



LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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To _____ No _____

Mrs Baiba Bāne
State Secretary
Ministry of Finance
e-mail: pasts@fm.gov.lv

Mrs Inta Vasaraudze
The Director of
Department of Economic Analysis

On the endorsement of the macroeconomic indicator forecast

Dear Mrs B. Bāne,
Dear Mrs I. Vasaraudze!

According to Article 20 of the Fiscal Discipline Law (hereafter – FDL) medium-term macroeconomic forecasts, including forecasts of growth rate of the gross domestic product (hereafter – GDP), deflator forecasts of the GDP and forecasts of growth rate of the potential GDP shall be developed by the Ministry of Finance (hereafter – MoF). According to the Article 28, Part 2 of the FDL, the Fiscal Discipline Council (hereafter – Council) shall perform an independent assessment of potential GDP and nominal GDP calculation by the MoF.

Article 4, Part 4 of the *Regulation (EU) Nr.473/2013 (21 May 2013) of the European Parliament and the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*, stipulates that draft annual state budget and draft medium term budget framework (hereafter – MTBF) shall be based on independent macroeconomic forecasts that are prepared or endorsed by independent bodies.

According to the Memorandum of Understanding (hereafter – MoU) between the MoF and the Council, signed on 8 February 2016, the Council shall assume the responsibility of the independent body and endorse the MoF macroeconomic forecasts twice a year – (i) while preparing the Stability Programme, and (ii) the annual state budget and the MTBF.

The first version of the macroeconomic forecast for drafting MTBF 2019-2021 was provided to the Council by the MoF on 17 September 2018, and later on 25 September 2018 with incorporated changes according to the discussions between the MoF and the Council at the meeting on 20 September 2018. On 3 October, the Council received updated forecasts from the MoF that were adjusted in accordance with the updated Central Statistical Bureau data at the beginning of October. On 4 October 2018 the Council sent to the MoF the opinion on the endorsement of the macroeconomic indicator forecast part from the output gap indicator. On 9 October after the reiterative meeting with the Council, the MoF has sent once again updated output gap indicators for 2020-2025.

After reviewing the MoF forecasts and comparing them with the endorsed forecasts from February¹ this year, the Council noted that:

- i) Real and nominal GDP growth is forecasted higher than previously for 2018 but lower for 2019. This is consistent with other forecasts by Bank of Latvia (June 2018), European Commission (May 2018) and International Monetary Fund (September 2018), however, the real GDP growth rate for 2018 forecasted by MoF is the highest among previously mentioned forecasts.
- ii) Potential GDP forecast for 2018-2020 and for 2023 remains at the level of previous forecast but the output gap is raised for 2018 by 0.2 percentage points (it is an equal difference of revision upwards for real GDP growth level for this year) but decreased for 2019 by 0.1 percentage points.
- iii) MoF's forecast includes the projection on total population, working age population and economically active population, where the total population in thousand persons has remained at the previously forecasted level but the working age population is revised upwards by 10 thousand persons each year for 2018-2021. This revision is explained by methodological adjustments done by Central Statistical Bureau.

On 21 September, the Council asked the MoF to comment on the possible need to revise the forecasted potential GDP and output gap because of ongoing further labour tightening (shortage) and increasing wage pressure. On 25 September, the MoF explained that forecast incorporates a higher yearly average gross wage increase by 3 euros for years 2018 to 2021 in comparison to the forecast for *Latvia's Stability Programme 2018-2021*, which is a difference of 0.3% percentage point (i.e., currently, the average gross wage increase is estimated 8,3% for 2018). The MoF points out that this is insignificant difference between the forecasts with no effect on the potential GDP. However, it is a cyclical indicator; therefore, the output gap is twice as large for 2018 in comparison to 2017, and revised upwards in comparison to previous forecast. In MoF's opinion, currently there are no structural factors affecting potential GDP in medium term.

The Council notes that economy is so obviously close to the height of the business cycle that any forecasts that would imply possible fiscal easing must be wrong. This is the time for fiscal tightening, not for fiscal easing.

At the same time the Council would like to indicate that the output gap can be estimated and forecasted by using several methods, where production function is only one (however, so far commonly agreed) method with important limitations. Other methods include univariate or multivariate unobserved components models and the principal components analysis. The Council invites MoF to consider usage of additional methods to better assess the output gap that would also exclude the assumption of definite closure of the output gap within 5 years' time horizon.

¹ 14/02/2018 endorsement of the macroeconomic forecasts. Available at the Council website: <http://fiscalcouncil.lv/14022018-macroeconomic-forecast-endorsement>

	2018	2019	2020	2021
Real GDP growth	4.2	3.0	3.0	2.9
Nominal GDP growth	7.4	6.2	5.8	5.5
Inflation (consumer prices)	2.5	2.5	2.2	2.1
GDP deflator	3.1	3.1	2.7	2.5
Potential GDP growth	3.4	3.4	3.3	3.2
Output gap	1.3	0.9	0.6	0.2
Output gap as forecasted in February 2018 for SP 2018/21 (endorsed)	1.1	0.9	0.6	0.3

Table 1. Macroeconomic forecast indicators endorsed by the Council.

On 10 October 2018, the Council by voting endorsed the macroeconomic forecast to underpin the fiscal projections for the MTBF for 2019-2021.

The Council expresses its gratitude for the co-operation and data exchange with colleagues from the MoF.

Kind regards,

Secretary of the Council

(signature*)

D. Kalsone

*Document has been signed with the secure electronic signature