Fiskālās disciplīnas padome

Opinion on the Ministry of Finance's macroeconomic forecast

Latvian Stability Program 2022 -2025

Preamble

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), which will be used as a basis for the Latvian Stability Program (hereinafter - SP) 2022-2025. (2022/25), which is planned to be submitted to the Cabinet of Ministers in April 2022. In order to support the work on the development of the annual documents - SP and Medium-Term Budget Framework (hereinafter - MTBF), 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 was presented with 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 10 February 2022, the Ministry of Finance informed about the assumptions and changes in the updated macroeconomic forecasts.

Overview of the economic situation

The MoF's forecasts for real GDP growth in 2022 are conservative, similarly to the Bank of Latvia (hereinafter - BoL) and the European Commission (hereinafter - the EC). For 2022, the MoF forecasts 0.2 percentage points slower real GDP growth than BoL. In 2023, the forecast of the Ministry of Finance is lower by 0.1 percentage points compared to BoL’s forecasts; however, in 2024 the forecast of the Ministry of Finance is 0.1 percentage points higher than the forecast of the Bank of Latvia.

Inflation forecasts of the MoF are slightly higher than forecasts prepared by the Bank of Latvia. Both institutions forecast that the inflation is expected to be around 6% in 2022, but the inflation is going to decline in the coming years. The sharpest decline in inflation is expected to happen in 2023, followed by a gradual decline. In general, it can be said that the forecasts of MoF and LB are very similar.

In its February forecast, the EC has reduced the expected GDP growth rate from 5% (autumn forecast) to 4.4%. Comparing the current EC forecasts with the MoF forecasts, the EC forecasts the GDP growth in 2022 to be higher by 0.4% points compared to the MoF; however EC's GDP growth forecast in 2023 is by 0.1 percentage points lower than the MoF. EC's inflation forecasts are lower than MoF's, and inflation is projected to decline more sharply in 2023. In 2022, the EC forecasts inflation to be lower by 0.3 percentage points compared to the MoF, while in 2023 the EC inflation forecasts for 2023 are lower by 2.9 percentage points compared to the MoF (Table 1), Data sources: MOF[1], LB[2], EC[3], IMF[4].

	2022	2023	2024	2025
Real GDP growth				
MOF (Feb. 2022)	4,0	3,9	3,4	3,4
BoL (Dec. 2021)	4,2	4,0	3,3	–
EC (Feb. 2022)	4,4	3,8	–	–
IMF* (Okt. 2021)	5,2	4,0	3,2	3,2
Nominal GDP growth				
MOF (Feb. 2022)	10,8	7,6	6,3	5,8
BoL (Dec. 2021)	–	–	–	–
EC (Feb. 2022)	–	–	–	–
IMF* (Okt. 2021)	8,6	5,9	5,4	5,4
Inflation (CPI)				
MOF (Feb. 2022)	6,2	3,1	2,5	2,0
BoL (Dec. 2021)	6,1	2,9	2,1	–
EC (Feb. 2022)	5,9	0,9	–	–
IMF* (Okt. 2021)	2,3	2,2	2,1	2,1
Deflator				
MOF (Feb. 2022)	6,6	3,5	2,8	2,3
BoL (Dec. 2021)	–	–	–	–
EC (Feb. 2022)	–	–	–	–
IMF* (Okt. 2021)	–	–	–	–

Table 1. Key macroeconomic indicator forecasts by various institutions, % y-o-y.

