

MONITORING REPORT No. 3

01.05.- 15.05.2020.

I. SUMMARY

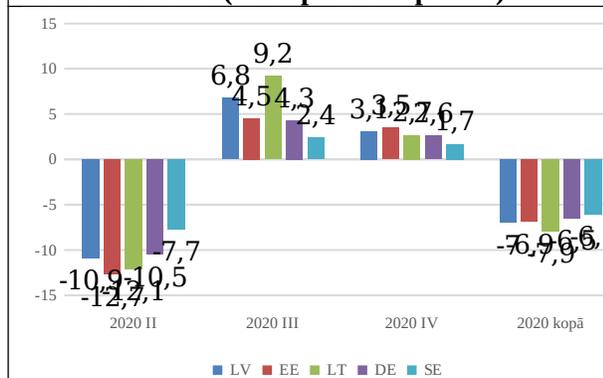
1. EC forecasts suggest that the decline in GDP across Europe, including in Latvia, in the second quarter of 2020 will be much larger than in the first quarter. In Latvia, the decline in GDP in the first quarter is estimated at 3.3 and in the second quarter at 10.9% year-on-year.
2. Entrepreneurs' business mood and outlook for the future are extremely pessimistic both in Latvia and its trading partner countries. An analysis of the available statistics shows that the economic situation continues to deteriorate and that there are no signs of improvement yet. At the same time, the situation remains relatively good in the area of household consumption and credit, but rising unemployment and declining savings may also worsen the situation in this area;
3. Tax revenues are relatively good and not yet worrying. The reasons why they do not correlate with the indicators of the decline in economic activity are an issue that would require a more in-depth analysis;
4. The FDC considers all existing economic and social protection programs to be adequate to today's economic situation, but calls on the government to take into account the growing fiscal risks associated with:
 - a) Insufficiently balanced distribution of risk between the government on the one hand and businesses and citizens on the other, thus causing significant moral hazard. In the FDC's view, the long-term (25 years) guarantees currently discussed for the support of large companies are an example of such disproportion;
 - b) A possible recurrence of Covid-19, which will require additional financial resources and increase public debt;
 - c) The sharp rise in government debt service costs over the medium term, due to uncertainty about the future effectiveness of the ECB's government bond purchase program.

DETAILED ANALYSIS

1. Economic situation

The economic situation in Latvia, the EU and the world continues to deteriorate. More recently, the European Commission's (EC) spring macroeconomic forecasts suggest that euro area GDP will contract by 7.7% and the EU by 7.4% in 2020, suggesting that the recession will be more severe in Europe than, for example, in the United States and the world as a whole (1.1). Figure). EC forecasts confirm the assumption that the eastern and southern EU Member States will be hardest hit by the Covid-19 crisis: although the pandemic is less prevalent, they will be dominated by large exporting manufacturing and service companies most affected by the Covid-19 crisis.

Figure 1.1. GDP forecast for EU, euro area, USA and world (% of previous period)



Source: *European Commission Spring 2020 Economic Forecast*

EC forecasts suggest that the decline in GDP across Europe, including in Latvia, in the second quarter of 2020 will be much larger than in the first quarter. In Latvia, the decline in GDP in the first quarter is estimated at 3.3 and in the second quarter at 10.9%. Among the Baltic States, the sharpest decline in GDP has taken place in Lithuania, but in the second quarter Estonia will also see a larger decline than in Latvia (Figure 1.3). Overall, Latvia's GDP is forecast to fall by 7.0% in 2020 – this relates also with EBRD¹ and

Latvian government forecasts.² According to Latvian economists, the most difficult period is still ahead and a further decline is expected before the situation improves.³ In Latvia, the biggest problems are the decline in exports and investment due to the closure of borders, while the decline in domestic consumption has been smaller than in many other countries due to less stringent restrictions. In contrast to Lithuania, which has one of the largest declines in producer prices in the EU (-5.1%), Latvia has seen a small increase of 0.2%.⁴

