

Key messages:

- Economic growth has slowed in 2019 and GDP growth projections for the coming years are cautious. Weaker economic prospects will require scrutiny of the fiscal projections adopted under more optimistic growth conditions.
- The Tax reform passed in 2017 has resulted into lower tax revenues and difficulties to meet expenditure commitments, while the positive impact on the economic performance is still to be assessed.
- The Council finds the fiscal framework for 2020-2022 compliant with the fiscal rules, except for the deviation due to the tax reform from the fiscal targets.

Macroeconomic outlook

Economic growth in 2019 has slowed compared to optimistic projections earlier. Real GDP growth projections for 2019 have been revised by national, IMF and the EC experts downwards by 0.4-0.6 percentage points. The main reasons for the slowing economic growth have been the decrease in export volumes and investments, risks in the Latvian banking sector and the decrease of economic sentiment of Latvia's trading partners. Weaker economic prospects may require a fresh look at the feasibility of the fiscal projections prepared under more optimistic sentiment.

The Latvian economy still maintains growth inertia, keeps high employment and strong demand for labor, 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, while being highest since 2010. Lending remains weak and banks are cautious expanding lending to non-financial residents of Latvia.

Short-term fiscal outlook

Latvia's fiscal outlook has been adversely affected by the tax reform of 2017 with most negative fiscal impact in 2019 and 2020. Tax revenues lost around 1% of GDP per year and resulting fiscal stimulus in period of steady economic growth. Resulting revenue shortfall reduced the resources required to meet the expenditure commitments, mostly the salary increases in public sector to keep up with compensation growth in the rest of the economy. General government debt has been increasing in recent years, reflecting the practice of preparing budgets with deficits. At the same time in 2018 public debt ratio to GDP has declined reflecting strong growth of GDP. General government consolidated gross debt decreased in 2018 to 10.6 billion euros – by 0.2 billion euros or 1.8% compared to 2017.

Medium-term fiscal outlook

The commitment of the government to consolidate the fiscal position in 2019 and 2020-2022 is appreciated after engaging some fiscal stimulus measures in 2017 and 2018. Meanwhile, it should be noted that more contribution to reducing debt to GDP levels should have been achieved during high-growth stage of the economic cycle. Medium-term budget envisages achieving the structure balance objective in 2021 and 2022, while the effort on containing the expenditure growth not to exceed the growth of the potential GDP should be improved.

Fiscal framework and national fiscal rules

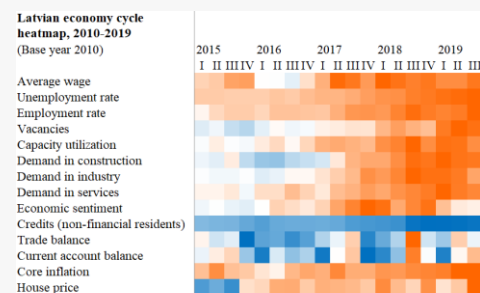
The Council, while reviewing the compliance with the numerical fiscal rules prepared by the Ministry of Finance, and agrees that the expenditure benchmark rule applies for 2020 as the tightest condition, and structural balance rules shall apply for 2021 and 2022. At the same time the Council estimates the expenditure ceilings for 2020 should have been set at EUR 94.6 million euro less than the budget. The Council finds that the numerical fiscal rule of debt limit of 60 percent of GDP may not be adequate for Latvia and a discussion should be initiated to adopt a debt anchor to guide the fiscal policy.

Key indicator forecast

		2019 forecasts	2020 forecasts	2021 forecasts	2022 forecasts
Real GDP growth	[% y-to-y]	3.2	2.8	2.8	2.8
Nominal GDP growth	[% y-to-y]	6.4	5.6	5.3	5.3
Consumer price index	[%]	2.8	2.5	2.1	2.0
GDP Deflator	[%]	3.1	2.7	2.4	2.4
Potential GDP growth	[% y-to-y]	3.5	3.4	3.2	3.2
Output Gap	[% of GDP]	1.4	0.8	0.4	0.0

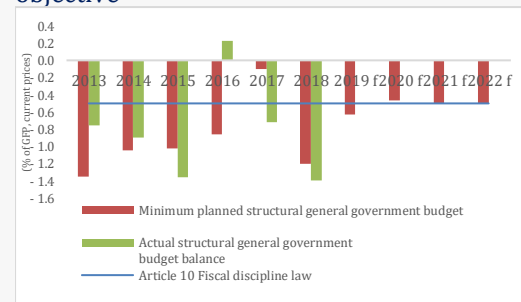
Source: Macroeconomic forecast endorsement, June 2019. Available: https://fiscalcouncil.lv/27062019_macro-economic_forecast_endorsement

Chart 1: Latvian economy cycle heatmap for the period 2016-2019



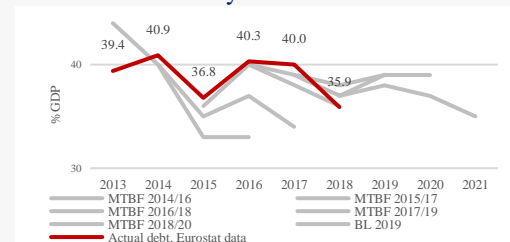
Source: <https://fiscalcouncil.lv/cycle-heatmap>

Chart 2: Structural balance level and medium-term objective



Source: Ministry of Finance and Fiscal Council calculations

Chart 3: GG debt dynamics % of GDP



Source: MTBF in period 2014-2019, BL 2019, Eurostat