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 Medium term budget framework (hereafter – MTBF) for 2019-2021. This is an early review before the Medium-term budget framework drafting process for 2019-2021. The Council conducts the review and endorsement of the MoF's macroeconomic projections to assist the development of the fiscal projections well ahead of the presentation of the draft budget and the medium term budget framework (hereafter – MTBF) for approval. An early review and the 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 (hereafter – SP) and the MTBF.

Through the Memorandum of Understanding, signed on 8 February 2016, the MoF has requested and Council has accepted a responsibility to endorse MoF's macroeconomic forecasts underpinning fiscal projections. 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, 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 5 at the end of this document).

	2018	2019	2020	2021
Real GDP growth, change in %p	**+0.2**	**-0.4**	**–**	**–**
MTBF2019/21	4.2	3.0	3.0	2.9
SP2018/21	4.0	3.4	3.0	2.9
Nominal GDP growth	**+0.2**	**-0.3**	**–**	**+0.1**
MTBF2019/21	7.4	6.2	5.8	5.5
SP2018/21	7.2	6.5	5.8	5.4
Inflation (consumer prices)	**-0.3**	**+0.1**	**+0.1**	**–**
MTBF2019/21	2.5	2.5	2.2	2.1
SP2018/21	2.8	2.4	2.1	2.1
GDP deflator	**–**	**+0.1**	**–**	**–**
MTBF2019/21	3.1	3.1	2.7	2.5
SP2018/21	3.1	3.0	2.7	2.5
Potential GDP growth	**–**	**–**	**–**	**–0.1**
MTBF2019/21	3.4	3.4	3.3	3.2
SP2018/21	3.4	3.4	3.3	3.3
Output gap *(not endorsed)*	**+0.2**	**-0.1**	**-0.042**	**–**
MTBF2019/21	1.3	0.9	0.6	0.3
SP2018/21	1.1	1.0	0.7	0.3

Table 1. Macroeconomic forecast indicators changes since endorsement in spring 2018. Data available here: http://fiscalcouncil.lv/14022018-macroeconomic-forecast-endorsement

Since Latvia's Stability programme 2018/21 (hereafter – SP2018/21) the MoF has changed the real GDP growth forecasts for 2018 and 2019 (see Table 1 above). At the Council meeting on 20 September 2018 the MoF has informed about the one-off factors, including slower contraction in 2018 of the financial sector output providing services to non-residents compared to the projections in the spring and early summer. In the meantime the contraction in the financial sector will continue in 2019. Very fast growth in the construction sector also is going to slow the growth rates in 2019 because of base effects of 2018.

Responding to the Council's concerns the MoF has argued that such one-off effects are not affecting the potential GDP growth apart from 2021 (last year of MTBF). Thus, the revision in the real GDP growth in 2018 and in 2019 results into modifications in the output gap, i.e. expanding cycle for 2018 and closing the gap faster in MTBF years. The positive output gap increases for 2018, reflecting the economic conditions heating up, while the positive output gap reduces for 2019.

	2018	2019	2020	2021
Real GDP growth				
MoF (Sep 2018)	**4.2**	**3.0**	**3.0**	**2.9**
BoL* (Jun 2018)	3.9	3.0	–	–
EC (March 2018)	3.5	3.2	–	–
IMF (Sep 2018)	3.7	3.3	3.1	3.0
Nominal GDP growth				
MoF (Sep 2018)	**7.4**	**6.2**	**5.8**	**5.5**
BoL (Jun 2018)	–	–	–	–
EC (Nov 2017)	6.9	6.5	–	–
IMF (Sep 2018)	7.3	6.1	5.6	5.5
Consumer prices (inflation)				
MoF (Sep 2018)	**2.5**	**2.5**	**2.2**	**2.1**
BoL* (Jun 2018)	2.9	2.9	–	–
EC (March 2018)	3.1	2.9	–	–
IMF (Sep 2018)	2.7	2.4	–	–
GDP deflator				
MoF (Sep 2018)	**3.1**	**3.1**	**2.7**	**2.5**
BoL (Jun 2018)	–	–	–	–
EC (March 2018)	3.4	3.2	–	–
IMF (Sep 2018)	3.5	2.7	2.5	2.4
Output gap				
MoF (Sep 2018)	**1.3**	**0.9**	**0.6**	**0.3**
BoL (Jun 2018)	–	–	–	–
EC (May 2018)	2.1	2.0	–	–
IMF (Sep 2018)	1.2	1.0	0.5	0.2

Table 2. Key macroeconomic indicator forecasts by various institutions, % y-o-y. Data sources: MoF, BoL, EC, IMF.
**Seasonal and calendar unadjusted.*

The MoF real GDP growth forecast for 2018 is the highest among others – the European Commission (hereafter – EC), the International Monetary Fund (hereafter – IMF) and the Bank of Latvia's (hereafter – BoL) (Table 2). Increase in the gross domestic product (hereafter – GDP) has been boosted by exports, private consumption and EU-funded investments. The real GDP growth forecast for 2019 has been brought below the projections of the EC and the IMF.

