Fiskālās disciplīnas padome

Monitoring report Nr. 15

Period 17.08-20.09.2021

Summary

1. Due to the new Delta variation of Covid-19 virus, the level of infection is rapidly increasing in most European countries, the USA, as well as in Latvia. However, in countries with higher vaccination rates, the number of seriously ill and hospitalized patients has decreased significantly compared to previous waves, which allowed to prevent new restrictions on economic activity. The proportion of vaccinated persons in Latvia is still one of the lowest in the EU countries. On September 13, 2021, 41.9% of the population in Latvia were fully vaccinated; the corresponding figure was 56.5% in Lithuania, 50% in Estonia and 70% on the average in the EU. Despite massive misinformation questioning the vaccination benefits for different purposes including pre-election caimpaigns, achieving maximum vaccination coverage remains one of the main priority for Latvian government
2. Latvia's GDP grew by 10.8% in the second quarter (seasonally adjusted data), with real GDP reaching 6.976 billion euros in the second quarter of 2021. In the structure of second quarter GDP, the largest positive contribution have been made by investments (12.5%), exports (9.5%) and household consumption (8.2%). Compared to the second quarter of 2020, the data GDP changes by kind of activity shows that the activity in almost all sectors has successfully recovered. The epidemiological and fiscal risks identified by FDC during the the macroeconomic forecasts confirmation process in June 2021[1] did not worsen the economic growth.
3. The business sentiment remains positive, but is slowly beginning to deteriorate. Despite the growing infection rates, the sentimnet of service providers is also positive and even has improved compared to July. Entrepreneurs increasingly mention labor shortages as a limiting factor, but production entrepreneurs note that they do not currently feel any restrictions on their business. At the same time, the activities of EU producers are limited by the shortage of materials and equipment, which may soon affect Latvia as well.
4. There is still a high degree of uncertainty regarding the development of macroeconomic indicators. The Bank of Latvia plans to increase this year's GDP forecast to 5.4%, instead of the 3.3% forecasted in June, however, more information on the update will be provided at the official seminar on 30 September. At the same time, the International Monetary Fund cut Latvia's GDP forecast by 0.3 percentage points to 3.6% in September, but left the 2022 growth forecast unchanged at 5.2%. The risks identified by FDC of insufficient vaccination coverage and rising inflation have materialized.
5. Despite beggining of the wave of Covid-19, currently there are no new restrictions, however the government might be forced to impose them. Considering the economic recovery in recent months, MoF’s and even more optimistic Bank of Latvia’s GDP projections are still achievable, however, the projected inflation rate of 2% has already

[1] Available: 14.06.2021. The Endorsement of the Ministry of Finance macroeconomic forecasts for the medium-term budgetary framework 2022/24 | Fiscal Discipline Council (fdp.gov.lv), viewed 06.09.2021

been exceeded. Therefore, this needs to be taken into account in the budget preparation process, especially on new policy initiatives that can further stimulate inflation.

6. According to Eurostat, annual inflation in the euro area has reached 3% and 3.2% on average in the EU in August 2021. Latvia's annual inflation was 3.6% in August which is higher compared to the EU and the euro area. In Europe and Latvia, energy prices (fuel, gas, electricity) are becoming a more worrying factor in the structure of inflation, which will continue to increase the costs of food, production and housing maintenance as the cold season approaches. Recent increases in construction costs and producer prices point to supply-side constraints. Although some of them are global, this indicates that further fiscal stimulus will increase inflation rather than economic growth.
7. According to the State Employment Agency data, unemployment registered in August has fallen to 6.5%. Comparing the second quarter of this year with the same period of 2019 the labor differs with structural changes. For example, considering the number of jobs by type of activity, the employment in accommodation and food services decreased during the crisis (-20%), but the employment in information and communication services increased (+ 19.9%).
8. Simultaneously with the fall in unemployment, the share of vacancies in Latvia has been increasing since the last quarter of 2020, reaching 2.6% in the second quarter of this year. This points at labor market imbalances between the demand and supply side of labor. The situation is similar globally: The Economist[2] reports that pre-pandemic countries had very high levels of employment in developing countries, which are now moving to the opposite direction, with labor supply currently 3% lower than before the crisis. It has been concluded that the restrictions on Covid-19 are the main reason for the weaker labor supply. On the other hand, three factors are identified on the demand side: (i) disruptions caused by Covid-19 (especially emigration), (ii) support measures and pension policies, (iii) changes in people's attitudes towards work.
9. During the second quarter of this year there was an increase in the average wage (+ 10.2%), and the average amount of the gross wage was 1237 euros. The rise in the wage level was influenced by both the increase in the minimum wage to 500 euros and the increase in employment in higher-paid sectors. At the same time, it is important to maintain and increase the productivity of companies[3].
10. In August, the positive trend of increased amount of collected taxes and Social contributions that started in April continued. In August, 18% more taxes and Social contributions were collected compared to the respective period a year ago. Unfortunately, a more detailed tax collection analysis the taxes collected is currently not possible to make due to the introduction of a single tax account - a large part of the taxes collected are still not identified by type of tax.
11. Since the beginnig of the pandemic, global public debt has averaged 97% of world GDP in 2020 and is projected to reach 99% in 2021[4], a historically unprecedented high. According to Eurostat, in the first quarter of 2021, general government debt in the euro area reached 100.5%. These circumstances force governments and fiscal institutions around the world to pay special attention to debt sustainability and to avoid, as far as possible, rising debt levels. Compared to other EU countries, Latvia has a relatively low level of debt. Since February 2020, Latvia's public debt has grown by 3.8 billion euros.

