FISCAL DISCIPLINE COUNCIL OPINION ON MACROECONOMIC FORECASTS OF THE MINISTRY OF FINANCE

This document presents the opinion of the Fiscal Discipline Council (hereinafter - the Council) on the macroeconomic forecasts prepared by the Ministry of Finance (hereinafter - the MoF), which will be used for drafting Latvia's Stability Program (SP) 2020/23, which is scheduled to be submitted to the Cabinet of Ministers in mid-April 2020. An early review and endorsement of the MoF's macroeconomic projections by the Council have been agreed upon to support the preparation of the annual SP and the medium-term budget framework (hereafter – MTBF).

The Council considers that the MoF macroeconomic projections for the period 2020-2023 are realistic and acceptable, but points to a number of risks, in particular in 2021/22.

According to the Memorandum of Understanding, signed on 8 February 2016, the Council has a responsibility to endorse MoF's macroeconomic forecast. The Council assesses 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 granted access to the detailed data 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 the mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarized in Table 2 at the end of this document).

	2019	2020	2021	2022	2023
Real GDP growth					
MoF (Feb 2020)	**2.1**	**2.2**	**2.8**	**2.8**	**2.4**
BoL[1] (Dec 2019)	2.3	2.6	–	–	
EC[2] (Jan 2020)	2.1	2.3	2.4	–	
IMF[3] (Oct 2019)	2.8	2.8	2.9	3.0	3.0
Nominal GDP growth					
MoF (Feb 2020)	5.2	5.0	5.3	5.1	4.6
BoL (Dec 2019)	–	–	–	–	
EC[4] (Oct 2019)	5.7	5.0	4.9	–	
IMF (Oct 2019)	5.7	5.2	5.3	5.2	5.1
Inflation					
MoF (Feb 2020)	**2.8**	**2.3**	**2.1**	**2.0**	**2.0**
BoL (Dec 2019)	2.8	2.4	–	–	
EC (Jan 2020)	–	2.3	2.2	–	
IMF (Oct 2019)	3.0	2.6	2.3		
GDP deflator					
MoF (Feb 2020)	**3.0**	**2.7**	**2.4**	**2.3**	**2.2**
BoL (Dec 2019)	–	–	–	–	
EC[5] (Oct 2019)	3.1	2.3	2.2	–	
IMF (Oct 2019)	–	–	–	–	
Missing difference					
MoF (Feb 2020)	**1.1**	**0.5**	**0.4**	**0.4**	**0.0**
BoL (Dec 2019)	–	–	–	–	
EC (Oct 2019)	2.2	1.4	0.8	–	
IMF (Oct 2019)	–	–	–	–	

Table 1. Forecasts for the main macroeconomic indicators of the various institutions,%. Data sources: MoF, BoL, EC, IMF.

The MoF's forecast of real GDP growth for 2020 is conservative and largely in line with the European Commission's (hereinafter - EC) estimates. At the same time, it is by 0.4 %p. lower than the real growth forecast of the Bank of Latvia (hereinafter - BoL) and by 0.6 %p. lower than forecast of the International Monetary Fund (hereinafter - IMF) forecasts. See Table 1.

The forecast for nominal GDP growth is 5.2%, in 2020, which is by 0.5 %p. lower than EC and IMF forecasts.

The inflation rate forecast for 2020 is conservative and

[1]Bank of Latvia, Latvijas Bankas Prognozes [18.12.2019], available: https://www.bank.lv/darbibas-jomas/monetaras-politikas-istenosana/prognozes, accessed on 12.02.202020.

[2]European Commission Winter 2020 (Interim) forecast. available: https://ec.europa.eu/info/sites/info/files/economy-finance/ecfin_forecast_winter_2020_statistical_annex_en.pdf, accessed on 13.02.2020

[3]International Monetary Fund, IMF World Economic Outlook Database, October 2019 available: https://www.imf.org/external/pubs/ft/weo/2019/02/weodata/index.aspx, accessed on 12.02.2020

[4]Macroeconomic database AMECO: Gross domestic product at current prices (UVGD) (National currency) available at: https://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, accessed on 13.02.2020.

