Annex 2. Council's Opinion on the Ministry of Finance's Macroeconomic Forecast (4 August 2017)

This document presents the opinion of the Fiscal Discipline Council (hereafter - the Council) on the macroeconomic forecast prepared by the Ministry of Finance (hereafter – MoF) that will be used for drafting Latvia's medium term budget framework (hereafter – MTBF) 2018/20MTBF 2018/20, which is scheduled to be submitted to the Saeima on 15 October 2017. An early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the efforts of the Government during the preparation of the annual Stability Programme and the MTBF.

According to the Memorandum of Understanding, signed on 8 February 2016, the Council has a responsibility to endorse MoF's macroeconomic forecast. During the endorsement process the Council was presented with detailed information on MoF's forecast, such as the gross domestic product (hereafter – GDP) structure and development scenarios of GDP components, as well as the information on the tax reform measures, that do have impact on the economy and their fiscal effects. The Council has consulted with external experts to gain a comprehensive understanding of the developments in Latvia's economy.

	2017	2018	2019	2020
Real GDP growth				
MoF (July 2017)	**3.7**	**3.4**	**3.2**	**3.2**
BoL* (June 2017)	3.3	3.4	–	–
EC (August 2017)	3.2	4.3	4.4	4.3
IMF (July 2017)	3.2	3.2	3.1	3.0
Nominal GDP growth				
MoF (July 2017)	**6.6**	**6.3**	**5.7**	**5.6**
BoL (June 2017)	–	–	–	–
EC (May 2017)	–	–	–	–
IMF (July 2017)	6.3	5.3	5.7	5.4
Inflation				
MoF (July 2017)	**2.8**	**2.8**	**2.4**	**2.1**
BoL (June 2017)	2.9	–	–	–
EC (May 2017)	2.2	2.0	–	–
IMF (July 2017)	3.0	2.5	2.4	2.4
GDP deflator				
MoF (July 2017)	**2.8**	**2.8**	**2.4**	**2.3**
BoL (June 2017)	–	–	–	–
EC (May 2017)	3.1	2.7	–	–
IMF (April 2017)	2.4	2.5	2.4	2.3
Output gap				
MoF (July 2017)	**-0.1**	**0.3**	**0.5**	**0.8**
BoL (June 2017)	–	–	–	–
EC (August 2017)	2.7	1.5	0.5	-0.5
IMF (July 2017)	-0.2	0.0	0.1	0.0

Table 1 Key macroeconomic indicator forecasts by various institutions, % y-o-y. Data sources: MoF, BoL, EC, IMF. *Seasonal and calendar unadjusted.

The MoF macroeconomic forecast is largely in line with the forecasts of the European Commission (hereafter – EC) (with the exception of assumptions regarding the output gap), the International Monetary Fund (hereafter – IMF) and the Bank of Latvia's (hereafter – BoL) (Table 1).

The outlook for the European Union (hereafter – EU) economy is improving[1], and the political environment has stabilised, which has stimulated the return of an optimistic outlook among Latvia's entrepreneurs[2].

In June 2017, the Baltic states had the highest inflation rates in the EU[3], confirming and facilitating economic activity in Latvia.

To boost public sector investments, it is important to implement projects supporting structural changes. Although the implementation of EU-funded projects was slow in 2016, it is expected that the coming years will witness faster, but at the same time – moderate, growth, assuming that all available funds will be absorbed.

The Council takes note of the MoF's impact assessment of the secondary effects of the tax reform for the MTBF

[1] European Commission Spring 2017 Economic Forecast: steady growth ahead. Available at: *https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/spring-2017-economic-forecast_en*, accessed on 27.07.2017.
[2] Bank Citadele index. 6 June 2017. Available at: *http://fdp.gov.lv/files/uploaded/20170606_ilgtspeja_MAbolins_Citadele.pdf*, accessed on 27.07.2017.
[3] *Eurostat* news release on annual inflation in EU. 17 July 2017. Available at: *http://ec.europa.eu/eurostat/documents/2995521/8113568/2-17072017-AP-EN.pdf/d5bb6552-3c1f-4531-a705-3c6bc947bdbe*, accessed on 27.07.2017.

