Fiskālās disciplīnas padome

Opinion on the Ministry of Finance's macroeconomic forecast

For 2022 and Medium-Term Budget Framework 2023 -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 Medium-Term Budget Framework (hereinafter - MTBF) 2023-2025, which is planned to be submitted to the Cabinet of Ministers in autumn of 2022*. In order to support the work on the development of the annual documents - SP and MTBF, it was agreed that the approval procedure of the MoF's macroeconomic forecasts by the Council takes place earlier.*

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 3 at the end of this document).

At the Council meeting on 10 August 2022, the Ministry of Finance informed about the assumptions and changes in the updated macroeconomic forecasts.

Overview of the economic situation

The MoF forecasts for 2022 are significantly more cautious than those of the European Commission (hereinafter – EC) and the Bank of Latvia (hereinafter – BoL), but not as pessimistic as the forecasts of the International Monetary Fund (hereinafter – IMF). When forecasting real GDP growth, the MoF maintains a conservative and cautious approach, compared to other forecasters, also for the next three years. The MoF forecasts for real GDP growth for 2022 are a bit more cautious than the forecasts published by the Bank of Latvia in June. The forecasts published by the Bank of Latvia contain calendar-adjusted data. For 2022, the MoF forecasts 0.1 p.points slower real GDP growth than the BoL, but in 2023 the MoF forecast is 1.4 p.points lower than the BoL. Also, the GDP growth in 2024 compared to BoL is 1.2 p.points lower. Compared to other forecasters, MoF has predicted the highest inflation rate for 2022 (16.5%), but also the sharpest inflation decline trajectory for the next three years. The main causes of inflation are related to a very sharp increase in energy prices (natural gas, electricity, fuel), which is reflected in production costs and household consumption. Inflation is expected to reach its peak in the autumn of 2022 and significantly affect household consumption and business viability. Government support program is expected to ease inflationary pressure on energy prices in winter 2022/23. In the long run normalization of the situation is expected with the reorganisation of gas infrastructure, replacing Russian gas supplies. (see Table 1, Data sources: MOF[1], BOL[2], EK[3], IMF[4]).

	2022	2023	2024	2025
Real GDP growth				
MOF (Aug.2022)	2,8	1,0	3,0	3,4
BOL (Jun.2022)*	2,9	2,4	4,2	
EC (Jul.2022)	3,9	2,2		
IMF (Apr.)	1,0	2,3	3,9	3,3
Nominal GDP growh				
MOF (Aug.2022)	16,7	7,7	5,4	6,1
BOL (Jun.2022)	–	–	–	–
EC (Jul.2022)	–	–	–	–
IMF (Apr.)	9,7	5,6	7,0	6,2
Inflation (CPI)				
MOF (Aug.2022)	16,5	6,5	1,0	2,0
BOL (Jun.2022)	14,8	7	2,4	
EC (Jul.2022)	15,5	6,0		
IMF (Apr.)	10,0	3,9	3,0	2,8
Deflator				
MOF (Aug.2022)	13,5	6,7	2,3	2,6
BOL (Jun.2022)	–	–	–	–
EC (Jul.2022)	–	–	–	–
IMF (Apr.)	–	–	–	–

Table 1. Key macroeconomic indicator forecasts by various institutions, % y-o-y.
*calendar adjusted data

According to the CSB quick estimate, GDP in 2022 2nd quarter has increased by 2.5%, compared to the same period of 2021[5] (seasonally and calendar adjusted data). Although there is a GDP decrease of 1.4% compared to the previous quarter, the first half of the year showed a 4.5% GDP growth. This result will make it possible to achieve positive annual GDP growth as a whole, however, a recession in the last quarter of 2022 and the first quarter of 2023 remains possible.

