• Latvia is one of the low-debt countries in Eurozone. However, the Council has repeatedly pointed out and still emphasizes that in the previous years of fast economic growth, the fiscal policy was not sufficiently counter-cyclical.

• The Council welcomes the country's responsible fiscal policy in 2019. Preliminary data for 2019 indicate fiscal targets have been achieved: the general government budget deficit is 0.2% of GDP, instead of the planned deficit of 0.5% of GDP.

• The stable fiscal policy in allowed the Treasury to borrow on the international financial markets on favourable terms in the crisis.

• In conditions of uncertainty, the growth scenarios of the euro area and individual member states, including Latvia, differ sharply. The IMF forecasts a 7.5% contraction in the euro area economy in 2020; ECB is even more pessimistic and forecasts contracting up to 15%. Latvia's economic development scenarios are also different. The IMF forecasts the most pessimistic forecast for the Latvian economy, with GDP falling to -8.6% in 2020. The Bank of Latvia has forecast a decline in the Latvian economy to -6.5%, with a comment that forecasts may worsen; Swedbank economists have forecast a decline in GDP to 5.8%. The forecasts are based on the assumption that the Covid-19 outbreak and quarantine restrictions will end after the second quarter of 2020.

• The Council supports the need to develop a number of macroeconomic scenarios, as the current uncertainty calls for a change in dynamics and an understanding of the fiscal consequences of a prolonged recession.

• The Ministry of Finance responded adequately to the rapidly changing situation and changed its medium-term forecasts accordingly. In the autumn of 2019, the Medium-Term Budget Framework Law (MTFL-2020/2022) was adopted, which envisaged GDP growth of 2.8% in 2020. In February 2020, the Stability Program Baseline Scenario (SPBS) was developed, which projected a lower GDP growth of 2.2%, but the consequences of the global pandemic had not yet been assessed. The SPBS is based on macroeconomic forecasts prepared and discussed by the Fiscal Discipline Council on 11 February 2020. As the crisis unfolded, the Covid-19 Stability Program (SPCoV) scenario was developed, which predicts economic contraction and includes government decisions to mitigate the effects of the pandemic and support the economy, but does not yet include government decisions in the context of the 2021 state budget. During the development of the stability program, the MoF presented the SPCoV scenario to the Council. The Council's opinion was immediately forwarded to the officials of the Ministry of Finance, as well as included in the section of this report on the procedure for updating macroeconomic data.

• In view of the rapid development of the Covid-19 crisis, the Council considers that the baseline scenario of the Stability Program, developed in February 2020, is no longer relevant, as economic indicators continue to deteriorate sharply from February to April. Consequently, the Council bases its judgments on the SPCoV scenario.

• Upon receipt and assessment of the Stability Program 2020/23 estimates of the allowable Structural Balance derogation in 2021, in accordance with the provision of the third paragraph of Article 12 of the FDL, the Council notes the following:

• The MoF used the Baseline Scenario (SPBS) when preparing the Stability Program and in particular the calculation of the structural balance deviation in 2021, forecasting a structural balance of -1.6% of GDP in 2021, while the deviation from the balance condition is allowed in the amount of -1.1%. Assuming MTFL-2020/2022 as a valid regulation, the calculated allowable structural balance would be -0.3% of GDP in 2021, while the law stipulates the balance in amount of -0.5%

The Council sees shortcomings in both calculation options because:

1. When comparing the baseline scenario (SPBS) with the SPCov scenario, it should be noted that there are shortcomings in estimating the potential GDP and output gap in the SPCov scenario.

2. Compared to the SPBS, the scenario MTFL-2020/2022 is even more outdated and the SPBS had the possibility to take into account the actual tax revenues in 2019.

3. Comparing the MTFL 20/22 and SPCov scenarios and without making an adjustment for the taxes actually collected in 2019, a smaller percentage decrease in revenue in 2021 is obtained (-3.9% vs. -5.1%) - therefore, the structural balance becomes completely different.

4. Considering that Article 12 of the FDL is used for the first time, when developing the next MTFL 2021/2023, a discussion with the Ministry of Finance would be required- on developing a common methodology for calculating the derogation.

• The Council welcomes the commitment made in the Stability Program to align with the Council the size of the derogation (in the context of Article 12, paragraph 3 of the FDL), when drafting the medium-term budgetary framework law in autumn 2020. Thus, the structural balance and the permissible deviation from it of year 2021 and the following years will be re-examined and agreed in the Council when drafting MTFL 2021/2023.

• The Council sees significant gaps in the assessment of potential GDP that they need to be addressed before starting work on the next MTFL 2021/2023. At present, considering the high level of uncertainty about future economic developments, the estimates of potential GDP proposed by the MoF are considered as technical assumptions that require adjustment and further coordination with the Council.

• The Council emphasizes the need to review the estimates potential GDP calculation by adjusting it to the long-term trend and addressing the deficiencies in regard of the ex-post assessment of the structural balance and the cyclical component, which are essential for meeting the requirements of Article 11 of the FDP.

• Examining the fiscal numerical conditions (expenditure ceiling), the strongest is the balance condition, which provides for a maximum allowable expenditure of EUR 10,436.7 million for 2021, EUR 10,619.0 million for 2022, and EUR 11,026.1 million for 2023. However, considering that the Council has expressed doubts about the reliability of potential GDP estimates, it is considered that the calculation cannot be used as a basis for developing MTBF 2021/2023 until the MoF and the Council have reached an agreement on the assessment of potential GDP.