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[2] The Economist August 14, 2021 edition

[3] Latvia's productivity report 2020. Available http://eppi.lza.lv/wp-content/uploads/2021/01/LPZ_2020_.pdf, viewed 21/09/2021

[4] IMF Fiscal Monitor 2021 (apr) Fiscal Monitor, April 2021 (imf.org)

According to the latest available Eurostat data, general government debt was already 45.7% of GDP in the first quarter of this year.

12. At the beginning of September, the international credit rating agency Fitch Ratings maintained Latvia's credit rating at a high "A-" level with a stable credit rating outlook, a positive approval of Latvian government's fiscal policy at a time of great challenges to the global and Latvian economies

13. Budget process is continuing in Latvia. In 2022, the EC general exemption clause is still in force, so the fiscal provisions of the Fiscal Discipline Law are not applied, instead the recommendations of the EU Council are applied. Unprecedented fiscal measures have helped to address the significant negative economic effects of the Covid-19 crisis. In the ECOFIN negotiations on future fiscal rules in the EU, Latvia advocates for fiscal discipline in post-pandemic conditions and joins a group of like-minded countries (Austria, Finland, Latvia, Sweden, the Netherlands, Slovakia, Denmark and the Czech Republic). The Council welcomes this initiative from the government side.

14. Considering that currently the legislation does not set the maximum allowable budget expenditures, the Ministry of Finance proposes to set the level of public debt close to 50% of GDP as an anchor for determining the maximum allowable expenditures in the coming years[5]. According to the MoF scenario, the government debt would reach 50.9% of GDP in 2022, 49.8% of GDP in 2023, and 49.9% of GDP in 2024. In this scenario, the budget deficit in 2022 would reach 3.9% of GDP, but the fiscal space would be 302 million euros.

15. The Council supports the fiscal policy goals set by the coalition government and hopes that it will be able to observe the government debt and budget deficit ceilings considering the potential Covid-19 support measures and the 2022 parliamentary elections.

16. Systematic support programs with a direct impact on the GGBB ended in June and the support are currently provided through indirect support instruments or discrete direct measures. The impact of the currently planned support measures on the GGBB in 2021 is estimated at 2.2 billion euros (7% of GDP), but in fact the support is currently is disbursed in amount of 1.5 billion euros (4.7% of GDP). The Council calls on the government to remain fiscally responsible and to introduce new support instruments only if the epidemiological situation worsens and new restrictions follow.

17. The Council calls on the government to assess very carefully and to avoid general economic warming measures that do not have a long-term positive impact on economic potential. The sharp rise in consumer, producer and construction prices, as well as rising wages and increasing difficulties in finding workers, suggest that there is a lack of spare capacity in the economy and that general warming measures risk contributing to macroeconomic imbalances.

[5] Informative report “On Macroeconomic Indicators, Revenues and General Government Budget Balance Forecasts for 2022-2024”, approved by the Cabinet of Ministers on August 24, 2021. Available https://www.fm.gov.lv/lv/budzets2022 viewed 16/09/2021