Fiskālās disciplīnas padome

Surveillance report on the medium-term budgetary framework 2024-2026 years and the budget for 2024

Summary and main conclusions

Summary

1. The development of the medium-term budget framework project for years 2024-2026 is based on macroeconomic forecasts approved by the Council on June 13[1], 2023. However, since the MoF forecasts were approved, two significant changes have occurred: (1) on September 29, CSB did a large-scale revision of national accounts data and (2) the macroeconomic environment has worsened and the impact of previously identified risks on the economy has increased.

2. The revision of CSB national accounts data has significantly affected the assessment of GDP in both actual and comparative prices, as well as the assessment of the GDP deflator. The revisions cover period from 2018, including the 2023 GDP growth rate. According to data published by CSB, after 29.09.2023 national accounts data revision, Latvia's GDP decreased by 0.6% in the first half of 2023. This was influenced by the negative contribution of exports of goods and services (-1.6%) and the negative contribution of household consumption (-0.9%). Positive contributions to GDP in the first half of the year were government consumption (+1.1%) and investments (+1.6%), which is largely related to the use of EU funds.

3. The CSB data revision has not impact on the macroeconomic forecasts prepared by MoF and approved by the FDC, this was also not foreseen in the budget development schedule. In our view, the revision of the national accounts may affect the ex-post accumulated deficit estimate. The Council, in accordance with the procedures provided for in Article 11 of the FDL, will conduct an annual assessment of the application of the accumulated deficit correction mechanism, based on current CSB data, and will publish the report in December of this year.

4. On September 29, GDP forecasts by Bank of Latvia[2] were published, predicting that in 2023 Latvia's economy will grow by 0.6% (correction -0.2 pp.), but next year GDP growth will be 3% (correction -0.1 pp.). The forecasts were published 2 hours before the announcement of the CSB downward correction.

5. The inflation indicators of Latvia and the Eurozone (EZ) have decreased significantly, however, the ECB's medium-term inflation target (2%) has not yet been reached, and inflation expectations[3] in the EZ are still slightly higher than could be expected under the current strict monetary policy conditions. The latest forecasts of international institutions also predict a slight rise in inflation: for example, the IMF forecasts[4] Eurozone inflation at 3.6% in 2024, while the ECB forecasts[5] 3.2%. In Latvia,

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[1] Makroekonomiskās prognozes 2023 un VTBI 2024-2026 | Fiskālās disciplīnas padome (fdp.gov.lv)
[2] Prognozes | Latvijas Banka
[3] Inflation perceptions and expectations (europa.eu)
[4] World Economic Outlook, October 2023: Navigating Global Divergences (imf.org)
[5] ECB speciālistu 2023. gada septembra makroekonomiskās iespēju aplēses euro zonai (europa.eu)

according to BoL's[6] latest forecasts, inflation could reach 2.3% in 2024, while the Ministry of Finance forecasts inflation at around 2.2%. Regarding the year 2025 - most forecasters, including MoF, BoL and commercial banks, predict inflation of 2.5%.

6. Inflation in the Baltic States was one of the highest in Europe for almost a year, and although consumer prices are generally decreasing, core inflation indicators remain high, currently hovering around 8%. In September forecast of the Bank of Latvia for 2023, core inflation is forecast at 8.2%, and in 2024 at 5.3%.

7. In the following years, MoF has predicted that the economy will function below its potential and the output gap will be negative. At the same time, the unemployment rate is low, this year it did not exceed 6.5%. The unemployment rate is below the MoF's estimated non-wage unemployment rate, which is 6.8% for 2023. Such a disproportion shows that there is a shortage of labour in the labour market and there is expected pressure on employers to raise wages, especially against the background of the lost purchasing power due to inflation. This also means a risk to the performance of companies and shows that there is no reason to expect significant economic growth and budget revenue growth in MTBF 2024-2026. during the planning period.

8. Expressing its opinion on MTBF 2024-2026, the Council in its analysis and decisions relies on the economic essence of the application of FDL norms and recognizes that the economy has experienced the shocks of several crises, which required softening of fiscal requirements. At the same time, the Council's mandate as an independent collegial institution is to provide legislators with an independent assessment of MTBF's compliance with the norms of the Fiscal Discipline Law, which in turn ensures the planning of a balanced fiscal policy in the economic cycle.