Exports/Imports. Due to trade disruptions between Latvia, Russia and Belarus, there was a risk that exports would decline. However, statistical data show that exports to other countries have compensated for the losses by leaving the market of Russia/Belarus. According to latest CSB data, during the first half of the year foreign trade turnover of Latvia at current prices reached EUR 21.77 billion – EUR 5.71 billion or 35.5% more than in the corresponding period of 2021. The exports value constituted EUR 9.62 billion (a growth of EUR 2.32 billion or 31.8%), whereas the imports value comprised EUR 12.14 billion (a rise of EUR 3.39 billion or 38.7%). There is still a trade balance shock scenario in imports due to the dramatic increase in energy resource import prices.

According to the CSB data, **inflation** in July 2022, compared to July 2021, increased by 21.5% and its growth dynamic remains fast. Inflation in Latvia (and other Baltic countries) is twice higher as than in the rest of the EU countries. The high inflation in the Baltic countries can be explained by the higher housing and food share in the consumption basket, which is almost twice as large as in other Eurozone countries. Compared to July of the previous year, prices for housing have risen by 50.7%, food by 24.3% and transport by 28.8%. However, inflation has taken over all groups of goods and services, as evidenced by core inflation, which reached an average of 5.7% in the year's first half (*Eurostat data*). It should be noted that the BOL has predicted a core inflation rate of 6% for 2022. In 2021, there has been a significant (+24%) increase in the export of goods. Activity in the accommodation,

[1] MoF - MOF paaugstina 2022. gada ekonomikas izaugsmes prognozi līdz 2,8%, nākamajā gadā gaidāma izaugsmes palēnināšanās līdz 1,0% | Finanšu ministrija
[2] Prognozes | Latvijas Banka
[3] ip183_en_statistical annex.pdf
[4] International Monetary Fund, World Economic Outlook Database, April 2022
[5] 2. ceturksnī IKP pēc ātrā novērtējuma palielinājies par 2,6 % | Oficiālās statistikas portāls.

catering and entertainment sectors has recovered after the pandemic, while currently and also during the pandemic, employment in the ICT sector has developed steadily. The labor market continues to be affected by labor shortages, which will continue to put pressure on wages and affect inflation.

The **unemployment** rate in the first half of the year was on average 6.7% and gradually decreased month-by-month except July. The latest level on registered unemployment as reported by the National Employment Agency, in July was 6%, an increase by 0.1 percentage points. Despite the decrease in the unemployment rate, there is a possibility that unemployment will increase in the last quarter of 2022 and the first quarter of 2023, due to the decrease in economic activity.

According to the CSB data, the **volume of industrial production** in the first half of the year increased by 4.1% on average. Manufacturing (+ 7.2%), mining and quarrying (+ 6.9%), but electricity and gas supply declined by (-14.1%) which played a significant role in overall growth.

Assessment of the position of the Latvian economic cycle

FDC experts provide an independent assessment of the current position of Latvia´s economy in its business cycle. While there are different methods 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. Specifically, the method of statistical filters has been used to disentangle short and longer-term fluctuations and provide a view of the economy´s potential, 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.

