OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST

This document presents the opinion of the Fiscal Discipline Council (hereafter – the Council) on the macroeconomic forecast prepared by the Ministry of Finance (hereafter – MoF) that will be used for drafting Latvia's Medium term budget framework (hereafter – MTBF) for 2021-2023. This is an early review before the Medium-term budget framework drafting process for 2021-2023. The Council conducts the review and endorsement of the MoF's macroeconomic projections to assist the development of the fiscal projections well ahead of the presentation of the draft budget and the medium term budget framework (hereafter – MTBF) for approval. An early review and the endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the efforts of the Government during the preparation of the annual Stability programme (hereafter – SP) and the MTBF.

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

The Council has a mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarised in Table 4 at the end of this document).

Since Latvia's Stability programme 2020/23 (hereafter – SP CoV 2020/23) the MoF has changed the real GDP growth forecasts for 2021, 2022 and 2023 (see Table 1).

	2020	2021	2022	2023
Real GDP growth, change in %p	**–**	**+4.1**	**-0.4**	**+0.7**
MTBF 2021/23	-7.0	5.1	3.1	3.1
SP (CoV) 2020/23	-7.0	1.02	3.53	2.40
Nominal GDP growth	**+0.5**	**+4.1**	**-0.4**	**+0.8**
MTBF 2021/23	-7.4	6.5	5.3	5.2
SP (CoV) 2020/23	-7.9	2.4	5.6	4.4
Inflation (consumer prices)	**-0.2**	**-0.5**	**–**	**–**
MTBF 2021/23	0.2	1.2	2.0	2.0
SP (CoV) 2020/23	0.4	1.7	2.0	2.
GDP deflator	**+0.5**	**–**	**–**	**+0.1**
MTBF 2021/23	-0.5	1.3	2.0	2.0
SP (CoV) 2020/23	-1.0	1.3	2.0	1.9
Potential GDP growth	**-0.5**	**-0.4**	**-0.3**	**-0.4**
MTBF 2021/23	2.4	2.5	2.5	2.4
SP (CoV) 2020/23	2.9	2.9	2.8	2.9
Output gap	**+0.9**	**+4.9**	**+4.8**	**+5.8**
MTBF 2021/23	-7.9	-5.6	-5.0	-4.4
SP (CoV) 2020/23	-8.8	-10.4	-9.8	10.2

Table 1. Macroeconomic forecast indicators changes since endorsement in April 2020 endorsement.

At the Council meeting on 15 June 2020, the MoF has informed about the one-off factors, including Covid-19 negative effects on the global and national economy Forecasts confirmed that the economic downturn will continue until the end of 2020, with particularly negative results in the second and third quarters of 2020.Recovery will start at 2021, but level of the pre-

Covid-19 crisis period will reached at 2022. Economic contraction this year will largely be determined by falling private consumption. Number of employed may decrease by 4.4% this year while unemployment rate could rise to 10.5%. The inflation forecast for 2020 has been reduced compared to the SP (CoV) scenario to 0.2%, mainly due to the sharp fall in energy prices. As the main macroeconomic risks, Ministry of Finance noted the second wave of Covid-19, the slower-than-expected recovery of the global economy and a number of other important factors.

As the positive factor affecting economy recovery are mentioned economic growth in the world and Latvia's trading partners recovers faster than expected, Covid-19 vaccine and/or drugs are developed faster, EU monetary and fiscal policies stimulate faster economic recovery in the EU, In the Latvian economy, even in the conditions of a sharp recession, activity in the construction sector shows good results.

