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FISCAL DISCIPLINE SURVEILLANCE REPORT

ON LATVIA'S MEDIUM TERM BUDGETARY FRAMEWORK 2021/2023

Riga, 2020

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ANNOTATION

In general, the Council agrees with the government's concept to prepare the state budget for 2021 and the MTBF for 2021-2023, which envisages a sharp slowdown in economic activity in 2020 and a gradual recovery in 2021. The government's plan envisages that the conditions of the severe economic downturn in 2020 will continue to affect the economy in 2021 and will not leave a chance to compensate for the losses incurred. The government assumes that the general fiscal clause of the EU fiscal framework will be in force in 2021 and that the achievement of fiscal targets will not apply to the 2021 draft budget, while a better budget balance in 2023 will compensate for the planned structural balance surplus in 2022 by 0.5%. However, the government's fiscal policy should be flexible depending on the circumstances. If the economic situation deteriorates, an additional fiscal stimulus may be needed; if the economic situation develops better than planned, the budget balance needs to be improved with additional budget revenues.

The budget framework envisages the following budget balances under the no change in policy: -3.9% in 2021, -2.8% in 2022 and -1.7% in 2023. The above targets, according to the Ministry of Finance, would ensure the government structural balance of -2.0% in 2021, -1.0% in 2022 and -0.1% in 2023, taking into account the difference between actual and potential economic growth. The Council notes that, although the fiscal policy of the state will be conservative in 2021, the set maximum amount of state budget expenditures in 2022 does not comply with the requirements of the FDL. At the same time, the Council acknowledges that the budget balance targets set are commensurate with the economic downturn and take into account the principles of counter-cyclical policies in 2022 and 2023. Considering the high level of uncertainty in economic development and the need to overcome the effects of the economic downturn, the Council will clarify its position on the 2022 budget expenditure ceiling in the 2021 Monitoring Report.

The current government plan does not leave any fiscal space for new policy initiatives in 2022 and 2023- the government will have to cover any new priorities and spending initiatives from savings, or through other spending cuts or effective revenue-raising measures. The Council looks forward to the government's specific commitment, including policy measures, to limit expenditure growth in 2022-2023 beyond the ceilings set by the MTBF.

The Council welcomes the fact that the priorities for the 2021 budget are socially oriented, with the potential to stimulate aggregate domestic demand fiscally, improve the capacity of the healthcare system and reduce social inequalities without endangering the country's fiscal sustainability.

The Council notes with satisfaction that the international credit rating agency S&P Global Ratings maintains Latvia's credit rating at "A +" with a stable future rating. At the beginning of October, the international agency "Fitch" also maintained Latvia's credit rating at "A-", raising the future rating from negative to stable. This is a high assessment of the government's fiscal policy in the difficult crisis times.

SUMMARY

The Covid-19 virus triggered a general economic crisis, which led to the activation of the EU Stability and Growth Pact's general exemption clause, which allows governments to increase the general government deficit in 2020. Consequently, the derogation condition of Article 12 of the FDL was activated, which allows the structural deficit target of 0.5% to be disregarded in 2020. The later adopted “Law on coping with the consequences of the spread of Covid-19 Infection” stipulated that the fiscal conditions of the FDL are invalid in 2021 as well.

The draft state budget for 2021 and MTBF for 2021-2023 have been prepared in the context of the severe economic downturn in 2020 caused by the Covid-19 pandemic and the economic downturn, in response to business constraints and changes in human economic behavior.

In 2020, the government has been operating in a severe economic downturn leading to a deviation from the balance rule, in accordance with Article 12 (1) (3) of the FDL. The Council agrees that the conditions of identifying the situation of the economic downturn are met, as economic activity declined for two consecutive quarters (1st and 2nd quarters of 2020) (based on seasonally adjusted CSB data) and the downturn is global and government ability to control the downturn is limited.

The European Commission has not set an expiry date for the general exemption clause, but its duration depends on the existence of a severe economic downturn in the EU as a whole or in individual EU Member States. It should be taken into account that already in 2021, a faster or slower return of economic growth is forecast in Latvia; however, growth will be lower than the potential of the economy.

The Council broadly agrees with the government's approach to preparing the draft state budget for 2021 and the MTBF for 2021-2023, considering the sharp slowdown in economic activity in 2020 and the expected recovery in 2021. The government's plan assumes that in the face of a severe economic downturn, year 2020 will have an impact on the economy in 2021, preventing all losses to be recovered. Therefore, the government assumes that EU general exemption clause will be in force in 2021 and the fiscal targets will not apply to the 2021 draft budget, while a better budget balance in 2023 would compensate for the planned structural balance deviation from the target by 0.5% in 2022.

The Council reminds about the mechanism for adjusting the minimum planned general government structural balance (Article 11 of the FDL), which is triggered if an excessive amount of structural balances from previous years has accumulated in the year of preparation of the draft framework law. However, even though economic growth might resume soon, output gaps is not expected to return to positive values in the next 3-4 years; therefore, there is little risk that the structural balance adjustment mechanism could be triggered to compensate for the excessive deficit accumulated during the crisis years in the near future.

The budget framework envisages the following budget balances, with an assumption of no change in policy, -3.9% in 2021, -2.8% in 2022 and -1.7% in 2023. According to the calculations of the Ministry of Finance, the above-mentioned targets would ensure the government structural balance -2.0% in 2021, -1.0% in 2022 and -0.1% in 2023, considering the difference between actual and potential economic growth. The Council notes that fiscal stance for year 2021 is conservative, but the requirements of the FDL law on the maximum budget expenditure amount in 2022 are not met. However, the Council recognizes that the set

balance targets are proportionate to the economic downturn and follow the principle of counter-cyclical policy in years 2022 and 2023. Considering the high level of uncertainty in economic developments and need to overcome the consequences of economic downturn, **the Council will formulate its position on the 2022 budget expenditure ceiling in its 2021 Surveillance report.**

Current fiscal plans leave no room for new policy initiatives or spending measures in 2022 and 2023: any new government priorities and spending initiatives should be offset by savings elsewhere or effective revenue-raising measures. The Council looks forward to the government's specific commitment, including policy measures, to limit expenditure growth in 2022-2023 beyond the ceilings set by the MTBF.

The priorities of the 2021 budget are socially oriented, with the potential to fiscally stimulate the aggregate domestic demand, improve the capacity of the health care system and reduce social inequality, without jeopardizing the fiscal sustainability of the country. The Council supports the government's efforts to improve tax policy, in particular the emphasis on improving collection of social security contributions by the self-employed. However, tax policy will not increase the resources available to the government to address better health care priorities by continuing plans to increase wages for large groups of civil servants, funding social benefits and infrastructure spending following the pandemic, and stabilizing the fiscal balance after the economic downturn.

In general, the Council supports the government's program of support measures and calls for it not to be extended further unless the country's economic situation deteriorates materially from the current projections. Fast and most effective use of the European recovery and resilience facility in the next two years to strengthen the potential of the Latvian economy in accordance with the requirements set by the EU is considered the nearest priority. The facility is a new instrument, with fast implementation schedule- this could fill the EU structural funds financing gap the next two years.

The international credit rating agency S&P Global Ratings has announced that Latvia's credit rating will be maintained at "A +" with a stable future prospect, which is a high assessment of the government's fiscal policy in the current circumstances. The positive assessment of the fiscal policy in the crisis allowed the Treasury to borrow on international financial markets on favorable terms.

Expansive fiscal policies have significantly increased public debt and fostered a culture of excessive government interference in economic processes. According to IMF calculations, even before the Covid-19 crisis, the debt of developed countries reached 105% of their GDP; however, by the end of this year, the debt level could exceed 120% of GDP[1]. The council considers that fiscal and monetary policy is not a full substitute for long-term structural reforms.

The council draws attention to the high increase in the government debt – to create cash reserves and to finance the budget deficit. The sharpest rise in government debt took place in April of this year. However, moderate growth in government debt continued to reach 12.610

[1] Source: https://www.imf.org/external/datamapper/G_XWDG_G01_GDP_PT@FM/ADVEC/FM_EMG/FM_LIDC, accessed: 09/10/20

billion euros in July. As a result, public debt has risen by more than € 2 billion (or € 2.248 billion in August) or about 8% of GDP since the state of emergency was declared in March.

The Council considers that the setting of the fiscal reserve for year 2021-2023 is adequate, while unplanned expenditures to keep some state-owned enterprises afloat during and after the pandemic require more effective risk prevention strategies to reduce public resource requirements in the future.

The coming years will be difficult from the country's fiscal point of view - uncertainty in the external economic and political environment, increased public debt, the need to return to sustainable fiscal policy. The priority and challenge of the country's current economic policy is to stimulate the economy and maintain economic performance, while maintaining the medium-term sustainability of public finances and gradually returning to a fiscally sustainable budget.

The government should strengthen the monitoring and management of fiscal risks, in particular in relation to the risks arising from Covid-19 financial instruments for entrepreneurs, the deterioration of the financial position of public corporations and developments in the financial sector.

The Council approved the macroeconomic forecasts prepared by the MoF for the development of MTBF for 2021-2023, envisaging a resumption of economic growth in 2021 after a significant downturn in 2020.

While acknowledging that recent statistics signal economic stabilization, the Council calls for special attention to be paid to the Covid-19 second wave scenario developed by the MoF, as risks remain very high both in terms of morbidity and in terms of pre-crisis geopolitical tensions: post-Brexit trade negotiations complications, the political crisis in Belarus, and others. The Council welcomes the MoF on the development of an alternative macroeconomic scenario for the second wave of the Covid-19 pandemic, which projects real GDP to fall in 2020 to (-9%) instead of (-7%) and weaker economic growth in 2021 (+2 %), instead of the approved one (+ 5.1%). The Council considers that such risks remain significant with the recent increase in local transmission of the infection. Such a situation would limit economic development, government action, and consumer action. Overall, this could lead to a further reduction in the potential for economic growth, reducing the efficiency of investment in sectors in which demand is declining.

Economic sentiment indicators in Latvia continue to improve, although the balance is still in the negative range. Eurostat data show that economic sentiment indicators for Latvia's main trading partners continued to improve in August, but these improvements do not yet correlate with Latvia's export performance. In general, sentiment indicators are expected to be followed by real improvements in the economy, but economic indicators are very sensitive and may fall just as rapidly as new Covid-19 constraint threats increase.

During the Covid-19 period, the sharpest increase in unemployment took place in April. However, comparing the situation in the previous financial crisis, the increase in unemployment cannot be considered dramatic. Already in August, the unemployment rate started to decrease. This positive situation was due to both the availability of downtime benefits and the high overall demand for labor before the Covid-19 crisis. This situation allowed workers to reintegrate into other sectors where demand remained. Workers in the tourism and hospitality sector, whose jobs have been maintained thanks to state aid measures, are still at risk, but the aid is a temporary instrument and will not last until the start of the next tourist season.

In the Covid-19 crisis, consumer price indices did not fall steadily, but prices fell in some sectors. Looking at consumer prices, it can be seen structurally that prices fell significantly for insurance, accommodation services, personal vehicle operating expenses. Housing rents and the costs of electricity, gas and other fuels decreased.

The transport and storage sector has been in decline since 2019. A particularly unfavorable situation is observed in the port segment: in 2019 compared to 2018 the volume of cargo turnover has decreased by -5.7%, while in the first half of 2020 compared to the corresponding period of 2019 the decline in turnover has reached -30.1%. The volume of freight transport by rail and road transport registered in Latvia in 2019 compared to 2018 decreased by -8.5%, but in the first half of 2020 compared to the corresponding period of 2019 the volume of transported freight decreased by -17.4% . This calls for a serious assessment of the potential for future investment recovery in the transit sectors.

Exports of services have shown a dramatic decline in both quarters of this year. The Bank of Latvia's data show that in the second quarter of 2020, there was a sharp decline in exports of services by 29.5% year-on-year, which means a decrease of 414 million euros in monetary terms. This decline was mainly due to a decrease in exports of transport services (-19.5%) and a decrease in exports of travel services (-11%), which is a direct effect of the Covid-19 crisis.

ABBREVIATIONS

BPP	Budget plan project
LBFV	Budget and Financial Governance Law
EC	European Commission
EKS	European Account System
EU	European Union
OECD	Organization for economic co-operation and development
FDL	Fiscal discipline law
MoF	The Ministry of Finance
FSR	Fiscal security reserve
FRD	Fiscal risk declaration
PIT	Personal income tax
GDP	Gross Domestic Product
BoL	The Bank of Latvia
-	Not applicable / not available
The Council; FDC	Fiscal discipline council
VAT	Value added tax
SGP	Stability and growth pact
SP	Latvia's stability program
SP 2020/23	Latvia's stability program 2020.-2023
SPBS	Stability program's base scenario
SPCoV	Stability program's Covid-19 scenario
SRS	State Revenue Service
SSC	Social Security Contributions
Monitoring report	Fiscal discipline monitoring report
MTBF	Medium term budgetary framework
MTO	Medium term objective
GGBB	General government balance

1. FISCAL POLICY DEVELOPMENT

1.1. 2020 perspective

1. **The Covid-19 virus triggered a general economic crisis, which led to the activation of the EU Stability and Growth Pact's general exemption clause, which allows the general government deficit to increase in 2020.** Consequently, the derogation provided in Article 12 of the FDL, which allows disregarding the structural deficit target of 0.5% in 2020, has been applied. The later adopted "Law on Coping with the Consequences of the Spread of Covid-19 Infection" determined that the fiscal conditions of the FDL are not valid in 2021 as well.
2. **The economic crisis caused by Covid-19 has negatively affected both the country's economic growth and the country's fiscal position - it is already clear that the country will be achieve its fiscal targets in 2020.** Both declining budget revenues and higher budget expenditures caused by government support measures negatively affect the GGBB. Although the country's economic and financial forecasts have slightly improved since SP 2020/23, the MoF currently forecasts that the GGBB deficit will reach 2.1 billion euros in 2020, or 7.6% of GDP.

Table 1

Budget balance plans and forecasts for 2020 and results for 2019[2], mill. euros

Balance	2020		2019
	plan	forecast	result
General Government budget balance	-111.3	-2 143.8	-63.2
EKS2010[3] corrections	73.1	-361.0	54.4
Consolidated Government Budget	-184.4	- 1 782.8	-117.6
Government basic budget	-342.0	-1 607.3	-485.0
Government special budget	234.5	-1 77.4	299.6
Local government budget	-78.6	-18.3	50.1
Derived public persons budget	1.7	20.1	17.9

Source: the MoF

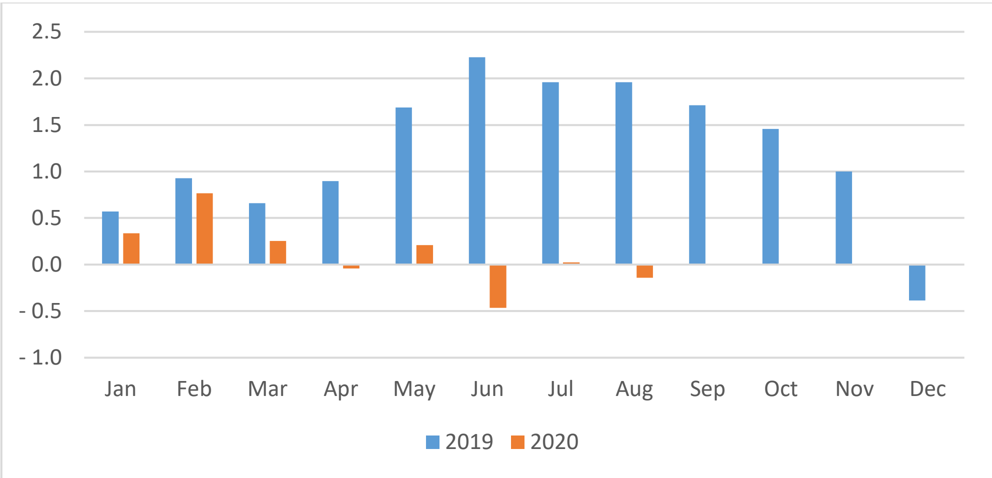
3. **The government responded promptly to the economic crisis caused by Covid-19. In March, support measures were launched to: (i) stimulate the economy in order to reduce the extent of the crisis-induced fall in GDP and maintain potential GDP capacity, (ii) social protection of the population most affected by the crisis, (iii) strengthening the capacity of the health care system, (iv) providing liquidity to businesses and the financial sector.** The report contains the detailed analysis of the aid scheme in section 1.4. The estimates currently show that the fiscal impact of the support measures on GGBB in 2020 will be 1.2 billion euros, or 4.3 percent of GDP.
4. **In first the 8 months of this year, the expenditures of the consolidated general budget have increased by 7.9% compared to the corresponding period in 2019**. The largest increase in expenditure was on social benefits (13.6%), subsidies and grants (24.7%). The increase can be considered proportionate given the fiscal impact of the government

[2] MoF Balance_07082020 data

[3] In accordance with SIP and FDL, fiscal result is being accounted applying European account system 2010 (EKS2010) methodology based on the accrual method. Meanwhile, traditionally in Latvia, the state budget is approved and assessed based on the cash flow method.

support program, though the impact of a number of support program measures on the GGBB will be reflected in the coming months. In the 8 months of 2019, expenditure had increased by 5.7% compared to the 8 months of the previous year.