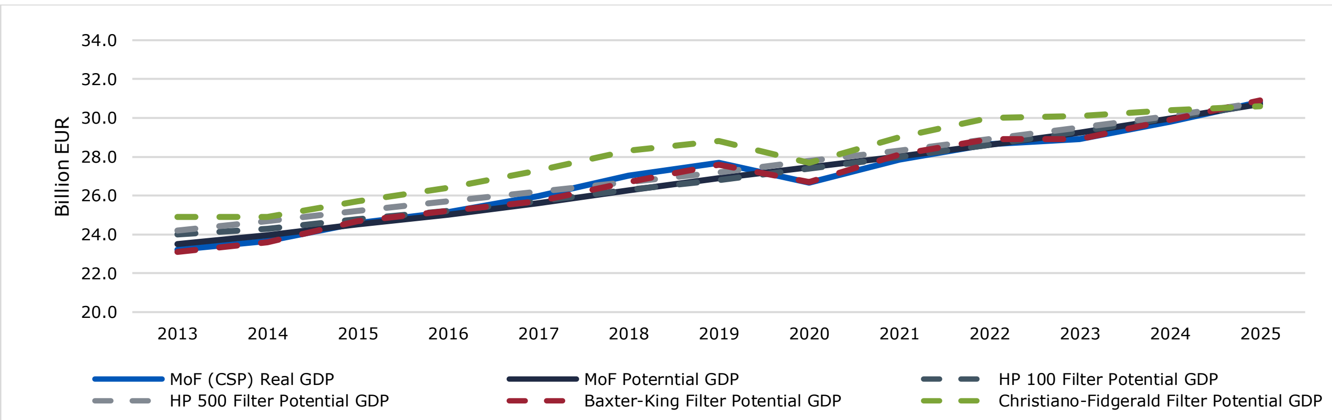


Figure 1. Real GDP (historical and projected) compared to the calculation of potential GDP by four statistical filters and MoF calculations

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

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 HP (500). Hamilton filter calculations show a sharp rise in the gap in 2022 and a drop in 2023, consistent with the MoF's estimated positive value for 2022 and a return to a negative gap in 2023. The Christiano-Fitzgerald filter calculation deviates the most from the calculated MoF values.

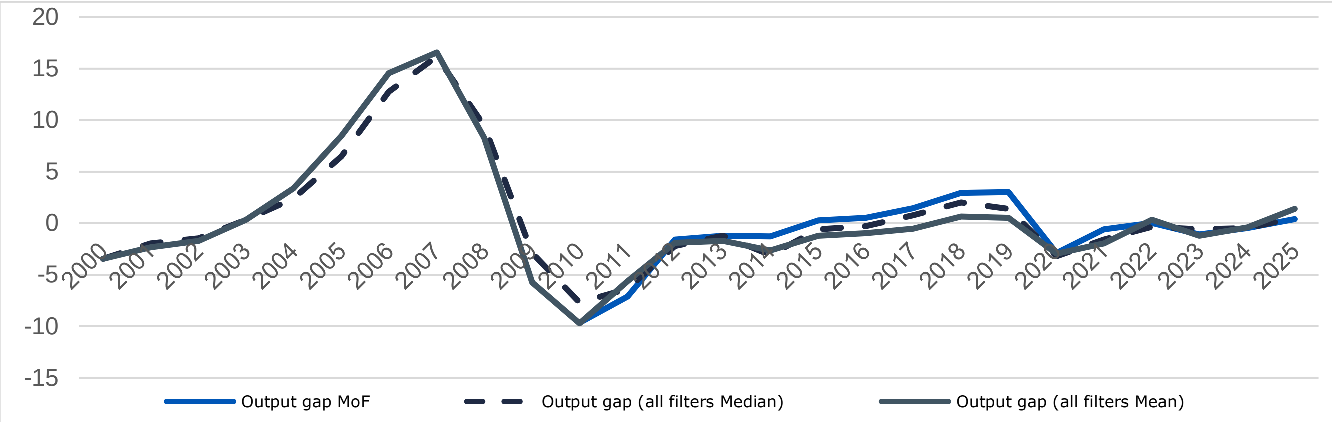


Figure 2. Comparison of output gap calculation results: mean and median of four statistical filters compared to MoF

For 2022, the MoF has calculated a close to zero output gap value (0.03%), and the median of all used statistical filter calculations for 2022 shows a negative value (-0.4%), but the average value of all statistical filters for 2022 is positive 0.3%. For the next three years, the calculations of MoF and FDC do not differ significantly and indicate a negative output gap for 2023 and 2024. On the other hand, for 2025, all filters show a sharper output gap improvement than in MoF estimates.

Table 2 summarizes the MoF output gap estimates compared to the FDC estimates.

Table 2

Comparison of output gap calculation results

	Output gap MoF	Output gap (all filters Median)	Output gap (all filters Mean)
2022	0.03	-0.4	0.3
2023	-1.1	-0.6	-1.2
2024	-0.5	-0.5	-0.4
2025	0.4	0.5	1.4

Source: FDC calculations

Calculations confirm that, the economy is currently far from steady state, so assumptions about its potential and output gap are also very cautious. Currently, it is not clear how the economy will be able to adapt to new trade conditions under the Russian military aggression in Ukraine and different kind of sanctions.