	2020	2021	2022	2023
Real GDP growth				
MoF (Jun 2020)	**-7.0**	**5.1**	**3.1**	**3.1**
BoL (Jun 2020)	-7.5	6.7	5.0	
EC (May 2020)	-7.0	6.4		
IMF (Apr 2020)	-8.6	8.3		
Nominal GDP growth				
MoF (Jun 2020)	**-7.4**	**6.5**	**5.3**	**5.2**
BoL (Jun 2020)	–	–	–	–
EC (May 2020)	–	–	–	–
IMF (Apr 2020)	–	–	–	–
Consumer prices (inflation)				
MoF (Jun 2020)	**0.2**	**1.2**	**2.0**	**2.0**
BoL (Jun 2020)	0.0	0.2	1.3	
EC (May 2020)	0.2	1.9		
IMF (Apr 2020)	-0.3	3.0		
GDP deflator				
MoF (Jun 2020)	**-0.5**	**1.3**	**2.0**	**2.0**
BoL (Jun 2020)	–	–	–	–
EC (May 2020)	1.4	2.3		
IMF (Apr 2020)				
Output gap				
MoF (Jun 2020)	**-7.9**	**-5.6**	**-5.0**	**-4.4**
BoL (Jun 2020)				
EC (May 2020)	-5.7	-1.8		
IMF (Apr 2020)			–	–

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

The MoF real GDP slowdown forecast for 2020 is in line with the European Commission (hereafter – EC), but lower than International Monetary Fund (hereafter – IMF) and the Bank of Latvia (hereafter – BoL) (Table 2). Slowdown in the gross domestic product rate (hereafter – GDP) has been determinates by falling, private consumption, exports and investment.

The MoF inflation forecasts are in line with EC, but higher than BoL and IMF, which forecasted deflation for 2020. MoFs assumptions are based on sharp decline of energy prices answering the global energy overproduction, industrial constraint and mobility restrictions.

The EC forecasts higher output gap than the MoF – by 2.2% for 2020 and 3.8% for 2021, nevertheless in negative rates also. IMF does not provide an output gap estimate.

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

The Council endorses the real GDP growth forecast for MTBF 2021/23. Compared with the previous forecast in April 2020 (SP CoV), which was prepared for the development of the Stability Program 2020/23 in the context of the Covid-19 crisis, the real GDP growth rate has been raised by 4.1% in 2021, decreased by 0.4%p. in 2022, and raised by 0.7%p in 2023. The real GDP growth rate forecast for 2020 remains the same (Chart 1). Based on discussions with the MoF, the Council concludes the importance of reducing private consumption. Coulcil also considers that there is concern about structural changes in the post-crisis economy, which may hamper the return of fiscal stimulus to the budget and increase the risk of excessive government debt growth.

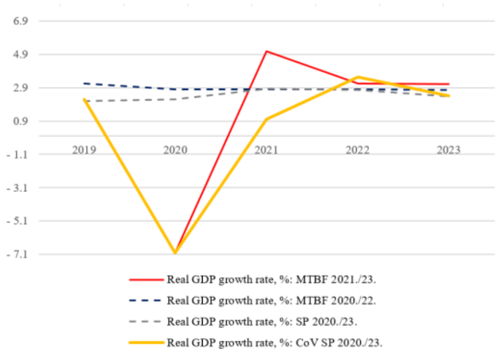

Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

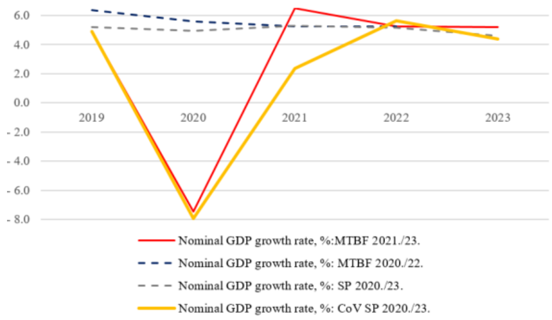

Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council endorses the nominal GDP growth forecast for the MTBF 2021/23. The MoF has further raised the nominal GDP growth forecast for 2020 by 0.5 and 2021 by 0.2 and 4.1 percentage points respectively; however, the nominal GDP growth rates is lowered by 0.4 percentage points for 2022. Nominal GDP growth forecast for 2023 raised by 0.8 percentage points (Chart 2).

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the MTBF 2021/23. For 2020 and 2021 the CPI forecast has been lowered by 0.2 and 0.5 percentage points respectively, however, CPI for 2022, 2023 remains the same. (Chart 3).

