

## SOCIO-ECONOMIC IMPLICATIONS OF THE CORONAVIRUS PANDEMIC IN LATVIA

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**Abstract.** The spread of COVID-19 requires immediate policy response and future-oriented actions to reduce devastating economic and social impact of crisis and preserve sustainable growth. The aim of this paper is to assess the current economic and social consequences of the ongoing crisis in Latvia, the government response, public perceptions and future scenarios. Research is based on the macroeconomic assessment and survey-based analysis of people's attitude towards the government's emergency programs. The comparison of statistically justified findings with the public perception helps formulate conclusions on the future sustainability scenarios and policies.

**Keywords:** *coronavirus crisis, economic resilience, recovery, public perceptions.*

**JEL code:** E6, H12, H6, O11, Z13

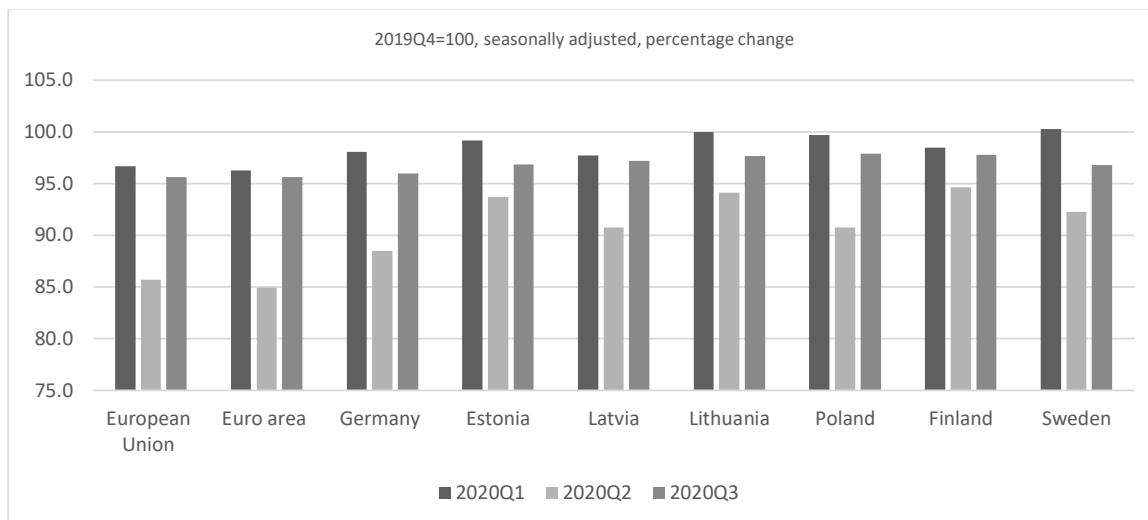
### Introduction

The turmoil for the EU economy is symmetrical, as the pandemic has affected all EU Member States but the impact of the pandemic varies considerably from one country to another, as does their ability to absorb and respond to economic crisis. Small countries are naturally vulnerable to external economic shocks, however, they can increase their resilience by efficient government, business and social response. Extraordinary pandemic crisis can be seen as a stress test of the vulnerability and resilience of a small and open Latvian economy. The aim of this paper is to assess the current economic and social consequences of the ongoing crisis. To this end, the research tasks include the analysis of latest trends in the Latvian economy, the government response, public perceptions and future scenarios. The key issue is whether the current crisis, which will bring severe losses in the short-term, could be seen as an opportunity of economic transformation and accelerated growth in the future and what are the preconditions for the economic recovery. The research methods include analysis and mathematic modelling of macroeconomic data and data from public opinion survey.

### Analysis of Latvia's economic trends 2020

In Latvia, the economic growth started slowing down already in the second half of 2019 because of structural problems and labor shortage that resulted in lower manufacturing output and decline in exports. In addition, decrease in transit cargo and anti-money-laundering efforts in the banking sector considerably contributed to the slowing growth. The underlying factors of this slowdown increased the negative economic effect of the pandemic shock.

The Covid-19 pandemic and preventing measures caused the decline in GDP, which in the first 3 quarters of 2020, compared to the 4th quarter of 2019 (pre-crisis level), was, however, much lower than the average in the EU and the euro area. The economy of Estonia, Lithuania and Latvia's main trading partners in the EU, lagged the pre-crisis level by 2-4% in the third quarter (Fig.1). The situation was much worse in several southern EU countries, where the gap with the pre-crisis level was close to 10% (Croatia, Spain, Malta).

