Fiskālās disciplīnas padome

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SUMMARY

1. The global economy is currently in a difficult phase. Russian war in Ukraine, pandemics and war-induced disruptions to supply chains, shocks resulting from the reduced global demand, as well as the rising costs of energy resources, increase risks of recession and inflation in all the world. European Union (EU), given its geographical proximity to the war and significant dependence on Russian gas import, is impacted particularly strong. EU countries economies are at a tipping point, teetering on the brink of recession and slow growth. The EU economic growth forecast for 2023 is only 0.3%, while recession is predicted in Germany Latvia and Sweden, but very slow growth in other EU countries. In eurozone inflation is constantly increasing and has reached 10.6% in October. Inflation is forecasted high next year as well: 7% in the EU as a whole, and 6.1% in the Eurozone[1].
2. Regarding Latvia, it is predicted that the deepest point of the current crisis will be reached in 2023. It is expected that the year 2022 for Latvia will end with a slower, but still positive GDP growth than expected at the beginning of the year. The latest forecasts for 2023 are not optimistic and increasingly show a decline. The European Commission (EC), renewing its forecasts on November 11[2], lowered Latvia's GDP for 2022 from 3.9% to 1.9%, but predicted a recession for 2023 (-0.3%). Such a forecast is similar to the estimates of the Bank of Latvia[3], which published updated forecasts in September and predicted a (-0.2%) recession in 2023.
3. The Council has previously indicated that the economy can develop in two difficult-to-control trajectories: (1) an inflation/wage spiral and (2) a recession. There are currently no signs of an inflation/wage spiral. Although gross wages increased by 8.3% and net wages by 7.5% in the second quarter, the real net wage changes in the second quarter were negative (-7.6%)[4]. As a result of such a wage-price relationship, the population faces a decline in real income and purchasing power, which brings recession closer. Recession is inevitable not only as a result of the drop in demand of the population, but also due to the decrease in the export capacity of companies, and due to the high prices of energy resources and other raw materials. Indicators of economic sentiment also show a prolonged negative vision of future prospects. CSB data show that in October the sentiment is negative in all sectors: especially in construction (-15.5%) and industry (-9%).
4. According to CSB's quick assessment[5], the beginning of the recession in Latvia is recorded in the third quarter of 2022, when seasonally adjusted GDP decreased by 0.4%. The decline in GDP in the third quarter was significantly influenced by the decline in manufacturing by 3.9% and insufficient growth in

[1] EC Autumn 2022 Economic Forecast: Autumn 2022 Economic Forecast: The EU economy at a turning point (europa.eu), accessed 25/11/2022
[2] Economic forecast for Latvia: Economic forecast for Latvia (europa.eu) , accessed 25/11/2022
[3] Latvijas Banka pārskata makroekonomiskās prognozes: Latvijas Banka pārskata makroekonomiskās prognozes | Prognozes | Makroekonomika , accessed 25/11/2022
[4] CSP: 2. ceturksnī vidējā bruto darba samaksa 1 362 eiro 2. ceturksnī vidējā bruto darba samaksa 1 362 eiro | Oficiālās statistikas portāls , accessed 25/11/2022
[5] CSP: 3. ceturksnī IKP pēc ātrā novērtējuma samazinājies par 0,6 % | Oficiālās statistikas portāls ,skatīts 25/11/2022

services by 1.7%. Latvia's GDP growth in entire 2022 could still be positive, as it reached 2.4% in three quarters.

5. A more significant trend in fiscal development is the growing difference between tax revenues, inflation and increases in government support. Tax revenues are already growing more slowly than inflation, which limits the possibilities of support from the state's own revenues. Tax revenues in the 10 months of this year increased by 15% compared to the 10 months of the previous year, and inflation increased by 16.4% compared to the 10 months of the previous year. At the same time the rate of growth of state aid and some other budget expenditures is faster than that of taxes revenue growth. So, compared to October 2021, expenses for social support increased by 22.5%. Expenditure on goods and services also increased substantially in the meantime (+203%), mostly related to public infrastructure an increase in maintenance costs.
6. At a time when both social tension and the need to increase public infrastructure maintenance expenses are increasing, we cannot do without state support. In response to the unstable economic situation and the social problems of the population, the government established economic stabilization and population support mechanisms with a significant impact on GGBB. This year, the impact of these measures on GGBB could reach 2 billion euros (5.2% of GDP), a year ago it was 2.1 billion euros (6.4% of GDP). Of the 2 billion euros of support, about 1.2 billion euros are intended for mitigating the effects of energy resource price increases (including purchased gas for reserves), the rest for eliminating the effects of Covid-19 and other measures. Studies show that the amount of Latvian support for mitigating the consequences of energy resource price increases is commensurate with the levels those of other EU countries[6].
7. Despite the significant state support in the conditions of the pandemic and energy resource crisis, Latvia has so far managed to maintain a relatively low level of public debt. Currently available data for the second quarter show that the general government debt was 41.6% of GDP, or 14.3 billion euros. Credit rating agencies maintain Latvia's credit rating at a consistently high level (S&P Global A+, Fitch Ratings A-). However, it should be taken into account that Latvia's fiscal response to existing challenges is related to an ever-increasing fiscal imbalance, budget deficit (currently forecast at 7% of GDP) and faster growth of national debt, and very limited fiscal space.
8. Latvia's inflation rate is one of the highest in the EU. In October, it reached 21.8% compared to October of the previous year and has not fallen below 21% since July. Under the influence of high energy resource prices, prices for housing maintenance costs have risen the fastest (+46.9%), however, the price increase is slower than September's indicators, when housing maintenance costs rose by 51.6%. The rapid rise in prices for food and non-alcoholic beverages still continues- 29.5%, when compared to October of the previous year.
9. In an effort to curb high inflation, central banks have initiated a tighter monetary policy and increased interest rates. Both the US Federal Reserve

