MONITORING REPORT N. 12
21.01.- 28.02.2021.

SUMMARY

1. Different trends in Covid-19 infection rates are observed in EU countries. For example, in Portugal, Ireland and Lithuania, infection rates are falling and restrictions are being slightly eased; while in others, such as the Czech Republic and Estonia, infection rates are rising and restrictions are being tightened. In Latvia, the emergency situation has been extended until April 6, 2021. Vaccination rates in Latvia lag behind other EU countries. On February 28, 2.8% of the Latvian population received at least one dose of vaccine in Latvia, while in Lithuania and Estonia this indicator is 5.9%. Low vaccination rates in the EU and Latvia significantly slow down the chances of returning to the full functioning of the economy.
2. According to CSB data published in February, GDP contracted by 3.6% in 2020 in Latvia- a much better result than the Ministry of Finance (MoF) forecast in June last year -7%[1]. Other macroeconomic indicators in 2020 are also better than forecast in the first half of 2020. The budget deficit reached 5.3% of GDP instead of the planned 7.6%. According to preliminary estimates, government debt reached around 44% of GDP instead of the planned 47.3%. In general, considering the severity of the Covid-19 crisis, the macroeconomic data in 2020 indicate that the goal of economic stabilization was achieved by the government from the macroeconomic point of view.
3. Recent developments point to macroeconomic risks. The decline in retail trade was observed at 4.5% in December 2020, but already reached 11.4% in January, which is higher than the decline in April 2020, when the country had even stricter restrictions on movement and shopping. Thus, without a revision of the approach to trade restrictions, the contribution of household consumption to GDP in the first quarter of 2021 can be expected to be negative, but a resumption of full trade could be expected to have a deferred consumption effect, as observed in the third quarter of 2020.
4. The Council has approved the macroeconomic forecasts of the Ministry of Finance for the development of the Stability Program for 2021-2024. The Council has assessed them as acceptable in a context of high uncertainty and downside risks, while pointing to a number of risks. The MoF scenario envisages a moderate resumption of GDP growth of 3% in 2021[2] and higher GDP growth of 4.5% in 2022. The European Commission (EC) and the International Monetary Fund predicted a different growth trajectory for 2021 and 2022, with an emphasis on faster growth in 2021 and more moderate growth in 2022. In February the EC forecast GDP growth at 3.5% in 2021 and 3.1% in 2022[3]. In October 2020, the International Monetary Fund forecast rapid growth of 5.2% in 2021. and 5.1% in 2022[4], but since then the situation has deteriorated and risks have increased. It should be noted that the scenario of the Bank of

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[1] 15.06.2020. FDP viedoklis par Finanšu ministrijas makroekonomisko rādītāju prognozēm 2020. gadam un 2021-2023.gadam

[2] Finanšu ministrija 2021. gadam prognozē ekonomikas izaugsmi 3,0% apmērā | Finanšu ministrija (fm.gov.lv)

[3] ecfin_forecast_winter_2021_lv_en.pdf (europa.eu)

[4] International Monetary Fund, World Economic Outlook Database, October 2020

Latvia is similar to that of the Ministry of Finance, forecasting slower GDP growth of 2.8% in 2021, but faster growth of 5.3% in 2022[5].

5. When commenting the macroeconomic forecasts prepared by the MoF, the Council highlighted the following main risks: (i) delays in vaccination rates and low levels of public confidence, which could significantly delay the economic return to pre-crisis levels; (ii) the use of EU funds and the Economic Recovery and Sustainability Mechanism in a way that is incompatible with the challenges of increasing economic potential and productivity; (iii) delayed the start of economic recovery programs, which could lead to uneven economic recovery and overheating in 2023/2024 in certain sectors of the economy, in particular construction.
6. At its meeting on 4 February 2021, the Cabinet of Ministers took note of the Informative Report on the draft plan of the European Union Recovery and Resilience Facility (RRF), which envisages that the FDP is also involved in the evaluation of the plan. Effective and rapid use of this support instrument is one of the preconditions for the country's economic growth in the near future. There are risks that the implementation of the program may be delayed and that its economic and fiscal impact may not achieve the intended objectives. In Latvia, the final version of the RRF plan must be submitted to the EC by the end of April 2021.
7. In November 2020, the government consolidated debt reached 13.079 billion euros. (44.6% of GDP in 2020) and 12.459 billion euros in December 2020 (42.5% of GDP in 2020). but in January 2021 it was measurable at 11.771 billion euros (38.2% of projected GDP in 2021). In December 2020 and January 2021, Eurobonds issued in 2014 and 2015 were redeemed, which allowed to reduce the amount of consolidated government debt by 1.550 billion euros. Government debt trends in January 2021 were affected not only by debt repayment, but also by borrowing transactions, including receipt of the remaining part of the loan from the Nordic Investment Bank in amount of 250 million euros, and 66.750 million euros in debt securities issued in the domestic market. In addition to debt repayment, a number of support measures are planned, which could raise debt levels again to an even higher level than in 2020.
8. Looking at GDP losses by type of output, they measure at 1.169 billion. (4% of GDP in 2020) and an increase in government consolidated debt from January 2020 of € 1.520 billion (5.2% of GDP in 2020). Considering this, it can be concluded that the amount of economic support paid by the Government (1.313 billion euros) is comparable to economic loses; however, it could not offset the existing socio-economic tensions and address the income inequalities that existed before the Covid-19 crisis. Further economic support should focus on the post-crisis reintegration of enterprises and addressing labor market challenges, assessing the multiplier effect of government investment on GDP.
9. The amount of taxes collected in January and February 2021 reached 104% and 101% of the level of the respective period of the previous year, respectively. This suggests that the second wave of Covid-19 has a smaller impact on the economy and the amount of taxes collected than the first wave.
10. The impact of the support measures planned and conceptually approved by the Cabinet of Ministers on the state budget for 2021 is rapidly increasing, which

[5] Monetārā politika - Prognozes (bank.lv)

currently already exceeds the impact of support measures on the 2020 budget (1.4 and 1.1 billion euros, respectively). According to the assessment of the Ministry of Finance, the impact of support measures on this year the budget could reach from 1.7 to 2 billion euros, which could increase the level of public debt to 50.8% of GDP by the end of 2021 and the budget deficit to 9.4% of GDP. The Council believes that the government is moving from too little aid to the other extreme, too much spending. The Council is concerned about the pace and volume of projected increases in budgetary expenditure, with support increasingly appearing to be politically rather than economically justified. Further expenditure growth is very risky. From a budgetary point of view, the amount of aid is likely to already exceed the negative output gap in the economy caused by the COVID crisis. The question is also whether such a sharp increase in spending will not create a political temptation to further increase spending in a number of areas. The country risks causing inflation and unreasonably increasing the level of debt. The COVID-19 crisis is not over, and there are concerns about what will happen to unemployment and insolvency after the end of support measures. Therefore, it would not be right to use all the available reserves now.

11. The EC has issued Fiscal Guidelines[6], with proposals for Member States' fiscal strategies. The document predicts that the EU's fiscal rules will not be in force in 2022, and calls on member states to use fiscal instruments to protect their economies and populations until they have fully stabilized their economies. The guidelines warn that EU debt is approaching 100% of GDP and that support measures will need to be carefully reduced in 2022 to return to fiscal sustainability without slowing down the economic recovery. Reduced taxes and wage subsidies are offered as the most effective tools in the economic recovery phase.

