2020, a total of 13.1 thousand of non-unique persons employed with 670 merchants have been trained. In spring 2020, 5 projects of the second selection round implemented (trainings have started) implemented by sectoral associations. These associations represent manufacturing subsectors, the ICT sector or international business service centre sectors. The deadline for the implementation of both the first and second selection rounds is 31 December 2022.
  On 24 November 2020, the Cabinet of Ministers supported the expansion of training to improve the digital skills of employees and to promote the digital transformation of businesses. Additional funding of 14.7 million euro is available for the implementation of the training program. By the end of 2023, it is planned to provide training support to at least 2000 employees from 500 businesses.
- *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 total ERDF funding is 6.9 million euro. 3 projects implemented by the LCCI, LICTA, and IDAL the were approved in 2016 with the period of implementation as 31 December 2022. By Q4 2020, a total of 6.2 thousand of non-unique persons employed with 1299 merchants have been trained.
  On 1 December 2020, the Cabinet of Ministers decided on additional financing of 5 million euro for high-level training (for top and middle-level managers) and the take-up of good practices as well as new support measures for the training of investor employees. The support is intended for companies in sectors corresponding to Latvia's high-potential and smart specialization strategy in order to promote their competitiveness in international markets. The planned deadline for implementation of the measures is 31 December 2023. There are plans to support the training of at least 900 employees from 240 businesses.

20 thousand people were involved in reskilling and upskilling activities implemented by the State Employment Agency (SEA) for the unemployed and job seekers in 2019, and 15 thousand persons in the 9 months of 2020. In 2020, the SEA offers the opportunity to acquire new or improve existing knowledge online by participating in the mastering of free training programmes on distance education platforms. 1 thousand participants, including employees, had started training on the international distance learning platform *Coursera* by December 2020 within the Covid-19 reduction initiative *Coursera for Workforce Recovery*, mainly mastering digital and entrepreneurial skills.

ACTIVE EMPLOYMENT MEASURES

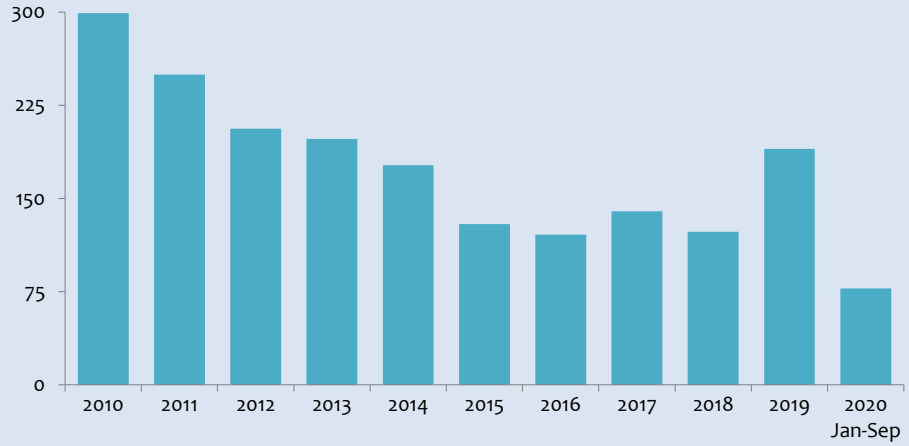
The national policy in the field of unemployment reduction and support for the unemployed, job seeker and persons subject to risk of unemployment is implemented by the State Employment Agency. The active and preventive labour market measures that are being implemented (see Box 7.1) foster economic activity and competitiveness of the population in the labour market.

The most important measures implemented by SEA:

- training measures – vocational training, retraining and improvement of professional skills, training with an employer, acquisition of non-formal education, competitiveness improvement measures (key competences);
- employment measures – measures for certain groups of persons (subsidised jobs), paid temporary community work, measures for starting a business or self-employment, summer employment of pupils;
- job search support measures and consultations – profiling of the unemployed and preparation of an individual job search plan, career planning consultations, information days;
- other support measures – activation measures for the long-term unemployed, including with addictions, support for regional mobility (getting to the place of work or training), etc.

Figure 7.14

Persons involved in active employment measures*
thousands



* one person may be involved in several activities. In 2019, the methodology was changed to indicate participations. Data are not comparable with previous periods.

Data source: SEA

When the market situation has improved, the involvement in active employment measures in the last 10 years has reduced. In 2019, 80.3 thousand unique persons were involved in active employment measures and received support by participating in 190 thousand activities (number of participations). The funding for active labour market policy measures reduced as well – from 91.1 million euro in 2010 to 27 million euro in 2019.

In recent years, increased attention has been paid to those population groups (long-term unemployed, young people not in education or employment, the unemployed of pre-retirement age, and people with disabilities), for whom it is most difficult to return to the labour market and who need more targeted support to promote their economic activity and inclusion in the labour market.

In order to overcome the Covid-19 crisis, the services and measures provided by the SEA were reviewed and improved, adapting them to the situation in the labour market and the restrictions set by the state in connection with the changing epidemiological situation. Among other things, existing and new employment support measures have been expanded – the term of participation in paid temporary work has been extended to 6 months, as well as the range of the unemployed who can participate in them has been extended; a new wage subsidy support measure has been introduced, which provides financial support to employers for hiring new employees from the unemployed; in cooperation with the Ministry of Education and Science, a support measure has been developed for full-time students of higher education institutions who have acquired the status of the unemployed, which would allow students to develop research, organisational and IT skills during their studies, scholarship is paid to students during their participation, etc.

In total, in the first nine months of 2020, 47.4 thousand people were involved in active employment measures at the SEA by participating in 77.5 thousand activities (participations).

INTERNAL LABOUR MOBILITY

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

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. Also, in order to resolve regional unemployment challenges, persons employed by employers can receive financial compensation to cover expenses of transport and rental of a dwelling in the first four months after starting the legal employment relationship. In 2019, regional mobility support for getting to work was granted to 288 persons.

SMART IMMIGRATION

The shortage of highly qualified specialists, which is currently experienced by a number of companies, particularly in knowledge and technology intensive sectors, is hindering Latvia's economic growth, growth in business productivity and attraction of investments, 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. The aim of the smart migration policy is to promote the attraction of highly qualified professionals from third countries. It should be emphasised that activities to promote smart immigration do not focus on cancellation or facilitation of immigration of labour force from third countries in total, but focus on the improvement of the process for the Latvian employer to be able to attract qualified employees as soon as possible. For instance, the period for application of a vacancy has been shortened from a month to 10 days, if an employer wants to invite a foreigner from a third country for employment.

In order to ensure development of the ICT sector and satisfy the demand of other sectors for ICT specialists, trilateral cooperation between national regulatory authorities, leading ICT companies and higher education representatives has been established in a targeted manner for Latvia to create an innovative interdisciplinary study programme in the ICT area. The Baltic IT bachelor of leader excellence programme *Computer Science and Organisation Technologies* was created by the University of Latvia and the Riga Technical University (RTU) in cooperation with the University at Buffalo (United States), and it is coordinated by RTU Riga Business School. 22 youths started studies in this programme in its first year (2019). In 2020, 32 new students were enrolled.

A joint IT education platform called Baltic IT Society or *BITS.education* has been created. The platform collects IT education programmes to promote the preparation in Latvia of new IT professionals, who are ready for the international market, and will create digital campaigns to attract students from foreign countries.

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. Specific support measures for those wishing to return, as well as networking and cooperation with the diaspora, are set out in the *Diaspora Law*, which entered into force in 2019.

It can be seen that remigration in 2020 was facilitated by the decisions made by the Latvian population to return to Latvia, which in the first wave of Covid-19 was one of the least affected countries with relatively milder safety and restrictive measures imposed by the government.

A targeted remigration support measure is a network of five regional remigration coordinators created by MoEPRD in 2018, 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. Remigrants had the opportunity to participate in the competition of

projects for receiving support for starting or developing economic activity in Latvia. The funding available per project in 2019 was increased to 10 thousand euro. With the support of coordinators, 577 families or 1.5 thousand people have returned to Latvia from March 2018 to July 2020. Furthermore, 14 projects have received financial support for economic activity in two years.

The SEA and IDAL also take measures to address potential remigrants by providing information and consultations, participating in events organised by the diaspora, etc. In order to develop Latvia's human capital and use the experience of the diaspora, including measures have been taken to promote diaspora involvement in export, investment attraction and knowledge and technology transfer.

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

PART II. ECONOMIC POLICY PRIORITIES

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

8.1. EUROPEAN SEMESTER

On 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: 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 draft every spring and to submit until the mid-April to the EC their *National Reform Programmes* along with *Stability* or *Convergence Programmes* (drafted 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 budget, because a large part of the measures is co-financed from the EU budget.

In order to ensure the implementation of the *Europe 2020* strategy and above-mentioned national programmes of EU Member States, as well as provide annual recommendations to EU Member States, an annual EU economic policy implementation supervision tool – the European Semester – was introduced on 1 January 2011 (see Figure 8.1).

Figure 8.1

European Semester Process

	November-February	March	April	May	June	July	September-October
European Commission	Annual Growth Survey and Alert Mechanism Report Publication of recommendations for the euro area	EC Country Reports on EU Member States		EC proposal for EU Council's recommen-dations to EU Member States			EU-level review
European Council / EU Council	Discussions				Discussion of recommen-dations	Approval of recommen-dations	
European Parliament	Discussions						
Member States		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, and these are *Annual Sustainable Growth Strategy*, *Alert Mechanism Report*, *Draft Joint Employment Report, Single Market Performance Report* and *EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area*. In the above-mentioned documents the EC evaluates the economic situation across 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 EU Member States and the EC at different meetings of the EU Council.

Taking into account that the *Europe 2020 strategy* is no longer relevant after 2020, as well as the rapid spread of the new coronavirus (hereinafter – Covid-19) worldwide and its negative impact on economic development, the EC has proposed changes in the coordination and monitoring of economic policies at the EU level, incl. in the European Semester process.

The European semester process 2021 will be adapted to address the existing Covid-19 crisis. Major changes in the European Semester process 2021 are related to the change in the deadlines for the publication of key documents related to the European Semester process, as well as the need for development of new documents, taking into account the launch of the EU multiannual financial framework for 2021-2027 and the need to link these two processes more closely. Thus, for instance, the *Annual Sustainable Growth Strategy* (see Box 8.1) was published on 17 September 2020, which is well in advance than the other documents (*Alert Mechanism Report* (see Section 6.8) and *EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area* (see Box 8.2), which were published on 18 November 2020.

Box 8.1

Annual Sustainable Growth Strategy 2021

The *Annual Sustainable Growth Strategy 2021* is based on the priority dimensions set in 2020 (environmental sustainability, productivity, fairness, macroeconomic stability), but also takes into account new challenges related to the need to overcome the Covid-19 crisis and the new EU long-term priorities approved under the *European Green Deal*, namely the need to promote the transition to climate neutrality (i.e. a modern, resource-efficient and competitive economy in which all greenhouse gases are neutralised by 2050 at the latest and economic growth is decoupled from resource use), and the digitalisation of the economy.

Taking into account the abovementioned, the EC's *Annual Sustainable Growth Strategy 2021* suggests EU Member States to focus on the implementation of the seven flagships and to plan national investments and reforms in the *National Recovery and Resilience Plans* to implement these flagships:

1. **power up** – future-proof clean technologies should be frontloaded and the development and use of renewables should be accelerated as well as their integration through modernised networks and enhanced interconnectivity;
2. **renovate** – improving the energy and resource efficiency of public and private buildings will substantially contribute to achieving the EU's climate objectives, create a large number of local jobs throughout the Member States and foster digital development through smart living and metering;
3. **recharge and refuel** – promoting future-proof clean technologies to accelerate the use of sustainable, accessible and smart transport, charging and refuelling stations and extension of public transport will make European cities and regions cleaner, accelerate the industrial transition and contribute to reaching the *Paris climate objectives*;
4. **connect** – citizens and businesses in Europe should have access to rapid broadband services;
5. **modernise** – EU-ID and key digital public services should be modernised and accessible to all;
6. **scale-up** – the EU digital transition depends on increasing European industrial data cloud capacities and on ability to develop the most powerful, cutting edge, and sustainable processors;
7. **reskill and upskill** – investments in human capital, incl. in re- and upskilling are central to supporting the green and digital transitions, enhancing innovation and growth potential, fostering economic and social resilience and ensuring quality employment and social inclusion.

Similarly, taking into account the Covid-19 crisis and the new EU multiannual financial framework for 2021-2027, EU Member States will have to draft *National Recovery and Resilience Plans* in the context of the new *EU Recovery and Resilience Facility* (see section 8.2). The EC urges EU Member States to submit draft *National Recovery and Resilience Plans* in the autumn 2020 in order to launch a bilateral dialogue on the necessary investments and reforms. The *National Recovery and Resilience Plans* are expected to be integrated into the National Reform Programmes, which will have to be submitted to the EC by April 15.

In 2021, the EC does not plan to draw up annual country reports and proposals for EU Council recommendations for those EU Member States that will have submitted *National Recovery and Resilience Plans* to the European Commission. The EC is planning only to draw up in-depth reviews for those EU Member States where macroeconomic imbalances have been identified within the *Alert Mechanism Report 2021* (see Section 6.8). Another major novelty to the European Semester 2021 will be related to the annual EU Council's country-specific recommendations. They will only be made for all EU Member States in terms of fiscal policy, in line with the requirements of the *Stability and Growth Pact*. In 2021, the EC is also planning to publish evaluations about the *National Recovery and Resilience Plans* submitted by EU Member States, which will be discussed in the EU Council between EU Member States and the EC.

In accordance with the European Semester process (see Figure 8.1), every year EU Member States should draft and by mid-April submit to the EC national programmes (the *National Reform Programme*, *Stability* or *Convergence Programme*).

Box 8.2

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

According to the *EC proposal for EU Council's Recommendations on the Economic Policy of the Euro Area* published on 18 November 2020, euro area Member States are urged to take action, individually, through their *Recovery and Resilience Plans*, and collectively within the Eurogroup, in the period 2021–2022 to:

1. **ensuring a policy stance which supports the recovery**. As the health emergency persists, fiscal policies should remain supportive in all euro area Member States throughout 2021. Policy measures should be tailored to country-specific circumstances and be timely, temporary and targeted. As downside risks continue to materialise, Member States should continue coordinating actions to effectively address the pandemic, sustain the economy and support a sustainable recovery. When the epidemiological and economic conditions allow, phase out support measures to firms and citizens in a way that mitigates the social and labour-market impact of the crisis, and pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. Euro area countries should pursue reforms that strengthen the coverage, adequacy, and sustainability of health and social protection systems. Euro area countries should pay particular attention to the quality of budgetary measures. Improve public financial management, including notably investment and green budgeting and public procurement frameworks. Make use of spending reviews to better focus public expenditure on recovery and resilience needs;
2. **further improving convergence, resilience and sustainable and inclusive growth.** Mitigate the risk of further divergence and enhance economic and social resilience in the euro area by implementing reforms that strengthen productivity and employment, ensure a smooth allocation of resources and improve the functioning of markets and public administration, and by increasing the level of public and private investment to support the recovery consistent with fair and inclusive green and digital transitions. Further integrate the EU single market for goods and services, including digital, by removing unnecessary restrictions, enhancing market surveillance and guaranteeing sufficient administrative capacity. Ensure effective active labour market policies and support to job transitions, notably towards the green and digital economy. Foster fair working conditions and address labour market segmentation. Ensure the effective involvement of social partners in policy making, strengthen social dialogue and collective bargaining. Strengthen inclusive education and training systems and investment in skilling, addressing skills shortages. Continue working on a global consensus-based solution to address the tax challenges arising from the digitalisation of the economy within the Organisation for Economic Co-operation and Development (hereinafter – OECD) framework and stand ready to move ahead with action at the EU level by June 2021. Make further progress to combat Aggressive Tax Planning, lower the tax wedge and support a shift in taxation towards carbon pricing and environmental taxation;
3. **strengthening national institutional frameworks.** Pursue and frontload reforms to address bottlenecks to investments and to ensure the efficient and timely use of EU funds, including of the Recovery and Resilience Facility. Strengthen the effectiveness and digitalisation of public administration, including justice and health systems, as well as public employment services. Reduce the administrative burden for firms and improve the business environment. Put in place effective frameworks to counter fraud, corruption, and money laundering. Promote concrete actions to increase the efficiency, effectiveness and proportionality of insolvency frameworks and ensure an efficient allocation of capital;
4. **ensuring macro-financial stability.** Maintain the credit channels to the economy and measures to support viable companies as long as necessary during the emergency of the unprecedented crisis. Keep sound bank sector balance sheets, including by continuing to address non-performing loans, in particular through the development of secondary markets for non-performing loans;
5. **completing the EMU and strengthening the international role of the euro.** Make progress on deepening the Economic and Monetary Union to increase the resilience of the euro area by completing the Banking Union and Capital Markets Union and through initiatives implementing digital finance, retail finance and sustainable finance policies. Increase the efficiency, proportionality and overall coherence of the bank crisis management and depositor insurance framework, including robust Banking Union safety nets as short-term priorities. Progress in these areas will contribute to enhancing the international role of the euro and promote better Europe's economic interests globally while fully respecting the Union's internal market.

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

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 growth of GDP in the medium term by 4-5% and a high 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 for 2020, it is planned to achieve an employment rate of 73% in the population aged 20-64, to increase investments in research and development (R&D) to 1.5% of GDP, to increase the share of the 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 and timeline, the Cabinet of Ministers approved the ninth ***Progress Report on the Implementation of the NRP of Latvia*** (hereinafter – Progress Report) and *Latvia's Stability Programme for 2020-2023* on 30 April 2020. Both documents were submitted to the EC on 30 April 2020.

The Progress Report contains an updated medium-term macroeconomic scenario described in the NRP of Latvia, provides an insight into the main measures adopted and implemented by the government to mitigate the impact of the Covid-19 crisis, evaluates the progress of Latvia in addressing the recommendations issued by the EU Council in 2019, provide a short description of the progress in the achievement of the *Europe 2020 strategy* targets and the UN sustainable development goals, gives a more detailed description of policy directions reflected in the NRP of Latvia, including national quantitative targets of Latvia in the context of the *Europe 2020 strategy* (see Table 8.1), and, where applicable, reflects information on the fulfilment of the UN sustainable development goals, reflects information on the use of EU funds, includes information on the involvement of institutions and social partners in the implementation of the NRP of Latvia and the preparation of the Progress Report.

Table 8.1

Progress Towards the Achievement of Latvia's Targets in the Context of the Europe 2020 Strategy

	Fact	Target 2020
Employment rate (population aged 20-64, %)	77.4	73.0
Investment in research and development (R&D), as per cent of GDP	0.64	1.5
Tertiary education (share of population aged 30-34 having completed tertiary education, %)	45.7	34-36
Share of early school leavers aged 18-24, %	8.7	10.0
Share of people at-risk-of-poverty, %	22.9	21.0
Energy efficiency (energy savings compared to 2008, Mtoe)	0.602	0.67
Share of renewable energy in the final consumption of gross energy, %	40.3	40.0
Total greenhouse gas emissions, Mt CO_2 equivalent	12.2	12.2

As shown in the Table 8.1 Latvia has managed to exceed its national targets set for 2020 for the level of employment, the share of those who acquired tertiary education, the share of early school leavers, and the share of renewable energy. Latvia has reached its 2020 target for greenhouse gas emissions and is close to the achievement of the target for the share of persons at risk of poverty. The only target Latvia has failed to reach in the context of the implementation of the *Europe 2020 strategy* in 2010-2020 is the target related to investment in research and development.

When evaluating the national programmes submitted by the EU Member States and their implementation, on 20 May 2020 the EC published proposals for EU Council's country-specific recommendations for the EU Member States, which were approved by the European Council on 8 June 2020 after discussions at different EU Council's meetings (see Box 8.3). The European Semester of 2020 has been completed with the approval of these recommendations by the European Council.

Box 8.3

The EU Council's Country-Specific Recommendations for Latvia 2020

The following recommendations are made for Latvia for 2020-2021:

- take all necessary measures, in line with the general escape clause of the Stability and Growth Pact, to effectively address the Covid-19 pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. Strengthen the resilience and accessibility of the health system including by providing additional human and financial resources;
- provide adequate income support to the groups most affected by the crisis and strengthen the social safety net. Mitigate the employment impact of the crisis, including through flexible working arrangements, active labour market measures and skills;
- ensure access to liquidity support by firms and in particular small and medium-sized enterprises. Front-load mature public investment projects and promote private investment to foster the economic recovery. Focus investment on the green and digital transition, in particular on research and innovation, clean and efficient production and use of energy, sustainable transport and digital infrastructures;
- continue progress on the anti-money-laundering framework.

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

It should be noted that the *National Reform Programme of Latvia* and the *Stability Programme of Latvia* are being implemented in close cooperation with the European Commission. The progress on the implementation of both

programmes is being regularly discussed in the bilateral meetings between Latvia and the EC. The Ministry of Economics will continue monitoring the progress in implementation of measures reflected in the NRP of Latvia and EU Council's country-specific recommendations, and the information on the progress in the implementation of these measures will be included in the *Progress Report on the Implementation of the National Reform Programme of Latvia for 2021*, which will have to be submitted to the EC by 15 April 2021 together with the *Latvia's National Recovery and Resilience Plan* and the *Stability Programme of Latvia*.

