Fiskālās disciplīnas padome

Fiscal Discipline Council Opinion on the Ministry of Finance macroeconomic forecasts for

Medium Term Budgetary Framework 2024-2028

Preamble

This document gives an opinion of the Fiscal Discipline Council (hereinafter - Council) on the macroeconomic forecasts developed by the Ministry of Finance (hereinafter - MoF) for the period 2024-2028. The forecasts will be used as the basis for the development of the Medium Term Budgetary Framework (hereinafter - MTBF) for 2024-2028 (2024./28.), which is planned for submitting to the Cabinet in October 2024. To support the Government's work on the medium-term budgetary framework– an agreement was reached on early approval by the Council for the MoF macroeconomic forecasts.

Under the Cooperation Agreement signed on 8 February 2016, the Council is responsible for the approval of the MoF macroeconomic forecasts. During the forecast approval procedure, detailed MoF forecast data were submitted to the Council at 7th of June, including scenarios for the development of the gross domestic product (GDP) and individual GDP components.

At the meeting of the Council on 10 of June 2024, the MoF informed about the assumptions and changes in the updated macroeconomic forecasts since February of 2024, and latest outcomes of 2024 as well. The Council discussed with MoF experts and asked explanations on forecasting assumptions and the justification for individual indicators. MoF explanations was plausible, and data based.

Formulation of the opinion on macroeconomic indicators is the duty of the Council, in accordance with the scope of the indicators specified in Section 20 of the Fiscal Discipline Law (indicators are collected in table 3 at the end of this document). The members of the Council, considering the materials and explanations provided by the MoF, adopted a decision on the approval of the forecasts based on an internal discussion.[1]

Overview of the situation

The Ministry of Finance (MoF) has maintained its forecasts for 2024 and 2025 since February this year, adopting a conservative and cautious stance in light of minimal growth in the first quarter. However, projections for 2026-2027 have shown slight improvements. Over the next five years, GDP growth is forecasted not to exceed 2.9%, with an average annual growth rate of 2.4%.
The inflation forecast reflects a significant decline in consumer price growth, driven by restrictive monetary policies and normalization of the global energy prices. Projections for the upcoming years suggest an even lower inflation rate than previously anticipated in February.

[1]Minutes Nr. 4 (72) of the meeting of the Council available here download (fdp.gov.lv)

Table 1 presents the current macroeconomic forecasts from the MoF[2], the Bank of Latvia (BoL) [3], the European Commission (EC) [4], and the International Monetary Fund (IMF) [5]. Currently, the latest alternative macroeconomic forecasts are available from the Bank of Latvia and the European Commission, published in June and May 2024, respectively. Comparing the MoF real GDP growth forecast for 2024 with that of the BoL, the MoF's forecast is 0.4 percentage points more conservative. For 2025, the MoF's GDP growth forecast is 0.6 percentage points lower than the BoL's.

	2024	2025	2026	2027	2028
Real GDP Growth					
MoF (Jun .2024)	1.4	2.9	2.8	2.6	2.3
BoL (Jun. 2024)	1.8	3.5	3.8	-	-
EC (May. 2024)	1.7	2.6	-	-	-
IMF (Apr. 2024)	1.7	2.4	2.5	2.5	2.5
Nominal GDP growth					
MoF (Jun .2024)	3.8	5.9	5.5	5.4	5.1
BoL (Jun. 2024)	-	-	-	-	-
EC (May. 2024)	-	-	-	-	-
IMF (Apr. 2024)	4.6	6.7	5.2	5.2	5.2
Inflation (CPI)	-	-	-	-	-
MoF (Jun .2024)	1.2	2.2	2.5	2.5	2.5
BoL (Jun. 2024)	1.5	2.1	1.8	-	-
EC (May. 2024)	1.6	2.0	-	-	-
IMF (Apr. 2024) *end of period	5.7	2.0	2.4	2.2	2.3
Deflator					
MoF (Jun .2024)	2,4	2,9	2,7	2,7	2,7
BoL (Jun. 2024)	-	-	-	-	-
EC (May. 2024)	-	-	-	-	-
IMF (Apr. 2024)	2.9	4.1	2.7	2.7	2.6

Table 1. Forecasts of various institutions on the main macroeconomic indicators, %.