5. **Revenues of the consolidated general budget this year In the 8 months have decreased by 1.1% compared to the corresponding period in 2019.** The fall in revenue is also proportionate, given the economic impact of the Covid-19 crisis. In the 8 months of 2019, revenue had increased by 3.4% compared to the 8 months of the previous year. Given that the amount of taxes collected has improved in recent months, there is reason to hope that the implementation of the tax collection plan in 2020 will not be as dramatic as planned at the beginning of the Covid-19 crisis.
6. **The general government consolidated budget balance after eight months of 2020 showed a deficit of 40.1 million euros, which is -0.1% of GDP.** In 2019, after eight months, there was a surplus of 2% of GDP (see Figure 1 below). According to the MoF's calculations, in 2020 the consolidated general budget balance could reach a deficit of 2.1 billion, which is 7.6% of GDP. Of course, this figure depends on a number of factors that are currently difficult to predict. According to the MoF's estimate, the output gap in 2020 is 7.7% of potential GDP, which, together with the impact of - 0.12% on one-off measures (including 0.3% of tax reform not recognized by the Council), would give **a structural deficit of 4.6% of GDP in 2020.**



Source: The Treasury

Figure 1. Consolidated budget balance, % of GDP in accumulated units at the end of the month

1.2. *Fiscal position in 2021-2023*

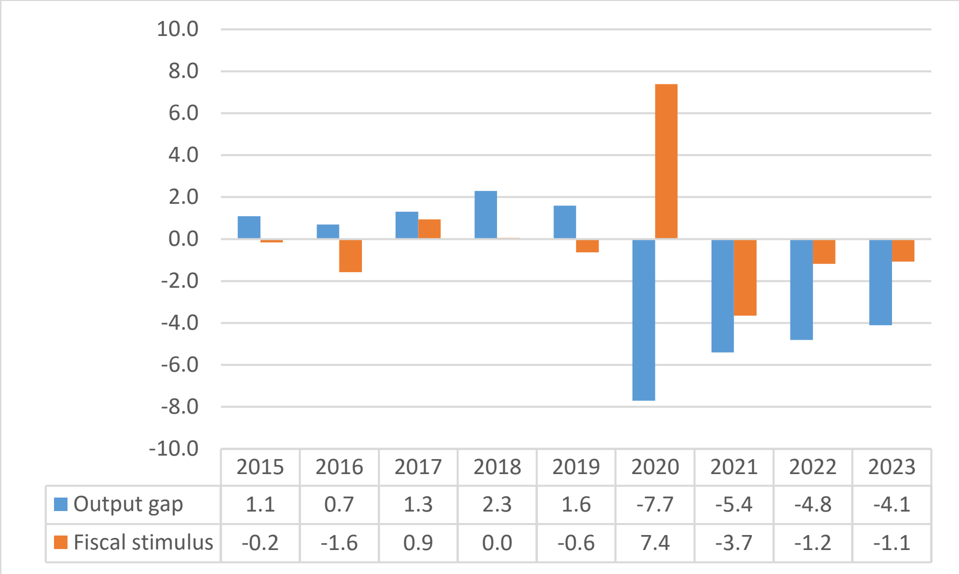
7. **The coming years will be difficult from the country's fiscal point of view - uncertainty in the external economic and political environment, increased public debt, the need to return to sustainable fiscal policy.** Although Latvia is coping relatively well with the economic crisis caused by Covid-19, we are a small and open economy that will always be affected by external factors. It is still unclear when the Covid-19 vaccine will be developed, so the depth and duration of the current crisis are unknown. Although part of the economy in Latvia and in the world in a functionally normal mode, there is a development slowdown in some sectors due to Covid-19. In spite of the fact that, according to economists, there is no inflation increase threat, the world's monetary base has increased significantly, which may put pressure on inflation in the future. Due to

expansive fiscal policies, the public debt has significantly increased, and there appeared a culture of excessive government interference in economic processes. According to IMF calculations, even before the Covid-19 crisis, the debt of developed countries reached 105% of their GDP; however, by the end of this year, the debt level could exceed 120% of GDP. Fiscal and monetary policy is not a full substitute for long-term structural reforms

8. **Although the EK has not set a deadline for the application of the block exemption clause, it is highly likely that it will remain in force in 2021, as after the fall in GDP during 2020, the projected growth in 2021 will not compensate the decline of the previous year and fiscal policy will have to be maintained stimulating**. In its turn, Article 33 of the "Law on Coping with the Consequences of the Spread of Covid-19 Infection" provides for derogations from the conditions of fiscal discipline in 2020 and 2021. However, if the general exemption clause is not extended in 2021, there is a possibility that an excessive deficit procedure will be initiated against Latvia, which sets out recommendations with a view to meeting the Maastricht criterion in 3 years.

9. **In the informative report "On Macroeconomic Indicators, Revenues and General Government Budget Balance Forecasts for 2021–2023", the government forecasts the following budget balances at a constant policy of -3.9% in 2021, -2.8% in 2022 and -1.7% in 2023. According to the calculations of the Ministry of Finance, the above-mentioned targets would ensure the government structural balance -2.0% in 2021, -1.0% in 2022 and -0.1% in 2023.** As mentioned above, if a numerical fiscal condition in 2021 does not limit the structural balance, then in 2022 the scenario with a no-policy change will exceed the 0.5% structural deficit by 0.5% of GDP, but in 2023, the country can afford to fill the fiscal space by 0.4% projected under an unchanged policy. Taking into account the significant difference between the planned releases in 2021 and 2022, 5.6% and 5.0%, respectively. **The Council considers that the balance sheet targets set are commensurate with the economic downturn and respect the principle of counter-cyclical policies, although formally the requirements of the FDL are slightly violated.** Setting such targets would not require consolidation in 2022 on the one hand, but would prevent the adoption of new expenditure-increasing or revenue-reducing measures in 2021-2023 on the other. Of course, such targets and fiscal policy are optimal, assuming that there are no new external or internal economic shocks in the coming years.

10. **The government's counter-cyclical policy has improved in recent years.** The graph below shows that starting from 2019, the important principle of counter-cyclical fiscal policy is observed - the government must stimulate the economy fiscally when the economy is operating below its potential and vice versa. Due to the crisis caused by Covid-19, 2020 and the coming years have a negative projected output gap. For this reason, the government's fiscal momentum has been most noticeable this year. However, the scope for the fiscal stimulus is hampered by fiscal sustainability and local and EU fiscal rules, so in the coming years, although fiscal policy will be expansionary, the fiscal momentum is projected to be negative, approaching 0, as the economic recovery is also projected.



Source: the MoF and FDC calculations

Figure 2. Output gap and fiscal stimulus[4] (% of GDP) from 2015 to 2023 including forecasts 2020-2023

11. **From 2021, the government will make tax changes aimed at: (i) social sustainability and equalization of the tax burden, (ii) reduction of labor taxes, (iii) increase of the tax burden and certain excise goods.** The Council is generally positive about the tax change, but draws attention to the fact that to increase the tax burden in the medium term the tax policy may need changes that are more significant[5]. The tax policy will need such changes after the end of the Covid-19 crisis and the development of public debt policies and targets.
12. **The tax revenue projections for the 2021 Draft Budget look conservative.** Table 2 shows that the next year tax revenues are planned by 3.5% less than was planned in budget 2020. The sharpest decrease in revenues is expected from excise tax -7.4% and VAT -5.2% PIT revenues is expected to increase by 1.2%

Table 2

Tax revenue dynamics, plans and fulfillment 2019-2021, %

	2019 actual/ 2018 actual	**2020 budget/ 2019 actual**	**8 m 2020 actual/8 m 2019 actual**	**2021 BPP / 2020 budget**
Tax revenue	4.6%	6.9%	-1.1%	-3.5%
CIT	-85.3%	483.0%	707.0%	0.8%
PIT	11.6%	-8.9%	-2.1%	1.2%
SSC	8.8%	5.7%	-1.8%	-4.0%
Real estate tax	1.5%	4.0%	-6.6%	-2.1%

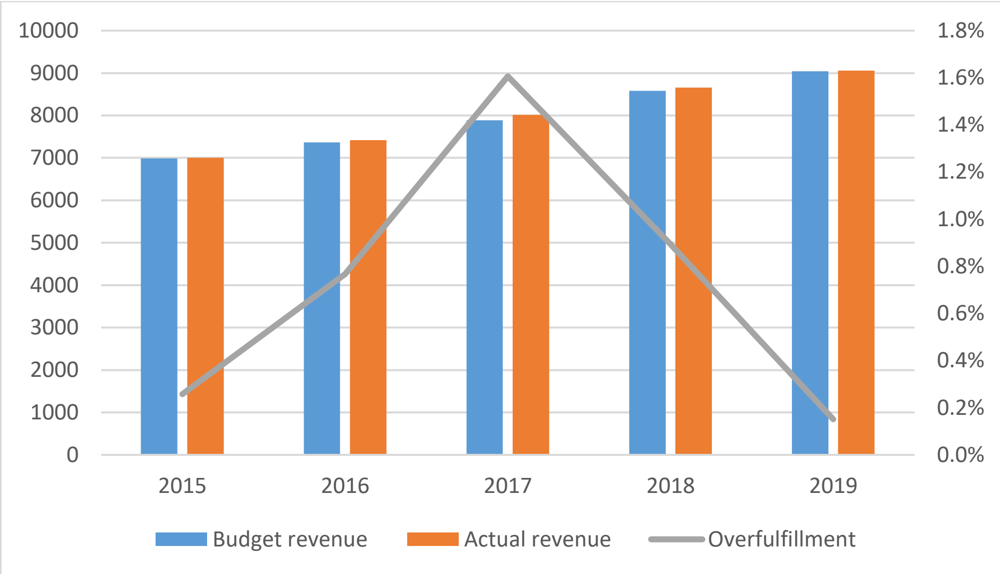
[4] The fiscal stimulus is defined as the deterioration of the GGBB compared to the previous year (% of GDP) to stimulate the economy. For example, see the IMF's 2019 report on the Latvian economy. Available: https://www.imf.org/en/Publications/CR/Issues/2019/08/06/Republic-of-Latvia-2019-Article-IV-Consultation-Press-Release-and-Staff-Report-48565. Viewed: 17/09/2020

[5] FDP views on tax reform. Available: https://fdp.gov.lv/jaunumi/Fiskalasdisciplinaspadomenakklajaarpriekslikumiemnodoklusistemaspilnveidosanai. Viewed: 28/09/20

VAT	7.8%	8.9%	-5.9%	-5.2%
Excise tax	3.4%	13.1%	-2.2%	-7.4%
Other indirect taxes	-1.9%	12.4%	-4.3%	2.4%

Source: Ministry of Finance and Council calculations

13. **In general, it should be noted that the forecasting of tax revenues by the Ministry of Finance has been conservative in recent years and tax revenues collected have always been higher than planned in the budget law.** Figure 3 below shows that the tax collection plan is always fulfilled, even in years of lower-than-expected economic growth. Of course, this year's plan is unlikely to be fulfilled because of Covid-19. In addition, the tax holidays granted by the government due to Covid-19 affect the implementation of the tax collection plan this year, the amount of which the Ministry of Finance estimates at 140 million euros.



Source: Ministry of Finance and Council calculations
Figure 3. Consolidated budget revenue plan, fulfillment and over-fulfillment from 2015 to 2019 (thous. euros and % of over-fulfillment)

14. **The Council notes that the potential for a revision of budgetary expenditure is not being fully exploited, leading to no major savings from structural reforms and irrational reductions in budgetary expenditure.** If last year's budget review process revealed 93.7 million euros in savings for the 2020 budget (47.7 million of which were allocated to the overall fiscal space, the rest for the priorities of the relevant ministries), then year, only 53.6 million euros of savings for the 2021 budget were found in the review process, which is 43% less. Expenditure reviews and analyzes are a valuable tool for reallocating budget appropriations to more efficient use of budgetary resources and policy priorities - the Council believes that expenditure reviews can be carried out more efficiently.

15. **The priorities of the 2021 budget are socially oriented, with the potential to stimulate the total domestic demand fiscally, improve the capacity of the health care system and reduce social inequality**. At the sitting of 22 September 2020, the Cabinet of Ministers approved the informative report "On Proposals for State Budget Revenues and Expenditures for 2021 and the Framework for 2021-2023",[6] which determined the budget priorities. The largest funding was allocated for the implementation of health care

[6] Report available: http://tap.mk.gov.lv/lv/mk/tap/?pid=40491864&mode=mk&date=2020-09-22, viewed: 29/09/2020

financing norms (183 million euros), 40.6 million euros in 2021 will be allocated to increase the remuneration of teachers and academic staff, and 70.7 million euros in 2021 will be allocated to the state budget for execution of Constitutional Court judgments in welfare. The three priorities mentioned above will increase the budgetary base in the coming years as well. However, given that the additional budgetary funding is targeted at relatively low-income groups, this expenditure can be expected to have a relatively high fiscal multiplier i.e. a large share of it will increase government GDP as well as budget revenues. These expenditures, as well as the increase in the minimum wage and the differentiated non-taxable minimum, should reduce the social inequalities repeatedly reported by both the FDC and the EU institutions in their reports. Additional sources of funding for the priorities in 2021 are redistribution of PIT from local governments (90.9 million euros), European Recovery and Sustainability Mechanism (50 million euros), Cohesion funding (2012-2020, 20 million euros), minimum implementation of SSC (53.3 million euros). In 2022 and 2023, a significant increase in social budget revenues is planned from the introduction of the minimum SSC - 118.9 and 137.2 million euros, respectively.

16. In the conditions of great uncertainty in the external environment, the coming years may be difficult for the Latvian economy. In these circumstances, the government must be able to react quickly and stabilize the economy. Overall, the government has so far succeeded in tackling the effects of the Covid-19 crisis. However. The next priority is the rapid and effective use of the European Recovery and Sustainability Mechanism in the next two years to strengthen the potential of the Latvian economy in line with the EU's priorities[7]. They are: (i) to promote EU economic, social and territorial cohesion, (ii) to strengthen economic and social sustainability, (iii) mitigating the social and economic impact of the crisis, (iv) to support green and digital transformations.

1.3. Recent years' fiscal retrospective

17. In 2019, the general government consolidated budget had a deficit of 117.6 million euros, which is 97.8 million euros less than in 2018 and 154.1 million less than forecasted in the Law "On the State Budget for 2019". The increase in foreign financial assistance (FIFG) revenues (by 178.3 million euros more than budgeted) and more positive local government and special budget balances (111.6 and 75.8 million more positive balances than in the budget, respectively) explain the reason of the more positive GBB. Although the EKS adjustments are slightly worse than planned in the budget, the general government budget balance in 2019 is provisionally -63.2 million euros, which is -0.2% of GDP, which is significantly better than planned. See the table below for the budget balance plan and results for 2019 and 2018.