• Compared to MTFL-2020/2022, expenditure will increase by EUR 53.5 million in 2021, but budget consolidation of EUR 175.8 million is expected already in 2022, which indicates the Government's commitment to stimulate economic development during the crisis and rapidly reduce expenditures at the end of the crisis period. Given the limited predictability of the situation, it must be assumed that the estimates in particular for 2023 are currently of a technical nature.

• In previous years, when the economy was growing rapidly, public debt was not significantly reduced, and the practice of adopting a budget with a deficit was implemented in a pro-cyclical manner. Although debt level in Latvia is relatively low, the government had committed to continue reducing debt in MTFL 2020/2022, this commitment is currently not feasible. It is also unknown at this time how long the effects of the Covid-19 crisis will continue, but already in 2020 it is expected that general government debt level will only be separated by 8.3% from the Maastricht criteria- 60% of GDP. In the coming years, the situation will deteriorate and the gap will be 7.8% until the 60% threshold in 2021, 6.7% in 2022, and 6.9% in 2023. It should be noted that with the deteriorating economic situation and falling GDP, there is a serious risk of exceeding this threshold, which will be followed by a threat to fiscal sustainability, the deterioration of Latvia's credit rating and possible adjustments within the SGP.

• The Council considers the fiscal outlook to be more optimistic than the macroeconomic dynamics. The Ministry of Finance expects GDP to grow by only 1% in 2021, but the budget deficit will reach a significantly lower level compared to the previous year - around 5% of GDP. This could be partly explained by the government's plans not to have support measures in 2021, and the planned fiscal consolidation measures, if they will form part of the crisis exit strategy. In turn, the share of general government debt of GDP in 2021, compared to the previous year, will increase insignificantly - from 51.7% to 52.2%, which could be explained by the fact that companies will partially repay the debts accumulated in the crisis. However, the Council points out that from 2021 onwards, the forecast of budget revenue and expenditure, deficit and government debt is of a technical nature and will need to be adjusted.

• In assessment of the Stability Program as a whole, the Council conclusions are as follows.

• The crisis caused by Covid-19 will have a negative impact on the country's economy and fiscal position in 2020 and beyond. The European Commission has suspended the fiscal framework of the SGP during the crisis and adopted a temporary framework that will allow Member States to make maximum use of the flexibility provided by state aid rules to support the economy in the wake of the coronavirus outbreak.

• As a result of the crisis, four aspects of the functioning of the economy are successively threatened:

1. The liquidity crisis of companies, because of restrictions and rapid reduction in demand;

2. The economy is experiencing supply shocks due to disruptions in raw material supply chains;

3. A second demand shock is gradually emerging, as both export markets are shrinking as economic activity in the world shrinks and the capacity of the internal market is declining because of declining personal and business incomes. Due to the uncertainty and increasing risk of recession, investment projects are cancelled or postponed;

4. If the established economic stabilization mechanisms are not effective or insufficient, a crisis in the financial sector can emerge, which is causes massive bankruptcies, which results

in a lack of capital in the banking sector.

• It is important to take measures to reduce the above-mentioned risks. The priority and challenge of the country's current economic policy is to stimulate the economy and maintain economic capacity, while maintaining the medium-term sustainability of public finances and gradually returning to a fiscally sustainable budget.

• In general, the Council supports the government's program of support measures, it suggests the government to carefully evaluate further support measures size. For comparison, the cost of support measures for Estonia and Lithuania is currently 4.1% and 5% of GDP, respectively, while Latvia's support is 3.4% of GDP[1].

• The Council draws attention to the need to plan, in a timely manner, measures to reduce the budget deficit in the post-crisis period, already assessing priority and sustainable sectors. When envisaging consolidation measures as part of the exit strategy, it is important to implement measures to improve the tax system and administrative-territorial reform, one of the goals of which must be to reduce administrative expenses.

• The government has to continue fiscal risk monitoring and management, especially risks arising from Obligatory electricity purchase component, state companies financial situation worsening, and developments in the financial sector.

• The Council notes that no rapid economic recovery is expected. Depending on the depth and duration of the crisis, the structure of the Latvian economy may change significantly. It can already be predicted that IT companies, drug manufacturers, and leaders in innovative technologies will strengthen. There will be a change in public behaviour, incl. wider use of e-services, use of remote work opportunities, etc. Industries that will prove viable even in times of crisis will be drivers of future development. At the same time, with the economic support from the government, sectors that have been completely halted by the crisis, such as air transport, tourism and related businesses, which must play a key role in growth, must be maintained. The Council will continue to carefully analyse the implications of fiscal policy and its relevance to the rapidly changing economic situation.

[1] Lithuanian and Estonian FDC information as of April 23, 2020. Information about Lithuanian support program available here: https://finmin.lrv.lt/uploads/finmin/documents/files/EN_ver/ACTION%20PLAN%20FOR%20ECONOMIC%20STIMULUS%20AND%20MITIGATION%20OF%20CONSEQUENCES%20OF%20CORONAVIRUS%20(COVID-19)%20TRANSMISSION%20.pdf, accessed: 26/04/2020