When comparing the MoF's real GDP forecast with the EC's forecast for 2024, the MoF's forecast is 0.3 percentage points more conservative. However, for 2025, the MoF's growth prediction is 0.3 percentage points higher than the EC's.

Overall, the MoF's GDP forecasts for 2024 are more conservative than those of the EC, BoL, and IMF. For 2025, however, the MoF estimates slightly higher growth than the EC and the IMF, but lower than the BoL. The MoF's inflation forecast reflects the current situation where consumer price growth has significantly slowed down, though household consumption remains steady with minimal improvement in the first quarter of this year. The MoF forecasts 1.2% inflation for 2024, while the BoL's forecast is 0.3 percentage points higher, and the EC's forecast is 0.4 percentage points higher. The MoF's projected inflation rate for 2025 is 0.1 percentage points higher than the BoL's and 0.2 percentage points higher than the EC's.

Considering the modest economic growth observed in the first quarter of this year, the Ministry of Finance's cautious forecasts for 2024 and 2025 appear to be realistic. The consensus forecast by the LV PEAK think tank of the University of Latvia, presented on June 10 as part of the "Economic Barometer," aligns closely with the Ministry of Finance's scenario. It is estimated that the GDP growth rate will reach 1.5% in 2024 and 2.6% in 2025.

The projected increase in consumer prices, according to the LV PEAK barometer, is slightly higher: 2% in 2024 and 2.2% in 2025[6].

Latest macroeconomics developments of 1st quarter of 2024

According to data from the Central Statistics Authority (CSB), the gross domestic product (GDP) grew by 0.9% year-on-year in the first quarter of 2024, based on seasonally and

[2]MoF updated macroeconomic forecasts: Finanšu ministrija aktualizējusi makroekonomisko rādītāju prognozes | Finanšu ministrija (fm.gov.lv)
[3]Bank of Latvia forecasts: Macroeconomic forecasts | June 2024 | Latvijas Banka
[4]EUROPEN Commission Spring forecasts, Economic forecast for Latvia - European Commission (europa.eu)
[5]International Monetary Fund IMF - World Economic Outlook, April 2024: Steady but Slow: Resilience amid Divergence (imf.org)
[6] Latvia University think tank LV PEAK Economic Barometer 1 (5) LV_PEAK_BAROMETRS_ENG.pdf (lu.lv)

calendar-adjusted data, or by 0.1% based on unadjusted data. Compared to the fourth quarter of 2023, the growth was also 0.9%. In current prices, GDP growth in the first quarter was 3% year-on-year and 1.6% compared to the fourth quarter of 2023.

From an expenditure approach, the largest year-on-year contributions to GDP growth came from government consumption (1.5%) and household consumption (+0.3%). However, exports (-2.3%) and investments (-1.7%) negatively impacted GDP growth.

From a production perspective, the sectors contributing most positively to GDP were agriculture, forestry, and fisheries (+8.1%), the public sector (+7.2%), and mining (+6.2%). In contrast, the largest negative contributions came from transport and storage (-8.9%), construction (-5.6%), and the ICT sector (-3.3%).

Industrial production in the first quarter decreased by 0.1% compared to the first quarter of 2023 but increased by 0.5% compared to the fourth quarter of 2023. The most significant positive effects come from mining and quarrying, with an 18.6% increase year-on-year, and in electricity and gas supply, with a 9.3% increase. Meanwhile, the manufacturing industry's output decreased by 3.9%.

Inflation continued to decrease in the first quarter, reaching 0.8%, driven by more than a 7% decrease in housing maintenance, gas, and electricity prices. **Retail sales** rose by 0.4%, driven mainly by increases in fuel retail sales (+6.1%) and food retail sales (+0.3%) after six quarters of decline. However, non-food retail sales continued to decline (-1.7%).