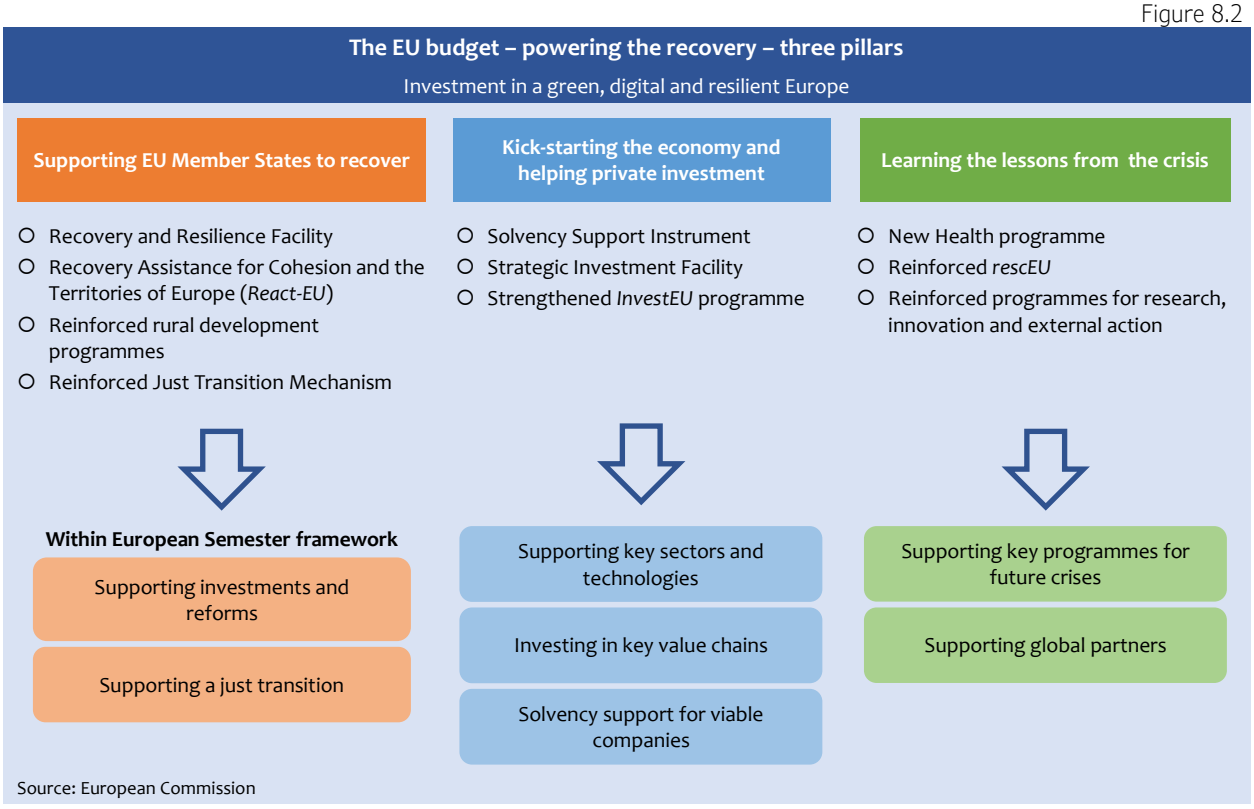
EU MULTIANNUAL FINANCIAL FRAMEWORK FOR 2021-2027

On 2 May 2018, the EC published the communication *"A Modern Budget for a Union that Protects, Empowers and Defends"*[1]. It marked the EC's vision of the new EU's multiannual financial framework for 2021-2027 (a detailed description of this communication is reflected in the Report on the Economic Development of Latvia for 2019). The Communication from the Commission of 2 May 2018 served as a basis for discussions between EU Member States and the EC on the new EU multiannual financial framework for 2021-2027. However, considering the Covid-19 pandemic and the related crisis, the EC was urged to present a revised EU multiannual financial framework for 2021-2027.

On 27 May 2020, the EC presented a revised proposal for the EU multiannual financial framework for 2021-2027 by publishing a communication ***"The EU budget powering the recovery plan for Europe"***[2]. The EU's long-term priorities to boost the green and digital transitions have been integrated in the new proposal for the EU multiannual financial framework for 2021-2027. These horizontal priorities are embedded into all instruments and programmes of the EU multiannual financial framework. The reviewed EU budget proposal is based on three pillars:

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

Figure 8.2



Source: European Commission

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

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

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

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

For EU Member States to be able to qualify for the funding from the *Recovery and Resilience Facility*, they will have to draft *National Recovery and Resilience Plans*, which will be part of *National Reform Programmes* and will have to be submitted to the EC by mid-April in accordance with the European Semester process (see Section 8.1). The EC urges EU Member States to take into account the EU Council's country-specific recommendations to EU Member States made in 2019 and 2020 when preparing their *National Recovery and Resilience Plans* and planning funding for the necessary investments and reforms. In order to ensure efficient and effective use of funding, specific milestones and targets to be reached will be set for each EU Member State within *National Recovery and Resilience Plans*. The funding to EU Member States is planned to be allocated in instalments. EU Member States will be able to receive the next portion of the funding, if they fulfil the set milestones and targets within the set time limits.

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

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

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

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

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

The total funding of the EU multiannual financial framework for 2021-2027 offered by the Commission is 1.850 trillion euro, which is historically the highest amount so far, of which 1100 billion euro will come from the EU multiannual financial framework, 750 billion euro will come from the new *European Recovery Instrument* (*Next Generation EU)* and 540 billion euro will come from the *Support to Mitigate Unemployment Risks in an Emergency (SURE)/European Stability Mechanism (ESM)*.

It should be noted that on 10 November 2020 the European Parliament and EU Member States reached an agreement in the EU Council on the EU multiannual financial framework for 2021-2027, incl. the *European Recovery Instrument (Next Generation EU)*.

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

The *Latvia's National Recovery and Resilience Plan*, which is currently under development, will be another important document in acquiring EU funding in Latvia in the context of the *European Recovery and Resilience Facility*. The plan will include investment projects and reforms for the purposes of promoting a more rapid recovery from the current Covid-19 crisis. The plan will be closely linked to the European Semester process, the fulfilment of EU Council's country-specific recommendations for Latvia and the National Reform Programme of Latvia.

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 and the Cohesion Fund, which are tools for the implementation of the EU's regional cohesion policy.

GENERAL CHARACTERISTICS IN THE 2014-2020 PROGRAMMING PERIOD

In accordance with the EU Council decision on the EU's multiannual financial framework for 2014-2020 Latvia has received 4.4 bln euro for the implementation of Cohesion Policy targets using EU funds (ERDF, ESF and CF). This means that in this period Latvia will be the fourth largest net beneficiary among all other EU Member States and will receive about 3 thousand euro per capita from the EU budget in the 2014-2020 period. Therefore, Latvia currently receives from the EU budget 4 times more than contributes into it.

It should be noted that the contribution of EU funds to the Latvian economy in 2020 has remained at the previous level, despite the challenges caused by Covid-19. According to the MoF's assessment, the contribution of EU funds to Latvia's GDP in 2020 will remain at the level of 1.2 percentage points as in the previous few years. According to a survey conducted at the end of 2019, the majority of Latvians surveyed (73%) consider the investment of EU funding in Latvia to be successful.

Until 23 November 2020, a total of 1878 EU funds investment projects are being implemented for the total amount of 3.7 bln euro or 84% of the available funding. The actually disbursed support of EU funds is 2.3 bln – 52% of the 4.4 bln euro available in the 2014–2020 programming period. Of which in nine months of 2020: 463 mln euro – 108% of the forecast. Which is by 13.4 mln euro more than in the comparable period in 2019.

Box 8.4 reflects the measures for the use of EU funding for the 2014-2020 programming period to overcome the consequences of Covid-19.

Box 8.4

Use of EU funding for the 2014-2020 programming period to overcome the consequences of Covid-19.

In 2020, the Cabinet of Ministers supported the use of EU funds for measures to promote economic recovery to overcome the consequences caused by Covid-19, as well as to reduce the negative impact of Covid-19 in the implementation of EU funds projects.

In 2020, the government supported a number of proposals for the use of EU funds and additional state budget over-commitments for measures to overcome the crisis caused by Covid-19 and promote economic recovery, as well as to reduce the negative impact of Covid-19 on EU fund projects.

According to this year's government decision of June 2, additional over-commitments of up to 70.44 mln euro have been granted for the implementation of EU funds in the fields of entrepreneurship, education and research and health care, taking into account the needs of economic recovery, investment efficiency and the amount to be financed from the state budget. Over 34.7 mln euro was allocated to business and energy efficiency, including 19.7 mln euro for employee training, and 15 mln euro for heat insulation of residential buildings. In the field of education and science, over-commitments amounting to 19.34 mln euro were allocated, including 11 mln euro for practical research, 0.48 mln euro for international projects in research and innovations, 7.86 mln euro for better governance of higher education. In the field of health, 16.4 mln euro were allocated to ambulance vehicles. 3 mln euro for educational institutions for ICT solutions are proposed to be financed from the state budget outside the EU funds programme.

Section 21 of the Law "On the Medium-Term Budgetary Framework for 2020, 2021 and 2022" stipulates in accordance with the decision of the Cabinet of Ministers to ensure the neutral impact of over-commitments on the general government budget balance by the end of the programming period. At the same time, in 2020, the maximum amount of over-commitments was increased by CM decisions from the previous 66.3 mln euro to 207.7 mln euro cumulatively.

On 20 July 2020, the EC approved the proposals submitted by Latvia for amendments to the European Union (EU) Funds Operational Programme "Growth and Employment", envisaging reallocation of funding to mitigate the effects of the Covid-19 crisis in the field of health, business and employment.

Box 8.4 continued

Only amendments have been submitted to the EC for approval, which, in accordance with the decisions taken by the government, provided for support measures to reduce the consequences of Covid-19 amounting to almost 500 mln euro. The amendments approved by the EC envisage directing 386 mln euros of EU Funds funding to work on economic recovery measures – fast-track projects. The EC is still being consulted on the allocation of 109 mln euro for specific projects in the transport sector.

A total of 386 mln euro of EU Funds funding has been reallocated to economic recovery measures. Financing from suspended railway projects of the Ministry of Transport for 100 mln euro will be allocated to strengthening health services (30 mln euro), loans and loan interest rate subsidies for investment projects of exporting companies (35 mln euro), support for employment measures (20 mln euro) and workforce qualification and reorientation measures (15 mln euro). Financing of energy efficiency projects under the Ministry of Economics of 4.5 mln euro will be diverted to the projects of municipal energy efficiency measures to be implemented in 2020.

The EC also supported proposals for reallocation of funding within sectoral ministries. Additional funding for economic recovery measures is planned at 17.8 mln euro, 42 mln euro for active employment measures and provision of social services, 10.7 mln euro for reskilling and upskilling of employees, general education infrastructure and development or adaptation of digital teaching and methodological aids, international cooperation in research and innovation. It is planned to allocate 37 mln euro for biodegradable waste measures, regional investments, as well as redistributions between information and communication technology projects. In turn, environmentally friendly public transport development projects and other MoT projects will receive 174 mln euro.

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

At the meeting of the Cabinet of Ministers on 30 June 2020, amendments to the EU funds support programme "To promote the increase of energy efficiency in residential buildings" were approved. Along with the amendments, the Development Financial Institution Altum has been granted additional funding in the amount of 35 mln euro **to increase the energy efficiency of multi-apartment residential buildings**, which will allow the implementation of projects that meet the conditions included in CM regulations, the applications for which were submitted to Altum before this January 11, but for which there was insufficient funding. Approximately 150 more multi-apartment buildings are expected to receive support (in the form of guarantees and grants) within the framework of this funding.

The completed building renovation projects so far show a significant reduction in energy consumption – before the house was renovated, the average energy consumption was 165 kWh per year, after renovation works it is on average 67% lower or 54 kWh per year, which is a significant saving for dwellers. By this January 11, when the acceptance of projects was suspended, a total of 885 project applications for the preliminary amount of 375 mln euro have been submitted to Altum.

In order to promote investments in Latvian industry and promote economic activity, at the sitting of 28 July 2020, the Cabinet of Ministers decided on 3.5 mln euro reallocation of unused funding from the first selection round for **creation or reconstruction of production premises and infrastructure** to the second selection round of projects. This will support a larger number of project applications submitted in the second selection round.

In the second project selection round, a total of 52 project applications were submitted to CFLA, but only 20 project applications could be approved within the funding available in the programme. Additional reallocated funding will help to effectively manage the funding available in the programme and will make it possible to support future project applications with the highest score.

Currently, the implementation of 14 projects continues within the first round of the programme, while 19 projects have already been implemented. In total, projects with a total investment of 18 mln euro have been completed within the project.

The EU funds support, 11.7 mln euro, intended **for the performance of reconstruction or renovation works that increase the energy efficiency of industrial production buildings and warehouses**, as well as the purchase of energy efficient production and ancillary equipment to replace existing, less energy efficient equipment. It is also envisaged that funding may be invested in the renovation, reconstruction or creation of building engineering systems, the recovery of secondary energy sources from technological production processes and the use of renewable energy sources, as well as the preparation of technical project documentation.

The opportunity to receive **EU funds co-financing for the issue of shares** has caused the greatest interest among entrepreneurs – CFLA has received eight project applications for the implementation of this objective. Of the available 800 thousand euro, 759.2 thousand euro or 95 percent have been requested.

The planned amount of private financing exceeds the total result planned in the programme by 9% – it is planned to attract 5.4 mln euro of private funding for the EU funds support, which is provided in the form of grants.

Table 8.2

Progress towards the implementation of EU fund programmes under the Ministry of Economics
as at 23 November 2020

	Support programme	EU funds funding (allocation) *mln euro*	Amount of payments *mln euro*	*Per cent of allocation*
1.2.1.1.	Competence centres	63.2	38.4	60.8%
1.2.1.2.	Technology transfer system	30.0	6.1	20.3%
1.2.1.4.	Introduction of new products	52.6	20.4	38.7%
1.2.2.1.	Employee training	14.7	6.8	45.9%
1.2.2.2.	Motivation for innovation	4.8	2.7	56.6%
1.2.2.3.	ICT and non-technological training	6.9	1.9	26.9%
3.1.1.1.	Loan guarantees	43.8	27.6	63.0%
3.1.1.2.	Mezzanine loans	7.0	5.2	74.0%
3.1.1.3.	Support for attracting financing for small and medium-sized enterprises in the capital markets	1.0	0	–
3.1.1.4.	Microcredits and start loans	5.0	3.7	74.0%
3.1.1.5.	Production premises	49.0	13.8	28.1%
3.1.1.6.	Business incubators	23.9	10.4	43.5%
3.1.2.1.	Venture capital	30.6	22.6	74.0%
3.1.2.2.	Technology accelerator	14.6	10.8	74.0%
3.2.1.1.	Cluster programme	6.2	4.7	76.5%
3.2.1.2.	International competitiveness	69.3	36.6	52.8%
4.1.1.	Energy efficiency of manufacturing enterprises	23.7	10.2	42.8%
4.2.1.1.	Energy efficiency of multi-apartment buildings	141.5	72.0	50.9%
4.2.1.2.	Energy efficiency of public buildings	93.4	40.3	43.1%
4.3.1.	Energy efficiency of district heating	49.6	36.5	73.5%
Total		**730.9**	**370.6**	**50.7%**

8.3. EU SINGLE MARKET

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

The EU Single Market still 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. On 10 March 2020, the European Commission published several communications (the so-called March Package) outlining the new EU's industrial strategy, a strategy for small and medium-sized enterprises, long-term action plan for better implementation of the rules of the Single Market and providing an analysis of the residual barriers in the Single Market.

The long term action plan for better implementation of Single Market rules[3] provides for future-oriented approach to single market which aims to liquidate residual unjustified obstacles, prevent the occurrence of new obstacles, in particular with regard to freedom of provision of services and digitalisation. The action plan provides for 22 specific, cross-integrated action initiatives, which may be structured into 6 categories: 1) increasing knowledge and awareness of single

[3] https://eur-lex.europa.eu/legal-content/LV/TXT/HTML/?uri=CELEX:52020DC0094&from=EN

market rules; 2) improving the transposition, implementation and application of EU rules; 3) making the best use of preventive mechanisms in relation to new national draft legislation to preventively remove any unnecessary obstacles and creation of administrative requirements to free circulation of goods and services; 4) better detection of goods not complying with EU safety and other manufacturing requirements inside the single market and at the external borders to prevent their sale to consumers; 5) strengthening cooperation between the European Commission and market surveillance authorities of Member States, as well as strengthening the role of SOLVIT as alternative dispute resolution tools and 6) closer dialogue with Member States to explain the substance of adopted EU laws and reduce instituted infringement cases against Member States.

In accordance with Articles 34-36 and 49-62 of the *Treaty on the Functioning of the European Union* (TFEU), the MoE supervises and coordinates the freedom of provision of goods and services and the right to do business in Latvia. 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** is available on the MoE website for better governance of the EU Single Market providing all the information on different EU information and aid services. The main purpose of the EU Single Market Centre is to help businessmen to use all the advantages related to the EU Single Market, as well as to provide practical assistance in relation to the limitations of the freedom of provision of goods and services.

The **technical regulations notification** serves as a preventive, 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 draft laws prepared by any Member State, which might potentially affect that economic operator's product exports or cross-border provision of information society services. The draft technical regulations notified by Member States are freely available in the *database of the Technical Regulations Information System (TRIS)*[4], where information on drafts is available 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 EEA countries at national, regional and local level in a fast and effective way. Using the IMI system, authorities of Member States can verify the information indicated in applications of legal entities and individuals, authenticity of documents issued in other Member States, and clarify other 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. MoE is the national coordinator of the IMI system in Latvia. IMI helps to implement 67 administrative cooperation procedures in 17 different policy areas.

For example, the *Services Directive (2006/123/EC)* 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. 126 Latvian responsible authorities are registered in the IMI system in different areas – 63 authorities deal with the services area, 29 – with professional qualifications, 9 – with posting of workers, 5 – with patients' rights, 1 – with e-commerce, 2 – with train drivers' licences, 31 – with 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 or EEA Member State. From 2017, requests with regard to *EU type-approvals* for non-road transport machinery are processed under *Regulation 2016/1628*. Furthermore, from 2018, information requests and notifications are processed in the cross-border context under the *General Data Protection Regulation (Regulation 2016/679)*, which helps to ensure higher data protection. Similarly, 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 are processed, which facilitates the exchange of information on respective public procurements and contribute to faster evaluation of tenderers. Since September 2019 IMI has been processing requests for arms shipments and issuing of licences. In 2020, a consumer protection cooperation module was created, and a module for resolution of cases and exchange of information within the European Judicial Network was introduced.

From January to October 2020 Latvia sent 156 information requests to other Member States within the IMI system: 150 in the professional qualifications area, 3 in the public procurement area, 2 in the services area and 1 in the patients' rights. Latvia received 121 information requests: 118 in professional qualifications area, 1 in the service area, 2 in the patients' rights.

[4] http://ec.europa.eu/growth/tools-databases/tris/lv/search

SOLVIT Centre – an alternative EU Single Market problem solution network, created by the EC and the Member States, has been operating in Latvia since 2004. Its task is to find a fast and practical solution of the EU Single Market's problems caused by decisions adopted by public authorities in case of incorrect application of EU law. In situations, when a resident or a businessman is harmed by wrongful decisions taken by responsible authorities of other Member States, the SOLVIT Centre operates as a free problem-solving tool. There are SOLVIT Centres in each EU/EEA Member State. From January to October 2020 the Latvian SOLVIT Centre received 29 complaints as a Home Center on problems of Latvian citizens in the EU countries and 9 complaints as a Lead Center on problems of EU citizens in Latvia. To submit a complaint to the SOLVIT Centre, the case must meet the following criteria: 1) the decision has been taken by a public authority; 2) the public authority is located in another Member State (cross-border element); 3) EU's legal norms (regulations, directives, etc.) have been violated. Most frequently the Latvian SOLVIT Centre solves 1) cases of individuals related to social benefits and issues of residence permits, 2) 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 information necessary for business is available electronically, as well as e-services are available in one place on the portal of Government Services *www.latvija.lv*. 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 the provision of 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. Information about life situations, interinstitutional information and functionality in the section for the population is cooperated by SRDA in cooperation with institutions involved, but the section for companies – by MoE (see Chapter 9).

9. IMPROVEMENT OF THE BUSINESS ENVIRONMENT

Measures for improvement of the business environment in Latvia have been implemented since 1999. The Ministry of Economics, with the participation of a wide range of sectoral ministries and organizations representing entrepreneurs, prepares the Action Plan for Improvement of the Business Environment (hereinafter referred to as the Business Plan), which is updated and approved by the government every other year. The Business Plan is a business policy making tool, which hears and solves the problems identified by businesses, and it has so far helped to introduce more than 560 different measures for improvement of the business environment. 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 2020 rating Latvia is placed 19th among 190 countries. On 22 May 2019, CM approved the current version of the Business Plan for 2019-2022(see Box 9.1) aiming to create an attractive business environment for businesses: affordable and clear services, smaller administrative burden, and including 40 measures, which have effect also on Latvia's indicators in the World Bank's Doing Business study.

Box 9.1

Action Plan for Improvement of the Business Environment 2019-2022

Basic principles included in the Business Plan approved by CM on 22 May 2019: customer-oriented public administration, digitalisation of services, competitiveness of the tax system, openness of the business environment, legality, promotion of innovation. Special attention is drawn to promotion of innovation, human capital and protection of investor rights, which are important components of a developed business environment.

The Business 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 Business Plan has been developed in close cooperation with public institutions and organisations representing businesses, includes measures developed based on the challenges identified by social, cooperation partners and public institutions, as well as taking into account the challenges noted in Doing Business and the Global Competitiveness Index. At the same time, the action lines identified in the recommendations prepared on an annual basis by the Foreign Investors' Council in Latvia and reflecting the challenges identified by foreign investors in Latvia have been taken into account.

MoE 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 Business Plan.

Given the resource and time-consuming nature of the existing Business Plan process, it is necessary to create a more efficient model for identifying and administering business environment improvement measures. The new process needs to be developed as a tool for reducing administrative burden, including through the process of developing and administering business environment improvement measures with a view to developing solutions to identified problems as efficiently and quickly as possible and facilitating cooperation between the parties (institutions) concerned. The new process for identifying and administering business environment improvement measures should be swift and targeted, based on the agreement of the departments, rather than on the approach that the tasks to the institutions are determined by a CM decision. The basic functions of the Business Plan will not be changed, it will be replaced by a more efficient process (the process of identifying and administering measures), replacing the existing policy planning document with a digital

environment, establishing feedback and allowing continuous follow-up to the progress of the implementation of the measures. The new process is intended to be developed as a continuous process of improving the business environment, inviting natural and legal persons, organisations representing the industry and public administration authorities to make suggestions to MoE or other sectoral ministries on new business environment improvement measures throughout the year.

REDUCTION OF BUREAUCRACY

As of 1 November 2019, national regulatory authorities have started to apply the Zero bureaucracy principle in the process of drafting of regulatory enactments. The purpose of the approach is to stop the increase in administrative burden on businesses. Furthermore, when submitting a draft regulatory enactment that increases administrative burden or creates new compliance costs for businesses for approval to CM, the ministry should at the same time submit a draft regulatory enactment, which reduces administrative burden or cancels compliance requirements in an equivalent scope for the same target group.