RECOMMENDATIONS

1. The planned support measures and their impact on government deficit and debt levels are growing rapidly. Some of the support measures are not well targeted at those affected by the crisis. Therefore, the Council calls on the government to consider very carefully the introduction of new support instruments and to limit financial support to those citizens and businesses affected by Covid-19. The construction sector is one of the least affected by the crisis, and over-supporting it is not only pointless, but also increases the risk of inflation in the sector. Support must be well targeted and selective, based on economic and social rather than political considerations. The Council considers that, in the current context, it would be desirable to keep public debt below 50% of GDP. It is possible to use the positive performance of economy in 2020 and meet the planned level of debt envisioned in 2021/23 medium-term budget framework.
2. As the economic recovery is expected in 2021, it would be necessary not to increase general government debt, which would put additional political pressure on governments in the coming years and reduce the fiscal space for necessary

[6] https://ec.europa.eu/info/sites/info/files/economy-finance/1_en_act_part1_v9.pdf

development projects and reforms, as well as negatively affect Latvia's current high credit rating in the long run.

3. Labor shortages in a wide range of occupations will be one of the obstacles to economic development in the medium term. For this reason, the Council calls on the government not to extend the terms and amounts of unemployment benefits. Increased support is allowed only in the coming months - until the end of the second wave of Covid-19.
4. The effective and rapid use of the Recovery and Resilience Facility (RRF) must be one of the current priorities of the government's economic policy.
5. The indicative implementation of the RRF and the investment directions should be included in the forecasts of the Stability Program. It would still be important to work on a number of scenarios like (i) a delayed vaccination scenario and the need to maintain restrictions in the second half of 2021, and (ii) delaying the implementation of the ANM program- and assess the impact on public finances and the economy

1. General situation development

Different trends in Covid-19 infection are observed in EU countries. For example, in Portugal, Ireland and Lithuania, infection rates are falling and restrictions are being eased slightly; while in others, such as the Czech Republic and Estonia, infection rates are rising and restrictions are being tightened. In Latvia, the reduction in the rate of infection is minimal, and accordingly no significant restrictions have been eased. The Cabinet of Ministers has once again extended the emergency situation in Latvia, this time until April 6, 2021. Vaccination rates in Latvia are relatively low even compared to other Baltic countries. On February 28, 2.8% of the Latvian population received at least one dose of vaccine in Latvia, while in Lithuania and Estonia this indicator is 5.9%. Low vaccination rates in the EU and Latvia significantly slow down the chances of returning to a fully operational economy.

The International Monetary Fund (IMF) has published the World Economic Outlook for January 2021[7], which forecasts global economic growth of 5.5% in 2021 and 4.2% in 2022, in the euro area at -4.2% and 3.6%. This year's forecast has been slightly improved in view of the forthcoming vaccination and the introduction of support programs in major economies. The contraction of the global economy in 2020 is estimated at 3.5%, in the euro area -7.2%. The pace of economic recovery will vary widely between countries, with the main drivers of the pace of recovery being: (i) access to health care, (ii) the effectiveness of support programs, (iii) the impact from other countries, (iv) the structural characteristics of national economies. In order to achieve the fastest possible economic recovery, the report recommends policies aimed at: (i) increasing economic potential, (ii) benefiting economic growth and security for all, (iii) reducing CO2 emissions faster, and (iv) international cooperation in the vaccination process.

There is a growing debate among the world's leading economists about the possible rise in inflation and its potential impact on the economy and financial markets. Although too little inflation has been a problem in recent years and economic models are still predicting relatively low inflation in the near future, there are increasing signs that inflationary pressures are increasing. Global oil prices have risen sharply, with supply chain disruptions leading to deficits, which in turn have led to rising prices for

[7] https://www.imf.org/en/Publications/WEO/Issues/2021/01/26/2021-world-economic-outlook-update

certain commodity groups. The US fiscal stimulus of 1.9 trillion (more than 8% of GDP) is projected to have a significant impact on post-crisis inflation in the US. Rising inflation has the potential to cause interest rates to rise. This, in turn, leads to more expensive public debt service and limits the ability of countries to use fiscal instruments to promote economic growth. It also has the potential to shake the stock market, as stock prices are calculated on the basis of low interest rates. Of course, there is no much reason to panic yet, but the development of economic indicators must be closely monitored. For example, in the euro area, annual inflation reached 0.9% in January 2021, and US 10-year government bond yields reached 1.5% at the end of February.

At the end of February, the European fiscal board held its annual conference to discuss the fiscal situation and regulation in EU countries. The Covid-19 crisis has increased the debt levels in all member states, and there is a need to develop a new fiscal framework for the post-crisis period. At the conference, EC Executive President Valdis Dombrovkis emphasized that fiscal regulation is effective only if it has the political support of the Member States. The new framework must be drawn up by agreement between the countries - what they want to achieve with it. The current framework is too complex and needs to be simplified to meet the economic interests of all countries and to ensure that fiscal policy objectives of sustainability, counter-cyclicality and quality are met. The EC has presented the Fiscal Guidelines with proposals for Member States' fiscal strategies. The document predicts that the EU's fiscal conditions will not be in force in 2022, and calls on member states to use fiscal instruments to protect their economies and populations until countries have fully stabilized their economies. The guidelines warn that EU debt is approaching 100% and that support measures will need to be carefully reduced in 2022 to return to fiscal sustainability without slowing down the economic recovery. Reduced taxes and wage subsidies are offered as the most effective tools in the economic recovery phase.

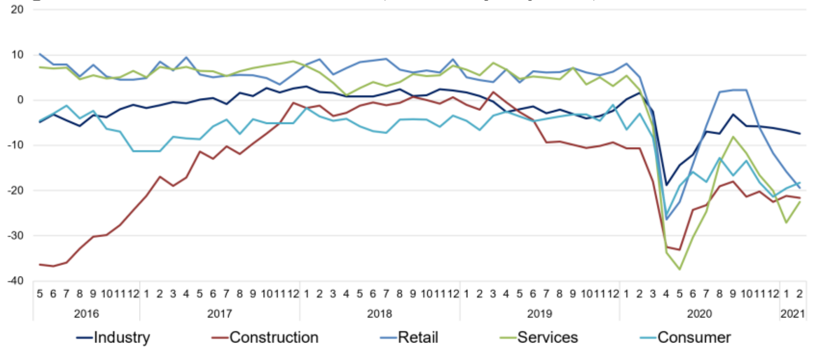
At European level, there is growing talk of the effective use of the European Recovery and Resilience Instrument (RRF) to strengthen the potential of European economies in line with EU priorities: (i) promoting EU economic, social and territorial cohesion, (ii) strengthening economic and social resilience, (iii) mitigating the social and economic impact of the crisis, (iv) supporting green and digital transformations. This is a new EU instrument and is expected to be financed from the EU's own revenues, which would be a major step towards fiscal centralization in the EU. A draft RRF plan has been prepared in Latvia. The Fiscal Discipline Council has established a common platform with the Productivity Council and will make proposals for improving the RRF plan.

2. Macroeconomic situation in Latvia

2.1. Economic Sentiment

Confidence indicators in Latvia continued to decline in the first months of 2021; however, in February compared to January, the decline slightly slowed down, which could indicate the expected resumption of operations and hopes that the restrictive measures will be lifted. At the same time, it should be noted that the economic sentiment of the service sector in February was (-22.5%), which is the lowest indicator among other sectors.

