Fiskālās disciplīnas padome

Fiscal Discipline Council

Opinion on the macroeconomic forecasts of the Ministry of Finance

for 2022 and the medium-term budgetary framework 2023 - 2025

Preamble

This document presents the opinion of the Fiscal Discipline Council (hereinafter - the Council) on the macroeconomic forecasts developed by the Ministry of Finance (hereinafter - MoF) for 2022 and the medium-term period from 2023 to 2025. Forecasts will be used as a basis for the Medium-term Budget Framework (hereinafter - MTBF) 2023-2025. for the year (2023/25), which is planned to be submitted to the Cabinet of Ministers in February 2023. To support the work on the development of the annual documents - SP and MTBF, an agreement was reached on early approval by the Council of the macroeconomic forecasts of the Ministry of Finance.

According to the Cooperation Agreement signed on February 8, 2016, the Council is responsible for approving the macroeconomic forecasts of the MoF. During the forecast approval procedure, the MoF provided detailed forecast data for the Council, including the structure of the gross domestic product (after this referred to as GDP) and development scenarios of individual GDP components.

At the meeting of the Council on December 1, 2022, the MoF informed Council about the assumptions and changes of the renewed macroeconomic forecasts. The Council asked the MoF questions about the assumptions of the estimates and the justification of specific indicators and received answers.

The Council's duty is to provide endorsement of macroeconomic indicators, in accordance with the scope of indicators defined in Article 20 of the Law on Fiscal Discipline (the indicators are summarized in Table 3 at the end of this document). Council members, taking into account the materials and explanations provided by the MoF and based on the internal discussion, made a decision on approving the forecasts[1].

Situation review

MoF's forecasts have been revised several times during 2022, taking into account the high uncertainty and the Council's call to revise forecasts in cases where the development of the situation deviates significantly from the previously foreseen scenario[2],[3],[4]. Since the beginning

[1] Council meeting minutes Nr 8 (60): Microsoft Word - FDP_1_04_463_20221201_Council_minutes8_60.docx , December 1, 2022 meeting
[2] 14.02.2022 Macro forecasts endorsement: 14.02.2022 Macro forecasts endorsement | Fiskālās disciplīnas padome (fdp.gov.lv)
[3] 09.03.2022 Adjusted macro forecasts endorsement: 09.03.2022 Adjusted macro forecasts endorsement | Fiskālās disciplīnas padome (fdp.gov.lv)
[4] 12.08.2022 Endorsement of the Ministry of Finance macroeconomic forecasts for 2022 and the medium-term budgetary framework 2023/25: 12.08.2022 Endorsement of the Ministry of Finance macroeconomic forecasts for 2022 and the medium-term budgetary framework 2023/25 | Fiskālās disciplīnas padome (fdp.gov.lv)

of 2022, MoF forecasts have deviated in a pessimistic direction, GDP has been estimated lower and lower in each new iteration of the forecast, while the inflation forecast has been increased. Compared to the forecasts of other institutions (the Bank of Latvia (BoL), the European Commission (EC), and the International Monetary Fund (IMF), the MoF's assessment of real GDP is more pessimistic throughout the forecast period 2022-2025. Comparing the averages of real GDP forecasts of the mentioned institutions with MoF calculations, MoF's forecasts are lower in 2022 by 0.9% points, in 2023 by 1.3% points, in 2024 by 0.5% points and in 2025. per year by 0.4% points. The IMF forecast made in October is the most optimistic and does not foresee a downturn for Latvia's economy, while the EC's November forecast is already much more cautious and predicts a recession in 2023 by 0.3%.

Inflation forecasts. MoF has repeatedly raised inflation forecasts. Compared to the average indicators of the BoL, EC and IMF forecasts, the MoF's forecast is 0.3 percentage points lower for 2022, however, in 2023, the MoF forecasts 1.5 percentage points higher inflation than the average estimate of other forecasters. Regarding the forecast for 2024, the MoF assessment is 1.4% points lower, and for 2025 it is 0.5% points lower. In general, MoF predicts that inflation will remain high in 2023, but will decrease more rapidly in 2024. Table 1 summarizes the current macroeconomic indicators forecasts of the MoF and other institutions, Data sources: MoF[5], BoL[6], EC[7], IMF[8].

