

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) MTBF 2020/22, which is scheduled to be submitted to the Saeima on 15 October 2019. 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 (hereafter – SP) and the MTBF.

According to the Memorandum of Understanding, signed on 8 February 2016, the Council has assumed a responsibility to review and 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, such as the gross domestic product (hereafter – GDP) structure and development scenarios of GDP components. The Council has consulted with external experts to obtain 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 2 at the end of this document).

	2019	2020	2021	2022
Real GDP growth				
MoF (June 2019)	3.2	2.8	2.8	2.8
BoL (June 2019)	2.9*	–	–	–
EC (May 2019)	3.1	2.8	–	–
IMF (Apr 2019)	3.2	3.1	3.1	3.0
Nominal GDP growth				
MoF (June 2019)	6.4	5.6	5.3	5.3
BoL (June 2018)	–	–	–	–
EC (May 2019)	5.6	4.6	–	–
IMF (Apr 2019)	5.5	5.2	5.2	5.0
Inflation (consumer price index)				
MoF (June 2019)	2.8	2.5	2.1	2.0
BoL (June 2019)	2.9	–	–	–
EC (May 2019)	2.8	2.4	–	–
IMF (Apr 2019)	2.4	2.4	2.1	2.1
GDP deflator				
MoF (June 2019)	3.1	2.7	2.4	2.4
BoL (June 2019)	–	–	–	–
EC (May 2019) ¹	2.7	2.0	–	–
IMF (Apr 2019)	3.2	2.9	3.0	3.0
Output gap				
MoF (June 2019)	1.4	0.8	0.4	0.0
BoL (June 2019)	–	–	–	–
EC (May 2019) ¹	2.2	1.3	–	–
IMF (Apr 2019)	–	–	–	–

*Seasonally adjusted GDP growth forecasts.

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

- less output for district heating and energy generation in hydro power stations in the first quarter of 2019 suppressing output growth, while the rest of manufacturing continues expansion;
- Export growth has weakened mostly due to the fall in re-exports.

The MoF's projections for the economic growth are generally in line with the forecasts of the European Commission (hereafter – EC¹), the International Monetary Fund (hereafter – IMF²) and slightly exceed the Bank of Latvia's (hereafter – BoL) (Table 1). Similarly, the inflation rate forecast is in line with forecasts by BoL, and EC for 2019, but the nominal GDP growth – higher (almost by 1,0 percentage point in comparison to EC).

The Council would like to note the key MoF's assumptions underpinning the slowing economic growth in 2019 and 2020 compared to 2017-2018:

- The economic sentiment moderates, while remains positive in the countries – key trade partners of Latvia;
- Economic growth projections have been reduced for both 2019 and 2020 in EU and Eurozone;
- Construction and investment growth will slow and will not contribute to the growth in the same degree as during the past two years;
- The weather conditions resulted in

¹ European Commission Spring 2019 Economic Forecast. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip102_en.pdf, accessed on 18.06.2019.

² International Monetary Fund World Economic Outlook 2019 APR. Available at: <https://www.imf.org/en/Publications/WEO/Issues/2019/03/28/world-economic-outlook-april-2019>, accessed on 18.06.2019.

The output gap is forecasted to close faster during 2020, 2021 and 2022 in comparison with previous forecast of the MoF, while still remain below the EC forecast.

The Council endorses the real GDP growth forecast for MTBF 2020/22 with comments. Compared to the previous forecast in February 2019, which was prepared for the SP 2019/22, the real GDP growth rate for 2019 remained unchanged with slightly reduced growth for the foreseen following years by 0.2 percentage points, -0.1 percentage points and -0.1 percentage points for 2020, 2021 and 2022 (Chart 1). The Council finds both negative and positive deviations from the growth projections equally feasible.