Table 3

Budget balance plans and results 2018-2019, mill. euro.

Balance	**2019**	**2018**

[7] EC Working Document Guidance to Member States on Recovery and Sustainability Plans. Available:https://ec.europa.eu/info/sites/info/files/3_en_document_travail_service_part1_v3_en_0.pdf, viewed: 29/09/2020

	plan[8]	result	plan[9]	result
General Government budget balance	-168.6	-63.2	-265.3	-242.9
EKS2010[10] corrections	103.1	54.4	-101.6	-27.5
Consolidated Government Budget	-271.7	-117.6	-163.7	-215.4
Government basic budget	-438.3	-485.0	-321.7	-302.1
Government special budget	223.8	299.6	125.9	202.2
Local government budget	-61.4	50.1	31.6	-150.5
Derived public persons budget	4.2	17.9	0.6	35.2

Source: the MoF

18. **In 2019, the revenue of the consolidated general budget increased by 4.9% compared to the previous year, reaching 11.4 billion euros.** The main source of general budget revenue - tax revenues in 2019 increased by 4.6%, exceeding the tax collection plan to general budget by 0.2%, largely due to good labor tax revenues. EU structural funds have been disbursed for 1.3 billion euros during the year, which is 189.3 million euros or 16.7% more than in 2018. In general, 2019 is as good from the aspect of the consolidated general budget revenue, as the amount of revenue reached the planned indicators despite the negative circumstances: unplanned but necessary excise tax cuts for strong alcohol from July 1, 2019, faster than forecast GDP slowdown, negative external economic and political factors. In addition to these factors, the Council estimates that the state budget in 2019 did not collect almost 400 million Euros due to tax reform[11]. It should be noted that the FM tax collection plan has been implemented in all recent years. The revenue plan administered by the SRS and its implementation in 2019 is in the table below. Despite the fulfillment of the general budget tax plan, there are several significant taxes, the collection plan of which was not fulfilled - CIT, ET, Customs tax, Natural resources tax, etc. However, PIT revenues collected by 198.4 million or 11.5% more than planned and SSC collected by 70.9 million or 2.5% more than planned offset the negative effect of other taxes.

4.tabula

Revenue	2019 actual	2019 plan	Fulfillment (%)
CIT	44.8	201.8	22.2
VAT	2 648.3	2 648.4	100.0
Excise tax	1 064.1	1 118.9	95.1
PIT	1 946.7	1 731.2	112.5
Other taxes	238.8	264.2	90.4

[8] Explanations of the Law "On the State Budget for 2019". Chapter 2 Fiscal Review. Available: https://www.fm.gov.lv/lv/sadalas/valsts_budzets/valsts_budzeta_izstrade/_budzets2019/, skatīts: 17/04/2020

[9] Explanations of the Law "On the State Budget for 2018". Chapter 2 Fiscal Review. Available: *http://www.fm.gov.lv/files/files/FMPask_D_050218_bud2018.pdf*, viewed: 17/04/2020

[10] In accordance with SIP and FDL, fiscal result is being accounted applying European account system 2010 (EKS2010) methodology based on the accrual method. Meanwhile, traditionally in Latvia, the state budget is approved and assessed based on the cash flow method.

[11] Fiscal Discipline Council study "Results of the 2018 tax reform and criteria for further improvement of the tax system". Available: https://fdp.gov.lv/files/uploaded/FDPnodokluzinojumsgalaversija.pdf, viewed 19/04/2020

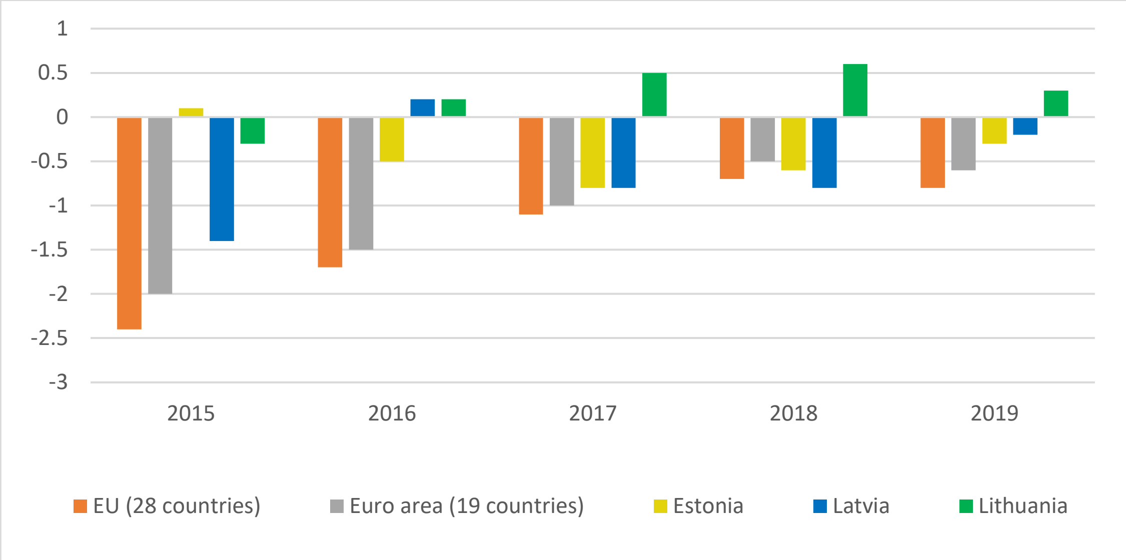
Non-tax revenue	463.6	448.5	103.4
SSC	3 509.9	3 406.8	103.1
Total	**9 916.2**	**9 818.9**	**101.0**

SRS administrative revenue plan and its fulfillment in 2019 (thous. euro)

Source: SRS

19. **Expenditures of the consolidated general budget in 2019 increased by 4.0%, reaching 11.5 billion euros**. In percentage terms, the largest share in the general government consolidated budget expenditures is on social benefits - about 28%, which in 2019 increased by 6.4%. The second most important item of expenses is remuneration; its share is around 23%, and it increased by 6.5% in 2019. On an annual basis, contributions to the EU budget and funding for international cooperation grew the fastest by 13.5%. However, the percentage of this expenditure in the consolidated general budget expenditure is relatively small - around 3%. Interest expenses have decreased in the consolidated general budget 2019 expenses by 4.6%.
20. **The general government structural balance target of -0.55% of GDP set in the Budget Law in 2019 was slightly missed, despite the better-than-planned GGBB. Current estimates suggest that the structural budget deficit for 2019 is 0.75%.** The Council and the EU do not recognize the impact of tax reform on the structural balance as a one-off measure. Including the impact of the tax reform on the structural balance, as the MoF does, it calculates a structural deficit of 0.23%. The central government basic budget result and the EKS adjustments worsened the structural balance result relative to the planned budget, while the local government budget and social budget balances improved the general government structural balance.

21. **In general, in recent years the general government deficit of Latvia has been at a controllable level. It was on average lower than in the EU and euro area countries** and meets the Maastricht criteria for budget deficits. Against the background of other countries, Lithuania stands out, which has been able to work with profit in recent years (see Figure 5). In 2019, Latvia's general government deficit decreased - it is still negative, but has approached zero. Of course, due to Covid-19, budget deficits are expected in the coming years both in Latvia and in all EU countries.



Source: Eurostat

Figure 4. General government budget deficit (% of GDP) EU28, Eurozone and Baltic countries 2015-2019

1.4. Fiscal impact of economic stabilization measures

22. The Latvian government has responded promptly to the crisis caused by Covid-19 and established mechanisms for economic stabilization and population support, in line with the recommendations of international organizations. According to the current assessment of the Ministry of Finance, the impact of the support measures on the GGBB in 2020 will reach almost 1.2 billion euros, which is 4.3% of GDP. In fact, the impact of the measures on the economy will be even greater, as some of the measures, such as guarantees, redistribution of EU funds, will not affect the GGBB (see Table 5 below). Currently, only a part of the measures is actually launched and is working - according to the MoF's assessment, the impact of the support measures on the GGBB in mid-September is about 0.7 billion euros. The measures are limited in time to the crisis and aim to maintain liquidity in the financial sector, social protection of workers and the most vulnerable, support for businesses and sectors, and capacity building in the health and other sectors.

23. Initially, Article 28 of the Law on Measures for the Prevention and Management of State Threats and their Consequences Due to the Spread of Covid-19 stated that all support measures were to be considered as one-off and have no impact on the structural budget balance. However, the EC has decided that crisis-related expenditure is not a one-off and has an impact on the structural deficit. Consequently, the Law on the Management of the Consequences of the Spread of Covid-19 Infection no longer provided for an article of the law that would stipulate that measures to reduce the impact of an emergency related to the spread of Covid-19 are one-off measures. As a result, the structural deficit will be significantly higher in 2020 and 2021.

24. In general, the Council supports the program of support measures set up by the government, although the relevance of some measures to the Covid-19 crisis appears

inconclusive. Criticism has been leveled at the relatively small size of the program[12]. However, it should be borne in mind that the comparison of transnational support programs is subjective due to the different accounting methodologies used, as well as the different criteria used to consider a crisis measure. In addition, support mechanisms may be at different stages of development in different countries. For example, in Latvia some of the events have not even been started yet. The Latvian program should also be less ambitious in nature due to the relatively modest spread of the virus. It will be possible to evaluate support programs more objectively after the end of the crisis.

25. Table 5 below summarizes the statistics of Latvia's support measures by groups of beneficiaries. Of course, the proposed calculations are only preliminary, based on the decisions of the Cabinet of Ministers and the approved programs. The public aviation and public transport sectors receive relatively high levels of support. Relatively little money was allocated to the social protection of the population. The legislation stipulates that **almost all support measures have a limited duration and most of them are expected to have an impact only on the 2020 GGBB.**

Table 5

Estimated impact of support measures on the GGBB in 2020 and their share (%)

Measure	GGBB 2020/2021 (mil. euros)*	Redistribution of EU funds (without affecting GGBB)	Measures with no effect on GGBB	Total	Share of total (%)
Population and workforce support	155.0	88.7	19.7	264.9	11.9
Downtime (including assistance) aid	56.9			56.9	2.6
Different types of aids - unemployment, families, children, etc.	25.9			18.9	1.2
Human capital and demography, retraining of employees	2.0	25.7	19.7	47.4	2.1
Subsidized jobs for the tourism industry and exporters, subsidized employment	70.2	63		133.2	6.0
Aid for entrepreneurs	475.7	52.8	142.1	670.6	30.1
Aid related to time limits for tax payments**	104.5			104.5	4.7
ATUM working capital loans	50.0			50.0	2.2
ALTUM guarantees and investments	190.0	35.0	25.0	250.0	11.2
Road sector aid	75.0			75.0	3.4
International competitiveness aid for companies		17.8		17.8	0.8
Aid for agriculture and food business	56.3		117.1	173.4	7.8
Aid for state JSCs and sectors	811.5	354.5	135.8	1301.9	58
Aid to the air transport industry	310.4		36.1	346.5	15.6
Aid to public transport sector	66.0	283.0		349.0	15.7
Aid to healthcare industry	214.7	30.0	42.4	287.1	12.9

[12] For example, LB 29.09.2020 discussion on the latest Latvian GDP and inflation forecasts. Available: https://www.bank.lv/darbibas-jomas/monetaras-politikas-istenosana/prognozes, viewed 01/10/2020.

Aid to cultural and sports sectors	**37.7**			**37.7**	**1.7**
Aid to municipal investments	**122.0**	**41.5**	**35.0**	**198.5**	**8.9**
Others, including private and public media	**49.4**		**22.3**	**71.7**	**3.2**
TOTAL	**1430.9**	**496.0**	**297.6**	**2224.5**	**100**
% of GDP (28 194 mil. euros)	**5.1%**	**1.8%**	**1.1%**	**7.9%**	
*** The calculations take into account the planned repayment of tax debts in the coming years**					

Source: MoF data and the Council's calculations

26. **Initially, the Downtime Allowance (OP) was planned as the most significant and comprehensive support measure, which would have a positive impact on both entrepreneurs and protect employees from being fired**. However, the potential impact of the measure did not reach the expected impact due to the beneficiary criteria, despite several expansions of the criteria to increase the number of beneficiaries. If the amount of benefits initially paid was estimated at more than 170 million, then in the end it reached 56.9 million, which is only 34% of the planned amount. According to the Bank of Latvia, the amount of downtime benefits in Latvia was 0.2% of GDP, in Lithuania and Estonia 0.3% and 0.9%, respectively. The number of recipients of downtime benefits was 55.2 thousand in Latvia, 137.7 thousand and 200.6 thousand in Lithuania and Estonia, respectively. The average amount of downtime benefit in Latvia, Lithuania, and Estonia is 974.2 euros, 766.6 euros, 1866.6 euros, respectively.[13] The number of recipients of downtime benefits was 55.2 thousand in Latvia, 137.7 thousand and 200.6 thousand in Lithuania and Estonia, respectively. The average amount of downtime benefit in Latvia, Lithuania, and Estonia is 974.2 euros, 766.6 euros, 1866.6 euros, respectively.

27. **There were plans of various extensions of tax deadlines as one of the most important benefits for entrepreneurs.** The estimates initially had shown that this measure would have a negative impact on the GGBB for 331 million euros in 2020. Currently the impact assessment is 139.9 million euros. The Ministry of Finance estimates that in the coming years the repayment of these taxes will improve the GGBB by 38.4 million euros.

28. **The State Financial Development Institution ALTUM is the main institution that provides support to entrepreneurs with various Covid-19 instruments - loans, guarantees, capital investments.** By October 2, 469 loans have been approved for the total amount of 86 million euros and guarantees in the amount of 30.8 m for the total amount of 85 million euros have been approved. In addition to these instruments, ALTUM has provided 172 million non-crisis instruments since the beginning of the crisis, with a total funding of € 387 million. Thus, since the beginning of the crisis, ALTUM has stimulated the economy by 558 million euros, or almost 2% of GDP.[14] The Capital Fund has also recently started operating, under which ALTUM will invest in large companies affected by the Covid-19 crisis.
29. **Airbaltic has received the largest amount of state aid during the crisis, with 250 million in share capital increases, and a government debt of 36.1 million euros.** The national

[13] BoL 29.09.2020 discussion on the latest Latvian GDP and inflation forecasts. Available: https://www.bank.lv/darbibas-jomas/monetaras-politikas-istenosana/prognozes, viewed 1/10/2020.
[14] According to information provided by ALTUM

airline has chosen to use the crisis as an opportunity to increase its market share.[15] The Council does not have the information to assess the benefits and risks of such a strategy. The air transport sector receives a large share of state aid - 346.1 million, which is more than 15% of the total amount of aid.

30. **In order to ensure the financing of support measures, the Treasury has borrowed in the financial markets, as well as provided borrowing opportunities from international financial institutions.** The loans were issued on favorable terms for Latvia, which once again demonstrates the confidence of the financial market in Latvia's fiscal policy.

2. FISCAL RISKS

31. **Although the macroeconomic stability caused by the Covid-19 crisis is currently the main source of fiscal risk, other risks could still potentially worsen the country's fiscal position.** Globally, the second wave of Covid-19 has begun, and formally, 1 million people worldwide have died from Covid-19, a figure that is thought to be twice as high. Fortunately, mortality from Covid-19 has dropped significantly, so the countries do not impose a measure that restricts economic growth to the same extent as during the first wave of Covid-19.

32. **The deepening and broadening of fiscal risk assessment remains desirable.** The Council expects further improvements by expanding the range of quantified fiscal risks. International experience shows that most fiscal shocks are caused by either macroeconomic instability or problems in the financial sector; often the former summons the latter, thus exacerbating fiscal risks and the country's ability to meet its fiscal targets.

