Fiskālās disciplīnas padome

Surveillance report on the medium-term budgetary framework 2023-2025 and the temporary (no policy change) budget plan 2023.

Adopted at the meeting of the Fiscal Discipline Council

Protocol No. 6(58) of 2022 No. §1.1.

Summary

1. Due to the upcoming Saeima elections this year, the development of the budget for 2023 and the medium-term financial framework has been delayed. Article 15 of the Law on Budget and Financial Management determines the authorization and limitations for the Minister of Finance to determine state budget expenditures, loans and borrowings in circumstances where the annual state budget law has not entered into force. Such a temporary (no policy change) budget is created for 2023. The Fiscal Discipline Council reviews a limited range of issues in this monitoring report, which is based on the information at its disposal. A full monitoring report will be prepared once the new government has approved the 2023 budget and the Medium-Term Budget Framework for years 2023-2025.
2. In 2022, the economy had already begun to return to pre-pandemic indicators, as evidenced by both the first half GDP indicators of 4.6% and the projected return of the output gap to minimal positive indicators (0.03%) of GDP. However, as a result of Russia's aggression, the geopolitical environment has rapidly deteriorated, which significantly negatively affected economic growth prospects in the coming years. Consequently, macroeconomic forecasts were revised several times in the current year. According to the latest forecasts, the biggest economic slowdown is expected at the end of 2022/the beginning of the year 2023, when consumer consumption and the real sector will be significantly negatively affected, while fiscal challenges will increase taking into account the need to support citizens and entrepreneurs during the period of rapid increase in the price of energy resources. The deterioration of the macroeconomic environment will cause the economy's functionality to fall below its potential level, which will be reflected in negative output gaps in 2023 and possibly 2024.
3. In August of this year, the Council approved macroeconomic forecasts for the period 2022-2025, on the basis of which the temporary budget for 2023-2025 is being developed. It is expected that the Medium-Term Budget Framework Law will also be based on these forecasts. MoF predicted real GDP growth of 2.8% for 2022, 1%, in 2023, 3% in 2024, and 3.4% in 2025.
4. The latest forecasts were published by the Bank of Latvia in September: compared to June, GDP for 2022 is estimated to be 0.1 percentage points more optimistic (3%), while for 2023 the forecast has been lowered from 2.4% growth to -0.2% decline. Then the Bank of Latvia predicts a faster growth of 4.4% for 2024. MoF and EC are more optimistic in their forecasts for 2023; however, predicting slow growth rather than recession: MoF (1% of GDP) and EC (2.2% of GDP). However, the MoF has also developed a risk scenario, which predicts (-2.1%) economic recession in 2023, slow recovery (+1.5%) in 2024 and (+3.4%) GDP growth in 2025. The deviation of the budget balance from the base scenario would be (-0.3%) in 2023, and (-0.4%) in 2024 and 2025, and tax revenues, especially VAT and excise taxes, would decrease rapidly throughout the period.
5. Inflation forecasts differ in the assessment of forecasters, exceed the 16% level for 2022 and are revised upwards in each forecasting cycle. Also in the September forecasts, the Bank of Latvia increased the inflation forecast for 2022 from 14.8% in June to 16.9% forecast. The MoF's August forecast for 2022 foresees inflation at the

level of 16.5%, 6.5% in 2023, 2% in 2024 and 1% in 2025. Inflation is currently one of the most important factors limiting economic development both in the Eurozone and especially in the Baltic States. In the eight months of this year, consumer prices in the Eurozone have risen by an average of 8%, at the same time by 15% in Latvia, by 18% in Estonia, and by 17% in Lithuania. Core inflation in Latvia reached an average of 6.4% in eight months, which indicates that inflation has taken over all sectors of the economy. Russia's destructive actions in the gas market have repeatedly created panic in the gas market and caused gas shortages. Under the influence of this and other factors, energy price inflation remains extremely high both globally and in Latvia. In the case of Latvia, it reached 67% in August and maintains its dominant position as a component of overall inflation.