[6] National fiscal policy responses to the energy crisis (bruegel.org), accessed 14/11/2022

and the ECB have raised interest rates several times. In the USA, which has been the most active in raising interest rates, the 10-year bond yield has reached around 4%, however, the restrictive monetary policy has produced its results - the annual inflation of consumer prices, after reaching its peak this year. 9.1% in June, has started a downward trajectory and fell to 7.7% in October. The ECB has started the restrictive monetary policy later, because the causes of inflation in the US and the Eurozone are different, and the restrictive policy of the ECB could reduce inflation only in the medium term.

10. Currently, the biggest challenge in the EU economy is to balance the restrictive monetary policy of combating inflation, which inevitably slows down GDP growth, with a smart fiscal policy. The task of fiscal policy in the short term is to provide vital support to households and individual businesses in difficulty. However, when the acute crisis period ends, fiscal policy should move towards reducing the national debt. This year, the historically highest debt level of 93.6% is forecast in the Eurozone, and 86% in the EU. In addition, the national debt of Portugal, Italy, Greece, Belgium and France has well exceeded 100% of their GDP. In Latvia, the ratio of public debt to GDP is more than 2 times lower than the average in the EU; however, debt servicing payments are also increasing in Latvia. Currently, debt service costs are around 200 million euros per year - that could double in the next few years. The EU's challenge is to gradually reduce the ratio of national debt to GDP, or at least to prevent further debt growth.

11. In search of more appropriate instruments for fiscal policy challenges, the EC has published a communication[7] on the reform of the Eurozone fiscal framework. Such a reform is necessary because the debts of some Eurozone countries have reached unprecedented levels and they need to be reduced while promoting economic growth. When creating this regulation, the EC is trying to find a way to balance national expenditures with medium-term economic policy priorities, while simultaneously achieving a real reduction of national debts. The new regulation will mean fewer fiscal conditions. Basically, the growth of budget expenditures and changes in the national debt will be controlled. The new regulation also envisages a structural change in the application of sanctions for non-compliance with fiscal discipline. Penalties will be less severe, but will be triggered immediately. The role of independent fiscal institutions, including the Latvian Fiscal Discipline Council, will increase, as the range of analytical and control functions entrusted to them will also expand, including the assessment of the fiscal impact of structural reforms. It is planned that the new regulation will be approved in 2023 and will enter into force in 2024. The new EU fiscal regulation will most likely create the need to adjust the domestic fiscal regulations of EU countries, including Latvia.

12. The results of the Saeima elections lead to cautious optimism that the next government could also adopt a relatively responsible fiscal policy. The outgoing government has approved the medium-term budget framework for years 2023-2025 and the draft budget plan for 2023 at an unchanged policy, according to which the GGB deficit would reach 3.7% next year and the new government would have only 95 million euros large fiscal space. In general,

[7] https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf, accessed 27/11/2022

the Ministry of Finance in the Informative Report "On macroeconomic indicators, revenue and general government budget balance forecasts"[8] proposes a conservative fiscal policy, which the Council supports. Currently, the Ministry of Finance is developing new macro-economic forecasts, which the Council of Fiscal Discipline will consider at its meeting on December 1.

13. From the point of view of fiscal discipline, a difficult period awaits the new government, which is determined by a set of several risks: 1) high uncertainty, which makes macroeconomic and fiscal forecasting difficult; 2) geopolitical risks, which require additional investments for domestic military security and energy security, as well as for the support of Ukrainian war refugees; 3) supply chain disruptions, both due to China's 0-Covid policy and due to geopolitical tensions in the region; 4) the growing financial needs of the state for social protection and maintenance of public infrastructure; 5) the impact of rising interest rates on debt servicing costs; 6) the need to move towards a prudent fiscal position and introduce the new EU fiscal regulation, which will also require reforming the national fiscal regulation; 7) restrictive monetary policy, which can cause liquidity problems for companies and the economy as a whole; 8) the possibility of a deep recession, which will also negatively affect tax revenues.

14. In order to overcome the above-mentioned challenges, Fiscal Discipline Council calls on the new government to prevent an unjustified increase in budget expenditures in 2023, to provide only well-targeted and timed support to the most vulnerable households and energy-intensive companies. If the recession is deeper than predicted, the need to increase budget expenditures for social protection will increase. However, if the situation improves, budget expenditures could even be reduced. After 2023 - it is necessary to ensure a prudent fiscal policy in order to achieve a stable and balanced fiscal position with a low deficit and a sustainable level of public debt in the medium term.

[8] Par makroekonomisko rādītāju, ieņēmumu un vispārējās valdības budžeta bilances prognozēm 2023.-2025. gadā (mk.gov.lv) , accessed 25/11/2022