The decline in **exports** persisted but at a slower pace, with Latvia exporting goods worth 4.7 billion euros in the first quarter, 8.9% less than in the same period last year. Exports to EU countries decreased by 6%, to CIS countries by 1%, and to other countries by 1.9%. Among the main trading partners, the largest decreases in exports were to Sweden (-22%), Germany (-11%), and Lithuania (-8.5%), while exports to Estonia increased by 3.4%. The **trade deficit** was 5% of GDP in the first quarter, an improvement of 3.4 percentage points compared to the fourth quarter of 2023. **Service exports** decreased on average by 1.6%, with the largest decline in unclassified services (-5.5%) while transport services (+3.2%) and travel services (+0.7%) saw increases.

The **transit sector** was among the weakest performers in the first quarter. Cargo turnover in Latvian ports decreased by 11.3% year-on-year, while rail transport saw a significant decline of 29.5%. **Manufacturing production output** in the first quarter decreased by 0.1% compared to the same period in 2023 but saw a 0.5% increase compared to the fourth quarter of 2023. The most significant contributions to industrial output growth came from mining and quarrying (18.6%), and electricity and gas supply (9.3%), whereas manufacturing output fell by 3.9%. Specifically, the manufacturing industry experienced a 7.7% decline in output compared to the first quarter of 2023. The wood processing industry continued its downward trend (-3.2%), along with the construction materials industry (-1%) and the production of other unclassified products (-3.3%). Modest increases were noted in the food industry (+0.4%) and the chemical substances and products industry (+0.2%). Out of 20 manufacturing sub-sectors, 14 experienced declines. The furniture manufacturing sector recorded the worst performance (-21%), while the metals and metal alloys sector saw the largest increase (+18%).

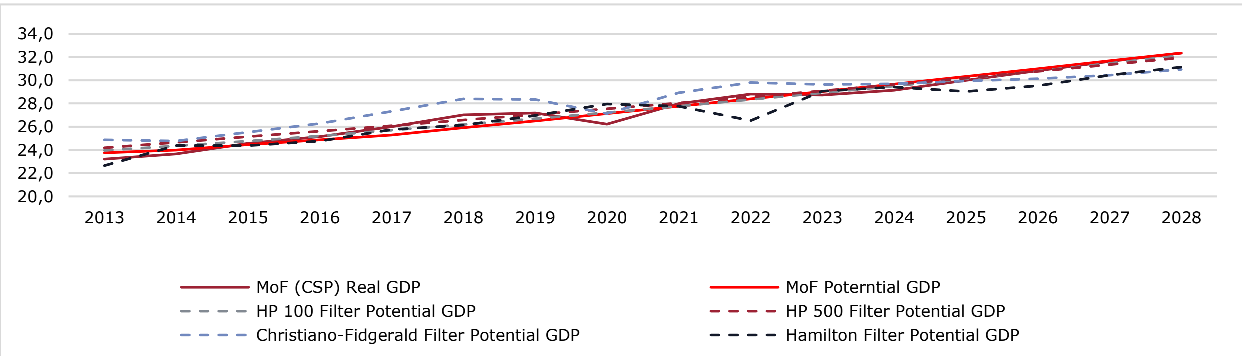
The **construction industry** entered a recession in the first quarter, despite maintaining growth throughout 2023. Output fell by 5.5%, with the most substantial decline in building construction (22.2%). However, civil engineering and specialized construction continued to grow, by 19% and 3% respectively. The number of issued building permits decreased by 6%, and the total building area covered by these permits fell by 26%. Construction costs rose by

1.8% in the first quarter, while workers' wages increased by 6.6% compared to the same period in 2023, and the prices of building materials decreased by 1%.
Lending in Latvia remains insufficient, partly due to the restrictive monetary policy of the ECB. According to the Bank of Latvia, new loans issued to households for housing purchases decreased by 5% in the first quarter, while loans to companies fell by 10% year-on-year. Conversely, consumer loans to households grew by 13%, and other loans to households increased by 31%.
The **unemployment** rate in the first quarter was 6.9% (seasonally adjusted data), with registered unemployment at 5.8%. Economic activity among those aged 15 to 74 was 68.9%, still below the pre-pandemic level of 69.4% in 2019. **Wages** rose by 11% in the first quarter, with public sector wages increasing by 16.3% and private sector wages by 8.9%. The average gross wages were 1,657 euros in the public sector and 1,514 euros in the private sector. The median gross wages were 1,293 euros, with the net salary at 957 euros. Real net wages increased by 9.3%, indicating an improvement in household purchasing power. Labor costs rose by 11% in the first quarter, with an 18% increase in the public sector and an 8% increase in the private sector.