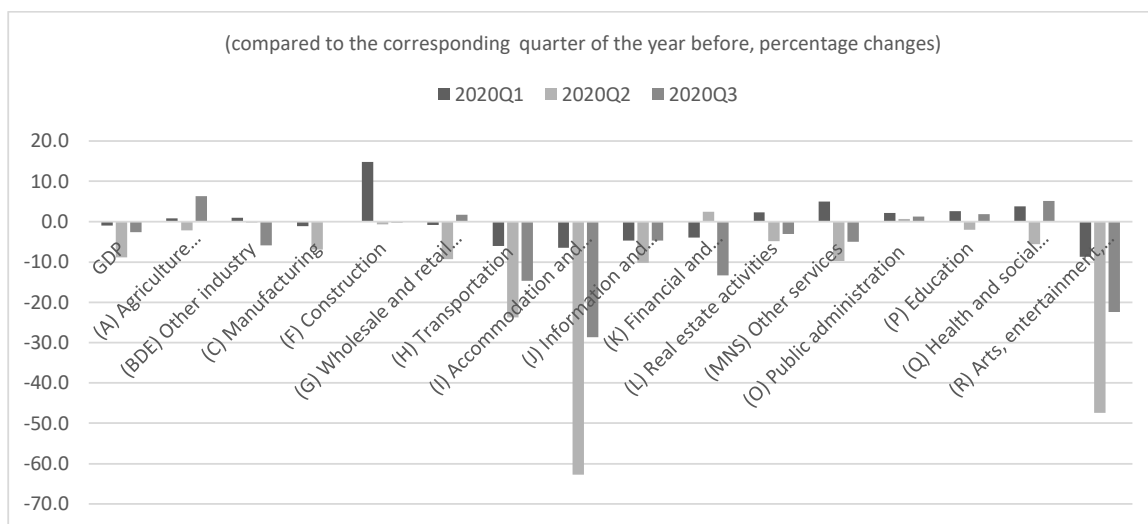


Source: author's construction based on the Eurostat data, 2020

Fig. 1. Growth rates of GDP

Restrictions on international transport, reduction of travel flows, losses to companies accrued due to quarantine and self-isolation of employees, a decrease in demand in export markets, delays in raw material supply chains, a decline in demand for domestic services and other pandemic-related factors have significantly affected various economic sectors.

The value added of the sectors most affected by the coronavirus is almost 800 million EUR, which represents 2.9% of GDP, incl. accommodation (0.6%), passenger air transport (0.5%), travel agency, and tour operator reservation services (0.2%) (Ministry of Economics..., Macroeconomic..., 2020). The most significant decrease in the three quarters of 2020 y-o-y was in the accommodation and food service activities, as well as in the arts, entertainment and recreation sectors, where the annual decrease was 34.9% and 26.1%, respectively. The restrictions imposed on Covid-19 also had a significant impact on aviation, land transport and railway companies. In the three quarters of 2020, the decline in the transport and storage services sector reached 15%. Manufacturing output fall in three quarters of 2020 by 2.7% due to both the decline in demand in export markets and delays in supply chains. There was also a significant decline in financial and insurance activities, information and communication services, and commercial services. Agriculture and forestry, construction and public services were among the few sectors that continued to grow in the three quarters of 2020 (Fig. 2).



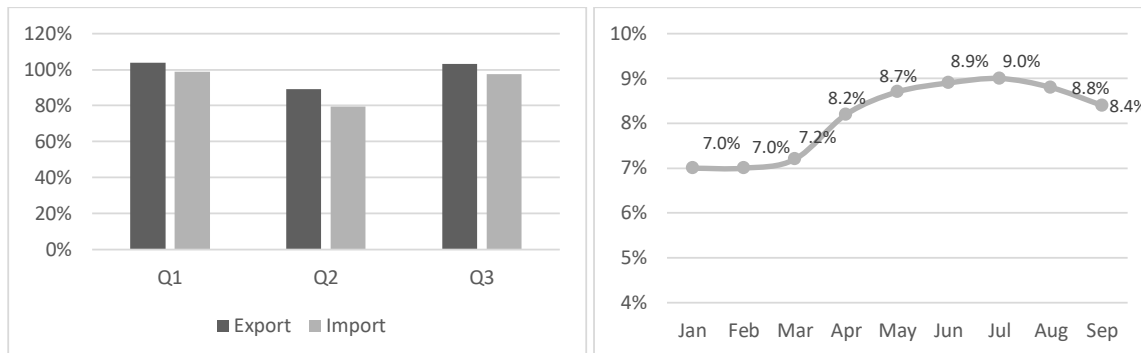
Source: author's construction based on the CSB of Latvia data, 2020

Fig. 2. Growth rates of GDP by kind of activity in Latvia

Unemployment had been decreasing in Latvia in recent years, and lack of labor was considered one of main factors preventing faster economic growth. Due to Covid-19 crisis, the unemployment started increasing in March 2020, however, the increase was not particularly steep, and already

in July the unemployment changed its trajectory (Fig.3). Even though sectors most affected are labour intensive, and therefore, if Covid-19 second wave persist for a longer period, the unemployment levels can sharply increase again.

Weak Latvian export (much lower export share of GDP compared with the Baltic neighbours) was identified as a challenge well before pandemic crisis. Covid-19 naturally hit country's foreign trade, even though it improved Latvia's trade balance as the exports turned out to be more resilient than the imports. (Fig.3). However, the export development was mixed: for instance, Latvia's timber export (main export product) decreased by 8.5% in three quarters of 2020 y-o-y, which unexpectedly was compensated by 17% increase in electrical equipment export.



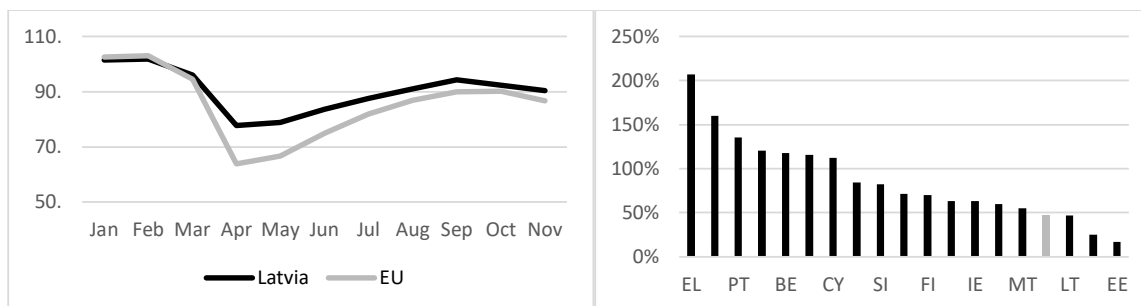
Source: CSB

Source: Eurostat

Fig. 3. Latvian foreign trade in 2020 (% of 2019) and unemployment trends in 2020

Like in the EU, economic sentiment in Latvia dropped sharply in March and reached the lowest point in April, then slowly started improving and declined again in October when the Covid-19 second wave started (Fig.4).