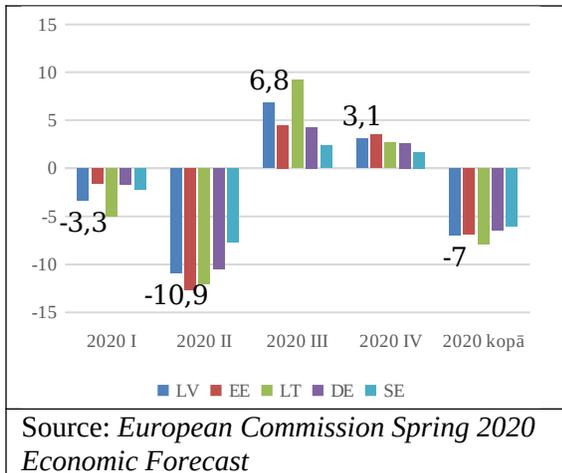
1.3. picture. GDP forecast by quarter and 2020 overall (% of previous period)

¹ EBRD, *Regional Economic Prospects* (May 2020), <https://www.ebrd.com/what-we-do/economic-research-and-data/rep.html>.

² Ministry of Finance, *Latvia's Stability Program for 2020-2030*, https://www.fm.gov.lv/files/fisklpolitika/FMINFO_30042020_SP.pdf.

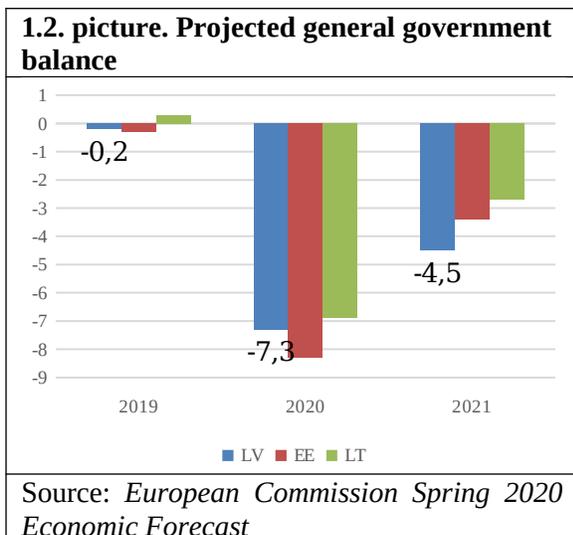
³ "Economists on exports: before we get better, will see a much gloomier picture", *Delfi*, 11.05.2020., https://www.delfi.lv/bizness/biznesa_vida/ekonomisti-par-eksportu-pirms-klus-labak-redzesim-daudz-drumaku-ainu.d?id=52128259.

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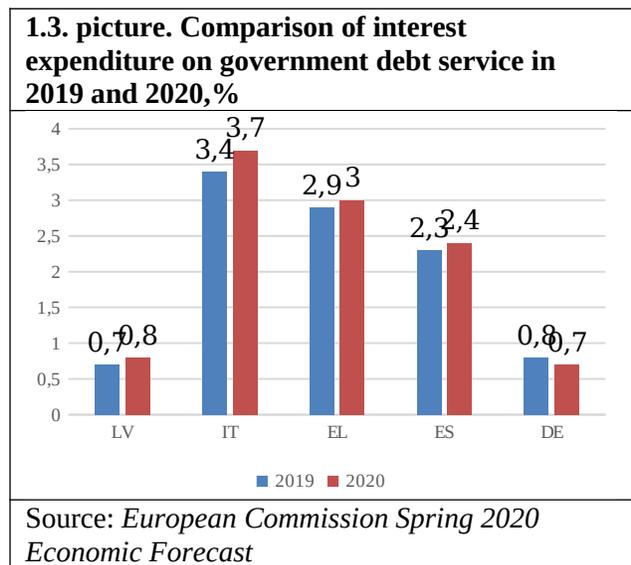
In the EC's assessment, the economic situation in the euro area countries could improve from the third quarter onwards, subject to a number of conditions: (1) a gradual reduction of restrictive measures; (2) if the pandemic does not return; (3) if the monetary and fiscal stimulus measures put in place prove sufficiently effective. However, uncertainty remains very high and the EU is likely to expect a gradual, U-shaped recovery, the EC concludes. The EC also notes that economic rescue measures have succeeded in improving corporate finance, maintaining purchasing power and maintaining financial stability, despite renewed investor concerns about the sustainability of eurozone peripheral debt. Eurointelligence has highlighted the risks associated with these support programs, namely that they can effectively replace lost income in the short term in the form of loans and guarantees, but they also increase the debt burden on these companies, which will significantly reduce their ability to invest in the future. The situation in the USA is different, because there is a lot more money spent on government procurement, as a result of which companies in the USA do not make such significant savings on unrealized products.⁵

According to the EC's estimate, the total euro area government deficit will reach 8.5% of GDP in 2020 and government debt will reach 103% of GDP. Latvia's general government budget deficit could reach 7.3% in 2020 and the debt could increase to 43.7% of GDP by 2021 (Figure 1.2).