Figure 2.1. Confidence indicators (seasonally adjusted) balance, %

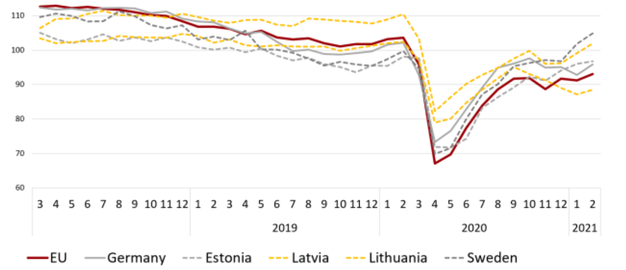


Source: CSB [KR020m]

The second lowest confidence indicator is in the Construction sector (-21.6%), which is low for a long time, and thus no significant decrease was observed compared to January -0.4pp. The consumer confidence indicator is also negative (-18.3%), although compared to January, the decline decreased minimally by 1.2pp. In February, compared to January, the confidence indicator for retail trade deteriorated by 3.6pp., reaching (-19.4). As a result of the Covid-19 containment measures, the mobility of the population has decreased, as well as the introduced trade restrictions keep the mood of retail entrepreneurs negative.

The confidence indicator in manufacturing is (-7.4%), there is a certain stability in this segment, which is also confirmed by the small fluctuation of the indicator by months. For example, in February, the decrease compared to November was only 0.7 percentage points. In February, the long-term average economic sentiment indicator in Latvia was 88.5%, and compared to January, it has improved by 1.3pp. It also improved slightly for Latvia's main trading partners compared to January. Eurostat data show an improvement of 3%pp in Germany, 3.1pp in Sweden and 2.8pp in Lithuania compared to January. A more cautious increase compared to January is observed in Estonia at 0.8pp. In general, Latvia's sentiment looks more pessimistic against the background of its trading partners, although it has started to improve minimally.

Figure 2.2. Economic sentiment indicators in Latvia's main trading partners

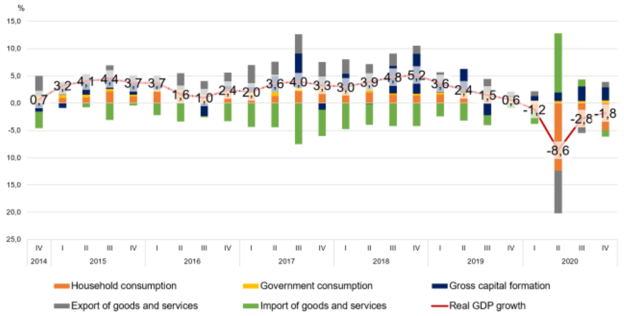


Source: Eurostat [Code: teibs010]

2.2. The fall in GDP in 2020 was smaller than projected

The decline in gross domestic product in 2020 reached 3.6% and this indicator is 3.4 percentage points higher than the approved forecast of the Ministry of Finance.
In forecasting GDP growth, the MoF used a conservative approach, which allowed for additional fiscal security in times of high uncertainty. According to the CSB data[8], GDP at current prices in 2020 was 29.334 billion euros. In the 4th quarter of 2020, compared to the 4th quarter of 2019, GDP decreased by 1.8%. In the fourth quarter of 2020, household consumption had the largest negative impact (-5%), while investment (2.4%) and government consumption (0.5) and exports (1%) had a positive impact on the result of the last quarter of 2020.

Figure 2.3. Contribution to GDP growth (increase over the corresponding period of the previous year)

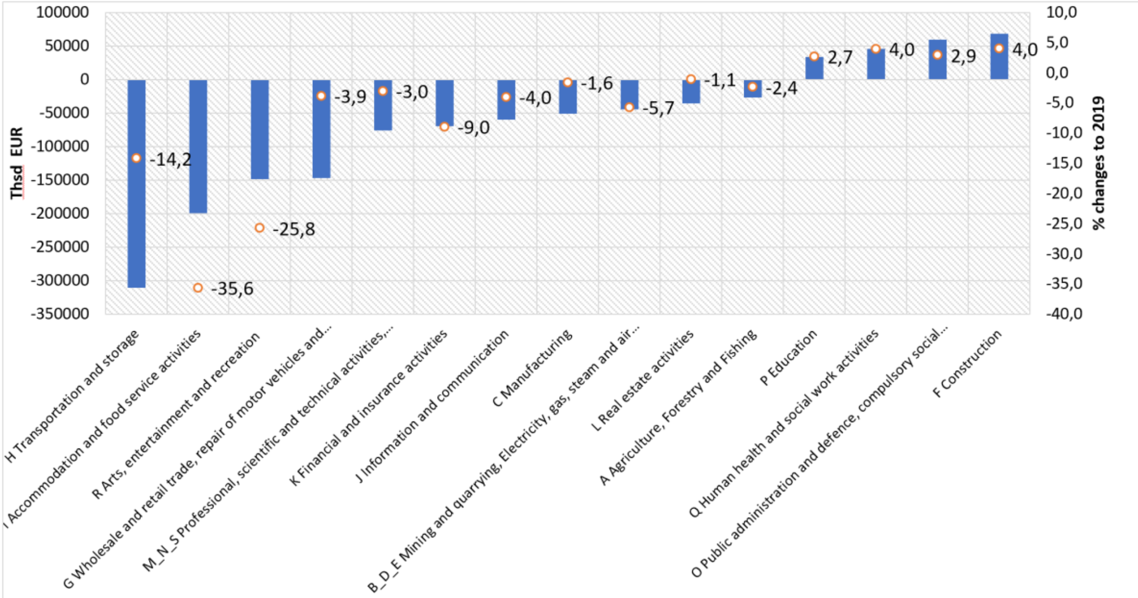


Source: CSB [IK10_07]

Looking at the contribution of various kind of activities to GDP, it can be seen that compared to 2019, most sectors were unable to make an equal contribution to GDP growth. The largest decrease in euro terms were in transportation and storage (-310 million euros), accommodation and food service activities (-199 million euros), arts, entertainment and recreation activities (-148 million euros) and wholesale and retail trade (-147 million euros). In total, the reduction of the most affected sectors in GDP is more than 805 million euros. In addition to these sectors, the reduction in other affected sectors to GDP is estimated at 364 million. euro. At the same time, the activities that contributed to GDP in 2020 are education, health and social care, public administration and defence, and construction. Compared to 2019, the contribution of these types of activities to GDP increased by 206 million euros.
Overall, looking at the loss of GDP by type of activity in 2020 (-1.169 billion euros) and the increase in general government consolidated debt in 2020 (1.520 billion euros), it can be said that the amount of economic support paid by the Government so far (1.313 billion euros) has been adequate with the amount of damage. However, it could not offset the existing socio-economic tensions and address the income inequalities that existed before the Covid-19 crisis. Further economic support should be focused on the post-crisis reintegration of enterprises and the resolution of labour market problems, assessing the multiplier effect of government spending on GDP. As the economic recovery is expected in 2021, it would be necessary
discontinue increasing the general government debt, which would put additional political pressure on the governments of the coming years and reduce the fiscal space for necessary development projects and reforms, as well as negatively affect Latvia's current high credit rating.