Low public debt and deficit, balanced current account and low private indebtedness are considered as Latvian strengths. Naturally, the slowing economy has dented budget revenues and government's fiscal response to the crisis has increased expenditures. The public deficit and debt might reach accordingly 7.6% and 47.3% of GDP at the end of 2020. However, Latvian Debt-to-GDP ratio will remain one of the lowest in Euro Area, where the average debt level is about to reach 101.7% of GDP at the end of 2020 (Fig.4).



Source: Eurostat

Source: EC

Fig. 4. Latvian economic sentiment and debt level (% of GDP) in 2020

### The government response

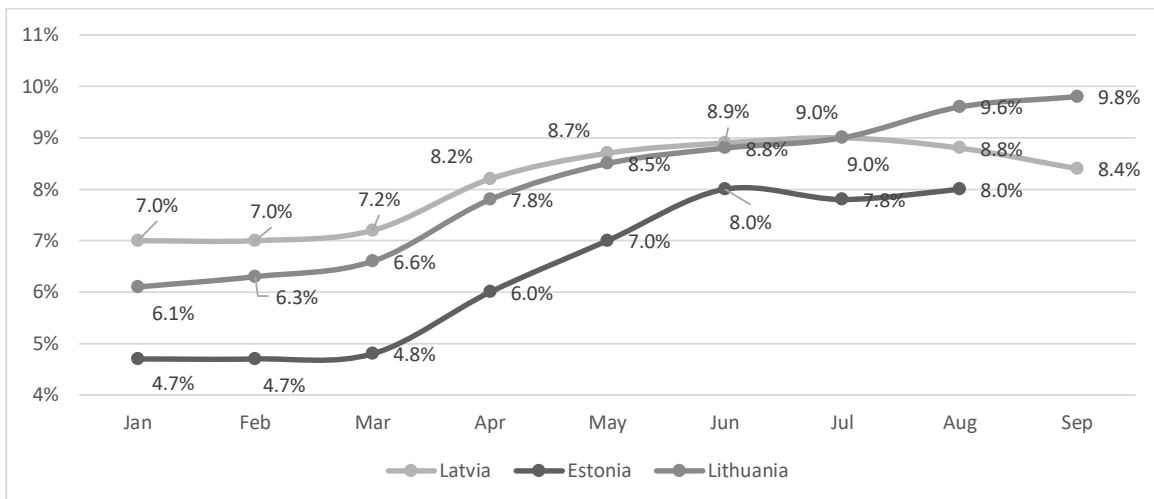
At the end-May 2020, the Latvian government has adopted a three-phase strategy (Ministry of Economics..., Informative Report..., 2020) for overcoming the crisis. The first phase (survival) was aimed at limiting the spread of the virus and improving financial stability in lockdown (2020-2022). The second reorientation phase (2023) included post-crisis measures for immediate activating business continuity and structural adjustment. Finally, the growth phase (from 2023) is aimed at implementing a set of growth-enhancing measures based on stimulus for export and productivity, automation and digital transformation, green course, etc.

The stabilisation measures of the Covid-19 induced economic crisis are very different from the financial crisis in 2008. The latter was caused by economic overheating because of excessive aggregate demand, hence consolidating the expenditure was the solution. The former was caused by sharp reduction in aggregate demand and disrupted supply, hence, stimulating aggregate demand with monetary and fiscal policies have to play important roles to overcome economic crisis. The activating of the EU Stability and Growth Pact's general exemption clause allowed governments of the Member States to increase the general government deficit. EU also allowed state support to enterprises in trouble.

The economists were unanimous that the fiscal support has to meet three key criteria: (i) timely (as soon as possible), (ii) well targeted to all segments important for functioning of the economy and cover social sphere, (iii) for a limited time.

As in most countries, fiscal response of the Latvian government was aimed at both stimulating demand and supporting supply. By the end of September, the government has approved public support in amount of 3.14 billion euros, or 11.1% of GDP (Ministry of Finance..., 2020). The largest share (38.4%) represents the support of company liquidity in form of loans, guarantees, capital injections. State joint stock companies and health care got 25% of support package. Redistribution of EU funds in amount of 24.3% was aimed at supporting activities with immediate social or economic impact. Public support included also tax measures (7.5%) and benefits and allowances (4.9%).

Latvia like other countries used furlough schema to prevent rapid increase in unemployment. However instead of the initial government intention to disburse 148 million euros in allowances, the amount actually disbursed was only 53.6 million despite several rounds of lowering eligibility criteria (State Revenue Service, 2020). The main reasons for this rather modest support were linking furlough payments with tax paid and apparently with an attempt to reduce the size of tax evasion. In accordance with Bank of Latvia estimates, furlough support in Latvia has been the most modest among the Baltic states (Bank of Latvia, 2020): it's intensity in end-July was 0.2% of GDP, while in Lithuania 0.3% and in Estonia 0.9%. The intensity of furlough support seems not to correlate with unemployment trends (Fig. 5). However, as in the first wave of crisis the unemployment level in Latvia remained relatively low, one may conclude that the Latvian furlough schema was effective.