Assessment of the Latvian economic cycle

The Council's experts give their assessment of the state of play of the Latvian economy during its economic cycle. This evaluation uses the Hodrick-Prescott statistical filter method with a smoothing parameter of 100 and 500, Chistiano-Fidgerald and Hamilton filter as well. The statistical filters method has been used to separate short-term and long-term fluctuations in GDP and to provide an understanding of the economic potential, thereby allowing the calculation of a comparable output gap value that can be used for MoF's forecasts assessment. **Figure 1** shows that, in the period from 2013 to 2028, the closest to the MoF calculation is the potential GDP obtained by the HP (100) method. The time series estimated with the Hamilton and filter differs the most from the MoF, which shows both a faster decline in potential GDP in the 2022 (energy prices shock year) and a lower level of potential GDP in the medium term starting from 2025.

Figure 1. Real GDP (actual and projected), MoF estimate of potential GDP and Council estimate of potential GDP (HP 100, HP 500, CF and Hamilton statistical filter methods).

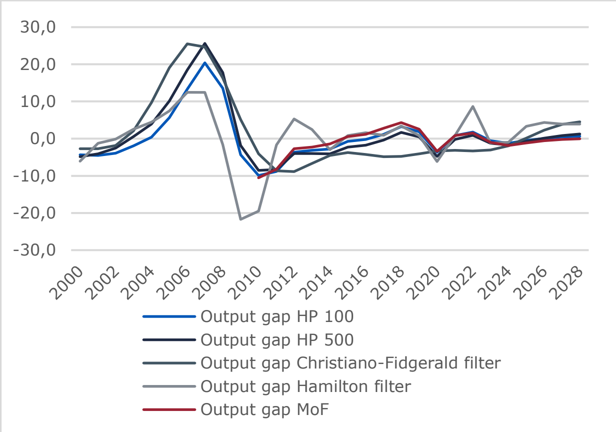


Source: MoF and FDC calculations

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 2028, the results of various alternative statistical filtering methods basically follow a similar trajectory as the MoF data. The output gap estimated by the Hamilton filter shows higher and positive values, while the output gap calculated with the HP filters (100) and (500) differs minimally from the MoF estimate ones, see Figure 2.

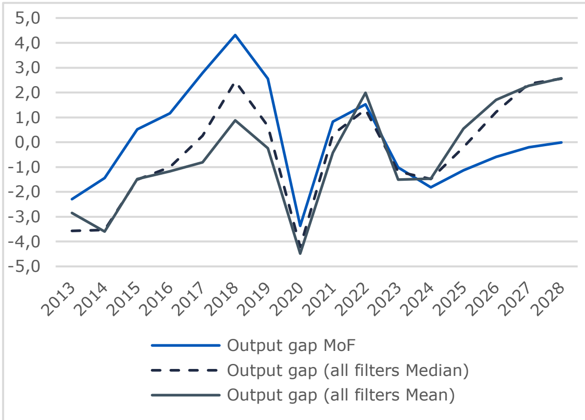
It should be noted that in previous Council assessments[7,8,9] it was concluded that, in the period from 2013 to 2026, the results of various statistical filtering methods basically follow a similar trajectory as MoF data.