9. From a fiscal point of view, 2022 was relatively successful - the general government budget had a deficit of 1720.9 million euros or 4.4% of GDP (a 4.8% deficit was planned in the budget law); the structural budget balance is positive (+0.3%). Currently, the budget for 2023 is well executed in general, and it is predicted that the year will end with a deficit of 2.7% of GDP, even though the budget law foresaw a budget deficit of 4.2% of GDP this year. Compared to the indicators provided for in the budget law, an improvement of GGBB in the amount of 616 million euros is expected, resulting from 475 million euros of higher revenues, 224.2 million less expenses and more negative ESA corrections in the amount of 83.3 million.

10. In 2024, the general exemption clause of the EC will not be valid, while the FDL norms have been valid since the beginning of 2023. The recommendations in the fiscal field approved by the EU Council this July advises Latvia to: i) terminate the current energy resource support measures, ii) the nominal increase of net primary expenses next year should not exceed 3% iii) to maintain state-financed public investments and ensure RRF grants and other EU funds are effectively absorbed, iv) expand taxation, including on property and capital.

11. The government's fiscal strategy for the budget of 2024 and subsequent years is based on maintaining the minimum structural balance of the general government (-0.5% of GDP). The following are accounted to the one-off expenses, which are excluded from the goal of the structural balance of the general government budget: (a) Covid-19 support measures, (b) reduction of the extraordinary increase in the prices of energy resources, (c) additional defence and internal security expenses above year 2022

[6] Prognozes | Latvijas Banka

annual level and one-time investments (expenses) for national defence and internal security (d) support for Ukraine.

12. This year the impact of the one-off measures on GGBB is estimated at 1.06 billion euros (2.5% of GDP). Most of them are defence and security measures (EUR 456 million) and energy support measures (EUR 429 million). In 2022, the impact of one-time measures on the GGBB reached 1.88 billion euros (4.8% of GDP). In the coming years, additional financing for security and defence will worsen GGBB by 457 million euros (1.1% of GDP) this year, by 810 million euros (1.8% of GDP) in 2024, by 881 million euros (1.8% of GDP) in 2025 and by 596 million euros (1.2% of GDP) in 2026.

13. According to the fiscal policy defined by the MoF, macroeconomic and fiscal forecasts, after filling the relevant fiscal space, the MoF predicts the following GGBB: (-2.8%) in 2024, (-2.3%) in 2025 and (-0.9%) in 2026. Such indicators would ensure compliance with the structural balance target of -0.5% of GDP in the coming years. It should be noted that the 2024 GGBB result is achieved with a significant adjustment of ESA EU funds in the amount of 426 million euros. Adjustment of ESA EU funds should be understood as financial accounting adjustments from the cash flow of various EU funds, if the incoming cash flow in a given year refers to another year.

14. **MTBF 2024-2026 partially comply with fiscal numerical rules described in FDL.** The differences between the structural and nominal deficit, which are -0.5% and -2.8% for 2024, respectively, indicate a significant impact of the amount of one-off measures in the structural balance target. The current budget plan gives the false impression of an almost structurally balanced budget. The Council emphasizes that a constant increase in expenses over time should be coordinated with additional revenue sources or lower relative expenses in other areas.

15. **The Council believes that additional defence and internal security expenses above the 2022 level and one-time investments (expenditures) for national defence and internal security should not be considered as one-off expenses.** Creating such a precedent for one-off expenses is dangerous and creates an incorrect impression that these expenses will not need to be financed in the future, although this is not realistic in the current geopolitical situation. The use of one-off measures was to some extent justified in SP 2023-2026. during the development period, as a temporary solution for 2023, when the FDL rules were in force, but the EU rules were still suspended.

16. In addition, the Council draws attention to the following deviations from compliance with the fiscal numerical rule of the FDL:

(i) The amount of the structural balance for the entire period 2024-2026 is planned to be 0.5% of GDP, which is in line with the rule of Article 10 of the FDL, however, the content of this balance target cannot be recognized as adequate. This level of structural deficit was achieved by excluding from the general government budget balance not only cyclical components and one-off support measures, such as: (1) measures for the Covid-19 pandemic, (2) measures to reduce the increase in energy prices and (3) support for Ukraine for refugees, which are one-time emergency measures in nature, but also (4) defence and homeland security funding above the 2022 level, and (5) one-time expenditures for national defence and homeland security. In this and also in previous reports, the Council has stated that the expenses for the increase in defence and internal security investment funding above the level of 2022, as well as the one-off investments (expenditures) specifically allocated by the MoF for national defence and internal security, cannot be recognized as one-time measures in the methodological framework of the EU Vademecum[7] comprehension. Following the opinion of the Council and excluding such measures from the structural balance, the structural deficit exceeds the level specified in Article 10 of the FDL (-0.5% of GDP), therefore this numerical rule of the FDL has not been met. The Council emphasizes that the concept of one-time measures is not defined in the Law on Fiscal Discipline. However, the MoF maintains the approach defined in the Stability Program for 2023-2026[8], setting different goals: according to the national and according to the EU methodology, and also referring to the scope of one-time expenses, which is established in the Law on the State Budget for 2023 and budget framework for 2023, 2024 and 2025 in Article 5[9].