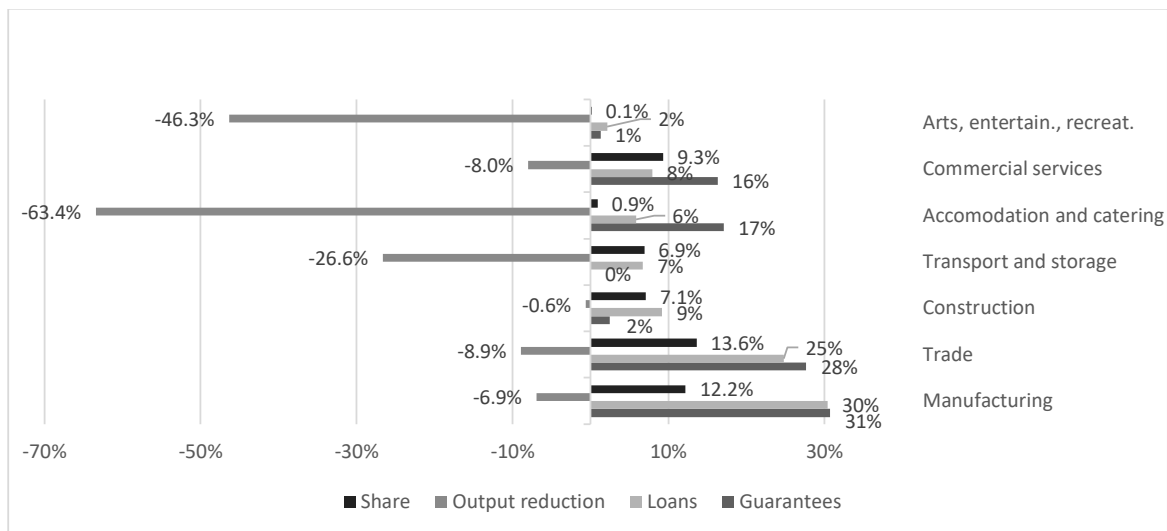


Source: Eurostat, database UNE\_RT\_M

Fig. 5. Rate of unemployment in the Baltic States (% seasonally adjusted)

The biggest support to entrepreneurs was planned in form of credits, guarantees and capital injections. Public financial institution “Altum” took responsibility for assisting business with the following instruments: (i) working capital loans, (ii) guarantees for bank credit holidays, (iii) portfolio guarantees, (iv) export credit guarantees, (v) guarantees for large enterprises, (vi) equity fund. These instruments have reached all economic sectors affected by the crisis (Fig.6). The largest beneficiaries are trade and manufacturing enterprises, whose share in value added is significant, as is the decline in GDP. It is surprising to see construction companies among the biggest beneficiaries, considering the sector's resilience to the Covid-19 crisis. The transport and storage sector, on the other hand, with a value added similar to construction, but a much larger decline in GDP, receives about the same relatively small share of support as construction companies.

Ministry of Finance estimated that business support measures would stimulate economy in amount of 1.055 billion euros or 3.74% of GDP. However, by the end-October 2020, the absorption of assistance instruments for entrepreneurs was relatively low reaching only 178.1 million euros or 0.6% of GDP. Nevertheless, these instruments should help entrepreneurs to overcome the second wave of Covid-19 (Ministry of Finance..., 2020).



Source: CSB of Latvia, information provided by Altum

Fig. 6. Sector shares of loans and guarantees, sector shares in value added, and GDP reduction in the Q2 2020

On average EU countries has stimulated their economies with direct measures in amount of 7% of GDP and indirect measures in amount of 14%. There are wide variations among the countries, for instance Germany, the strongest EU country, has chosen to stimulate its economy with massive indirect measures (30% of GDP). In comparison to other countries, Latvia's support has been quite moderate as it accounted only for 3% support with direct measures and 6.8% support with indirect measures. However, international comparisons should be interpreted carefully because of potentially different accounting methods across the countries. When the size of support package is compared to the infection rate, Latvia stands out as a country with relatively moderate support program.

### Public perceptions

A public opinion poll (University of Latvia..., 2020) gives an impression of the impact Covid-19 pandemic first wave on peoples' personal economic situation, as well on peoples' perception of the governmental emergency support and tax discipline. The share of respondents, including the risk group, which received or applied for emergency support can be seen in Fig.7.

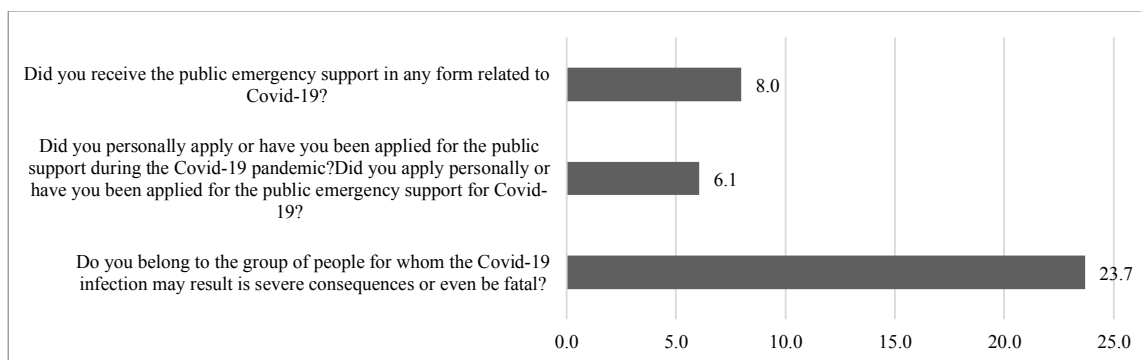


Fig. 7. The status of respondents in the context of the Covid-19 pandemic, percentage

Fig. 8 shows that 26.1 percent of respondents experienced a decrease in income during the pandemic, while 17.3 percent - a decrease in expenses. 23.4 percent of respondents did experience temporary and long-term financial difficulties. At the same time, only one fifth (22.7 percent) of respondents admitted that by losing their monthly income, they would be able to cover current expenses without borrowing for more than three months. The survey also revealed that the longer a respondent was able to survive without regular income, the more likely this respondent was among those who had decided to make savings for rainy days. The impact of the pandemic on people's income had considerable regional differences.