The MoF inflation forecasts follow the trends during first half of 2018, when inflation was driven by a recovery in energy prices and wage increase, however, the overall consumer prices have grown slower than forecasted in February 2018.

The EC forecasts much higher output gap than the MoF – by 0.8% in 2018 and 1.1% in 2019. In spring 2018 the EC has increased the output gap forecast for 2019 from 1.4% to 2.0%. IMF does not provide an output gap estimate, while warns against the fiscal policy turning pro-cyclical.

Historically low unemployment (since 2007) has been reached pushing up wages. Unemployment rate is forecasted to decrease gradually to 7.0% by 2020, which is at the level of 2006. This indicates possibly increasing difficulties in attracting the necessary human resources in certain industries, which is already observed by increasing share of enterprises claiming shortage of labour is restricting business development among all sectors (manufacturing, construction, services, and retail). 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 unemployment level decreases below 8% after 2018, the NAWRU forecast for 2018 is 10.3%, for 2019 is 9.7%, for 2020 is 9.4%, and for 2021 is 8.8%.

Based on the economic developments to date and the MoF assumptions underlying the forecasts the Council has made its decision regarding the endorsement of the forecasts as described below.

The Council endorses the real GDP growth forecast for MTBF 2019/21. Compared to the previous forecast in February 2018, which was prepared for the SP 2018/21, the real GDP growth rate has been raised by 0.2 percentage points in 2018 but lowered by 0.4 percentage points in 2019.The real GDP growth rate forecast for 2020 and 2021 remains the same (Chart 1). Based on discussion with the MoF the Council finds the revisions in the real GDP growth in 2018 and in 2019 resulting from one-off factors and base effects of accelerated growth in 2018.

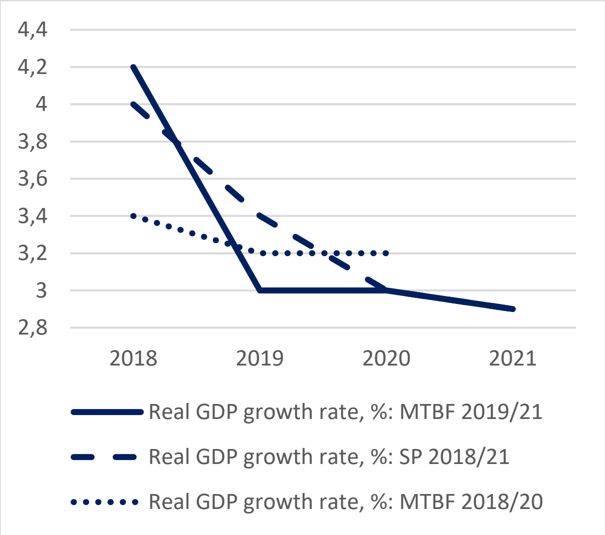

Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

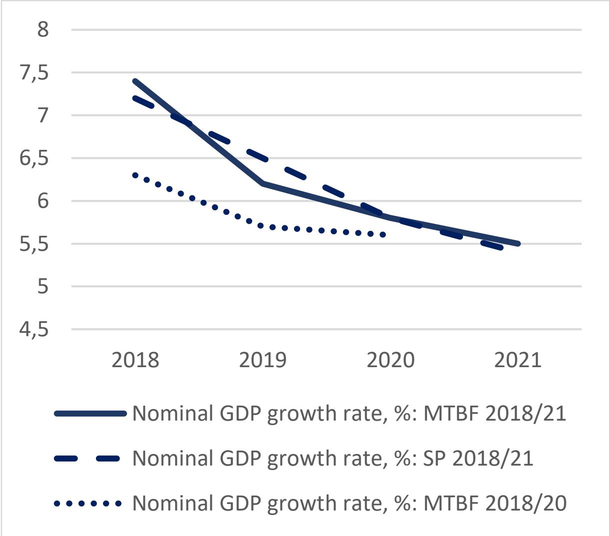

Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council endorses the nominal GDP growth forecast for the MTBF 2019/21. The MoF has further raised the nominal GDP growth forecast for 2018 and 2021 by 0.2 and 0.1 percentage points respectively; however, the nominal GDP growth rates remain unchanged for 2020, and is lowered by 0.3 percentage points for 2019. (Chart 2).