⁵ Eurointelligence, "The monetary impact of Covid-19," *Professional Daily Morning Newsbriefing* (6 May 2020).

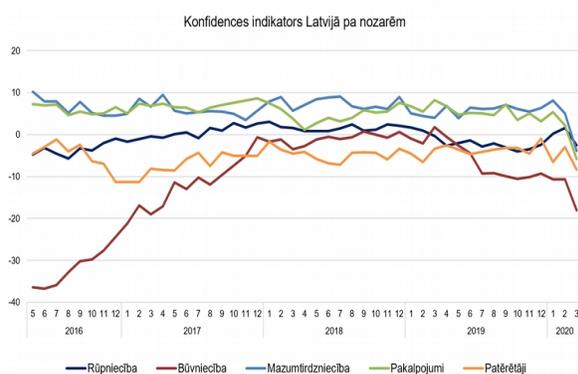
So far, the ECB's government bond purchase program has been projected to show no significant increase in EU Member States' government debt service interest expenditures, despite the increase in government debt as a result of the Covid-19 crisis (Chart 1.3). However, the German Constitutional Court 05.05.2020. judgment creates uncertainty about the long-term functioning of this program, thus increasing the risk of rising debt refinancing rates in the periphery of the euro area.



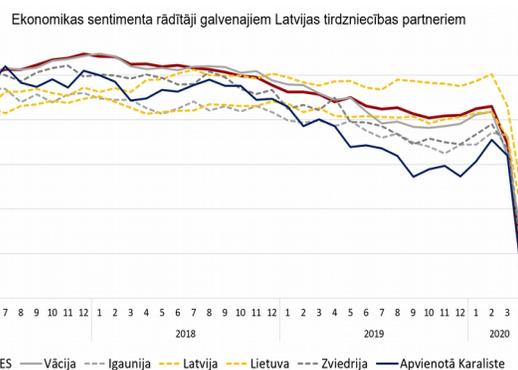
2. Macroeconomic situation in Latvia

Entrepreneurs' business sentiment and outlook for the future are extremely pessimistic both in Latvia and its trading partner countries (Figure 2.1). The tendencies of confidence indicators characterizing the economic situation in Latvia are downward and are experiencing a sharp and uniform decline since March, with the service and construction sectors experiencing the sharpest decline in confidence. Confidence in the construction sector has remained low since the second half of 2019 and the current decline has started from a lower point compared to other sectors. For Latvia's main trading partners, economic sentiment indicators have experienced a dramatic decline, reflecting the quarantine effect in the economy, as well as a lack of clear positive signals about the possibility of overcoming the current situation.

2.1. picture. Confidence indicators by industry and major trading partners



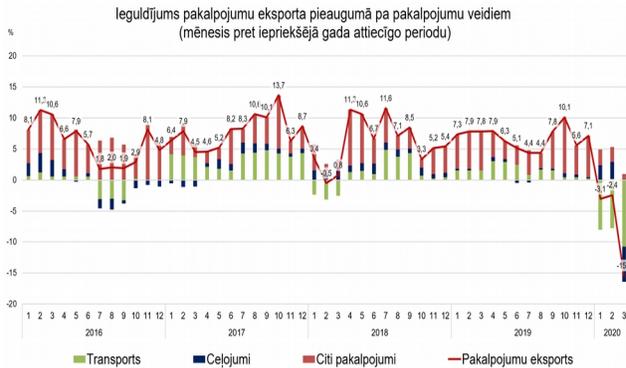
Confidence indicators (balance, %)
Source: CSB (KR020m)



Economic sentiment indicator by trading partner countries
Source: Eurostat

The Latvian economy continues to lose ground in the transit and freight transport sectors, as evidenced by the prolonged decline in port freight turnover and the decline in rail freight transport, thus reducing the tax revenue base in sectors that were considered leading sectors a few years ago (Figure 2.2).