	2022	2023	2024	2025
Real GDP growth				
MoF (Dec.2022)	1,6	-0,6	3,0	3,0
BoL (Sep.2022)	3,0	-0,2	4,4	
EC (Nov.2022)	1,9	-0,3	2,6	
IMF (Okt.2022)	2,5	1,6	3,4	3,4
Nominal GDP growth				
MoF (Dec.2022)	17,0	8,1	5,4	5,7
BoL (Sep.2022)	–	–	–	–
EC (Nov.2022)	–	–	–	–
IMF (Okt.2022)	16,8	9,1	6,2	5,6
Inflation CPI				
MoF (Dec.2022)	17,3	8,5	1,0	2,0
BoL (Sep.2022)	16,9	9,2	3,4	
EC (Nov.2022)	16,9	8,3	1,3	
IMF (Okt.2022)	18,9	3,4	2,6	2,5
Deflator				
MoF (Dec.2022)	15,2	8,7	2,3	2,6
BoL (Sep.2022)	–	–	–	–
EC (Nov.2022)	11,0	6,2	3,8	
IMF (Okt.2022)	13,9	7,3	2,7	2,2

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

The latest data from CSB show that in the third quarter of this year, compared to the third quarter of 2021, real GDP decreased by 0.6% (seasonally and calendar unadjusted data), or when looking at seasonally and calendar adjusted data, the decrease was 0.4%. Compared to the previous quarter, according to seasonally and calendar-adjusted data, real GDP decreased by 1.7%. In the third quarter, compared to the corresponding period of the previous year, changes in the total added value were affected by a decrease in manufacturing industries by 3.9% and an increase in service industries by 2.2%. The largest positive impact on the growth of total added value in the third quarter was provided by accommodation and catering service providers (+33.1%), information and communication service providers (+14.2%) and commercial service providers (+13.2%). The biggest decrease was observed in construction (-13.6%), trade (-10.3%), manufacturing (-1.6%) and other industry (-8.5%).

[5] MoF updated macroeconomic forecasts: Finanšu ministrija aktualizē makroekonomisko rādītāju prognozes | Finanšu ministrija (fm.gov.lv)
[6] BoL Forecasts (23.09.2022): Latvijas Banka pārskata makroekonomiskās prognozes | Latvijas Banka
[7] Europen Comission forecasts, 11.11.2022: Economic forecast for Latvia (europa.eu)
[8] International Monetary Fund (Okt.,2022), World Economic Outlook, October 2022: Countering the Cost-of-Living Crisis (imf.org)

Export. The value of export of goods increased by an average of 31.2% in three quarters. In the third quarter, compared to the third quarter of 2021, the growth was slightly slower at 28.7%, including the value of exports of goods to the EU increased by 22% and to other countries by 6%, while to the CIS countries alone by 0.7%. In total, the value of the export of goods was 5.64 billion. EUR, exceeding the result of the third quarter of 2021 by 1.26 billion. euro. The increase in the value of export of goods is mostly explained by a general increase in the price level because the value of exports is counted in euros and not the physical quantity, however, in general, this increase can be assessed as a temporary factor promoting GDP growth.

Inflation. The level of consumer prices is still high and has not fallen below 21% since July. In October, compared to October 2021, the average level of consumer prices increased by 21.8%. On average, in ten months, compared to ten months of the previous year, consumer prices rose by 16.4%.

In October, under the influence of high energy resource prices, prices for housing maintenance costs have risen the fastest (+46.9%), however, it should be noted that the state support mechanisms have taken effect and the price increase is slower than in September's indicators when the prices of housing maintenance costs rose by 51.6%. However, looking at the structure of housing maintenance costs, it can be seen that gas prices also rose in October (+106.1%), for electricity, gas and other fuels (+73.9%), while for electricity - 32.8%. The rapid rise in prices for food and non-alcoholic beverages continues in October (29.5%). In food prices, the fastest increase was for sugar (75.1%), flour and other cereals (+63.9%), and other edible oils (+50.6%). Currently, the most significant factors affecting inflation are related to the war in Ukraine and the imposition of sanctions on Russia, which result in supply chain disruptions, and energy and production raw material shortages, which in turn increase the price level in the world and in Latvia. In addition, supply chains are hampered by China's still-applied Zero Covid policy, which limits the free and timely flow of goods.

Wages. The latest CSB data show that in the 3rd quarter of this year, compared to the 3rd quarter of 2021, the average monthly gross salary increased by 6.3%, but compared to the second quarter of this year, the average monthly gross salary increased by only 1.6%. Net wages grew more slowly than gross wages (6%) compared to the 3rd quarter of the previous year. Considering the rise in consumer prices, the net wage decreased by 12.9%, which indicates a sharp decline in the purchasing power of salaried employees, and for the third quarter in a row.

