OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST

This document provides the opinion of the Fiscal Discipline Council (hereinafter - the Council) on the macroeconomic forecasts developed by the Ministry of Finance (hereinafter - the MoF), for the period 2021-2024, which will be used as a basis for the Latvian Medium-Term Budget Framework (hereinafter - MTBF) 2022-2024. (2022/24), which is planned to be submitted to the Cabinet of Ministers in October 2021. In order to support the work on the development of the annual documents – Stability Programme (hereinafter - SP), and Medium-Term Budget Framework an agreement was reached on early approval by the Council of the macroeconomic forecasts of the Ministry of Finance.

Through the Memorandum of Understanding, signed on 8 February 2016, the MoF has requested and Council has accepted a responsibility to endorse MoF's macroeconomic forecasts underpinning fiscal projections. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators, which are outlined below. During the endorsement process the Council presented detailed information 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 a mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarised in Table 2 at the end of this document).

At the Council meeting on 14 June 2021, the Ministry of Finance informed about the assumptions and changes in the updated macroeconomic forecasts.

	2021	2022	2023	2024
Real GDP growth				
MoF (Jun. 2021)	**3.7**	**5.0**	**3.5**	**3.4**
BoL (Jun. 2021)	3.3	6.5	3.6	–
EC (May 2021)	3.5	6.0	–	–
IMF (Apr. 2021)	3.9	5.2	3.9	3.2
Nominal GDP growth				
MoF (Jun. 2021)	**6.9**	**8.5**	**6.2**	**5.3**
BoL (Jun. 2021)	–	–	–	–
EC (May 2021)	–	–	–	–
IMF (Apr. 2021)	5.5	7.2	5.5	5.3
Inflation (CPI)				
MoF (Jun. 2021)	**2.0**	**2.4**	**2.2**	**2.0**
BoL (Jun. 2021)	2.0	2.9	2.0	–
EC (May 2021)	1.7	2.0	–	–
IMF (Apr. 2021)	2.1	2.2	1.9	2.1
GDP deflator				
MoF (Jun. 2021)	**3.1**	**3.3**	**2.6**	**1.9**
BoL (Jun. 2021)	–	–	–	–
EC (May 2021)	2.2	2.1	–	–
IMF (Apr. 2021)	–	–	–	–
Output gap				
MoF (Jun. 2021)	**-2.6**	**-0.5**	**-0.1**	**0.2**
BoL (Jun. 2021)	–	–	–	–
EC (May 2021)	-3.0	-0.2	–	–
IMF (Apr. 2021)	–	–	–	–

%. Table 1. Forecasts of the main macroeconomic indicators of various institutions, %.

The MoF's forecasts for real GDP growth in 2021 are more optimistic than the forecasts of the European Commission (hereinafter the EC) and the Bank of Latvia (hereinafter the BoL).

The MoF's forecasting approach in the current forecasting cycle is rather similar to the approach of the International Monetary Fund (hereinafter IMF), with a more optimistic assessment of the current 2021 in comparison, with other forecasters, to predict approx. by 1%p. slower growth in 2022.

The EC forecasts that Latvia's economic growth will resume in the second half of 2021 and in 2022, which will be positively affected by private consumption and investment - especially public investment related to the construction of Rail Baltica and the inflow of RFF plan investments into the economy.