[5]European Commission Statistical Annex of European Economy Autumn 2019, available: https://ec.europa.eu/info/sites/info/files/economy-finance/saee_autumn_2019_en.pdf, accessed on 12.02.202020.

consistent with EC data- and is lower than forecasts by BoL and the IMF.
The forecast for the output gap has been revised and downgraded compared to the forecasts approved in June 2019, which were taken as the basis for the development MTBF 2020/2021. Compared with forecasts for MTBF 2020/21, the output gap for 2020 has been reduced by 0.4 %p., the forecast for 2021 remains unchanged, but the forecast for 2022 raised by 0.4 %p. Compared to the EC assessment for 2020, the MoF's forecasted output gap is lower by 0.9 %p.
According to the MoF analysis, the main factor influencing the change in the output gap is related to the "base effect", as the Central Statistical Bureau of Latvia significantly revised the GDP time series until 2018 (especially 2017 and 2018), as well as slower GDP growth in 2019. The outturn for 2019 was lower than previously projected, thus also affecting the assessment of potential GDP and the output gap for subsequent periods.

The Council agrees with the MoF's analysis that the strong effects of the economic slowdown in 2019 will continue in 2020, but at the same time, the Council is cautious about the projections for 2021 and 2022.

The MoF links economic stabilization and GDP growth in the coming years (2021 and 2022) to the increase in investment and government consumption that is projected and included in the medium-term budget. The MoF expects that the contribution of private consumption and net exports to GDP growth will be stable in these years. In the coming years, growth will be driven by both private and government consumption, and in 2021, growth will be driven by faster investment growth as an active period on the Rail Baltic project begins.

The Council wishes to highlight the global and local risks that may reduce economic growth in the coming years, especially in 2021/22, which should be taken into account in the sensitivity analysis of macroeconomic development scenarios:
1) For the second year in a row, the winters in Latvia are warmer than normal. This has an impact on the performance of the energy market and the forestry sector. It is expected that this trend will continue and will have a negative impact on economic growth in Latvia in the coming years.
2) Regarding 2022, the volume of public investment may decline following the downturn in the absorption of EU funds. One may expect that the confidence in the construction sector is likely to go down as early as in 2021, as the construction industry will be waiting for signals of the start of the next EU funding cycle.
3) The downturn of the freight volume in transit sector, which began in 2019, may continue in 2020-2022, especially in the port segment, as freight operators have already invested in shifting freight flows to other ports, and additional costs for the reorientation of freight flows would create undesirable costs.
4) The commercial banking sector in Latvia has demonstrated very low lending activity, and non-residents currently meet difficulties in opening and managing accounts. Further consolidation in banking sector is also possible and creates an additional risk.
5) The beginning of 2020 marked a new unpredictable risk of a coronavirus (COVID-19) epidemic, which has already had a negative impact on global economic performance in 2020.
6) The previously indicated risks also remain important, including uncertainty about China's relations with its trading partners, including the EU and the US, and the final agreement on Brexit.

In assessing the MoF forecasts for Latvia's economy, the Council compares international forecasts and follows global growth forecasts, which show similar trends as in Latvia. The Council notes that although international organizations are adjusting their economic forecasts downwards, they nevertheless envisage medium-term recovery. According to the IMF forecast of January-2020, the

global output[6] compared to October-2019 forecast decreased by 0.1% p. for 2019, and by 0.2% p. for 2020, 2021. Thus, for the global economy, the IMF forecasts GDP growth of 2.9% in 2019, 3.3% in 2020 and 3.4% in 2021.
The European Central Bank (ECB)[7] projects growth for the euro area countries of 1.1% in 2020 and 1.4% in 2021 and 2022. ECB notes that factors, which will contribute to the medium-term stabilization of the economy from 2021 onwards, include sustained consumer sentiment, a continued favourable situation in labour market and the start of the ECB's accommodative monetary policy stance. In addition, a number of conditions of global uncertainty (China-USA trade tensions, Brexit, electoral period in USA) expected to normalize.

The Council expresses its opinion on the forecast of real GDP growth for SP 2020/23 and notes that real GDP growth in 2020 has been reduced by 0.6% compared to the previous forecast of June 2019 (MTBF 2020/22), and projected at 2.2%, the forecast for 2021 and 2022 remains unchanged at 2.8%, while the growth rate in 2023 is forecasted at 2.4%. (Figure 1).