[8] Gross Domestic Product in 2020 | Central Statistical Bureau of Latvia (csb.gov.lv)

Figure 2.4. Gross domestic product by kind of activity (Current prices, thsd euro)



Source: CSB [ISP030c]

2.3.Forecasts for GDP growth in 2021 and beyond are conservative

In February, the Council endorsed MoF macroeconomic forecasts[9], which will be used as a basis for preparing the Stability Program for years 2021-2024. The Council assessed the forecasts as acceptable in a context of high uncertainty and downside risks. Ministry of Finance forecasts a moderate resumption of GDP growth of 3% in 2021 and a higher GDP performance of 4.5% in 2022[10]. The European Commission and the International Monetary Fund forecast a different growth trajectory for 2021 and 2022, with an emphasis on faster growth in 2021 and more moderate growth in 2022. The European Commission forecasts GDP growth of 3.5% in 2021 and 3.1% in 2022[11]; and the International Monetary Fund 5.2% in 2021. and 5.1% in 2022.[12] The European Commission's forecasts were published in February, but the latest IMF forecast for Latvia was published in October 2020, but since then the situation has deteriorated and risks have increased. It should be noted that the Bank of Latvia's approach is similar to the MoF's approach, forecasting slower GDP growth of 2.8% in 2021, but faster growth of 5.3% in 2022.[13]

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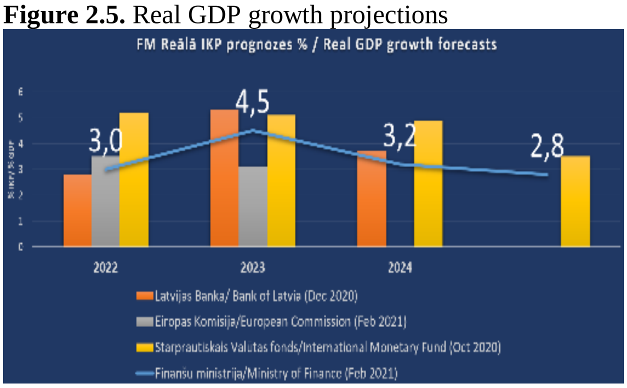
[9] 11.02.2021. FDC opinion on the ministry of finances macroeconomic forecast for SP 2021-2024 (fiscalcouncil.lv)
[10] Finanšu ministrija 2021. gadam prognozē ekonomikas izaugsmi 3,0% apmērā | Finanšu ministrija (fm.gov.lv)
[11] ecfin_forecast_winter_2021_lv_en.pdf (europa.eu)
[12] International Monetary Fund, World Economic Outlook Database, October 2020
[13] Monetary policy - Forecasts (bank.lv)

The Council called for an objective assessment of the risks involved and noted the following as the most important of them: (1) delays in vaccination rates and low levels of public confidence, which may significantly delay the return of the economy to the pre-crisis level, (2) inefficient use of economic recovery funds (EU structural funds and the Recovery and Resilience Facility) inconsistent with the funds objectives of increasing economic potential and productivity, (3) delays with launching RFF which will lead to uneven economic recovery and overheating in 2023/24 in certain sectors of the economy, in particular in construction.

Figure 2.5. Real GDP growth projections



Source: MoF, BoL, IMF, EC

2.4. Debt level

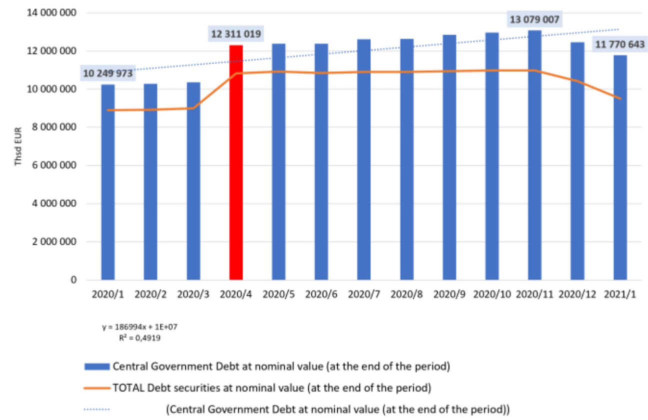
The operational data of the Treasury show that in January, the total nominal value of central government and local government consolidated debt was 11.845 billion euros. At the end of 2020, it was 12.561 billion euros. The fastest increase in debt was observed in April 2020 (+ 18.5%) compared to March 2020. Debt has continued to grow minimally since May 2020, but has already declined in December 2020 and January 2021.

It should be noted that the share of local government debt in the central government consolidated debt is small and most attention should be paid to the dynamics of the central government consolidated debt, as it makes up the largest part of the general government debt. In January 2021, the amount of central government consolidated debt was 11.771 billion euros, but in December 2020 12.459 billion euros and in November 2020 it reached 13.079 billion euros.

In December 2020, bonds in amount of 550 million euros issued in 2015 were repaid. In January 2021, Eurobonds in amount of 1 billion issued in 2014 were repaid. Government debt trends in January 2021 were also influenced by borrowing transactions, including receipt of the remaining part of the loan of the Nordic Investment Bank (250 mln. euros) and debt securities issued in the domestic market (66.750 mln. euros).

As a result, consolidated central government debt increased by 1.520 billion euros between January 2020 and January 2021.

Figure 2.6. Central Government debt dynamics by months



Source: State Treasury

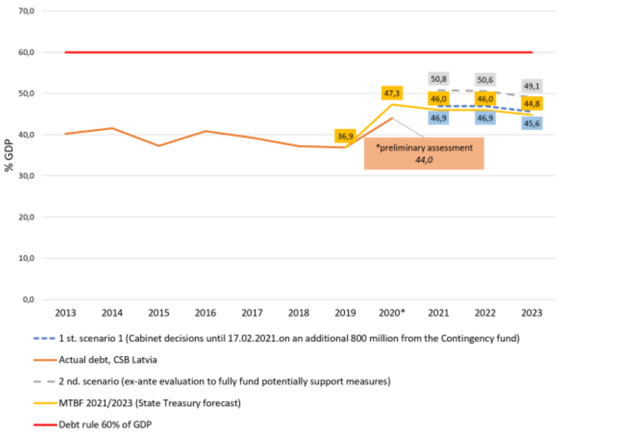
Given the recurrence of the rapid outbreak of Covid-19 at the end of 2020 and its socio-economic consequences, the need to extend state aid measures to citizens, businesses and public sector has increased. Therefore, by February 17, 2021, the Government has adopted a series of decisions that required 800 mln. additional funding from the "Fund for unforeseen events". According to the estimates of the Treasury and the Ministry of Finance, the use of this amount of funding will lead to an increase in general government debt in 2021 to ~ 47% of GDP[14]. Moreover, if budget funding will be granted to all state support measures foreseen, that could lead to an increase in general government debt in 2021 to ~ 50% of GDP.

Looking back at the debt projections in spring 2020, it is noticeable that the Stability Program 2020/2023, in the context of the first Covid-19 outbreak, projected an even higher debt level.

It projected that, general government debt would be short of only 7.8% in 2021, 6.7% in 2022 and 6.9% in 2023 the 60% of GDP threshold. It should be noted that the decline in GDP at that time was also projected to be much steeper than the real outcome in 2020, while the recovery forecast for 2021 was projected at only 1.02%.