The EC attributes the decline in the unemployment rate to the

expected labor shortage. Private consumption is currently supported by fiscal stimulus measure. It is expected that as soon as the epidemiological restrictions will be lifted and active consumption and economic functionality of the state will be resumed, Covid-19 time support measures will be offset by faster GDP growth. As external demand grows, a positive impetus is also expected for exports. At the same time, the EC points to a parallel increase in imports, which reduces the GDP result (see Table 1, Data sources: MoF[1], BoL[2] EC[3], IMF[4]).
According to the latest data published by the CSB in May, real GDP in the first quarter of 2021 was 6.681 billion. euro. Compared to the 1st quarter of 2020, it decreased by 1.2% of GDP (seasonally adjusted data), but compared to the previous quarter, the decline reached 1.7% (seasonally adjusted data). Compared with the first quarter of 2020, household consumption (-4.3%) and exports (-0.5) had the largest negative impact on GDP structure, while gross capital formation (3.4%) and government consumption (0.5%), give a positive effect. Changes in GDP by kind of activity, compared to the first quarter 2020 shows that the largest decreases were observed for accommodation and food services (-53.3%), arts entertainment and recreation services (36.2%), while the largest increases were observed for health and social care services (19.7%) and financial and insurance services (15.2%).
In Latvia, the performance in the first quarter was worse than in the fourth quarter of the previous year, and the fulfilment of the updated MoF Forecast is highly dependent on the performance in the second and third quarters, with domestic consumption intensity playing a major role. There are still a number of downside risks to GDP growth scenarios, but cautious optimism is possible. This is evidenced by the latest economic sentiment indicators, the growing activity of vaccination, the amount of private funds accumulated by the population and the interest in resuming active consumption.
CSB data indicate several positive signals at the beginning of the second quarter. In April 2021, compared to April of the previous year, the volume of industrial production according to calendar adjusted data at constant prices increased by 20.5%. The value of Latvia's exports in April increased by 33% compared to April 2020.
Business confidence indicators improved in May in all sectors except construction. Business sentiment is positive in the services sector, retail and industry.

At the same time, inflation volatility and a possible rise in heat and energy tariffs in the second half of the year are a cause for concern.
This can have a negative effect on the structure of household consumption as well as lead to a general rise in the prices of goods and services. Although consumer prices remained at the level of deflation in the first quarter (-0.1%), already in May the average consumer price level in Latvia, compared to May 2020, increased by 2.6%[5]. The large impact of such price increases is due to the general rise in fuel prices, which started in April. Globally, inflation is affected by supply chains instability caused by differences in post-crisis economic functionality resume of different countries. Economists also notes a global rise in raw material prices and foodstuffs prices as well as their raw materials.
The unemployment rate averaged 8.2% in the first quarter of 2021 and 8.3% in the same period in the last year. At the same time, wages increased by 9.5% in the first quarter. Surveys of employers conducted by the CSB show that the limitations of staff availability are increasingly mentioned as a business limiting factor. Changes in the qualification level of the unemployed have also been observed. Unemployment in the lower-skilled segment is rising, but the unemployment rate for higher-skilled workers is falling.

Since the adoption of the Stability Program 2021/24 in April 2021, the MoF has updated the forecasts of the main macroeconomic indicators for the period from 2021 to 2024.

[1] MoF forecasts: https://www.fm.gov.lv/lv/jaunums/fm-paaugstina-ekonomikas-izaugsmes-prognozes
[2] Press releases - Latvijas Banka has revised its macroeconomic forecasts for Latvia
[3] European Economic Forecast. Spring 2021 (europa.eu)
[4] International Monetary Fund, World Economic Outlook Database, (Apr 2021)
[5] Latvijā gada inflācija maijā sasniegusi 2,6% / Raksts (lsm.lv)

On the basis of past economic developments and the assumptions of the MoF underlying the forecasts, the Council has decided to approve the forecasts described below. **In general, the Council endorses all macroeconomic indicators proposed by the MoF, but emphasizes the need to analyse risks and further model stress scenarios.**

The Council endorses the real GDP growth forecast for MTBF 2022/24. compared with the previous forecast in February 2021, which was prepared for the development of the SP 2021/24. The real GDP growth rate has been raised by 0.7% points for 2021, raised by 0.5% points for 2022, and by 0.3% points for 2023. The real GDP forecasts for 2024 has been raised by 0.5% points. (see Chart 1).