MoE, when evaluating draft regulatory enactments through the business environment, shall evaluate this and see that no additional administrative burden is created for businesses.

INITIATIVE "AN OFFICIAL SHADOWS AN ENTREPRENEUR"

In order to improve the business environment, in 2020 MoE in cooperation with LCCI, ECL and Junior Achievement Latvia (JAL) organised the initiative "An official shadows an entrepreneur" for the second time. The prototype of the initiative was developed by the Public Administration Innovation Laboratory of SC in cooperation between experts of all the stakeholders.

In the public space, we often see stories of businessmen on different approach to the interpretation of regulatory enactments and the attitude of supervisory institutions. The initiative "An official shadows an entrepreneur" makes it possible for the functionary to gain new experience, to extend own range of vision, "to step into entrepreneur's shoes" and to assess how the regulation is applied in practice and what needs to be improved in future work. It also strengthens the application of the "Consult first" principle in supervision even more, encourages dialogue between the state and the economic operator and reduces the administrative burden. The purpose of the initiative is to enable the developer of laws and regulations to assess the functioning of the legislation developed by them as an implementer directly in the user's place, as well as exchange experience.

Within the framework of the initiative, the functionary means any public administration employee (not just an official). In turn, businesses are able to apply within the initiative their idea or achievement or even a problem, participate in its evaluation without an intermediary and to start its resolution with a responsible public administration employee. Similarly, during the meeting businessmen can get a functionary's consultation, an advice for resolution of a topical problem, as well as to make recommendations for the improvement of work processes in public administration and for the improvement of regulatory enactment, and thus participate in drafting of regulatory enactments. Overall, more than 60 companies and more than 150 functionaries participated in the initiative.

IMPROVEMENT OF THE INSOLVENCY REGULATION

Different reforms to improve the business environment are constantly performed in the field of insolvency. In 2019, including by implementing the Guidelines for Insolvency Policy Development for 2016-2020 and their plan, public awareness of the legal protection process and insolvency proceedings was promoted, the competence of the Solvency Control Service and the State Police was strengthened, the legal framework for insolvency was improved and the reform of the insolvency administrator's profession was completed.

In 2020, work was continued on promoting economic activity of businesses and the population and creating an attractive business environment, focusing on the second chance for individuals and legal persons, including taking into account the recommendations contained in the International Monetary Fund's Evaluation of the insolvency framework in Latvia and the Directive on restructuring and insolvency, which should be introduced by Latvia and other EU Member States by 17 July 2021. The insolvency regulations are improved for the implementation of these recommendations and the requirements of the Directive, and work continues on the implementation of Interreg Baltic Sea Region transnational cooperation programme project "RestartBSR" "("Restart SMEs in the Baltic Sea Region") started in 2019. The purpose of the project is to build institutional capacity for representatives of the innovation area to support businesses in financial difficulty. Capacity building activities will ensure smaller number of insolvency proceedings in such companies, foster performance of the Baltic Sea Region in non-technological innovations and increase the number of companies able to resume business, which will, in turn, result in total growth of the region, as well as preservation of jobs and increase in their number. To

achieve the goal, best practices were analysed, tools for supporting companies in financial difficulties were developed, as well as processes for the development of recommendations for policy implementers for further actions to handle the existing situation are organised.

INTRODUCTION OF THE "CONSULT FIRST" PRINCIPLE

In progress towards an excellent business environment in Latvia, work is gradually being carried out for the targeted implementation of the "consult first" principle in the activities of supervisory authorities. The purpose of introducing the "Consult first" principle is to change the behavioural culture of inspecting and controlling authorities from primarily repressive to supportive. The implementation of the principle contributes to compliance with the requirements of regulatory enactments and therefore fairer competition in the market, thus creating a stable business environment favourable for investments. A healthy and competitive business environment is based on fair businessmen, who want to observe the requirements of regulatory enactments and institutions, which are able to balance interests of society and business in their supervisory activities.

In 2017, MoE in cooperation with supervisory authorities developed the "Consult first" guidelines, which included recommendations for good practice by both foreign and Latvian supervisory authorities and examples for improving cooperation between supervisory authorities and entrepreneurs for the purposes of promoting joint understanding, and a memorandum of cooperation was signed where the authorities pledge to comply with the principles contained in the "Consult first" guidelines.

In order to ensure effective implementation of the "Consult first" project, an assessment of the progress of supervisory authorities in introducing the "consult first" principle in institutional work and customer service was carried out for three consecutive years on the basis of a dedicated methodology. The assessment data show that the policies implemented in recent years have been successful and that the "consult first" principle has integrated well in public administration. Institutions as a whole successfully implement the "consult first" principle – promote compliance with the fulfilment of set requirements, providing the necessary support and punishment is not their primary objective. In 2020, customers (entrepreneurs) have assessed their cooperation with most of the institutions involved in the initiative with 85 and more points (on a 100-point scale). Overall data dynamics show positive trends in customer opinions on public authorities in almost all matters. Entrepreneurs confirm that employees of supervisory authorities cannot be influenced in decision-making, apply and interpret regulatory requirements consistently and uniformly and impose sanctions proportional to infringements. Entrepreneurs appreciate that their voluntary activities to prevent non-compliance are often supported and a "leniency" regime is applied to the introduction of new legal requirements, recognise that authorities use modern and customer-friendly channels for the transfer of information, and mainly evaluate communication as kind and responsive. The average index for the assessment of the implementation of "consult first" in 2020 was 83.51 (of 100 index points). To compare: 79.59 in 2019, 78.15 in 2018.

For more successful achievement of project objectives to promote support and understanding of "consult first" initiative among supervisory authorities, institutional clients (entrepreneurs) and the general public over the last two years, depending on the willingness of each institution to engage, various activities were implemented to improve internal and external communication across different channels, embedding and strengthening the values of the initiative, and awareness of the "consult first" principle. As a result, the "consult first" initiative has succeeded in creating a positive movement, which other institutions have shown their willingness to join over time. In 2019, six institutions joined the initiative and also apply the "consult first" principle in their work moving towards improving cooperation between entrepreneurs and public administration in order to promote the fulfilment of the requirements applicable in the country.

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

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

DIGITALISATION OF THE BUSINESS ENVIRONMENT

One of the priorities in creating an excellent business environment is to promote the use of digital solutions in business, the digitisation of public services, to improve the competences of public authorities in the field of digitisation and to provide the necessary infrastructure for the development of digitisation (see also Chapter 10).

Modern digital technologies (broadband, big data, data centres, cloud services, artificial intelligence, etc.) create unprecedented opportunities for improvement of existing processes, procedures, development of new products and services, and process analysis and optimisation. At the moment, however, Latvian companies are significantly lagging behind in the use of digital technologies, entrepreneurs lack digital skills and the necessary knowledge, skills and proper tools for transformation (such as productivity tools for digital trade, online cross-border trade, etc.) compared with OECD member states. Although Latvia exceeds the OECD and EU average after the deployment of the high-speed broadband network, only a few Latvian companies use new digital technologies, such as analysis of large databases, radio frequency identification technology, etc.

It should be noted that the results of a study5 published by the European Commission show that nearly 40% of surveyed Latvian companies use at least one artificial intelligence technology, which is close to the EU average (40%). Latvia is significantly ahead of Estonia (27%), but still lags behind Lithuania (54%). The European Commission emphasises that improvements in the integration of digital services by businesses is limited by the shortage of high-skilled professionals. To make Latvian SMEs use digital opportunities more, it would be important to reduce the factors hindering development. Industry association leaders, for example, acknowledge that the main barriers to a more active digital transformation of companies are a lack of free finances in companies, as well as insufficient knowledge of the digital solutions available.

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

An increasing number of citizens are making use of online banking and e-administration services but half of the population still has no or low digital skills. Improving citizens' digital skills is a prerequisite for creating inclusive labour markets, and for increasing the productivity of the companies that currently enjoy very little digital benefits. Regions still have untapped potential for broadband-optic internet connectivity, which would provide reliable and fast digital infrastructure for businesses, as well as remote job opportunities for employees. Despite the availability of basic infrastructure in regional centres, the provision of electronic communications services to citizens in regions is still not possible until the "last mile" connection and adequate service provision policy are provided.

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

In 2020, in order to promote the development of the Latvian business environment, MoE started to draft the National Industrial Policy Guidelines for 2021-2027 aimed at offering a clear vision for the reallocation of public resources in favour of more productive growth of future sectors, industries and ideas, less – for maintaining unproductive structure of the national economy by providing support for the development of an innovation culture and creation process creating a range of global-level knowledge transfer support instruments, which contribute to the creation and development of new potential knowledge and ideas, contributing equally to the productivity and competitiveness of the business environment.

SINGLE INFORMATIVE PORTAL WWW.LATVIJA.LV

Since 2020, the State service portal www.latvija.lv has also been fulfilling the function of a single contact point for electronic products by implementing Regulation (EU) 2019/515 of the European Parliament and of the Council on the mutual recognition of goods lawfully marketed in another Member State and repealing Regulation (EC) No 764/2008 and Regulation (EU) 2018/1724 of the European Parliament and of the Council establishing a single digital gateway to provide access to information, to procedures and to assistance and problem-solving services and amending Regulation (EU) No 1024/2012. This contact point provides information on the mutual recognition of products, general product rules, product technical rules, remedies and market surveillance authorities in the non-regulated product area in Latvia. By the end of 2020, such single contact points for products should be established in all EU Member States (see Section 8.3).

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

The main principles of operation of the Portal are defined in the Information Society Development Guidelines for 2014-2020, and the legal regulation is stipulated in several CM regulations. In cooperation with MoEPRD, work has started on the introduction and implementation of Regulation (EU) 2018/1724 of the European Parliament and of the Council of 2 October 2018 establishing a single digital gateway to provide access to information, to procedures and to assistance and problem-solving services and amending Regulation (EU) No 1024/2012.

As of 14 October 2020, virtual assistant Eric also helps visitors of the State service portal www.latvija.lv. With the help of the virtual assistant, visitors to the portal have the opportunity to ask questions and get answers about different e-services and life situations. According to the studies, virtual assistants are able to answer up to 80% of routine questions, thereby reducing the amount of such questions in the user support service. For the purposes of calculations, it is assumed that the virtual assistant on www.latvija.lv will initially be able to resolve up to 60% of routine questions. The implementation of this solution will reduce the number of support service applications related to standard problems on www.latvija.lv. The knowledge base of the virtual assistant was developed by employees of the State Regional Development Agency on the basis of citizens' questions received by the portal's support service. Every visitor to www.latvija.lv can help Eric get smarter, because only the use of the virtual assistant will promote the diversity of answers. Introducing the virtual assistant on www.latvija.lv is a logical step towards a friendlier and more comfortable environment for e-service users. However, work on the development of www.latvija.lv has not been stopped, it is planned to further develop various available e-services, improve the functionality and design of the portal making the portal as friendly, proactive and user-oriented as possible.

As the digital modernisation of public administration continues, particularly as regards digital access to services provided by public administration, MoEPRD in cooperation with MoE and other public authorities have started the transformation of the Portal, creation of a new design to enable the population and companies to easily and conveniently find necessary information and receive public services electronically. In order to foster improvement of functionality and the quality of content of the business section of the Portal, MoE in cooperation with other ministries and their subordinated institutions in 2020 updated information about available services in a user-friendly way and in accordance with the requirements of the Services Directive and the Single Digital Gateway Regulation on www.latvija.lv. Work on the new version of the www.latvija.lv is expected to be completed in 2023.

10. INNOVATION AND NEW TECHNOLOGIES

An important precondition for transition to innovative economy is strengthening of the Latvian innovation system by eliminating its deficiencies and facilitating mutual cooperation between all subjects of the innovation system – businesses, science and education, as well as financial and legislative systems.

The European Innovation Scoreboard assessment 2020 has moved Latvia up to the 23rd place among 27 EU Member States included in the research, compared to the data of the report for 2019, at the same time keeping its position in the "moderate investors" group, where performance in the area of innovations is 50-90% of EU average level.

The Summary Innovation Index of Latvia has increased by 23.3 percentage points (EU average – 8.9 percentage points) since 2012, which is one of the highest increases in the index among member states. However, the achievement of innovation development and policy planning goals in Latvia is hindered by low investments in research and development, in particular in the business sector (8.9% of the EU average in 2019).

Latvia's total expenditure on R&D amounted to 195.1 mln euro in 2019 and constituted 0.64% of GDP. It rose by 4.8%, compared to 2018. Investments of businesses in R&D also increased by 13.9% affected by the implemented R&D measures for promotion of innovation in state capital companies, as well as measures to promote innovation in SMEs. Overall, the structure of R&D financing evidences that investments in research and development in Latvia depend on ESIF funding.

Private sector investments in R&D have been low in Latvia for a long time. From 2011 to 2019 investments of businesses in R&D amounted on average to 23.4% of total investments in R&D (0.14% of GDP). This indicator significantly lags behind EU Member States, where businesses provide more than half of total investments in R&D (in 2018: EU-27 – 58.9%; Latvia – 23.3%). Similarly, private sector investments in the sector of higher education and science in Latvia are insignificant, which is an evidence of insufficient cooperation between businesses and scientists.

Low activity and capacity of Latvian businesses in R&D is largely affected by the existing economy and business structure – low share of high and medium high-tech businesses in the Latvian economy. The data provides evidence that the target set for private sector investments in R&D in 2020 (48% of total investments in R&D) has not been reached.

Between 2016 and 2018, 32.9% of all Latvian companies were innovative, which is 2.6 percentage points more than in the previous period (2014-2016), however this indicator is lagging behind the average in the EU countries (2014-2016: EU-27 – 49.5%). The turnover of innovative companies in the total turnover of companies increased by 6.4 percentage points over this period reaching 59.7%, indicating that demand for the products of innovative companies or services has increased.

Overall, the share of innovative companies has been exceeding 30% of the total number of companies since 2016. The current trends have also been positively influenced by public intervention in the form of various actions, including information campaigns, support programmes, regulatory frameworks and improvements in the business environment.

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

IDAL, 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.

The *Technology Transfer Programme* provides an opportunity to commercialise or convert into new products and services the results of research funded from public resources, and the private sector will thus ensure further development and introduction into market of the research results. Moreover, the purpose of the *Technology Transfer Programme* is to make a contribution to the achievement of the goals of the *Latvian Smart Specialisation Strategy*, foster commercialisation of state-funded research results available to research organisations in Latvia and abroad, as well as to promote innovation activities in small and medium-sized enterprises, including in start-ups through technology transfer. Thus, companies get support for new or substantially improved product of technology development. By now 100 projects for commercialisation of ideas have received support, 282 agreements for support to start-ups in participation in exhibitions and visits to potential investors, as well as 130 innovation voucher agreements have been concluded within the scope of the *Technology Transfer Programme*. It is planned to continue these activities to support economic operators and research organisations in 2021.

CREATION OF START-UPS

Development of start-ups is an important chain link in the innovation system and promotes the change of the paradigm to modern and innovative economy. Over the last years the MoE and the bodies subordinated to it have been actively working on the creation of uniform supply for the start-up ecosystem. The Latvian start-up ecosystem has become more visible also in the international context. Every year several local events and festivals with international coverage bring together start-ups and their representatives. In 2020, work on the improvement of the regulatory framework for the start-up eco-system continued, taking into account the results and recommendations of the *Start-Up Ecosystem Study* conducted in 2019. On 3 September 2020, the Saeima adopted amendments to the *Law on Aid for Activities of the Start-up Companies*, which provides for the facilitation of the qualification requirements for start-ups and the mitigation of the limitations set out in the programme, provides for the possibility of qualifying for support also for start-ups which, in order to receive a venture capital investment, founded a related company abroad. Given that the process of developing a business idea may be longer than five years for individual start-ups, the amendments increase the age since their registration in the Commercial Register as one of the qualification criteria. It is intended to reduce the requirement for employees in a start-up with a master's or doctoral degree from 70% to 50%. It is intended to cancel employment restrictions with other undertakings (to support the recruitment of highly qualified employees). It is envisaged that, in the future, not only autonomous undertakings will be supported, but also those whose shareholders own other undertakings. It is envisaged to extend the aid period from 12 months in the current version of the law to 24 months. It is envisaged to cancel the requirement to suspend employment in other companies before the start-up receives the decision granting the aid and allowing start-ups to apply for the support programme repeatedly, including where no early-stage venture capital investment has been made.

In 2020, work on the amendments to related regulatory enactments also continued – amendments to CM Regulations No.74 of 7 February 2017 "Procedures for the Submission of Applications of Aid Programmes for Start-up Companies and Administration Thereof", amendments to CM Regulations No.30 of 17 January 2017 "By-Laws of the Commission for Evaluation of Start-up Activities" continues to integrate the requirements of the amendments to the *Law on Aid for Activities of the Start-up Companies* adopted by the Saeima. In addition, work on other related amendments is ongoing, for example, amendments to the Law "On Personal Income Tax" and the Commercial Law for the purposes of introducing a competitive regulation for options over shares. The current commercial law regulation in Latvia provides for the possibility to grant share purchase rights only to joint-stock companies, however, it is not intended for start-ups or other fast-growing companies operating, for example, in the field of ICT, whose chosen commercial form is a limited liability company. The tax exemption provided for in the Law on Personal Income Tax is applicable only in respect of the share purchase rights granted to joint-stock companies. Consequently, the wider use of the right to purchase capital shares as an incentive for employees requires legislative amendments. The Saeima also adopted directed proposals for amendments to the *Immigration Law* regarding the receipt of temporary residence permits for start-up founders from third countries.

In 2020, activities arising from the cooperation agreement concluded between the Ministry of Economics and the Latvian Startup Association, the Latvian Private and Venture Capital Association and the Latvian Private and Venture Capital Association on the basis of CM decree No. 538 of 5 November 2019 "On the reallocation of the appropriation between the budget programmes and sub-programmes of the Ministry of Economics" continue. Cooperation agreements provide for the implementation of measures to promote the ecosystem of start-ups until 31 December 2020.

In continuation of the cycle of discussions started in 2019, from 17 June to 26 August 2020 MoE in cooperation with the Helve innovation strategy company organised a cycle of six online discussions "#21gsLatvija" – live broadcasts are also provided on the LSM public media portal. The following topics were discussed there with participation of representatives of the private and public sector and experts: "Digital transformation" on challenges to digitisation in the public sector; "Is Latvia a digital country?" on challenges to digital transformation in public administration; "No export, no economy" on export challenges under the effects of Covid19; "Open for Business" addressing the current news in starting businesses, and the topic of challenges to the future economy.

COMPETENCE CENTRE PROGRAMME

One of the most important tasks is to build understanding of companies about research, development and innovation as drivers of growing productivity and competitiveness of companies. The purpose of *activity 1.2.1.1 "Support for Development of New Products and Technologies within the Competence Centres" of specific objective 1.2.1 "To increase investments of private sector in R&D" of the Operational Programme "Growth and Employment" (Activity 1.2.1.1)* is to increase competitiveness of economic operators by promoting cooperation between the research sector and the industrial sector when implementing projects developing new products and technologies and introducing them in production. The main challenges of activity 1.2.1.1 are to ensure the achievement of investment results and active involvement of beneficiaries of funding in the creation of international and intersectoral platforms. 10 competence centres received support as a result of selection of projects within the *Competence Centre Programme*. The total funding of the programme is 78.7 mln euro, incl. ERDF of 63.2 mln euro, including by raising private sector funding for research and development of at least 46.7 mln euro.

191 research projects were approved within the second round, of which 174 were completed. 149 performers of economic activities received support as at 31 December 2018. 492 new jobs, incl. those employing scientific employees in the public sector, were created within the scope of the *Competence Centre Programme*. 175 masters and doctors are involved in the implementation of research projects. 238 scientific articles were published in journals indexed in international databases (Scopus, Web of Science). The raised private sector funding is 24.5 mln euro.

As at October 2020, 186 research projects have been approved, including more than 74 intersectoral research projects, within the scope of the fourth round. The co-funding of companies involved in R&D projects in October 2020 was 11.5 mln euro. 138 performers of economic activities received support within the scope of the fourth round. The programme provides a perfect opportunity to study good innovation practices. The contributions received from ERDF have increased the number of innovations, productivity, export capability and other indicators, which considerably increase general competitiveness of industries.

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

In the future, digital transformation of companies, investment in research and development of new products or technologies will play an increasingly important role in promoting competitiveness. In particular, emphasis should be placed on the production of export capable products with commercial potential.

PROMOTING DIGITISATION

The digital component nowadays is an integral part of a company in any sector requiring a certain type of knowledge to enable a company to take full advantage of the benefits of digital technologies. The company's digital transformation involves channelling of funding to digitisation, research and development activities, which include the use of technology capabilities in manufacturing, trade, communications and financial processes, including the deployment and improvement of e-systems and e-services in accounting, stock control or sales in sectors, the development of data storage and management infrastructure, the modernisation of production processes or equipment, improving efficiency and integrating digital aids into the plant. It is also important to adapt technologies such as artificial intelligence, high performance data, robotics, cyber security, blockchain, etc. that will be able to provide benefits to different business and

public administration processes. In order to manage this process effectively and at the same time use it as an instrument for increasing the competitiveness of companies, the level of knowledge and skills of company management related to the benefits of digital technology in the business area concerned is important (see also Chapter 9).

Currently, Latvia has a low level of digital skills among the labour force, which limits the use of digital technologies by businesses and the potential for innovation. Only 43% of Latvians between 16 and 74 years old have basic digital skills (EU average – 58%), the Digital Economy and Society Index (hereinafter referred to as DESI), which reflects the progress of EU Member States in the field of digitalisation, integration of digital technologies, ranked Latvia the 23rd in 2020. Similarly, the low share of ICT professionals in the workforce (1.7% compared to the EU average of 3.9%) hampers digitalisation and productivity. Entrepreneurs lack opportunities to deploy their developed solutions, test them, there is no platform to use as a base for deploying and improving their services. Many companies do not have corporate websites, very few small and medium-sized businesses use electronic sales channels, and the level of income from online sales is one of the lowest. Online promotion opportunities and the development of e-commerce are not used sufficiently, which, within the framework of DESI, accounts for only 5% turnover resulting from e-commerce in the total turnover of Latvian companies compared to 11% EU average.