33. **The Latvian financial sector has successfully completed its clean-up of servicing non-residents, and this year has received a positive assessment of the implementation of the Moneyval recommendations.** The Latvian government has met all 11 efficiency indicators of the Financial Action Task Force (FATF). However, the financial sector remains an important source of fiscal risks and needs to be carefully assessed and appropriate risk management measures implemented. There are still a relatively large number of banks in Latvia, some of which may have difficulties in establishing a sustainable business model, taking into account the closing of non-resident accounts, which indicates the need for bank consolidation. In 2018, ABLV started the self-liquidation process. In 2019, the court declared PNB bank insolvent and its liquidation has begun. According to the government, both of these events will not have a direct negative fiscal impact on the GGBB. The Council expects the MoF to improve and expand the Financial Sector Chapter in the Fiscal Risk Statement.

34. **On 29 October, the Constitutional Court will announce a decision on the case regarding the compliance of the amount of funding for studies in state-founded higher education institutions specified in the 2019 state budget in the Constitution.** The decision has a potentially huge impact on state budget expenditures, as the guaranteed budget financing specified in all laws is not commensurate with today's budget possibilities.

35. **The State Financial Development Institution ALTUM has been entrusted with large budget resources in connection with the Covid-19 support instruments for entrepreneurs.** Increased responsibility requires in-depth monitoring. The Council is

[15] https://www.bloomberg.com/news/articles/2020-04-21/as-airlines-scrap-jet-orders-tiny-air-baltic-is-throttling-up?utm_content=business&utm_medium=social&utm_source=twitter&cmpid=socialflow-twitter-business&utm_campaign=socialflow-organic, viewed 22/04/2020

pleased that the FRD states that "the MoF continues to closely monitor the activities of ALTUM". **However, the Council calls on the MoF to quantify the risks from the ALTUM programs, as they pose a high risk to the national budget in the context of COVID-19.**

36. **Corporate governance problems in state and municipal capital companies classified in the general government sector** have the potential to have a negative impact on the general government budget balance, as evidenced by recent events in “Rīgas Satiksme” and “Latvijas Dzelzceļš”. **The Council considers that the exclusion of state and municipal capital companies from the calculation of the fiscal security reserve is not sufficiently justified**. The historical budgetary impact of state and municipal corporations has been negative and not symmetrical. In its report on the remuneration of the members of the board of state-owned companies, the State Audit Office emphasizes that a mechanism for monitoring the development and application of a common practice of the regulation of the remuneration of the members of the board of capital companies has not been established. Therefore, the shareholders (or the supervisory board) and the board of directors of capital companies have applied different principles or unregulated interpretation in determining the remuneration, thus allowing the members of the board of capital companies to receive financial benefits not provided by the Law on Capital Shares. Inadequate levels of remuneration in state-owned companies reduce people's trust in the state and willingness to pay taxes.

37. **EU-UK negotiations on Brexit are difficult - the full impact of the event on the Latvian economy and fiscal situation is still unknown. Other international political events also have the potential to affect Latvia's fiscal position negatively.** Given that Great Britain was a donor country to the EU, it is clear that Latvia's contributions to the EU will increase in the medium term. As there are too many aspects and uncertainties in Brexit, it makes it difficult to ensure the exact fiscal impact of Brexit, but Latvia's exports to the United Kingdom, which currently account for 6.5%, may be affected. The political situation in Belarus could increase Latvia's fiscal risks, although currently only 1.5% of all Latvian exports go to Belarus. The Armenian-Azerbaijani conflict also has the potential to affect the economic processes of the world and, consequently, of Latvia, if the conflict continues to deepen.

38. The declaration of fiscal risks plays a role in the management of fiscal risks and serves as a basis for the calculation of the fiscal security reserve. However, in view of Article 33 of the Covid-19 Infection Management Act, which essentially removes the ceiling of the state budget expenditure for the 2021 state budget, the fiscal safety margin is formal in the context of the 2021 budget. Therefore, the Fiscal Risk Group of the Fiscal Discipline Council accepted a fiscal safety margin of 0.1% of GDP for 2021. In the current situation, there are too many legal, macroeconomic, and fiscal unknowns, so the Working Group on Fiscal Risks is currently postponing an opinion on the required amounts of the fiscal safety margin for 2022 and 2023.

3. Fiscal numeric conditions – under construction!

39. **Pursuant to the provisions of Article 33 of the Law on Coping with the Covid-19 Infection and fulfilling the competence of the Council specified in Article 28 (3) of the Fiscal Discipline Law, the Council assessed alternative numerical fiscal rules for the 2021 budget and 2021-2023. as well as formulated an opinion in accordance with Article 12 (3) of the FDL on the permissible deviation from the balance rule in case of a serve economic downturn.** The FDL provides for the examination of four fiscal rules: the balance rule, the expenditure benchmark rule, the continuity rule and the general government debt rule.

40. Taking into account the norms of the Covid-19 special regulation for 2021, **the expenditure benchmark rule is not calculated and verified**. Its fulfilment is regulated by the Regulation (EU) No. 1175/2011 of the European Parliament and Council of 16 November 2011, which allows amending Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the coordination of economic policies, as this law has currently been suspended by an exception clause.

41. **The fiscal rule of continuity for 2021 is adjusted** by Section 5 (2) of the FDL. The law provides that in case the amount of adjusted maximum state budget expenditure ceilings determined from Section 15 of the FDL, from which the fiscal security reserve for the respective year has been excluded, and the amount of expenditure determined in accordance with Section 5, paragraph one of the FDL, from which the fiscal security reserve specified in the previous framework law for the respective year is excluded, **differ by more than 0.1 percent of GDP (at current prices), the draft budgetary plan shall include such adjusted maximum expenditure ceilings of state budget, which is in accordance with Section 15 of this Law**. The Ministry of Finance has not prepared calculations of the inheritance condition for 2021 and 2022, but according to the Council's experts, the sharp economic downturn in 2020 creates a difference between the maximum allowable amount of state budget expenditures by two methods exceeding 0.1% of GDP.

42. **The Council agrees with the MoF's proposal to develop a fiscal policy for 2021 based on the balance rule taking into account the serve economic downturn and allowing the state budget balance to deteriorate according to the conditions of the economic cycle phase. The maximum allowable state budget expenditure ceilings for 2021 are 10 795.01 EUR, for 2022 are 11,085.81 EUR and for 2023 11,095.62 EUR.**

43. The budget framework envisages the following budget balances under a unchanged policy of -3.9% in 2021, -2.8% in 2022 and -1.7%. In 2023. According to the calculations of the Ministry of Finance, the above targets would ensure the government structural balance -1.9% in 2021, -0.9% in 2022 and -0.05% in 2023, taking into account the difference between actual and potential economic growth. The Council notes that the requirements of the FDL are not fully met in setting the maximum level of government expenditure in 2022, but recognizes that the balance targets set are commensurate with the economic downturn and follow the principle of counter-cyclical policies in 2022 and 2023 as a whole. Given the high level of uncertainty in economic development and the need to overcome the effects of the economic downturn, the Council will clarify its position on the 2022 ceilings on government expenditure in its 2021 Surveillance Report.

44. According to Article 28 (4) of the FDL, the Council prepares an opinion on the extent to which a derogation from the balance rule is permissible during a severe economic downturn (Article 12 (1) (3) of the FDL). Section 33 of the **Covid-19 Infection Management Act** stipulates that in 2020 and 2021 the provisions of the third paragraph in Section 7, Section 9 and paragraph three of Section 12 of the Fiscal Discipline Law shall not apply. The Council has assessed the derogation and summarized its results in Table 6.

Table 6

Permissible deviations from the balance sheet condition Article 12 (3) of the FDL

Calculation order	Fiscal parameters	2021 FM
1	GG budget revenue in the baseline scenario mln. Euro Budget Law (14.11.2019)	11963
2	GG budget revenue in the baseline scenario mln. Euro DBP (15.10.2020)	11505
(3)=(2)-(1)	Revenue changes mln. Euro	-458
4	Nominal GDP projections approved at 15th of june 2020.	30035
(5)=(3)/(4)*100	GG revenue changes % GDP	-1.5
6	Output gap % of GDP Budget Law (14.11.2019)	0.4
7	Output gap % of GDP DBP (15.10.2020)	-5.4
(8)=(6)*0,378	Cyclical component baseline scenario Budget Law (14.11.2019) % of GDP	0.2
(9)=(7)*0,378	Cyclical component baseline scenario % of GDP DBP (15.10.2020)	-2.0
10	MTO % GDP	-0.5
(11)=(10)+(8)	Nominal balance baseline scenario Budget Law (14.11.2019) with MTO % GDP	-0.3
(12)=(11)+(5)	nominal balance in the event of a projected decline % GDP	-1.9
(13)=(12)-(9)	structural balance in the event of a projected decline % GDP	0.2

Source: FM data and FDP calculations

45. According to the Council's calculations, the fall in revenue in 2021 corresponds to 458 million euros, which allows for a deterioration of the general government budget balance compared to the baseline scenario of 1.4% of GDP in case a condition under Article 12 (1) (3) of the FDL takes place. **The nominal balance calculated by the Ministry of Finance for 2021 is -3.95% of GDP, which is broadly in line with the minimum allowable nominal balance calculated by the Council of -3.9%, with the projected decline in revenue, but no further increase in the deficit is allowed. The Council concludes that the Covid-19 Infection Management Act, by imposing restrictions on the operation of the FDL, has led to a significant increase in the general government deficit, which may need to be offset by the correction mechanism in Article 11 of the FDL.**

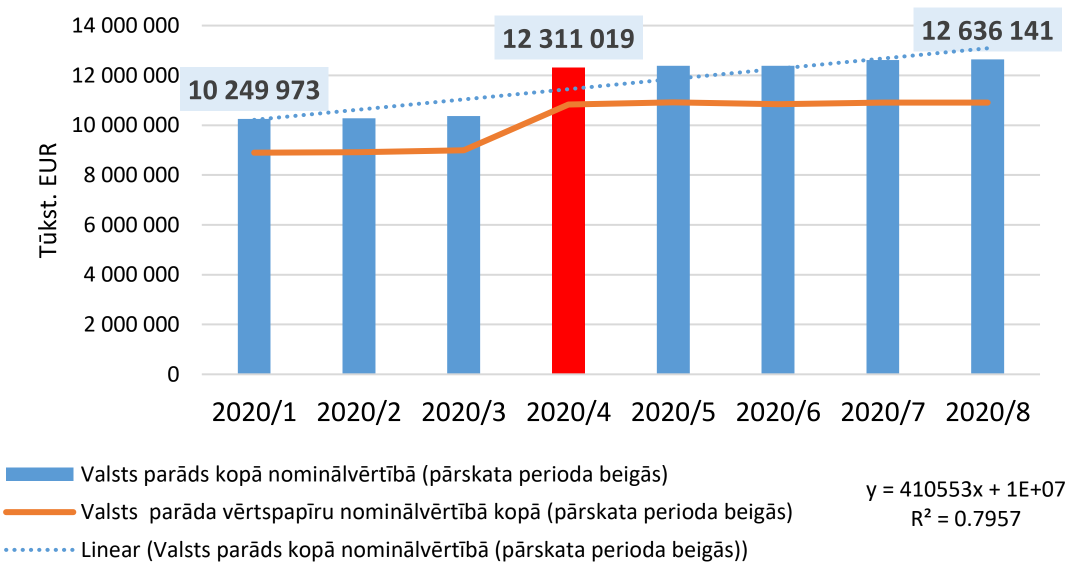
3.1 Government debt condition

46. Due to Covid-19 outbreak crisis, in order to provide financial coverage for support measures to mitigate the effects of Covid-19, Latvia has been rapidly borrowing in both domestic and international financial markets since March 2020, issuing bonds, which caused a rapid and unplanned increase in debt. According to the CSB data, in the 1st quarter of 2020 the value of general government debt reached 11.29 billion euros[16] (publication of the CSB data for the 2nd quarter is expected on October 20 this year).

47. The operative data of the Treasury show that at the end of this year's first quarter the total nominal value of central government and local government debt was 10.487 billion euros (37% of GDP), but at the end of the second quarter, it already reached 12.485 billion euros (44% of GDP).

48. Government debt is still growing moderately, reaching 12.610 billion euros in July. Thus, since the declaration of the state of emergency in March, the government debt has increased by more than 2 billion euros (2.274 billion in August), or 8% of the projected GDP in 2020.

49. Latvia has signed a number of agreements under which borrowing may take place. However, the borrowing also may not take place, so its reflection in the government debt will be reflected post-factum. Figure XX shows that there is a breaking point in March, after which the public debt increased significantly, incl. the amount of debt securities in circulation, the share of which is more than 80% of the government's debt amount. To cover the challenges of Covid-19, Eurobonds were issued in both the additional issue and the new issue, as well as domestic debt bonds were intensively auctioned.



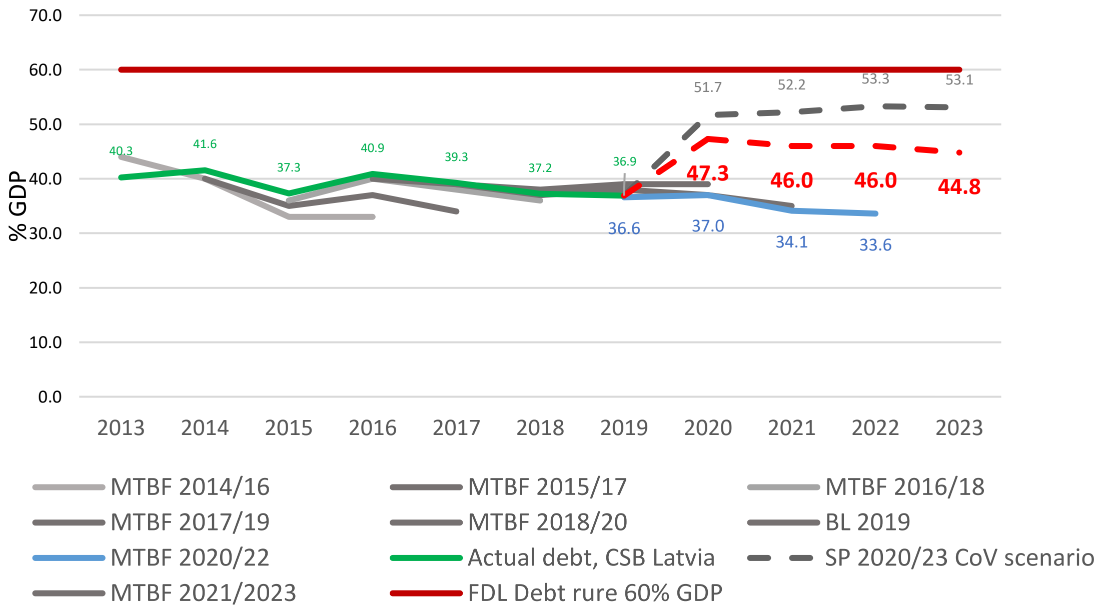
Source: the Treasury

Figure 5. Dynamics of government debt before and after Covid-19

50. Despite the rapid increase in government debt, the general government debt is projected at 47.3% of GDP in 2020, and is it also projected to decline in the coming years. However,

[16] CSB data matrix [VF020c.] General government debt by sub-sector, quarterly at end of period (million euro).

meeting this projection requires meeting projected GDP growth rates, which are threatened by the challenges of the second wave of Covid-19.



Source: the Treasury

Figure 6. Dynamics and forecasts of general management debt

51. According to the current general government debt forecast prepared by the Treasury, the debt condition set out in the Fiscal Discipline Law is expected to be met, however, as the GDP growth rate deteriorates and the budget deficit increases, critical debt values may be reached.