Despite the rapid increase of general government debt at the beginning of 2020, already when planning of the Medium-Term Budget Framework 2021/23 (MTBF), the debt was projected to be significantly lower in 2020 than in the Stability Program - at 47.3% of GDP, and it will be reduced in the coming years. According to updated Treasury calculations, the actual debt level at the end of 2020 is expected to be lower than forecast and will tentatively amount to 43.7% of GDP (data will be confirmed in April).

Figure 2.7. General government debt development scenarios - forecasts and outcome



Source: ST, CSB, MoF
2020 Data on the actual outcome of general government debt will be available in April 2021*

Considering that the economic downturn in 2020 was lower than projected and the debt level did not reach the projected level, it left fiscal space for expanding support measures, but at the same time to observing debt level of 47.3% of GDP projected in the MTBF 2021/23. This fiscal space should not be used considering the high uncertainty and risks for economic development[15].

Planning expenditure growth according to the current macroeconomic forecasts, it should be taken into account that the economic downturn is not

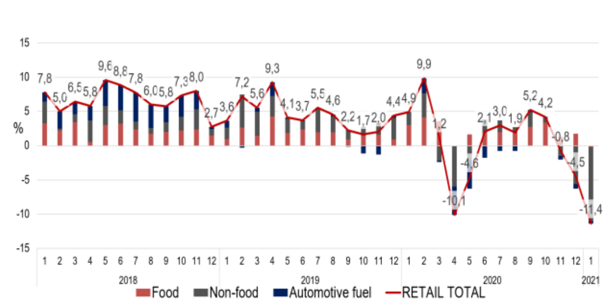
[14] Latvijas Republikas Ministru Kabinets: Tiesību aktu projekti (mk.gov.lv)
[15] 11.02.2021. makroekonomikas prognožu apstiprināšana (fdp.gov.lv)

expected in 2021. Instead, the growth of 3% was projected for 2021, therefore increasing the level of debt and deficit in such circumstances is allowable at a very small margin.

2.5.Retail turnover

Retail sales continued to decline, both in response to retail restrictions and in a context of pessimistic consumer sentiment and uncertainty. The decline in retail trade was observed by 4.5% in December 2020, but in January it reached 11.4%, which is similar and higher than the decline in April 2020, when the country had even stricter restrictions on mobility and shopping. In January, the largest decline was in non-food retail trade (-10.8%), which most directly reflects the effect of trade restrictions, followed by relatively small declines in trade in motor fuels and food products (-0.4%) and (-0.2%), respectively.

Figure 2.8. Retail (month over the corresponding month of the previous year)

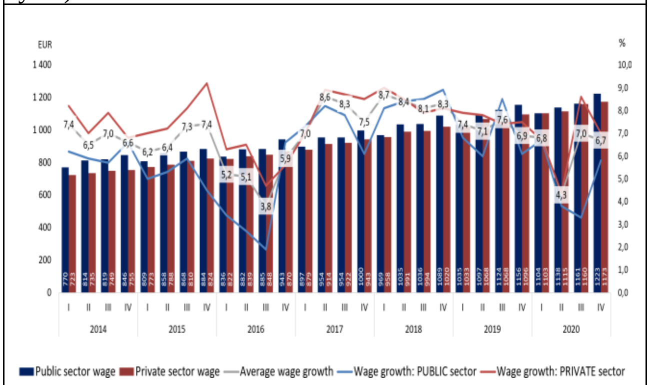


Source: CSB [TI030m.]

2.6. Labour market and wages

In January 2021, the actual unemployment rate in Latvia was 8.8%, which is 0.6 percentage points more than in December of the previous year, according to the Central Statistical Bureau (CSB) Labour Force Survey data. The unemployment rate registered with the State Employment Agency (SEA) was 8.0%, and compared to December, the unemployment rate has increased by 0.3 percentage points[16]. The forecast of the Ministry of Finance on the unemployment rate for 2021 is 8.3%, which indicates that the unemployment rate will vary around the indicators achieved in April 2020 with the start of the first wave of Covid-19.

Figure 2.9. Average gross wage and annual wage growth (increase over the corresponding period of the previous year)



Source: CSB [DS020c]

The labour market reflects economic developments in general and the very uneven impact of the COVID-19 crisis on various sectors as well as social groups. The COVID-19 pandemic has severely affected certain service sectors, which have been severely restricted for almost a year now. Meanwhile, other sectors such as industry, construction and professional services have not been significantly affected by the second wave of COVID-19 and are continuing to grow. Unemployment for people with higher education has fallen

[16] Unemployment in January 2021 | Central Statistical Bureau of Latvia (csb.gov.lv)

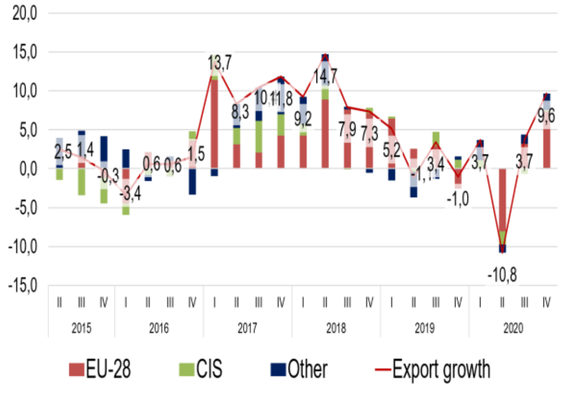
from 5.6% in the first quarter of 2020 to 4.5% at the end of the year. Meanwhile, the unemployment rate for workers with secondary education has risen from 7.5% to 10%.

In the last quarter of 2020, gross wages and salaries of employees increased by 6.7%, while wages and salaries in the private sector increased by 7% and in the public sector by 5.8%. On average, wages increased by 6.2% in 2020, with the growth rate in the private sector being higher (6.7%) than in the public sector (4.9%). In 2020, gross wages for full-time work averaged 1143 euros. The average salary in the public sector in 2020 was 1157 euros, but in the private sector 1138 euros, i.e., by 19 euros less.[17] According to the CSB in-depth study, because of the COVID-19 pandemic crisis, the number of full-time employees in the country decreased by 29.3 thousand or 3.9% in 2020 compared to 2019. It was affected by redundancies, reductions in workloads and a decrease in the number of full-time employees due to downtime benefits paid. The decline was observed in all sectors except information and communication services, real estate and health and social care- where there was an increase.
The uneven impact of the COVID-19 crisis can also be seen in the income structure: the proportion of workers receiving the minimum wage or lower has fallen by 15% to 10% over the year, while the proportion of high-wage earners has risen from 6% to 8%.

2.7. Exports

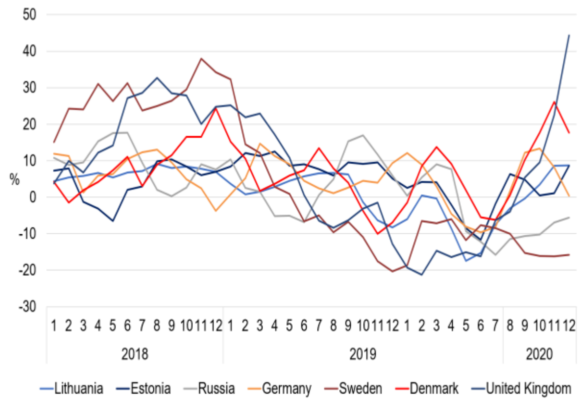
The volume of exports in the last quarter of 2020 increased by 9.6% compared to the last quarter of 2019. Exports to EU countries increased by 7.3%, but to other countries by 2.1%. At the end of 2020, exports of timber and timber products to Denmark and the United Kingdom increased significantly. Compared to November 2019, exports of these goods to Denmark increased by 42% and to the United Kingdom by 59%, while in December timber exports to the United Kingdom increased by 126% due to the closure of Brexit.