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[6].

The Council agrees with the MOF's estimates of the output gap for 2022, where the impact of the short-term GDP improvement can be seen and agrees that the economic potential

[6] 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.

during the next year will be significantly negatively affected due to the high probability of various downside risks. Forecasts are made in conditions of high uncertainty and increasing downside risks, which limit forecasting opportunities in the medium term.

Comparison of updated and previous forecasts of the Ministry of Finance

Since the adoption of SP 2022/25 (hereinafter - SP 2022/25) in March 2022, the MoF has updated the forecasts of the main macroeconomic indicators for the period from 2022 to 2025.

Considering the current economic development and the MoF assumptions on which the forecasts are based on, the Council's decision regarding the approval of the forecasts is described below.

The Council approves the real GDP growth in the forecast for 2022 and MTBF 2023/25. Compared to the previous forecast of SP 2022/25 in March, the real GDP forecast for 2022 has improved by 0.7 percentage points. For 2023, the forecast significantly dropped by 1.5 percentage points, and by 0.3 percentage points for 2024. The real GDP growth projection for 2025 is raised by 0.1 percentage points (see Figure 3). The forecast for 2023 of 1% GDP growth can be assessed as optimistic considering the risks related to the decline in the purchasing power of the population in conditions of high inflation. The Council would like to note that the set of risks in the economy is so high that a recession scenario in 2023 cannot be disregarded (see Figure 3).

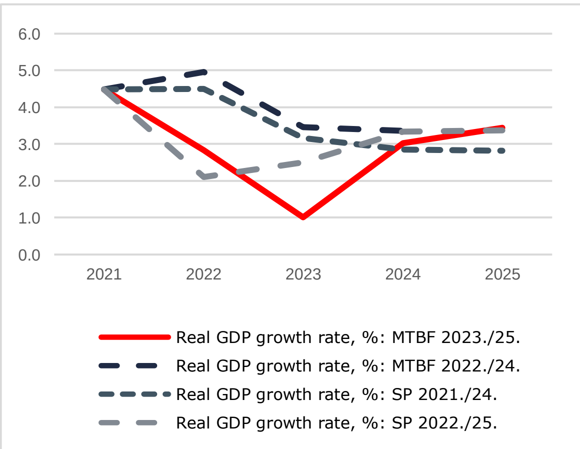


Chart 3 Forecast for real GDP growth, y-o-y. Data source: MoF.

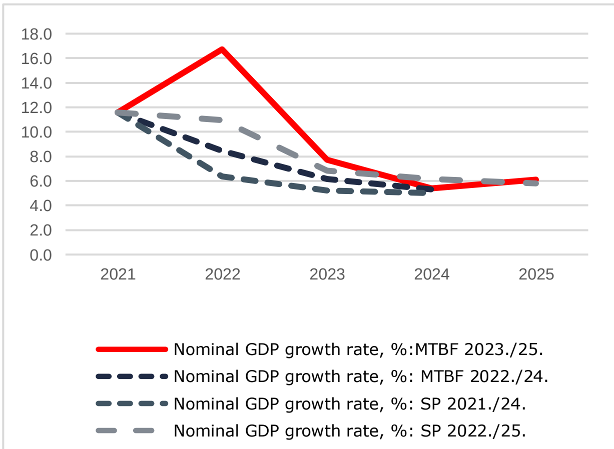
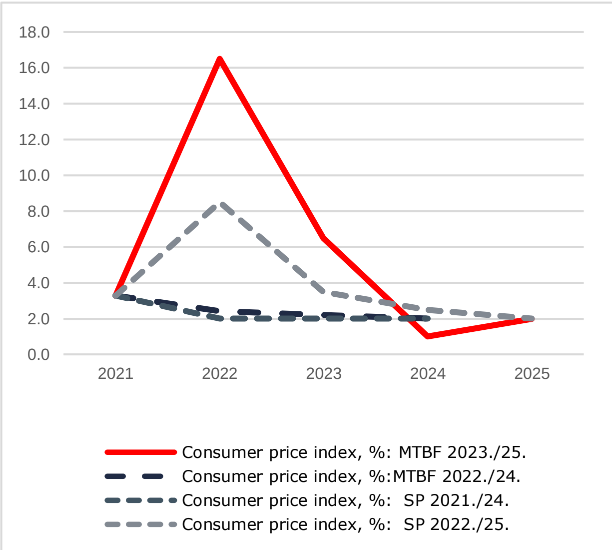