2018/20 (Table 2). On 17 July 2017 the Council indicated in its non-conformity report[4] that it was hesitant to accept potential revenue estimates based on the secondary effects of the tax reform, because these estimates were not based on the agreed upon macroeconomic assumptions. The Council takes note of the MoF's assumption[5] that the growth impact of the tax reform will be 103 million euro in 2018, 67 million euro in 2019 and 119 million euro in 2020. The MoF suggests that the main driving force behind the growth is an increase in private consumption – 105 million euro in 2018, 225 million euro in 2019 and 222 million euro 2020. In addition, it is expected that investments (gross fixed capital formation) will increase by 100 million euro in 2020. This is mainly caused by the decision to levy a 0% corporate income tax rate for reinvested profits. These MoF assumptions are based on the prediction of rapid (2-3 years) behavioural changes in response to the tax reform. These assumptions should be treated with caution. The Council believes that the tax reform could bring some long-term structural benefits, particularly in terms of stronger business balance sheets and facilitated crisis resilience, but it may not be evident in the next three years.

	2017	2018	2019	2020
GDP	**0**	**103**	**67**	**119**
Private consumption	0	105	225	222
Government consumption	0	85	130	176
Gross capital formation	1	-9	-257	-142
Gross fixed capital formation	0	13	56	100
Inventories	1	-22	-314	-242
Exports of goods and services	-70	-140	-140	-140
Imports of goods and services	-69	-62	-110	-4

Table 2 Economic growth effect from the tax reform, in current prices, million euro. Source: MoF.

The Council endorses the real GDP growth forecast for MTBF 2018/20. Compared to the previous forecast, which was prepared for the Stability programme 2017/20, the real GDP growth rate has been raised by 0.5 percentage points to 3.7% for 2017. The forecast remains unchanged for 2018 and 2019, 3.4% and 3.2% respectively. The forecast for 2020 has been raised by 0.2 percentage points to 3.2% (Chart 1).

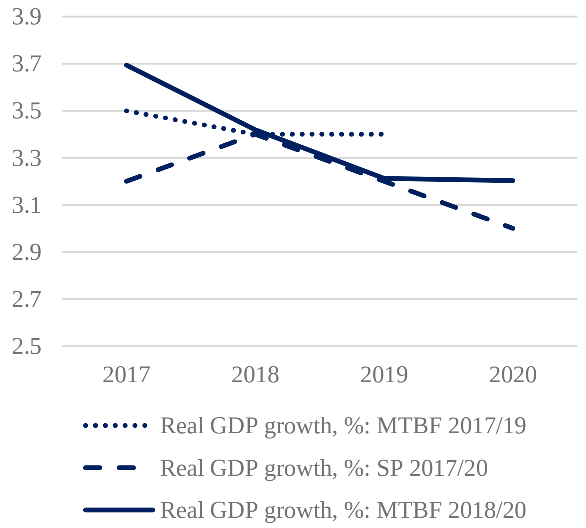

Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

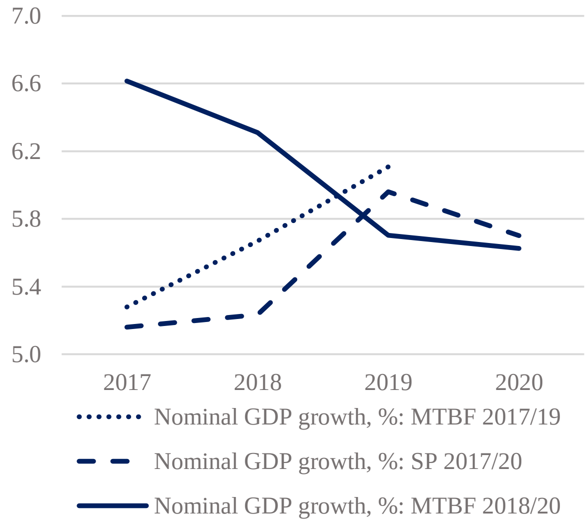

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

[4] 17 July 2017 Council irregularity report on tax reform draft laws fiscal impact. Available at: *http://fiscalcouncil.lv/17072017-irregularity-report*, accessed on 27.07.2017.
[5] On 27 July 2017 the MoF provided detailed data on tax reform impact, that unfortunately differs from that of 21 July 2017 given in the reply from the MoF on the non-conformity report.

Economic growth has picked up in the second quarter of 2017, reaching an annual growth of 4.1% (without calendar or seasonal adjustment). The main reasons behind the faster growth rate were (i) increased external demand, which stimulated the upswing in the manufacturing industry, (ii) a pickup in investment activity, which revitalised the construction sector, as well as (iii) household consumption has regained strongly. In addition, Latvian ports experienced turnover growth and the retail sector figures grew steadily in the beginning of 2017.