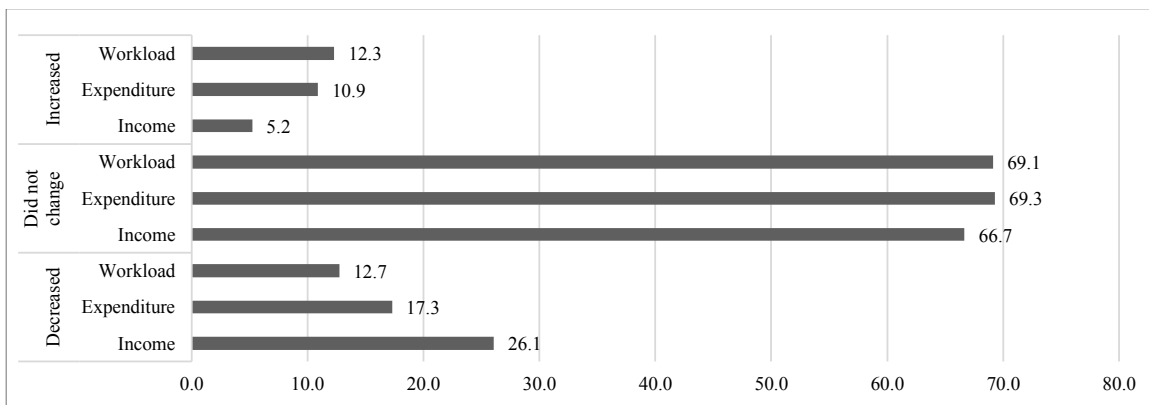


Fig. 8. Impact on income, expenditure and workload of the population, percentage

A majority of people considered the emergency support programs to be adequate and associated them with fiscal prudence (Fig. 9). Compared to other EU member states, in Latvia, the level of public satisfaction with the governmental assistance was above the EU average (European Commission, Standard..., 2020). People advocating tighter tax discipline and more responsible fiscal policies tended to support more restrictive access to national emergency support programs, while those who supported weaker tax moral and fiscal discipline advocated more inclusive state support programs.

The opinion poll also showed that the incidence of negative views on the public emergency programs among the respondents employed in the private sector and entrepreneurs was more frequent than in the panel of respondents in general. The difference between the share of positive views among those who were employed in the private sector and the other groups of respondents was statistically significant (pearson chi-square between the two groups of respondents 9.47 (at the level of statistical significance 0.009), but in the case of entrepreneurs – was not (pearson chi-square between the two groups of respondents 0.56 (at the level of statistical significance 0.756)).

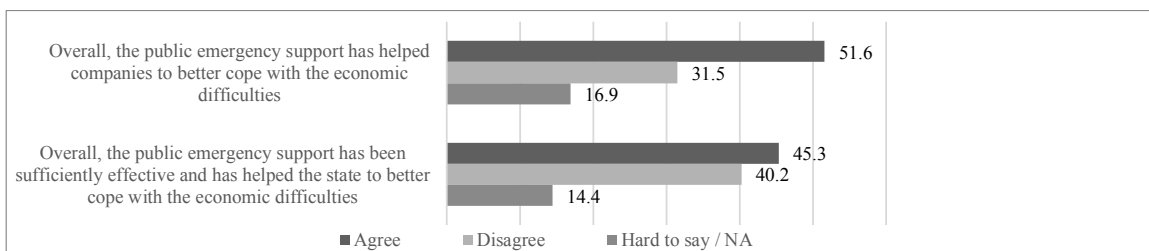


Fig. 9. Public assessment of the public emergency programs, percentage

Less than half (41.4 percent) of respondents agreed with the view that large companies should be supported even if such support increase their dependence on state support in the future (Fig.10). The largest share of supportive respondents was among the older generation of respondents (44.5 percent), among respondents with higher education (44.4 percent), among non-citizens (47.3 percent), and among those employed in the private sector (43.1 percent). Regionally, the more supportive of the necessity to support large companies were respondents in Zemgale (55.2 percent), while the least supportive (22.1 percent) were in Kurzeme.

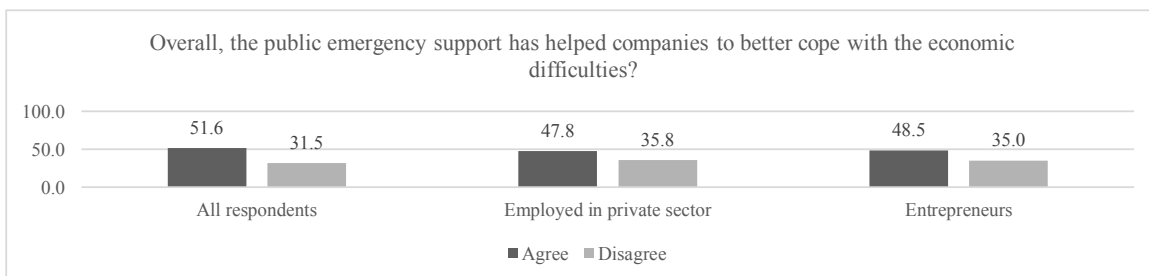


Fig. 10. The opinion of private sector employees and entrepreneurs on the effectiveness of the public support for enterprises, percentage

About a third (35 percent) of respondents admitted that they were proud of the work of public authorities during the pandemic (Fig. 11). Moreover, half of the respondents (50.5 percent) agreed to the claim that the public institutions were able to perform their functions as well or even

better during the emergency, and somewhat less than half (45.7 percent) of respondents agreed with the opinion that the telework created due to the emergency had made public administration more modern and easily accessible to individuals. Data analysis revealed that pride in government work during a pandemic was felt mainly by supporters of the ruling and "right" wing parties, while supporters of the opposition and "left" wing parties, on the contrary, was not.