(ii) According to the EU methodology, when calculating the structural balance target for MTBF 2024-2026, only the cyclical component was excluded from the GGBB's nominal balance, while the one-off expenses mentioned above were not included at all, because otherwise the SB deficit level determined in the EU methodology would also be exceeded (-1% of GDP). Thus, according to the EU methodology, the structural balance for 2024 is -1.7%, in 2025 (-1.2%), and in 2026 -0.7%. The structural balance is reduced annually by a step of 0.5 pp., however, in 2024 it exceeds the level of the structural balance allowed in the EU fiscal regulation by 0.7 pp., and in 2025 by 0.2 pp.

(iii) The calculation of the adjusted expenses has not been fully carried out in accordance with the procedure established by the FDL - because instead of the adjusted expenses of EU funds and state debt expenses, the actual expenses forecasted for these positions in the respective year are taken. Although in such a case the numerical deviations are not large, such practice indicates a situational interpretation of FDL norms. Thus, according to the calculation of the MoF, the adjusted maximum allowable state budget expenditures are planned at 13,577 EUR in 2024, 13,725 EUR in 2025 and 14,116 EUR in 2026.

(iv) The information for the calculation of the expenditure increase rule has not been provided in full, therefore the Council relies on indicative calculations. Calculations show that nominal GDP will increase by 5.5% in 2024, while expenses will increase by 12%, but tax revenues incl. (bank tax, excise tax, etc.) are predicted at 8.9% and do not compensate for the expected increase in expenses. Thus, the concept of spending growth rules is essentially not followed. In this regard, the MoF has indicated in its explanations on the MTBF 2024-2026 that in the context of high inflation and war-induced one-off expenditure forecasts and deviations of actual learning, compliance with the rule of expenditure growth and heritability would mean that the potential fiscal space should be reduced to ensure the fulfilment of such mathematical conditions, for which no economic justification can be found.

17. The Council draws attention to risks on the revenue side of the budget. Tax revenues are the most important source of income in the consolidated state budget, which will

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[7] Vade Mecum on the Stability and Growth Pact – 2019 Edition (europa.eu)
[8] https://tapportals.mk.gov.lv/meetings/protocols/85f82008-0af8-430c-a9ef-1704b9920e3e
[9] Par valsts budžetu 2023. gadam un budžeta ietvaru 2023., 2024. un 2025. gadam (likumi.lv)

make up 80.7% of its total volume next year. The risk is that the significant revenue growth spurred by high inflation is not expected to continue in the coming years as inflation falls. At the same time, the cost level inherited from the period of high inflation could have a negative fiscal effect. The tax revenue forecasts of the MoF's 2024 general budget plan are conservative and similar to the forecasts of the FDC tax model, which in total are 1.6% higher than the MoF's forecast. The FDC's tax revenue model also took into account the expected slow economic growth and also lower inflation. In 2024, tax revenues in the general budget are planned to amount to 13.8 billion, which is 1.1 billion or 8.9% more than what is planned to be collected this year.

18. The Declaration of Fiscal Risks prepared by the MoF and approved by the MK offers a fiscal security reserve of 0.1% of GDP in 2024, 2025, and 2026. The Fiscal Discipline Council accepts a fiscal security reserve of 0.1% of GDP in 2024.

19. The fulfilment of the debt rule is in accordance with the Maastricht criterion. In 2023, the projected general government debt is projected at 39.9%, 41% in 2024, 41.1% in 2025, and 41% in 2026. The Council welcomes the commitment contained in the government's declaration to implement a fiscal policy that maintains the general government debt at an average level of 40% of GDP in the long term and calls for compliance with it. The Council draws attention to the fact that the MoF predicts an increase in interest expenses from 233 million euros in 2023 to 381 million euros in 2024, but in 2026 it will exceed 500 million euros. Thus, additional GGB deficit costs at the 4% interest rate level will increase the government's interest rate expenses by more than 50 million euros in the following years.