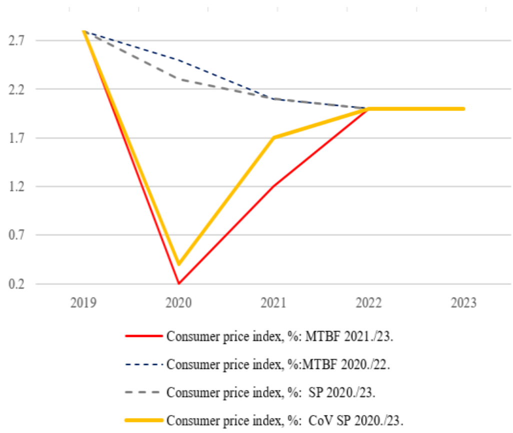

Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

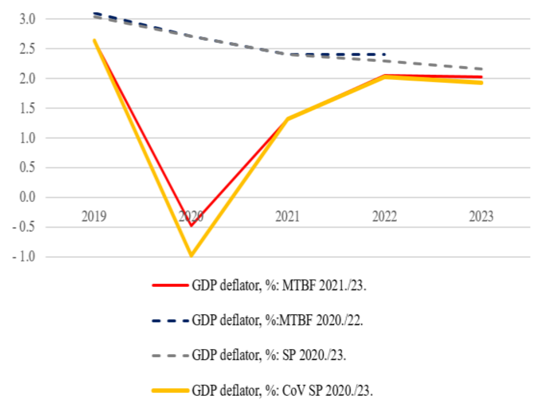

Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator forecast for the MTBF 2021/23. The GDP deflator forecast has changed compared to the April 2020 forecast for 2020, where it has been revised upwards by 0.5 percentage point and by 0.1 percentage point for 2023. (Chart 4), thus indicating the warming-up of the Latvian economy. Deflator for 2021, 2022 remains the same. (Chart 3).

The Council endorses the potential GDP growth forecast for the MTBF 2021/23 with comments. In previous years1 Council noted, that the projected potential GDP growth over the eight-year period above the 3% threshold is high and there are factors driving down the potential GDP growth in Latvia in the long run as the economy converge with the EU average and the labour supply remains limited.
Since MTBF 2020.2022, the potential GDP has been reduced in two steps. The recalculation and reduction of potential GDP took place as a result GDP actual data revision by Central

[1] https://fiscalcouncil.lv/15102018-macroeconomic-forecast-endorsement

Statistical bureau in autumn 2019, the results of that revision is reflected in the macroeconomic forecasts of the SP 2020-2023. The second revision and reduction of potential GDP took place for the macroeconomic forecasts for MTBF 2020-2023. Since the previous of macroeconomic forecasts for SP, potential GDP growth has been revised and down-warded for long-term period from 2012-2023. See table 3.

Forecasts for budgetary framework	Period	10 year average potential GDP	Changes
MTBF 2020/21	2016-2026	3.1	-
SP 2020/2023	2017-2027	2.8	-0.3
MTBF 2021/2	2017-2027	2.6	-0.2

Table 3. Changes of 10-year average Potential GDP growth rates

The potential GDP growth forecast has changed compared to the April 2020 forecast for 2020, and has been down-warded for all forecasting period as following: 2020 -0.5%p.; 2021 -0.4%p; 2022 -0.3%p; 2023 -0.4%p. (See chart 5).

The Council endorse the output gap forecast for the MTBF 2021/23, with the comments. The Council appreciate the assessment of the growing output gap beyond 2020, as well as the upward adjustment of the output gap compared to the SP (CoV) 2020/2023 forecast. The Covid-19 outbreak leaded to sharp global and national economy slowdown. The economy is moving to the lowest point of the business cycle, which inevitably leads to fiscal stimulus measures. For MTBF 2021/23 planning, the updated output gap provides the possibility of additional fiscal easing, but at the same time raises excessive expectations about the scope for fiscal expansion in the long run. See Figure 6.

