Fiskālās disciplīnas padome

Monitoring report Nr. 16

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SUMMARY

1. The period of strict lockdown has successfully ended in Latvia, as a result of which the number of people infected with Covid-19 has significantly decreased; however, Latvia still has one of the highest infection rates in the world. The level of infection is also rising in other European countries, but the high share of vaccinated population ensures that the cases are soft, so national health care systems are not overloaded and thus, unlike in Latvia, economic constraints are not significant. This proves that generalpublic vaccination, the pace of which in Latvia has significantly increased in recent months, is an important precondition for social balance and economic growth.
2. Unlike several EU member states, the third wave of Covid-19 is likely to slow down the country's economic growth in Latvia and worsen the fiscal position this year and possibly next year. Considering the scientists' predictions that Covid-19 will eventually transform into seasonal Covid-19 endemics, the insufficient coverage for vaccination of the Latvian population could create a risk that Latvia's development will fluctuate in the future according to Covid-19 outbreaks.
3. During the first three quarters of this year, Latvia's GDP has provisionally grown by about 4.9%. Thus, it could be concluded that GDP growth before the third wave of Covid-19 has returned to the level of 2019. However, GDP growth does not guarantee macroeconomic stability. Rising inflation, the projected high budget deficit (the fourth highest in the EU) and the risk of higher debt growth point to macroeconomic imbalances. The Council warns that public finances are currently in a manageable but fragile balance. There is a very high risk that the situation worsens, as the division of the society and political tensions could result in additional budgetary expenditures, which would increase prices, deficit and debt.
4. The inflation growth in Latvia, which is mainly stimulated by increased energy prices, makes the financial situation for households, businesses, and local governments more difficult. The October statistics shows that prices of food and non-alcoholic beverages increased by 4.4% during the year. Rising prices for heating (17.8%), electricity (18.1) and natural gas (51.3%) will further increase household expenditure and reduce the competitiveness of energy-intensive businesses. As a result, the risk of additional expenditures increases both for the economy as a whole and for the state budget. Rapid inflation negatively affects purchasing power and internal consumption.
5. The construction sector overheating which the Council had already warned about in spring became reality. Compared to the corresponding month of 2020, September 2021 data show that prices for construction materials increased by 14.4%, costs for maintenance and operation of machinery and equipment increased by 6.2%, and wages and salaries increased by 5%. The amount of public investment planned for 2022 will continue to stimulate the already high increase in construction costs. The Council warns that construction companies are already facing situations where signed contracts have to be fulfilled in conditions where real costs exceed the expected ones. In such circumstances, if the costs of the identified projects exceed the planned amount, the public financial investments should be critically assessed, and the implementation of such projects possibly should be postponed until the market situation returns to normal and signs of the construction sector overheating diminish.

6. The value of Latvia's exports reached 4.39 billion euros in the third quarter of this year. Compared to the corresponding period in 2020, the increase was 27%. Latvia's exports of wood, chemical and metal products continued to grow. At the same time, however, imports have also increased, leading to a deterioration in the foreign trade balance, reducing the share of exports from 47.3% to 47.2% in the total foreign trade.
7. Forecasts shows that Latvia would have the fourth highest deficit target in the EU (9.3%) in 2021, the higher deficits are projected only in Greece (9.9%), Italy (9.4%) and Malta (11.1%). For the first time since the global financial crisis, Latvia is among the deficit champions, despite our determination to belong to a group of fiscally responsible Nordic countries. Latvia plans one of the highest deficit levels (4.8%) in 2022 as well, which exceeds the plans of Lithuania (3.1%), Estonia (2.2%) and even the already mentioned Greece (3.7%). Latvia's cumulative deficit over the last three years (2020-2022) could reach 1.45 billion euros. Given that the exception clause of the EU SGP will not be in force starting from 2023, Latvia must plan additional expenditures very carefully, especially *current expenditures*.
8. The EC has published its autumn economic forecasts[1], which are more optimistic compared to the spring forecasts; however, bottlenecks limiting faster economic growth, such as supply chain disruptions, unexpected fluctuations in demand, and rising energy prices, have become stronger. Latvia's economic growth is planned to be 4.7% this year and 5.0% next year which is close to the forecasts of the Ministry of Finance and the Bank of Latvia.
9. The world economists start focusing more on rising inflation and the monetary policy needed to control it. Inflation in the euro area increased to 4.1% in October (compared to 10/2020), which is the highest level in 13 years. In the United States, the figure was even higher at 6.2% (the highest since 1990). Sooner or later developed countries' central banks will have to think about ending the asset-buying program and raising interest rates to limit the inflation. However, it has the potential to shake financial markets and slow down the economic development which is still fragile after the crisis.
10. The Saeima had started the second reading of the state budget law for 2022 on 15th of November, as well as the draft law on the medium-term budget framework for 2022, 2023 and 2024. In general, the Council supports[2] the government's fiscal policy outlined in the two documents mentioned above.
11. Overall, the positive trend in tax and SSC collection started in April remained during September and October. In September, 16% more taxes and SSC was collected compared to the same month of 2020, and, despite the prevalence of Covid-19, 8% more taxes and SSC were collected in October. A more detailed analysis of the taxes collected is currently unavailable due to the introduction of a single tax account - a large part of the collected taxes is still not identified by the tax type.
12. To compensate for the economic losses caused by the lockdown, the government has approved new support measures during the 3rd Covid-19 wave. The largest spending allocated to working capital grants and downtime allowances. The impact of the measures on this year's and next year's budgets is estimated at around € 400 million. The Council calls on the government to assess new mechanisms very carefully and avoid general warm-up measures that do not have a long-term positive impact on economic potential.

[1] EC autumn economic forecasts. Available: https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2021-economic-forecast_en, viewed 11.11.2021
[2] FDC surveillance report. Available: https://www.fdp.gov.lv/lv/media/3246/download, viewed 11.11.2021

The sharp rise in consumer, producer and construction prices, as well as rising wages and increasing difficulties in hiring employees, suggest that there is a lack of spare capacity in the economy and that general warming measures risk to enlarge the macroeconomic imbalances even more.