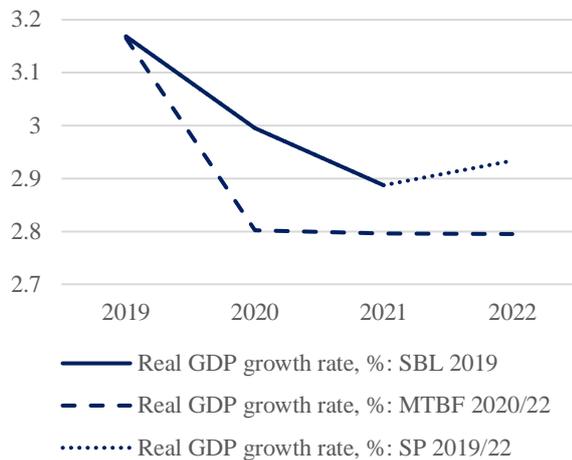


Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

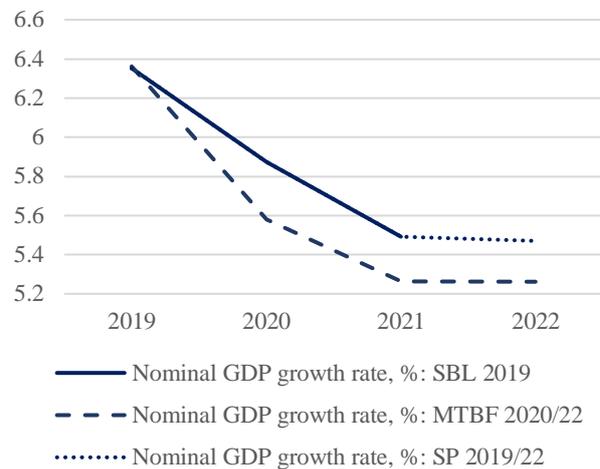


Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council endorses the nominal GDP growth forecast for the MTBF 2020/22. The forecast for nominal GDP growth rate remained unchanged for 2019 in comparison with previous forecasts in February with slightly reduced growth outlook by 0.3 percentage points for 2020 and by 0.2 percentage points for 2021 and 2022 (Chart 2).

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the MTBF 2020/22 with comments. Since February 2019, slight adjustments upwards have been made to the inflation forecast for years 2019 and 2020 of 0.3 percentage points increase for both (Chart 3), however, as already in previous endorsements, the Council emphasizes the importance to follow, if the wage growth and the labour market impact on the prices does not signal overheating of the economy.

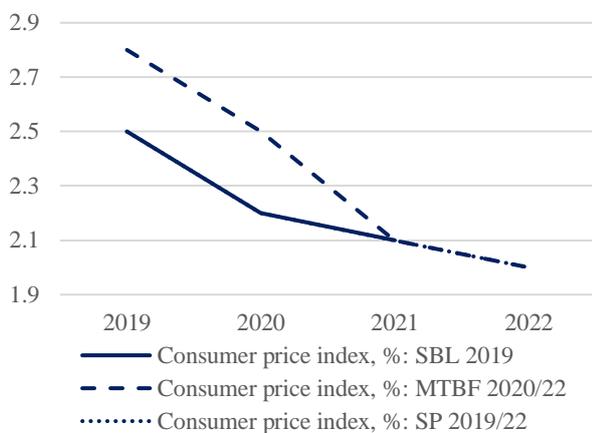


Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

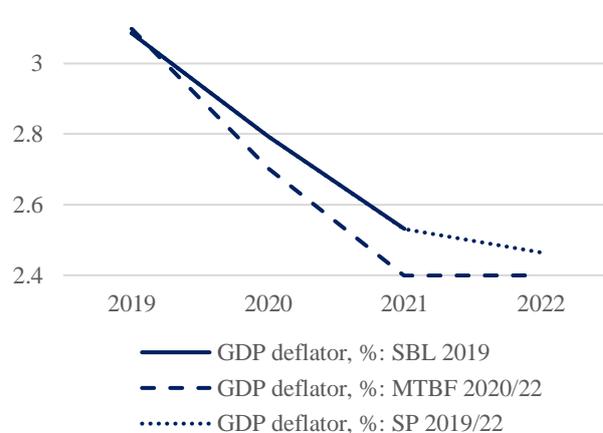


Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator forecast for the MTBF 2020/22. The GDP deflator forecast has been revised downwards by 0.1 percentage points for 2020 and 2021 (Chart 4).

The Council endorses the potential GDP growth and output gap forecasts for the MTBF 2020/22 with comments. Since February 2019, no revisions have been made to potential GDP growth estimates. The potential growth rate has been set at 3.0% for 2023, 2.9% for 2024, 2025 and 2026 (the expanded time horizon is necessary for further calculations of the expenditure benchmark). The Council agrees that the current output gap is in line with what previously forecasted with slightly reduced output gap forecasts for the years starting from 2020. As there have been no adjustments made to the growth of potential GDP, all the impact on output gap comes from changes made to the real GDP growth rates.