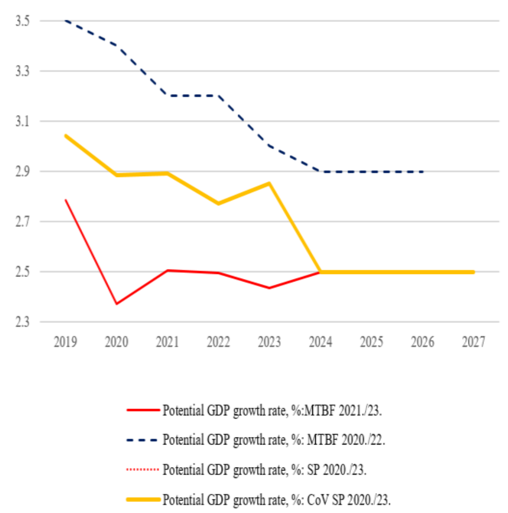

Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

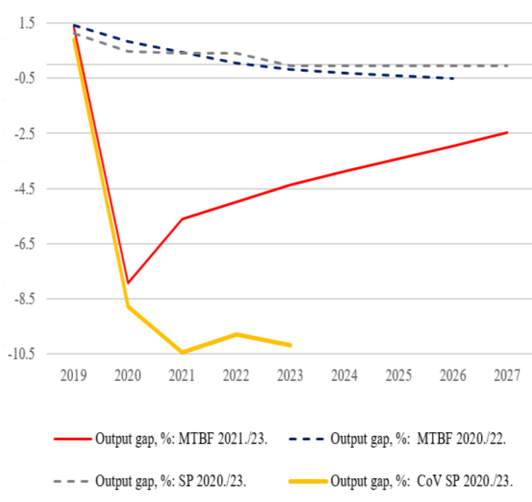

Chart 6 Output gap, % of potential GDP. Data source: MoF.

Summary

The Council approves macroeconomic forecasts to support the development of MTBF 2021/23, while underlining existing risks to long-term instability.
The Council is aware that the calculation of the potential GDP-output gap is challenging in the current highly volatile context. The Council welcomes the conservative assumptions regarding the level of potential GDP. Analyzing the sharp increase in the output gap in 2021, as well as its increase in 2022 and 2023, we see that the MoF reflects the V-shaped recovery scenario and the assumption that no potential significant risks will fulfill. The Council emphasizes that the scenario of a lasting negative output gap is rather risky, as it could lead to unjustified

expectations of available fiscal space in the coming years. The Council keep in mind, those calculating expenditure ceilings, and the medium term objectives is tested by the Stability and Growth Pact's balance rule scenario as well as against the expenditure growth rule, where the expenditure ceiling depends on 10-year average potential GDP growth, but does not exclude risks, associated with the effects of persistent negative output gaps.

The Council considers that the size of the fiscal stimulus should be adequate and proportionate to the actual damage caused by Covid-19. Given that projected real productivity growth in the coming years is volatile compared to SP (CoV) 2020/23 and insufficient to deliver strong economic growth, there is a lack of justification for planed investment in warming up the economy. If productivity growth, which will boost economic growth, is not promoted in the future, unpopular expenditure restraint policies may be needed after generous economic stimulus. The Council considers that maintaining the output gap in the negative range over time is not justified and will encourage excessive fiscal stimulus measures in the long run.

The Council welcomes short-term government support measures, but urges caution with regard to excessive deficit and debt growth in 2021 and coming years.

The Governing Council notes the inconsistency in leaving the government debt forecast unchanged since the establishment of the Stability Program 2020-2023, while updating the macroeconomic indicators framework for MTBF 2020/23. development.

Recommendations

1) Develop a scenario for reducing the government debt-to-GDP ratio as soon as possible and gradually returning to pre-Covid-19 levels.

2) Taking into account the rapidly changing situation in the world and in Latvia, it would be useful to carry out an operative revision of macroeconomic forecasts this year in the fall.

3) Revision of the potential GDP and output gaps closer to pre-Covid-19 levels is highly recommended at the period when economic environment recovers on the stabilization path.

	2020	2021	2022	2023
Real GDP growth	-7.0	5.1	3.1	3.1
Nominal GDP growth	-7.4	6.5	5.3	5.2
Inflation (consumer prices)	0.2	1.2	2.0	2.0
GDP deflator	-0.5	1.3	2.0	2.0
Potential GDP growth	2.4	2.5	2.5	2.4
Output gap	-7.9	-5.6	-5.0	-4.4

Table 4. Macroeconomic forecast indicators endorsed by the Council.