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the MTBF 2019/21. For 2018 the CPI forecast has been lowered by 0.3 percentage points, however, it has been raised by 0.1 percentage point for both 2019 and 2020 compared to the forecast of February 2018. (Chart 3).

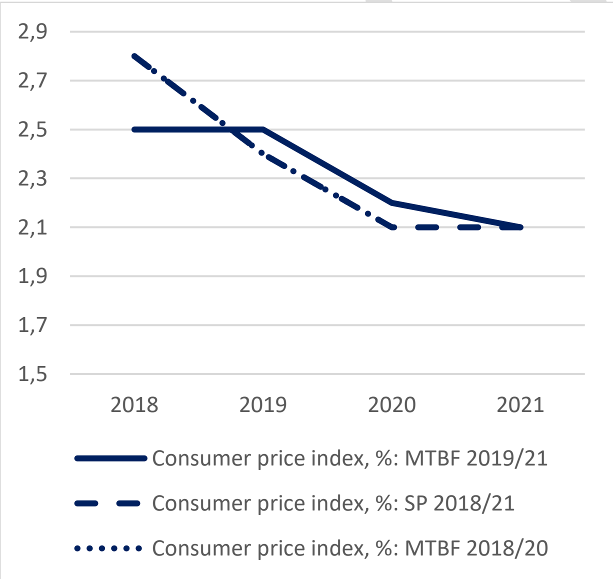

Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

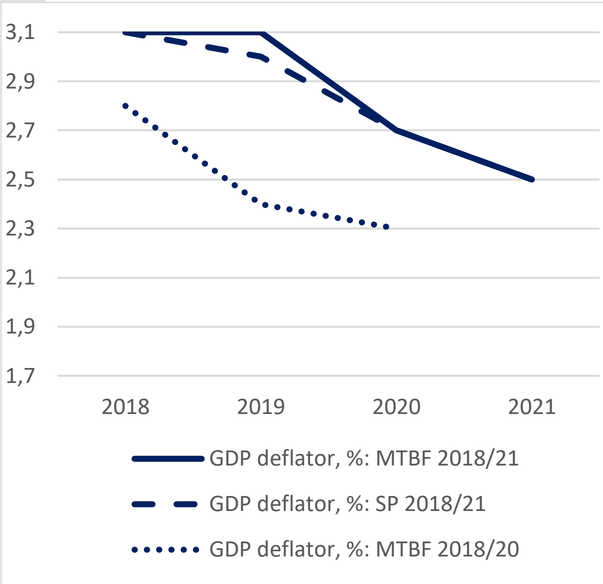

Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator forecast for the MTBF 2019/21. The GDP deflator forecast has not changed compared to the February 2018 forecast except for 2019, where it has been revised upwards by 0.1 percentage point. (Chart 4), thus indicating the warming-up of the Latvian economy.

The Council endorses the potential GDP growth forecast for the MTBF 2019/21 with comments. Since the previous endorsement of macroeconomic forecasts, potential GDP growth has not been revised for 2018-2020 and 2023. Meanwhile, the Council has concern that the assumption of one-offs and base effects shifting GDP growth from 2019 to 2018 reflects warming effects in the economic cycle and thus impacting the long-term potential growth downwards. Moreover, the Council does not find it justifiable to increase the potential GDP growth in the September forecast compared to the February forecast in 2022, 2024, and 2025 (see Table 3), when demographic effects will result into downward pressure for the potential growth.

	2018	2019	2020	2021	2022	2023	2024	2025
Potential GDP growth	**–**	**–**	**–**	**–0.1**	**+0.1**	**–**	**+0.1**	**+0.1**
MTBF2019/21	3.4	3.4	3.3	3.2	3.0	3.0	2.9	2.9
SP2018/21	3.4	3.4	3.3	3.3	2.9	3.0	2.8	2.8

Table 3. Changes in the potential GDP growth since endorsement in spring 2018. Data available here: http://fiscalcouncil.lv/14022018-macroeconomic-forecast-endorsement

The Council endorses the output gap forecast for the MTBF 2019/21. Taking into account the increase of the output gap in the year 2018 by 0.2% points, the Council supports a reduction of the output gap for the year 2019 by 0.1% point. The labour market continues its tightening with unemployment expected to fall even further below its natural rate/equilibrium level. The 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.