4. Macroeconomic environment assessment

4.1 Changes in the macroeconomic indicators forecasted by the MoF after the revision of the CSB national accounts

52. In 2020, the Central Statistical Bureau has performed an annual revision of time series data on national accounts. **The audit has affected the Council's assessment of the Output Gap and the assessment of nominal GDP. Given that the output gap has narrowed and thus provides for a tighter structural balance, the Council accepts these changes and considers them when assessing the examination of fiscal numerical conditions.**

53. On 30 September 2020, as part of its annual revision, the Central Statistical Bureau published audited time series data on national accounts starting from 1995. The data revision has affected the FDP-approved Macroeconomic Forecast in the sections “output gap” until 2023 and in the section “nominal GDP” until 2020, as reflected in Table 7.

Table 7

Macroeconomic indicators and changes approved by the Council after the revision of CSB national accounts data

Data section	2020	2021	2022	2023
Real GDP growth (approved by FDC)	**-7**	**5.1**	**3.1**	**3.1**
Real GDP growth (After CSB revision)	-7	5.1	3.1	3.1
Difference	0	0	0	0
Nominal GDP growth (approved by FDC)	**-7.4**	**6.5**	**5.3**	**5.2**
Nominal GDP growth (After CSB revision)	-7.5	6.5	5.3	5.2
Difference	-0.1	0	0	0
Inflation (approved by FDC)	**0.2**	**1.2**	**2**	**2**
Inflation (After CSB revision)	0.2	1.2	2	2
Difference	0	0	0	0
GDP deflator (approved by FDC)	**-0.5**	**1.3**	**2**	**2**
GDP deflator (After CSB revision)	-0.5	1.3	2	2
Difference	0	0	0	0
Potential GDP growth (approved by FDC)	**2.4**	**2.5**	**2.5**	**2.4**
Potential GDP growth (After CSB revision)	2.4	2.5	2.5	2.4
Difference	0	0	0	0
Output gap (approved by FDC)	**-7.9**	**-5.6**	**-5**	**-4.4**
Output gap (After CSB revision)	-7.7	-5.4	-4.8	-4.1
Difference	0.2	0.2	0.2	0.3

54. The Council has received a technical adjustment to the forecasts from the MoF, calculated on the basis of the forecast growth rates and actual statistics for 2019 approved in June 2020. The MoF has also provided an explanation on the nature of changes in national accounts time series. The largest difference in the time series of the new GDP level in actual prices appeared in the period until 2018, but in 2019, the new GDP indicator is by 13 million euros less compared to the data before the revision. Consequently, the impact on the projections of the new GDP time series is insignificant.

4.2 Forecasts and external environment

55. Latvia's macroeconomic environment in 2020 was affected by both global events related to the Covid-19 outbreak and the general economic slowdown, as well as the base effects from 2019. The main forces affecting the macroeconomic environment in Latvia in 2019 were related to the slowdown in global economic growth, uncertainty and deteriorating economic sentiment related to US-China trade tensions, the decline in exports and the transit sector. There were tensions in the Latvian labour market due to declining labour supply and wage growth, which was not matched by slow labour productivity growth. In early 2020, these dampening factors were compounded by falling oil prices, the global Covid-19 outbreak and panic in financial markets. In these conditions of growing uncertainty, the possibilities of economic forecasting were limited and forecasts were rapidly and repeatedly revised both in the world and in Latvia.

56. The OECD Economic Outlook has modelled two equally possible scenarios, one in which the second wave of Covid-19 with the re-introduction of strict restrictions will take place by the end of 2020, and the other in which the second wave of Covid-19 is eliminated.

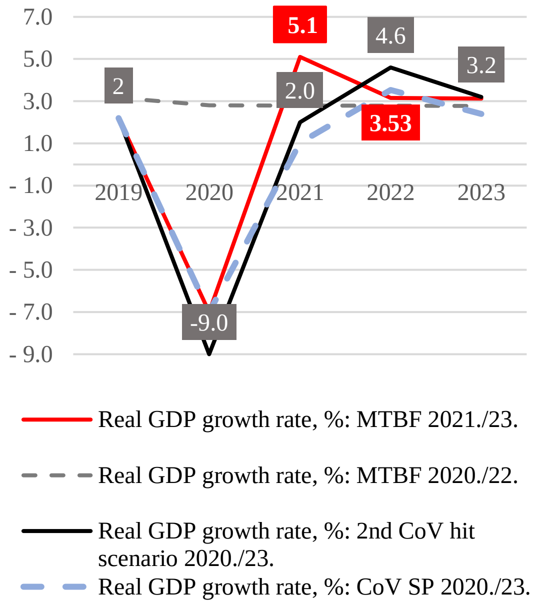
According to this OECD estimate, **Latvia's GDP** is projected decline in 2020 (-8.1%), while in the second case a decrease is projected (-10.2%). Maastricht debt growth in 2020 Latvia is forecast (+ 8.35%) if the second Covid-19 outbreak does not occur, but in the event of a second pandemic, the debt could increase by 14%17. **The IMF** forecasts a decline in real GDP for Latvia in 2020 (-8.6%), but already in 2021 (+ 8.3%) growth is forecast, describing Latvia's situation in 2020 worse than in the euro area as a whole, however, forecasting a sharp economic recovery in 2021 (+ 8.3%), which would be faster than for Lithuania and Estonia.

57. **On 29 September, the Bank of Latvia revised and improved its macroeconomic forecasts, noting that the Latvian economic downturn in 2020 will be (-4.7%) instead of the June forecast (-7.5%). Consequently, growth in 2021 will start from a higher point and will reach (+ 5.1%) in 2021, but in 2022 GDP will grow by (+ 5%).** The Bank of Latvia's assumptions regarding the improvement of the economic forecast is mainly based on the lower unemployment rise as forecasted previously, the positive dynamics of economic sentiment which is likely to be followed by economic recovery, and on the fact that the deepest point of the crisis has already been overcome road. The stabilization and sustainability of the labor market will also stabilize wage growth, which will have a positive impact on the currently very low inflation rates.

58. **Fiscal Discipline Council this year on June 15, approved the macroeconomic forecasts for years[18.] 2021-2023. With endorsing the macroeconomic forecasts, the Council noted the second wave of Covid-19, the slower-than-expected recovery of the global economy and several other important factors as the main macroeconomic risks.** In its recommendations, the Council noted that, because of the rapidly changing situation in the world and Latvia, it would be useful to conduct an operational review of the macroeconomic forecasts in autumn 2020.
59. The Council welcomes the calculations made by the MoF modelling the Covid-19 second hit scenario and notes that international organizations have done the same. The real GDP modelled by the Ministry of Finance in the “2nd hit” scenario compared to the approved forecast Medium Term Budget Framework (MTBF) 2021/2023. Compared to the previous forecast for the (MTBF) 2021-2023, approved by the FDC in 15th of June 2020, the implementation of the Covid-19 second hit scenario would imply a 2%. decrease in real GDP growth by 2020. In 2021 a decrease of 3.1%. is projected and only for 2022 the forecast will increase by 1.5%, but for 2023 it will increase by 0.1%.
    The nominal GDP modelled by the Ministry of Finance in the “2nd wave” scenario compared to the approved forecast MTBF 2021/2023. In the second hit scenario, a decrease in the nominal GDP growth rate compared to MTBF 2021/2023 would mean that in 2020 the nominal GDP would be 2% lower than forecast in June, in 2021 lower by 3.6% and only in 2022 the forecast will increase by 0.9%, but for 2023 it will remain unchanged.

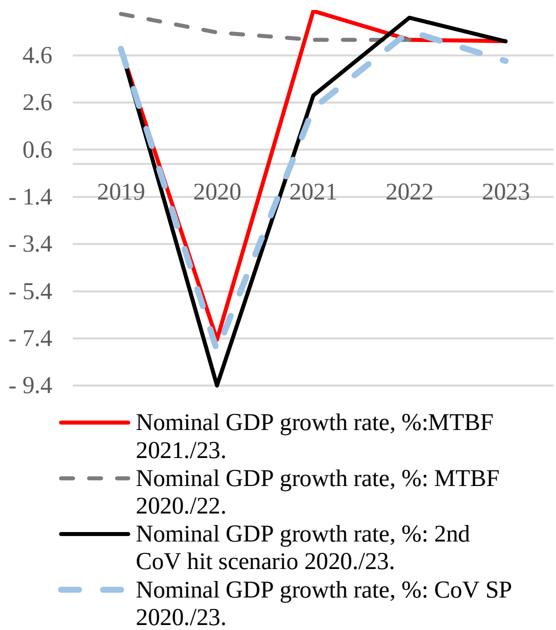
[17] OECD Economic Outlook https://www.oecd.org/economic-outlook/june-2020/?utm_source=facebook&utm_medium=social&utm_campaign=ecooutlookjun2020&utm_content=en&utm_term=pac

[18] https://fiscalcouncil.lv/17062020-fdc-opinion-on-the-ministry-of-finances-macroeconomic-forecast-for-2020-and-2021-2023



Source: MoF

***Figure:* 7** Real GDP – 2nd Covid-19 hit scenario compared to previously confirmed macroeconomic forecasts



Source: MoF

***Figure:* 8** Nominal GDP – 2nd Covid-19 hit scenario compared to previously confirmed macroeconomic forecasts

60. The Council calls on the Government to be prudent in planning state budget expenditures and revenues, as the MoF also notes that forecasts have never been made in such a high level of uncertainty and that the risks to the projections are a downside.

61. This year in the autumn, the prevalence of Covid-19 in the world and Latvia has started to grow rapidly, thus the second onset of Covid-19 can be detected. At present, however, mortality rates in Europe are lower19, so possible control measures will be more socially and economically friendly. However, the Ministry of Finance's Covid-19 second wave scenario assumes that the economic recovery would be significantly slower and would drag on throughout 2021, as well as below the currently approved forecast values.

62. While acknowledging that recent statistics signal economic stabilization, the Council calls for special attention to be paid to the Covid-19 second hit scenario estimated by the MoF, as risks remain very high both in terms of morbidity and pre-crisis geopolitical tensions: Brexit, Tensions between the United States and China, coupled with the political crisis in Belarus.

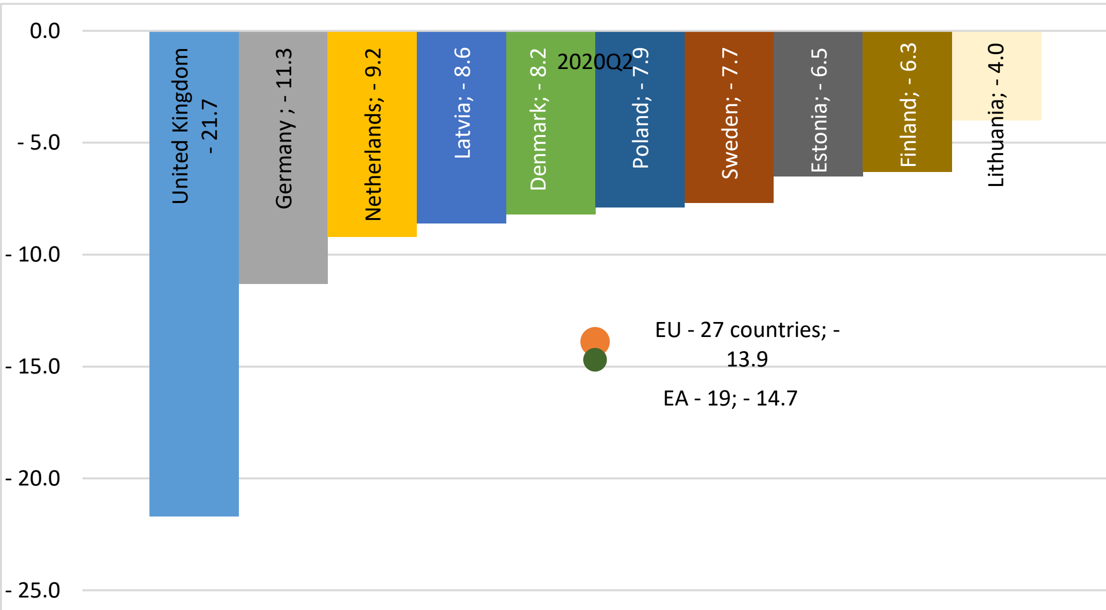
63. The forecasts of the International organizations (IMF, OECD ECB) have revised the macroeconomic forecasts several times since the beginning of 2020, and a relatively more optimistic outlook for the 2020 outcome than at the beginning of the summer characterizes later forecasts. For 2021, growth in the euro area is projected to return to growth path. The European Central Bank's (ECB) September macroeconomic

[19] WHO WHO Coronavirus Disease (COVID-19) Dashboard [07.10.2020] https://covid19.who.int/?gclid=CjwKCAjwzvX7BRAeEiwAsXExo5gbHYH08kwDJHMV_E3nABGjLDNUSeq-XdsSRKTNxp6HqEabC0NyAhoC3V0QAvD_BwE

forecasts20 show that the euro area's prospects for recovery are improving compared with those published in June. Compared to the decline in real GDP forecast for June by -8.7% in June, the forecast improved to (-8.0%) in September. However, the ECB's September forecast for the coming years projects real GDP growth to be slower than in June, at 5.2% for 2021 and + 3.2% for 2022. The Organization for Economic Co-operation and Development (OECD) forecasts a decline in the euro area in 2020 -7.9% and economic growth in 2021 5.1%. The International Monetary Fund has forecast[21] (-7.5%) a decline in the Eurozone in 2020 and (+4.7%) growth in 2021.

64. Although the downturn in the Eurozone has been dramatically rapid, Latvia and its main trading partners in the first two quarters have been able to keep the decline above the level of the Eurozone decline, as well as production volume indices this year. July shows a recovery in the manufacturing sector in Latvia, Ireland and Poland, while the rest of the EU continues to decline. No country in the European Union whoch is not facing a GDP downturn, and despite a rebound in 2021, pre-crisis levels in the European Union's economy is expected to return only in 2022, as growth will resume from a lower point after the Covid-19 crisis.

65. Observing the real performance of the economy, according to Eurostat, in the first quarter of 2020 the euro area's GDP at market prices contracted by -3.2% year-on-year, but in the second quarter, the decline reached (-14.8%), which is a record drop. However, it should be noted that the decline in euro area GDP varies between regions and Latvia's main trading partners GDP decline was significantly lower than in the euro area or the European Union as a whole (-13.9). The Lithuanian economy has suffered the least, but the worst affected countries in the European Union are Spain, France, Italy and United Kingdom.



