Fiskālās disciplīnas padome

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Surveillance Report on the 2025-2027 Medium-Term Budgetary Framework, the 2025 Budget, and the 2025-2028 Fiscal Structural Plan

(executive summary)

2024

Executive summary

1. The Council has a broadly positive assessment of the draft Budget 2025 and the Medium-Term Budgetary Framework for 2025–2027. Both EU and national fiscal requirements have been met. However, high geopolitical uncertainty and sluggish economic growth present significant fiscal risks and challenges. Due to various constraints, the budget has been prepared within a very short timeframe, which has required the Council to base its review on preliminary budget documents. A more comprehensive analysis will be provided in the Council's interim monitoring report in spring 2025.

2. The development of the draft Medium-Term Budgetary Framework for 2025–2027 is based on macroeconomic projections approved by the Council on 10 June 2024[1]. These projections foresee real GDP growth of 1.4% this year, 2.9% in 2025, 2.8% in 2026, 2.6% in 2027, and 2.3% in 2028. On 30 September, the CSB published comprehensive national accounts audits for the period 1995-2023, reducing GDP in real prices over this period, changing the base year for constant prices from 2015 to 2020, and making minimal changes to growth rates. This audit may impact past assessments of the structural balance and general government deficit, potentially worsening them. The CSB audit results have not been included in the medium-term budgetary framework by the MoF.

3. Latvia, like other EU Member States, is experiencing 'post-crisis syndrome,' with recovery trajectories varying by country. Latvia's economic performance in the first half of the year was weaker than initially expected. In response to recent economic data, commercial banks revised their forecasts more pessimistically in August, predicting growth of 0.8-0.9% for the year. On 8 October, the Bank of Latvia significantly lowered its GDP forecast for this year from 1.8% growth in June to 0.6%. Projections for subsequent years have also been revised downwards, with 2.6% growth now projected for 2025 instead of 3.3%, and 3% for 2026 instead of 3.8%[2]. Given the slower growth context, it is essential to monitor economic developments closely and prepare for necessary adjustments to public finances.

4. The MoF's pessimistic scenario[3] forecasts GDP growth of only 0.4% this year and 1.8% next year. Based on this scenario, the MoF estimates a general government budget deficit of 2.8% of GDP in 2024, 3.4% in 2025, 3.1% in 2026, 2.9% in 2027, and 2.6% in 2028. The Bank of Latvia's even more pessimistic projection[4] suggests that the deficit could exceed 3% of GDP from this year onward: potentially 3.1% in 2024, 3.3% in 2025, and 3.2% in 2026. This is not the 'worst case' but rather the baseline scenario in the BoL's projections. In light of these risks, the Council advocates for savings during budget execution, rather than reallocations, to achieve budgetary targets, particularly considering slippages in tax collection.

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[1] FDC's view on the MoF's macroeconomic forecasts for the MTBI 2024-2028 download (fdp.gov.lv)
[2] Macroeconomic projections | October 2024 | Bank of Latvia
[3] Explanatory draft of the draft Law on the State Budget for 2025 and the Budgetary Framework for 2025, 2026 and 2027
[4] Macroeconomic projections | October 2024 | Bank of Latvia

5. The ECB has begun gradually easing monetary policy in response to falling euro area inflation. In September, the ECB cut key interest rates by 25 basis points in response to inflation expectations and underlying inflation trends. The ECB now projects that inflation in the euro area will gradually decline to 2.5% in 2024, 2.2% in 2025, and 1.9% in 2026. Inflation is expected to rise slightly towards year-end due to base effects in price statistics following extreme movements in energy prices. These effects should dissipate by mid-2025, allowing inflation to fall once more.

6. Inflation in Latvia is below the EU and euro area average, with consumer prices rising by just 0.7% in August compared to a year earlier. However, Eurostat flash estimates suggest that it may have risen to 1.6% in Latvia in September. Goods and services price inflation in Latvia and the euro area show a rise in services inflation and a fall in goods prices, but the dynamics are different. In Latvia, prices of goods fell by 0.8% in August, while prices of services rose by 5.4%, faster than the euro area average.

7. The labour market is quite active despite the stagnating economy. The actual unemployment rate in recent months has been around 6.9%-7%, while registered unemployment is around 5%. Thus, the high demand for workers and the need for employers to adapt to wage pressures may become increasingly challenging for private entrepreneurs.

