SUMMARY

• The Fiscal Discipline Council assesses the Stability Program for years 2021/2024 in times of high uncertainty, when economic development and fiscal policy depend on the outcome of the fight against Covid-19. The fiscal indicators of the stability program are based on Macroeconomic forecasts of the Ministry of Finance approved by the Council on 15 February. However, the forecast will only come true if full economic functionality is regained in the second half of the year, which in turn depends on the rate of vaccination of the population.

• On 31 March 2021, the latest macroeconomic forecast of the Bank of Latvia (BoL) was published[1]. According to the BoL forecast, in 2021 GDP growth could increase to 3.3% (December 2020 forecast - 2.8%) and in 2022 - to 6.5%. However, the high level of uncertainty regarding compliance with vaccination rates and the achievement of mass immunity in the second half of 2021 is highlighted. Existing uncertainties and constraints affect investment decisions, household consumption and service provision. In the first half of the year, as constraints ease, the effect of deferred consumption will again be observed, as households actively use the accumulated financial resources.

• Compared to the forecasts of the Ministry of Finance, which were approved by the Council on 15 February, the Bank of Latvia's GDP forecast is higher by 0.3 percentage points in 2021 and 2% points in 2022, respectively. The inflation forecast of the Bank of Latvia is also slightly higher compared to the Ministry of Finance.

• The Ministry of Finance and the Bank of Latvia forecast economic growth in both 2021 and 2022. In the economic growth phase, budget expenditures in 2022 must be planned in such a way as to stimulate investment-based economic growth on the one hand, and on the other hand - to gradually begin the return to a balanced budget. *The government needs to develop a clear strategy on how to return to sustainable fiscal policy.*

• The Council notes the risks to the implementation of the macroeconomic forecast due to slow vaccination rates. On April 3, only 6.4% of the population in Latvia were vaccinated at least once. In comparison, 16.8% of the population in Estonia and 13.8% in Lithuania were vaccinated. *In conditions of high uncertainty, it is necessary to regularly update the macroeconomic and fiscal forecast in accordance with the current situation.* The Council welcomes the work of the Ministry of Finance in updating the forecasts in accordance with international practice.

• In the context of the economic crisis caused by Covid-19, the general escape clause of the EU Stability and Growth Pact was activated, which allowed to increase the general government deficit in 2020 and 2021. Consequently, the derogation provided for in Article 12 of the FDL was activated, allowing the 0.5% structural deficit target to be disregarded in both years. The EC anticipates that the fiscal conditions will not apply until at least 2023, but a final decision has not yet been taken.

[1] Available: Monetārā politika - Prognozes (bank.lv), accessed: 13/04/2021

• The fiscal policy provisions of the FDL are formally applicable to the annual and medium-term budget preparation process. The stability program does not require legally binding decisions on fiscal policy conditions for the coming years. However, a clear and coherent national and EU approach to the application of fiscal rules is needed before starting work on the annual and medium-term budgets.

• The Council welcomes the country's 2020 fiscal policy, which was developed in a difficult and highly uncertain environment. In 2020, GDP decreased by 3.6% - a much better result than forecasted by the Ministry of Finance in June last year (-7%). The relatively low decline in GDP had a positive impact on fiscal performance. The budget deficit reached 5.4% of GDP instead of the 7.6% forecasted in August; at the end of 2020, general government debt, according to preliminary estimates, reached 43.5% of GDP instead of the projected 47.3%. In general, considering the severity of the Covid-19 crisis, the macroeconomic figures of 2020 indicate that the government's economic stabilization goal, from a macroeconomic point of view, was achieved.

• The government's fiscal response to the Covid-19 crisis has been adequate in the first wave, but slightly delayed, excessive and less well targeted in the second wave[2]. Debt is projected to reach 49% of GDP in 2021 and 50% of GDP in 2022, while debt reduction is projected in 2023 (49% of GDP), symbolizing a gradual return to sustainable fiscal policy.

• The fiscal impact of state support measures on GGBB in 2020 is 1.1 billion euros, or 3.7% of GDP. The projected impact of the support measures on the GGBB in 2021 is currently € 1.8 billion, or 6.2% of GDP. The Council considers that the aid has already reached the required level and that no new aid measures are needed. The fiscal stimulus was largely provided through the Funds for Unforeseen events program. In general, based on the current fiscal forecasts the state support program may already deteriorate budget balance to -9.3% (2.85 billion euros) in 2021, instead of the planned 3.9% in VTBL2021 / 23. The Council notes that, in parallel with the large budget deficit, GDP growth is projected to be relatively low in 2021, at only 3%. The effect of the fiscal stimulus, which will promote the fastest growth, is expected starting from 2022.

• It should be noted that the crisis has a wide range of effects on various sectors of the economy, for example, the construction sector has even experienced growth in 2020. Consequently, the additional government stimulus of more than 200 million euros approved by the government[3] for the construction sector does not seem economically justified. Support measures must not be allowed to look increasingly politically rather than economically justified. New support measures might be needed in the second half of the year if the third wave of Covid-19 is to be significant.

