OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST

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 Stability Programme (hereafter – SP) 2018/21, which is scheduled to be submitted to the Saeima on mid-April 2018. 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 SP and the medium term budget framework (hereafter – MTBF).

According to the Memorandum of Understanding, signed on 8 February 2016, the Council has a responsibility to endorse MoF's macroeconomic forecast. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators, which are outlined below. During the endorsement process the Council was presented with detailed information on MoF's forecast (please see annex), such as the gross domestic product (hereafter – GDP) structure and development scenarios of GDP components. The Council has consulted with external experts to gain a comprehensive understanding of the developments in Latvia's economy.

The Council has a mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarised in Table 3 at the end of this document).

	2018	2019	2020	2021
Real GDP growth				
MoF (Feb 2018)	**4.0**	**3.4**	**3.0**	**2.9**
BoL* (Dec 2017)	4.1	3.2	–	–
EC (Feb 2018)	3.5	3.2	–	–
IMF (Oct 2017)	3.9	3.5	3.2	3.1
Nominal GDP growth				
MoF (Feb 2018)	**7.2**	**6.5**	**5.8**	**5.4**
BoL (Dec 2017)	–	–	–	–
EC (Nov 2017)	6.9	6.5	–	–
IMF (Oct 2017)	7.0	5.9	5.5	5.4
Inflation				
MoF (Feb 2018)	**2.8**	**2.4**	**2.1**	**2.1**
BoL (Dec 2017)	2.9	2.6	–	–
EC (Feb 2018)	3.1	2.9	–	–
IMF (Oct 2017)	3.0	2.5	2.4	2.3
GDP deflator				
MoF (Feb 2018)	**3.1**	**3.0**	**2.7**	**2.5**
BoL (Dec 2017)	–	–	–	–
EC (Nov 2017)	3.4	3.2	–	–
IMF (Oct 2017)	3.0	2.4	2.3	2.2
Output gap				
MoF (Feb 2018)	**1.1**	**1.0**	**0.7**	**0.3**
BoL (Dec 2017)	–	–	–	–
EC (Nov 2017)	2.1	1.4	–	–
IMF (Oct 2017)	–	–	–	–

*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 of real gross domestic product (hereafter – GDP) growth, nominal GDP growth, inflation and GDP deflator is largely in line with the forecasts of the European Commission (hereafter – EC), the International Monetary Fund (hereafter – IMF) and the Bank of Latvia's (hereafter – BoL) (Table 1). However, there is an exception of assumptions regarding the output gap – the EC forecasts by 1.4 percentage points higher output gap in 2018 and by 0.5 percentage points higher in 2019, nevertheless both institutions highlight positive output gap.[1]

After a better than excepted economic performance in 2017, growth is likely to remain solid in the European Union (hereafter – EU). Increase in the GDP both private consumption and EU-funded investments contribute to the growth acceleration. Global goods prices have been driven by a moderate recovery in energy prices and wage increase.

Decreasing unemployment (lowest since 2009) has been pushing up wages. Unemployment rate is forecasted to decrease towards 7.0% by 2021, which is at the level of 2006. This indicates increasing difficulties in attracting the necessary human resources in certain industries. Non-accelerating wage rate of unemployment (NAWRU) or the natural unemployment provided by MoF for the SP 2018/21 is forecasted well above the actual unemployment forecasts. Forecasted actual unemployment level decreases in 2018 to 8% (the NAWRU forecast for 2018 is 9.7%), in 2019 to 7.7% (NAWRU 9.4%), in 2020 to 7.2% (NAWRU 8.8%), and in 2021

[1] European Commission Autumn 2017 Economic Forecast. Available at: *https://ec.europa.eu/info/sites/info/files/saee_autumn_2017_en.pdf*, accessed on 08.02.2018.

to 7.0% (NAWRU 8.4%). Low unemployment level continues the pressure to raise wages. This may lead to the risk of inflation being higher than forecasted, we return to this issue later in the opinion.