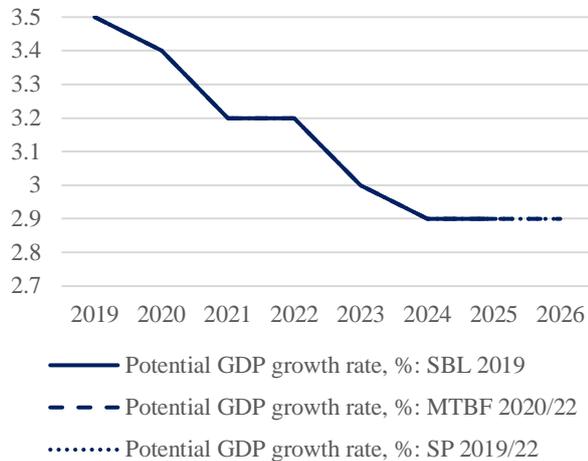


Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

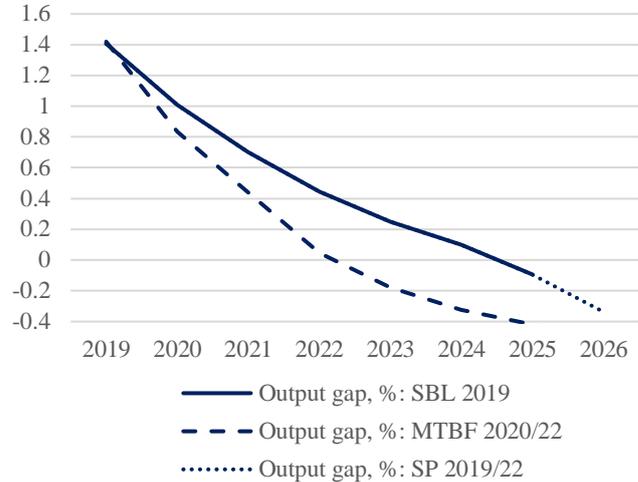


Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2019	2020	2021	2022
Real GDP growth	3.2	2.8	2.8	2.8
Nominal GDP growth	6.4	5.6	5.3	5.3
Inflation (consumer prices)	2.8	2.5	2.1	2.0
GDP deflator	3.1	2.7	2.4	2.4
Potential GDP growth	3.5	3.4	3.2	3.2
Output gap	1.4	0.8	0.4	0.0

Table 2 Macroeconomic forecast indicators endorsed by the Council, growth in percent compared to the previous year.

The Council points at much slower products and imports tax revenue growth (at +1.3%) compared to the fast growth of wage bill (at +8%) along with the operating surplus of businesses (at +7.1%) in period from 2018 to 2019, from the GDP income prospective. Council, in its previous reports, has highlighted the risks associated with the Tax Reform implementation, which has a negative impact on public revenue. Both members of the Council and representatives of the Ministry of Finance agreed, that in 2018 Latvia passed the peak in the economic cycle, which is expected to be followed by a moderate slowdown of economic growth in the near future.

Broadly, the Council considers the MoF's macroeconomic forecasts to be realistic and endorses them.

The Council is looking forward to the MTBF 2020/22 incorporating the sensitivity analysis, where negative risks are assessed as the following: decreasing unemployment contributing to wage growth and inflation, unfavourable external circumstance for external trade and lower external demand, effect of Brexit; as well as reputation risks in banking sector. As in the spring forecast last year, the Council has attached an evaluation of macroeconomic forecasts (in MS Excel). The Council encourages the MoF to continue to improve both the sensitivity analysis and the evaluation of previous forecast's deviations.

In addition, the Council continues using a monitoring tool - the heatmap (available online: <http://fiscalcouncil.lv/cycle-heatmap>), to follow on changes of main indicators characterizing the economic cycle. The heatmap indicates a clear "heating" of the composite index since beginning of 2017, and particularly in 2018Q2 and 2018Q3, which is characterized by tension in labour market, historically high capacity

utilization in manufacturing industries, high demand in construction, industry and services, as well as above the long term average house price index and economic sentiment.