2.2. picture. Dynamics of service exports and the contribution of different types of services

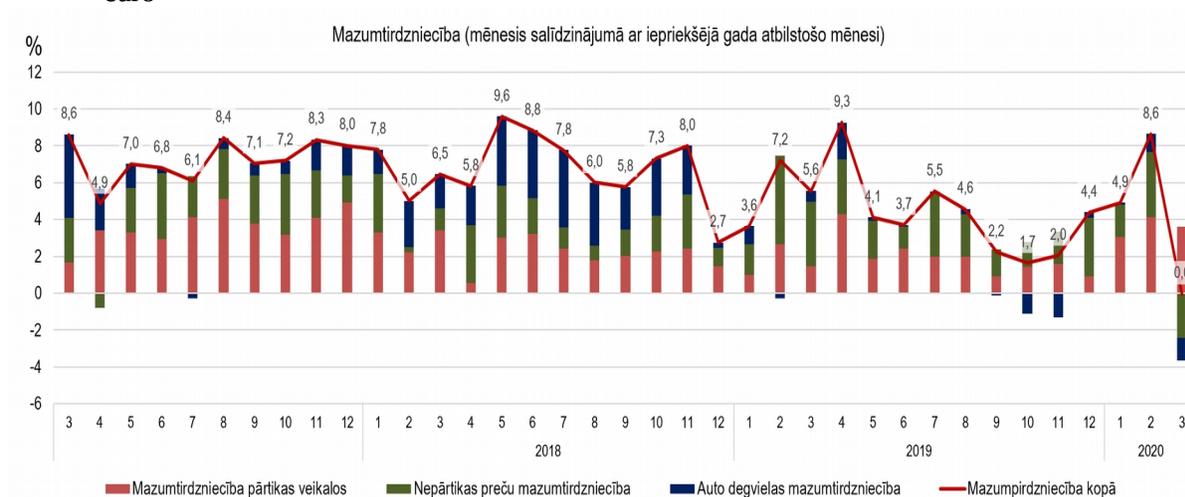


Source: BoL 02 MB monthly data tables

CSB data on retail trade turnover show that, compared to March 2019, the total retail trade turnover has not changed significantly, while the volume of production has decreased by 2.3%. Despite the economic downturn caused by the emergency in the first quarter, the situation in the credit market is less clear: compared to March 2019, lending in March 2020 decreased by 3% in the non-financial institutions segment and by 0.9% in the other financial institutions segment. but in the household segment there is a minimal increase in lending by 0.3% (Figure 2.3).

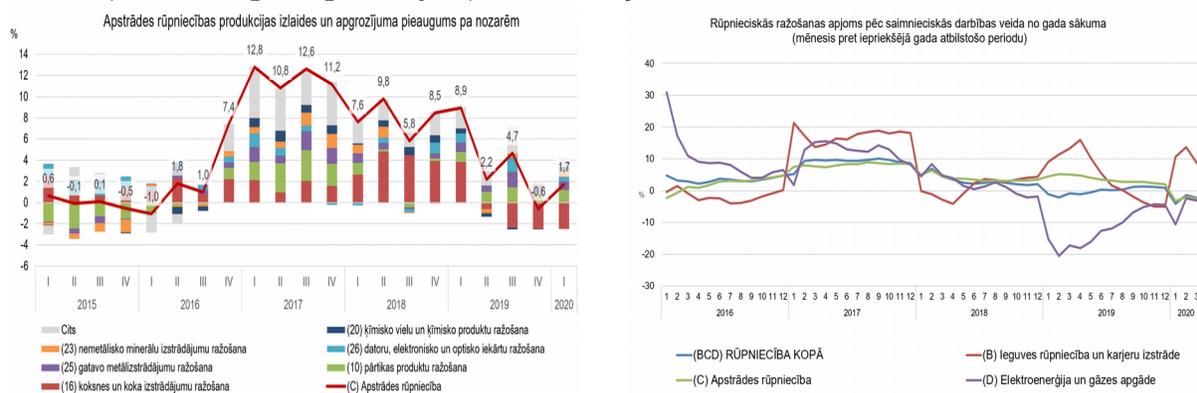
2.3. picture. Economic situation by economic sectors

a) Total turnover of retail trade enterprises by kind of activity, by months, at current prices, thous. euro