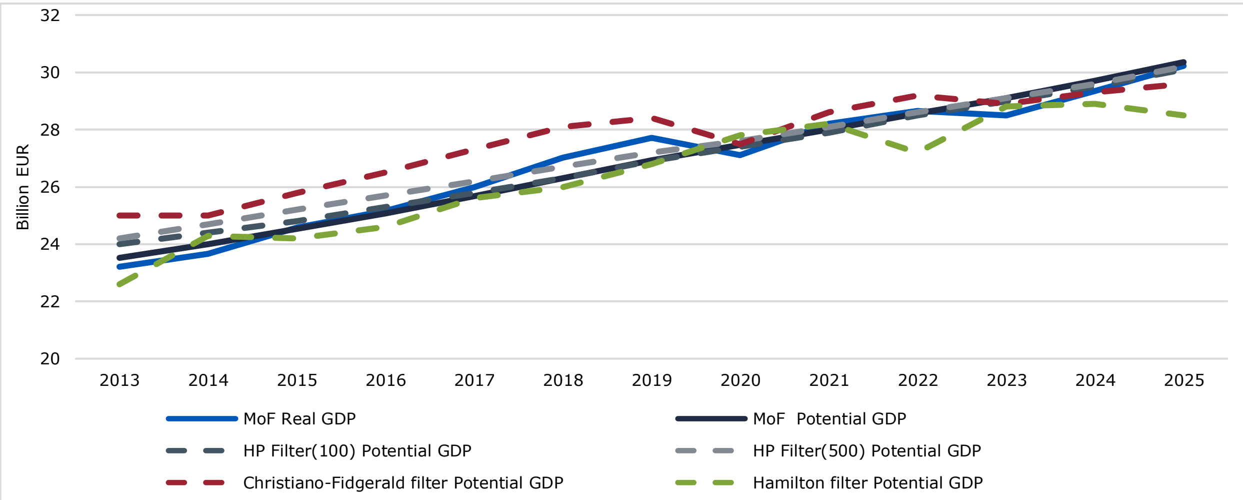
The unemployment rate in October was equal to September's rate of 7.1%, according to CSB data. Since May, it has been growing slightly on average within the limits of 0.2% points. If in, May it was still possible to judge that the unemployment rate has approached the pre-Covid crisis indicators, it is currently considered to be moderate, but still higher than before the crisis period. There is a risk that the unemployment rate will continue to rise as the economy continues to cool or decline. According to the NVA data, the registered unemployment rate fell to 5.7% in October, the indicator was the same in September.

The growth of industrial production in the third quarter averaged 2.1%, which is half as slow as in the previous quarters of this year. Looking structurally, the growth is slower in all segments: mining (+1.4%), manufacturing (+4.4%), and electricity and gas supply sector, a decline for the third quarter in a row (-13.9%). In the manufacturing industry, the output growth in the first quarter was 11%, the slowest of the three quarters of this year. The growth was provided by the food industry (+4.1%), Other industries (+6.4%), non-metallic mineral industry (+2%), however, the growth was slowed down by the decrease in the volume of production in the wood industry (-1.7%) and the chemical industry (-0.3%).

Assessment of the economic cycle of Latvia

The council's experts provide their assessment of the current state of the Latvian economy in its economic cycle. This assessment uses methods based on statistical filters. The method of statistical filters has been used to separate short-term and long-term fluctuations in GDP and provide a view of the potential of the economy, thereby allowing the calculation of an approximate value of the output gap that can be compared with MoF calculations. Three statistical filters were used to obtain GDP trend and cycle components: Christiano-Fitzgerald, Hodrick-Prescott (HP), with smoothing lambda parameter (100) or (500) and the latest Hamilton filter. Figure 1 shows that in the period from 2013 to 2025, the potential GDP obtained by the HP (100) method is the closest to the FM calculation, while the time series estimated by the Hamilton filter differs the most from the FM. The results show that the assessment of potential GDP used in this forecast is more similar to the trend line, without taking into account the changes in the economy during the Covid-19 period, as was done in the forecasts presented in August.

Figure 1. Real GDP (historical and projected) versus potential GDP estimated by three statistical filters and MoF estimates.

