Fiskālās disciplīnas padome

Monitoring report Nr. 20

Period 01.01.2023-14.03.2023

SUMMARY

1. The *Saeima* adopted the law "On the state budget for 2023 and the budget framework for 2023, 2024 and 2025" in the final reading. What risks have already been identified and what are the opportunities to reduce them? In conditions of high uncertainty, the main risk is significant deviation of macroeconomic indicators. When starting the development cycle of the Stability Program 2023-2026, the Ministry of Finance has renewed the macroeconomic forecasts that were reviewed and approved by the Council on February 10 of this year[1]. According to the new forecasts of the Ministry of Finance, real GDP will not grow in 2023, but inflation will reach 10%. The European Commission has also renewed the macroeconomic forecasts of the member states in February of this year, and the new EC forecast is very close to the FM scenario (real GDP growth for 2023 is 0.1%, while inflation may reach 7.9%). Impact of the new forecasts on the 2023 budget could be minimal or neutral, because the inflation forecast, compared to the 8.5% forecast in December 2022, has been increased by 1.5 percentage points, therefore, even if it does not enter the recession predicted in December (-0.6%), growth will be neutralized by the still high inflation, the forecast of which has been increased.
2. Recession risks arise from data available in January 2023 on the dynamics of indicators of the economic situation. The currently available data show a significant decrease in the volume of industrial production, a minimal increase in retail turnover and a slowdown in export growth. In industry, the year has started with a 10% decrease in production volume compared to January 2022, but compared to December, the decrease is 3.3%. In the manufacturing industry, the situation is not encouraging - the decrease in the volume of production compared to January 2022 is 6.1% and compared to December - the decrease is 1%. In January, production volumes increased in only four sectors – out of total of sixteen sub-sectors of the processing industry, but no increase was recorded in the food sector. Retail turnover in January, compared to January 2022, increased by only 2.9%, but compared to December - the increase was 1.4%, according to CSB calendar-adjusted data at comparable prices. The concern is caused by the food retail sales data, which show that the retail sales of food products decreased by 3.2% compared to January of the previous year. However, turnover increases were recorded in other segments. Exports are still showing good results, however, given the decline in industrial production, there are risks that this may worsen this year. In January 2023, compared to January 2022, Latvian exports decreased in the following product groups: wood, its products and charcoal (-9.6%), mineral fuel (-6.1%), mechanisms and mechanical devices (-4.3%). The pace of export growth has also slowed down, despite the still increasing total value of exports measured in actual prices.
3. Considering the not very good indicators of the economy in January, it must be said that the economy continues to balance on the edge of recession and this situation continues since the second half of 2022. Considering the decrease in purchasing power caused by high inflation and the unstable situation in the real sector, there is a risk of experiencing a recession in the second half of this year. Although the outcome of the year cannot be judged from one month's data, these data are an addition to the long-standing tense

[1] Makroekonomiskās prognozes Stabilitātes programmai 2023-2026 | Fiskālās disciplīnas padome (fdp.gov.lv)

geopolitical background and uncertainty regarding the development of energy prices and the development of inflation depending on it.

4. According to Eurostat's rapid assessment data, inflation in Latvia reached 20.1% in February (CSP data shows 20.3%). Although it decreased by 1.3 percentage points compared to January, it is still the highest in the Baltics. In Lithuania, the inflation rate in February was the lowest in the Baltics - 17.2%, while in Estonia it was only slightly higher - 17.8%. For comparison: inflation in the Eurozone was 8.7% in January.
5. The Council explains why there are still no significant signs of a decrease in inflation in Latvia. In both Latvia and the Baltics, high inflation is affected by the unresolved issue of energy independence from Russia. The cause of inflation in the Baltics was on the side of production, not consumption, and monetary measures to limit inflation do not work as quickly as in the rest of the Eurozone. The purchase prices of energy resources are still passed on to consumers, because the heating in season 2022/2023 is provided by using energy resources that were purchased in the first half of 2022, during the period of high gas prices. In addition, the increase in inflation recorded in Latvia in January compared to December (+0.7%p.) can be explained by the base effect, when a minimal decrease in consumer prices was observed in the corresponding period of 2021. Although we are now closely watching every percentage point of inflation, the trend has yet to change. The actual deceleration of other macroeconomic processes suggests that we will observe a moderate decrease in inflation in the coming months, however, the cost reduction of the consumer basket is not expected, which will continue to limit demand.
6. The future challenge of Latvia's economy is to accelerate growth, because only GDP growth will provide a stable basis for budget growth. To achieve this goal, it is necessary to increase both own investments and effectively invest EU funds, including the opportunities provided by the Recovery and Resilience Facility. RRF's funding envelope is set at 1.826 billion euros. Within the framework of this mechanism, it is planned to carry out reforms and improve the infrastructure in Latvia. A little more than one billion euros is planned to be invested in green transition and digital transformation projects, or 38% and 21% of the total investments. In addition, 196 million euros have been earmarked for increasing productivity.
7. Effective use of European resources is a prerequisite for stimulating growth. In EC's assessment, RRF's investments will have both a direct impact and a multiplier effect. FM calculations show that 380 million euros will be invested in economic transformation in 2023, 515 million euros in 2024, and 481 million euros in 2025, but 339 million euros in 2026. According to the EC's assessment, RRF will have the greatest impact on the gross domestic product in 2026, when it could be 1.3%-2%[2]. In addition, there will already be a return on previous years' investments. Investments will mainly affect the demand side. The impact on the supply side (RRF investment return) will initially be smaller, but it is connected with the demand side effects and will manifest itself in the long term, for example, comparing year 2040 with year 2028.
8. Productivity is the main engine of economic growth. The wage increase, which reached 7.5% in 2022, is unfortunately not linked to productivity growth; on the contrary - the gap between productivity and wage growth is widening. On the one hand, the pressure of the employed on the employers is understandable, in the conditions of the increasing cost of living and the open EU labor market. But on the other hand, wage growth unrelated to productivity hurts the competitiveness of the Latvian economy. Therefore,