* CPI end of period

According to the CSB's operative estimation, GDP has grown by 4.7% in 2021[5]. GDP growth in 2021 exceeded the Ministry of Finance's forecast for 2021 by 1 percentage point[6]. Although 2021 started with a modest growth rate, the following quarters saw a sharp economic recovery due to growth in exports, investment and private consumption. During the first three quarters of 2021, investments in machinery and equipment, vehicles, as well as intellectual property products played the largest role in gross capital formation. The positive impact of private consumption on GDP increased during the second and third quarters. Exports of goods accounted for a significant share of GDP growth in the third quarter

The increase in **exports** of goods in 2021 was significant (+ 24%) compared to 2020. The largest contribution to this growth is provided by exports of wood products, base metals and articles thereof, and other goods. In total, in 2021, Latvia's foreign trade turnover at current prices reached 35.92 billion euros which are 7.46 billion euros or 26.2% more than in 2020. The negative impact of Covid-19 on exports of services persists, especially in travel services.

According to the CSB data, **inflation** in 2021 reached 3.3%. Inflation dynamics was rapid: 2021 started with 0.1% deflation in the first quarter and ended with 7.1% inflation in the fourth quarter. In December 2021, compared to December 2020, the average consumer price level increased by 7.9%, which was the fastest price increase since March 2009. A significant part of the rise in consumer prices can be explained by rising prices in electricity, fuel and gas. The average electricity price in Latvia in 2021 reached 88.78 EUR/MWh, which is 2.6 times higher than the average price in 2020[7]. According

[1] MoF macroeconomic forecasts of 2022. Available https://www.fm.gov.lv/lv/jaunums/finansu-ministrija-2022-gadam-prognoze-ekonomikas-izaugsmi-40-apmera viewed 14.02.2022
[2] BoL macroeconomic forecasts. Available https://www.bank.lv/darbibas-jomas/monetaras-politikas-istenosana/prognozes Viewed 07.02.2022
[3] EC macroeconomic forecasts. Available https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-performance-country/latvia/economic-forecast-latvia_en Viewed 10.02.2022
[4] IMF world economic outlook database (Oct.2021)
[5] CSP operative estimation. Available https://stat.gov.lv/lv/statistikas-temas/valsts-ekonomika/ikp-istermina/preses-relizes/8211-ikp-atrais-novertejums-2021?themeCode=IS Viewed 07.02.2022
[6] FDC opinion on GDP forecasts MTBF 2021-2024. Available https://www.fdp.gov.lv/lv/14062021-finansu-ministrijas-makroekonomikas-prognozu-apstiprinasana-videja-termina-budzeta-ietvaram Viewed 08.02.2022
[7] Electricity market review. Available https://ast.lv/lv/electricity-market-review Viewed 08.02.2022

to the CSB data, the average price of natural gas in 2021 compared to 2020 increased by 23.8%, the price of fuel by 18.5%. The latest CSB data show that consumer prices rose by 7.4% in January.
Inflation triggers are currently more on the producers' (supply) side, but less strong on the consumption side, (e.g., household income), which is also causing social tensions. Households are feeling the burden of rising prices and low unemployment, which will be reflected in further wage growth.

The **unemployment** rate in the three quarters of 2021 averaged 7.7%. In the third quarter, the unemployment rate in Latvia reached 7.2%, the lowest level since the beginning of 2020. On the other hand, the level of economic activity lags behind the 2020 figures. The level of economic activity in the first three quarters of 2020 was 70%, but in 2021 it was 68.7% in the same period. As the situation for Covid-19 returns to normal, it is expected that people who have left during the Covid-19 period will return to the labour market.

According to the CSB data, the volume of industrial production in 2021 increased by 6.5%. Manufacturing (+7.3%), mining and quarrying (+4.7%) and electricity and gas supply (+2.9%) played a significant role in this growth. However, given the sharp rise in energy prices, there is a risk that both industrial growth and the competitiveness of companies in the sector will be affected.

In the construction sector, 2021 was marked by a decline in output (-6.2%). The decline in output was recorded in the construction of buildings (-10.5%), civil engineering (-5%) and specialized construction (-2.7%). The situation was deteriorated by rising costs. On average, in the 12 months of 2021, the increase in construction material prices was 9.1%, but the costs of maintenance and operation of machinery and equipment, as well as wages and salaries of workers, increased by 4.1%.