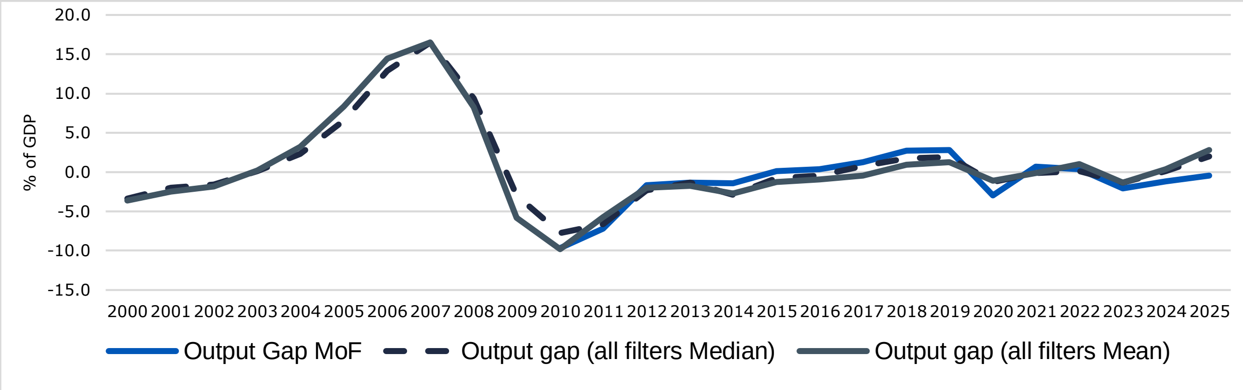


Source: MoF, CSB, FDC calculations

Alternative measures of the output gap were obtained based on the above statistical filters. It can be concluded that in the period from 2013 to 2025, the results of various alternative statistical filtering methods basically follow a similar trajectory as the MoF data.

Figure 2 shows a comparison between the arithmetic mean, median and MoF calculated output gap difference of all filters applied to the output gap calculation. Both the median and mean value curves point to a negative output gap in 2023, however, in the following years a faster trend of the output gap to positive values than calculated by MoF.

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



Source: MoF and FDC calculations

Comparing the values of the difference between potential GDP and output gap calculated by statistical filter methods and the values of these indicators calculated by MoF, it can be concluded that in 2023 all the estimated output gap are negative, but in the FM assessment, the output gap is 0.6-0.7 percentage points lower. Regarding the output gap in 2024 and 2025, the statistical filter method shows a faster return to positive values, while in the MoF assessment the output gap is negative until 2025. Such a result, in times of high uncertainty, may be fluctuating and be dependent on actual events in the economy. Therefore, the Council recommends updating the macroeconomic forecast in the 1st quarter of 2023. The numerical values of the output gap comparison are shown in Table 2.

Table 2

Output gap values in the evaluation of the MoF and the Council

	MoF evaluation	Council evaluation (Median of all stat. filters)	Council evaluation (Mean of all stat. filters)
2023	-2,1	-1,3	-1,4
2024	-1,2	0,2	0,4
2025	-0,4	2,0	2,8

Source: MoF and Council calculations

The Council agrees with the MoF's estimates of the output gap and potential GDP and recognizes that the economy is currently at a turning point. Whether the recession is quickly reversed or deepens depends on a set of global and hard-to-control risks.

Comparison of MoF current and previous forecasts

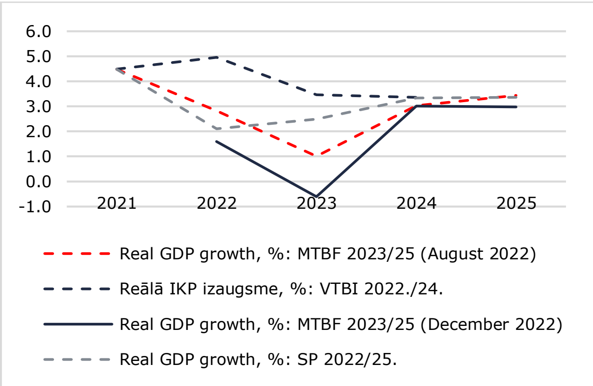
Since the previous approval of the macroeconomic forecasts of the Ministry of Finance in August 2022, the economic situation has significantly worsened and such a development necessitates a review of the macroeconomic framework, which will be used for the medium-term budget framework in period 2023-2025.