Figure 2.10. Contribution to export growth by region (quarter over the corresponding quarter of the previous year)



Source: CSB [AT020c]

Figure 2.11. Growth of export to main export countries, (three months aggregate over the corresponding period of the previous year)



Source: CSB [AT0051m]

In total, in 2020, the value of Latvia's exports of goods amounted to 13.19 billion euros, which is 1.7% or 224 million euros more than in 2019. During 2020, exports of cereals made a significant contribution to exports of goods in the last quarter of 2020, as well

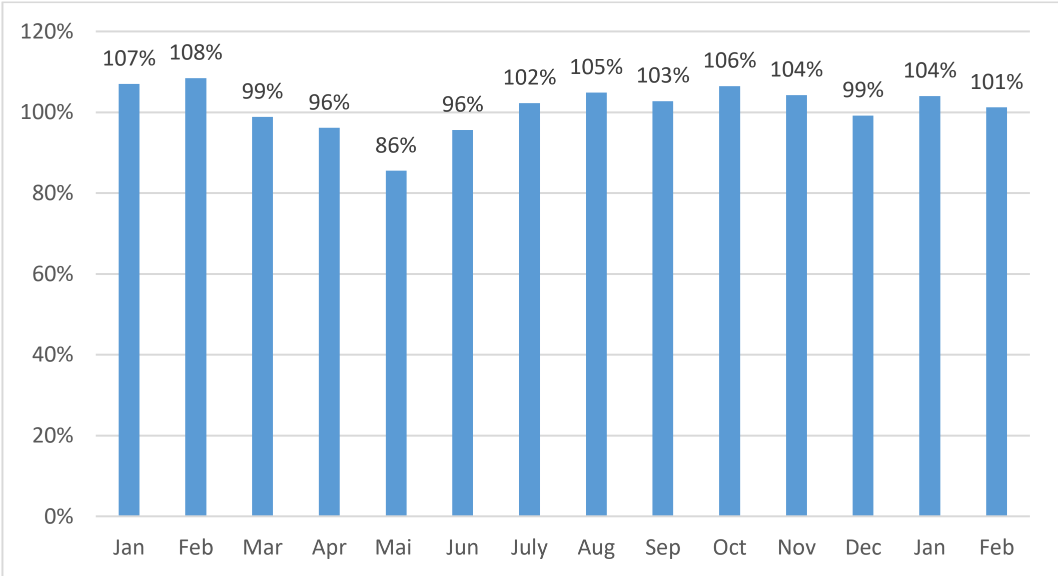
[17] Changes of wages and salaries in 2020 | Central Statistical Bureau of Latvia (csb.gov.lv)

as exports of electrical and electrical equipment and parts, and exports of boilers, machinery and mechanical appliances.

3. Budget balances and tax revenues

The results of the last months of tax collection show that the second wave of Covid-19 affects economic development and tax collection to a lesser extent than the first wave. In December, tax revenue was 99% of the previous year respective period

Figure 3.1. Total dynamics of state basic budget taxes and SSC revenues in the last 14 months compared to the corresponding period of the previous year

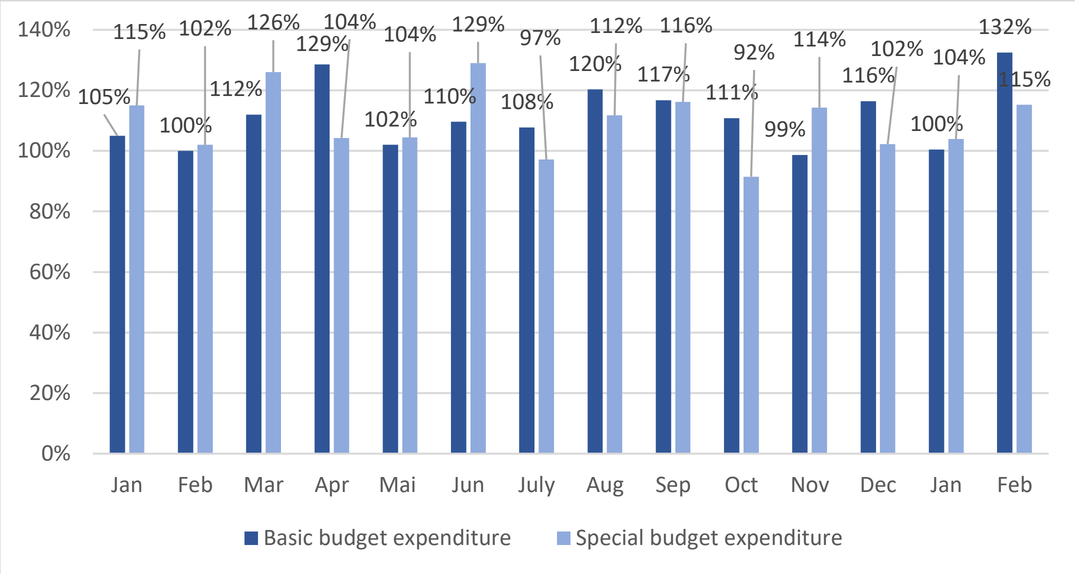


Source: Treasury operational data

level, while in January and February it was 104% and 101% respectively compared to the previous year's level. From Figure 3.1. it can be concluded that the first wave of Covid-19 had a greater negative impact on tax revenues than the second wave of Covid-19. Assuming that the first wave started in March 2020, the lowest tax collection point was two months later - in May. Accordingly, assuming that the second wave of Covid-19 began in November, the largest tax decline could be expected in January 2021. While it cannot be assumed with absolute certainty that the first and second waves of Covid-19 will be identical in intensity and timing, it is highly likely that the second wave will have less of an impact on tax revenues, assuming no cardinal epidemiological and economic consequences. It is worth noting that the relatively good results of tax collection have been achieved despite the fact that the social tax has been reduced on January 1.

It should also be noted that the SRS has switched to the single tax account on January 1 this year. Therefore, part of the January and February revenues is still not divided to groups by type of tax. As a result, the council is also unable to precisely analyze the dynamics of taxes collected by type.

Figure 3.2. Dynamics of central government basic budget and special budget expenditures in the last 14 months compared to the corresponding period of the previous year



Source: Treasury operational data

In contrast to tax collection, the dynamics of state budget expenditures remain volatile. Although the level of expenditures in both the basic budget and the special budget in January was close to the level of the previous year, in February there was a large increase in expenditures - basic budget expenditures increased by 32% and special budget expenditures by 15% compared to the previous month.