One of the weak spots of the updated economic growth forecasts is the continued risk of inadequate capacity to absorb the expected inflow of EU funds into the economy. The unemployment level forecast for 2020 (7.2%) is approaching the level of 2006 (7.0%) and indicates potential difficulties in attracting the necessary human resources in certain industries. NAWRU for the MTBF 2018/20 is well above the actual unemployment forecasts, i.e. NAWRU for 2017 at 9.5%, for 2018 at 8.9%, for 2019 at 8.4% and for 2020 at 7.9%. The MoF forecasts of the natural unemployment rate (NAWRU in this case) is further indication that labour market is heating up.

The Council endorses the nominal GDP growth forecast for the MTBF 2018/20. The MoF has substantially raised the nominal GDP growth forecast for 2017 and 2018, i.e. for 1.5 percentage points and for 1.1 percentage points respectively, but lowered growth forecasts for 2019 and 2020, by 0.3 percentage points and 0.1 percentage point respectively (Chart 2) compared to the Stability Programme 2017/20 forecasts. The revisions are mainly related to considerable revisions of GDP deflator and real GDP forecasts.

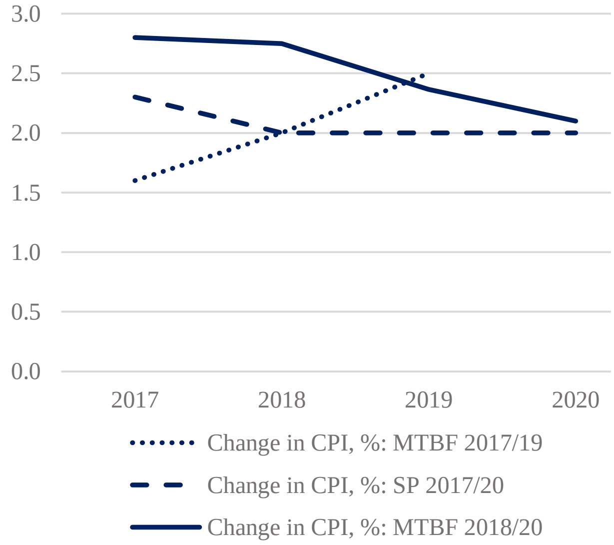

Chart 3 Forecast for inflation, y-o-y. Data source: MoF.

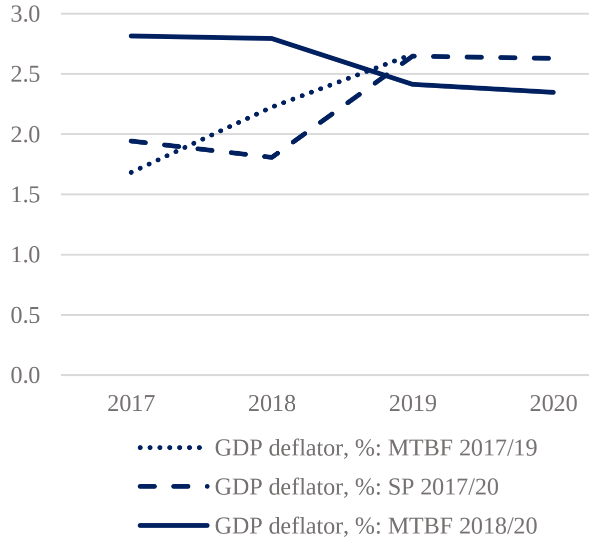

Chart 4 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the MTBF 2018/20. For the second time this year the Council supports an upward revision of the inflation forecast – for 2017, from 2.3% in the Stability Programme 2017/20 to 2.8% currently; for 2018, from 2.0% to 2.8%; for 2019, from 2.0% to 2.4%, and to 2.1% for 2020 (Chart 3).

The actual change in the CPI shows a 3.1% average annual inflation for January-June 2017, which suggests that the average annual inflation forecast of 2.8% is realistic. The forecasts are slightly higher than what the European Central Bank projects for the EU as a whole (1.5% for 2017, 1.3% for 2018 and 1.6% for 2019)[6], which can be explained by an ongoing price convergence and by administratively induced higher excise tax.