Digital transformation as a fundamental principle of Latvia's economic development is included in a number of state government planning documents for the next policy development period 2021-2027, for example:

- *National Development Plan of Latvia 2021-2027*;
- *National Industrial Policy Guidelines 2021-2020*;
- Regional Policy Guidelines 2021-2027,
- other binding strategies and guidelines.

It should be noted that the government supports digital transformation of businesses through a number of additional programmes and initiatives, incl. EU funding, for example, within the framework of the *Competence Centre Programme*. They support companies of any size and encourage research and sectoral cooperation in projects for the development of new products and technology raising 25% co-financing for experimental development. There are also three digital innovation centres in Latvia, which are intended to act as centres of digital excellence and single digital transformation contact points. During the 2021-2027 programming period, the introduction of European Digital Innovation Centres (hereinafter referred to as EDIC) will be carried out at Latvian level with regional coverage. The Ministry of Economics believes that the creation of an EDIC will be able:

- to raise awareness among companies of the benefits of digital technologies to boost competitiveness;
- to ensure the process of digital transformation in each company throughout Latvia with the introduction of contact persons and infrastructure at national level;
- to provide an opportunity for each company:
  - to conduct a self-assessment of the digital development stage (digital maturity test);
  - to provide the necessary digital skills training for the management of the company and its employees;
  - to ensure the identification of the investment needs for digitalisation of infrastructure;
  - to promote further international awareness, testing modern solutions and specialised skills training;
  - to create new innovative products and technological solutions.

To date, a successful initiative to promote innovation activities for SMEs is the *Technology Transfer Programme*, which provides: (i) innovation vouchers (e.g. for feasibility studies, industrial research, experimental development and recruitment of highly qualified personnel); (ii) research and innovation support (e.g. support for the preparation of commercialisation offers or participation in exhibitions and conferences); (iii) support for start-ups (e.g. meetings with potential investors).

Support for company digitisation also includes initiatives to develop high digital skills. For example, LIKTA training programmes promoting the use of digital tools, particularly among SMEs. The target audience of the EU co-financed project "Training for small and micro enterprises for innovation and the development of digital technologies in Latvia" launched in 2016 were entrepreneurs, managers and MSE employees. By the end of 2019, more than 1200 companies were involved in the project and more than 3 900 training activities were organised.

In 2020, the introduction of the Norwegian grant programme "Business Development, Innovation, Small and Medium-Sized Enterprises" was launched in Latvia. The implementation of this programme will be ensured by the IDAL and will enable businesses to attract co-financing of 35% to 70% of the eligible costs of the project for the deployment of green technologies and innovations.

In order to further address the identified challenges in business digitalisation areas, measures to raise the level of knowledge for mastering of basic digital skills in companies and the development of high-level digital management skills at company management level, for the use of digital technologies in different business processes, as well as it is necessary to strengthen the cooperation between the state and businesses in the field of ICT and digitalisation and automation of the public sector in accordance with modern technological opportunities. It is also necessary to contribute to improving positions in DESI, given that it also serves as an important aspect of attracting investment. For this purpose, MoE has reserved funds for the implementation of training programmes on basic level and medium level digital skills for employees and company managements within the European Commission's *Recovery and Resilience funding and Operational Programme* 2021-2027 within the European Regional Development Fund (hereinafter referred to as ERDF).

In order to increase the efficiency of and interaction between the public and private sector, it is necessary to develop cooperation between the state, local governments, businesses and non-governmental organisations and to coordinate the development and functioning of elements of the information and communication technologies (ICT) ecosystem. On the other hand, in order to enable the private sector to create new, innovative ICT solutions and to develop services, as well as to ensure integration into the EU Digital Single Market, it is planned to carry out the transfer of data at the disposal of the public administration, the creation and development of the data economy and ecosystem, incl. the opening of data sets with high value added, provision of high-quality data services to the private sector by providing online access to data, continuing the transition to open solutions. For the implementation of these activities, the MoE has already started work in 2018 on the modernisation of public services such as e-delivery notes, e-cheques, cash registers and other public services. Within the next programming period, it is planned to further review the interaction between the public and private sectors in the provision and reception of services in order to improve the exchange of information between the state and businesses through support measures, enabling businesses to use public infrastructure as a platform for further integration and improvement of solutions, and to ensure cross-border availability of services, including the introduction of the "submit once" principle and the establishment of proactive services.

The implementation of the planned actions and initiatives will ensure the integration of digital technologies into the business and their use in a variety of business-related processes, making the use of the digital format self-evident. Promoting digitisation will be one of the main tools for boosting productivity in the future.

DEVELOPMENT OF STRATEGIC ECOSYSTEMS

In order to increase the potential of Latvian scientists and the potential of companies to get included the leading European innovation platforms and attract public investments in the next programming period, proactive actions are necessary to determine strategic competitiveness factors and strengthen the local cooperation model (triple helix). The multiannual financial framework of the EU after 2020, which will mark further EU policy and investment directions, sets research and science as one of the main priorities. Taking into account the funding attraction conditions and investment priorities set by the European Commission, MoE delegated IDAL the implementation of pilot projects in three development areas such as biomedicine, smart cities and smart materials.

The pilot projects will be implemented according to the uniform methodology, where the main task is to identify the main participants of ecosystems by reviewing the private, public and scientific sector. The Latvian leading design thinking experts were 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.

Given that the aim is to promote closer integration of Latvian companies (value chains) into global value chains, one of the most important functions provided by the Ministry of Economics during the implementation of the project is local and international visibility promotion activities. The introduction of the "one country, one story" concept is promoted by creating a single information field between policy makers and implementers.

In order to develop the created value chain ecosystems to independent functioning institutions, which would be able to take the leading role in European research and innovation environment and would be able to integrate into global value chains, the MoE, in cooperation with other responsible authorities, has achieved the development of a short-term and long-term strategy for the ecosystem. Similarly, in 2020, an action plan has been developed in each of the three ecosystems to achieve sectoral excellence, competitiveness and strong growth at global level. In order to continue the work and develop these ecosystems to 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 EU funds, further strategic approach to the development of such ecosystems and the introduction of action plans is necessary.

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 (ERDF) funding for financial instruments intended in the 2014-2020 programming period of EU funds forms 101 mln euro. In addition to this funding, the Development Financial Institution "Altum" (ALTUM) should attract indicatively its funding or use the repaid funding of funds (for direct microcrediting, for support to starters of economic activity and mezzanine loans) of 68 mln euro, as well as external funding of indicatively 36.15 mln euro (for ensuring venture capital and acceleration services) should be attracted.

It is important to ensure continuity of availability of funding to SME also in the new programming period of EU funds after 2020 and state support programmes should continue to be implemented in the form of financial instruments: ensuring loans for starters of business, providing guarantees, 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.

In spring 2020, in the face of the challenges posed by the spread of the Covid-19 virus and the resulting restrictions adopted by the government, additional state support programmes were developed, allocating 190-mln-euro state budget funding. The programmes for mitigation of the consequences of Covid-19 are primarily aimed at helping businesses overcome the liquidity difficulties caused by the spread of the virus, as well as providing funding for the implementation of investment projects by adapting or transforming their current business model.

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.

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

The programme has been functioning since June 2016 and by 30 September 2020 561 guarantees amounting to 124.48 mln euro were issued, guaranteeing financial services for at least 170 mln euro, which evidences of constantly high demand for such financial instruments.

PORTFOLIO GUARANTEES

On 12 September 2017 the state aid programme, portfolio guarantees, was approved. A portfolio guarantee provides entrepreneurs with the opportunity to receive investment and working capital loans and financial leasing with a term of 1-10 years and in the amount of up to 250 thousand euro. The aid programme is implemented by ALTUM, which in the process of open selection has selected and concluded agreements with 5 credit institutions, which are able to grant loans within the scope of available funding with a state guarantee to companies without direct involvement of ALTUM. 7.8 mln euro of repaid public funding are available for issuing of the guarantees. Since the start of the programme from 2018 to 30 September 2020, 363 guarantees in the amount of 15.69 mln euro have been issued within the framework of the portfolio guarantee programme providing financial services to companies in the amount of 19.61 mln euro.

EXPORT CREDIT GUARANTEES

Entrepreneurs have access to a state aid programme, export credit guarantees, which is designed to hedge against the risks of default and the political risks of the debtor's country when exporting goods and services. The export credit guarantee can also serve as a guarantee for the availability of trade funding from credit institutions (factoring, credit facility). Export credit guarantees are offered by ALTUM.

Since 2016, 340 export credit guarantees in the amount of 22.06 mln euro have been issued guaranteeing export transactions in the amount of approximately 70 mln euro.

PARALLEL LOANS

The Parallel Loan Programme is implemented in the 2014-2020 programming period of EU funds within the framework of *activity 3.1.1.2 "Mezzanine loans" of the Specific Objective 3.1.1 "To foster creation and development of SMEs, in particular in manufacturing and in RIS3 priority sectors" of the Operational Programme "Growth and Employment"*, which is planned to be implemented in the form of direct financial instruments.

The availability of parallel loans provides opportunities to receive funding to those economic operators, which are unable to receive funding from commercial banks in the necessary amount for the implementation of viable investment projects due to financial indicators not meeting crediting policies of commercial banks (for example, the ratio of undertaken obligations to net income, inefficient equity, security). The parallel loan instrument allows to resolve the problem of security and insufficient cash flow, as well as to some extent it resolves situations, when a commercial bank has reached the maximum accepted risk level for the specific customer or transaction and is unable to fund the transaction itself in full.

First, using a parallel loan, the bank keeps the first pledge right on the transaction security, thus distributing exposition, banks can improve the security/loan ratio and reduce estimated losses.

Second, ALTUM may postpone part of the principal loan amount to the loan maturity, which is a way of relieving customer's cash flow and supporting higher risk projects.

Third, at present, it is possible to create a transaction structure in such a way that a bank loan is repaid before repayment of the parallel loan to ALTUM starts, which allows to consider that the part of the loan from ALTUM is technically subordinated.

These opportunities make the use of the product more understandable from the point of view of credit policy of commercial banks. Furthermore, from the point of view of customers – businesses a parallel loan is a way to reduce participation of the customer, which is rather difficult to accumulate for companies. The programme has been functioning since July 2016, and 16 parallel loans for 7.7 mln euro have been issued by 30 September 2020.

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 are introduced in the form of direct financial instruments, and 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, 1 559 start loans for the total amount of 30.79 mln euro were issued in the 2007-2013 programming period of EU structural funds and the Cohesion Fund, 27.74 mln euro of which were loan amounts, and 3.05 mln euro were grants for interest rate subsidies.

Since June 2016 start loans were also provided within the scope of the current programming period for the implementation of viable business projects – for investments and working capital. The loans are issued to economic operators, which are not older than 5 years of their establishment, the maximum loan amount is 150 thousand euro. Start loans are an important instrument for starters of business, ensuring access to funding for the implementation of prospective and viable business projects to those economic operators, who due to insufficient security, history of economic activity, credit history, net income flow or the amount of current credit obligations are unable to attract funding from participants of the financial market (commercial banks, private investors) for the implementation of business projects in the necessary amount.

427 start loans for a 10.9 mln euro and 118 microloans for 1.5 mln euro have been closed by 30 September 2020.

LOANS TO PROMOTE THE DEVELOPMENT OF MICRO, SMALL AND MEDIUM-SIZED ECONOMIC OPERATORS AND AGRICULTURAL AND FORESTRY SERVICES COOPERATIVES SOCIETIES

Working capital loans, investment loans and loans for energy efficiency measures are available to promote the development of micro, small and medium-sized economic operators, as well as measures to increase energy efficiency, promote renewable energy sources, reduce carbon dioxide emissions, and reduce energy costs for final consumers.

By 30 September 2020, 2486 loan agreements have been signed and payments in the amount of 187.7 mln euro have been made.

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"*.

SEED, START AND GROWTH CAPITAL FUNDS

Continuing the experience of the 2007-2013 programming period of EU structural funds and the Cohesion Fund and taking into account market development trends, several venture capital instruments are offered, which are introduced through financial intermediaries selected in a public procurement procedure.

By 30 September 2020, 11 agreements for 8.2 mln euro have been concluded within the scope of venture capital.

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 thsd 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 thsd 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.

By 30 September 2020, 74 agreements for 2.9 mln euro have been concluded within the scope of venture.

BALTIC INNOVATION FUND

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 mln euro per company. At present, BIF has 5 active venture capital funds, and 20 venture capital investments amounting to 96.5 mln euro are made within them.

An agreement with the Baltic Innovation Fund 2 (BIF2) with a volume of 156 mln euro was concluded in 2019. In the next five years BIF2 will invest this funding in the private capital and venture capital funds concentrated in the Baltics countries, thus developing capital investments in small and medium-sized enterprises, and fostering growing of the Baltic region.

On 7 May 2020, the Cabinet of Ministers supported the accession to the Three Seas Initiative Investment Fund, and an agreement was signed in September. The Three Seas Initiative Investment Fund is a joint initiative of the 12 Baltic, Black and Adriatic Sea countries to promote the financing and development of infrastructure projects. The Fund's resources will come from institutions and other investors from the Three Seas countries around the world. The Three Seas Initiative Investment Fund is expected to total up to five bln euro. The current amount of the fund's capital already reaches 500 mln euro. Simultaneously with ALTUM, Estonia has also acceded to the fund, confirming its readiness to make a contribution of 20 mln euro to the fund.

PROGRAMMES FOR MITIGATION OF THE CONSEQUENCES OF COVID-19

In order to reduce the impact of the spread of Covid-19 virus on entrepreneurs facing liquidity problems, as well as to support the transformation of companies when adapting to the new situation, several support programmes have been developed, the results of which show a significant contribution to the national economy for mitigation of the consequences of Covid-19:

- working capital loans for companies affected by Covid-19. The programme has been implemented since 25 March 2020, the state budget funding of 50 mln euro, as well as ALTUM co-financing of 150 mln euro are provided for its implementation.
  By 23 October 2020, 477 loans in the amount of 85.71 mln euro have been issued.
- credit guarantees and portfolio guarantees – for the companies, which, due to the spread of Covid-19, have experienced objective difficulties in making loan payments to banks, have access to a guarantee allowing the commercial bank to postpone payments of the principal amount. The programme has been implemented since 25 March 2020, and the state budget funding for it is 50 mln euro.
  By 23 October 2020, 193 guarantees for the amount of 31.9 mln euro guaranteeing loans for the amount of 88.64 mln euro.
- capital investments in undertakings the operation of which has been affected by the spread of Covid-19, for the implementation of which 50-mln-euro state budget funding is provided;
- guarantees for large enterprises the operation of which has been affected by the spread of Covid-19, for the implementation of which 40-mln-euro state budget funding is provided;
- downtime benefit for the employers affected by the crisis for compensation of wages of employees in the period from 14 March to 30 June 2020, the State Revenue Service has paid 53.8 mln euro as part of the support.

Taking into account the second wave of Covid-19, the Cabinet of Ministers approved new support programmes at its meeting of 10 November 2020:

- support programme for working capital compensation for SMEs and large enterprises, under which grants will be available amounting to 30% of the company's total gross wages, for which payroll taxes were paid in August, September, and October 2020, but not more than 50,000 euro for the support period from 1 November to 31 December 2020. Available to companies in those sectors where operations have been restricted since 6 November 2020, when the state of emergency has been declared in the country.
- downtime support to compensate remuneration of employees, self-employed persons and patent-fee payers (downtime support) and support to compensate remuneration to part-time employees (wage subsidy support). The support is available in the sectors where operations are restricted by the state of emergency declared in the country. Downtime support is available to the employee in the amount of 70% of the declared average monthly gross wage for the period from 1 August to 30 October 2020, not less than 330 euro and not more than 1000 euro. Downtime support for a self-employed person and a recipient of royalties is 75% of the average income or royalties, but not more than 1000 euro, and a downtime benefit for a patent-fee payer is in the amount of 330 euro. The wage subsidy support is available at 50% of the declared average gross monthly earnings in August, September, and October.
- loans and their interest rate subsidy programme or crisis syndicated loans. Large and medium-sized enterprises will be able to receive syndicated loans. ALTUM loans will be provided jointly with credit institutions. An undertaking will be able to receive a loan of up to 15 mln euro. Loan interest rate subsidies will be applied to ALTUM loans. The term of the loan will be determined taking into account the specifics of the industry, the purpose of using the loan, the amortisation period of the investment and other aspects. The term is up to 20 years for loans for initial investment, not exceeding the useful life and amortisation period of the assets to be acquired. The loan will not exceed 3 years for working capital loans, where the allowable costs are calculated on the basis of the estimated wage costs of the jobs

created as a result of the initial investment. The support will be available until 31 December 2021. State budget funding of 50 mln euro is planned for the implementation of the programme.

11.2. SUPPORTING ACCESS TO FOREIGN MARKETS

To strengthen and extend economic, industrial, scientific, and technical cooperation, including by creating favourable conditions for cooperation between economic operators, Latvia has concluded agreements on economic cooperation with the United Arab Emirates, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Russia, Kuwait, China, Moldova, Turkmenistan, Tajikistan, Ukraine, Uzbekistan, Turkey.

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.

Despite the restrictions imposed by the Covid-19 pandemic to continue the intergovernmental dialogue within the framework of the concluded agreements, in 2020 a series of meetings took place remotely, during which the possibilities of expanding Latvia's co-operation with Azerbaijan, Ukraine, Turkey, Moldova and Turkmenistan were discussed. Also, in 2021, it is planned to discuss topical issues of bilateral cooperation, using the opportunities provided by this format.

Representations of the Investment and Development Agency (IDAL) operate in several countries of the world to solve economic issues and support Latvian businesses. The Latvian network of external economic representation and cooperation ensures the availability of its services to any business and serves as a bridge to the most important foreign markets and for foreign businesses to Latvia. 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.

In the period from 2017 to 2019, IDAL has provided 3464 consultations to Latvian companies, incl. 2852 consultations have been provided by Latvia's foreign economic representations. During this period, more than 1250 Latvian companies have received support for participation in external marketing activities, incl. national stands, trade missions and visits by public officials.

In order to identify the current needs of Latvian companies for IDAL export support services, including the opinion on the countries where the greatest state support is needed, a survey of Latvian companies was conducted in February 2020 on the export market companies want to enter and the export support activities companies want to implement for entering the markets. Respondents – 250 companies covered the largest sectors of the economy. In addition, industry associations were surveyed on priority export markets over the next 5 years.

The surveyed companies mention Germany, Lithuania, Estonia, the United States, Sweden, Russia, the United Kingdom, Norway, Denmark, and other countries as existing markets, where IDAL representations also operate. Companies indicate as planned export markets also those countries that already have IDAL representations, but there is a tendency that companies see greater perspectives in some markets than have not been used so far.

Industry associations, on the other hand, identified the United States, Germany, Sweden, Denmark, Italy, China, Japan, France, the United Kingdom, the Netherlands, Australia, the UAE, Norway, South Korea, and Belgium as priority markets.

Based on the analysis of the dynamics of Latvia's foreign trade, survey data of companies and associations, as well as the evaluation of the services provided by representations to Latvian companies so far, it was decided to close representations in Poland, Lithuania, Frankfurt (Germany), Kazakhstan, Singapore and in 2020-2021 open representations in Belgium, Boston (United States), South Korea, Canada, and Austria.

In order to assess the quality of export support services provided by IDAL, in August-September 2020, the research centre SKDS conducted a survey of 500 exporting companies on the evaluation of services provided by IDAL, their usefulness and importance for exporting companies.

According to the survey data, exporters comparatively most often indicated the selection of contacts in foreign markets, support for Latvian companies to participate in foreign exhibitions, visits of potential foreign buyers to Latvia, market research, support for company digitisation, participation in business and industry forums, seminars and fairs organised by IDAL as useful to their company from various named IDAL export promotion services and organised events.

Thus, it must be concluded that companies need IDAL's export support services, and they must be provided in the future, developing and expanding 2014-2020 EU funds event "Programme for promotion of international competitiveness" and the range of services offered in it. Within this programme support is provided to small (micro) and medium-sized enterprises for external marketing activities in order to promote the competitiveness of sectors by supporting entrepreneurship and entering foreign markets (see Box 11.1).

Box 11.1.

Promotion of international competitiveness

Within the framework of the project "Promotion of International Competitiveness" (hereinafter referred to as the Project) support is provided for the following supportable activities:

- conformity assessment of production facilities and products;
- participation in international exhibitions with an individual stand or a joint stand or a national stand abroad;
- participation in trade missions and visits of high-ranking Latvian state officials abroad;
- participation in conferences and forums abroad with an individual stand, presentation or as a listener or visitor;
- participation in foreign fairs and online foreign fairs;
- participation in international digital industry platforms, including digital exhibitions, placement of end-user profiles and products in industry databases to search for cooperation partners;
- adaptation of products or services to foreign markets;
- brand or product or service publicity in foreign specialised printed and digital media;
- telemarketing services for finding foreign cooperation partners;
- membership in international industry associations;
- provision of advisory support;
- digital marketing services.

Within the project, support for businesses is provided both in the financial (grants) and non-financial form or as IDAL services.

From the beginning of the Project in March 2016 until 30 September 2020, IDAL has provided 4 799 supports (grants) for the total amount of support of 17.4 mln euro, 1891 supports have been provided in the form of IDAL services.

Undertakings showed the greatest interest in the Project in the period from the beginning of the Project to the beginning of 2020, when the undertakings actively participated in international exhibitions, thus all the (grant) funding available in the Project in the amount of 17 mln euro has been used.

In view of the ongoing economic changes in the world as a result of the Covid-19 virus and its restrictive measures, incl. cancellation of international exhibitions, impact on the business environment and international competitiveness of Latvian companies, amendments to Regulations of the Cabinet of Ministers No.678 were drafted, which entered into force on 1 August 2020 and provided not only for the allocation of additional funding to the Project, i.e. 7.8 mln euro for (grant) funding and 10.7 mln euro for IDAL services, but also provided for various new activities, incl. the inclusion of digital activities in the supportable activities.

Participation in international exhibitions has always been one of the most popular supportable activities in the Project, but currently international exhibitions in the world have stopped, thus the interest of entrepreneurs in the Project has decreased. Entrepreneurs around the world now need to reorient themselves to digital marketing activities. Therefore, Latvian companies have been given the opportunity to use the digital marketing opportunities offered by the Project in order to be able to more successfully find new foreign cooperation partners and expand their export markets.

