Fiskālās disciplīnas padome

Surveillance report summary

MTFL 2022-24

Summary

1. The Fiscal Discipline Council currently assesses Latvia's macroeconomic environment as favorable - able to recover and restructure with the existing set of state aid measures. Latvia's GDP growth was 10.8% (seasonally adjusted data) in the second quarter of 2021, with almost all sectors recovering. The Bank of Latvia has increased its GDP forecast for this year to 5.4% (this year's budget forecasts are based on the 3.7% GDP growth forecast by the Ministry of Finance). In the 8 months of this year, 12.8% more taxes were collected compared to the corresponding period of 2020.

2. However, a possibility of rapid deterioration of Covid-19 situation should not be disregarded, as vaccination coverage in Latvia did not reach the planned 70% and infection rates are rising rapidly. Macroeconomic forecasts for VTBI 2022/24 were based on the assumption that vaccination coverage will be achieved and the third wave of Covid-19 will not occur. It is now clear that the assumption has not materialized and that it poses new risks that are not included in the draft budget. Shortly before the budget review, the government declared a state of emergency and imposed restrictions. Although the restrictions are "modest" compared to expert recommendations, they will inevitably slow down economic growth and worsen the country's fiscal position. **There are still high uncertainmty conditions about the country's economic and fiscal development.** In addition to the epidemiological situation, additional uncertainty is caused by rising inflation, rising energy prices, and discussions in the US and the EU about the need to reduce the asset purchase program to reduce the risk of inflation. All these factors increase the uncertainty of economic and social processes, which also has an impact on the country's fiscal position.

3. Despite the restrictions imposed, it is highly likely that Covid-19 will continue to spread which will significantly increase the burden on the healthcare system. Thus, there is a risk that additional expenses necessary to support healthcare in the coming months are underestimated, in case of the high burden on the healthcare system in the coming months as predicted by Latvian experts.

4. The EC general exemption clause will remain in force in 2022, so the numerical fiscal conditions of the Latvian Fiscal Discipline Law (except for the debt condition) are not applied when drafting the 2022 budget and MTBF for 2022-24. This year's amendments of "Law on the Suppression of Consequences of the Spread of COVID-19 Infection[1]" accepted in June stipulated that the EU Council's fiscal policy recommendations[2] should be applied during the process of development and implementation of the draft law "On the State Budget for 2022" and MTBF 2022-24. The recommendations are: i) to control

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[1] https://likumi.lv/ta/id/315287-covid-19-infekcijas-izplatibas-seku-parvaresanas-likums

[2] com-2021-514-1_en_act_part1_v3.pdf (europa.eu)

the increase of nationally financed primary current expenditures, ii) if necessary, to finance Covid-19 support measures at the expense of budget deficit level, iii) maintain the level of nationally funded investments at least at the level of 2021.

5. Currently there is an uncertainty about the fiscal regulation in 2023 and the following years, which complicates the medium-term budgetary planning process. It is highly likely that the exemption clause will not remain in force in 2023, when the new EU fiscal framework will be accepted. Considering that currently the legislation does not set the maximum allowable budget expenditure, 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[3]. The Council agrees with this fiscal policy objective in the coming years.

6. The projected level of general government debt for 2021 is 49% of GDP, 52% for 2022, and 49% for 2023 and 2024. The projected debt level in 2022 is slightly above the above-mentioned debt anchor, yet it is expected to remain within 50% in the medium term. However, these calculations do not consider possible consequences of the third wave of Covid-19. The Council understands this situation, considering the sharp and unpredictable deterioration of the epidemiological situation in October 2021, which has led the government to declare a third emergency in two years. However, it is important to account that the 2022 budget does not include expenditure on Covid-19 third wave support measures which might increase the currently planned deficit. Considering the current circumstances, the debt planning approach can be evaluated as fiscally responsible and the debt target is considered as adequate. Together with controlling the growth of debt, the government should also pay attention to high-quality investments, which would allow to increase the economic growth and reduce the level of debt in the future, without additional fiscal restrictions.

7. The 2022 budget is based on a general government deficit projection of 4.8% of GDP. In the medium term, the deficit is planned to be reduced to 2.1% in 2023 and 1.3% in 2024. The general government structural balance deficit is projected at the level of 4.9% of GDP in 2022, 2.1% in 2023 and 1.4% of GDP in 2024. The Council emphasizes that the amount of the already accumulated budget deficits in total, would trigger the adjustment mechanism provided in Article 11 of the FDL as soon as the output gap becomes positive. According to the currently approved macroeconomic forecasts, the output gap in 2024 is projected to be positive (0.2%).