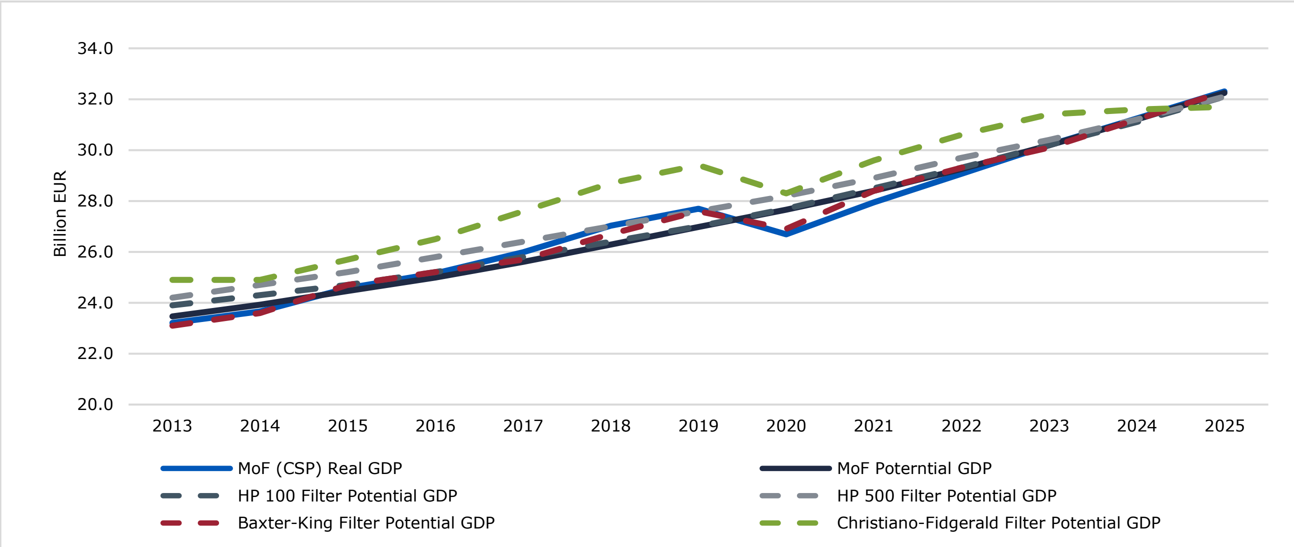
The situation in the sector was also deteriorated by labour supply issues. However, in the coming years, a significant increase in government investment in the sector is expected, which is related to both the implementation of the projects of the Recovery and Resilience Facility plan and the implementation of EU structural fund projects, including the construction of Rail Baltica infrastructure.

Assessment of the position of the Latvian economic cycle

FDC experts provide a new assessment of the current position of Latvia´s economy in its business cycle. While there are many ways to estimate the trend in GDP as well as to compute the economy's productive potential, most tend to make use of statistical-based techniques.[8] Specifically, the method of statistical filters has been used to disentangle short and longer-term fluctuations and provide a view on economy´s potential and, thereby, allowing to compute an approximate measure of the output gap which can be compared against that of the MoF. Four statistical filters were used to extract the trend and cycle components of GDP: Baxter-King, Christiano-Fitzgerald, Hodrick-Prescott (with a smoothing lambda parameter of either 100 or 500) and the more recent Hamilton filter. Figure 1 shows that over the period from 2013 to 2025, the closest to the MoF calculation is the potential GDP obtained via the HP (100), while the Christiano- Fitzgerald time series differs the most. Results show that the MoF´s approach to determining potential GDP is, in general and on average, conservative without a tendency to overestimate or underestimate this specific indicator.

[8] These methods are of relatively simple application and do not require judgments about trend breaks. However, they do require assumptions about how the filters are structured, including the values of one or more parameters.