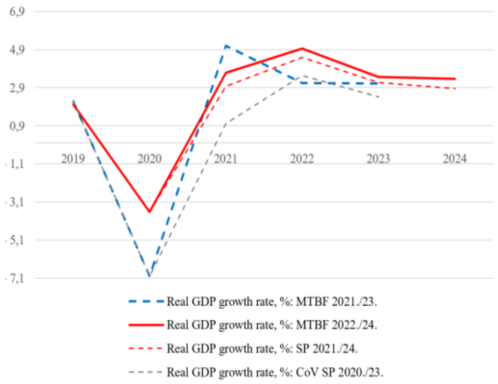

Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

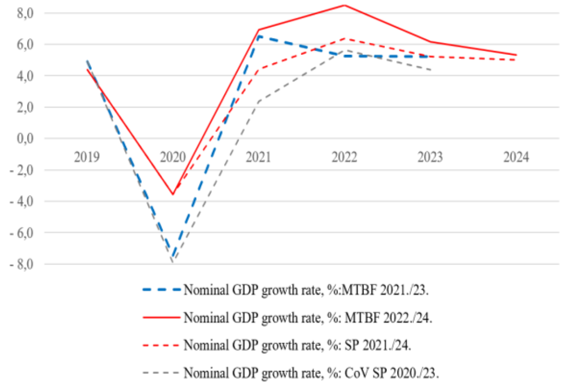

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

The Council endorses the nominal GDP growth forecast for MTBF 2022/24. Comparing to SP 2021/24, the MoF has raised the nominal GDP growth forecast for 2021 by 2.5% points and raised for 2022 by 2.1% points, forecasts for 2023 raised by 0.9% points. Nominal GDP growth forecast for 2024 has been raised by 0.3% points (see Chart 2).

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the MTBF 2022/24. In April, producer price inflation in Latvia already exceeded 5%. This suggests that consumer price inflation in Latvia will also exceed 3% in the second half of the summer. Worldly traded food prices are rising sharply, so consumer food prices will continue to rise. Globally, raw material supply chains are disrupted, raising producer costs, rising raw material prices and producers and service providers trying to make up for losses during a pandemic. All these circumstances suggest that inflation in 2021 may increase faster than currently forecast.
Comparing to SP 2021/24, for 2021 CPI forecast has been raised by 0.6 pp. The inflation rate forecast for 2022 has been raised by 0.4 pp, for 2023 by 0.2 pp points, but for 2024 it remains the same at 2% level (see Chart 3).

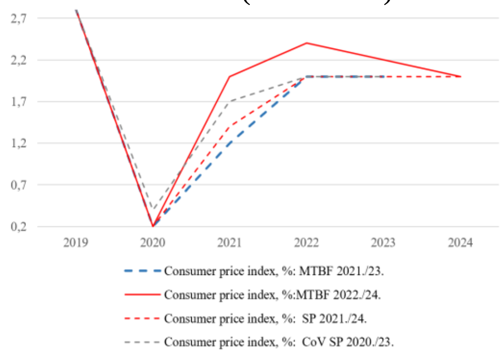

Chart 3 Forecast for inflation, y-o-y. Data source: MoF.

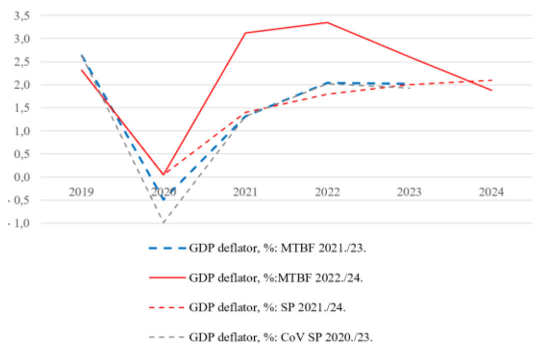

Chart 4 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council endorses the GDP deflator forecast for the MTBF 2022/24. The GDP deflator forecast has changed compared to the SP 2021/24, the GDP deflator forecast for 2021 has been corrected and increased by 1.7%p. The forecast for 2022 has been raised by 1.5%p. The deflator forecast for 2023 has been raised by 0.6%p., but for 2024 it has been reduced by 0.2%p. (see Figure 4).

The Council endorses the potential GDP growth forecast for the MTBF 2022/24. Compared to the previous forecast for SP 2021/24, the potential GDP forecast has been corrected and raised for the whole forecast period as follows: for 2021 by 0.1%p., for 2022 by 0.5 %p., for 2023 by 0.6%p., but for 2024 by 0.4%p. (see Figure 5).

The Council endorses the output gap forecast for the MTBF 2022/24. Comparing with the forecasts developed for SP 2021/2024, the value of the output gap has been increased for the whole forecast period, however, in the period from 2021 to 2023 it remains at negative rates. The forecasts for the following years have been changed as follows: the output gap for 2021 is estimated raising it by 0.4%p., for 2022 by 0.4%p., for 2023 by 0.1%p., and for 2024 by 0.2%p. (see Figure 6).