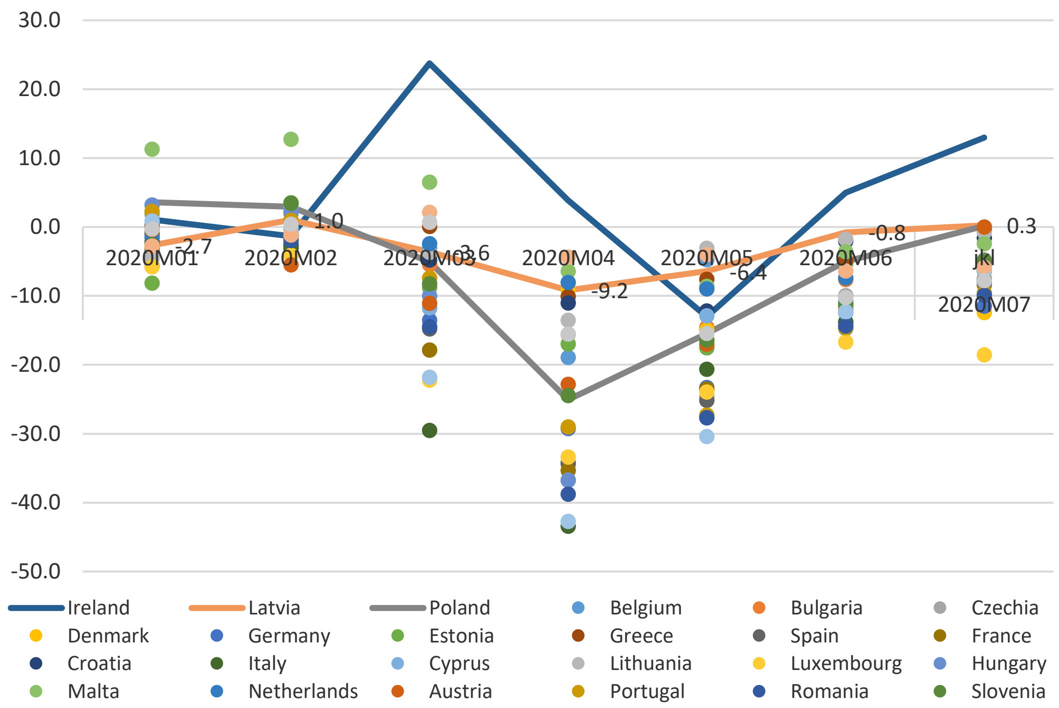
Source: Eurostat [namq_10_gdp]

Figure 9. *The decline in nominal GDP in the second quarter of 2020 for Latvia's most important export partners*

[20] ECB staff macroeconomic projections for the euro area, September 2020 https://www.ecb.europa.eu/pub/projections/html/ecb.projections202009_ecbstaff~0940bca288.en.html#toc3

[21] IMF datamapper https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/LVA/EURO

66. Observing production volume indices (2015 = 100) in EU countries this year in July, compared to July of the previous year, only three countries show a return to growth: Ireland (+ 13%), Latvia (+ 0.3%) and Poland (+ 0.2%). Among Latvia's trading partners, production is still declining, including in Denmark (-12.4%) and Germany (-11.5%), Lithuania (-0.8%) and Estonia (-0.5%).

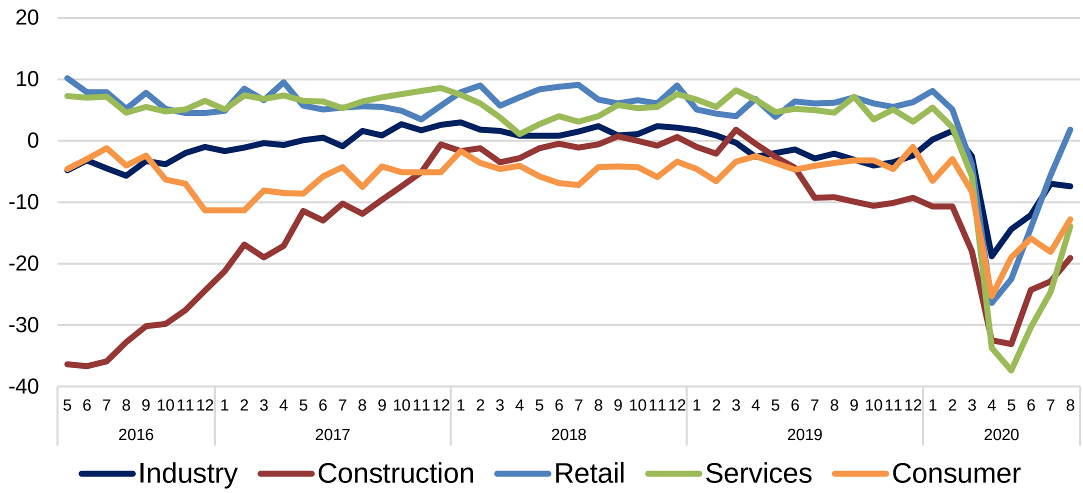


Source: Eurostat [sts_inpr_m]

Figure: 10 Dynamics of industrial production volume indices in EU countries, month-on-year (Mining and quarrying; manufacturing; electricity, gas, steam and air conditioning supply)

67. Confidence indicators in Latvia continue to improve, although the balance is still in the negative range. Eurostat data show that economic sentiment indicators for Latvia's main trading partners continued to improve in August, but these improvements do not yet correlate with Latvia's export performance. In general, sentiment indicators are expected to be followed by real improvements in the economy, but economic indicators are very sensitive and may fall just as rapidly as new Covid-19 constraint threats increase.

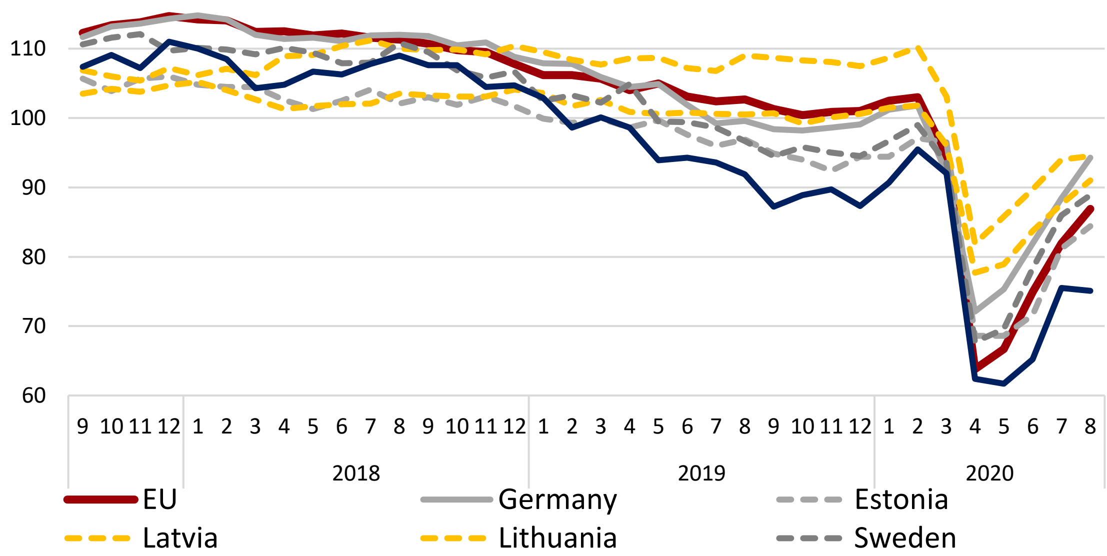
68. In August, the retail trade confidence showed a minimal positive surplus 1.8%, while business confidence in the construction sector is recovering the slowest. In industry, confidence indicators increased in previous months, but in July and August, the balance stabilized at around (-7%). It is necessary to note the positive fact that the long-term average economic sentiment indicator (long-term average = 100) has improved from 87.6 points in July to 91 points in August.



Source CSB [KR020m]

Figure 11. Confidence indicators seasonally adjusted (balance%)

69. Among Latvia's trading partners, Germany should be noted, where sentiment indicators improved by 6 percentage points compared to July, as well as Estonia (+ 3.2% points) and Sweden (+ 2.9% points).

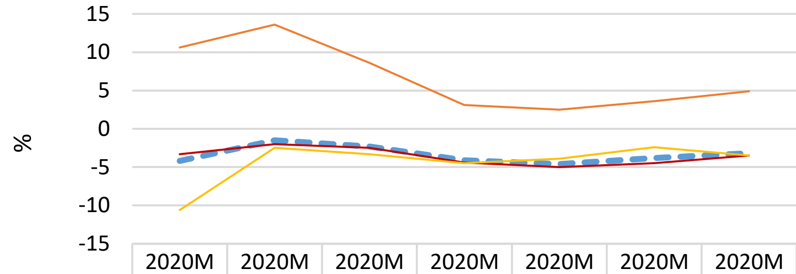


Source: Eurostat [Code: teibs010]

Figure 12. Economic sentiment indicators in Latvia's main trading partners

70. Eurostat data on Latvia show that compared to July, Latvia's sentiment indicator has increased by 3.4 percentage points. As Latvia's economic recovery is highly dependent on the stabilization of foreign trade partners, this is a positive signal.

71. In manufacturing industry, the production has been declining since the beginning of 2020, January to July by -3.2%. Of particular note is the decline in manufacturing and electricity and gas supply, which fell in July by -3.5% since the beginning of the year, while the mining industry showed an increase by 4.9% in July.



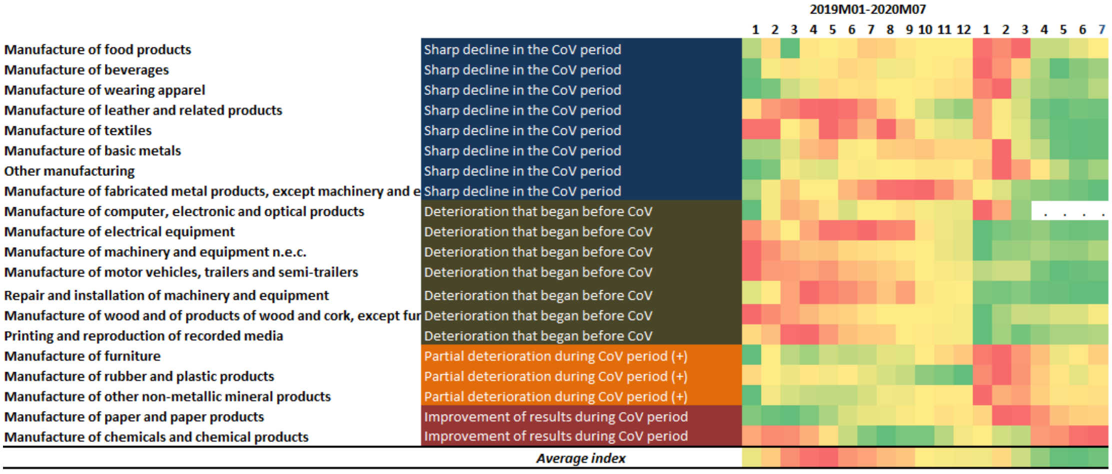
	2020M 01	2020M 02	2020M 03	2020M 04	2020M 05	2020M 06	2020M 07
(BCD) INDUSTRY-TOTAL	-4.2	-1.5	-2.3	-4.1	-4.6	-3.8	-3.2
(B) Mining and quarrying	10.6	13.6	8.6	3.1	2.5	3.6	4.9
(C) Manufacturing	-3.3	-2	-2.5	-4.4	-5	-4.5	-3.5
(D) Electricity and gas supply	-10.6	-2.5	-3.3	-4.5	-3.9	-2.4	-3.5

Source: CSB [RU030m]

Figure: 13 Volume indices of industrial production by economic activity (from the beginning of the year), calendar adjusted data

72. In the manufacturing processing sectors, a decline in output was observed, which is related both to the effects of Covid-19 and to the slowdown in economic growth that began last year. Looking at the dynamics of industrial production volume indices since the beginning of 2019 (2019M1-2020M7), a gradual decrease in production activity can be seen, which can be generally explained by the impact of the Covid-19 outbreak. However, the production activity of different types of products has variated. For example, during the Covid-19 restriction period (especially in April), production of food, beverages and clothing has fallen sharply, being sufficiently active throughout the year and especially in early 2020. This can be explained by the saturation of the market in February and March when there was a high demand in the food segment. Food production grew particularly sharply in March but fell sharply in April. A gradual decline in production in March and April was observed in the manufacture of leather, textiles, metal and metal products, as well as in the manufacture of computers and optical equipment.

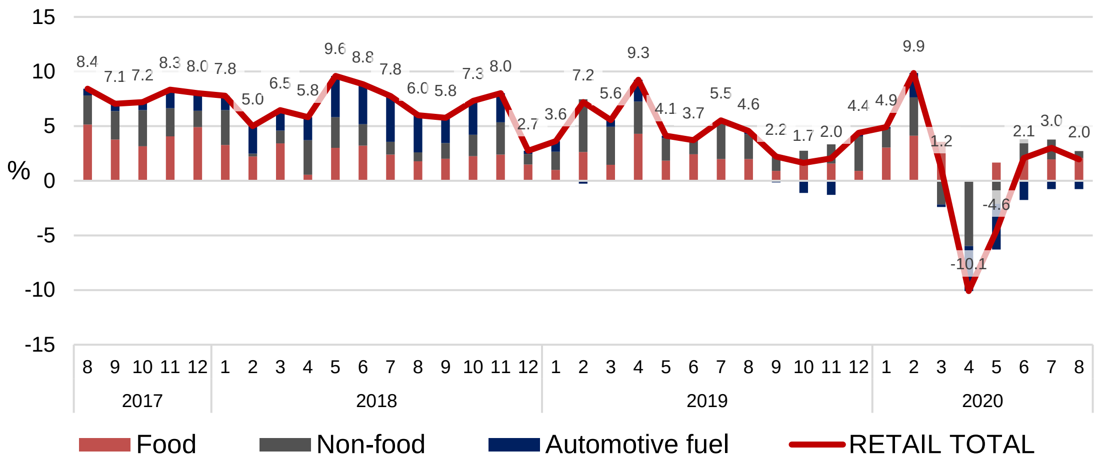
73. Since 2019, and especially since the beginning of 2020, the production of electrical and other equipment, the production of cars, trailers and semi-trailers, the repair and installation of equipment, and the production of wood and wood products have been steadily declining. In general, the decline in output in these sectors was determined by both the base effect of the previous year and the decline in external demand. Since the beginning of 2020, activity in the manufacture of furniture and rubber and plastic products has decreased slightly. It should be noted that some industries also showed increased activity, such as chemicals and paper products.



Source: CSB (RU030m)

Figure 14. Dynamics of industrial production volume indices by industry (from the beginning of the year), calendar-adjusted data.

74. Retail turnover has been strongly affected by both the applying and repeal of Covid-19 containment measures. Compared with the corresponding months of the previous year, the turnover from January to July has both fallen sharply by -10.1% in April and managed to return to growth by 2.6% in June and 3.7% in July. This year in February and March, the turnover in the food trade segment increased sharply by 4.1% and 3.6%, respectively, although in March the growth took place only in the food trade segment. With the onset of the state of emergency and the associated severe restrictions on gathering and movement, consumers had not the physical opportunity to visit outlets and inject those funds into the economy. At the same time, household savings have increased due to both uncertainties about future earning opportunities and the restrictive measures already mentioned.



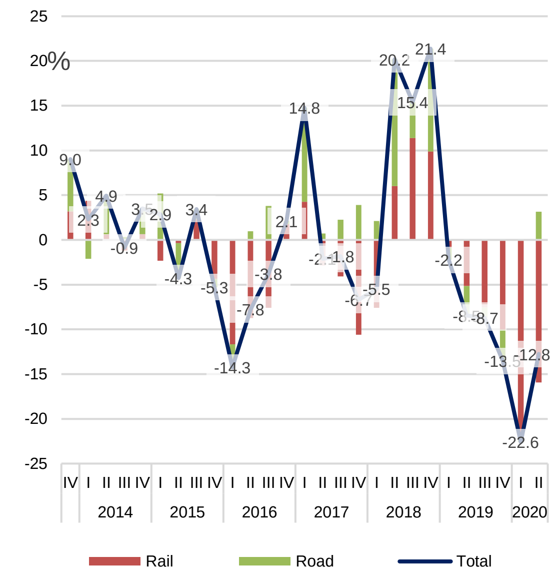
Source: CSB (TI030m)

Figure 15. XX Retail (month over the corresponding month of the previous year)

75. In the first quarter of this year, **the construction sector** was highly active, with construction output growing at current prices by 17%, but already in the second quarter, there was a decline by -0.04%. In both quarters, growth was shown by an increase in the volume of construction in specialized construction by 12.4% in the 1st quarter and 13.9%

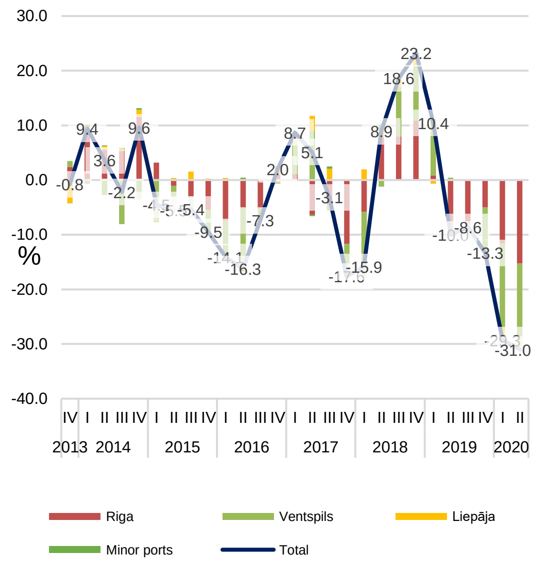
in the 2nd quarter, and in the construction of new facilities by 17.9% in the 1st quarter and 5% in the 2nd quarter. Unstained growth was observed in the construction of buildings by 20.3% in the 1st quarter and -2.5% in the 2nd quarter and in civil engineering which increased by 17.4% in the 1st quarter and -8% in the 2nd quarter.