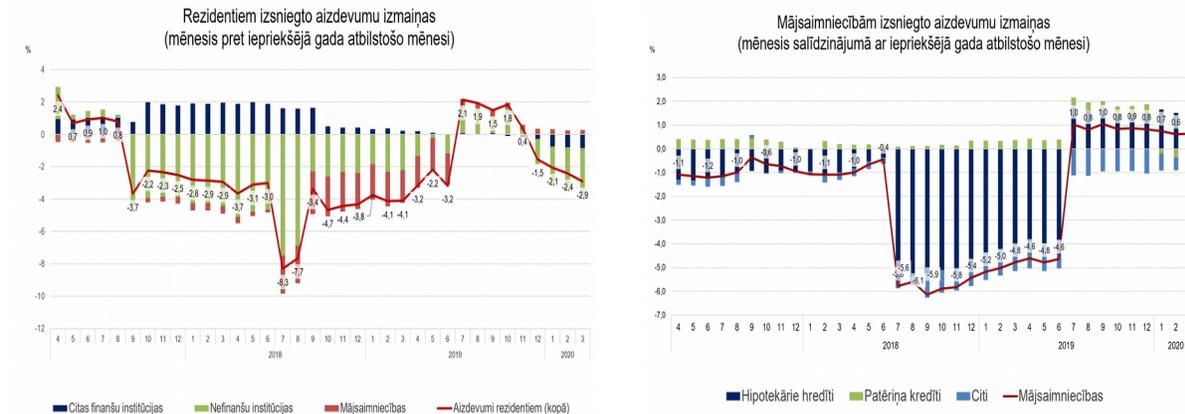
Source: CSB (TI030m)

b) Manufacturing indicators by quarters (thousand euros;%) and volume indices by industry (from the beginning of the year), calendar adjusted data



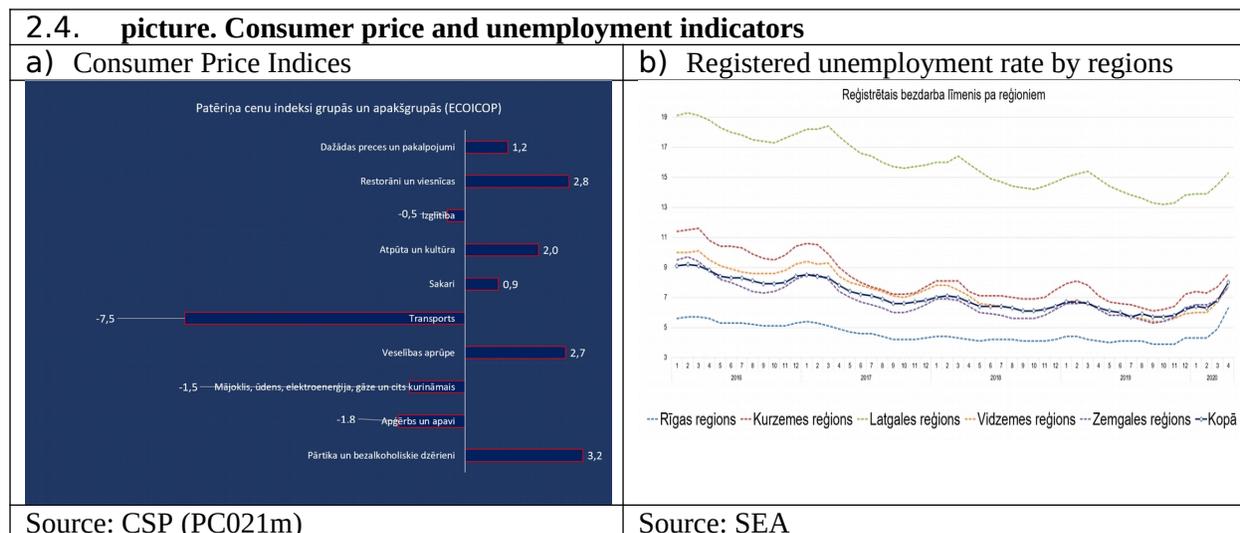
Source: CSB (TI030m)

c) Non-financial loans by residence, sector, subsector and target, currency group and maturity