Figure 1. Real GDP (historical and projected) compared to the calculation of potential GDP by four statistical filters and MoF calculations

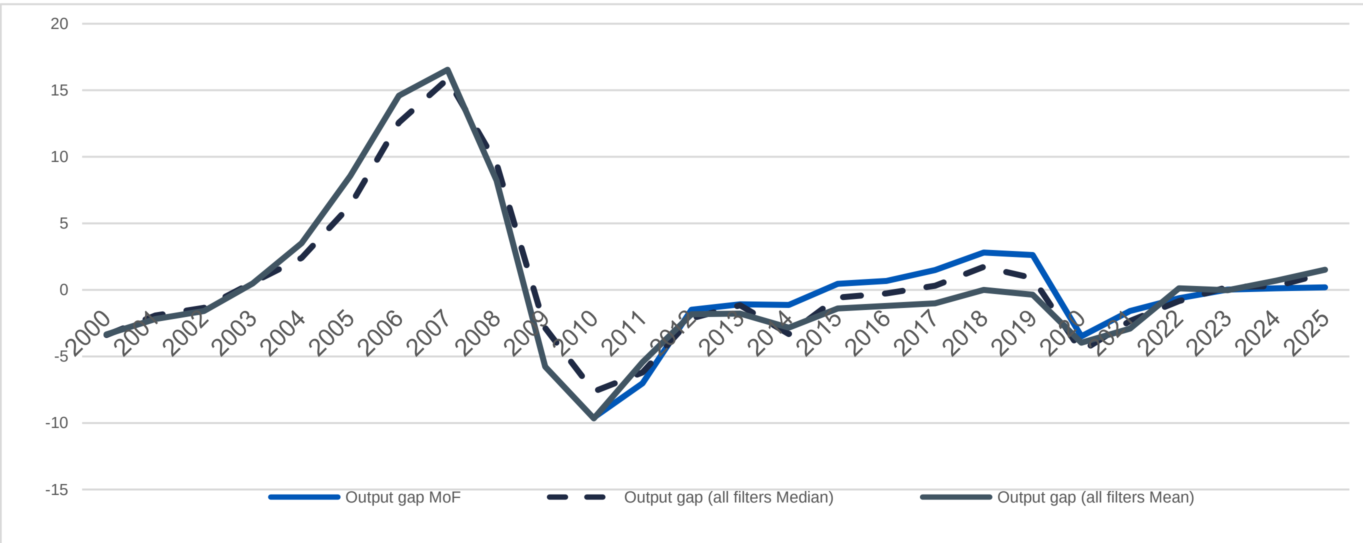


Source: MoF, CSB and FDC calculations

Alternative measures of the output gap were obtained on the basis of the statistical filters mentioned above. It can be concluded that over the period from 2013 to 2025, results of the different alternative statistical filtering methods are basically moving in one trajectory similarly to that of the MoF.

HP (100), HP (500) and the Hamilton filter show a trajectory of the Output Gap similar to that computed by the MoF; however, the values are lower for the former set of calculations. The Christiano-Fitzgerald filter calculation deviates the most from the calculated MoF values.
Figure 2 shows the alternative output gaps estimated with the different filtering techniques combined using either the simply average or their median. It compares against the MoF estimate. Both the median and mean curves indicate a higher value of the output gap, that is, move positive than that assumed by the MoF.

Figure 2. Comparison of output gap calculation results: mean and median of four statistical filters compared to MOF



Source: MoF, CSB and FDC calculations

Comparing the difference between potential GDP and output gap values calculated by the methods of statistical filters and the values calculated by the MoF, it can be concluded that there are no significant differences between them[9].

The Council agrees with the MoF's estimates of the output gap and potential GDP and acknowledges that the economy is currently on the path to recovery. GDP growth in 2021 has returned to pre-crisis levels, but it cannot be convincingly projected that real GDP returns to GDP potential in 2022 due to a lot of downside risks to economic recovery.