The Council endorses the GDP deflator forecast for the MTBF 2018/20. The GDP deflator forecast has also been revised upwards for 2017 and 2018 by 0.9 percentage points and 1.0 percentage point respectively, and is now 2.8% for both years. The forecasts for 2019 and 2020 have been lowered by 0.2 percentage points (down to 2.4%) and by 0.3 percentage points (down to 2.3%) respectively (Chart 4).

The Council endorses the potential GDP growth and output gap forecast for the MTBF 2018/20. Since the previous endorsement of macroeconomic forecasts, potential GDP growth has been revised upwards by 0.3 percentage points (up to 2.8% for 2017). A 3.0% growth rate has been set for 2018-2024. The expanded time horizon is necessary for further calculations of the expenditure benchmark. The Council invites the MoF to revise potential GDP growth for 2021-2024, as the impact of structural factors is not sufficient to maintain (for 2021-2024) potential GDP growth at 3.0%.

The Council agrees that Latvia's economy is currently close to its potential level. Nevertheless, from 2017 onwards the forecasts for private consumption and investment growth indicate that the business is on an upswing. The cyclical nature of the upswing also is confirmed by rising wage inflation forecast. This suggests that changes in the economy are not caused by structural changes, but by cyclical factors.

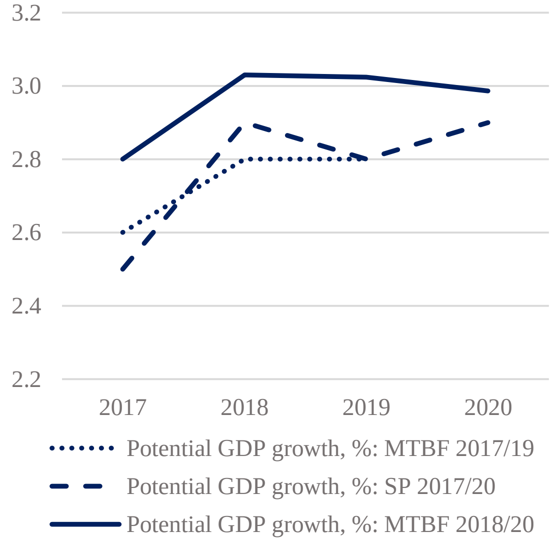

Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

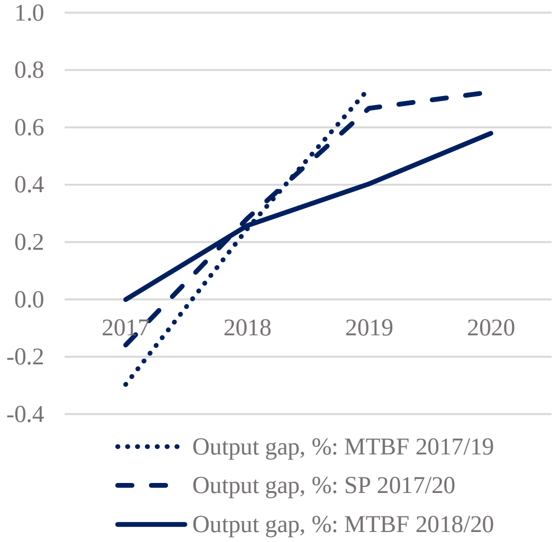

Chart 6 Output gap, % of potential GDP. Data source: MoF.

The Council notes that the contribution of structural factors is not sufficient to boost potential GDP growth, and invites the MoF to revise the potential GDP forecasts for 2021-2024 to accurately reflect the business cycle.

[6] June 2017 Eurosystem staff macroeconomic projections for the euro area. Available: *https://www.ecb.europa.eu/pub/pdf/other/projections201706_eurosystemstaff.en.pdf*, accessed on 27.07.2017.

	2017	2018	2019	2020
Real GDP growth	**3.7**	**3.4**	**3.2**	**3.2**
Nominal GDP growth	**6.6**	**6.3**	**5.7**	**5.6**
Inflation (consumer prices)	**2.8**	**2.8**	**2.4**	**2.1**
GDP deflator	**2.8**	**2.8**	**2.4**	**2.3**
Potential GDP growth	**2.8**	**3.0**	**3.0**	**3.0**
Output gap	**0.0**	**0.3**	**0.5**	**0.8**

Table 3 Macroeconomic forecast indicators endorsed by the Council.

Broadly, the Council considers the MoF's macroeconomic forecasts to be realistic and endorses them. In addition, the Council reiterates its recommendation to improve sensitivity analysis for MTBF 2018/20.