Source: BoL (02 MFI)

Compared to April 2019, the average consumer price level has remained unchanged: prices for goods decreased by 0.8%, but for services increased by 2.1%. Unemployment continues to rise in all regions, with the registered unemployment rate reaching 8% in April, which is approaching the 2017 figures. By 15 May, the number of unemployed registered with the SEA had increased by 75,523, an increase of 2,606 in May. (2.4.Picture)

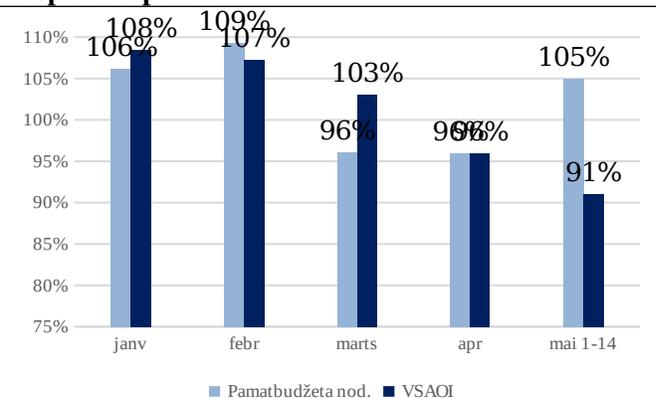


Positive trends in household consumption can be judged by the desire to turn to the bank for mortgage loans, to supply their households by actively shopping in retail food stores, even in conditions of uncertainty. At present, private consumption is one of the key factors in overcoming the GDP downturn more quickly. A negative factor hindering private consumption is the rising unemployment rate and the resulting fiscal burden.

3. Dynamics of budget balance and tax revenues

Although March this year has been marked by a decline in central government basic budget and SSIAl revenues, the April and May Treasury operational data show mixed trends in tax and SSIAl collection: although basic budget tax revenues in March and April 2020 reached only 96% of the previous year May (1-14 May) show that tax revenues have increased by 5% this year, despite the fact that this year Service (SRS) granted “tax holidays” in April in the amount of approximately 67 million euros. - if this amount were hypothetically added to the revenue, the taxes collected in April and the SSIAl would exceed the previous year's level by 7%. It is too early to draw far-reaching conclusions, but overall the results of tax and SSIAl collection are relatively good and not alarming.

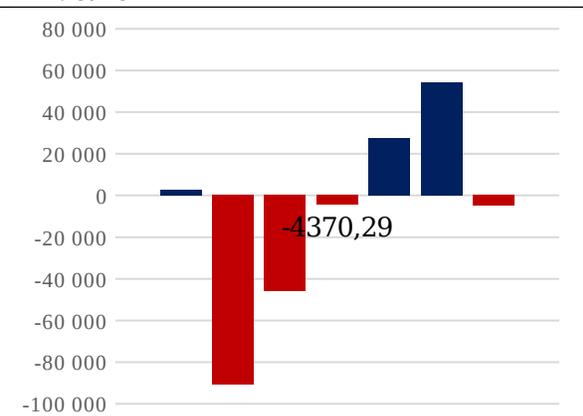
2.1. picture. Dynamics of state basic budget revenue and SSAI in 2020 against 2019 in the respective period



Source: MoF and FDC

In the first four months of the year, excise duty was collected in the amount of 87.5% and VAT - 89.4% of the plan (Table 2.2), while the PIT collection plan was exceeded by 10.5% in the four-month period, due to faster wage growth in the first two months. It was previously forecasted and also that part of the withheld tax on dividends paid in December 2019 was transferred to the state budget at the beginning of January. The April overrun of the PIT plan by 4.9% is unexpected, most likely due to dividends paid this month. The social insurance contribution plan was fulfilled by 99.6%, which is also a good result considering that the revenue of the SSAI is more affected by the crisis than the PIT. After a longer period, the CIT collection plan was overrun in April. The non-tax revenue plan, in turn, was exceeded by 26.1% due to revenue from confiscation of proceeds of crime.

