Latvia

Country note, May 2019

FISCAL DISCIPLINE COUNCIL
OF THE REPUBLIC OF LATVIA

Key messages:

- **The Government assesses 2018 as the peak of the economic cycle and the slowdown in the economy has been assumed approaching, while hot spots become more visible in the Latvian economy.**
- **The deterioration in the structural balance in 2018 compared to 2017 reflects insufficient counter-cyclical effort to meet the national fiscal discipline requirements.**
- **The Fiscal Council advises to revise the medium term fiscal scenario and opposes the treatment of the cost of tax reform not as a one-off measure instead of discretionary reduction in tax revenue.**

Macroeconomic outlook

Latvia's Stability Programme 2019-2022 highlights 2018 as the peak of the cyclical development of the economy and expects slowdown in economic growth during subsequent years.

Warming up the labour market is a good indicator of the cyclical nature of the economy (see Chart 1) – unemployment is falling, employment is rising, and the number of vacancies is increasing. When the construction sector enters the hot spot also in weaker regions, unemployment is falling. The rise in wages, which is faster than inflation, contributes to an increase in real purchasing power, which helps improving of the migration balance.

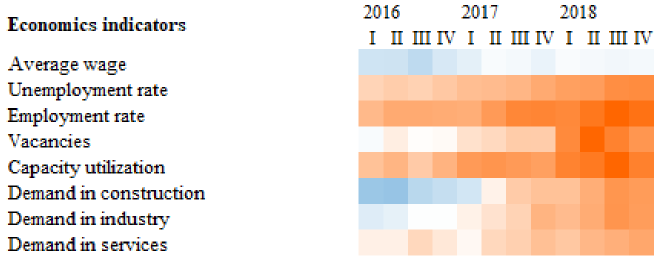

Chart 1. Latvian economy cycle heatmap, 2016-2018. Source: https://fiscalcouncil.lv/cycle-heatmap

Short-term fiscal outlook

The general government headline deficit reached 1.0% in 2018, suggesting a significant easing of fiscal policy compared to 2017, when the deficit was 0.6%. The structural balance in 2018 is assessed 1.7% according to the national framework, which further confirms weaker Latvia's fiscal performance against the Fiscal Discipline Law (FDL) requirements.

Most years since 2013 the Latvian government has not been able to meet the established fiscal targets (see Chart 2). 2019 budget envisage improved structural balance compared to 2018, while does not yet reach MTO (medium-term objective) established in FDL.

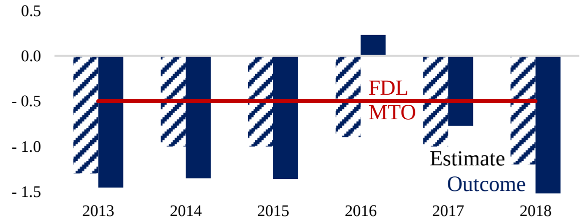

Chart 2. Structural balance level and medium-term objective (MTO, in %% of GDP). Source: Ministry of Finance and Fiscal Council calculations.

Medium-term fiscal outlook

Latvia's Stability Programme for 2019-2022 aims at fiscal consolidation, while the pressure to increase government expenditure continues. The fiscal conditions continue experiencing constraints resulting from a tax reform launched from 2018 resulting into a decline of the tax burden (see Chart 3), while aiming at improved conditions for savings of businesses and reduced income tax burden for low wage earners. Political parties forming the Government coalition have postponed revision of the tax policies beyond 2020, while criticizing different aspects and outcomes of the tax reform. Meanwhile, complicated conditions in the labor market and elevated expectations continue in the government sector despite negative outlook for resources available to augment compensation.

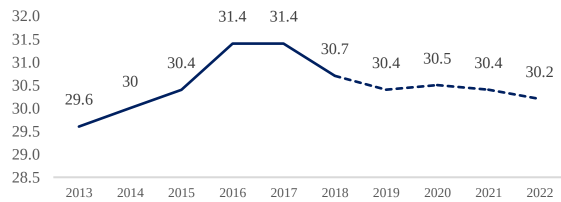

Chart 3. Tax-to-GDP, % of GDP. Source: Eurostat, 2013-2017, Latvia's Stability Programme 2019-2022 .

Fiscal framework and national fiscal rules

The Council objects the Government plans to apply the tax-reform effects as one-off measure for the purposes of applying the fiscal rules for 2020. The Council believes that the effort of fiscal consolidation towards the MTO for the structural deficit defined at -0.5% to GDP according to the FDL should be stronger after several years of significant fiscal easing.

The level of general government debt remains at 40% (see Chart 4) despite favourable economic conditions, and the Council finds the effort to create safety cushion insufficient. This would be particularly important to counter the ageing risks and the consequences of strong outward migration of significant portion of the population.

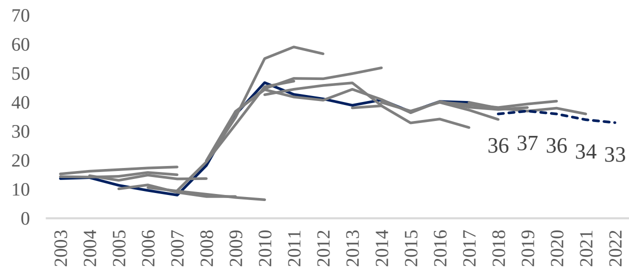

Chart 4. General government debt: forecasts and outcome, % of GDP. Source: Eurostat, 2003-2017, Treasury: 2018-2022.

Key indicator forecast

		2019 forecasts	2020 forecasts	2021 forecasts	2022 forecasts
Real GDP growth	[% y-to-y]	3.2	3.0	2.9	2.9
Nominal GDP growth	[% y-to-y]	6.4	5.9	5.5	5.5
Inflation	[%]	2.5	2.2	2.1	2.0
GDP deflator	[%]	3.1	2.8	2.5	2.5
Potential GDP growth	[% y-to-y]	3.5	3.4	3.2	3.2
Output gap	[% of GDP]	1.4	1.0	0.7	0.5

Source: Macroeconomic forecast endorsement, February 2019. Available: https://fiscalcouncil.lv/15022019-macroeconomic-forecast-endorsement