11.3. POLICY FOR ATTRACTION OF FOREIGN INVESTMENT

In 2013, the MoE developed *Guidelines for Promoting Latvian Exports of Goods and Services and Attracting Foreign Investments for 2013-2019*. These guidelines were amended in March 2017. They described the priorities and activities to attract foreign direct investment (FDI) to export-oriented industries, which also serve as a basis for FDI attraction activities in 2020. At present, no new guidelines for the promotion of exports of Latvian goods and services and attraction of foreign investments are created, but the functions and tasks of these guidelines are integrated into the *National Industrial Policy Guidelines 2021-2027* developed by MoE.

FDI attraction policy is aimed at raising the competitiveness of Latvia as an attractive investment environment, considering the aspects, which are significant for investors: macroeconomic indicators of states, the business environment – simplicity of bureaucratic procedures and the stability of tax policy, availability of an appropriately qualified labour force, market potential, accessibility of the necessary infrastructure, available support instruments and incentives. It is important to attract foreign investment in sectors which ensure changes of the economy structure in favour of external demand oriented sectors, especially in sectors that are defined as medium-high and high technology sectors.

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

economically stable and developed countries where the development potential and needs of economy sectors are appropriate for Latvian perspective cooperation opportunities; and countries with globally largest investment outflows – USA, France, Germany, United Kingdom of Northern Ireland and Great Britain, Japan, China, Russia, India.

Attraction and promotion of FDI is broken down into four main processes such as strategy and planning (creation of the national investment policy, setting of goals, investment promotion structure, positioning of competitiveness, targeted analysis of sectors), promotion of interest (marketing and addressing of companies), servicing (project management) and provision of investment services (post-service and improvement, monitoring of services).

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.

In the coming years, IDAL will promote greater investment in RIS3 areas, purposefully promoting the growth of foreign direct investment in knowledge-intensive sectors with high added value, including:

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

In 2020, the flow of foreign investment was significantly affected by the spread of Covid-19 in the world. As the government restricted the spread of Covid-19 in the Baltics and created the "Baltic Bubble", investors continued the initiated investment projects in Latvia, as well as launched several new projects. During this time, Latvia gained international recognition due to the achieved results and the innovative solutions created, which promoted a further degree of digitalisation of the country.

In August 2020, as the political situation in Belarus worsened, IDAL launched a marketing campaign on the possibilities of relocating companies to Latvia, addressing Belarusian technology companies, as a result of which several companies decided to relocate to Latvia in full or in part.

In order to promote the recognition of the Latvian business environment among foreign investors, in 2020 IDAL created a new website www.investinlatvia.org, which provides structured information of interest to investors.

The process of improvement of the FDI attraction policy is ongoing in close cooperation with the **Foreign Investors' Council in Latvia** (FICIL). The surveys of foreign investors in Latvia conducted by FICIL make it an important contribution to the improvement of the investment environment. FICIL Sentiment Index 2019 or the assessment of foreign investors working in Latvia for the potential of the competitiveness of the economy and the investment environment was published in January 2020.

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 slightly improved compared to 2018. More than half of the surveyed investors in the study have admitted that they planned to increase the amount of investment in Latvia.

However, there are some shortcomings weakening the investment environment. FICIL emphasised a number of priorities for improving the business environment – increasing the availability of labour force, modernising the governance of higher education institutions, restoring the stability and reputation of the financial system, and improving the efficiency of public administration. At the same time, investors note positive changes in labour efficiency, investment incentives, infrastructure and defence. In particular, many investors emphasised the zero interest rate on reinvested earnings as a very positive improvement.

In the study, foreign investors also provide a number of recommendations for foreign investors to address the most pressing issues, such as reducing the number of higher education institutions, as well as promoting the introduction of new methods in the training process, bringing the quality of education closer to international standards; promoting better links between education and science and business; avoiding uncertainty about the tax system and financial stability, and increasing the availability of information on the improvements made. Overall, foreign investors recognise that although progress in improving the investment environment has been reached, there is still potential for its improvement.

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 CM meeting of 28 May 2013, is to ensure positive effect of the energy sector on the Latvian national economy at the same time aspiring for 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, and energy efficiency improvement measures have been carried out.

The development of both gas and electricity infrastructure, as well as diversification of supply routes and sources is important in Latvia at national and regional level, keeping in mind the importance of reduction of energy dependence and long-term decarbonisation goals. Having identified the scattered network of Latvian energy consumers and the need to promote consumption, at the same time increasing the efficiency of energy production, supply and consumption, in 2019 special attention was devoted to the possibilities of reducing electricity tariffs, which resulted in a reduction of the fee for supply of electricity by about 8 percent in 2020.

ELECTRICITY MARKET

The full liberalisation of electricity market was completed on 1 January 2015, which means that households, as well as legal electricity users are free to choose the trader by mutually agreeing on the (unregulated) electricity price. According to the electricity trade register of the Public Utilities Regulation Commission (hereinafter referred to as the Regulator), 43 traders were registered for sale of electricity in November 2020.

The Latvian bidding area of electricity exchange *Nord Pool* started its operation on 3 June 2013. Currently, *Nord Pool* bidding areas are opened in all three Baltic States; and electricity trade is carried out in a uniform and consistent manner throughout the Baltic Sea region. Market participants of the *Nord Pool* Latvian open electricity bidding area may submit their quotes for transactions that will take place the following day (day-ahead market) or intraday market. The difference of an intraday electricity market from a day-ahead market is that the price offers are submitted for transactions that will take place on the current day, after the *Nord Pool* day-ahead electricity trading stock exchange *ELSPOT* trading session results are published. The existence of both markets not only ensures greater liquidity of the Latvian electricity market, but also a more efficient utilisation of network transfer capability, and transparent energy price that the market participants can rely upon. In 2019, the average electricity price at the *Nord Pool* exchange was 46.28 euro/MWh, the price has reduced by 7% compared to 2018. In nine months of 2020, the average electricity price has reduced to 31.64 euro/MWh. This is related to the particularly favourable weather conditions for wind power plants in Sweden, where the amount of electricity produced by wind power plants increased considerably, exceeding the projections. Intergovernmental electricity transmission capacities are sufficient to have a favourable effect on the electricity price in Latvia. As a result, even a negative electricity price (the lowest level – minus 1.73 euro/MWh) was reached in the Latvian price zone twice in 2020.

In accordance with the electricity market review data for 2019 by the transmission system operator Augstsprieguma tīkls AS, the Latvian total electricity consumption grew by 1.55% amounting to 7.3 Twh compared to 2018. From this amount, the share of electricity produced by Latvia was 84.7% in 2019. The amount of electricity produced by combined heat and power plants (hereinafter referred to as CHPP) grew by 4% in 2019, compared to 2018, which is sequentially consistent with the increase in natural gas consumption in this period of time.

In fulfilment of *Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC*, Latvia has separated the electricity distribution and transmission functions from the electricity trade and production company. As of 1 July 2007, functions of the electricity distribution system operator are performed by Sadales tīkls AS, independent subsidiary of Latvenergo AS

(MoE is the holder of capital shares). In Latvia, the Regulator has issued 11 licences in total to distribution system operators, of which Sadales tīkls AS provides the service in 99% of the territory of the state.

On 1 January 2012, Augstsprieguma tīkls AS started operating outside the Latvenergo Group as an independent transmission system operator, all capital shares of which are held by MoF. Assets of the transmission system are owned by Latvijas elektriskie tīkli AS, subsidiary of Latvenergo AS, which started its operation on 1 April 2011. Until now, Augstsprieguma tīkls AS rented transmission system assets from Latvijas elektriskie tīkli AS, but on 8 October 2019 CM adopted the decision on supporting Latvijas elektriskie tīkli AS in contributing in the form of capital shares in the share capital of Augstsprieguma tīkls AS, and as a result of that Augstsprieguma tīkls AS will obtain in property transmission system assets – poles, lines, high-voltage substations, related real estates and other. Augstsprieguma tīkls AS is the only transmission system operator in Latvia and is operating in conditions of natural monopoly.

On 27 November 2019, the Regulator approved the new tariffs of the distribution system services of Sadales tīkls AS, which have entered into force on 1 January 2020 and will be used for the next five years (until 2024 inclusive). Thus, the variable components of differentiated tariffs (fee for distribution of electricity) reduced – by 8% on average. The component for the provision of the connection fee (fixed fee) has remained unchanged. Sadales tīkls AS was able reduce the tariff thanks to the efficiency improvement programme initiated in 2017, which will continue until 2022.

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

Within the scope of the synchronisation project, energy systems of Baltic countries will start functioning in a synchronous mode with the network of the Continental Europe, at the same time disconnecting from the IPS/UPS (Russian and Belorussian energy system) network. Internal electricity trading of Russia and Belarus, as well as other CIS countries, which jointly with the Baltic countries form BRELL (abbreviation of *Belarus, Russia, Estonia, Latvia, Lithuania*), 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. Several studies and due diligence have been conducted for the synchronisation project to be as successful as possible, identifying all technical and economic considerations, as well as to find the most cost-effective solution. The project aims to reconstruct and build internal infrastructure of each Baltic country, as well as construct a *Harmony link* submarine direct current cable between Lithuania and Poland.

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

The EC's Connecting Europe Facility (CEF) co-finances 75% of total eligible costs of the project, the remaining funding is provided by transmission system operators of Baltic countries – Elering AA, Augstsprieguma tīkls AA and Litgrid AB. The CEF funding approved for the synchronisation project in January 2019 amounts to 323 mln euro. The total costs of measures of the first phase of the synchronisation project of the Baltic countries is 430.39 mln euro, of which 75% or 322.79 mln euro will be covered from the CEF funding, while other costs will have to be covered by electricity transmission system operators of Baltic countries. Co-funding of 57.75 mln euro was granted to Latvia for costs of the first phase of the synchronisation project. In May 2020, the transmission system operators of the Baltic States applied for co-financing for the second phase of synchronisation, which was approved in the European Commission on 1 October 2020. Therefore, the Baltic States will receive 719-mln-euro co-financing for the 2nd phase of synchronisation, securing a significant portion of functions for all the infrastructure works necessary in the 2nd phase.

Another vital matter is **electricity trading with third countries**. On 25 August 2020, the Latvian government decided that considering the current developments in Belarus and the consequent risks to the compliance with international nuclear security standards at Astravets Nuclear Power Plant (NPP), it is necessary stop trading electricity with Belarus, if Astravets NPP starts functioning. At the same time, the Latvian government urged the transmission system operator to develop a

methodology for the calculation of electricity trading capacities to ensure preservation of electricity trading with third countries, starting trading electricity through the already existing Latvian-Russian interconnection, which has recently not been used for trading flows.

In autumn 2020, transmission system operators of all the three Baltic States, with a significant support and participation of the European Commission, developed a uniform compromise methodology for electricity trading with third countries and submitted it for harmonisation to national regulatory authorities. Latvian and Estonian regulatory authorities provided support to the developed methodology. In parallel, the Latvian government also approved the necessary regulation, which will ensure traceability of the origin of electricity. In order to ensure that electricity in transit from Belarus does not flow through Russia into the Baltic States, Russian responsible authorities should provide a guarantee of origin declaring that the electricity imported into Latvia was produced in Russia.

Along with the approval of the methodology and the introduction of the necessary guarantee of origin regulation, all the preconditions have been created for Latvia, whereof an agreement has been reached among the Baltic States to start electricity trading through the Latvian-Russian interconnection after the Astravets NPP starts operating and the Lithuanian-Belorussian electricity trading border is closed. Since the Astravets NPP started operating in test mode on 3 November 2020 and Lithuania stopped trading electricity with Belarus, Latvia opened the Latvian-Russian interconnection for electricity trading, which will also to keep *status quo* in trading electricity with third countries.

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 *Nord Pool* Estonian and Finnish bidding areas. Although these interconnections improve the situation in ensuring the integration of Estonian and Finnish power systems and liquidity of the Estonian and Finnish bidding areas, they do not reduce the risk of overload in the Latvian-Estonian cross-section, which, although of a highly seasonal nature, is characterized by a negative impact on the dynamics of electricity prices in the *Nord Pool* Latvian and Lithuanian bidding areas. In addition, the load on Estlink II in the direction from Finland to Estonia could lead to additional load on the Latvian-Estonian cross-section, thus increasing the risk of overload or line outage. In order to improve the interconnection capacity, Lithuanian-Polish 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.

Part of the NordBalt project is the 330kV transmission line project Kurzemes loks implemented in the western region of Latvia, which started in 2010 and has been implemented in 3 stages (construction of a 330 kV cable between Riga TEC-1 substation and Imanta substation in 2013, construction of Grobiņa-Ventspils electricity transmission line in 2014 and Ventspils-Tume-Imanta 330 kV electricity transmission line) creating, in total, a 330 km long 330 kV electricity transmission line, which increases the availability of capacity and power supply safety in Kurzeme. Also, with commissioning of Kurzemes loks in November 2019, the Latvian energy system will provide a potential for the renewable energy sources generation connection to the network at least in the amount of 800MW. The costs of the third stage of Kurzemes loks amounting to 55.1 mln euro were covered by CEF.

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, as well as will strengthen operational efficiency and interoperability of infrastructure.

Construction of the third Estonian-Latvian interconnection is also strategically important, which will allow eliminating the existing transmission network overload and increasing the available transmission capacity of the Latvian-Estonian interconnection. Within the project, there are intents to construct a 176 km long 330 kV high-voltage electricity transmission line from Riga TEC-2 330 kV substation to the Estonian-Latvian border. A 28 km long 330 kV power line section in Rujiena Municipality was commissioned in October 2020. Overall, the electricity transmission line was completed also in Mazsalaca, Burtnieki, Aloja and Limbaži Municipalities, and they are soon planned to be commissioned. Line construction works in other sections are in their final phase and the new line is planned to be made live this year. Total costs of the third Estonian-Latvian interconnection are approximately 172.7 mln euro. The total planned costs in the territory of Latvia are approximately 102 mln euro. In November 2014, EU co-funding of 65% was granted for the construction of the third Estonian-Latvian interconnection from CEF funds.

The Riga TEC-2-Riga HPP electricity transmission line is also a technical important project commissioned in November 2020. The Riga TEC-2– Riga HPP project is an important reinforcement for the Latvian internal network to ensure full functionality of the third Estonian-Latvian interconnection not only in normal, but in emergency and repair modes. At a regional scale, this network reinforcement is important for increasing the throughput capacity of the Baltic region in the Northern-Southern direction.

In order to implement the requirements defined in *Regulation (EU) No 347/2013 of the European Parliament and of the Council of 17 April 2013 on guidelines for trans-European energy infrastructure and repealing Decision No 1364/2006/EC*

and amending Regulations (EC) No 713/2009, (EC) No 714/2009 and (EC) No 715/2009 (hereinafter referred to as Regulation No 347/2013), EC, using the delegated acts procedure, the **EU's lists of projects of common interest are adopted**. Regulation No 347/2013 provides that the products included in the list of projects of common interest not only may qualify for the support of the EU co-funding, but also benefit from fast and efficient authorization procedures, while respecting the environmental assessment and protection standards. In Q3 2019, EC included the third Estonian-Latvian interconnection, the Riga TEC-2-Riga HPP electricity transmission line, and the synchronisation project in the list of projects of common interest, and the first two were awarded the status of projects of national interest by an order of the Cabinet of Ministers.

Continuation of the synchronisation project by starting the second phase of the project has an important priority in the coming years, which has currently received co-financing of the Connecting Europe Facility (CEF). At the same time, it is especially important for Latvia to defend its position about the amount of CEF budget in the next support period 2021-2027 not only in the context of the synchronisation project, but also for transborder cooperation projects in the field of renewable energy sources to create favourable conditions for an increase in internal generation volumes.

Since 2015, when the electricity market has fully opened, a certain group of electricity users has access to the **vulnerable user trading service** to fulfil the recommendations included in EU laws and regulation with regard to reducing the risk of poverty for vulnerable energy users. Vulnerable user (about 150-160 thousand families/persons) is a poor or a low-income family (person), a large family or a family (person), which takes care of a disabled child, or a person with disability group I, which uses electricity in their household for their own needs (final consumption). Under the current legal regulation, the vulnerable user trading service can be received only by those vulnerable users, who have concluded an electricity trade agreement with a service provider (since 2015 – Latvenergo AS).

In 2019, the Saeima adopted amendments to the *Electricity Market Law*, which provide for changes in the current principle of provision of the service, namely, the service can be provided by any electricity trader, and compliance with the status of a vulnerable user will be checked by the vulnerable user data information system (VUIS), the controller of which is the State Construction Control Bureau. Each electricity trader providing the service will have a link to VUIS so that after data exchange it allocates once a month a reduction for an electricity bill for those of customers, which qualify for the status of a vulnerable user. The service is funded from the funds allocated for this purpose in the state budget funds. The described service provision regulations are currently being drafted by MoE, and they are expected to enter into force from 2021.

NATURAL GAS MARKET

Since April 2017, the natural gas market has been fully liberalised, which is mainly related to the purpose of creating an effectively functioning and integrated EU energy market, ensuring high flexibility of the system, competition among companies, competitive prices, as well as strengthening energy security. In order to promote the development of competition and independence of operators of the transmission and distribution system, and at the same time observing the amendments to the *Energy Law* adopted on 11 February 2016, the historical natural gas monopoly Latvijas Gāze AS had to separate its natural gas transmission and storage infrastructure from the natural gas trading and distribution functions, namely legally separated natural gas transmission and storage system operator Conexus Baltic Grid AS and distribution system operator GASO AS were created. 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 retained the user status and the possibility to buy natural gas according to the tariffs set by the regulator, rather than the market price.

The total natural gas consumption in 2019 was 1354 mln m^3. In ten years (2010-2019), the share of natural gas has reduced by 8 percentage points and amounted to 23.5% in 2019. The drop in natural gas consumption was also accompanied by the drop in the volume of imported natural gas, which may be largely linked to the use of alternative fuel resources and taking energy efficiency measures. Despite the drop in its share, natural gas still occupies an important role in the Latvia's total structure of consumption of energy sources. Most of natural gas is used for generation of electricity and heat in boiler houses and cogeneration stations. It should also be taken into account that natural gas consumption is always seasonal in nature, because, for instance, the demand for natural gas in 2018 is explained by comparatively low outdoor temperatures in months of the heating season.

One of the most significant processes in the natural gas sector is the establishment of a single regional natural gas market of the Baltic States and Finland. The establishment of a single natural gas market of Latvia, Estonia and Finland on 1 January 2020 is considered to be an event unique for Europe and historical for the Latvian natural gas sector. This is the result of long-term cooperation that was rich in challenges among regulatory authorities, natural gas transmission system operators and ministries responsible for the sector of the Baltic countries and Finland. At present, a single gas transmission tariff zone is functioning in Finland, Estonia and Latvia. The single natural gas market started functioning with two balancing zones – the combined Latvian and Estonian balancing zone and Finland. At the same time, parallel

work is ongoing on a single IT platform, which will simplify operations of every natural gas trader in the single market zone.

The process of integration of the regional gas market started in December 2015 at a political level when the Prime Ministers of the Baltic States approved an action plan for the development of the regional gas market and invited Finland to participate in the process. The regional natural gas market will create access to new gas trading platforms and routes, improve market liquidity, diversify gas supplies, as well as promote transparency of tariffs. This might become the only single market region of such a type in the EU.

The initial participants of the single market area are Finland, Estonia, and Latvia, but there are plans to develop the market providing benefits to all players, and also users, of this market, and other European Union Member State will be urged to join it.

In addition, it should be emphasised that the Estonia-Finland interconnection (Balticconnector) project was completed at the end of last year and has been used commercially since 1 January 2020. This interconnection connects the Finnish natural gas transmission system with the natural gas transmission system of Baltic countries. It consists of a land pipeline section, a submarine pipeline section and two compressor stations.

On 17 September 2019, CM supported amendments to the *Energy Law*, which prevents obstacles in the creation of a regional natural gas market and operation of Latvia in a single input-output tariff system with Finland and Estonia. Amendments to the Energy Law were supported in Saeima on 17 October 2019.

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 one of the most important future priorities on the natural gas market. It is important to emphasise the need to continue work on provision of safe and accessible infrastructure, which corresponds to market conditions. In order to improve security of natural gas supplies in the Baltic region and to create an effective market, there are plans to implement several projects (see Box 12.1).

Box 12.1

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

GIPL interconnection of the Lithuanian-Polish natural gas supply systems

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

Latvian-Lithuanian interconnection modernisation project

At present, the are flows in two directions in the Latvian-Lithuanian interconnection. Last year, Conexus Baltic Grid AS in cooperation with the Lithuanian natural gas transmission system operator AB Amber Grid presented the results of a study, which was conducted using EU funding. The study included the cost-benefit analysis for the interconnection capacity project. The study identifies optimum interconnection capacities, taking into account other gas interconnection projects implemented in the region (*Balticconnector* and GIPL) and potential gas flows. At the Lithuanian side, it is planned to modernise the Kiemenai gas measuring station and the Panevezys compressor station, while at the Latvian side, it is planned to modernise high-pressure pipelines to be able to increase working pressure of the system to 50 bar. By making respective investments, the interconnection capacity would increase up approximately 130 GWh/d in the Latvian direction and to 119 GWh/d in the Lithuanian direction. The planned investments are 10.3 mln euro, of which 4.7 mln euro would be attributable to the territory of Lithuania. Regulators are also raising EU co-funding. If financial and other aspects resolve as planned project might be fully implemented by 2023.

Modernisation of the Inčukalns underground gas storage facility (UGSF)

Latvia has the only natural gas storage facility and an important strategic site in the entire Baltic region – the Inčukalns underground gas storage facility (UGSF), which is managed by the natural gas storage operator Conexus Baltic Grid AS ensuring regional gas supply stability and strengthening energy security of the region, as well as providing market players with an opportunity to store natural gas in a strategically advantageous place. This modern main natural gas transmission system connects the Latvian natural gas market with Lithuania, Estonia, and Russia. The total volume of UGSF is 4.3 bln m^3, including the active natural gas volume of approximately 2.3 bln m^3, thus fully securing natural gas demand even in the coldest winter months. The Inčukalns UGSF modernisation project is included in the list of projects of common interest, and in early 2019 the European Commission allocated 50% co-funding for it (the total project investments amount to 88 mln euro) from CEF funding. The implementation of this project intends to improve technical infrastructure of UGSF, operational flexibility of the storage facility and safety of operation of equipment.