The Council endorses the real GDP growth forecast for SP 2018/21. Compared to the previous forecast in August 2017, which was prepared for the MTBF 2018/20, the real GDP growth rate has been raised by 0.6 percentage points in 2018 and 0.2 percentage points in 2019, but lowered by 0.2 percentage points in 2020 (Chart 1). The forecast for nominal GDP growth rates together with GDP deflator has been raised for all years.

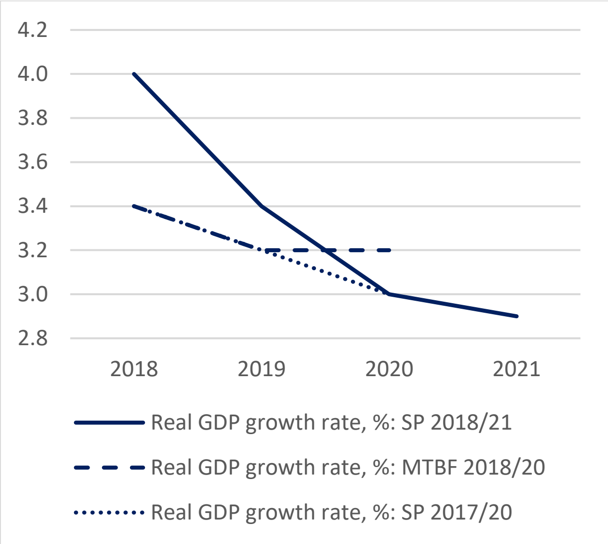

Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

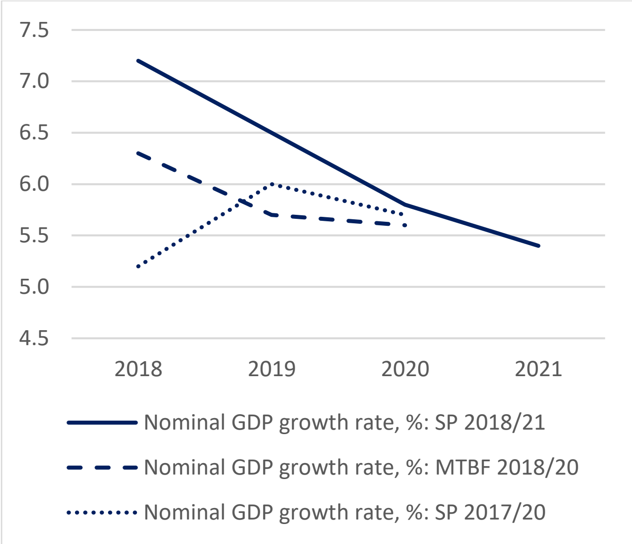

Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council endorses the nominal GDP growth forecast for the SP 2018/21. The MoF has further raised the nominal GDP growth forecast for 2018 to 2021 (Chart 2). The revisions are mainly related to considerable revisions of GDP deflator.

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the SP 2018/21. In 2017, the CPI has increased by 2.9% (annual raise according to European statistics, Eurostat), and it has slightly overreached the previously expected level of 2.8%. Therefore, since August 2017, there are no changes made to the inflation forecast (Chart 3).