76. The transport and storage sector has been in decline since 2019. A particularly unfavorable situation is observed in the port segment. In 2019 compared to 2018 the volume of cargo turnover has decreased by -5.7, while in the first half of 2020 compared to the corresponding period of 2019 the decline in turnover has reached even -30.1%. The volume of freight transport by rail and road transport registered in Latvia in 2019 compared to 2018 decreased by -8.5%, but in the first half of 2020 compared to the corresponding period of 2019 the volume of transported freight decreased by -17.4%.



Source CSB [TR200c; TR200c]

Figure 16. Contribution of rail and road transport to freight growth (quarter over the corresponding quarter of the previous year)



Source CSB [TR250c]

Figure 17. Contributions of ports to the growth of cargoes turnover (quarter over the corresponding quarter of the previous year)

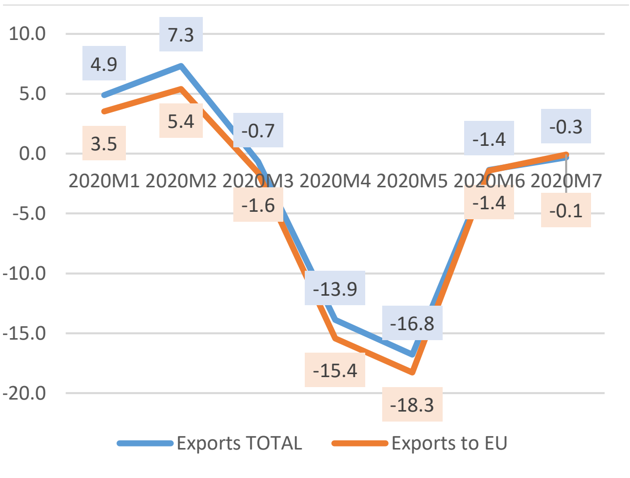
It should be noted that in the 2nd quarter of 2020, for the first time since the 4th quarter of 2018, an increase in road transport was recorded by+ 3.2%. The internal distribution of road freight transport in domestic and international transport has been stable over the last two years. About 75% of transportation is Domestic transportation, but 25% is international transportation, while in international transportation more than half of the volume is attributable to transportation abroad.

77. In **airline industry** compared to the first month of the previous year, the volume of cargo handled at Riga International Airport has increased by almost + 3% in January. However, cargo and mail received and dispatched decreased in the following months. According to data published by the CSB, in April and June, compared to the corresponding months of 2019, the volume of cargo and mail received and sent (in tonnes) decreased by -49.4% and -37.7, respectively.

78. Passenger traffic in the first half of 2020 was strongly affected by the restrictions imposed by Covid-19. Passenger transport by land in the first half of 2020 decreased by -38.9% compared to the corresponding period of 2019, incl. the largest decline was recorded in the second quarter, when the number of passengers decreased by -64.1%, according to the CSB data. In the first half of the year, fewer passengers travelled by rail -31.8% than in the corresponding period of 2019, moreover, domestic passenger transport decreased by -31.4% and international transport by -76.6%. In the first half of 2020, -57.2% fewer passengers entered and left Latvian ports by ferries than in the first half of 2019. In the second quarter, passenger turnover in ferry traffic decreased even by -95.2%, with the Port of Riga, which provides regular ferry traffic with Stockholm, suffering the most. In the first half of the year, the Port of Riga served by -66.5% fewer passengers than last year.

79. At the beginning of this year, Riga Airport started operating with very good results[22] in passenger transportation, including transit passenger transportation. Compared to January 2019, the number of passengers served in January increased by (+ 12.2%), including an increase (+ 17.3%) in the number of transfer passengers. However, in the first half of the year as a whole, passenger traffic at the airport decreased by -62.9% compared to the first half of 2019.

Foreign trade



Source: CSB (AT0051m)

Figure18. *Export growth% Overall and to the EU*

80. The growth of foreign trade in Latvia began to slow down already in period between of 2018-2019 when exports at constant prices increased by only (+ 1.9%). The first months of 2020 have had positive results for exports, however, already from March and according to the data published by the CSB until July, the volume of exports fell sharply, reaching its lowest point this year in May. In the 2nd quarter of this year, a significant decrease in the volume of exports was observed by -11% compared to the corresponding period of 2019. The largest decline in exports was observed in the EU countries by -12.1% and the CIS countries by -1.6. Exports to Other countries, on the other hand, have increased by 2.8%.

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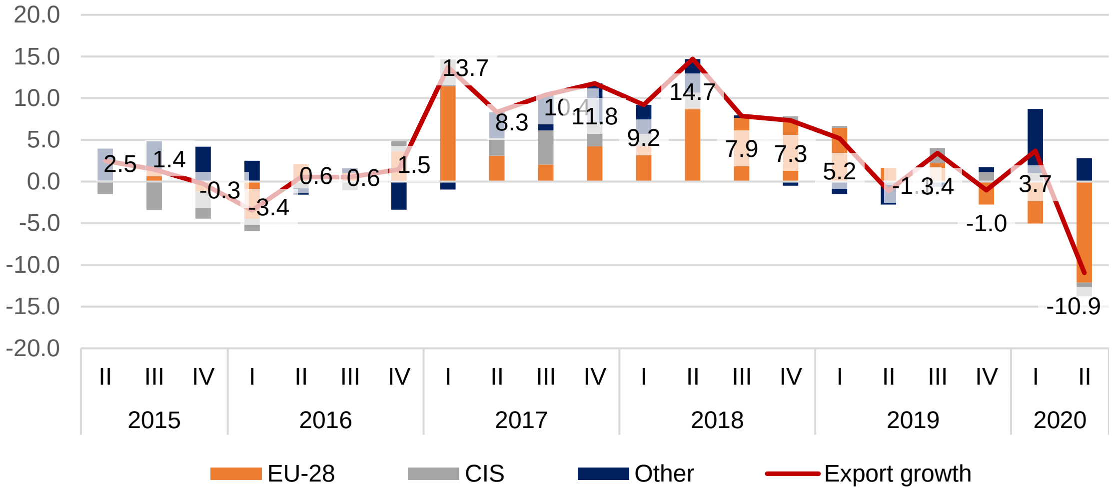
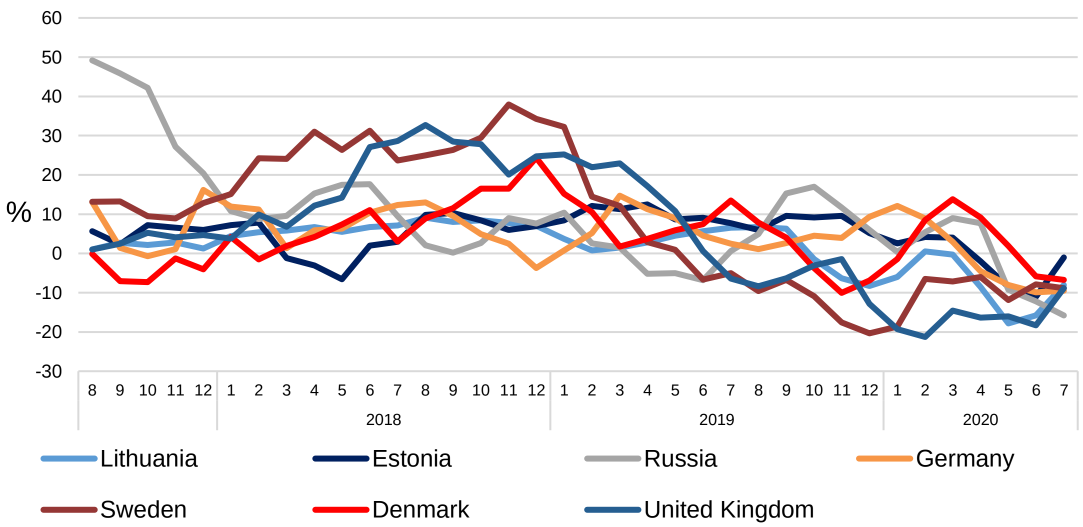
[22] Airport "Rīga" starts year with impresive 12.2% passenger number increase: https://www.riga-airport.com/preses-telpa/jaunumi/lidosta-riga-gadu-uzsak-ar-iespaidigu-12-2-pasazieru-skaita-pieaugumu



Source CSB [AT0020m]

Figure 19. *Contribution to growth by region, quarter over the corresponding quarter of the previous year*

81. CSB export data by Combined Nomenclature section and country (euro) in the second quarter show that goods were mainly exported to Lithuania 16.7% and Estonia 12.1%, as well as to Russia 8% and Germany 7.1%.

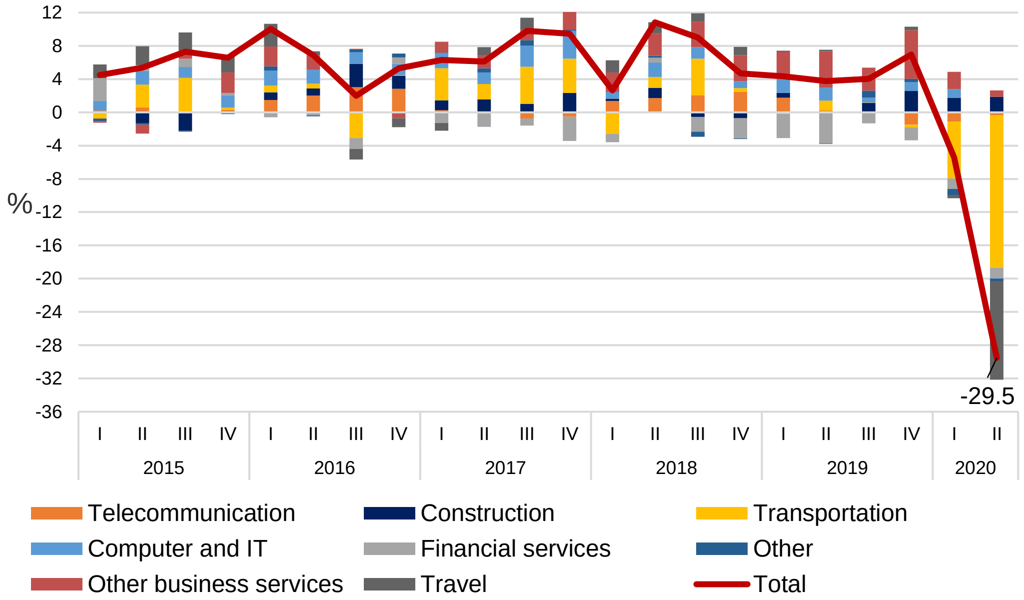


Source CSB [AT0051m]

Figure 20. Growth of export to main export countries, three months aggregate over the corresponding period of the previous year

82. **Exports of services have shown a dramatic decline this year in both quarters.** The Bank of Latvia's data shows that in the second quarter of 2020, there was a sharp decline in exports of services by-29.5% year-on-year, which means a decrease of 414 million euros in monetary terms. This decline was mainly due to a decrease in exports of transport services by -19.5% and a decrease in exports of travel services -11%, which is a direct effect of the Covid-19 crisis. However, in the same period, there was a minimal (+1.9%)

increase in exports of construction services, which amounted to 26 million in monetary terms.

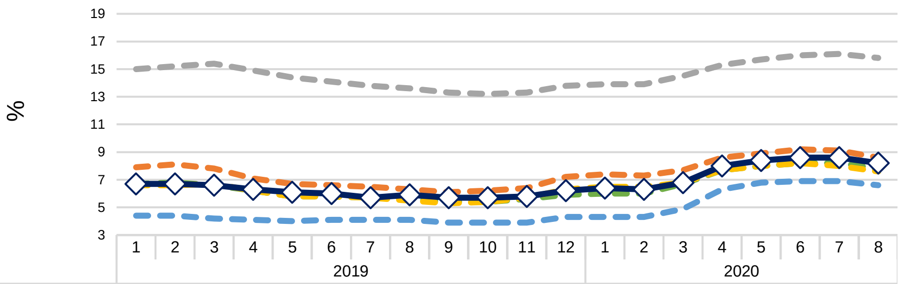


Source: BoL [03 MB quarterly / annual data tables]

Figure 21. Contribution to services export growth by industry (quarter over the corresponding quarter of the previous year)

83. During the Covid-19 period, the sharpest increase in unemployment took place in April, but in general, comparing the situation in the previous Global Financial Crisis, the increase in unemployment cannot be considered dramatic. Already in August, the unemployment rate started to decrease. This positive situation was due to both the availability of state aid and the high overall demand for labor before the Covid-19 crisis. This situation allowed workers to reintegrate into other sectors where demand remained. Workers in the tourism and hospitality sector, whose jobs have been maintained thanks to state aid measures, are still at risk, but the aid is a temporary instrument and will not last until the start of the next tourist season.

84. The seasonally adjusted unemployment rate reached 8.8% in August, according to CSB data. The registered unemployment rate in August was 8.2%, according to the State Employment Agency (SEA). Already this year the unemployment rate recorded in June and July stabilized in all regions and generally did not increase significantly, but in August there was a slight decrease in the unemployment rate. In terms of regions, the highest registered unemployment in August was observed in Latgale region (15.8%), but the lowest - in Riga region (6.6%).



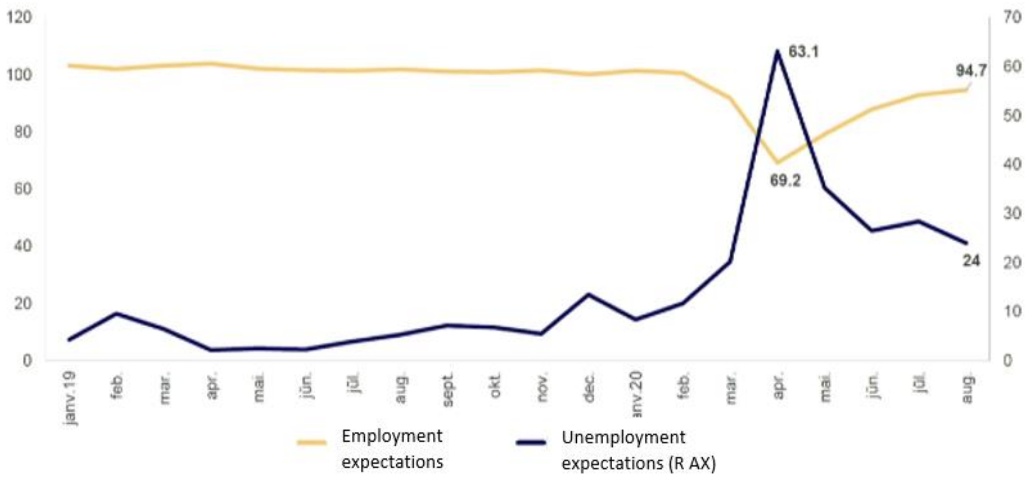
	1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8
	2019												2020							
Riga region	4.4	4.4	4.2	4.1	4	4.1	4.1	4.1	3.9	3.9	3.9	4.3	4.3	4.3	4.9	6.3	6.8	6.9	6.9	6.6
Kurzeme region	7.9	8.1	7.8	7.1	6.7	6.6	6.5	6.3	6.1	6.2	6.4	7.2	7.4	7.3	7.7	8.6	8.9	9.2	9.1	8.6
Latgale region	15.0	15.2	15.4	14.9	14.4	14.1	13.8	13.6	13.3	13.2	13.3	13.8	13.9	13.9	14.5	15.3	15.7	16	16.1	15.8
Vidzeme region	6.7	6.8	6.6	6.2	5.8	5.8	5.7	5.6	5.4	5.4	5.6	5.9	6	6	6.7	7.7	8	8.2	8.2	7.8
Zemgale region	6.6	6.6	6.7	6.2	5.8	5.8	5.7	5.5	5.3	5.4	5.7	6.3	6.5	6.5	6.8	7.7	8	8.2	8.0	7.6
Total	6.7	6.7	6.6	6.3	6.1	6.0	5.7	5.9	5.7	5.7	5.8	6.2	6.4	6.3	6.8	8	8.4	8.6	8.6	8.2

Source: National employment agency data

Figure 22. Registered unemployment rate by region

85. Observing the dynamics of the number of unemployed by sex and level of education by quarters, it can be concluded that since the second quarter of 2019, the number of unemployed with higher education has been increasing among both men and women. In turn, the number of unemployed men and women with vocational education has decreased, even in the Covid-19 period this year.