Figure 2. The output gap calculation result-comparison of three statistical filters with MoF



Source: MoF and Council calculations

Figure 3. Comparison of output gap calculation results - mean and median of statistical filters compared to output gap calculated by MoF



Source: MoF and Council calculations

Figure 3 shows a comparison between the mean, median and MoF calculated output gap of all filters used for the calculation of the output gap. The median value indicates a negative output gap in both 2024 and 2025, however, in the following years, a faster trend of the output gap, to positive values than calculated by MoF. The mean value of all filters indicates a negative output gap in 2024 but starting from 2025 the value returns on positive side. However, considering the set of existing risks and high uncertainties, a long-term assessment of the output gap is currently challenging, and current-day assessments are more reliable, see table 2.

Table 2.

Output gap: Output gap: MoF calculations and the mean and median value of the statistical filter results calculated by the Council

	Output gap MoF	Output gap (all filters Median)	Output gap (all filters Mean)
2024	-1,8	-1,5	-1,5
2025	-1,1	-0,2	0,5
2026	-0,6	1,2	1,7
2027	-0,2	2,4	2,3
2028	0,0	2,6	2,6

Source: MoF and Council calculations

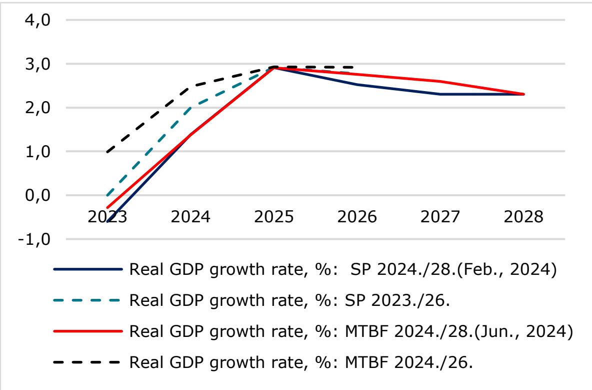
7 14.02.2022Approval of macroeconomic forecasts | Fiscal Discipline Board (fdp.gov.lv)
8 12.08.2022. Macroeconomic forecasts for 2022 and VTBI 2023/25 .| Fiscal Discipline Board (fdp.gov.lv)
9 Adjusted Macro Forecasts 2022 and VTBI 2023-2025 (1.12) | Fiscal Disciplinary Board (fdp.gov.lv)

Comparison of current and previous MoF forecasts

Below is a comparison between the forecasts for SP 2024/28 in February 2024 and update for MTBF 2024./28. Given the latest economic developments and the MoF assumptions underpinning the forecasts, the Council has adopted a decision on the endorsement of the forecasts described below.

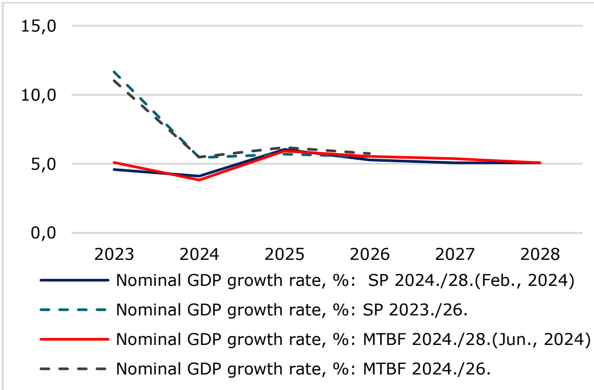
The Council has approved the real GDP growth forecast for the five-year period from 2024 to 2028. Compared to the February SP 2024/2028 forecast, the GDP growth rates for 2024 and 2025 remain unchanged. However, significant changes have been made to the structure of GDP. Compared to the SP 2024/28 forecast, the current forecast for 2024 shows a reduction in the growth of private consumption by 0.3 percentage points (pp.), government consumption by 2.1 pp., and investment by 3.6 pp. Conversely, the growth of exports of goods and services has increased by 1.1 pp. For 2025, the forecast indicates reductions in private consumption by 0.8 pp., government consumption by 3.7 pp., and changes in goods and services by 0.1 pp., while investment growth has increased by 0.4 pp.Looking ahead, the GDP forecast for 2026 has been improved by 0.2 pp., for 2027 by 0.3 pp., while the forecast for 2028 remains unchanged at 2.3%. (see Figure 4).