Chart 4 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

The Council approves nominal GDP growth in the forecast for 2022 and MTBF 2023/25. Compared to the previous forecast for SP 2022/25, the nominal GDP forecast for 2022 was significantly risen by 5.8 percentage points. The forecast was raised for 2023 by 0.9 percentage points and dropped by 0.8 percentage points for 2024. The nominal GDP growth projection for 2025 is raised by 0.3 percentage points (see Figure 4).

The Council approves the inflation forecast for 2022 and MTBF 2023/25 with comments. Compared to the previous SP 2022/25 forecast, the inflation forecast for 2022 is half as high as in March (upwards by 8 percentage points). The inflation forecast for 2023 has been raised by 3 percentage points, for 2024 dropped by 1.5 percentage points. The inflation forecast for 2025 has not change and is estimated at 2% (see Chart 5). The inflation forecast for 2022 may exceed 16.5%, as it has already reached an average of 14% in seven months, and it is expected that the level of consumer prices will continue to rise through the heating season.



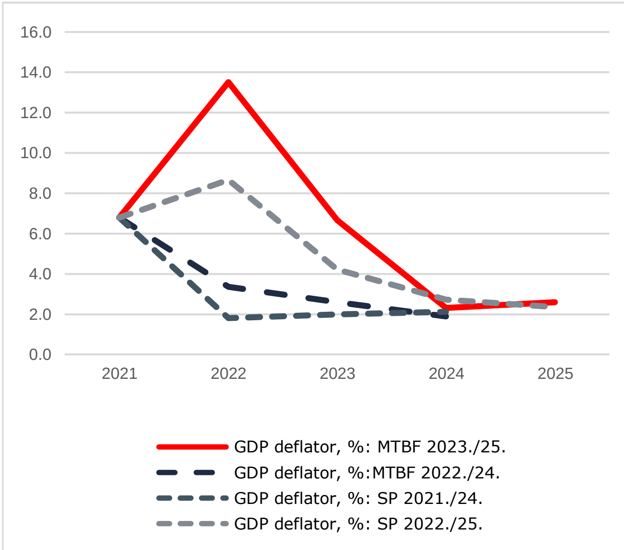


Chart 5 Forecast for inflation, y-o-y. Data source: MoF.

Chart 6 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council approves the GDP deflator forecast for 2022 and MTBF 2023/25. Compared to the previous SP 2022/25 forecast, the GDP deflator forecast for 2022 has been raised by 4.9 percentage points. The forecast for 2023 has been raised by 2.4 percentage points. The deflator forecast for 2024 has dropped by 0.4 percentage points, while the deflator forecast for 2025 is raised by 0.3 percentage points (see Figure 6).

The Council approves the potential GDP growth projection for 2022 and MTBF 2023/25. Compared to the previous forecast of SP 2022/25, the potential GDP has been reduced for the whole forecast period as follows: for 2022 by 0.9 percentage points, for 2023 and 2024 by 1 percentage point, for 2025 by 0.8 percentage points (see Chart 7).

The Council approves the output gap projection for 2022 and MTBF 2023/25. Compared to the forecasts of SP 2022/25, the value of the output gap has been improved by 0.7 percentage points for 2022 but reduced for 2023 by 1.2 percentage points, and by 0,6 percentage points for 2024. For 2025, the output gap projection is improved by 0.2% (see Figure 8).