8. Wage growth averaged 10.3% in the first half of the year but slowed slightly to 9% in the second quarter, bringing the rate of wage growth below double digits. During this period, public sector wages rose by 12.4%, while private sector wages increased by a more modest 8.3%. The misalignment between wage growth and productivity has been repeatedly highlighted in productivity reports by the PEAK think tank of the University of Latvia[5]. Additionally, an in-depth IMF[6] study concluded that Latvia's income convergence trails behind that of other Baltic countries, with relatively low labour productivity, especially in manufacturing. This productivity gap is attributed to weak investment flows, a high share of low-productivity firms, and limited innovation.

9. Both wage growth and the ECB's monetary policy easing positively impacted the increase in retail deposits in commercial bank accounts. According to the Bank of Latvia, retail deposits rose by 5.8% in August. However, card transaction data indicate that people have become more cautious in their spending and are increasingly inclined to save.

10. Industrial production in Latvia declined by 2% in the first seven months of the year, with manufacturing experiencing a notable 4.4% drop. Conversely, the mining and quarrying industries, along with electricity and gas supply, grew by 12.8% and 6.8%, respectively. Manufacturing results varied, with food production increasing by 1% while industries such as wood processing (-2.2%) and metal products (-10%) faced declines. However, the latest data from August show a recovery in overall industrial output, which increased by 2.1%, driven primarily by growth in the mining and electricity sectors, while manufacturing continued to decline by 0.9%.

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[5] Latvian Productivity Report (lu.lv)
[6] Republic of Latvia: Selected Issues (imf.org)

11. Lending activity in Latvia lags significantly behind that in Lithuania and Estonia in both the household and corporate sectors. Eurostat data indicate that household loan liabilities amount to 35% of GDP in Estonia, 22% in Lithuania, and only 17% in Latvia. Lending to households in Latvia has begun to recover this year following prolonged stagnation, supported by the ECB's signals of interest rate cuts. In the first eight months of the year, housing loans increased by 11%, consumer loans by 14%, and other household loans by 47%. However, corporate lending remains stagnant, with new loans to non-financial corporations decreasing by 1% over the same period.

12. In the first half of the year, export values declined by 6% compared to the same period in 2023. The most recent monthly export data available for July shows a 6.5% increase compared to July of the previous year. This rebound is particularly notable following a prolonged downturn, as similar export increases were last observed in early 2023.

13. From a fiscal perspective, 2023 was a relatively successful year, with an improvement in the government's fiscal position. The deficit decreased from 4.4% to 2.2% of GDP, amounting to 893.1 million euros, compared to the budgeted deficit of 4.2%. This resulted in a structural balance of 0.2% of GDP, despite the fiscal strategy targeting a structural deficit of 0.5% of GDP. This improvement was supported by nominal GDP growth and higher tax revenues driven by inflation, alongside a gradual reduction in COVID-19 and energy support measures.

14. The 2024 budget was based on projected GDP growth of 2.5% and inflation of 2.2%. However, the MoF's June projections adjusted expectations to slower GDP growth of 1.4% and lower inflation of 1.2%. Consequently, general budget tax collection for the first eight months met 98.2% of the target. Non-tax revenue collection has also exceeded expectations, while spending on subsidies and grants has been reduced by €1.1 billion due to slower implementation of EU-funded projects and reallocations. As a result, the GGB deficit is now projected at 2.6% of GDP, with a structural GGB deficit of 0.2% of GDP.

15. This spring, the EU's new economic governance framework was introduced, aiming to gradually and sustainably reduce the EU's rising deficit and debt levels. While several Member States consider the framework complex and challenging to apply, it emphasizes economic growth while directing some of the additional budget revenue toward deficit reduction. Under this framework, EU Member States must prepare a medium-term Fiscal Structural Plan (FSP), which replaces the annual Stability Programme and National Reform Programme. This fiscal path sets a cap on the growth rate of government-financed net primary expenditure. Consequently, the draft law "On the State Budget 2025 and the Budgetary Framework 2025, 2026, and 2027" must align with both the FDL's structural balance condition, whose deficit tolerance has been increased to 1%, and the new EU fiscal guidelines.