The national and regional gas supply projects listed in Box 12.1 are included in the *Fourth Union list of Projects of Common Interest*.

The natural gas market will also be significantly affected by the project for synchronisation of electric networks of Baltic countries with the network of Continental Europe because connection to the European network envisages that Latvian electricity producers will have to provide generating capacities themselves, and natural gas will play an important role in guaranteeing stable energy supplies.

Cyber security is one of challenges in the natural gas sector that are growing year on year. For example, Conexus Baltic Grid AS carries out a risk assessment on a regular basis paying special attention to constant exchange of information with respective supervisory authorities, as well as equipment and software in supervision of natural gas transmission and storage processes. In 2018, Conexus Baltic Grid started several projects for improvement of cyber security management processes.

It should be indicated that in March 2019, the NATO Energy Security Centre of Excellence organised training for protection of infrastructure sites of strategic importance in crisis situations in Vilnius. One of the most important matters, which were updated during the training, are natural gas solidarity mechanisms, application of crisis communication procedures, evaluation of preventive emergency action plans of countries, mainly focusing on their implementation at regional level. This training largely emphasised the important role of cooperation between employees of the energy sector, policy makers and decision makers, identifying risks and areas where capacity neds to be improved.

12.2. PROMOTING ENERGY EFFICIENCY

The Latvian government has set[6] energy efficiency targets to be reached by 2020:

- total indicative national energy efficiency – the primary energy savings in 2020 – 0.67 Mtoe (28 PJ), which correspond to the total primary energy consumption of not more than 225 PJ;
- annual saving of 1.5% for energy supplied to end consumers – final energy savings in 2020 – 0.213 Mtoe (8.9 PJ) and the final energy saving accumulated from 2014 to 2020 – 0.85 Mtoe (9897 GWh);
- annual renovation of 3% of the state-owned building area (maximum estimates – 678.5 thsd m^2).

The main task of implementation of energy efficiency improvement measures is to limit an increase in final consumption of primary energy sources and energy. In accordance with the indicative energy efficiency target achievement trajectory, the Latvia's total primary energy consumption should not exceed 220 PJ in 2019.

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

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

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

By November 2020, approximately 822 Latvian companies have conducted an energy audit, or have introduced a certified energy management system according to ISO 50 001.

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

From 2014-2018, the accumulated final energy saving obtained as a result of implementation of energy improvement measures until 2020 is 6959 GWh or 70% of the mandatory cumulative target (9896 GWh). In order to ensure the fulfilment of the accumulated final consumption target, an assessment of the accrued energy saving was carried out in

[6] Energy Sector Development Guidelines 2016-2020 http://polsis.mk.gov.lv/documents/5499

2020 based on up-to-date information on promotion and regulatory measures adopted by state and local governments, which improve energy efficiency.

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

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

In 2014-2020 EU funds programming period, support to energy efficiency measures is provided through several programmes supervised by the MoE (see Box 12.2).

Box 12.2

Support Programmes for Improvement of Energy Efficiency (Conditions as at November 2020)

Energy efficiency programme for multi-apartment houses:

- 972 projects requesting ERDF funding of 210 mln euro were submitted to the Development financing institution Altum;
- 329 positive decisions on granting of grants were taken;
- the implementation of 176 projects has completed, 132 projects are being implemented, incl. at the construction stage;
- 60 Altum loans for 9.7 mln euro were issued;
- 167 guarantees for 29.4 mln euro were granted.

Average indicators of projects:

- the average energy consumption reduction in homes – 41%;
- the annual average energy consumption for a renewed house – 56 kWh/ m^2.

Annual energy saving in submitted projects:

- annual consumed heating energy reduction– 55.75 MWh/ m^2;
- annual CO_2 reduction – 26.6 thousand tons.

Energy efficiency programme for public buildings:

- 134 project applications requesting ERDF funding of 104.3 mln euro were received;
- the implementation of 42 projects requesting ERDF funding of 22.2 mln euro has been completed;
- the total area of state-owned buildings, which will be renewed within projects – 115,162 m^2;
- the annual average energy consumption of the buildings after a year of implementation of the project – 110 kWh/ m^2.

Energy efficiency programme for production buildings:

- 45 agreements for Cohesion Fund funding of 11.97 mln euro were concluded;
- the implementation of 30 projects for Cohesion Fund funding of 6.65 mln euro has been completed.

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

- annual energy savings – 107.2 GWh;
- installed capacity of renewable energy sources (heating boilers + solar collectors) – 9.5 MW;
- annual CO2 reduction – 12.7 thousand tons.

Energy efficiency programme for the district heating system:

- 97 agreements for Cohesion Fund funding of 48.79 mln euro were concluded;
- the implementation of 52 projects for Cohesion Fund funding of 13.54 mln euro has been completed.

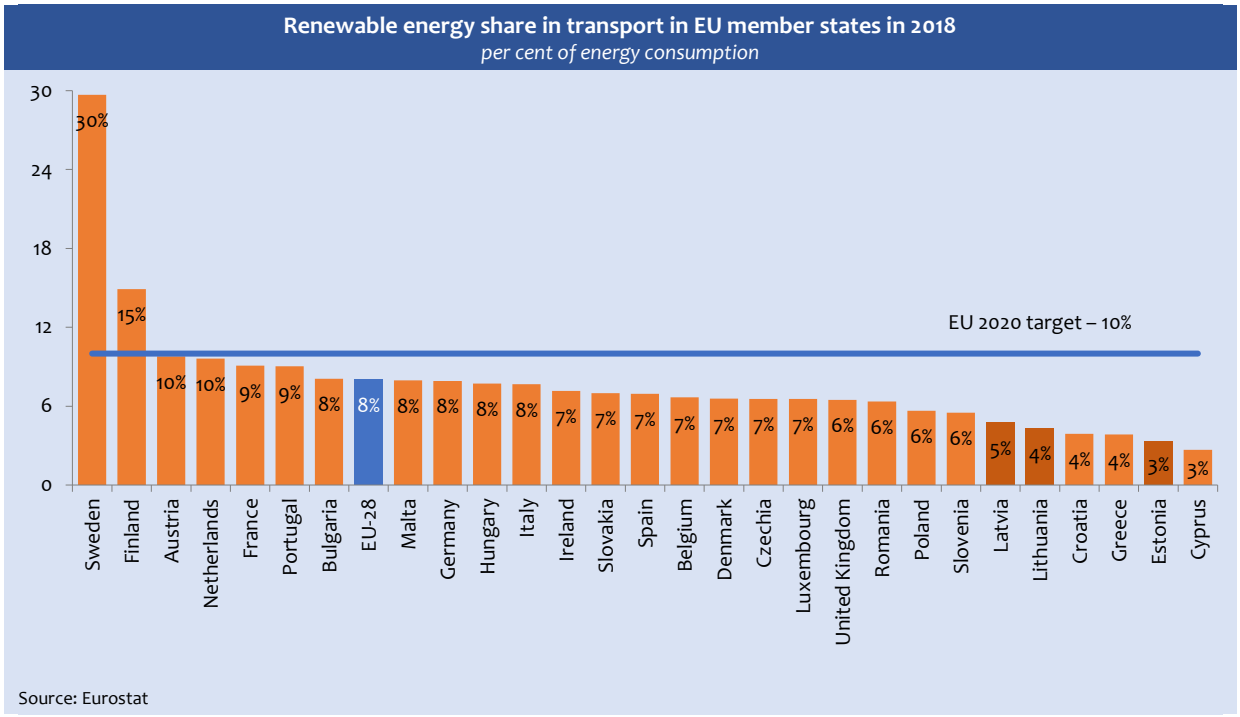
The following indicators will be achieved within the framework of approved projects:

- additional installed capacity of renewable energy sources – 9.31 MW;
- reconstructed production capacity– 217.82 MW;
- reconstructed heating networks – 61.86 km;
- annual reduction in heating energy losses in reconstructed heating networks – 47.75 GWh;
- annual CO2 reduction – 163.03 thousand tons.

12.3. ENERGY FROM RENEWABLE SOURCES

The National Reform Programme of Latvia for the implementation of Europe 2020 strategy and also the *Energy Development Guidelines for 2016-2020* sets national target to achieve a 40% share of renewable energy in the gross final energy consumption and a 10% share of renewable energy in the transport sector final consumption. Latvia has the 3rd highest share of renewable energy in the final energy consumption in the EU, it was 40.3% in 2018 (the EU average is 18%). Furthermore, in the transport sector the share of renewable energy reached 4.7% in 2018, which is a significantly lower than the EU average of 8% (see Figure 12.1).

Figure 12.1



In 2019, the total consumption of renewable energy sources (hereinafter referred to as RES) in Latvia was 75.5 PJ, and since 2015 has increased by 16.7 %. The main type of RES in Latvia is woodfuel (firewood, wood residues, woodchips, wood briquettes, wood pellets) and hydroresources. The share of woodfuel in the total consumption of RES was 82% in 2019 (80.7 % in 2018). The reduction in RES consumption in 2019 was affected by the reduction in volumes generated by hydropower plants (HPP), which is explained by less precipitation than in 2018. The consumption of biogas (landfill gas, sludge gas, other biogas) in 2019 was 3.4 PJ, which is by 7.3 % lower than in 2018 (3.6 PJ), and biogas consumption has reduced by 8.1 % or 0.3 PJ over five years,

In 2019, Latvia produced 6,438 GWh of electricity, 3,190 GWh of which were made of RES. Volumes produced from RES reduced by 8.8% compared to 2018. Last year, cogeneration plants produced 4 174 GWh of electricity, 22.2 % of which were produced from RES (biogas and biomass cogeneration plants). Primary electricity produced from RES decreased by 11.4% or 1 PJ in 2019, compared to 2018. In 2019, HPP produced 2 107 GWh of electricity, which is 13.4 % or 325 GWh less than in 2018. Wind power plants (WPP) produced 152 GWh in 2019, which is 24.6 % or 30 GWh of electricity more than in the previous year, while solar power plants produced 3 GWh of electricity, which is 3 times more than a year ago.

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 (hereinafter referred to as 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 been reduced to 22.68 EUR/MWh[7]. 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[8].

In 2020, the further improvement of the electricity mandatory procurement system continued by paying special attention to the supervision of power plants receiving state aid.

From 1 January 2020 energy policy administration functions, including supervision of electricity mandatory procurement, are implemented by the State Construction Control Bureau, thus ensuring more effective control of the state aid system. In the field of legislation, on 15 February 2020, amendments to the *Electricity Market Law* (hereinafter referred to as EML) entered into force, which, inter alia, provide for strengthening of control of the electricity producers receiving state aid in the form of mandatory procurement, a framework for prevention of overcompensation and recovery of the unjustifiably received state aid. Furthermore, according to EML on 2 September 2020 CM adopted subsequent CM Regulations No. 560 "Regulations on Electricity Production Using Renewable Energy Sources, as well as Pricing Procedure and Supervision" and CM Regulations No. 561 "Regulations on Electricity Generation, Supervision and Pricing when Producing Electricity in Cogeneration" developed by the Ministry of Economics, which supplement the regulatory framework with requirements to fuel raw materials for biogas plants, conditions for the use of thermal energy, as well as strengthens responsibility of electricity producers. By the end of 2020, it is planned to conclude work on the improvement on the power plant overcompensation prevention mechanism.

The Ministry of Economics has been gradually promoting the development of self-consumption of electricity by improving the NETO accounting system created on 1 January 2014, which is now offered to households 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. In spring 2020, changes to the NET system entered into force – the payment of the variable part of MPC was cancelled for that amount of electricity, which the participant of the NETO system transfers to the electrical network and receives it back within the scope of one year. This was the first step to reduce the period of repayment of solar panels. In the future, it is intended to open the NET system for legal persons to provide an opportunity for small companies to reduce costs of electricity. It is also intended to make changes to the NETO settlement system so that participants might consume electricity produced and transferred to the distribution network within the scope of their other connection (incl. Remote self-consumption).

12.4. REDUCING GREENHOUSE GAS EMISSIONS

Climate has changed the fastest 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 RES, improvement of energy efficiency, promotion of electromobility, measures to reduce the use of fossil fuels, etc. (see Box 12.3).

According to the 2020 GHG inventory for 1990–2018[9] (hereinafter — 2020 GHG inventory) and a approximate GHG inventory for 2019[10], total GHG emissions of Latvia from 1990 to 2018 and 2019 have decreased by 55.5 % and 56.2 % respectively, while in the period from 2005 to 2018 (see Figure 12.1) and 2019 total GHG emissions of Latvia decreased by 2.7 % and 1 % respectively. Latvia's total GHG emissions in 2018 amounted to 11,727.5 kt CO2 eqv. but approximate GHG emissions in 2019 – 11,537.3 kt CO2 eqv.

In 2018, non-ETS GHG emissions dominated in the total amount of GHG emissions of Latvia with 77.7 %[11]. The approximate share of GHG emissions of non-ETS activities in Latvia's total GHG emissions in 2019 is slightly higher – 78.4 %. GHG emissions generated by Latvian ETS operators amounted to 2 612.6 kt CO_2 eqv. in 2018, and 2 493.1 kt CO_2 eqv.in 2019, or 22.3 % or 21.6 %, respectively, of Latvia's total GHG emissions.

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

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

[9] https://unfccc.int/documents/227704

[10] https://cdr.eionet.europa.eu/lv/eu/mmr/art08_proxy/envxwuuw/

[11] The non-ETS activities subject to Decision 406/2009/EC, the calculation of GHG emissions has been carried out using the formula defined by the European Commission – total GHG emissions minus amount of CO_2 emissions verified by EU ETS operators minus local aviation CO_2 emissions

Box 12.3

Reducing GHG Emissions in Latvia

Taking into account Latvia's participation in the EU, Latvia's political goals in terms of climate are linked to the EU climate policy goals, as well as the international climate policy – the UN Framework Convention on Climate Change and its Kyoto Protocol and the Paris Agreement.

A common EU GHG emission reduction target has been set within the EU, and it is 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).

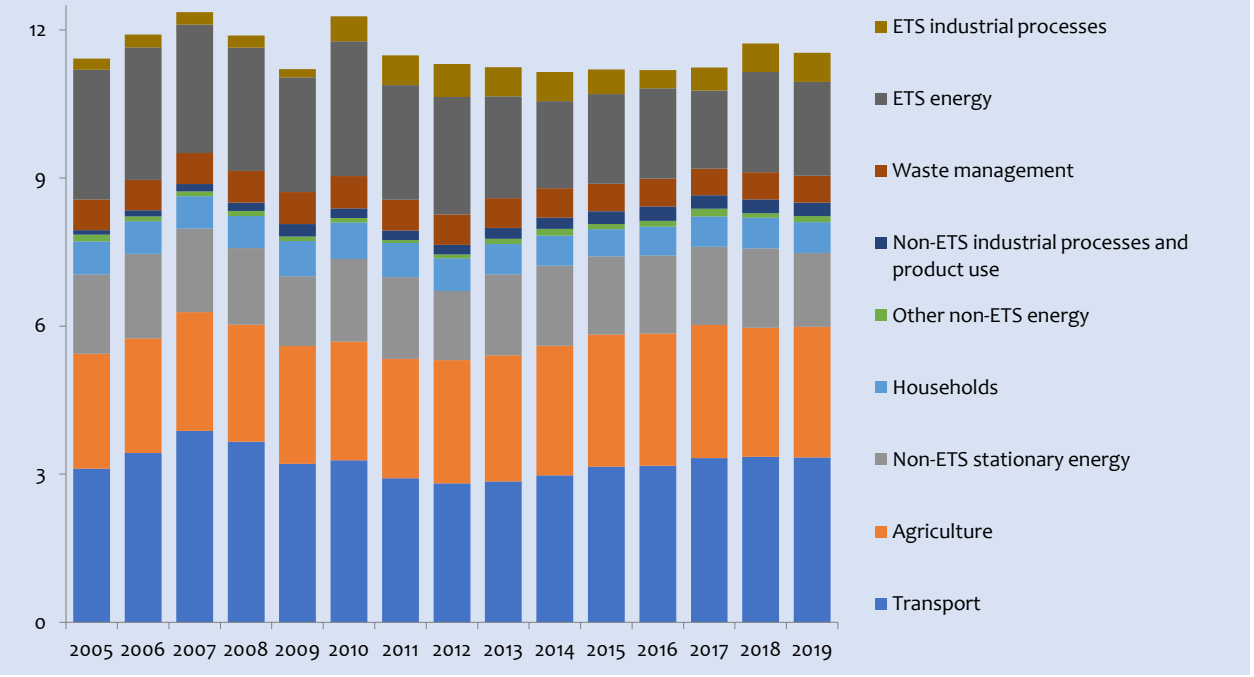
The organisation of fulfilment of the **EU-ETS target** is responsibility of the European Commission (hereinafter referred to as EC).. ETS operation conditions have been approved for the fulfilment of this target and responsibility of operators has been set with EU regulations. Measures for reduction 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 obligations 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 set in *Decision 406/2009/EC*, and for the period from 2021 to 2030 – with *Regulation 2018/84*. In the period from 2013 to 2020 Latvia is allowed to increase the amount of Latvia's non-ETS GHG emissions by no more than 17%. In the period from 2021 to 2030 Latvia should reduce GHG emissions from non-ETS activities by 6% in comparison with 2005. The total target of the period is broken down into annual binding targets.

Figure 12.2

Latvia's non-ETS and ETS GHG emission trend in 2005-2018 [12]

thsd kt CO_2 eq.



[12] The data of 2019 are the data of approximated GHG inventory (excluding total approximate CO_2 equivalent emissions and removals from land use, land use changes and forestry in accordance with Article 17 of Commission Implementing Regulation 749/2014), which were calculated, taking into account the initial statistical data, and which have not been verified or approved by experts of the European Commission and the Secretariat of the UN Framework Convention on Climate Change. In this section, the approximated GHG inventory data for 2019 are included for approximate description of the situation in 2019

The development of GHG emissions from non-ETS activities suggests an increase of emissions by 6.4% from 2005 to 2018 and by 5.6% from 2005 to 2019. Overall, until 2019 Latvia was within the annual targets set for non-ETS activities in Decision No 406/2009/EC[13]. Latvian ETS operators had reduced their GHG emissions by 8.5% before 2018 and by only 12.7% before 2019, in comparison with 2005, thus lagging behind the Latvian national ETS GHG emissions reduction target for 2020 – minus 21% compared to the volume of 2005.

In 2018, the biggest source of GHG emissions was energy (37% of total GHG emission without LULUCF) followed by transport (28.6%) and agriculture (22.3%), the rest was industrial processes and product use and waste management. Total emissions of the energy sector reduced by 60.2% in 2018 in comparison with 1990, and by 5.4% in comparison with 2005. Agriculture is the second largest emissions sector in the Latvian GHG inventory, which generated 22.3% of Latvia's total GHG emissions in 2018. Non-ETS emissions from waste management constituted 4.7% of the total GHG emissions in 2018.

CM decree No.46 of 4 February 2020 approved the *National Energy and Climate Plan 2021-2030*, which sets the main 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 RES and fulfilment of energy efficiency improvement targets. On 28 February 2020, the informative report "Latvian strategy for reaching climate neutrality by 2050" was approved at the CM meeting, which sets the Latvia's climate neutrality goal for 2050 and necessary action lines for the achievement of this goal. On 16 April 2020, Amendments to the Alternative Fuel Infrastructure Development Plan for 2017-2020 were approved, which set short-term more efficient measures, which, inter alia, ensure a reduction of GHG emissions from transport.

[13] https://eur-lex.europa.eu/legal-content/LV/TXT/PDF/?uri=CELEX:32009D0406&from=EN

13. CONSTRUCTION POLICY

Overall, the growth in the construction sector, which started in 2017, continued also in 2020. In 2020, due to the prudent and meaningful deployment of electronic processes and the development of the functionality of the construction information system, the restrictions introduced to combat the Covid 19 pandemic had a minimal impact on the development of the construction process and on the development of the construction sector.

Additional funding for public infrastructure development projects was envisaged by the government in a rapid response to the first indications of a sharp reduction in private investment in Q2 2020. The construction sector is one of the sectors that will serve as the Latvian economy heater and help to mitigate the negative impact of the Covid 19 pandemic on the economy by receiving targeted support from the state. In 2021-2027, cash inflows to the construction sector are expected, leading to a sharp increase in the sector's volumes over the next three years. Construction will involve at least 30-40% of investments from total public funding available in the coming years (see Box 13.1).

Box 13.1

Construction projects and public funding

A number of new major projects are being launched in 2020, the results of the public design contest on the territory development vision for construction on the right coast of Daugava – the block between the Salu Bridge, Krasta Street and Daugava (the territory of the historical Zvirgzdu Island) were announced this September, the project development is planned for 10 years in several phases with investments reaching 150 mln euro. Also in April, a construction permit for the reconstruction of the Press House was issued for a hotel, conference centre and multi-functional centre that will include commercial, catering and recreational areas. It should be noted that the implementation of a number of projects already under way will continue, which will help to stimulate the national economy and, in particular, the construction sector, such as the reconstruction of Mežaparks Large Stage, the Rail Baltic project, the Skanstes area revitalisation project, etc.

Distribution of total available public funding:

- Continuation of the absorption of the Cohesion Fund 2014-2020 (1 698 projects underway for 3.8 bln euro (+589 mln euro in 2019) – 85.6% of the total investment of EU funds amounting to 4.4 bln euro;
- 2.062 bln euro – state aid to mitigate the effects of the Covid-19 pandemic;
- 2.2 bln euro – state budget funding under the NDP;
- 272 mln euro – recovery aid for cohesion and European territories – REACT-EU programme;
- 1.993 bln euro – European Recovery and Resilience Funding – RRF, investments to mitigate the effects of the long-term Covid-19 pandemic in the economy, the transition to the green and digital economy;
- 198 mln euro – Just Transition Fund (JTF), investments for the economic diversification of the areas most heavily affected by climate change;
- 4.63 bln euro – Cohesion Policy Instruments – ERDF, ESF+, CF, the largest amount of funding for comprehensive investment under NDP 2021-2027 measures;
- 2.962 bln euro – Other foreign funding – requested funding for transport, climate, energy, education and digital solutions, including the construction of Rail Baltica.