6. Revenues of in 8 months of this year in the consolidated general budget have increased by 12.5% compared to the corresponding period in 2021. Tax revenues increased even more rapidly in the relevant period - by 14.6%, of course largely due to inflation. In general, the prediction for this year is that tax revenues could exceed the budgeted plan by 1 billion euros, which is a significant figure. However, the impact of support measures on GGBB this year is estimated at about 2 billion. Therefore, the good tax collection performance will not improve in GGBB at the end of 2022. The tax revenue projections of the 2023 Budget draft look reasonable given the potential economic recession and high uncertainty. Next year, tax revenues in the General consolidated udget are planned at 11.76 billion, only 610.5 million or 5.5% more than estimated this year. The FDP conservatively estimates next year's total budget revenues at 12.42 billion euros, which is 5.9% more than the MoF's forecast
7. The rapid deterioration of the geopolitical background in 2022 manifested itself not only by the rise in global energy prices, but also by the rise in food prices what has required a rapid fiscal response, especially supporting the most vulnerable households and companies. In Latvia, the volume of the deficit of general government for 2022 is forecasted in the amount of 7%, which is 0.5 percentage points higher than in Stability program 2022-2025, when it was planned the highest in the EU. Although this year the economy is still operating close to its potential and additional fiscal stimulation should be considered pro-cyclical, it must be taken into account that the economy is receiving a repeated blow at a time when it started a new growth cycle after the Covid-19 pandemic crisis. Conditions of very high uncertainty for the country's economic and fiscal development remain in the nearest period.
8. The general escape clause of the EC Stability and Growth Pact will be valid in 2023, while the provisions of the Fiscal Discipline Law are currently valid and applicable in accordance with the provisions of Article 12, Part 1. According to the provisions of the mentioned article, the consequences of the Covid-19 pandemic in the national economy are considered as a natural and social phenomenon, the losses of which exceed 0.1% of GDP. This approach was initially applied in the Fiscal Strategy of Stability program 2022-2025. (approved by the Cabinet on 12.04.2022) and supplemented by creating the Informative report "On forecasts of macroeconomic indicators, revenues and general government budget balance in 2023-2025". In addition, the recommendations of the Council of the EU, among other things, state: "Ensure that in 2023 the increase in state-financed current expenditures corresponds to a generally neutral policy position, taking into account the fact that the provision of temporary and targeted support against the rise in energy prices to the most

vulnerable households and companies will continue, as well as persons fleeing Ukraine. Be ready to adjust current expenses to the changing situation. Increase public investment that will contribute to the green and digital transition and energy security, including through ANM, REPowerEU and other EU funds. In the period after 2023, implement a fiscal policy aimed at achieving a prudent medium-term fiscal position. To reduce inequality, expand, among other things, property and capital taxation and strengthen the adequacy of health care and social protection."

