MONITORING REPORT NR.14

16.05-16.08.2021.

SUMMARY

1. Dynamics of the epidemiological situation is still the determining factor in the development of the world economy. The Delta variant of the Covid-19 virus has made it more difficult to fight the spread of the virus, despite the fact that in many countries vaccination rates are already relatively high. The number of infected people is rising again in several countries, but vaccination has led to a reduction in the number of seriously ill and hospitalized patients. This has led to partial cancelation the restrictions on economic activity, so the economies of developed countries experienced a rapid economic growth in the second quarter. This is also reflected in the EU's summer economic forecasts[1], which are more positive than previous forecasts. The EU economy is forecasted to grow by 4.8% this year and by 4.5% in 2022, in Latvia at 3.8% and 6% respectively. Although Latvia needs to increase vaccination rate, the proportion of vaccinated persons is still one of the lowest in comparison with other countries. Comprehensive vaccination of Latvian society, which is a precondition for economic growth and long-term fiscal policy, must remain one of the country's main priorities.
2. Concerns about the likelihood of prolonged and high inflation are growing worldwide. The annual inflation rate in the euro area reached 2.2% in July; the US consumer price index reached 5.4% year-on-year in July. The ECB is following the American federal system and has adjusted its inflation targets. The ECB has moved from an annual inflation target of "just below 2%" to a symmetric 2% [2] inflation target, which equally allows the 2% inflation rate to be exceeded. Changes in the target allow for both higher inflation fluctuations and higher inflation rates. If inflation is expected to rise in the future, the ECB's framework will be adjusted accordingly.
3. In July, the EC raised its inflation forecast for Latvia, according to updated data it could reach 2% in 2021 (the May forecast was 1.7%), but in 2022 inflation could reach 2.1% (May forecast 2%). Although the new forecast for the consumer price index remains relatively low, prices for some goods and services in Latvia continue to rise significantly, and fuel, gas and electricity prices are a major concern. Since the beginning of the year, there has been a sharp rise in prices in the segment of personal vehicle operation, where the rise in fuel prices plays a key role. In July, the rise in fuel prices reached 18%. A sharp rise in prices was observed for electricity, gas and other fuels, where the price of gas rose the fastest (+ 36%). The prices of such basic products will also be affected by changes in producer prices in industrial sectors, as well as the volume and structure of household consumption.

[1] https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/summer-2021-economic-forecast

[2] https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html

4. On 14 June, the Council approved the macroeconomic forecasts submitted by the Ministry of Finance, which will be used in drawing up the budget for 2022. In 2021, the Ministry of Finance forecasts economic growth in the amount of 3.7%, while in 2022 it is already in the amount of 5%; inflation is forecast at 2% this year, reaching 2.4% next year; the budget deficit in 2021 is estimated at 9.3% of GDP, but in 2022 at 2.7% of GDP. The Council approved the MoF's forecasts, but pointed to a number of risks, including epidemiological, political, inflationary fiscal and administrative risks.
5. At present, a rapid growth of GDP is observed - in the second quarter it has reached 10% (according to the CSB operative estimate) compared to the corresponding period of the previous year. GDP has reached pre-crisis levels and it can be concluded that, overall, government stimulus policies have achieved the economic stabilization and growth objective. However, state aid to certain sectors was excessive. Disproportionate support is shown, above all, by the sharp rise in construction costs, as well as the difficulties of construction companies in finding employees.
6. The FDC has repeatedly pointed at the risks of overheating in the construction sector. Data published by the CSB in the second quarter indicate that after the downturn in the first quarter, activity in the sector has returned and the volume of construction output has increased by 1.1%. Construction is very active in the segment related to the construction of road and railway infrastructure, including Rail Baltic facilities. Activity in the construction sector is expected to continue, as evidenced by the increase in the construction area approved in the building permits. The number of building permits issued in the second quarter has increased by 37%, so the industry will continue to be burdened. The already overheated sector is expected to become overheated even more, which will be affected by staff shortages (already emerging), rising raw material prices, as well as expected large public orders during the RRF plan and the EU multi-annual budget.
7. According to the latest CSB data, unemployment fell to 7.5% in July, despite seasonally lower labor market activity. In the first quarter, there were more than 21 thousand job vacancies- employers indicated a high need for employees. Therefore in the second quarter there was a decline in the unemployment rate. However, with high labor shortages, wage growth may continue, which will not be linked to labor productivity.
8. In the second quarter of this year, the value of exports reached EUR 3.79 billion and increased by EUR 954.7 million or 33.6% compared to the first quarter of the previous year. Currently, timber exports play an important role in Latvia's foreign trade, due to the high demand for this raw material in foreign markets; therefore it is expected that in the coming years the restoration of forest resources and related industries will play an important role.
9. Economic conjuncture and the latest capacity utilization indicators show that the Latvian economy will continue to grow in the third quarter and that industry and exports will continue to play an important role. This assumption is also supported by favorable economic sentiment indicators for Latvia's main trading partners. However, it should be noted that due to the proliferation of the Covid-19 Delta variant, the situation is still unclear and the current positive trends are still fragile.

10. The amount of taxes collected has increased significantly since April. This year, in July 2020, it was collected by 21% more taxes collected in the basic budget and SSC than in July 2020. Despite good tax collection trends, the general government deficit reached EUR 1.23 billion (3.9% of GDP) on 13 August, due to the continuing intensive government support during the second wave of Covid-19. A year ago, on 13 August, the deficit was only 362 million euros, or 870 million euros less.
11. In July, the most important support instruments with a large impact on GGBB- downtime benefits, salary subsidies, and working capital grants ended. However, the impact of government support measures on the GGBB has already reached a significant level, the impact of the measures on the GGBB is expected to reach 2.1 billion euros (6.8% of GDP) this year. The Council calls for decreasing the support instruments if the infectious situation allows. Should new support instruments need to be introduced in the autumn, they must be proportionate, effective and well targeted.

RECOMMENDATIONS

- Given that Latvia will soon start receiving funds from the EU recovery funds, additional budget expenditures could increase the forces of inflation rather than boost the economy. We need to continue to end support instruments, allow market forces to work again and the economy to adapt to the post-pandemic reality. This will mean the structural changes in the economy that are needed for productivity growth;
- General government debt should remain below 50% of GDP, providing a sufficient safety margin against unforeseen economic shocks and future events;
- A medium-term strategy is needed to reduce the deficit to sustainable levels, leading to a reduction in government debt in the coming years.
- Reducing the deficit in the coming years should not have a negative impact on investment. When planning investments, the government should consider the expected investment flows from the EU Recovery Fund, which should avoid a sudden increase or decrease in investments.