The pressure to the wage growth from the labour market remains high - unemployment forecasts remain significantly below the NAWRU forecasts and labour shortage is increasing. The Council notes that faster increase of wages affects the competitiveness and signals of upward swing of economic cycle, therefore, the output gap in medium term is wider than forecasted by the MoF.

	2018	2019	2020	2021
Potential GDP growth	**–**	**–**	**–**	**-0.1**
MTBF2019/21	3.4	3.4	3.3	3.2
SP2018/21	3.4	3.4	3.3	3.3
Output gap	**0.2**	**-0.1**	**-0.042**	**–**
MTBF2019/21	1.3	0.9	0.6	0.3
SP2018/21	1.1	1.0	0.7	0.3

Table 4 Changes in potential GDP growth and output gap forecasts since endorsement in spring 2018. Data available here: http://fiscalcouncil.lv/14022018-macroeconomic-forecast-endorsement.

Average annual potential GDP growth rate from 2018 to 2025 remains forecasted above 3.0%. The Council notes that the projected potential GDP growth over the eight-year period above the 3% threshold is high and there are factors driving down the potential GDP growth in Latvia in the long run as the economy converge with the EU average and the labour supply remains limited.

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.

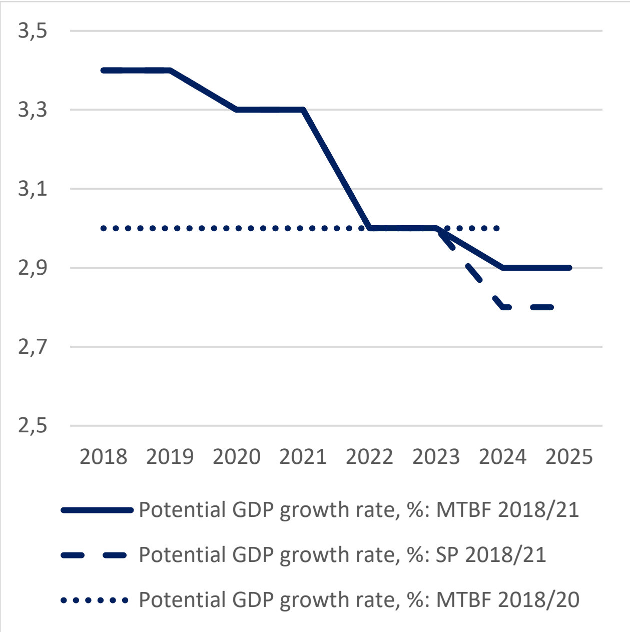

Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

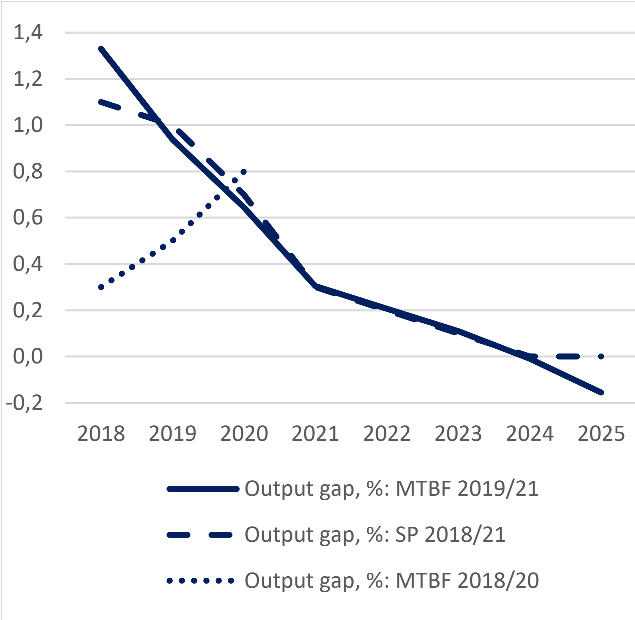

Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2018	2019	2020	2021
Real GDP growth	**4.2**	**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**	**0.3**

Table 5. Macroeconomic forecast indicators endorsed by the Council.

Summary:

The Council endorses the macroeconomic forecasts to underpin the fiscal projections for the MTBF for 2019-2021.