In view of the increase in public investment in the coming years, it would be very important to follow the even distribution of the availability of funding over the years, reducing the risk of rapid increases and falls in construction volumes, and therefore possible overheating of the sector. A study carried out by the Ministry of Economics – *On projected changes in costs of labour and construction materials in the construction sector and their impact on the national economy* – evidence that a moderate increase in construction volumes and costs is expected in the coming years. The experts foresee a very negligible increase in construction production in 2020, but from next year onwards, the sector could gradually recover by growing by a few percentage points each year and reaching 4.3% growth in 2022 and 6% growth in 2024. Between 2020 and 2022, the increase in construction costs would be measured at 1-5% a year but could reach a 6% level in 2024. The study can be found on the website of the Ministry of Economics https://www.em.gov.lv/lv/buvniecibas-nozare-attistiba-strategija-un-petijumi.

In order to ensure the quality of the construction process, it is important to further improve the regulatory framework of construction. Two draft amendments to the *Construction Law* were submitted to and examined in the Saeima in 2020. The Ministry of Economics has developed a number of amendments to the *General and Special Construction Regulations*, as well as improved and updated the regulation of construction standards separately (see Box 13.2).

Box 13.2

Significant legislative initiatives in 2020

Amendments to the Construction Law were adopted in the Saeima in the 2nd reading on 15 October 2020, the adoption in the final reading is planned by the end of the year (No. 626/p.13). The draft law envisages:

- to cancel the restriction on construction specialists with a professional qualification of a construction technician to continue to work as managers of construction works and construction supervisors after 31 December 2020;
- improvements in the regulatory framework for the construction process for craftsmen and conservators who perform or manage construction craftsmanship or conservation works, with a clear definition of their independent practice rights in construction;
- the right to make changes in structure usage method during the design and construction works, as well as in the conditions for changing the type of use.

Amendments to the *Construction Law* were adopted in Saeima in the 1st reading on 17 September 2020. The draft law envisages:

- to significantly improve the regulation regarding the responsibility of the participants in the construction process, distinguishing the responsibility of the participant in the construction process as a legal person and a certified construction specialist as a natural person, to clearly define the scope of responsibility of each participant in the construction process, including the construction initiator, scope of responsibility, avoiding overlapping of responsibilities;
- to clarify the competence, rights and obligations of the bodies controlling construction;
- the framework for obtaining the information necessary for carrying out the construction design and the responsibility for the sufficiency of the information;
- the introduction of the tacit consent principle.

Amendments to CM Regulations No. 500 of 19 August 2014 **"General Construction Regulations"** (announced by MoSS on 29.10.2020) – the current breakdown of structures into groups is updated and reviewed.

Amendments to CM Regulations No. 529 of 2 September 2014 **"Construction Regulations for Buildings"** (announced by MoSS on 12.11.2020) – harmonisation of restoration and reconstruction of buildings and their parts is simplified promoting a faster and more efficient construction process, reducing the administrative burden and costs.

Amendments to CM Regulations No. 253 of 9 May 2017 **"Construction Regulations for Separate Engineering Structures"** (announced by MoSS on 12.11.2020) – harmonisation of restoration and reconstruction of engineering structures is simplified promoting a faster and more efficient construction process, reducing the administrative burden and costs.

Latvian Construction Standard LBN 200-20 **"General Requirements to Structures"** (announced by MoSS on 24.09.2020; together with amendments LBN 201-15, LBN 221-15, LBN 261-15) – two significant design construction standards are combined creating a single and mutually harmonised construction standard on joint requirements to design of all structures. Related regulation in three other construction standards is moved, mutually arranged in addition.

The draft CM Regulations **"Regulations on Conditions that Must be Included in Contracts for Public Construction Works and their Content"** was submitted for public consultation in November 2020. The draft regulations provide for the introduction of uniform conditions for the procedures for acceptance-transfer of and payment for construction works, as well as uniform conditions for reinforcing the conditions to be included in each contract for construction works under a public procurement without any change in their content. The introduction of uniform acceptance and transfer conditions for construction works, a payment procedure and contract performance guarantees will contribute to the transparency of the process of public construction works, reduce the risk of corruption and the implementation of unsuccessful processes.

Amendments to CM Regulations No. 499 of 19 August 2014 **"Regulations on Construction Inspectors"** (entered into force on 06.11.2020) – improve qualification criteria for construction inspectors extending the range of violations in professional activity prohibiting a person to obtain the rights of a construction inspector at the same time simplifying professional experience requirements for candidates. The regulations also change the procedure of supervision of construction inspectors delegating the right to supervise construction inspectors to their employers.

Over the last three years, a number of complex measures have been implemented in cooperation with the construction sector, which has enabled a significant improvement in the competitiveness of the sector. The construction sector is one of the sectors with high levels of the shadow economy, the main component of which is envelope wages. In 2016, when the Association "Latvian Contractors' Partnership" conducted the first study to assess the shadow economy and its components, the shadow economy volume was 40% in 2015. Thanks to effective and informed concerted action by the construction sector and the government, the volume of the shadow economy has fallen 9.3% in 2019 compared to 2015, reaching 30.7%. The reduction in the shadow economy was most influenced by the *General Agreement of the Construction Sector*, which entered into force on 3 November 2019. The general agreement sets the minimum wage for the construction sector at the level of 780 euro, the minimum hourly tariff rate at the level of 4.67 euro, as well as a mandatory 5% premium if the employee has obtained education in the profession. At the same time, in February 2020, the establishment of a single electronic system for registration of working hours was completed, which collects data from electronic working time recording systems on the actual working time on the construction site, as well as data on contracts for construction works entered into within the scope of implementation of the specific construction concept. The data of the single electronic system for registration of working hours are available to the State Revenue Service for the purposes of tax administration, the State Labour Inspectorate for the supervision of legal employment relations,

supervision of the activities of specialists certified by the State Construction Control Bureau, as well as the Central Statistical Bureau for statistical purposes and in a anonymised manner also for the Ministry of Economics for the planning of sectoral policy. Together, the two measures are considered to be an effective tool for limiting the shadow economy.

In order to promote competition, including in the construction sector, on 11 February 2020 CM approved an ***Action Plan for the Improvement of the Public Procurement System***, which contains a number of measures to improve the selection process for tenderers, attract highly qualified foreign undertakings and mitigate the risk of corruption. In 2020, drafting of guidelines started to ensure an effective process of recognition of qualifications for competence testing bodies in the field of architecture and construction. The guidelines will be published on the MoE website. A working group established by MoE has started working to develop a methodological material for the determination of qualification requirements for the procurement of design, construction expertise, construction supervision services, as well as for the procurement of construction works. The aim of the guidelines is to reduce the risk of inclusion of biased, disproportionate, and one-tenderer-oriented qualification requirements into public procurement regulations, as well as to promote the understanding of the controlling bodies of the specific nature of the construction sector and aspects of assessing the qualifications and experience of construction undertakings.

The **digitisation of the construction sector** continues in 2020. In 2020, the first round of the construction process and information system development project is in its final phase. The project is implemented with financial support from the European Regional Development Fund (ERDF). 7 processes have been improved/developed within the framework of the project, the most important of which is a platform for examining and coordinating construction concepts and construction designs and monitoring the construction process. Participants in the construction process, the bodies controlling construction, as well as other bodies and persons related to the construction process were provided with an opportunity to perform all activities related to the implementation of the administrative process on an electronically convenient and easily accessible platform of the construction information system. From 1 January 2020, with a transition to the electronic construction administrative process, in the construction information system it is possible to initiate construction, obtain a construction permit, request, and receive technical and special regulations, submit documentation of the construction project, obtain all necessary coordinations and acceptances, initiate the commissioning of a structure, and receive a statement on commissioning of a structure. The work on electronic logs for construction works has been completed, allowing the documentation created in the process of all construction works to be stored electronically in the construction information system.

In 2020, the implementation of the 2nd round of the **construction process and information system** development project was launched. The aim of the project is to increase the efficiency of the construction process, the productivity of the sector and to promote the use of information and communication technologies in the management of the construction process and the lifecycle of the building. This will improve the availability of public administration services and ensure the re-use of the data available to the state. At the same time, the administrative burden, the costs associated with the organisation of the construction process and the time needed to prepare the documentation will be reduced. The process of submitting and coordinating the construction concept, the risk management-based supervision process, as well as reporting and information will also be improved. By the end of 2022, it is planned to improve the total of 8 processes of the construction information system, the most important of which are the improvement of the process of supervision of the use of buildings, the improvement of the energy efficiency management process for buildings, the establishment of a process for recording construction and demolition waste, the improvement of a process for examining and coordinating construction projects.

The Ministry of Economics continues to implement the measures provided for in the **construction information modelling** (CIM) road map. The implementation of CIM in Latvia is essential to increase productivity of companies in the construction sector on a local and international scale, as well as to increase quality of construction, shorten the time of implementation of construction and to reduce the costs of life cycle of buildings. CIM consists of modern and transparent construction processes aimed at quality and more efficient use of public funding in construction procurements.

CIM 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 CIM one of the most efficient tools for the development of environmentally friendly and sustainable construction. CIM models may also be used in management and maintenance, as well as supervision of use of structures, because the information available in the CIM model simplifies performance of these activities, as well as reduces their costs considerably.

A work group was created in 2019 representing national regulatory authorities, capital companies, education institutions, non-governmental organisations of the construction sector for the development of a CIM roadmap. The CIM roadmap is a document describing CIM implementation goals, the most essential benefits and priority tasks. The roadmap has been

developed to promote common understanding of the goals to be reached and necessary tasks for implementation of CIM, as well as promotion of public leadership and political support in the implementation of CIM in Latvia.

The CIM roadmap lays down main action lines necessary for its successful implementation in the construction sector – development of standards, guidelines, and regulatory requirements to increase competence of new and existing construction specialists in work with digital tools, identification and demonstration of examples and good practices. Non-governmental organisations, education and state institutions have expressed their support to the measures included in the CIM roadmap by signing the CIM roadmap in December 2019 (available at: https://www.em.gov.lv/lv/buvniecibas-informacijas-modelesana-bim).

In 2019 and 2020, several tasks set in the CIM roadmap were fulfilled, including in 2019 guidelines for employers and the construction sector for setting CIM requirements in public procurements and guidelines for CIM consultation procurements were developed (available at: https://www.vni.lv/lat/projekti/bim_kompetences_centrs/?doc=1160), standards of the ISO 19650 series were taken over, a study of the necessary investments for the implementation of CIM in companies was conducted, as well as training materials on CIM modelling, CIM management and CIM coordination were drafted (available at: https://www.lvs.lv/page?slug=bim).

In 2020, consultations were provided to public employers on the application of CIM guidelines in public procurements, training for construction specialists on CIM modelling, CIM management and CIM coordination will be started and a study of the definition of CIM indicators for evaluation of benefits of CIM will be conducted and good practices in the implementation of CIM projects in Latvia were identified.

At the same time, a review of the most significant profession standards for the construction industry started in 2020 to make it possible to improve study programmes in construction, introducing in them skills and competences related to CIM and construction digitalisation.

In 2021, the Ministry of Economics will continue simplification of the construction process and reduction of bureaucratic obstacles. A review of the regulation of CM Regulations No. 500 of 19 August 2014 "General Construction Regulations" started and improvement of the regulation of Latvian Construction Standard No. 405-15 "Technical Inspection of Structures" continues together with representatives of the construction sector. A number of measures are planned for the qualitative progress of the design process and the performance the process of construction works and for the protection of the interests of the construction initiator. The Ministry of Economy is planning to pass a draft law for the introduction of new and conceptually improved civil liability insurance to public consultation in the near future.

In 2021, MoE will pay great attention to the issues of upskilling and lifelong learning of those employed in the construction sector.

14. HOUSING POLICY

The housing stock in Latvia is rapidly deteriorating. The state, local governments and the population face the challenges of timely and optimal building maintenance. Similarly, with the ageing and the relatively poor technical state of the building stock, the energy efficiency of the existing housing stock is in parallel also lost. According to the estimates of the Ministry of Economics, it is currently necessary to renovate more than 23,000 buildings in the sector of multi-apartment buildings.

44.5% of the total number of buildings in the housing stock were constructed before 1941, 51% – in the Soviet period (until 1992) and 4.4% were renewed in the period of the free state. Only 3% of the buildings in the total share of multi-apartment buildings were built after 2003.[14]

In accordance with Eurostat data, in 2018, only 7.5% of the population rented a housing in accordance with market value, while most of the population (69.3%) own housing without mortgage liabilities, which is mainly related to the extensive privatisation process after the restoration of independence. The report of the European Commission for 2019 about Latvia indicates that access to adequate housing is limited, particularly for low-income groups. 15.2% of the population experiences severe housing deprivation, significantly above the EU average of 4.5%.

Taking into account growing housing costs, the low level of income and purchasing capacity of the population is the main reason for housing availability problems in Riga and other regions. Lack of affordable and qualitative housing is one of the reasons delaying internal mobility of the state, and this causes other negative effects – lower opportunity to involve job seekers and unemployed in the labour market, delayed national economy growth and profound depopulation. The development of the market of rental apartments is stagnating – there are economic, administrative and regulatory obstacles, which delay attraction of investments into construction of low-cost rental apartments – high taxes, long procedure of resolution of rent disputes and lack of long-term funding (for 30 years or more) for projects. OECD has indicated for in its research that a successfully functioning housing market promotes mobility, which respectively ensures effective distribution of human resources and jobs throughout the labour market.[15]

The main directions for resolution of the situation are:

- promotion of the availability of rental housing;
- drafting of a legal framework for rental;
- improvement of a housing support programme for acquisition of housing.

In line with the OECD recommendations (see Box 14.1), by the end of 2021 the Ministry of Economics intends to develop a comprehensive housing policy strategy – a long-term document set out the housing policy objectives for the coming years, which will provide innovative solutions and the necessary funding to address the problems identified, as well as provide for the development of support programmes for housing availability targeting individual groups of society, such as families with children.

The Ministry of Economics has already carried out a number of important tasks to support housing affordability, for example, a support programme for large families has been set up to support housing affordability by granting grants to purchase housing or to extend existing housing (see below – housing support programme). In order to reduce design costs, which on average account for approximately 8% of the total construction costs of a single multi-apartment residential house, the CM has approved financing for the development of a model rental house project, which will therefore be available free of charge. In order to support energy efficiency in private houses, a new support programme will be established providing guarantees for loans for energy efficiency works in such houses.

[14] Information provided by SLS

[15] D.Andrews, A.Caldera Sanchez, A.Johansson. OECD Economics Department. Working Papers No. 836 "Housing Markets and Structural Policies in OECD countries", (2011).

Box 14.1

OECD project on housing affordability in Latvia

To address the situation, in May 2019, the Ministry of Economics launched a cooperation project with OECD on housing affordability in Latvia, in which OECD experts have analysed the situation and developed proposals for an effective set of support tools to improve housing availability in Latvia, inter alia by taking over and adapting good foreign practices.

According to the OECD study, the privatisation process in Latvia, like in other post-Soviet countries, after the change of the Communist regime resulted in the majority of housing being privately owned – seven out of ten households have loan-free housing. The average household expenditure on housing is below the OECD average. On the other hand, the low cost of housing has created another challenge – poor housing quality. Most of the housing has been built during Soviet power and has not been properly maintained. More than a third of households live in overcrowded housing, which is the highest rate in the OECD. Many households do not have the option to move to more qualitative housing without spending more than 30% of their disposable income. Mortgage loans are not available for a large part of the population.

State support for housing availability is received by a small proportion of vulnerable households and low-income households, as well as the level of support is limited. Social rental housing and apartment benefits are the main support tools for people with the lowest income. The state offers mortgage loan guarantees to families with children and young specialists (persons with higher vocational secondary education under 35 years of age). This support can mainly be used by households with higher income in the Riga region. Thus, the existing housing support is not available to a large proportion of households – the "missing middle", which constitutes approximately 44% of all Latvian households, which are too wealthy to receive social housing or housing benefits, but whose income is insufficient to obtain mortgage loan.

Within the scope of the study OECD recommends Latvia:

- to improve assessment of housing affordability and quality, and evaluate needs by undertaking a comprehensive assessment of the technical quality of dwellings and improving the monitoring of housing affordability;
- to invest more in quality affordable housing and reduce construction costs by considering establishing a revolving fund to support upgrades to the housing stock, where upgrades are determined to be most cost-effective, and new affordable housing development; by reducing administrative costs related to construction; and by exploring innovative approaches to enhance the environmental quality and reduce costs of affordable housing development;
- to develop a more affordable, attractive private rental market by levelling the playing field in the private rental market to support more attractive and affordable rental options, which could be particularly beneficial in the Riga region and other urban areas; and diversifying the offer of housing providers;
- to close the gap among the "missing middle", by better calibrating housing support for different households by considering developing a housing refurbishment programme; expanding housing support for lower-income households; and making housing support to moderate-income households, including families with children, conditional on income and dwelling size.

AVAILABILITY OF RENTED HOUSING

At present, investments of the private sector in construction of rental houses on market conditions are insufficient. Available crediting periods are considerably shorter than the period of use of buildings, which increases costs of residential premises. Development of rented housing is only viable if long-term funding with low interest rates is available. The share of households whose total housing related costs cause financial hardship for vulnerable groups (very burdensome/slightly burdensome) was 75.6% in 2018. Construction of multi-apartment houses considerably lags behind Estonia and Lithuania in terms of private investments. 1 889 apartments in multi-apartment buildings were built in Latvia in 2019, while almost two to three times more or 4 193 apartments were built in Estonia and 5 507 apartments were built in Lithuania. Compared to other OECD member states, the share of commissioned apartments in the total residential housing has been one of the lowest in Latvia for a long time. Only 0.28% of apartments in all residential housing were commissioned in 2018. To compare, this indicator was 0.77% in Lithuania and 0.92% in Estonia.

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 statistics on residential areas constructed, because from 2010 to Q2 2020 79.1% of all housing areas and 96.9% of multi-apartment housing areas were built in Riga and Pieriga.

The OECD has shown in its Economic Survey on Latvia that welfare of the population in Latvia in comparison with the OECD's average indicator is one of the lowest exactly in income, healthcare and housing categories. There is also high share of population in Latvia, whose net income is below the poverty threshold, leading to a situation that many households with low income are insufficiently provided with housing.[16]

[16] OECD survey on Latvia (2017). Available at: http://www.oecd.org/economy/surveys/Latvia-2017-OECD-economic-survey-overview.pdf

In light of the foregoing, it is planned to create a sustainable support model for construction of affordable, quality and energy efficient rental housing in the territories with growing employment by creating a financial instrument for granting of long-term loans with low interest rates, such housing would be available to disadvantaged population or more socially vulnerable groups, which cannot acquire housing in market conditions due to solvency restrictions.

There are also plans for support targeted to developers of multi-apartment houses, who wish to construct quality, energy efficient multi-apartment buildings for rent or sale on market conditions. The support would manifest as the availability of guarantees and lowans for construction projects of new energy efficient buildings, in particular in provinces, which is one of the conditions for attraction of investors for the implementation of such projects.

DRAFTING OF A LEGAL FRAMEWORK FOR RENTAL

The currently existing living space rent regulation is outdated, it has been in force since 1993. No residential houses are built today for the purposes of renting. This is related to the lessor's risks, which arise from the regulation, which is currently in force. These risks, at the same time taking into account that a tenant may be removed from living spaces only based on an action, considerably increase the costs of rental houses being built for potential developers of rental housing (increasing also the potential rent), and it is not profitable to build rental houses right now. Therefore, the priority of the Ministry of Economics is to draft a legal regulation for rent, the purpose of which was to promote construction of rental housing and the availability of housing, ensuring a fair balance between interests of lessors and tenants.

The new draft law "Law on Rental of Living Spaces" is currently in the Saeima waiting for the 3rd reading[17]. The new draft law for reduction of shadow economy provides for the right, but not the duty to register tenancy agreements in the Land Register, thus mainly 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.

With a view to provide protection of the interests of tenants, the draft law stipulates that the lessor will 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 draft 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.

Compared to the current law, significant changes are provided for as to 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 provided for in the law.

It should also be noted that the changes in this regulatory framework will affect tenants of denationalised houses with tenancy agreements valid for an indefinite period of time. According to the information report "On proposals for State budget revenue and expenditure for 2021 and the framework for 2021-2023", the priority measures set out in this information report were supported and the State co-financing for the provision of the housing vacation benefit for tenants of denationalised houses was defined. In 2020, information has been submitted to the Ministry of Economics regarding 9 persons registered in Jurmala and 225 persons registered in Riga for the receipt of the vacation benefit for the total amount of 2.8 mln euro.

Viewing and discussion of the draft law continued in the Public Administration and Local Government Commission of the Saeima also in 2020. The Ministry of Economics keeps improving the offered draft law together with parties involved sticking to the initially set goals. 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.

[17] The status of the draft law at the time of preparation of the material (4 November 2020).

HOUSING AID PROGRAMME

The housing aid programme has been highly appreciated by the population so far simplifying families with children securing of the first instalment for the loan for acquisition or construction of housing. During the years of functioning of the programme, since 2014 it has helped more than 12.7 thousand families with 18.3 thousand children to get housing of appropriate size. The programme was extended in 2018 providing 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 guarantee for the first instalment for the loan for acquisition or construction of housing. It was defined that the guarantee for families with children will be available to persons, 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.

In 2020, the improvement of the housing aid programme continues, and amendments were made to Regulations of the Cabinet of Ministers No.95 of 20 February 2018 "Regulations on Public Aid for Acquisition or Construction of a Residential Space". The regulations provide for a guarantee from 10% to 30% for the purchase of a housing for a person living together with or caring for at least one child. Amendments to the regulations provide for an increase of the guarantee by 5% in addition if the residential spaces to be purchased conform to the energy efficiency class "A" of buildings in accordance with Regulations of the Cabinet of Ministers No. 383 of 9 July 2013 "Regulations Regarding Energy Certification of Buildings" or are nearly zero-energy buildings. Such an additional guarantee of 5% would be an incentive to generate higher demand for energy-efficient housing in society.

Box 14.2

Aid Programmes "Support"

This programme will support Latvian families within the framework of CM Regulations No.95 of 20 February 2018 "Regulations on Public Aid for Acquisition or Construction of a Residential Space" providing the possibility of receiving a non-repayable state subsidy for the purchase or construction of housing for families with at least three children.