The economy is now entering a new cycle in terms of growth, but the growth is threatened by a number of macroeconomic risks, including inflation and labor shortages. Both the MoF's and the Council's calculations suggest that the values of the minimum positive output gap can be projected for 2023 and that the economy can start operating above its potential in 2024-2025.

<u>Comparison of updated and previous forecasts of the Ministry of Finance</u>

Since the adoption of MTBF 2021/24 (hereinafter - MTBF 2021/24) in October 2021, the MoF has updated the forecasts of the main macroeconomic indicators for the period from 2022 to 2025.

On the basis of the current economic developments and the MoF basic assumptions for the forecasts, the Council has decided to approve the forecasts described below.

The Council approves real GDP growth the forecast for SP 2022/25. Compared with the previous forecast of MTBF 2021/24, in June 2021, the real GDP forecast for 2022 was dropped by 1 percentage point. For 2023 forecast raised by 0.4 percentage points, and by 0.1 percentage points for 2024. Real GDP growth for 2025 is projected at 3.4% (see Figure 3).

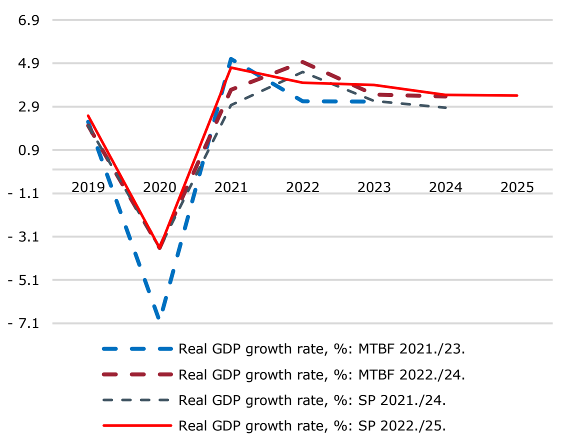


Chart 3 Forecast for real GDP growth, y-o-y.

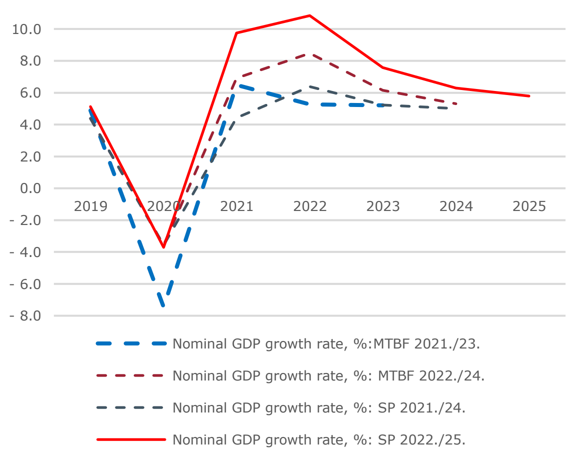


Chart 4 Forecast for nominal GDP growth, y-o-y.

9 Student's t-test was used to determine the significance of the differences between the MoF and the Council's assumptions on the output gap and potential GDP. As a result, no statistically significant differences were found between MoF's and the Council's estimates of potential GDP and the output gap.

Data source: MoF.

Data source: MoF.

The Council approves the nominal GDP growth forecast for SP 2022/25. Compared to the previous forecast for MTBF 2021/24, the nominal GDP forecast for 2022 was risen by 2.4 percentage points. The forecast was raised for 2023 by 1.4 percentage points, and by 1 percentage point for 2024. For 2025, nominal GDP is projected at 5.8% (see Figure 4).

The Council approves the inflation forecast for SP 2022/25 with comments and notes the following: the largest part of current inflation can be explained by rising energy prices, and there are currently no convincing signs of normalization. Therefore, the forecast for the decline in inflation by 3.1 percentage points in 2023 can be assessed as the preferred scenario.