Below is a comparison between forecasts confirmed in August 2022 and forecasts updated in December 2022. Based on the economic development to date and the

assumptions of the MoF, which are the basis of the forecasts, the Council has taken a decision regarding the approval of the following forecasts:

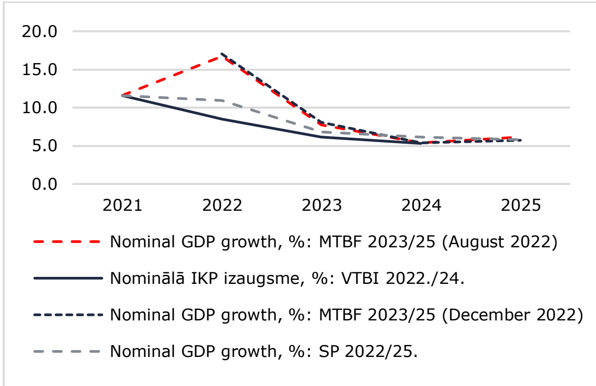
The Council endorses the real GDP growth forecast for 2022 and MTBF 2023/25. Compared to the previous (August) forecast, the real GDP forecast for 2022 was revised down by 1.2 percentage points, and for 2023 by 1.6 percentage points. Regarding the year 2024, the real GDP forecast remains unchanged (3%), but for 2025 it has been lowered by 0.4 percentage points (see Figure 3).

Figure 3. Real GDP growth forecast.



Source: MoF.

Figure 4. Nominal GDP growth forecast.

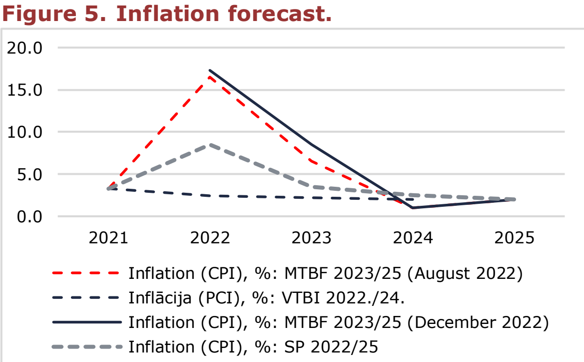


Source: MoF.

The Council endorses the nominal GDP growth forecast for 2022 and MTBF 2023/25. Compared to the previous forecast, the nominal GDP forecast for 2022 has been revised upwards by 0.3 percentage points, as well as for 2023, but for 2024 it has been left unchanged (5.4%), while for 2025 it has been lowered by 0.4 percentage points. (See Figure 4).

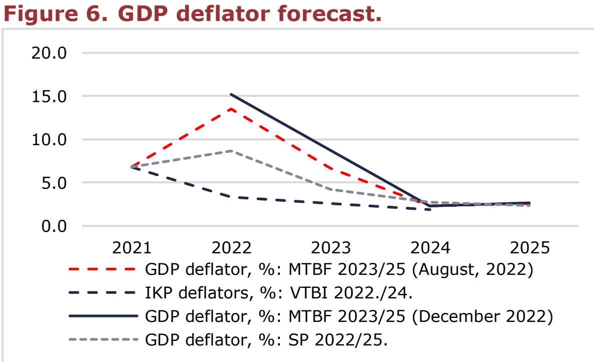
The Council endorses the inflation forecast for 2022 and the MTBF 2023/25. In the MoF forecasts, compared to the previous August forecast, the inflation value for 2022 was increased by 0.8 percentage points, and for 2023 it was increased by 2 percentage points. On the other hand, the forecast for 2024 and 2025 has not been changed and is 1% and 2%, respectively (See Figure 5).

Figure 5. Inflation forecast.



Source: MoF.

Figure 6. GDP deflator forecast.



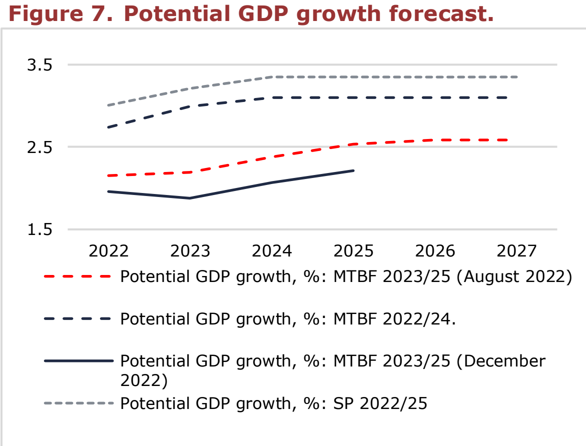
Source: MoF.

