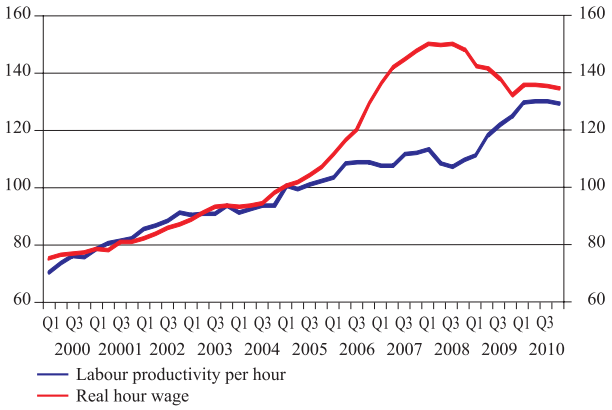
3 In Focus

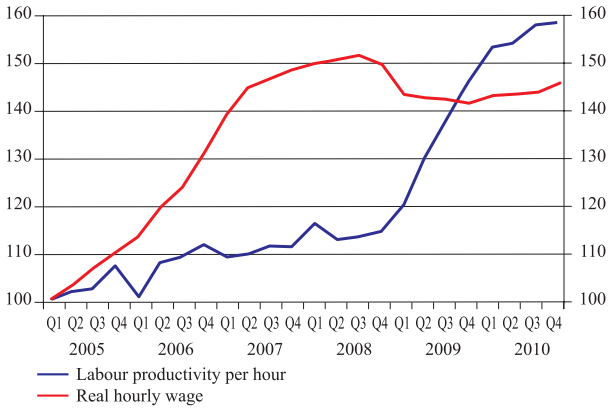
The wage-productivity gap has been narrowing rapidly

As from the end of 2008, both wage decline and upswing in labour productivity contributed to the narrowing of the real wage-productivity gap. The wage-productivity gap was one of the main indicators of economic imbalances accumulated during the previous boom years. Considerable narrowing of the wage–productivity gap restored the competitiveness of Latvian economy via shrinking unit labour costs, particularly in manufacturing. The restored competitiveness is already reflected in value added and employment dynamics.

Labour productivity and real hourly wage index
(total economy; 2005 Q1 = 100)



Labour productivity and real hourly wage index
(manufacturing; 2005 Q1 = 100)



Up to 2004, wage developments were broadly in line with labour productivity. However, starting from 2005 massive credit expansion and the real estate / construction boom led to a labour shortage and a resulting wage pickup, further fuelled by the EU funding windfalls and labour outflows, particularly to the UK and Ireland. For example, in 2006 and 2007 about 40% of construction businesses (about 30% in manufacturing) pointed out labour shortage as the main business-limiting factor, while the nominal wage doubled in 2008 compared to 2005. By that time, the real wages had increased by almost 50%. Labour productivity, in turn, stagnated: first, there were few incentives to raise production efficiency in the face of continuing profit windfalls as a result of the boom; second, low-qualified people who were economically inactive entered the labour force and this biased average productivity statistics down. For example, the participation rate climbed to 67.6% in 2008, well above EU-27 average, as compared to a modest 60% in 2000, while the rate of job-seekers hit the bottom at 6% in 2007, well below the NAIRU.

Robust labour productivity developments helped to narrow the wage-productivity gap substantially, thereby restoring Latvia's competitiveness at a time when the real hourly wage decline was only moderate. Although labour productivity dynamics were often ignored by international observers pointing out that price and wage adjustment was not sufficient to restore competitiveness, labour productivity developments were, in fact, the primary force behind the successful resetting of the real unit labour costs back to the pre-boom level. For example, quarter-on-quarter GDP growth resumed as from Q4 2009 (seasonally adjusted data) and Latvian employment growth during both Q2 and Q3 2010 was the fastest in the EU.

The upswing in labour productivity was particularly strong in manufacturing, closing the real wage-productivity gap in this sector already in Q4 2009. Ongoing restoration of competitiveness made manufacturing the driving-force of Latvian economic recovery (value added in manufacturing rose by 15.4% in 2010 as compared to 2009). Moreover, manufacturing provided more than half of the employment increase in 2010. However, the unit labour cost adjustment was not homogenous across all sectors. In particular, the adjustment was lagging behind in construction, thus hindering output and employment recovery in this sector.