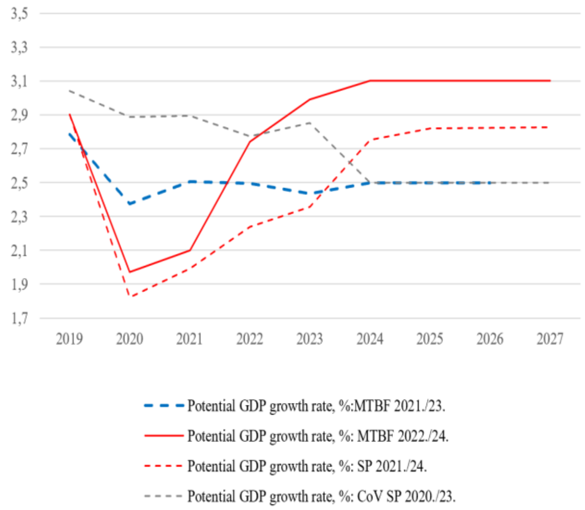

Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

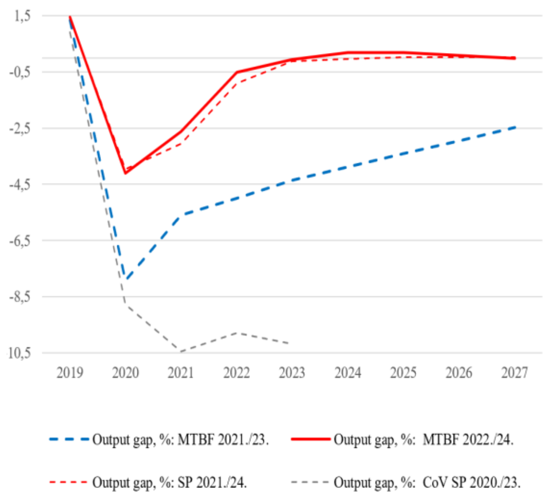

Chart 6 Output gap, % of potential GDP. Data source: MoF.

Conclusions

In general, the Council endorses the MoF's macroeconomic forecasts for MTBF 2021/24 and calls for an objective assessment of the risks involved and notes as the most important the following risks:
1) **Epidemiological risks -** failure to achieve 60% to 70% vaccination coverage on time and low efficacy of vaccines in case of mutation in Covid-19 virus.
2) **Risks of inflation growth** – considering the set of global and also domestic factors, there is a risk of rapid inflation growth, which will exceed 2% level forecasted for 2021.
3) **Political risks** - the approach of elections and populist decisions typical of such periods.
4) **Fiscal risks** - an increase in the size of the deficit, the compensation of which will fall on the shoulders of the next government and potentially be a factor of political instability. The stability program projections in the stability program (SP 2021/24) for 2021 are -9.3% and -2.8% and -0.5% of GDP for 2021, 2022 and 2023, respectively. However, with the increase of the state social liabilities (e.g. family benefit growth) and continuation of EU SGP escape clause facilities, there is a notable risk that deficit exceeds the rates projected in SP for 2021 and 2022.

The Bank of Latvia's experts have increased the possible budget deficit forecast for 2021 to -9.9% of GDP. For 2022 and 2023, it is -2.1% and -0.8% of GDP, respectively[6]

5) **Administration risks -** delayed and inefficient absorption of investments in the Recovery and Resilience Facility, in particular against the background of changes in public procurement legislation and the slowdown in other administrative procedures.

Recommendations:

The Council welcomes the cooperation with the MoF so far, however the Council discussed the need to further supplement the macroeconomic forcasts with indicators of general government deficit debt and general government deficit.

	2021	2022	2023	2024
Real GDP growth	3.7	5.0	3.5	3.4
Nominal GDP growth	6.9	8.5	6.2	5.3
Inflation (consumer prices)	2.0	2.4	2.2	2.0
GDP deflator	3.1	3.3	2.6	1.9
Potential GDP growth	2.1	2.7	3.0	3.1
Output gap	-2.6	-0.5	-0.1	0.2

Table 2. Macroeconomic forecast indicators endorsed by the Council.

[6] https://www.bank.lv/lb-publikacijas/zinas-un-raksti/latvijas-bankas-informacija-presei/12535-latvijas-banka-parskata-latvijas-makroekonomiskas-prognozes