The Council endorses the GDP deflator forecast for 2022 and MFBF 2023/25. Compared to the previous forecast approved in August, the GDP deflator forecast for 2022 has been adjusted and increased by 1.7 percentage points. The forecast for 2023 has been increased by 2.1 percentage points. The deflator forecast for 2024 and 2025 is left unchanged at 2.3% and 2.6%, respectively (see Figure 6).

The Council endorses the potential GDP growth forecast for 2022 and MTBF 2023/25. Compared to the previous forecast, the forecast for potential GDP growth has been adjusted and lowered by 0.2 percentage points for 2022 and lowered by 0.3 percentage points for the entire period from 2023 to 2025. (See Figure 7).

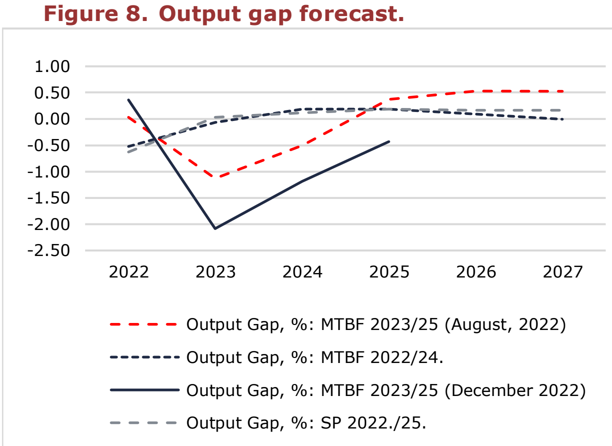
The Council endorses the output gap forecast for 2022 and MTBF 2023/25. Compared to the previous forecast, the output gap has been adjusted upwards for 2022 by 0.3 percentage points, but for the subsequent forecast period lowered by 1 percentage point for 2023, 0.7 percentage points for 2024 and 0.8 percentage points for 2025, respectively. for the year. (See Figure 8).

Figure 7. Potential GDP growth forecast.



Source: MoF.

Figure 8. Output gap forecast.



Source: MoF.

Summary

Since the recession has started in the Latvian economy, there is an objective need to review macroeconomic forecasts. The Council generally approves the MoF's macroeconomic forecasts for 2022 and MTBF 2023/25. The Council has no significant objections to the forecasts of macroeconomic indicators submitted by the Ministry of Finance in general. The Council considers them acceptable at the current time of high uncertainty

In the opinion of the Council, the most significant negative factors affecting the national economy will be the economic risks of the existing geopolitical tension, high inflation, supply chain disruptions and a drop in household consumption. As a result of these factors, the economic downturn is likely to continue. The updated forecasts predict an economic slowdown in 2023 and a negative output gap between 2023 and 2025.

Inflation in Latvia is one of the highest in the eurozone, it reached 21.7% in October and, according to Eurostat's rapid assessment, the same level remained in November. Currently, the most important factors determining inflation are energy and food prices, as well as the problem of disruptions in supply chains, which also manifests itself in the delay of production processes and the delivery of goods. In the fight against rising inflation, the European Central Bank has started a restrictive monetary policy.

The Council is concerned about the possible increase in the deficit in the context of high inflation. Fiscal policy should serve as an inflation-limiting tool. Taking into account the limited fiscal space, state support should be termed and especially well targeted, mostly to socially disadvantaged households.

The Council calls to prevent a situation where the increase in wages will become faster as social tension increases. Although the impact of inflation on the development of wages has not been fully reflected in MoF forecasts, the Council, referring to the observations of statistical data, sees that the rate of wage growth does not exceed and does not even come close to inflation indicators. Therefore, there are currently no indications that a wage/inflation spiral may be forming. However, since unemployment rates remain low, it cannot be ruled out that the pressure of the employed-on employers will increase, leading to faster wage growth.

Table 3

Macroeconomic forecast indicators endorsed by the Council

Macroeconomic indicators	2022	2023	2024	2025
Real GDP growth	1,6	-0,6	3,0	3,0
Nominal GDP growth	17,0	8,1	5,4	5,7
Inflation (consumer prices)	17,3	8,5	1,0	2,0
GDP deflator	15,2	8,7	2,3	2,6
Potential GDP growth	2,0	1,9	2,1	2,2
Output gap	0,4	-2,1	-1,2	-0,4

Source: MoF