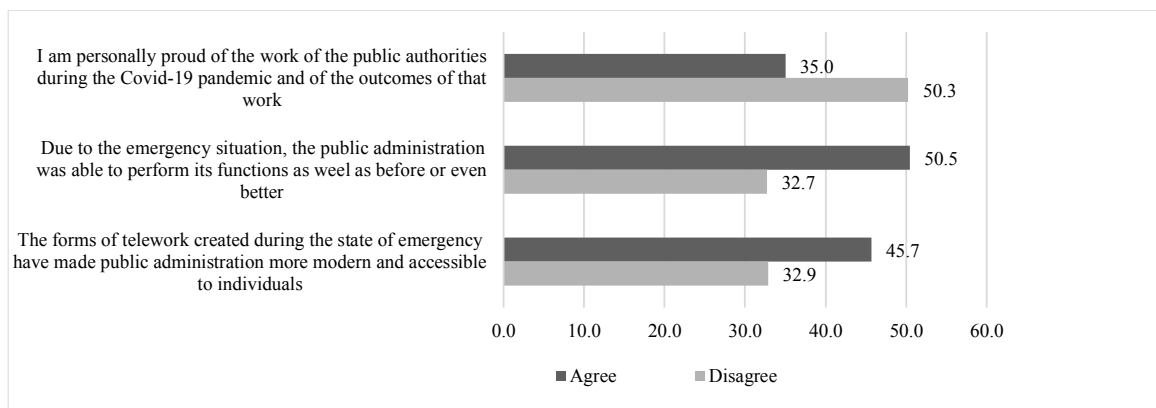


Fig. 11. Respondents' attitude towards the work of state institutions during the pandemics

Close to two thirds (63.5 percent) of respondents in the event of a recurrence of the Covid-19 pandemic were willing to admit restrictions to human contact as strict as during the first wave or even stricter and even higher number of respondents (70.9 percent) that in crisis situations, the state should act more decisively, even if it would involve greater interference in the personal lives of individuals (Fig.12).



Fig. 12. Support for stronger restrictive measures in the event of a recurrent pandemic wave, percentage

Despite satisfaction in performance of public authorities, overall, the public trust in national public institutions has decreased (Fig.13). The pandemic had also eroded trust in the EU institutions – even to a greater extent than in national institutions. Yet, 51.9 percent of respondents agreed that without EU support Latvia would not have been able to successfully contain the pandemic, and 61.6 percent – that the fight against the pandemic would be more efficient at the EU level.

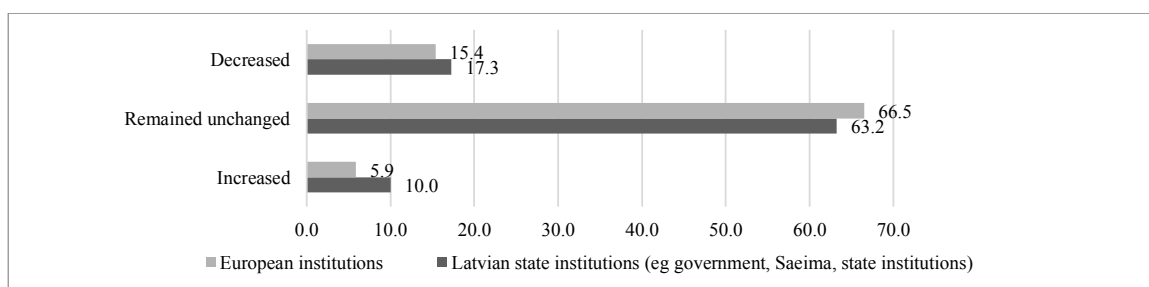


Fig. 13. Impact of the Covid-19 pandemic on trust in public institutions, percentage

Although correlation analysis revealed a very close relationship between the experience of long-term financial difficulties and respondents' intention to emigrate, survey also showed that 83 percent of respondents had not thought about leaving Latvia (Fig.14).

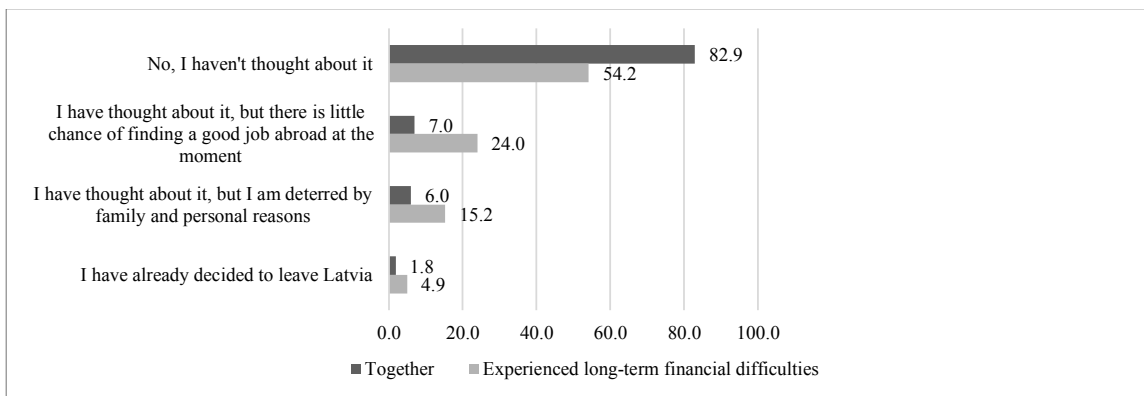


Fig. 14. Respondents' intentions regarding emigration, percentage

Figure 15 shows, that two-thirds (68.4 percent) of respondents agreed with the statement that tax evasion is a reprehensible behavior, but only 18.6 percent agreed with the statement that people prefer to pay taxes as a result of the Covid-19 pandemic. The main reasons why people would not pay taxes were too low wages after taxes (54.3 percent) and too high tax rates (45.8 percent). Those who trusted public authorities were more likely to agree that tax evasion is reprehensible and that all non-taxpayers should be cracked down on. Likewise, the supporters of the ruling parties were more supportive of both the government response and fiscal prudence.