8. The Council calls the government to comply the EU Council recommendations on deficit reduction. The deficit should be reduced gradually by choosing an optimal and sustainable development trajectory. The deficit increase should be stopped when the macroeconomic indicators stabilize at the level of 2019. The Council supports the gradual deficit reduction outlined in the current budgetary plan that was projected despite the rapidly changing development of Covid-19, which inhibits the economy's sustainable return to the level of 2019.

9. The amount of general government expenditure and the GG balance are assessed separately each year. Considering that a general exemption clause is in force in 2022, there is no formal limit on the deficit level, but it should be noted that the revised EU fiscal regulations will enter into force in the coming years. The regulations could also

[3] Informatīvais ziņojums "Par makroekonomisko rādītāju, ieņēmumu un vispārējās valdības budžeta bilances prognozēm 2022.- 2024.gadā", apstiprināts MK 2021.gada 24.augustā. Pieejams: https://www.fm.gov.lv/lv/budzets2022, skatīts 16.09.2021

include deficit and debt reduction trajectory, the magnitude of which is currently unknown.

10. The fiscal space for 2022 has been fully utilized and even exceeded by the EC-authorized investments, which has led to an increase in the previously projected deficit of 3.8% to 4.9%. The Council notes that the output gap in 2022 is relatively low, but the overall deficit level is high. The expenditure is projected at € 14.6 billion in 2022, including both primary expenditure and investments, as well as more than € 500 million in Covid-19-related measures. 54% of the expenditure on priority measures is for maintenance measures, 38% for investments and 8% for Covid-19 measures. Assessing these plans, the Council would like to emphasize the macroeconomic context. Employers more often point at the labor shortages in surveys, which will rise wages in sectors not affected by Covid-19. Also, looking at the macroeconomic forecasts, it can be seen that the actual unemployment rate will exceed the NAWRU this year and further, so the pressure on wages will continue. Consumer price inflation could be close to 6% by the end of the year. The current account has changed from a positive balance in 2020 to a deficit of almost 4% in the first half of 2021. Lending has become more active, and the amount of new mortgage loans has increased significantly in 2021. If construction costs continue to rise, the government has to be more critical in its project planning and consider shifting its expenditure to other priorities, such as helping the poor with utility bills or even freezing individual projects.

11. No new Covid-19-related measures are currently planned for 2023 and 2024; however, the current expenditures, which include the budget base increasing measures, will rise, but the investment level fall. Compared to 2022, the capital expenditures of the general budget would also decrease.

12. Like in other EU countries, Latvia's fiscal policy has been expansionary and counter-cyclical in response to the crisis during 2020 and 2021. As economic growth resumes, the government should be cautious in planning expansionary fiscal policies, as they may stimulate inflation rather than homogeneous economic growth. The EU Council recommends not to reduce investments, however, considering current macroeconomic developments, the 4.9% deficit target for 2022 is clearly a threat to rising inflation. The Council emphasizes that the approach to investment projects should be very critical, giving priority to those that will ensure sustainable economic growth and do not contribute to the overheating of certain sectors.

13. The Council notes that the fiscal policy will remain expansionary in 2022, supporting the economy in the post-crisis period, which is based on the set of recommendations of the EU Council. Increase of state-financed primary expenditures in MTBF 2022/24 is evaluated as controllable, however, in 2023 and 2024 it will reach and exceed the 10-year average potential growth rate. In the context of prolonged uncertainty and the period of structural change in the economy currently being observed, it should be noted that modeling the potential of GDP is difficult, which may lead to a misconception about the available fiscal space. In such circumstances, revenue-imbalanced increases of expenditure or increases of expenditure that do not contribute to the long-term potential of the economy should be avoided.

14. The European Union is currently reviewing and discussing the fiscal framework and the budgetary surveillance mechanism. New fiscal regulations are expected to be accepted in the coming years, with a post-crisis transition period and a moderate deficit reduction trajectory for EU Member States. Considering this, the Council notes that MTBF 2022/24 includes the general government deficit reduction trajectory, however, its assessment should be approached flexibly in times of uncertainty to avoid slowing down the recovery or causing excessive overheating.

15. The Latvian economy was supported by both automatic stabilizers and economic support measures programs during the crisis. If the support measures impact on the GGBB was 959 million euros (3.3% of GDP) in 2020, the impact of the 2021 program is already estimated at 2167 million euros (6.9% of GDP). The measures are aimed at maintaining liquidity, social protection of workers and other affected groups of population, entrepreneurs and affected industries, as well as strengthening the capacity of healthcare and other sectors. In the Council's view, the government's fiscal response to the Covid-19 crisis has been adequate during the first wave; however, slightly delayed, excessive and less well targeted during the second wave[4].