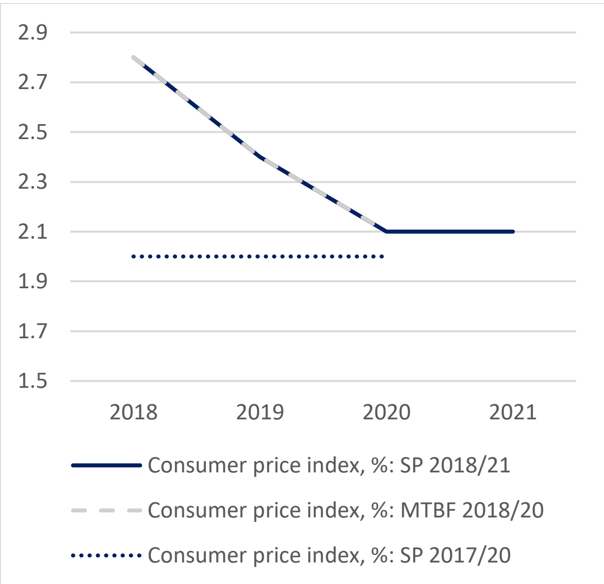

Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

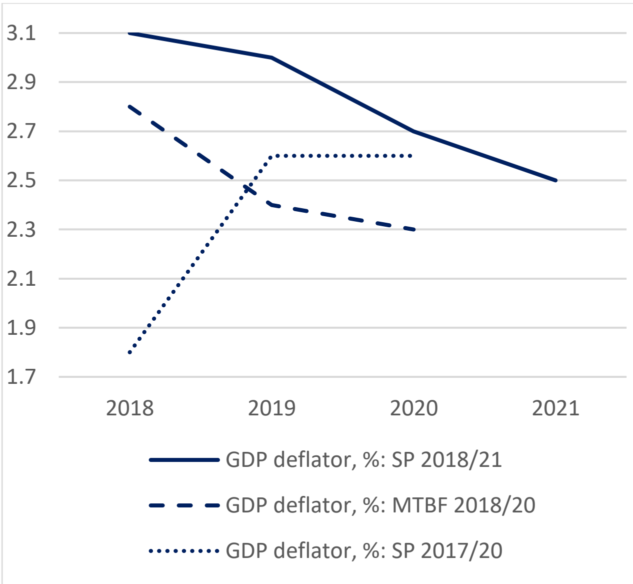

Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator forecast for the SP 2018/21. The GDP deflator forecast has been revised upwards by 0.3 percentage points in 2018, 0.6 percentage points in 2019 and 0.4 percentage points in 2020 (Chart 4).

The Council endorses the potential GDP growth and output gap forecast for the SP 2018/21 with comments. Since the previous endorsement of macroeconomic forecasts (please see Table 2 below), potential GDP growth has been revised upwards by 0.4 percentage points in 2018 and 2019. A 3.3% growth rate has been set for 2020 and 2021, 3.0% for 2022 and 2023, and 2.8% for 2024 and 2025 (the expanded time horizon is necessary for further calculations of the expenditure benchmark).

The pressure to the wage growth from the labour market remains high (unemployment forecasts remain significantly below the NAWRU forecasts) and therefore inflation outcome and forecasts might be significantly higher than the current MoF's forecasts, particularly for 2020-2021. The Council notes that faster increase of wages and inflation also will demand lower potential GDP growth and higher positive output gap. In situation when the inflation outcome and wage growth will be higher than current forecasts the Council will ask the MoF to update the potential GDP growth and output gap forecasts.

	2018	2019	2020	2021
Potential GDP growth (August 2017)	3.0	3.0	3.0	
Potential GDP growth (February 2018)	**3.4**	**3.4**	**3.3**	**3.3**
changes in potential GDP	***0.4***	***0.4***	***0.3***	
Output gap (August 2017)	0.3	0.5	0.8	
Output gap (February 2018)	**1.1**	**1.0**	**0.7**	**0.3**
changes in output gap	***0.4***	***0.5***	***-0.1***	

Table 2 Changes in potential GDP growth and output gap forecasts since August 2017, %.

Average potential GDP growth rate from 2018 to 2025 is above 3.0% threshold. The Council notes that the projected potential GDP growth over the eight-year period above the 3% threshold is high and there are significant constraints on the potential GDP growth in Latvia in the long run above 2.5%[2].

The Council finds the economy of Latvia in positive output gap in 2017 and the trend continuing strongly in 2018. The business cycle is on an upswing with strong confidence, high employment, and increasing pressure on wage inflation. Cyclical factors have been the key contributors for the economic growth, which cannot last without adequate structural changes enabling increase in productivity.

The Council finds substantial risks of prices accelerating mostly because of the labour market conditions and the steady wage growth. Wage growth and accelerating inflation beyond the current MoF's forecasts would highlight deterioration of productivity and result as lower economic growth potential and would indicate widening positive output gap.

[2] Fiscal sustainability report 2017-2037. Available at: *http://fiscalcouncil.lv/fiscal-sustainability-report-2017-2037*, accessed on 08.02.2018.