Figure 4. Real GDP growth forecast.



Source: MoF.

Figure 5. Nominal GDP growth forecast.

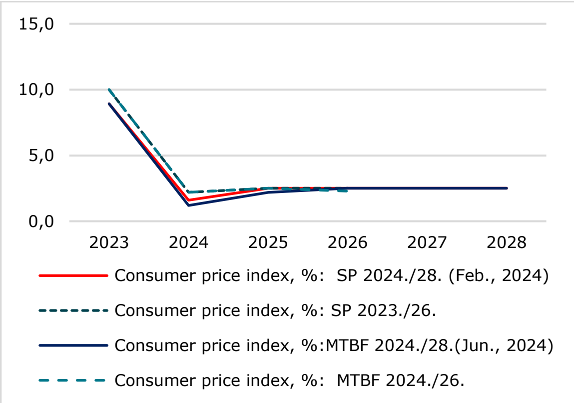


Source: MoF.

The Council approves the nominal GDP growth forecast for five-year period 2024.-2028. Compared to the previous SP 2024/28 forecast, the nominal GDP growth projections for 2024 and 2025 has been revised downwards by 0.3 and 0,1 percentage points respectively. The forecast for 2026 has been revised upwards by 0.2 percentage points, and the forecast for 2027 has been increased by 0.3 percentage points. The projection for 2028 remains unchanged at 5.1% (see page Figure 5).

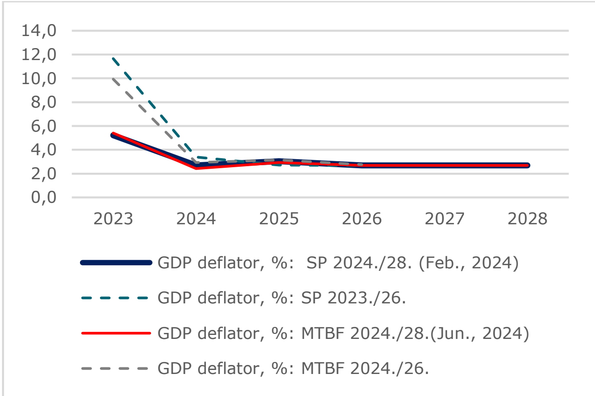
The Council approves the inflation forecast for period 2024-2028. Compared to the previous SP 2024/28 forecast the inflation forecast for the 2024 dropped by 0,4 percentage points, and for 2025 dropped by 0,3% percentage points. The projection for period 2026-2028 remains unchanged at 2.5% (see page Figure 6).

Figure 6. Inflation forecast.



Source: MoF.

Figure 7. GDP deflator forecast.



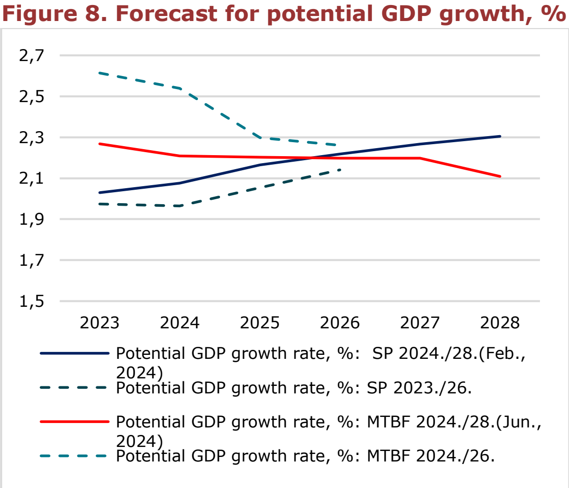
Source: MoF.

The Council approves the forecast of the GDP deflator for period 2024 - 2028 Compared with the previous SP 2024/28 forecast, the GDP deflator for 2024 and 2025 has been revised downwards by 0,3 and 0,1 percentage points respectively. The projection for period 2026-2028 remains unchanged at 2.7% (see page Figure 7).