For families with three children, the subsidy will be 8,000 euro or "normal" housing or 10,000 euro if the housing meets the energy efficiency requirements for nearly zero-energy buildings. For families with four and more children, the subsidies will be 10,000 and 12,000 euro, respectively.

In order to obtain the "Support" subsidy, the value of the property selected cannot exceed 250,000 euro and the income per family member should be up to 17,000 euro per year before tax. The recipient must be a Latvian tax resident for at least the last 12 months, and the subsidy may not exceed 50% of the residential space purchase or construction transaction amount. This non-repayable subsidy will also be available at the same time as the housing guarantee programme and can be used to reduce the amount of the first contribution.

TECHNICAL CONDITION OF BUILDINGS

In accordance with the resolution of the Prime Minister, the Ministry of Economic has been tasked with investigating problems and their causes and making proposals to prevent them with a view to finding solutions for providing a secure residential stock. In relation to this, a draft decree of the Cabinet of Ministers will be prepared, which will include an action plan with the measures to be taken for the improvement of the technical condition of the residential stock during its use. One of the measures already active in the process of identifying the technical condition of the residential stock is the study of the mechanical strength and stability of the enclosures of serial multi-apartment buildings and the preparation of standard solutions.

Since 2019, the Ministry of Economics has been focusing on due diligence of the technical condition of serial multi-apartment houses built in Soviet times to follow up the technical condition of the residential facilities and offer technical solutions for restoration of load-bearing structures of buildings and their elements. Guided by the conclusions and proposals made by specialists, the need to improve the requirements of regulatory enactments with regard to maintenance of buildings will be evaluated. In 2019, multi-apartment residential buildings of series 464 built on a large scale were selected as the object for the survey, as industry experts had indicated that buildings of this series could potentially be more vulnerable to the stability of the supporting structures, taking into account the peculiarities of the structures, the age and the prescribed average service life of the buildings. The survey and uncovering of buildings did not reveal signs of loss of mechanical strength or stability of the buildings – bearing structures of the buildings were in satisfactory technical condition.

After consultation with managers and experts, multi-apartment buildings of series 467 were selected and studied in 2020. The results on the technical condition of buildings of series 467 are expected be known by the end of 2020.

15. TOURISM POLICY

Sustainable development of the Latvian tourism industry, promoting increase in the competitiveness of tourism services in foreign markets, has been set as the objective of the Latvian tourism development policy. The set tasks promote the development of domestic and international tourism, increasing the competitiveness of the tourism industry and export of tourism services.

The main goals, development principles, lines of action and tasks to be implemented in Latvia's tourism policy are set out in the *Latvian Tourism Development Guidelines 2014-2020* (see Box 15.1).

Box 15.1

Latvian Tourism Development Guidelines 2014-2020

The tourism development objective set in the *Latvian Tourism Development Guidelines 2014-2020* (hereinafter referred to as the Guidelines) is sustainable development of Latvian tourism, promoting increase in the competitiveness of tourism services in foreign markets. The document defined main lines of action: 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; 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 ensure the recognition of the Latvian tourism offer in the target markets, especially through modern means of communication.

The growth of tourism services exports is promoted by the formation of tourism clusters in the regions, implementing a marketing strategy developed for each high-priority tourism market based on a well-defined territory, target market segments and corresponding tourism products, as well as clearly positioning Latvia in the supply of the Baltics and the Baltic Sea region.

In the period from 2014 to 2020, the daily average expenditure of a foreign overnight traveller has significantly decreased, although the dynamics of the number of tourists shows a significant increase in all strategic tourism markets, which are determined by the *Latvian Tourism Marketing Strategy for 2018-2023* for the implementation of tourism policy. The daily average expenditure of a foreign overnight traveller has been fluctuating since 2014, however, in 2018 it remained almost unchanged – 65.7 EUR/person, therefore, no increase in the daily average expenditure of a foreign overnight traveller has been achieved. This means that the tourists visiting Latvia choose to spend less and less. On the other hand, when assessing the income of the Baltic States from foreign tourists, the trends show that Estonia earns the most from foreign tourists, while Latvia earns the least. This trend has been observed for the last 10 years.

Business and event tourism and health tourism (including medical exports), cultural and nature tourism are defined as the most competitive types of tourism, and this setting will be maintained in the next period.

In accordance with the *Tourism Marketing Strategy for 2018–2023*, Latvia's priority foreign tourism target markets are Lithuania, Estonia, Germany, Russia, Sweden, Norway and Finland. The secondary target markets are Belarus, the United Kingdom, Poland, Belgium, France and the Netherlands. According to the survey data of tourist accommodations, in 2019 the share of foreign travellers from the countries identified as priority target markets increased, reaching 59.3% (57.5% in 2018), while the share of travellers from secondary target market countries remained at the same level as in the previous year – 15.7% of the total number of foreign travellers.

In the regions of Latvia, the tourism offer is fragmented, undifferentiated and includes the satisfaction of unrelated basic tourism needs, it is often not offered as a package and does not cover a wider scale – tourist destination, so the tourist is not interested in staying longer. In order to develop tourism in regions, it is necessary, firstly, to optimise tourism management by adapting it to the needs of tourist destinations and, secondly, to encourage the development of new products for export and local tourists, and the latter with the growing capacity will be able to attract also foreign tourists.

The development of digitalisation in the industry is relatively low, but technological development trends show that smart tourism is becoming a necessity. Digitalisation is increasingly becoming the basis for the competitiveness of the tourism and travel industry. Also the responsible institutions of the European Union in the period from 2021 to 2027 set out Digitisation and Innovation, Sustainable and Responsible Tourism, Promoting Europe as a Tourism Destination and Internationalising Travel Companies, Skills and Training/Labour Mobility and Improving the Regulatory Business Environment and Promoting Investment and Access to Finance as main priorities of the tourism policy for 2021-2027. The development of digitalisation of public administration is equally important in the processes of increasing the efficiency of tourism – the task of the state is to ensure real-time data accounting, a full-fledged database of tourism resources and support for full-fledged development of the tourism information infrastructure system.

Climate change is also having an increasingly significant impact on the tourism industry. It can influence tourism development in Latvia both as a deterrent and as a developing factor. Climate change can change the visual quality, aesthetic, ecological, economic, scientific, historical and recreational value of landscapes, which in turn can change tourist behaviour and habits and affect the economy of a particular place, region or country. On the other hand, as the air temperature rises and the number of sunny days increases, the flow of tourism could increase.

In addition to the above-mentioned influential role of institutional organisations (policy planning and related funding allocation), there is a multi-layered and horizontal impact from non-governmental professional tourism organisations and strategic partnerships (geographically formed groups and groups forming specific types of tourism) in Latvia. Their impact is widely observed in the form of different types of funding, sources and implemented projects, and the results show the fragmentation of public financial support, taking into account the specificities of the tourism sector – links with different sectors and their management in different institutions.

In 2019, the tourism industry in Latvia formed 4.6% of GDP. It should be noted that the tourism industry has a multiplier effect, increasing the flow of tourists (domestic and international) promotes the growth of various industries. In 2020, the Covid-19 pandemic and related travel and service restrictions have had a particularly severe impact on tourism service providers, given that the number of foreign tourists in the overall tourism turnover was more than 70%. The World Tourism Organization predicts that with the decline in demand for international travel, the decline in tourism globally in 2020 could be up to 78%. It should be taken into account that travellers will be more cautious in planning tourist trips.

Strengthening the export capacity of the Latvian tourism industry remains the central focus of tourism policy also in the new tourism policy planning period in 2021-2027 (see Box 15.2). In order to promote development more rapidly, it is also planned to create tourism infrastructure of national significance, ensuring faster return of tourism flows after the Covid-19 crisis.

Box 15.2.

New tourism policy initiatives for 2021-2027

At the end of 2018, work started on new tourism policy initiatives for 2021-2027, launching a public opinion study for the development of an *Action Plan for Development of Export Capable Tourism Products in Latvia* by studying and analysing existing support instruments and consequently developing proposals for the tourism industry. In 2019, MoE in cooperation with representatives of the tourism industry and researchers carried out work on the development of a new tourism policy planning period for 2021-2027. A study on the tourism industry has also been carried out to develop effective solutions for the next policy planning period.

It is planned to include a series of measures for more rapid development of the tourism industry in the future including the promotion of tourism revenue growth and increasing the number of domestic trips and spending in Latvia. The tourism policy also provides for a more thorough assessment of the return on investment, as well as a reduction of the shadow economy in the tourism industry, in particular, in the hospitality sector. In order to strengthen Latvia's international competitiveness and reduce the impact of factors negatively affecting the development of the industry, it is planned to carry out various development-promoting activities in the next planning period in areas such as health, culture and nature tourism, promoting the development of the export-oriented cluster, implementation of the brand strategy and international tourism marketing, improving of tourism infrastructure and accessibility, strengthening the export capacity of businesses, promoting the development of smart travel destinations and cross-border cooperation.

In the new planning period, the strategic settings of the tourism policy of the MoE have been defined in the *National Industrial Policy Guidelines* on the basis of existing *Latvian Tourism Development Guidelines 2014-2020* and the conclusions included in the mid-term evaluation, the priorities marked in the *National Development Plan for 2021-2027*, discussions with institutions involved in national development planning, as well as the *New Industrial Strategy for Europe.*

Latvian tourism development challenges are also related to the promotion of domestic tourism and cooperation among providers of tourism services and organisations to ensure the development of a qualitative supply, in particular in Latvian regions. The work on separately implementable measures to promote export of medical tourism will continue. In order to promote export capacity of tourism, MoE in cooperation with the Ministry of Health and the medical industry worked on the "Health Care Services Exports Development Plan 2019-2023", the fulfilment of which ensures the development of health tourism and an increase in export of medicine.

International tourism organisations forecast that countries will return to the tourism development indicators of 2019 not earlier than in 2026, thus the main task in the field of tourism in the period until 2022 will be to promote the gradual restoration of international tourist flows and support the recovery of the industry to ensure their international competitiveness in the highly competitive environment. As travel restrictions ease, the world's tourist destinations will fight for the attention of potential tourists, and fierce competition is expected in the coming years.

In response to the consequences of the Covid-19 pandemic and changes in global tourism demand, the implementation of tourism development and promotion measures will face challenges, and therefore the main lines of action in the recovery period of the tourism industry until 2022 will be:

1) to stimulate demand in priority foreign markets, implementing purposeful tourism promotion activities in the target markets, gradually returning the lost foreign tourism market share – 15% per year (compared to 2020);
2) to stimulate domestic demand by partially compensating for the decrease in the flow of foreign tourists and increasing the share of domestic tourism in the total structure of tourism;
3) to support tourism business sectors with high added value and potential to attract foreign tourists, to create a positive image of the country at the international level and export revenues (business and event tourism sector);
4) to provide support and competence in product reorientation and development, adapting to new realities, especially in the field of digitalisation;
5) to promote the formation of ecosystems for mutual synergy between tourism companies and for cross-sectoral cooperation, thus creating added value, new services, increasing the competitiveness and productivity of the tourism industry.

The *Latvian Tourism Marketing Strategy for 2018-2023*, which will be updated according to the current situation related to the spread of the Covid-19 pandemic, has been developed for the coordination of foreign tourism marketing activities. In the post-crisis period, attention will be paid to domestic tourism promotion activities.

IDAL implements cooperation among the countries of the Baltic Sea region in the fields of joint tourism products and marketing, ensuring regular communication with the national tourism organisations of the Baltic States within the framework of the Joint Tourism Committee of Baltic States. In ensuring the efficient use of the resources of international organisations, IDAL participates in the European Travel Commission and the activities organised by it, as well as ensures participation in the European Commission's project "Europe's most outstanding tourist destinations EDEN". In turn, within the framework of the project *3.2.1.2/16/I/002 "Promotion of Latvia's International Competitiveness in Tourism"*, support will be provided for the activities to promote the competitiveness of tourism companies in foreign markets, as well as Latvian tourism marketing activities in foreign markets will be implemented:

- organisation of national stands at international tourism exhibitions;
- implementation of tourism marketing and advertising campaigns in priority tourism markets;
- organisation of visits to Latvia of journalists, bloggers, social network opinion leaders;
- organisation of acquaintance visits to Latvia of representatives of tourism service companies, organisers of corporate and business events registered abroad;
- preparation and publication of tourism information and marketing materials;
- organisation of Latvian tourism publicity events and foreign specialised tourism promotion events;
- organisation of foreign tourist attraction events in the regions of Latvia;
    - organisation of business tourism promotion events:
    - participation in specialised business tourism exhibitions with a national stand;
    - participation in specialised business tourism fairs, forums and exhibitions;
    - publications on business tourism opportunities in Latvia;
    - incoming visits of business tourism service organisers to Latvia;
    - Latvian business tourism presentations abroad;
    - introduction of a program of business and event tourism newsletters.

16. CONSUMER RIGHTS PROTECTION AND MARKET SURVEILLANCE

Consumers are the largest driver of the economy. Today the range of fundamental rights of consumers is rather extensive: the right to secure own needs, the right to safe goods and services, the right to be informed, the right to choose, the right to resolution of disputes, etc. In order to ensure their observation, it is important to ensure the implementation of the consumer rights protection policy in different directions. When shaping the consumer protection policy, all the necessary measures to protect rights and economic interests of consumers should be taken. Consumer rights protection requirements should be taken into account, when defining and implementing other policies directions.

The modern consumer policy includes: protection of rights by law, help in quick and effective resolution of disputes with traders, guarantee of safety of any goods purchased in the single market, alignment of consumer rights with economic and social changes, in particular in the area of digital technologies, energy, financial services, as well as provide consumers with the possibility to choose on the basis of clear, accurate and consistent information.

Taking into account the rapid dynamics under the influence of rapid development of globalisation, digitalisation and technologies, also the consumer rights protection policy is made flexible to respond to the situation dynamically. The policy is implemented in such a way to foster more complete use of the potential of e-commerce to create a favourable and safe environment for consumers.

Therefore, one of important aspects is information of consumers and businessmen on consumer rights protection matters through different informative campaigns, by preparing advertising videos and distributing other materials. In line with our dynamic daily life, the development of e-commerce and rapid development of information technologies, it is important to emphasise the right of consumers to be informed and educated, because it is important for consumers to take well-considered decisions at every step in this fast daily life.

The consumer rights protection system in Latvia is constantly being developed to ensure effective market surveillance and consumer rights protection. The Ministry of Economics is working to improve and develop the existing framework and ensure a high level of consumer rights protection. There is also active cooperation in shaping of the international consumer protection policy and good practices of other countries are used for protection of consumers.

The Ministry of Economics cooperates closely with the Consumer Rights Protection Centre (CRPC) regarding consumer protection.

The CRPC is the main coordinating authority in the area of surveillance of laws and regulations on consumer protection, and the goal of its operations is to ensure efficient protection of consumer rights and interests. In order to ensure the performance of functions, the CRPC implements activities related to monitoring of the consumer rights protection (in the field of protection of consumers' economic interests and supervision of the respect for consumer rights in the draft agreements and agreements concluded by consumers with producers, sellers or service providers), considers consumer complaints, informs and advises consumers and entrepreneurs, implements monitoring activities in relation to unfair commercial practices, e-commerce and advertising, licences non-bank credit providers and extrajudicial debt recovery service providers, measures on the safety and compliance of goods and services, carries out the national metrological supervision, supervision of dangerous equipment and investigations of dangerous equipment accidents (see Box 16.1).

Box 16.1

Activities of the Consumer Rights Protection Centre in 2020.

In handling consumer complaints and providing consultations in the first nine months of 2020, CRPC has provided 31,668 consultations, which is by 5733 consultations or 22.1% more than in the corresponding period of 2019. 26,073 consultations were provided to consumers. 5,177 consultations were provided to legal entities. In the first nine months of 2020, CRPC has received 3219 applications and complaints, which is almost 6% more.

The number of consultations related to the Covid-19 crisis has increased the most, when consumers are interested in their rights if they have purchased a package holiday service, an air service, tickets for concerts and other events. Consumers are also interested in what to do if children's parties, various events have been planned and cancelled. Consumers are interested in what to do if the goods purchased remotely have not been delivered and the amount paid for them has not been refunded.

The question of the duration of provision of repair of goods and provision of answers to consumer complaints has become topical for consumers. Undertakings delay the provision of answers to consumers and repair goods for a long time referring to the obstacles caused by the Covid-19 crisis – shortage of employees, illness of employees, quarantine, as well as long deliveries of parts.

Box 16.1 continued

In connection with the crisis caused by Covid-19, CRPC was mostly approached by consumers who had purchased and could not use package holiday services and air services, or attend the planned concerts, festivals, cultural and sports events.

In the second half of the year, there was a negative trend in the field of e-commerce – several online undertakings faced problems with the delivery of goods purchased and paid for by consumers, which led to an avalanche of complaints at CRPC. 654 complaints have been received about this problem, but it must be admitted that in most cases the involvement of CRPC does not solve the disadvantage for consumers. In several cases, the State Police has initiated criminal proceedings on the actions of such undertakings.

In the case of EU cross-border purchases the European Consumer Centre (hereinafter referred to as ECC Latvia) continues to provide support and information to consumers. 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 first nine months of 2020, consumers and businesses received 760 consultations and more than 400 complaints about cross-border problems within the EU have been dealt with. This is more than in the same period of 2019. Most complaints and consultations are directly or indirectly related to the problems caused by Covid-19 – cancellations of flights, cancellation of package holiday services, and cancellation or postponement of events. Complaints and consultations on online shopping are still relevant – complaints from residents of other EU countries about problems with Latvian e-undertakings, and residents of Latvia about online sales outlets registered in other EU countries.

In consumer rights supervision, in the ten months of 2020, 245 proceedings on violations of the collective interests of consumers had been initiated, including about implemented commercial practices and terms of contracts offered to consumers. The proceedings were mainly initiated in case of unfair commercial practices, which do not meet professional care standards and are misleading, offering consumers goods or services without indicating appropriate or without specifying at all the information laid down in regulatory enactments, or implementing other rights or duties arising from regulatory enactments or contacts in an inappropriate way. Many cases have been initiated in the field of tourism, with increased monitoring of the securing of customer money by providers of tourism services, as well as practices in the online environment (influencers, trade in social networks, practice in online shops), consumer solvency assessment when concluding crediting agreements, in particular taking into account the new requirements of regulatory enactments.

In the wake of the Covid-19 emergency, CRPC prioritised and initiated the monitoring and supervision of commercial practices that offer consumers the purchase of goods and services related to Covid-19 and its prevention, as well as paid increased attention to price increase practices when selling essential goods. Thus, having received reports, inspections were initiated in 71 cases, where violations were stated in 28 cases, voluntary elimination of the violations was achieved. CRPC has sent information on the findings related to unjustified price increases to the Competition Council for evaluation.

In the field of financial services, a number of warnings and recommendations have been provided to consumers (on taking on credit obligations, the nature of credit facilities, changes in the regulatory framework).

In turn, questions and answers have been developed for undertakings regarding the assessment of solvency and the types of granting credit holidays.

At the same time, CRPC called on credit service providers to demonstrate obliging attitude to consumers in relation to the difficulties caused by Covid-19 by reducing commission fees, penalties and other sanctions, postponing recovery actions, granting credit holidays, etc., as well as reducing marketing activities (including the appeal to respect professional diligence and not to benefit from the emergency situation, strengthen creditworthiness assessments).

In order to promote a single interpretation, a question-and-answer document on consumer rights in various areas has been published and developed on the CRPC website: http://www.ptac.gov.lv/lv/buj-covid-19.

Licencing and supervision of providers of consumer crediting services and debt recollection services, registration of and supervision of observation of general requirements by mediators in real estate credits continues, as well as supervision of and issuing/amendment of licences to providers of tourism services is actively performed taking into account insolvency risks.

CRPC continues to monitor the regulation for anti-money laundering and countering the proliferation and financial of terrorism, as well as the regulation on sanctions of the Republic of Latvia and international sanctions in relation to providers of consumer crediting and out-of-court debt services.

The following priority axes are set by CRPC for **market surveillance** in 2020: improvement of safety and compliance of goods and services in fields such as construction products, electrical appliances, machinery, explosive equipment, toys and goods safe for children, radio and telecommunication terminal units, as well as targeted supervision inspections in the field of e-commerce. In addition, inspections were performed in the regions of Latvia, as well as market analysis for smart products was performed.

Projects for inspection of dangerous equipment – in the fields of surveillance of elevators and cargo cranes – is 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.

Taking into account the spread of Covid-19, CRPC has also monitored the prices of essential goods, disinfectants and face masks (respirators, hygienic and medical masks), as well as is involved in public procurement related to the purchase of personal protective equipment to meet the needs of the state. As the epidemiological situation with Covid-19 worsened, there was a sharp increase in the interest of undertakings and other stakeholders and in the demand for advice on personal protective equipment, in particular respirators and various types of face masks. CRPC has provided several hundreds of such consultations to manufacturers, traders and other stakeholders.

In the 9 months of 2020 CRPC carried out 1288 market supervision inspections, 75 metrological supervision inspections in companies, where measuring instruments are used and in companies distributing measuring instruments. 44 inspections were carried out in metrological supervision of pre-packaged products and 92 inspections – in supervision of dangerous equipment.

Along with the rapid pace of innovation and digitalisation in the world, not only the adaptation of supervisory work to new market conditions is taking place, but also the regulatory framework is being updated and European regulation is being transposed into national regulatory enactments. The trend of recent years shows that the number of internet users is growing rapidly, and Latvians have also made an online purchase at least once. Entrepreneurs are also increasingly using the digital environment. The development of e-commerce brings many benefits, but it is important to protect consumer rights in these changes. Also, in 2020, MoE has started work on updating of consumer rights in connection with the sale of goods in person and by means of distance communication, as well as started work on the development of rules for the purchase of digital content and digital services, which currently is a very topical type of goods among consumers.

At the same time, it is important to protect consumers from unfair traders who systematically do not deliver goods ordered by consumers and do not reimburse the price of the purchase in the event of undelivered goods, so MoE has started and continues to work to enable supervisory authorities to restrict access to online interfaces.

2020 has also been important in the field of consumer protection in connection with the Covid-19 pandemic worldwide, which has required increased involvement of the Consumer Rights Protection Centre and the Ministry of Economics.