2.2. table. Difference between actual and planned revenues at the end of April 2020, mln. euro

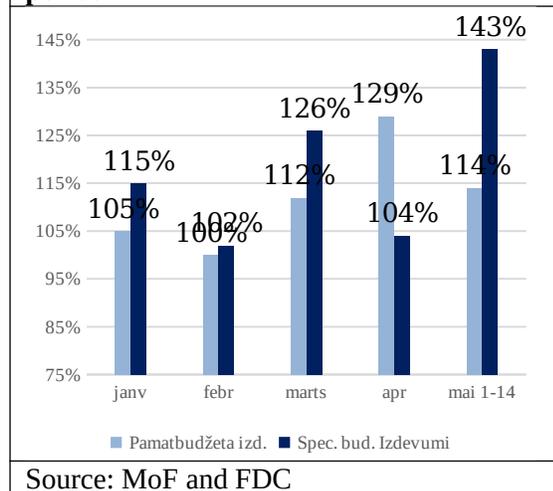


Source: MoF and FDC

The government has set up a program of support measures to stimulate the economy and socially protect the population. Already in March, the impact of the crisis on budget expenditures was felt, especially in the social budget, then in April the central government basic budget expenditures increased very significantly. The operational data of the Treasury show that 1.-14. In May, the burden of support

measures again falls on the special (social) budget, the amount of expenditure of which increased by 43% compared to the corresponding period of the previous year. Both in April and in the first half of May, the EU received significantly higher repayments to the state budget than in the previous year, which contributes to budgetary balance, despite a significant increase in expenditure.

2.3. table. Dynamics of the state basic budget and special budget expenditures in 2020 against 2019 in the respective period



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

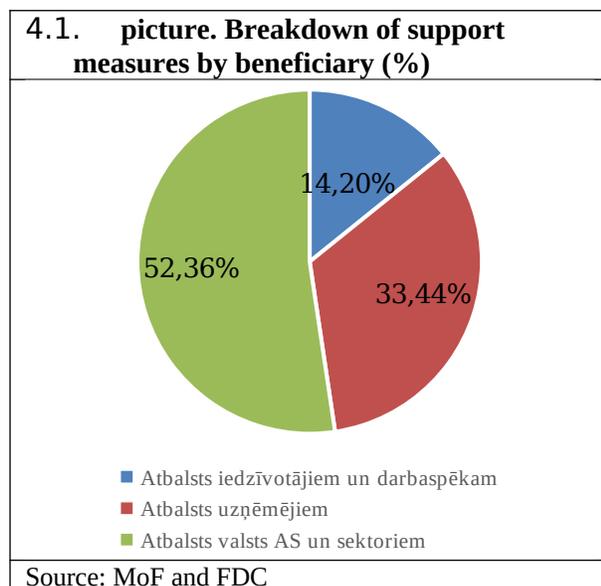
In the Latvian Stability Program for 2020-2023, the impact of economic support measures on the general government budget balance (VBBB) in 2020 is estimated at 851.4 million euros (3% of GDP). Recent calculations by the Ministry of Finance (MoF) and the Fiscal Discipline Council (FDC) show (Table 2.1) that the impact of support measures on the VBB in 2020 could exceed 4.7% of GDP, as the government continues to work on improving existing instruments and new support measures. Over the next three years, the support measures are expected to have a positive impact on the VBB by receiving extended revenues from budget revenues of 0.2% in 2021 and 2022 and 0.3% in 2022, respectively. It should also be noted that the government has decided to allocate 500 million euros of EU structural funds for measures to prevent and mitigate the effects of Covid-19. This decision does not worsen the VVBB in 2020.

2.1. table. Estimates of the MoF and the Council on the impact of support measures on the VBB in 2020

Activities	Measures with an impact on the VSE (EUR million)*	Redistrib of EU funds, without impact on the VSE	Total	Amount disbursed (EUR million)**
Support for the population and the workforce	161.7	89.8	251.5	
Downtime (including assistance) allowance	32.9	20	52.9	22.3
Different types of benefits - unemployment, families, children, etc.	124.3	43.7	178.0	
Retraining of employees		26.1	26.1	