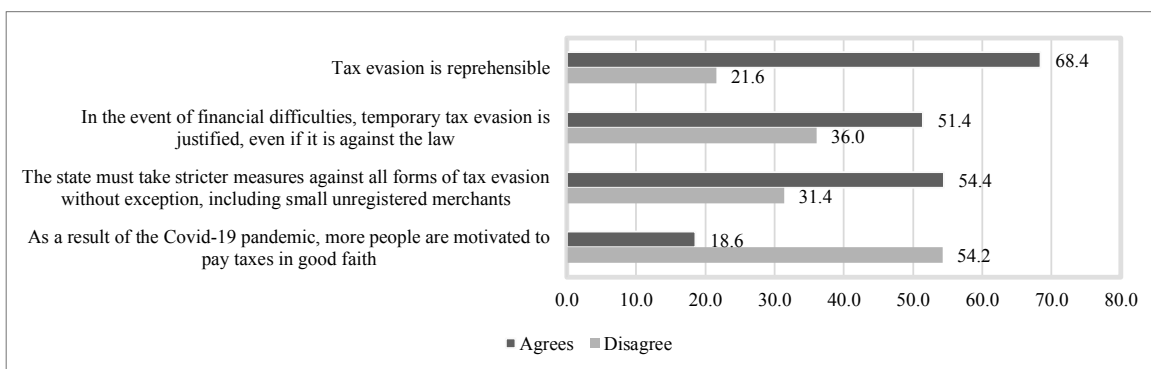


Fig. 15. Respondents' attitude towards tax discipline, percentage

These data confirm the hypothesis raised by other studies (Williams, 2015) that in Latvia a considerable gap persists between formal (i.e., legislative requirements that embody public morality) institutions and informal institutions (i.e., unwritten norms of behavior that embody civic morality) in the field of taxation. Namely, the view that tax evasion is reprehensible reflects the existing public morality, while the view on the positive effect of a pandemic on tax morality of people – the civic morality. Moreover, the gap between formal and informal institutions was also indirectly confirmed by the respondents' view of the reasons why people do not pay taxes, namely, that the respondents were not inclined to blame the state for inefficiency of tax administration, thus demonstrating relatively little interest in stricter actions by the state against tax transgressors (Fig.16).

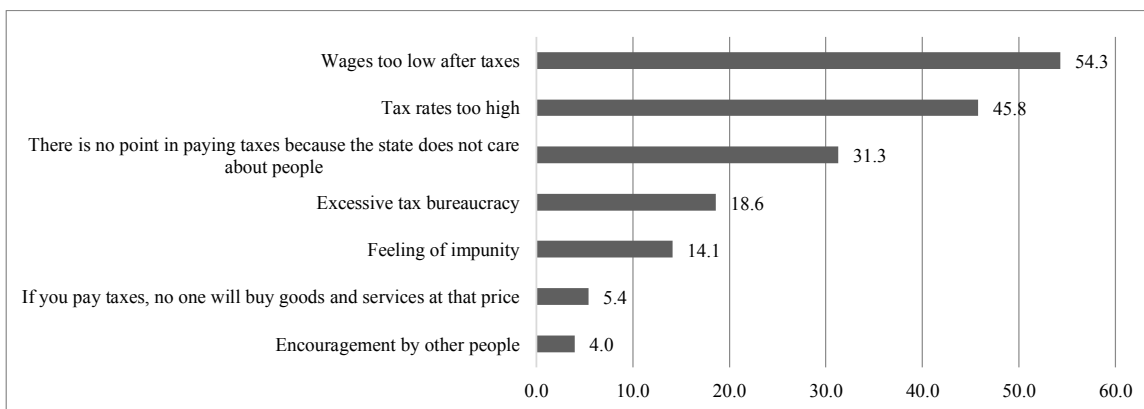


Fig. 16. Respondents' opinion on the reasons why people do not pay taxes, percentage



## Future scenarios

The output in the European and Latvian economy would barely return to pre-pandemic levels in 2022. The depth of the recession in 2020 and the speed of the recovery in 2021 and 2022 is expected to vary widely across Member States. This does not only reflect differences in the severity of the pandemic and the stringency of containment measures, but also differences in economic structures and domestic policy responses (European Commission, European..., 2020). Obviously, close monitoring of economic consequences and speedy adjustment of the government response will be necessary in Latvia in the nearest future.

Pandemic related response will be combined with the response to major global economy challenges linked to technological change, digital transformation and the effects of global climate change. The country's ability to adapt its economy to future needs will become increasingly important, reaping the full benefits of new production opportunities and market niches, while minimizing risks and maintaining the ability to respond flexibly to pandemic consequences.

These processes increase the threats and opens new opportunities for the development of the Latvian economy.