20. The Council draws attention to the fact that Latvia has a relatively high credit rating in international assessments, which was obtained, among other things, thanks to a responsible fiscal policy. However, the geopolitical situation has negatively affected S&P's future rating for Latvia. Moody's credit rating for Latvia is A3 and the future rating is stable, S&P rating A+, the future rating is negative, Fitch rating A-, the future rating is positive, R&I rating A future rating stable[10]. A high international rating allows to borrow funds and refinance the debt at the most favourable rates, although the consequences of the restrictive monetary policy will also apply to the costs of servicing Latvia's debt.

21. The Council has carried out an assessment of the quality of macroeconomic and fiscal forecasts in the period from 2004-2021, and the results of this analysis allow us to conclude that, in general, the quality of the forecasts developed by the MoF is at an acceptable level in periods when there are no significant negative changes in the economy, for example, the global financial crisis, the Covid-19 pandemic, the energy crisis, etc. During periods of crisis, the amount of errors increases significantly both in MoF forecasts and in EC forecasts, which were accepted as benchmark values for the real GDP forecast.

22. The Council would like to point out the set of existing risks that in the medium term may negatively affect the country's fiscal performance[11], among them the Council would like to emphasize the still very tense geopolitical and security situation in the world, global slow economic growth, the risks of Latvia's economic development, the inability of the EU member states to agree on effective reforms in the fiscal legal

[10] Kredītreitings | Kredītreitings | Valsts kase
[11] LV_PEAK_BAROMETRS_LV_08062023.pdf (lu.lv)

framework, the excessive pressure of interest rates on society, as well as the rise of populism in the political discourse.

23. International military conflicts and the macroeconomic instability caused by them, the unpredictability of events are currently the main source of fiscal risks. Latvia is a small and open economy, which is often exposed to the influence of external economic and political factors. Considering that fiscal policy is the government's fastest-influencing tool in solving unexpected problems, the country needs fiscal safety reserves. This is also evidenced by the risky fiscal policy implemented by many countries of the world, which may cause a serious global financial crisis, which would also affect Latvia.

24. The events of recent years have revealed and actualized the inadequacy of crisis regulation norms in both the EU and the national fiscal legal framework. The legal frameworks developed in times of peace were not fully suitable for the fiscal absorption of the consequences of the Covid-19 pandemic, the war situation and also rapid climate change. This was manifested in a rapid increase in the amount of debt of the entire EU from 78% in 2019 to 87% in 2021. It should be noted that in 2022 the EU debt decreased to 84%, largely due to high inflation. However, the deficit indicators planned for 2024 in many EU countries exceed 3%. The national fiscal framework of Latvia was also faced with the need to create a special regulation - the law on overcoming the consequences of the spread of the Covid-19 infection, which made it possible to temporarily limit the FDL norms. In addition, during the development of SP 2022-2025, a special strategy of the Government's fiscal policy was formulated, which made it possible to recognize as one-off measures the increase in expenditures for national defence and internal security. Thus, in the period since 2020, a set of precedents has accumulated in Latvian fiscal regulation, which potentially allows further situational interpretation of the fiscal legal framework in order to achieve formal compliance with fiscal numerical rules. The Council draws attention to the fact that such a situational approach may adversely affect fiscal discipline in the long term. The Council expects that after the implementation of the reforms of the EU economic management legal framework, the reformed fiscal rules will be appropriately incorporated into the national fiscal legislation. In the case of the opening of the FDL, the Council proposes to strengthen its sections that provide for the occurrence of extraordinary circumstances, as this would prevent the possibility of different interpretations of the FDL norms, including regarding the application of one-time discretionary measures.

25. Rising interest rates have allowed the financial sector to significantly increase its profits, while at the same time significantly reducing the leverage of mortgage borrowers. In this regard, the government and the parliament are currently considering four policy initiatives: i) for the financial sector to determine advance payments from profits, ii) Altum to give additional guarantees to socially less protected borrowers, iii) to impose on credit institutions the obligation to reduce interest rates for a limited time; iv) mortgage borrower protection fee, which would be paid by banks. The Council states that the authors of the rate reduction project have concluded that such regulation could create legal risks and impact on the availability of financial services and the investment environment in the future.