Compared to the previous MTBF 2021/24 forecast, the inflation forecast for 2022 has been revised and increased by 3.8 percentage points. The inflation forecast for 2023 has been raised by 0.9 percentage points, for 2024 by 0.5 percentage points. The inflation forecast for 2025 is 2% (see Chart 5).

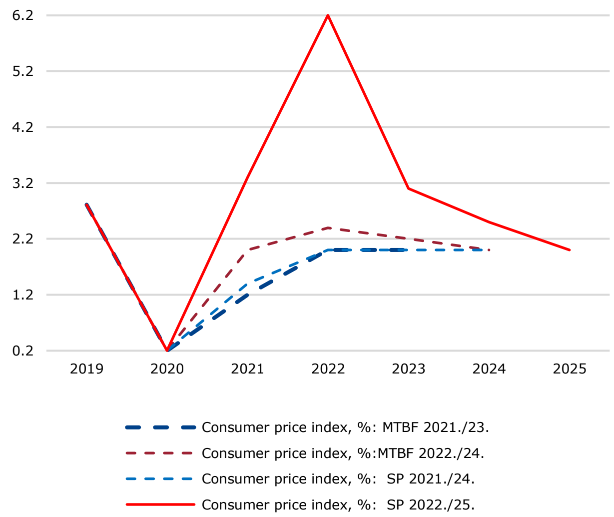


Chart 5 Forecast for inflation, y-o-y.

Data source: MoF.

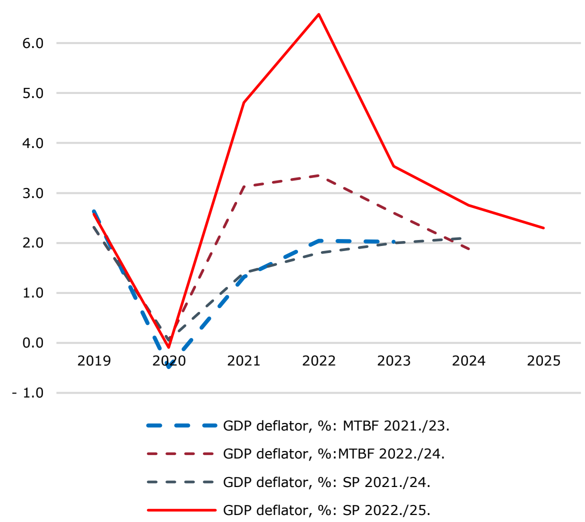


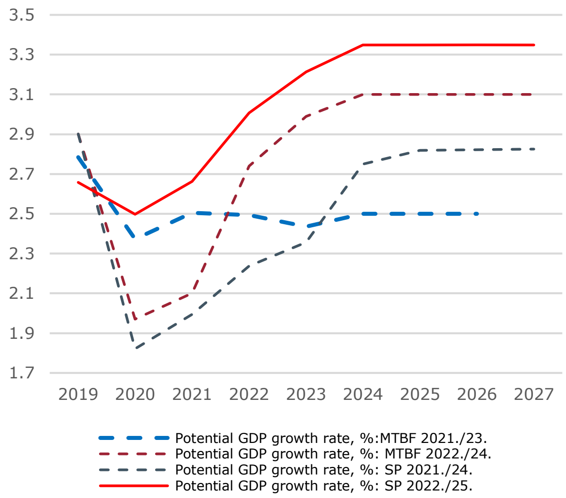
Chart 6 Forecast for GDP deflator, y-o-y.

Data source: MoF.

The Council approves the GDP deflator forecast SP 2022/25 with comments. The Council would like to point out that it does not find a convincing explanation for the deflator value, which is estimated at 6.6% in 2022 and is by 0.4 percentage points higher than the consumer price forecast. Compared to the previous MTBF 2021/24 forecast, the GDP deflator forecast for 2022 has been adjusted and raised by 3.2 percentage points. The forecast for 2023 has been increased by 0.9 percentage points. The deflator forecast for 2024 has been raised by 0.9 percentage points, while the deflator forecast for 2025 is 2.3%. (see Figure 6).