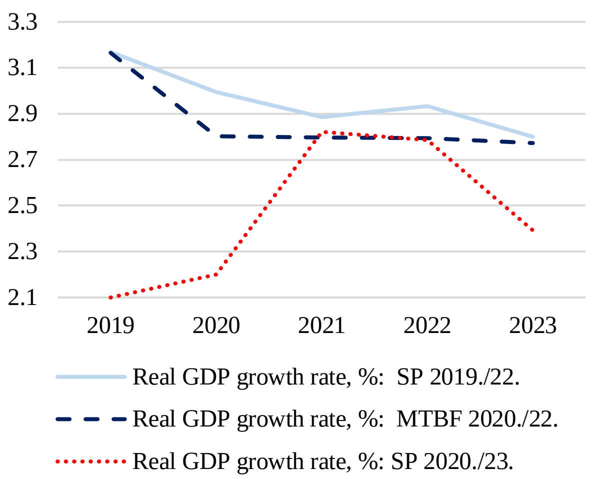

Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

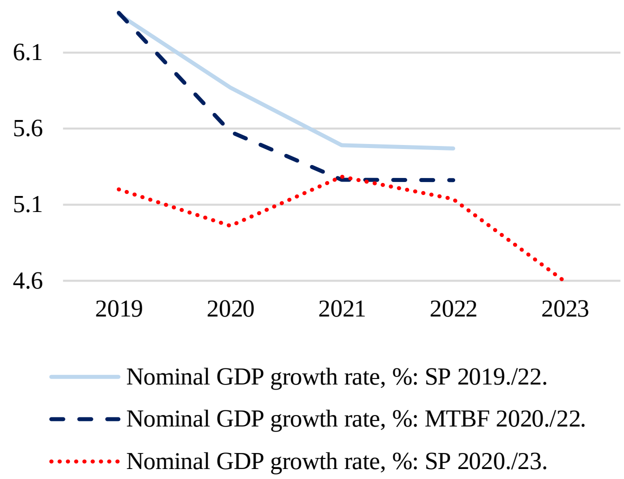

Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council expresses its opinion on the nominal GDP forecast for SP 2020/23. Compared with the projections for MTBF 2020/2022, the nominal GDP forecast for 2020 has been revised downwards by 0.6% p, the forecast for 2021 remains unchanged and for 2022 it has been revised down by 0.1% p. MoF forecasts that GDP will reach 37'269 million EUR by 2023. Overall, GDP growth at current prices projected to be on average 5% over the medium term (Chart 2).

The Council expresses its opinion on the CPI forecast for SP 2020/23. Compared to the MTBF 2020/2022 projections, the CPI projection for 2020 has been slightly revised downwards by 0.2 percentage points. Average gross wage growth in 2020-2023 is projected to be stable at an average of 5.4%, which will be a stimulating factor for private consumption (Figure 3).

[6] IMF World Economic Outlook 2020 Jan., available:
https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020, accessed on 12.02.2020.
[7] European Central Bank, Eurosystem staff macroeconomic projections for the euro area, December 2019 available:
https://www.ecb.europa.eu/pub/projections/html/index.en.html, accessed on 12.02.2020.