16. The fiscal conditions for the 2025 State Budget and the Medium-Term Budgetary Framework (MTBF) for 2025–2027 have been calculated according to the new EU economic framework, using three methods: (1) the structural balance condition, mandated by national legislation and EU Regulation 2024/1263; (2) the structural primary balance condition; and (3) the EU expenditure growth condition. According to these calculations, the general government structural balance target meeting all three conditions for 2025–2028 is as follows: -0.817% of GDP in 2025, -0.749% in 2026,

-0.792% in 2027, and -0.932% in 2028. The Council notes that the improved GGBB target for 2025 relies significantly on EAS adjustments, highlighting limited fiscal space in upcoming years: -€13.0 million in 2025, €32.2 million in 2026, €43.5 million in 2027, and €1.4 million in 2028.

17. The Fiscal Discipline Council recognizes that the fiscal path calculated by the MoF aligns with the provisions of Regulation 2024/1263 (EC technical information). The Council also appreciates the use of more current national data in the 2024 fiscal projections and the alignment of the 2025 budget preparation with the FSP fiscal path. In developing the draft General Government Budget Plan for 2025, the net increase in state-financed primary expenditure is projected, according to the MoF's calculations, to be 4.4% (excluding the fiscal buffer), which remains below the ceiling set by the FSP.

18. The tax reform approved by the government, set to take effect in 2025, aims to achieve several key improvements: reducing the labour tax burden for low- and middle-income earners, simplifying the tax system, and promoting income equality. To maintain fiscal neutrality, a temporary shift of 1% from the second to the first pillar of the pension system is proposed, which may increase government pension liabilities in future years. Nevertheless, the pension system remains stable. The reform also provides additional benefits, including enhanced business competitiveness, reduced labour costs, and increased investment opportunities.

19. The Fiscal Risk Declaration, prepared by the MoF and approved by the Cabinet, proposes a fiscal reserve in amount of 0.1% of GDP for 2025, 2026, and 2027. The Fiscal Discipline Council supports this fiscal reserve in amount of 0.1% of GDP for 2025.

20. Latvia faces several significant risks to economic growth and fiscal performance in the medium term:

- Geopolitical tensions and proximity to Russia and Belarus deter investors and tourists,
- Weak demand in key export markets poses a potential risk to export performance,
- Continued weakness in the manufacturing sector limits economic growth,
- Fiscal risks associated with the implementation of the Rail Baltica project,
- Fiscal risks related to the operations of state-owned enterprises, including AS AirBaltic and others,
- A sharp increase in public debt servicing costs anticipated in the coming years,
- Public sector wage increases that may expand the budgetary base, impact the labour market, and weaken national competitiveness.

21. According to the Ministry of Finance (MoF), government debt servicing costs under the MTBF for 2025–2027 are projected to be 1.1% of GDP this year, increasing to 1.2% in 2025 and rising by approximately one percentage point each year to reach 1.5% of GDP in 2028. High interest rates add to the debt servicing burden, limiting the capacity for public spending.

22. The Fiscal-Structural Plan projects gross government debt levels at 45.8% of GDP this year, increasing to 47.5% in 2025, 48.5% in 2026, 49.7% in 2027, and 50.8% in 2028. The Bank of Latvia's estimates are more conservative, anticipating government debt at 47% of GDP this year, 48.4% in 2025, and 49% in 2026. The approach of the 50% debt threshold underscores the need for fiscal discipline, as government debt typically spikes during crises. Although Latvia currently faces no imminent crisis, the volatile geopolitical climate suggests a prudent approach is warranted.

23. Latvia's government debt remains below the Maastricht criteria threshold of 60% of GDP, which supports its reputation as a fiscally responsible country. Rating agencies have acknowledged this, although Latvia's long-term rating has been downgraded in recent years due to regional geopolitical instability. On July 26, Moody's reaffirmed Latvia's A3 credit rating with a stable outlook[7]. Similarly, Fitch Ratings maintained Latvia's A- rating on July 12, highlighting the low cost of government debt and effective debt management policies, supported by EU and euro area membership[8].

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[7] Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | Moody's Ratings declares Latvia's credit rating at current A3 with stable future outlook | The Treasury

[8] Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | Fitch Ratings affirms Latvia's credit rating at the current A- level with a positive future outlook | The Treasury