The Covid-19 crisis should serve as a catalyst for faster change especially considering anticipated generous support by European Recovery and Resilience Facility. Thus, the biggest opportunity seems to be “the [unexpected] money rain from Brussels” which would complement the EU Long-term Budget/ Multi-annual Financial Framework 2021-2027 (Parliament of Estonia, 2020). The planned Recovery and Resilience Facility is an opportunity to enact productivity-enhancing reforms and to invest into innovations and human capital.

The Covid-19 crisis is accelerating the digital transformation process in the world. Countries and companies that have not previously implemented digital solutions will suffer the most, but by introducing digital solutions, they can significantly increase productivity and stay in business even under strict restrictive measures. Online commerce is growing and developing. Many consumers will become accustomed to online trading solutions and may not want to return to retail stores after the COVID-19 crisis, and some customers will continue to use these channels after the stores open.

New forms of work and teleworking will also bring change. Some companies will move to work remotely (in areas where this is possible, such as IT), but there are also many companies and sectors that will not be able to fully digitally transform. Telework will reduce demand (and prices) for office space and transport services.

The global economy is more affected by people who are afraid of COVID-19 than by those who are infected with the virus. As a result, consumer and decision-making behaviour has changed and will continue to change. Due to these fears, aggregate demand and supply in the global economy are changing. Fear reduced the demand for certain services like shopping or travelling. At the same time, however, the demand for online services has grown rapidly. Online sales will reduce the impact of the Covid-19 crisis on demand, but not in full. The Covid-19 crisis is having a negative impact on trade in durable goods (such as cars) and luxury goods.

Even before the Covid-19 crisis, global value chains faced a variety of challenges related to rapid technological development. In developed countries, for example, robots have replaced cheap workers of third world countries. This facilitates the transition to shorter value chains and localization, which can in turn boost investment.

The COVID-19 crisis has amplified profound fault lines in the functioning of global value chains (GVCs) and exposed the fragility of a model characterized by high interdependencies between leading firms and suppliers located across several continents (United Nations Conference..., 2020).

As a result of the Covid-19 crisis several changes are expected in the regional distribution of goods and services markets, stimulated by the firms seeking to improve their supply chain resilience – sudden need to keep more reserves, source from many suppliers instead of just one, and preferably closer to home. A positive side effect of governments resilience seeking behaviour in terms of securing the essential supplies would be a switch from Chinese products and contractors to domestically produced substitutes in Baltics and other EU member states. This would create opportunities for Baltic companies to expand production in new niches (Parliament of Estonia, 2020).

By structurally transforming the economy, it is possible to achieve a greater effect on the future growth and of the population's well-being. The changes caused by Covid-19, global technology development trends, the European Green Deal and the digital economy open new opportunities for increasing the productivity level of the Latvian economy by investing in new technologies, digitalisation, and innovation.

Economic modelling at the LV PEAK think tank of the University of Latvia shows that the introduction of the latest technologies, development of new products and services, as well as wider use of digital solutions and improvement of process efficiency, have a significant impact on faster growth. Thus, if the economy continues to follow the current trends, GDP growth could reach an average of 3.9% per year in the 2021-2024 period,

while in the period 2025-2030 the annual growth rate of the economy will slow down to within 2.5%. Contrary to this modest growth, in the scenario, which envisages competitive advantages on technological factors, production efficiency, innovations, as well as the ability to adapt and use the opportunities created by global change, economic growth may reach 5.3% annually on average from 2021 to 2024, but in the following years an average of 3.7% annually. In this scenario, the Covid-19 pre-crisis level (2019) is reached in 2022. In turn, the economy will return to the pre-crisis growth trend only in 2027 (University of Latvia..., Latvian..., 2020).

### Conclusions

The analysis of the socio-economic impact of the first wave of the COVID -19 pandemic crisis shows that economy as a whole, firms, and people have suffered lasting damage, in particular in transport, trade, tourism, healthcare, education and logistics. The assessment of the government response to the economic slowdown allows to conclude that government support was timely, relatively well targeted and generally appreciated by the people of Latvia. However, positive public perceptions after the first wave of crisis, when majority of people considered the emergency support programs to be adequate, should not be taken for granted, as people's attitude can quickly turn to the negative end. Therefore, permanent monitoring of people's perceptions is crucial for policy makers.

Optimistic assessments of the spread and impact of Covid-19 and "V" or "U" type economic recovery scenarios have not materialized. Further developments are likely to be wavy, with governments having to impose tighter restrictions from time to time. Even after the gradual deployment of vaccines, people will have to continue to distance themselves. Consequently, companies must be able to objectively assess the continuation of existing businesses in long-term restrictive circumstances.

The second wave of crisis in Latvia seems to be more devastating in terms of virus spread and related challenges. Permanent monitoring of economic dynamic and public perceptions is necessary for adjusting the government response.

COVID-19-related economic risks remain high, especially in the short term. The approaching vaccination provides confidence that day to day life will return to something closer to normal over the next year. In the meantime, timely government support will be needed to compensate or at least reduce the economic damage.

Relatively positive public perceptions after the first wave of crisis, when majority of people considered the emergency support programs to be adequate, can turn to the negative end. Permanent monitoring of people's attitude is crucial for policy makers.

The crisis caused by Covid-19 is also an opportunity to change habits and behaviour, such as accelerating digitalisation and online commerce, creating new forms of work and teleworking, seizing the opportunity for EU producers to replace Chinese substitutes, production and opportunities to expand production in new niches.

Economic modelling shows that the introduction of the latest technologies, development of new products and services, as well as wider use of digital solutions and improvement of process efficiency, have a significant impact on faster growth. In the scenario, which envisages intensive use of opportunities created by technological change and digital transformation, economic growth may reach about 5 % annually in the medium term.

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