Summary

1. According to the Regulation of the European Parliament and the Council no. 473/2013 "On common rules for the monitoring and evaluation of draft budget plans and the prevention of excessive budget deficits in the member states of the euro area", the Ministry of Finance already prepared the draft of the General Government Budget Plan for 2023 for the year 2023 in the fall of 2022, with an unchanged policy, which was approved by the MK on October, 2022. Due to the 2022 Saeima elections, further development of the budget for 2023 and the medium term was delayed. The Fiscal Discipline Council considering the rapid changes in economic development, repeatedly examined and approved the macroeconomic forecasts updated by the FM during the budget development in 2022. The last time the Council approved the corrected Macroeconomic forecasts was on December 1, 2022, which is the basis for the creation of the draft law "On the state budget for 2023 and the budget framework for 2023, 2024 and 2025". At the time, the Council emphasized that the main risks will be the ongoing geopolitical tensions, high inflation, supply chain disruptions, increased interest rates and a drop in household consumption.

2. Despite the identified risks, seasonally and calendar-adjusted data of CSB show that economic development in 2022 was better than forecast. GDP, according to preliminary assessment, has grown by 1.8% in 2022. The recession in 2022 was recorded only in the 3rd quarter, but already in the fourth quarter GDP grew by 0.1% compared to the fourth quarter of 2021, and compared to the third quarter of 2022, the increase was 0.3%. This result was positively influenced by the increase in service industries by 0.7%, which offset the decrease in manufacturing industries by 3.3%.

3. Currently, the economy is at its turning point and the level of uncertainty remains high. However, the Council supports the current rather conservative macroeconomic forecasts of the MoF. The MoF predicts a decline in GDP by 0.6% in 2023, and an increase by 3% in 2024 and 2025. For 2023, BoL predicts a half smaller recession than FM (-0.3%), but for 2024 faster growth (+4.4%). As for prices, the FM believes that the inflation rate will gradually decrease: in 2023 it will remain high (8.5%), but in 2024 it will drop sharply to 1% and in 2025 it could reach 2%. The Bank of Latvia forecasts a higher level of inflation in 2023 (10.9%) and a slower decline in inflation in 2024 (4.4%). The differences between the indicators predicted by FM and LB practically do not affect the budget forecast.
4. Inflation is currently one of the most important factors limiting economic development both in the Eurozone and especially in the Baltic States. In the fight against inflation, the ECB purposefully strengthens the restrictive role of monetary policy. Accordingly, there is a systematic increase in interest rates, the last time the ECB raised the base rate on February 2, 2023 to 3%. Perhaps the strict monetary policy had an effect, because since November 2022, inflation in the Eurozone has started to slowly decrease. However, there are no signs of a decrease in inflation in Latvia and this year in January- according to Eurostat's rapid assessment, inflation in Latvia reached the highest level in the Eurozone at 21.6%, surpassing the indicators of Estonia (18.8%)

and Lithuania (18.4%). A certain optimism is currently given by the drop in energy resource prices to pre-war levels. The price of natural gas this year at the beginning of January fell to 50-60 euros per megawatt hour, and the price of oil, since last December, has been in the range of 65-75 dollars per barrel, which is comparable to the price level of 2021.

5. Currently available CSB data show that in the third quarter of 2022, compared to the third quarter of 2021, the average monthly gross salary increased by 6.3%, but compared to the second quarter of 2022, the average monthly gross salary increased by only by 1.6%. Such indicators show that the income of workers grows more slowly than inflation, so the risk of a price-wage spiral is low. However, productivity growth lags behind labor costs. In 2022, labor costs have significantly exceeded pre-pandemic levels, while productivity growth has been more moderate over the same period, indicating a widening productivity gap.

6. Compared to 2021, revenues of the consolidated general budget have increased by 13.5% in 2022, tax revenues have increased even more - by 15.2%, largely due to inflation. In general, tax revenues exceeded the budgeted plan by 1.4 billion euros, which in terms of volume is similar to the impact of support measures on GGBB (1.5 billion euros). Good tax collection indicators significantly improved the 2022 budget deficit. Tax revenues for 2023 in the general budget are planned to be 12.3 billion euros, only 747.3 million or 6.3% more than what was collected in 2022. Such a budget tax revenue forecast looks conservative, even considering the possible economic recession. However, in the context of high uncertainty, the Council supports the conservative assessment of budget income.

7. The general exemption clause of the EC SIP will also be valid in 2023, while the FDL norms are currently valid. However, this year, in the national regulation, both the conditions of expenditure growth and expenditure heritability are not applicable in essence. Therefore, only two fiscal conditions are valid this year - structural balance condition and debt condition. The government's fiscal strategy was defined in the Latvian Stability Program 2022-2025 and supplemented in the Informative Report "On Forecasts of Macroeconomic Indicators, Revenues and General Government Budget Balance in 2023-2025" and clarified in Informative Report "On Updated Forecasts of Macroeconomic Indicators, Revenues and General Government Budget Balance in 2023-2025". It has formulated the fiscal policy for 2023: (i) a gradual transition to a neutral fiscal position, ii) the fiscal adjustment is proportionate to prevent a situation where excessive adjustment could have a negative impact on economic growth, (iii) one-off expenditures that are excluded from general government budget structural balance calculations are: (a) Covid-19 support measures, (b) energy support measures, (c) additional defense and internal security expenses above the 2022 level, (d) expenses related to support measures for people fleeing Ukraine as a result of the Russian invasion. The Council emphasizes that the structural balance of 2022 was already balanced, therefore reducing the structural deficit is not necessary. In 2023, the structural deficit can be increased to 0.5% of GDP and, in accordance with Article 10 of the Law on Fiscal Discipline, it is necessary to maintain it at this level in the future.