Support for entrepreneurs	552.3	52.8	605.1	
Aid towards time limits for payment of taxes	331		331	270.1
ALTUM working capital loans	50.8	35	85.8	57
ALTUM credit guarantees and portfolio guarantees	50		50	50
Support for the road sector	75		75.0	
Supporting companies for international competitiveness		17.8	17.8	
Support for agriculture and food businesses	45.5		45.5	
Support to State FSC and Sectors	590.2	357.5	947.7	
Aid to the air transport sector **	346.5		346.5	
Support for public transport		283	283	
Support for the healthcare sector	82.3	30	112.3	
Support for municipal investments	150.0	44.5	194.5	
Others, including private and public media	11.4		11.4	
TOTAL	1309.7	500.1	1804.3	
Of GDP	4.7%	1.8%	6.4%	
* FM data and Council calculations ** including 36.1 million euro support to AirBaltic, which from the accounting point of view does not affect the VBB in 2020, as well as the planned support to AirBaltic in the amount of 150 million euros and to Riga Airport in the amount of 54.4 million euros. *** including the planned procurement of centralized protection equipment **** data until 14.05.2020. Source: MoF and FDC				

Although the estimates of the fiscal impact of the aid measures summarized above are very rough and largely based on ministerial estimates, it can be concluded (Figure 2.1) that, due to high support for the air transport sector, one of the worst affected sectors, (%) go to sectors dominated by public limited companies. Support for the healthcare sector (6%) looks modest, given the medical origins of the crisis and the low level of funding for the healthcare sector even before the Covid-19 crisis. Entrepreneurs will receive about 33%, but residents and employees - about 14% of the amount of support.



Review of government decisions related to COVID-19 containment and economic support

05.05.2020. the government decided:

- To provide funding to Pauls Stradiņš Clinical University Hospital and Riga East Clinical University Hospital in the amount of 1,323,563 euros;
- Provide support for the maintenance of children in care by saving on the costs of existing benefits. The decision has no impact on the state budget;
- In order to reduce the negative impact of the Covid-19 containment measures on the construction industry, to extend the deadline for payment of the annual fee for the supervision of the independent practice of construction specialists until 1 September 2020. The decision has no impact on the state budget.

07.05.2020. the government decided:

- Prolong the state of emergency throughout the country until June 9, 2020;
- To extend support measures to those economic operators, associations and foundations that lease real estate or movable property from other public persons and capital companies controlled by a public person, not only local governments. The exact impact on state and local government budgets cannot be calculated;
- To provide the Council of Sworn Notaries with financing in the amount of 24,955 euros for the purchase of a server in order to ensure the continuous operation of the e-apostille register and connection with state and local government institutions;
 - To set 30 June 2020 as the end date of the downtime period and to extend the granting of downtime assistance benefits until 30 June 2020. Impact of the decision on the state budget - 5,625,984 euros.

12.05.2020 the government decided:

- To increase the state budget appropriations for contingencies by EUR 300,000,000;
- Extend the period for which sickness benefit is granted in respect of sick leave issued in connection with Covid-19 illness or quarantine until 31 December 2020. The exact impact on the state budget cannot be precisely determined;
- To provide support to local governments by providing the possibility to receive state budget loans to reduce and prevent the impact of the emergency situation related to the spread of COVID-19. It is not possible to indicate the exact amount of funding and the breakdown of funding by year;

- Provide support to the clergy and ministers of religious unions (churches) in connection with the restrictions imposed on the practice of religious activities. Impact of the decision on the state budget - 236,400 euros;
- To set allowances for medical practitioners, officials with special service ranks and employees of the Prison Administration in the amount of up to 20% of the monthly salary for the period from 1 April 2020 to 31 May 2020. Impact of the decision on the state budget - 518,730 euros.

14.05.2020. the government decided:

- Clarify the conditions for applying for, calculating and receiving the downtime allowance for exporting and other companies affected by the crisis. The decision has no impact on the state budget;
- Pay a lump sum of EUR 150 per disabled child for the period until a state of emergency has been declared throughout the country due to the spread of Covid-19. Impact of the decision on the state budget - 1,219,395 euros;
- To provide additional support to recipients of childcare allowance for children aged between one and a half and two years. Impact of the decision on the state budget - 4,291,200 euros;
- Clarify the criteria and requirements according to which self-employed persons affected by the crisis can apply for downtime benefits. The decision has no impact on the state budget;
- To provide financing for the issuance of short-term loans to farmers in the amount of 59,840,000 euros.