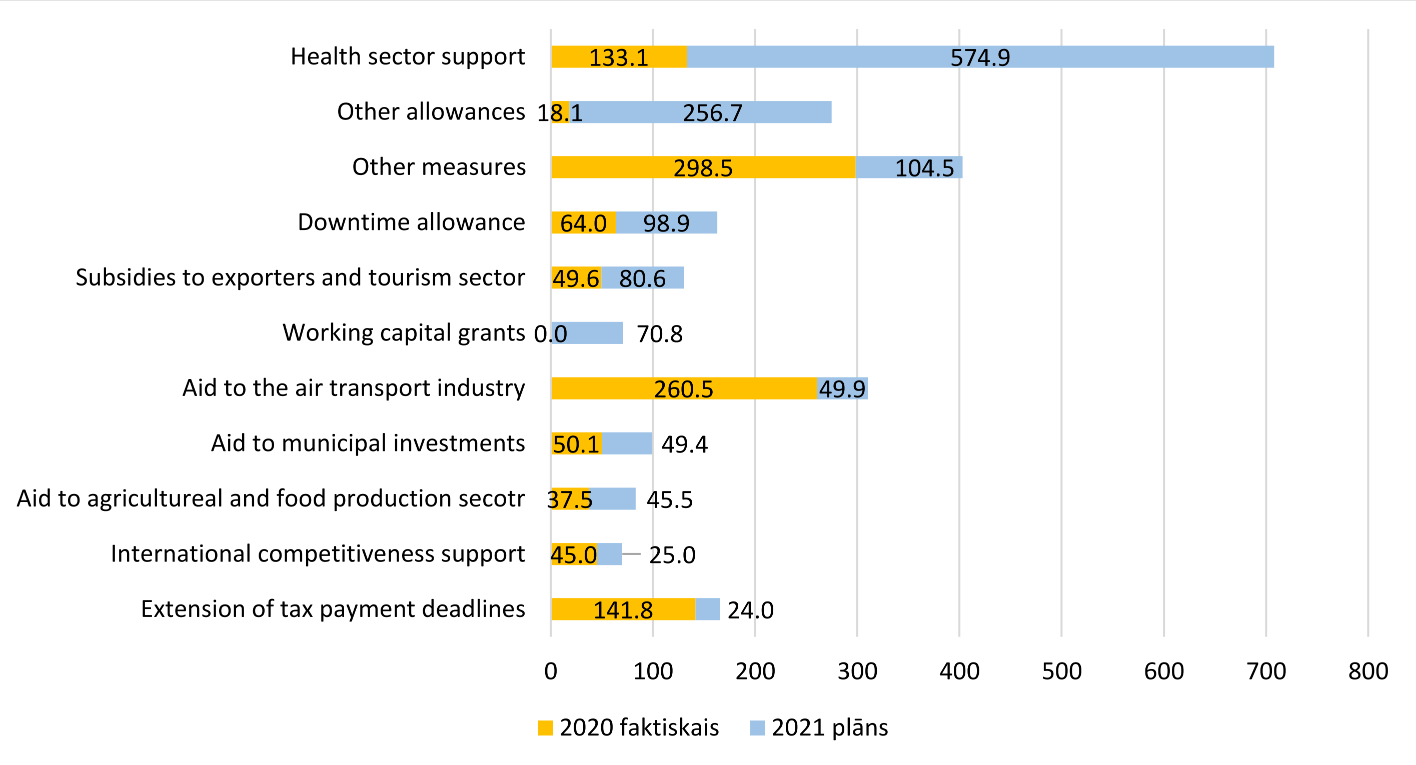
In general, both the basic budget and special budget balances can be considered adequate for an emergency situation: according to the operational data of the Treasury, the central government basic budget balance at the end of January was 145.6 mil. (a year ago, the balance was -27.0 million euros). The special budget balance in January 2021 was -62.8 mil. euros, a year ago it was 22.5 mil. euros. In February, the basic budget balance was -101.3 mil. euros, but the special budget balance was -24.5 mil. euros. In February 2020, the balances of the basic budget and the special budget were 17.7 and -24.5 mil. euros respectively.

4. Detailed analysis of economic support measures from a fiscal point of view

The second wave of Covid-19 continues, and the government continues to actively decide on new support measures, as well as easing eligibility criteria for existing instruments. According to the information provided by the Ministry of Finance and the calculations of the Council, the impact of the support measures already planned and conceptually approved by the Cabinet of Ministers on the state budget for 2021 exceeds the impact of support measures on the 2020 budget (see Table 4.1). Currently, the emergency situation and strict restrictions are in force until April 6, but considering the prevalence of the infection, there is a significant probability that the emergency situation will be extended and the impact of support measures on the 2021 budget will increase. According to the information gathered, the FDC has grouped the major support measures affecting the government budget in different ways. The planned support measures for 2021 have at least been conceptually approved by the government.

As it can be seen from Figure 4.1, in contrast to 2020, most of the support measures this year concern the health sector, which required about five times more financing than the second largest measure. A large part of the measures also concerns downtime benefits, subsidies to the tourism industry and exporters, as well as other benefits. Their amount in 2021 is 98.9 mil. euros, 80.6 mil. euros and 75.5 mil. euros respectively. Relatively significant support was provided to provide grants for working capital, which slightly exceeded 70 mil. euros. Support for other sectors and other groups does not exceed 50 mil. euros.

Figure 4.1. Support measures with a direct budgetary impact in 2020 and 2021 (mil. EUR)



Source: MoF data and FDC calculations

Table 4.1 provides information on the direct support measures that have already been paid so far, as well as details on the different support groups. It can be seen that most of the funding for the approved measures has not been paid yet, although these measures have already been conceptually approved by the government.

Table 4.1. Support measures with a direct budgetary impact in 2020 and 2021 (mil. EUR).

Measure	2020 actual support	2021 planned support	2021 actual support
Aid to the population and the workforce	**131.7**	**452.3**	**33.5**
Downtime (including assistance) allowance	64.0	98.9	24.9
Different types of benefits – unemployment, families, children, etc.	18.1	257.6	2.9
Human capital and demography	0.0	15.2	0.0
Subsidized employment, support to exporters and tourism	49.6	80.6	5.7
Aid to entrepreneurs	**396.8**	**177.3**	**76.3**
Extension of tax payment deadlines	141.8	24.0	6.1
ALTUM working capital loans	50.0	10.0	0.0
ALTUM guarantees and investments	50.0	2.0	0.0
Aid to the road sector	0.0	70.8	24.7
International competitiveness support	72.5	0.0	0.0
Aid to agricultural and food production companies	45.0	25.0	0.0
Aid to state companies and sector	37.5	45.5	45.5
Aid to the air transport industry	**569.7**	**751.4**	**105.2**
Aid to passenger and freight carriers	260.5	49.9	0.0
Aid to the healthcare sector	75.4	0.0	0.0
Aid to the cultural and sports sector	133.1	574.9	94.0
Aid to municipal investments	26.1	21.9	6.0
Aid to education sector	50.1	49.4	0.0
Other, including private and public media	17.1	23.1	2.1
Aid to the population and the workforce	7.4	32.2	3.1
Total	**1098.3**	**1381.1**	**215.1**
Of GDP (29545 mil. EUR in 2020, 30850 mil. EUR in 2021)	**3.72%**	**4.48%**	**0.70%**

Source: MoF data and FDC calculations

The budget approved in the Saeima for 2021 included support measures in the amount of only about 150 million euros, because the second wave of Covid-19 had not started during the budget preparation process. Therefore, most of the second wave support measures are financed from the program 02.00.00 “Funds for Unforeseen Events”. In the budget of 2021, only 26.7 mil. euros were devoted to the program, then this amount was increased by 300 mil. euros[18] and another 500 mil. euros. According to the information gathered by the FDC, out of this amount 715 mil. euros are already planned for concrete measures:

- 110 million to the Ministry of Finance to ensure the payment of downtime allowances and subsidies, as well as the flow of working capital of companies
- 211.7 million to the Ministry of Health, of which the largest amounts were spent on Covid-19 testing targets (€ 83 million), allowances for medical