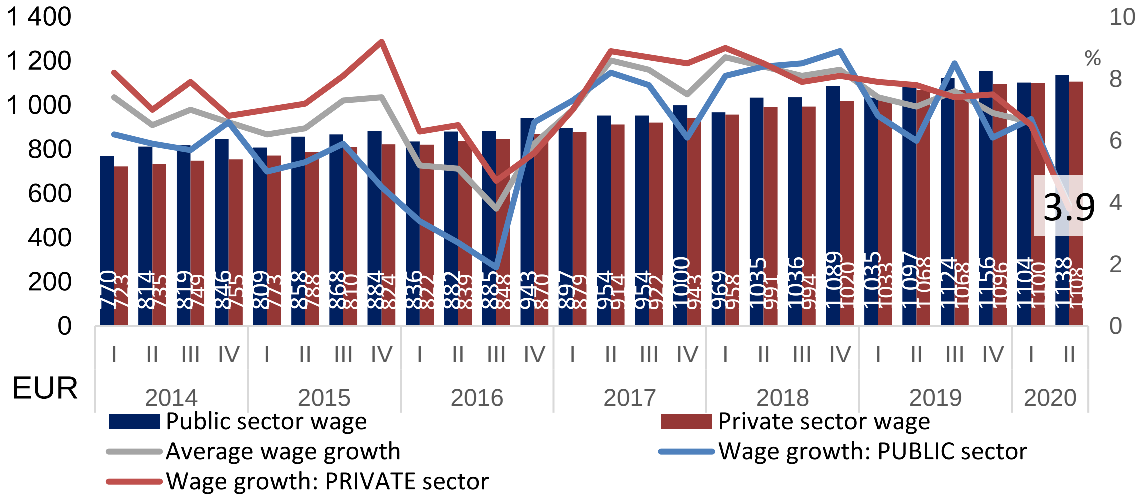
86. According to a study conducted by the Bank of Latvia, positive dynamics of employment expectations have been visible since June, while unemployment expectations are falling, which also correlates with the actual situation in the labor market and suggests that unemployment should not increase significantly soon.



Source: Bank of Latvia research based on CSB, SEA, SRS, and EC data

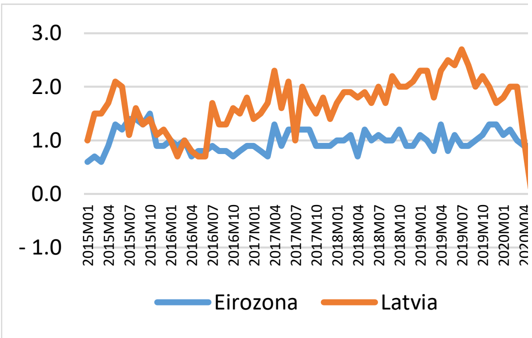
Figure 23. Employment expectations (100 = long-term average), unemployment expectations in the next 12 months (% of responses; right axis).

87. The latest data of the CSB show that in the second quarter there was a sharp slowdown in the average monthly increase in the number of employees (+ 3.9%) compared to the corresponding period of the previous year. In the 2nd quarter of 2020, compared to the 1st quarter of 2020, gross wages and salaries increased by 1.6%. In the second quarter of 2020, the average gross wage in the private sector was 1,108 euros, but in the public sector - by 30 euros higher (1,138 euros). In both the public and private sectors, average gross monthly earnings before taxes increased identically by 3.8%. During Covid-19, wages increased so-called other services + 14%, which includes the operation of organizations, repair of computers and personal and household goods and miscellaneous personal services not elsewhere classified. Wages also increased in construction + 6% and in public administration + 6.5%. At the same time, wages fell in the sectors affected by Covid-19, incl. in accommodation and catering -16.5%, in arts, entertainment and recreation -1%, as well as in the declining transport and storage sector -5.1%.



Source: CSB [DS020c]

Figure 24. Average gross wage and annual wage growth (an increase over the corresponding period of the previous year)

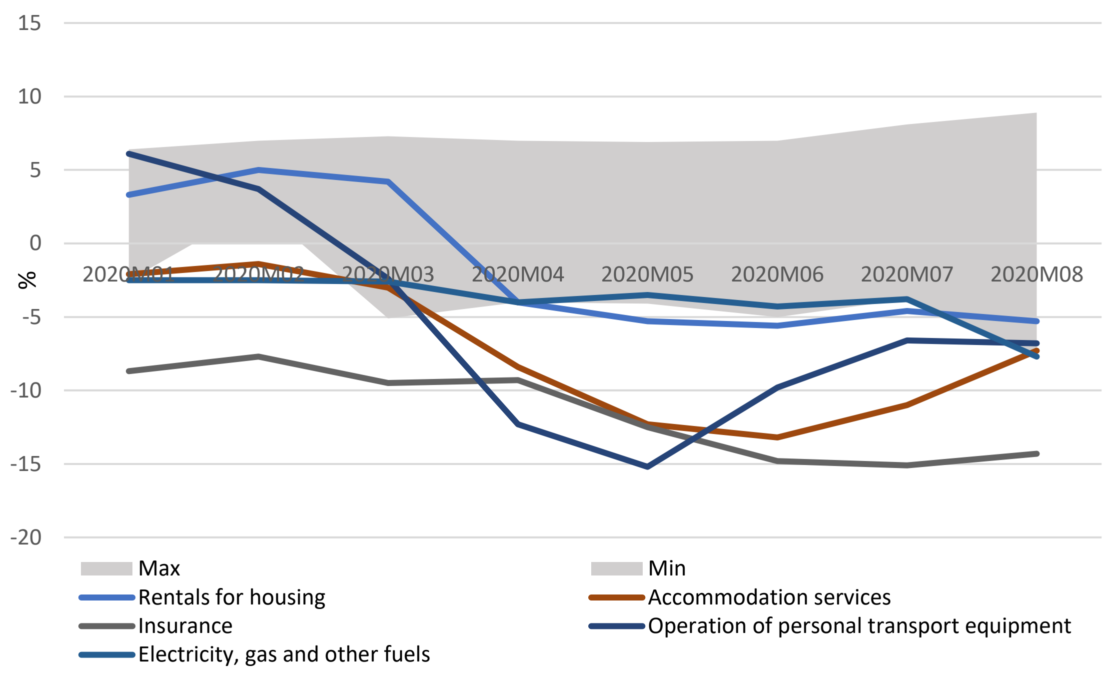


Source: Eurostat [prc_hicp_manr]

Figure 25. Core inflation in the Eurozone and Latvia

88. The core inflation chart shows that the period of Latvia's economic growth has coincided with the increase in core inflation between the end of 2016 and the end of 2019 when economic growth began to slow down. This period of the slowdown was accompanied by an external shock to Covid-19 restrictions, which sharply lowered core inflation rates below euro area values. At present, core inflation rates in the euro area and Latvia remain below 1%, below the euro area inflation target of 2%.

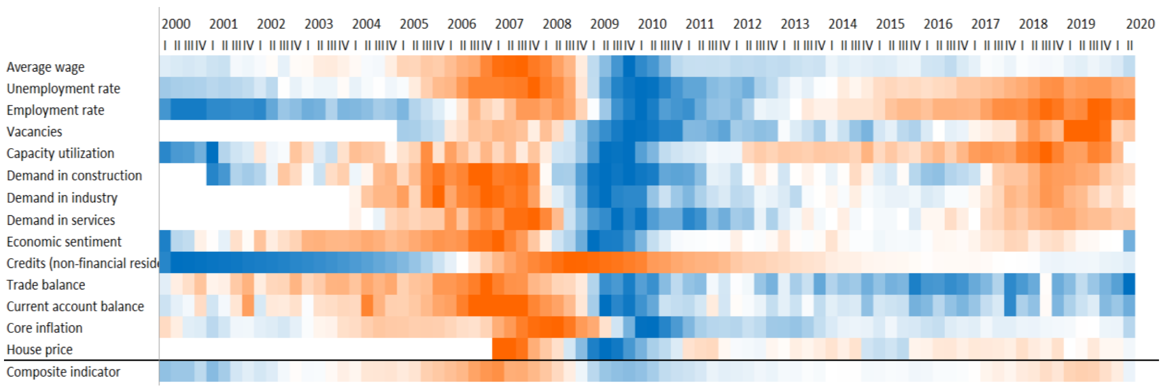
89. In the Covid-19 crisis, consumer price indices have not fallen steadily, but prices have fallen in some sectors. Looking at consumer prices, it can be seen structurally that prices fell significantly for insurance, accommodation services, personal vehicle operating expenses. Housing rents and the costs of electricity, gas and other fuels decreased.



Source: CSB [PC041m]

Figure 26*.* Consumer price indices in groups and subgroups (ECOICOP) (2015 = 1)

90. The heat map of the economic cycle[23] allows to compare the 20-year long-term averages of the economy and to judge whether the economy is in a phase of economic growth, recession or crisis. In the context of the current crisis, it provides an opportunity to compare trends in the economy with the picture before the financial crisis in 2008. The macroeconomic indicators shown in the heat map can be conditionally divided into four sections (1) labor market situation, (2) real sector situation, economic sentiment, bank lending activity (3) international trade indicators, (4) core inflation and house price changes. Long-term (20 years) changes in indicators are visualized by color transitions. When the indicator falls in the long run, the time series turns blue, when the indicator rises in the long run, the time series is displayed in orange. The overheating of the economy before the financial crisis of 2007-2008 is clearly visible on the heat map. And the general cooling of the economy in 2009-2010. years. Similarly, the phase of economic growth up to 2019 and the impact of the Covid-19 events on the economy can be seen, which shows that the economy is in a better position than the financial crisis in this crisis. Consequently, the consequences are not as profound as in the previous crisis.



[23] Latvian heat map of hte economic cycle https://fdp.gov.lv/ekonomikas-siltuma-karte

Source: CSB, Eurostat, BoL
***Figure** 27.* Heat map of Latvian economic cycle

91. **The situation in the labor market is unfavorable and there are still signs of stabilization. The current actual unemployment rates are lower than projected at 10.5% and rather reflect a short-term phase of reintegration of well-skilled workers in other sectors. In the second quarter of 2020, wage growth slowed down, but wages continued to rise by 3.9%, reaching an average of 1,118 euros before taxes, although the total planned wage bill in the economy may decline in the future, which will not lead to a sharp decline in wages. Number of vacancies this year in the second quarter, it returned to the level of the end of 2018.**

92. The labor market was affected by the Covid-19 crisis with rising unemployment, which reached 8.1% in the second quarter. In June and July 2020, unemployment stabilized at an average of 9% and fell slightly to 8.8% in August. The supply of vacancies has also remained stable in these months. It should be noted that the Ministry of Finance has forecasted an unemployment rate of 10.5% for 2020, but the actual indicators in the first two quarters of this year are lower. Such resilience in the labor market was facilitated by a set of support measures for the population and labor force, incl. granting of downtime benefits.

93. Compared to the situation during the financial crisis, unemployment rose to 17% in the second quarter of 2009, and reached as high as 20% in the first and second quarters of 2010. In addition, expenditure consolidation policies did not provide funding for comprehensive unemployment measures.

94. Wage level increase this year has contracted sharply in the second quarter, but is adequate to the current economic tensions and is expected to have a short-term effect, as labor market demand will also have a positive impact on wage growth, but is not expected to grow sharply.

95. By comparison, wages declined for six consecutive quarters in 2009, averaging -6% between the second quarter of 2009 and the third quarter of 2010. Prior to the financial crisis of 2008, wage growth reached very high levels in some quarters, even reaching more than + 30%, which coincided with an active bank lending policy and led to high inflation rates of 8% -9%. At present, despite the tight labor market situation at the end of 2019, wage growth has been modest in the long run and has kept inflation rates at acceptable levels, although consumer prices are currently on the verge of deflation.

96. **In the second quarter, entrepreneurs emphasize the lack of demand, which is lower than capacity utilization, as a limiting factor for economic activity, and it correlates with the very low confidence indicators observed in the second quarter in construction (-30.0 on average in the second quarter), industry (-15.1 on average) and services in June. 33.8). It should be noted that in July and August, confidence indicators have improved in industry, while improvements in construction and services have been minimal.** In the previous financial crisis, the opposite was the case: capacity utilization was below demand.

97. **Capacity utilization at the beginning of Covid-19 restrictive measures, this year in the second quarter it has fallen by -6%, reaching 69%. However, the latest published Eurostat data for the third quarter show that capacity utilization has risen to 72%.** In terms of sectors, it can be seen that the decline in demand has been most pronounced in the industrial sector, but according to the latest data published by the CSB for the third quarter, the problem of lack of demand continued to grow in the services sector. With the tourism services sector, which is in deep crisis. At the same time, the situation in construction and industry stabilized. This result is in stark contrast to the picture of the global financial crisis in early 2009, when capacity utilization was significantly lower than demand in construction, services and manufacturing. Since the introduction of the Covid-19 restrictions, the economic sentiment indicator has experienced a dramatic decline, which is comparable only to the indicators of the Financial Crisis.

98. **With the volume of Latvia's exports falling, the trade balance remains negative in the long run, however, as a result of the Covid-19 restrictions, the volume of imports has also fallen, which has also affected the trade balance in the short term.** Since 2018, Latvia's exports, especially re-exports, have continued to decline, while the value of imports has increased. Twenty-year long-term observations show that the average trade balance deficit in Latvia was -14.4% of GDP. In the second quarter of this year, the trade deficit reached -5.4% of GDP. In the assessment of the heat map of the economic cycle, such a deficit is relatively high, despite the fact that in the short term there has been an improvement in the trade balance, which this year in the second quarter was mainly due to reduced imports. The negative trade balance correlates with the current account deficit, which showed an average deficit of -5% of GDP over a 20-year period, but on the positive side, the current account surplus averaged + 2.4% of GDP in the last quarter of 2019 and in the first two quarters of this year.

99. **Lending activity, which has remained relatively low since 2018, has been able to keep both core inflation and house prices stable and relatively low.** Lending activity remained low since 2018, when ambitious banking sector supervision procedures were introduced in Latvia due to the MONEYVAL report. Although Latvia managed to successfully implement the MONEYVAL recommendations and gain confidence in the international banking environment, lending activity was additionally affected by the start of the economic slowdown, which reduced the overall demand for loans, and lending standards in banks have become stricter. At present, bank loans to households are linked to mortgage lending and to the general government sector to local government lending.

100. **Compared to the period before the financial crisis when the core inflation was high reaching 9% level in 2008, the core inflation has been stable and low since 2017. During Covid-19 crisis, its average value fell to 0.3% in the second quarter, while the core inflation value was negative at -0.1% in June this year.** House prices have been stable over the past five years and there were no signs of overheating of the real estate market, as it was before the financial crisis. In the second quarter, there was significant slowdown in house prices, which increased by only + 1.6%.