[2] The Latvian recovery and resilience plan and productivity / Valerie Vandermulen/ PowerPoint Presentation (lu.lv)

in order to break such a "vicious circle", targeted and far-sighted investments in increasing productivity are needed. Increasing productivity is the biggest challenge for the Latvian economy in the coming decade. Considering the negative demographic trends and the expected decrease in the number of the working-age population, the need for investment in human capital is especially increasing, increasing the level of working skills and competitiveness of the employees, as well as promoting good public health indicators[3].

9. Although the situation in the labor market is quite stable and the unemployment rate does not increase significantly, this situation also hides certain risks regarding the overall capacity of the labor market. In 2022, the overall unemployment rate was 6.9%. The registered unemployment rate was unchanged in January and February (6.3%), according to State employment agency data. The lack of workers in industries essential to the national economy is high and the pressure of workers to raise wages in such conditions increases the risks of widening the gap between wages and labor productivity, which already widened the previous year.
10. In January tax revenues of the consolidated general budget reached 1.1 billion euros, which is 135 million euros or 14.4% more than in January 2022. A tax collection plan has been completed in all tax groups. Operational data for February show that a similar result has been achieved in February as well. Although MoF tax forecasting has been conservative in recent years, the decrease in inflation and possible recession could significantly affect the decrease in budget revenues, which grew under the influence of significant inflation in the previous year. The government has declared its intention to carry out a tax reform in 2024 and has started work on tax policy guidelines for 2024-2027. The Council reminds that international studies rate Latvia's tax system relatively highly. The stability and immutability of the tax system are values in themselves, especially in times of high uncertainty. The Council respects the task of improving the tax system set out in the government's declaration, however, before making changes, it would be necessary to carefully assess the short-term and long-term economic, fiscal and social effects of the reform.
11. Interest rates continue to rise in Western economies. On February 8, the ECB increased its key interest rates for the fifth time in the past year. On the other hand, the US Federal Reserve System has already raised its interest rates 8 times in the last year. The growth dynamics of economic indicators, especially inflation, the labor market and GDP, show that the rise in interest rates will continue, which will also negatively affect the economy, reducing global demand and increasing the cost of servicing public debt. Rising interest rates are cited as one of the reasons for the failure of one of the largest US banks- SVB[4] (another small US regional bank was later suspended). Although the insolvency of other US banks is not currently predicted, the fight against inflation becomes more complicated. US economists are debating the FED's inflation versus financial system dilemma, and a less aggressive rate hike is now forecast. Future forecasts for Euribor are also being revised downwards.
12. Latvia's fiscal position is in a relatively favorable situation in an environment of increasing interest rates, because the national debt is relatively low (about 42% of GDP), the country's credit rating is high and the volume of loans for the purchase of real estate is

[3] Latvijas produktivitātes ziņojums 2022/LVPEAK/ LPZ_2022.pdf (lu.lv)
[4] https://edition.cnn.com/2023/03/11/business/svb-bank-collapse-explainer-timeline/index.html

relatively low. The Treasury can still refinance the national debt at reasonable interest rates (3.8% yield on 5-year bonds).

13. The European Commission has published a communication[5] to member states with recommendations for fiscal policy for 2024. Considering that the exception clause of the EC SGP will no longer be valid in 2024, and, apparently, the new EU economic regulation will not be valid yet next year, the EC has prepared guidelines for fiscal policy, which correspond to both the existing regulation and include elements of the planned regulation. The EC will also publish country-specific recommendations, which will include both quantitative indicators and qualitative guidelines. **In general, the fiscal policies of EU member states should ensure medium-term debt sustainability in 2024 and promote sustainable and inclusive economic growth.** The EC calls for fiscal goals to be included in the national stability programs, which would ensure the general government debt at a sustainable level and ensure that the general government deficit does not exceed 3% of GDP.
14. 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, disruptions in supply chains and a drop in household consumption. Since the real income of the population is decreasing due to inflation and the amount of household savings has also significantly decreased, the set of these factors will have a significant negative impact on consumption and limit GDP growth.

[5] https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/fiscal-policy-guidance_en