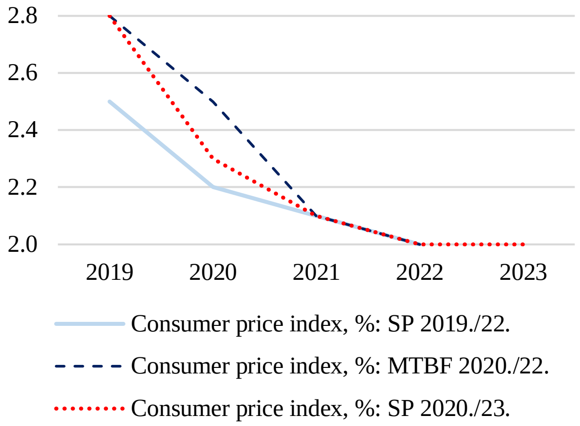

Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

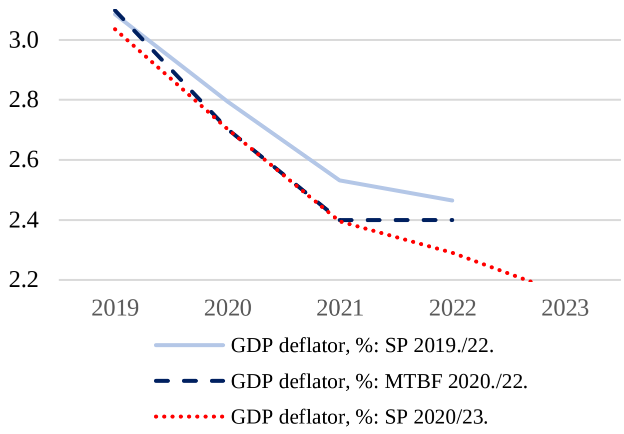

Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council expresses its opinion on projection of nominal GDP deflator for SP 2020/23. The forecast remains unchanged from MTBF 2020/22 for 2020 and 2021 and is reduced by 0.1% for 2022. (Figure 4).

The Council expresses its opinion on the projections for potential GDP and the output gap SP 2020/23. Compared to the MTBF 2020/22 projections, potential GDP growth has been revised down by 0.5%p. for 2020, by 0.3%p. for 2021, and by 0.4% p. for 2022. Potential GDP growth in 2023 is forecasted at 2.9% (Figures 5, 6).

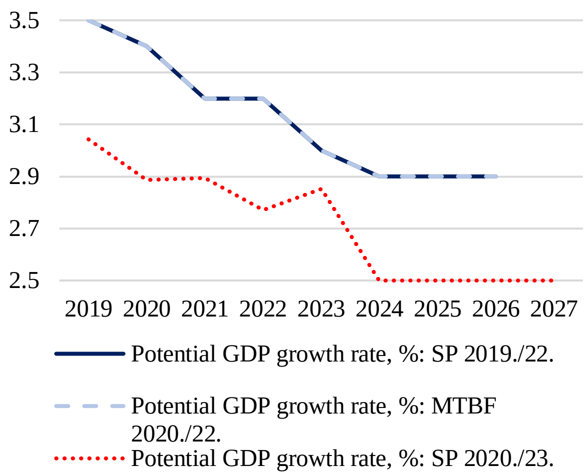

Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

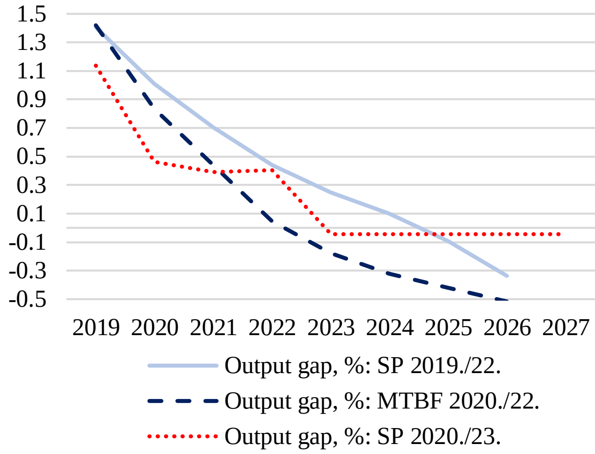

Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2019	2020	2021	2022	2023
Real GDP growth	2.1	2.2	2.8	2.8	2.4
Nominal GDP growth	5.2	5.0	5.3	5.1	4.6
Inflation (consumer prices)	2.8	2.3	2.1	2.0	2.0
GDP deflator	3.0	2.7	2.4	2.3	2.2
Potential GDP growth	3.0	2.9	2.9	2.8	2.9
Output gap	1.1	0.5	0.4	0.4	0.0

Table 2 Macroeconomic forecast indicators endorsed by the Council.

Overall, the Council considers that the MoF macroeconomic projections are realistic and plausible.

The Council conducts quarterly macroeconomic observations and incorporates them into the Latvian economy cycle heat map (available online at https://fiscalcouncil.lv/cycle-heatmap), which allows to observe the key economic cycle indicators. According to the currently available data (3rd quarter of 2019), despite the slowdown in 2019, the Latvian economy still maintains growth inertia, keeps high employment and strong demand for labour, as wage convergence to average levels in the EU continues in both the private and public sectors, and capacity utilization remains high. Price inflation remains low, but has been rising steadily since 2010. According to EUROSTAT, core inflation was 2.4% on average in the third quarter of 2019. Lending remains weak and banks are cautious expanding lending to residents and non-residents of Latvia.