9. The Ministry of Finance has formulated the fiscal policy for 2023 including the following basic principles: (i) a gradual transition to a neutral fiscal position, ii) the fiscal correction is proportionate to prevent a situation where excessive correction could negatively affect economic growth, (iii) "one-offs" include: (a) Covid-19 support measures, (b) energy support measures, (c) defense and internal security expenditures above the expenditure level of year 2022. When planning GGB's structural balance, its normalization trajectory of 0.5% annually in 2023 and 2024 has been observed, but in 2025 it is planned to reach the goal of -0.5% of GDP. The structural balance deficit is planned to be -1.8% of GDP in 2022, -1.3% in 2023, -0.8% in 2024 and -0.5% in 2025.
10. In the medium term, from 2023 to 2025, the fiscal policy planned in the interim budget is in line with the economic cycle. It is forecasted that in 2023 and 2024 output gap will be negative (-1.1% and -0.5% of GDP), respectively, which is characterized by a stimulating fiscal position and a deficit of -3.7% and -1.5% of GDP. On the other hand, in 2025, the output gap could return to positive indicators, but the GG budget deficit could improve to -1% of GDP.
11. Forecasts on the development of the debt of Latvia show that the debt condition set by the Fiscal Discipline Law (60% of GDP) will be met in the medium term. The general government debt forecast shows that in 2022 the amount of debt could reach 42% of GDP, or 16.1 billion euros. It is forecast that the debt % to GDP will reach a maximum of 43% in 2023, and then gradually decrease to 41.5% in 2025. However, in nominal terms, the debt will continue to grow annually by an average of 1 billion euros, reaching 19.2 billion euros in 2025. Thus, since the beginning of the pandemic in 2020, when the debt started to grow rapidly in nominal terms, it is predicted to increase by around 6.4 billion euros by 2025.
12. The Council generally supports the fiscal strategy and fiscal goals proposed by the MoF, however, points out the limited fiscal space in the coming years - 95.1 million euros in 2023, 283.5 million euros in 2024, and 306.9 million euros in 2025. The new government will have a difficult task - to meet the ever-increasing needs with limited funding, which is required by the return to a sustainable and disciplined fiscal policy. The Council offers the following priorities to the government: (i) to develop and implement an energy policy that is oriented towards the development of green and independent energy production capacities and the economy of energy resources (ii) to strengthen the internal and external security of the country, (iii) to mitigate the social and economic impact of the crisis, (iv) gradually move fiscal policy towards sustainability. Aware that security should be one of the government's priorities, the Council nonetheless points out that the increase in defense and internal security spending above the 2022 level cannot be recognized as a one-off measure, as it does

not meet the characteristics of one-off expenses in the sense of SGP Vade Mecum[1]. The Council has expressed a similar opinion in the Surveillance Report on Latvia's Stability Program 2015-2018. and in the Surveillance Report on the Stability Program 2022-2025.

13. Support measures are considered as one-off measures affecting the nominal balance but not affecting the structural balance. Their impact on GGBB this year could reach 2 billion (energy support 1.16 billion, Covid 0.83 billion) euros (5.2% of GDP). In 2021, the impact of support on GGBB was 2.1 billion euros (6.4% of GDP). In 2023, the total support is estimated at 820 million euros (2% of GDP). The calculation for the next year impact does not include 2023/24 winter energy support measures impact, which is currently unknown. Starting next year, the increase in security strengthening expenses, compared to the previous year, will also be added to the support measures.
14. Currently, the review and discussions of the fiscal regulation and budget monitoring mechanism are underway in the European Union. It is expected that a new fiscal regulation is expected in the coming years, which provides for a post-crisis transition period and a moderate deficit reduction trajectory for EU member states. The EU Fiscal Council is expected to publish a report on this topic in October.
15. In the current situation, the monetary policy is starting to become restrictive and acts as a factor slowing down the economy, while the fiscal policy applied in Latvia is still stimulating, supporting the functionality of the economy during the energy crisis. On September 24, the ECB decided to raise the three main ECB interest rates by 75 basis points and to continue raising rates until the inflation target (2%) is reached and price stability is ensured in the long term. At the same time, in Latvia, taking into account the negative trends in the economy, a stimulating fiscal policy corresponding to the economic cycle is applied, the aim of which is to maintain internal consumption and reduce the depth of the recession. The budget deficit remains high and there is a risk that it will increase further as a result of social tensions.
16. Although Latvia still maintains a high credit rating (Moody's A3, S&P Global A+, Fitch A-, R&I A) and a stable future assessment, it must be considered that in the coming years, debt servicing costs will inevitably increase due to a tighter monetary policy of the ECB. The era of low interest rates is coming to an end in the world, and although the ECB increases interest rates with a slight delay compared to other countries, it is clear that interest rates will increase in the Eurozone, including Latvia. Next year and in the years to come, Latvia has to refinance its foreign debt in the amount of more than 1.4 billion euros, therefore it is important for the government to maintain a responsible fiscal policy so that the rating companies maintain a high rating of Latvia and debt servicing does not become a significant fiscal burden.

[1] Vade Mecum on the Stability and Growth Pact: Vade Mecum on the Stability and Growth Pact – 2019 Edition (europa.eu)