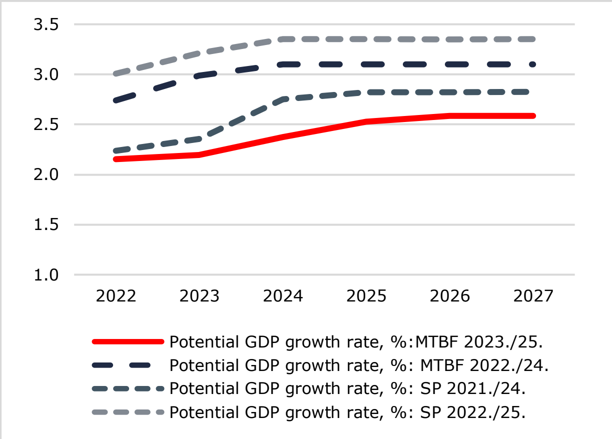


Chart 7 Potential GDP growth, %, y-o-y. Data source: MoF.

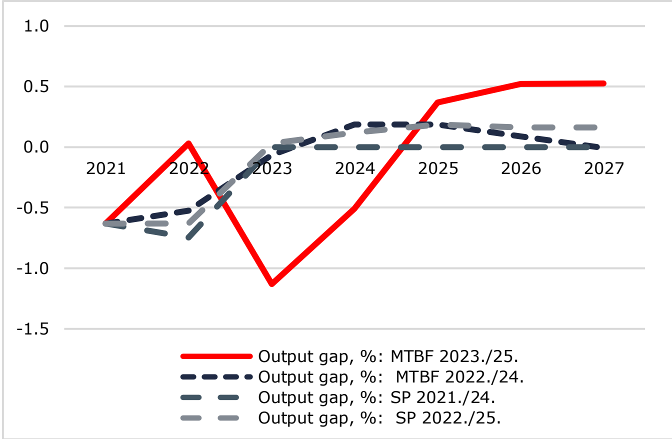


Chart 8 Output gap, % of potential GDP. Data source: MoF.

Summary

Overall, the Council approves the MoF's macroeconomic forecasts for 2022 and MTBF 2023/25. recognizing that the MoF's calculations are in line with the Council's estimates of economic developments in the coming years. The Council emphasizes that the forecasts are made in the conditions of complicated risks and high uncertainty, so it recommends maintaining the readiness to revise the forecasts if there are indications of a significant deviation from the forecasted base scenario.

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

1) **Geopolitical risks -** The war in Ukraine continues and there is no clarity about the solution to this situation. The war threatens global food security and civil security in the region.
2) **Internal political risks –** the elections to Saeima can lead to slow and delayed decision-making in a situation of high social tension and the potential natural gas shortage.
3) **Inflation** - the risk of persistent high inflation, which threatens GDP growth. In conditions of rising costs and labour shortages, the upward pressure on wages is very real and will continue to push up the inflation rate. The development of inflation can lead to the formation of an inflationary spiral, the insolvency of citizens and entrepreneurs, which will cause an economic recession.
4) **Fiscal risks –** *Citadele* bank calculations show that the increase in the price of energy resources can be estimated at around 3 billion euros (10% of GDP), while the amount of government compensation is expected to be 450-500 million. This amount does not include the cost of maintaining state and local government infrastructure (schools, hospitals, long-term care facilities, etc.). A dramatic rise in the fiscal deficit is a quite real scenario. The support mechanism will alleviate social tension, but the Council wants to emphasize that the current support system does not provide enough incentives to reduce energy consumption or invest in energy-efficiency, which is also against the Green deal objectives. Development of a strategy on energy-efficiency and reduction of energy consumption is needed.

5) **Natural gas shortage** - there is still no certainty that gas reserves are sufficient for the next heating season for all the consumer groups.

Table 3

Macroeconomic forecast indicators endorsed by the Council

Macroeconomic indicators	2022	2023	2024	2025
Real GDP growth	2.8	1.0	3.0	3.4
Nominal GDP growth	16.7	7.7	5.4	6.1
Inflation (consumer prices)	16.5	6.5	1.0	2.0
GDP deflator	13.5	6.7	2.3	2.6
Potential GDP growth	2.2	2.2	2.4	2.5
Output gap	0.03	-1.1	-0.5	0.4

Source: MoF