• It is a positive and important fact that the support measures introduced in 2020 and 2021 should not have a significant impact on the budget balances of the following years, as the support measures are short-term and do not affect the budgetary base.

---

[2] FDC monitoring Nr. 12 available: https://fdp.gov.lv/files/uploaded/MZ12_Web.pdf, accessed 13/04/2021

[3] Informative report available: : http://tap.mk.gov.lv/lv/mk/tap/?pid=40499551&mode=mk&date=2021-03-18 accessed 13/04/2021

• Latvia still has one of the lowest debt levels in the EU. Stable fiscal policy in the crisis situation allowed the Treasury to borrow on international financial markets on favourable terms. Credit rating agencies Fitch and S&P Global ratings maintained Latvia's sovereign credit ratings at relatively high levels, despite the challenging fiscal conditions.

• Although the debt condition (60% of GDP) set in the Fiscal Discipline Law is not expected to be exceeded in 2021 or in the medium term, the Council wishes to point to the risk of inflation, which could jeopardize debt reduction plans. Although borrowing rates are currently very low, there is a risk that a rapid global economic recovery following the Covid-19 recession will lead to higher inflation and is likely to stimulate interest rate hikes, leading to higher debt refinancing costs.

• At the EU level, there is a discussion about the need to create a new fiscal regulation, which would also affect Latvia's fiscal regulation. However, if the regulation remains the same, the transition from operating without fiscal restrictions to the regime of fiscal discipline could be challenging - already in 2023, a significant negative fiscal space will be formed. Macroeconomic forecasts indicate that the potential and real GDP gap (output gap) are expected to converge in the coming years, so a long-term stimulus policy would not be justified. In addition, if real GDP exceeds potential (with output gap turning positive), it will be necessary to implement a budgetary adjustment mechanism in line with the requirements of Article 11 of the FDL. The Council notes that the requirements of Article 11 of the FDL regarding the application of the adjustment mechanism have entered into force, but are not currently applicable, as the output gap is still negative[4]. Considering both the entry into force of the correction mechanism and the fact that the consequences of the current stimulus policy will be actualized in 2023, when there will be no fiscal policy deviations, but the fiscal space will be negative (-298.3 million or -0.9% of GDP), it is necessary to anticipate the fiscal adjustment scenario now and take it into account when planning expenditure growth in the coming years.

• The Council welcomes the successful trend in the collection of tax revenues. In 2020, compared to the previous year, the revenue of the consolidated general budget decreased by only 0.76%, reaching 11.3 billion euros. The main source of revenue for the general budget - tax revenue in 2020 decreased by 0.56%, and the tax collection plan was fulfilled by 93.9%. Expenditure in the consolidated general budget in 2020 increased by 8.2%, reaching 12.7 billion euros. Given the depth of the Covid-19 crisis, the annual results of the consolidated budget revenue can be considered good.

• Restricting the shadow economy is an important precondition for meeting revenue, and in particular tax revenue targets. In the light of the lessons learned from the Covid-19 crisis, the government needs to pay particular attention to reducing the informal economy. As there is a high risk that some entrepreneurs, especially in the services sector, may choose to pursue their activities informally during the Covid-19 restriction period, special measures are needed to both reintegrate entrepreneurs from the informal economy to formal and stimulate those already exposed to informal economy risk to work legally.

[4] FDC opinion on Article 11 implementation: 23.12.2020. Viedoklis par Fiskālās disciplīnas likuma 11. panta izpildi (fdp.gov.lv) accessed 13/04/2021

• In the coming years, a large amount of financial resources will flow into the economies of Latvia and the EU countries from both the EU multi-annual budget and the Recovery and Resilience Facility (RRF). Timely and effective implementation of the RRF is one of the conditions for Latvia's economic recovery and in the coming years it will allow making significant investments in increasing economic productivity. It is also subject to several risks: the implementation of the plan may be delayed because of the Latvian side, but also due to external reasons, if all EU member states do not ratify the new EU instrument in time. There is also a risk that the measures in the RRF plan will not achieve their intended objectives or will be implemented ineffectively.

• The government should continue to monitor fiscal risks and manage risks wisely, in particular with regard to state aid, inflation and financial sector risks. There are risks that the implementation of the RRF program may be delayed and that its economic and fiscal impact may not achieve the intended objectives. Risks arising from the politically motivated desire to increase expenditures on support measures that have a weak connection with Covid-19 have to be considered, especially considering the planned Saeima elections in 2022.

• The Council calls for the expenditure already incurred and still planned to be viewed from the point of view of fiscal sustainability, and for the easing of the SGP exception clause to be seen as a degree of fiscal policy flexibility that must not escalate into fiscal permissiveness.