The Council approves the potential GDP growth projection for SP 2022/25. Compared to the previous forecast of MTBF 2021/24, the potential GDP has been increased for the whole forecast period as follows: for 2022 by 0.3 percentage points, for 2023, 2024 increased by 0.2 percentage points. For 2025, potential GDP growth is projected at 3.3% (see Chart 7).

The Council approves the output gap projection for SP 2022/25. Compared to the forecasts of MTBF 2021/24, the value of the output gap has been reduced by 0.1 percentage points for 2022, increased by 0.1 percentage points for 2023, and reduced by 0.1 percentage points for 2024. For 2025, the output gap is projected at 0.2%. (see Figure 8).



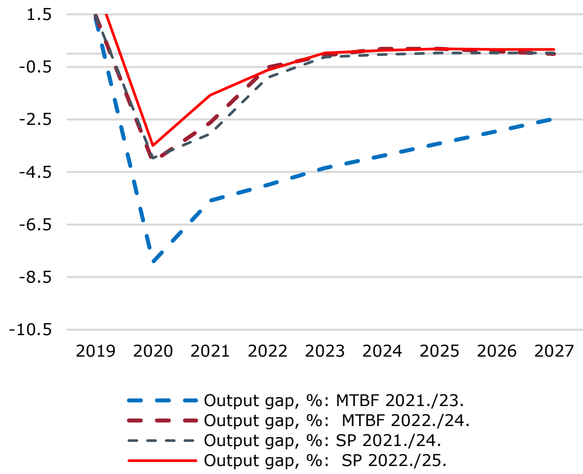


Chart 7 Potential GDP growth, %, y-o-y.

Data source: MoF.

Chart 8 Output gap, % of potential GDP.

Data source: MoF.

Summary

Overall, the Council approves the MoF's macroeconomic forecasts for SP 2022/25. recognizing that the MoF 's calculations are in line with the Council' s estimates of economic developments in the coming years

The Council calls for an objective assessment of the risks involved, and notes the following as the most important:

1) **Epidemiological risks** - Covid-19 mutations with unpredictable outcomes may deteriorate economic growth in 2022.
2) **Geopolitical risks -** tensions in Russia's and Ukraine's international relations and the potential involvement of Belarus in this process create an unfavourable environment for stable economic growth, negatively affect energy prices, especially natural gas, and create an unattractive investment climate in the region. There is also the possibility of an energy supply shock.
3) **Persistence of high energy prices** - there is a potential risk to local government budgets and changes in the structure of household consumption. Heating and electricity prices are closely correlated with natural gas prices. As the effects of rising gas prices become apparent with a 6–8-month lag, municipalities and households will start feeling larger burden in the cold season of 2022.

4) **Risks of rising inflation -** high inflation will be present in 2022, with energy prices (the main factor) currently showing no convincing signs of decline. There are already heightened expectations of rising prices on the part of households and producers. This generally creates an environment in which lending rates are expected to rise as well, however the European Central Bank is not currently giving clear signals about raising rates.
5) **Shadow economy** - Covid-19 restrictive measures have increased the risk of enhancing the share of the shadow economy.
6) **Fiscal risks -** oncoming parliamentary elections and possible pressure on additional budgetary spending, which could lead to 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.

Table 2

Macroeconomic forecast indicators endorsed by the Council

Macroeconomic indicators	2022	2023	2024	2025
Real GDP growth	4,0	3,9	3,4	3,4
Nominal GDP growth	10,8	7,6	6,3	5,8
Inflation (consumer prices)	6,2	3,1	2,5	2,0
GDP deflator	6,6	3,5	2,8	2,3
Potential GDP growth	3,0	3,2	3,3	3,3
Output gap	-0,6	0,0	0,1	0,2

Source: the MoF