[18] http://tap.mk.gov.lv/lv/mk/tap/?pid=40498657&mode=mk&date=2021-02-23

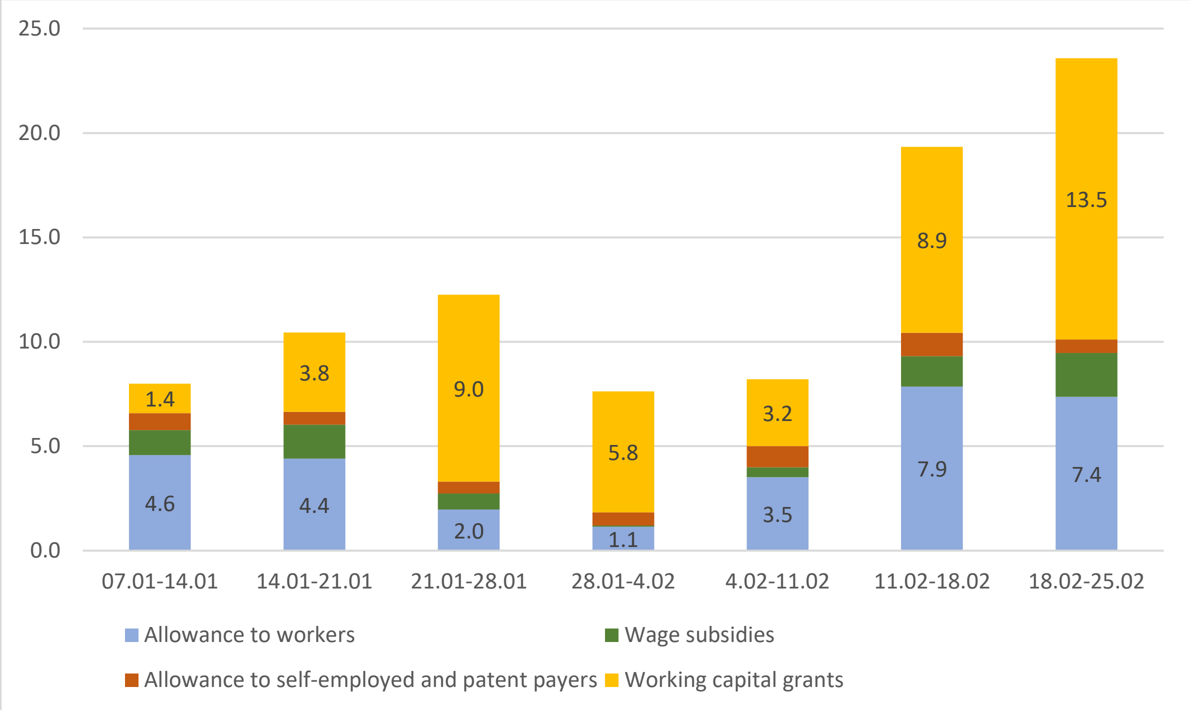
practitioners (€ 69.3 million) and the purchase of medical equipment and supplies (€ 40.3 million)
- 264.5 million to the Ministry of Welfare, of which the largest measures are a lump sum for each child in the amount of 500 euros (182.1 million euros) and payment of sickness benefits (67.6 million euros)
- 45.5 million euro to the Ministry of Agriculture for capacity building in agriculture
- 32.2 million EUR to the Ministry of Economics, most of which is intended for financing the investment fund (25 million euros)
- 12.4 million euro to the Ministry of Defense for the purchase of personal protective equipment
- 11.1 million euro for the Ministry of Culture for various programs
- 3.3 million for the Ministry of Education and Science
- 1.9 million euro to the Ministry of the Interior
- 17.4 million for the euro department "Targeted grants to local governments", which are mainly intended for allowances for teachers
- 5 million euro for municipalities, whose adjusted revenues fell by at least 10% due to the crisis.
- 0.85 million euro for other activities

Currently, the government has conceptually adopted other support measures, which include:
- 134 million euros to support taxpayers
- 240 million euros in addition to funding for companies affected by the Covid-19 crisis

Although these measures are one-off, it is clear that they will overall worsen the general government budget balance, especially given that it is now only the beginning of the year and further support measures may need to be approved over time if the spread does not decrease. It is already clear that the remaining amounts in the Contingency Fund will not be enough if all the conceptual decisions taken come into force. This would mean that the government will have to increase its borrowings again, which will significantly worsen the budget.

The Council is pleased that the government has responded to the Council's recommendation to make support more accessible to citizens and businesses. Figure 4.2 below shows that the Minister of Finance has fulfilled his promise and the relaxed conditions for granting support have increased the amount of support in Downtime benefits, salary subsidies, and grants for working capital.

Figure 4.2. Actual dynamics of support measures in January-February 2021



Source: SRS data

The Council generally welcomes the government's work on economic support measures, in particular its efforts to maintain a dialogue with business and social partners to make aid more targeted and effective. The goal of increasing the amount of support has been achieved. However, the decisions of recent weeks suggest that the government is in danger of falling to the other extreme: an inadequate increase in support, especially for groups not affected by the Covid-19 crisis. As mentioned above, the Council currently estimates the impact of the support measures on the 2021 budget at 1.4 billion. While the informative report "On Available Financial Resources in the State Budget Program "Funds for Contingencies" for financing one-off measures to limit Covid-19 in 2021 and their use, level of government debt and planned deficit) adopted by the Cabinet of Ministers on 23 February, the impact of unapproved support measures on the state budget balance in 2021 could be in the range of 1.7 to 2 billion euros. If the support reaches the mentioned level, the government debt at the end of 2021 could reach 50.8% of GDP, but the budget deficit 9.4%. From a budgetary point of view, the amount of aid is likely to already exceed the negative output gap in the economy caused by the COVID crisis. The question is also whether such a sharp increase in spending will not create a political temptation to increase spending in a number of areas. The country risks causing inflation and unreasonably increasing the level of debt. The COVID-19 crisis is not over, and there are concerns about what will happen to unemployment and insolvency after the end of support measures. Therefore, it would not be right to use the backup now.

OECD economist Nicolas Woloszko has estimated weekly GDP data for the world's largest economies using Google search data[19]. The researcher has concluded that the

[19] https://www.oecd-ilibrary.org/docserver/6b9c7518-en.pdf?expires=1614514308&id=id&accname=guest&checksum=A1ED81764886FC4D33562F142A6F90FF

overall European economy was operating at about 80% capacity during the first wave of Covid-19 and at 90% capacity during the second wave. The reasons of the increased capacity were: (i) less public fear of the virus, (ii) better calibrated government policies, (iii) adaptation of businesses to new circumstances. This conclusion suggests that the State aid intensity in the second wave should be lower than in the first. Latvia had a relatively low infection rate in the first wave of Covid-19, and a fall in GDP of only 3.6% in 2020 leads to the conclusion that the level of state support in the first wave has been adequate. In view of the above, in case of Latvia, the level of support during the second wave should not be excessively higher than during the first wave. However, the already planned level of support during the second wave is higher than the first. **Therefore, the Council calls on the government to consider very carefully the introduction of new support instruments and to limit financial support to citizens and businesses affected by Covid-19.**

Chairwoman of the Fiscal Discipline Council
Inna Steinbuka