16. A positive and significant fact is that the support measures do not have a significant impact on the budgetary balances of the following years, as the support measures are short-term and do not affect the budgetary base. At present, the impact of the support measures on the GGBB in 2022 is only 233 million euros (0.8% of GDP), but a year later 65 million (0.2% of GDP). The Council calls on the government to be fiscally responsible and to introduce new support instruments only if the epidemiological situation and constraints require.

17. The Council proposes to assess the situation very carefully and avoid stimulating 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 stimulating measures risk contributing to macroeconomic imbalances. GDP has already returned to the pre-crisis level in the second quarter, in September, the registered unemployment fell to 5.9%, producer price inflation is approaching 20%, and construction material prices increased by 12.8%. At the same time, a significant increase in investments is planned in next year's budget, which could contribute to price increases even more. Considering that, the justification of all projects should be assessed and, in case of significant price jumps, to abandon the implementation of some projects. Otherwise, economic warming measures increase the risks of macroeconomic imbalances rather than promoting sustainable economic growth.

18. Despite Latvia's intensive economic support program in 2021, Latvia still has one of the lowest debt levels in the EU. Due to the stable fiscal policy during crises the Treasury was able to borrow on international financial markets on favorable terms. At the beginning of September 2021, the international credit rating agency Fitch Ratings has maintained Latvia's credit rating at a high "A-" level with a stable assessment of the future credit rating highly appreciating the fiscal policy of the Latvian government at a challenging time for the world and Latvian economy. However, rising global inflation which could lead to rising interest rates and which in turn could increase debt servicing costs.

19. The implementation efficiency of the Recovery and Resilience Facility will have a significant impact on Latvia's economic development in the coming years. According to the assessment of the Ministry of Finance, the cumulative additional impact of the RRF

[4] FDP monitorings Nr. 12 pieejams: https://www.fdp.gov.lv/lv/media/1653/download, skatīts 07/10/2021

plan on the GDP growth would be 1.3-1.5% in 2022-2029, but the cumulative effect on employment would be around 0.7 percentage points. According to the FDC, the RRF program could increase budget revenues by more than € 500 million[5].

20. The sharp rise in inflation, initially triggered by the strong recovery of the world's leading economies after the Covid-19 downtime, stimulating monetary policy and global demand / supply imbalances is the global threat to economic stabilization. However, overheating in the international energy market has also become an increasingly important factor influencing inflation in the third quarter of this year. Latvia was not an exception - in Spetember, the prices for electricity (+ 7.8%), natural gas (+ 51.3%) and fuel (+ 19.1%) have risen sharply compared to the September of the previous year. Compared to August, the price of electricity on the NordPool exchange in Latvia in September has increased by 41%, from 87.23 euros per MWh to 123.5 euros per MWh. This rise in prices will have a negative impact on: (i) household consumption (social aspect), (ii) the competitiveness of energy-intensive service providers and producers, (iii) headline inflation, and (iv) municipal budgets, especially in municipalities where the share of gas consumption for building heating is high.

21. The Council evaluates the allocation of the fiscal safety reserve for 2022-2024 as adequate. However, due to the high epidemiological, economic, and fiscal uncertainty, the MoF needs to strengthen its monitoring and management of fiscal risks. In particular, the attention should be paid to the risks arising from: (i) Covid-19 financial instruments for companies, (ii) the financial position of state-owned companies (especially Airbaltic and Latvijas Dzelzceļš), (iii) situation in the financial sector.

22. The Council calls for the FRD to be extended by at least two more sections. The EU has declared the "green deal" as one of the EU's priorities and Latvia has agreed to its goals. The "green deal" implementation and environmental protection goals in the coming years will require additional investments, including investments from the state budget. Therefore, a specific chapter for the analysis of such fiscal risks should be established in FRD in the future. The Council also calls on to include a pessimistic macroeconomic scenario, with a correspondingly calculated fiscal reserve in the FRD. This would be when fiscal regulation is in force again and the fiscal risk reserve becomes essential.

23. The budget process has been very complex for the last two years due to the Covid-19 crisis, but the government and the Ministry of Finance have met the challenges of the current situation. However, the Council calls on the government not to rush the budget process, as the hurry can worsen the quality of the budget and limit the dialogue opportunities. The tight budgetary calendar over the last two years has made it difficult for the Council to analyze budgetary and fiscal information better. Considering the growing volatility of macroeconomic indicators in today's world, the Governing Council suggests that the MoF has to consider prepare macroeconomic forecasts required for budgeting in August instead of June.

[5] Novērtējums pieejams: https://www.fdp.gov.lv/lv/media/2979/download, skatīts 10/08/2021