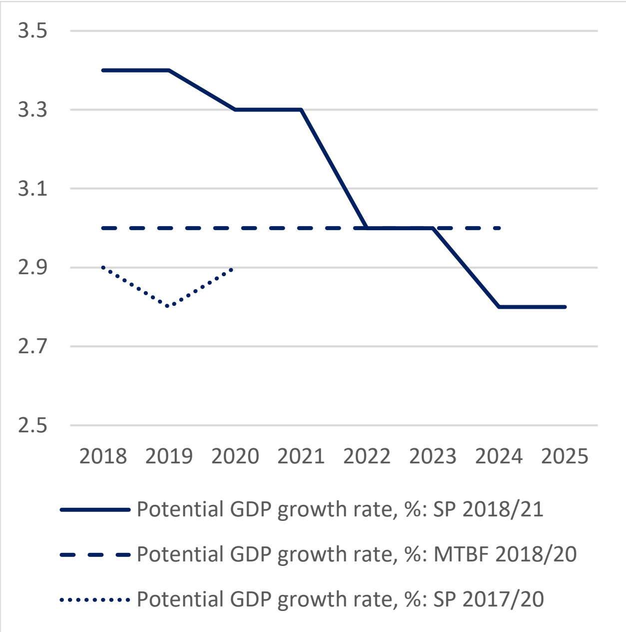

Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

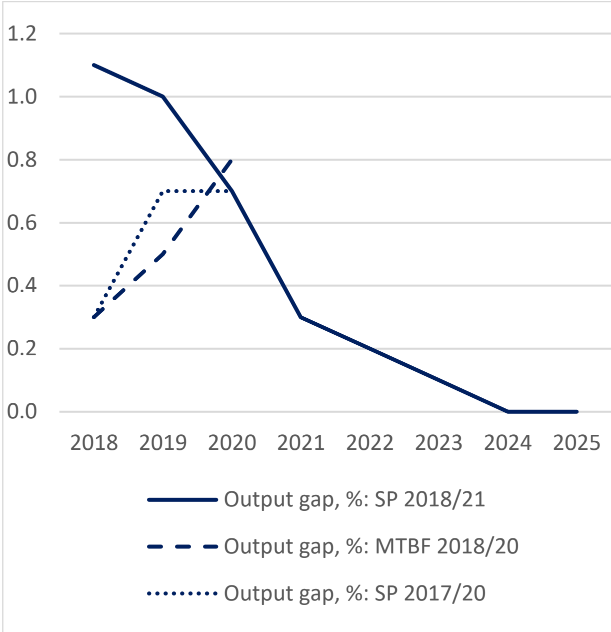

Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2018	2019	2020	2021
Real GDP growth	**4.0**	**3.4**	**3.0**	**2.9**
Nominal GDP growth	**7.2**	**6.5**	**5.8**	**5.4**
Inflation (consumer prices)	**2.8**	**2.4**	**2.1**	**2.1**
GDP deflator	**3.1**	**3.0**	**2.7**	**2.5**
Potential GDP growth	**3.4**	**3.4**	**3.3**	**3.3**
Output gap	**1.1**	**1.0**	**0.7**	**0.3**

Table 3 Macroeconomic forecast indicators endorsed by the Council.

Broadly, the Council considers the MoF's macroeconomic forecasts to be realistic and endorses them, while the price inflation and wage growth should be watched as an evidence of lower growth potential and widening positive output gap. In addition, the Council:

1. Reiterates its recommendation to improve the sensitivity analysis for the SP 2018/21 by incorporating in the tables of both optimistic and pessimistic scenarios the following indicators:
   a. Real GDP growth rate;
   b. Total budget revenue;
   c. Budget balance;
   d. Budget deficit.
2. Has performed an evaluation of macroeconomic forecast since 2004 (see Annex) and recommend the MoF to begin a regular self-assessment of macroeconomic forecasting that would help of data revisions in the future.

Prepared in cooperation with SIA "Ernst & Young Baltic" in accordance with the contract signed on 15 September 2017 for the provision of macroeconomic expert advisory services. Available at: http://fdp.gov.lv/files/uploaded/FDP_1_15_1427_20170915_FDP2017_3_Ligums_makro.pdf