8. The evaluations of the Council and the MoF regarding the potential of the economy and the negative output gap are consistent with regard to the year 2023. However, the Council's calculations indicate a faster trend of the output gap to positive values in 2024 and 2025 than the FM calculates. This is also indirectly indicated by the forecasts of the Bank of Latvia for the year 2024, which predicts faster GDP growth. Currently, with the assumption that the output gap will be negative in all the following three years, the Council believes that the fiscal policy planned in the draft budget is balanced and appropriate to the economic cycle. The FDL structural balance condition has been met in all planning years. The FM predicts that in 2023, 2024 and 2025 the output gap will be negative, respectively -2.1%, -1.2% and -0.4% of GDP, which allows for the implementation of a slightly stimulating fiscal policy and gradually improving output gap indicators, reduce the deficit. The reduction of the general government deficit is planned to -4.3% in 2023. In comparison with the Baltic neighboring countries, in 2023 the budget deficit of Lithuania is planned to be -4.9%, and in Estonia -3.8%. The MoF predicts that the general government deficit will continue to decrease and will reach -2.4% in 2024 and -2.1% in 2025. However, as the economic development scenario changes in an optimistic direction and the economy approaches its potential, the pace of reduction of the General Government budget deficit may be faster than currently forecast.

9. Forecasts on the development of the national debt show that the debt condition set by the Law on Fiscal Discipline (60% of GDP) has been met in the medium term. The general government debt forecast calculated by the State Treasury according to the EKS methodology shows that in 2023 the amount of debt could reach 41.9% of GDP or 18 billion euros. It is predicted that in 2024 the debt as a percentage of GDP will begin to decrease to 39.3% and in 2025 to 38.8%. The relative reduction in the size of the debt will largely depend on the impact of GDP growth and inflation on the size of nominal GDP. However, in euro terms, the debt will continue to grow annually, reaching 18.4 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 5.7 billion euros by 2025.

10. Due to the restrictive monetary policy of the ECB in the coming years, debt servicing costs will inevitably increase. Historically, the highest rates were in June 2000 (4.25%) and October 2008 (3.75%). Even now, the ECB is systematically and purposefully raising interest rates. The application of restrictive monetary policy instruments began in July 2022, raising the interest rate from zero, and for the time being, reaching the level of 3%. The increase in interest rates will affect both the public sector and entrepreneurs, the increase in interest rates will also be an additional burden for households. According to the experts of the Bank of Latvia, in Latvia as a whole, more than five billion euros have been issued in loans to households, of which the overwhelming majority, or almost 85%, are housing loans. About 147,000 households have mortgage obligations. The impact on public finances will be felt already this year, as Latvia refinances its external debt in the amount of more than 1.4 billion euros, therefore it is important for the government to maintain a responsible fiscal policy in

the future so that rating companies maintain a high rating of Latvia and debt servicing would not become a considerable fiscal burden.

11. Latvia has maintained a high credit rating for many years and is a country with access to financial markets. Global rating agencies rate Latvia's credit rating relatively highly - Moody's (A3), Fitch (A-) and R&I (A) and determine a stable future assessment. However, the S&P Global agency, maintaining Latvia's credit rating at a high level (A+) in 2022, has changed the future assessment from stable to negative. The agency has emphasized the risks related to the war in Ukraine, high inflation and the related direct and indirect costs to the Latvian budget.

12. Since 2020, the planning of support measures is a special challenge for the government. Support measures are considered to be one-off measures that affect the nominal balance but do not affect the structural balance. Their impact on GGBB in 2022 reached 1.5 billion (energy support 0.6 billion, Covid 0.8 billion, Ukrainian refugees 81 million) euros (3.8% of GDP). In addition to non-recurring expenses, expenses for the purchase of state gas reserves were added (0.4 billion euros, 1% 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 798 million euros (1.9% of GDP). The 2023/2024 winter energy support measures, the extent of which is currently unknown, have not yet been included in the fiscal impact of next year's support measures. Starting from 2023, the government plans to add to non-recurring expenses also the increase in defense and internal security strengthening expenses (467.8 million euros, 1.1% of GDP in 2023). Aware that security should be one of the government's priorities, the Council nevertheless points out that the additional increase in defense and internal security expenses cannot be recognized as a classic one-time measure, as it does not meet the characteristics of one-time expenses in the sense of SIP Vade Mecum. The Council believes that these expenses should rather be included in the fiscal space. Perhaps it would be necessary to issue a national regulation that would define the criteria for one-off measures.

13. The EC has published a statement on the reform of the fiscal regulatory framework of the European Union. Such a reform is necessary because the debts of some European Union countries have reached unprecedented levels and they must 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. It is planned that the new regulation will be approved in 2023 and will enter into force in 2024. The new EU fiscal regulation could lead to changes in Latvian fiscal regulations.

14. The Council generally supports the fiscal strategy, fiscal goals, prepared budget plan and medium-term budget framework proposed by the MoF. This year's budget is made in conditions of high uncertainty and both macroeconomic and fiscal forecasts are made conservatively. In general, the budget, in accordance with EC requirements, should be considered fiscally neutral and appropriate to Latvia's current economic, political and social situation. As the main risks, the Council sees the existing geopolitical tensions, the rise in energy resources and food prices, as well as the slow economic growth, if it is not possible to achieve a breakthrough in productivity and competitiveness.