The Council approves the forecast for potential GDP growth for 2024 – 2028. The forecast for 2024 has been revised upwards by 0.2 percentage points. The projection for period 2025-2026 remains unchanged at 2.2%. Projections for 2027 and 2028 has been revised downwards by 0.1 and 0.2 percentage points respectively (see page Figure 8).

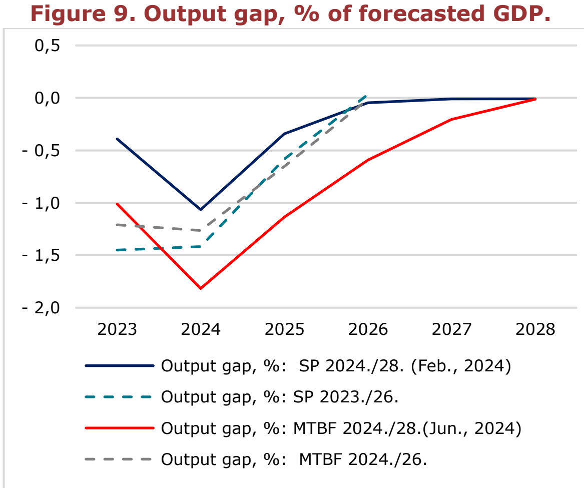
The Council approves the output gap forecast for 2024 – 2028. Compared with the previous SP 2024/28 forecast, the output gap for 2024 and 2025 has been revised downwards by 0,8 percentage points, for 2026 by 0,5 percentage points, and for 2027 by 0,2 percentage points. The projection for 2028 remains unchanged at neutral level, or 0% (see figure 9).

Figure 8. Forecast for potential GDP growth, %.



Source: MoF.

Figure 9. Output gap, % of forecasted GDP.



Source: MoF.

Conclusions

The Council generally approves the Ministry of Finance's macroeconomic forecasts for VTBI 2024-2028, considering them to be prudent and reflective of the current economic situation. The Council also highlights a range of existing risks that could negatively impact the projected economic growth trajectory. The Council notice the following risks:

- The highly tense and uncertain security situation in the region persists, with an intensification of hybrid attack risks.
- Weak lending and regional insecurity constrain entrepreneurs' ability to attract investments for business development and innovation.
- S&P has downgraded Latvia's long-term credit rating[10] due to security challenges, sluggish economic growth, and fiscal risks. This downgrade jeopardizes investment inflows and potentially increases the costs of financing for public borrowing.
- The sharp wage growth is driven by labour market constraints and the increased cost of living that arose during period of high inflation. However, this wage growth is not related with productivity gains. At the result - leading to higher business costs, reduced competitiveness, and limited investment funds. Additionally, it encourages the prevalence of envelope wages in the private sector, hindering faster economic growth.
- The accelerated wage growth in the public sector is driven by salary increases for teachers and the implementation of a new salary model for public sector employees. However, this could pose a significant fiscal burden if tax revenue growth does not keep pace with public sector wage increases.
- The Ministry of Finance is developing a tax reform aimed at reducing the tax burden on labor without decreasing total tax revenues. However, recent experiences in Estonia highlight the risks associated with tax reform, as significant deviations in expected tax revenue impacts are possible.
- Slow economic growth may not generate sufficient budgetary resources to maintain the budget deficit and public debt within acceptable limits, particularly given the high priority of defense spending and the increasing demand for state financial support for RailBaltica and AirBaltic.
- Risks associated with the operations of public joint-stock companies, particularly in the transport sector (such as the capitalization of AirBaltic and the construction of RailBaltic), remain significant and are escalating.

The identified risks largely in line with the risk assessment of the LV PEAK think tank, based on an expert survey[11].

Table 3.

Macroeconomic forecasting indicators approved by the Council, %.

Macroeconomic indicators	2024	2025	2026	2027	2028
Real GDP growth	1.4	2.9	2.8	2.6	2.3
Nominal GDP growth	3.8	5.9	5.5	5.4	5.1
Inflation (Consumption prices)	1.2	2.2	2.5	2.5	2.5
GDP deflator	2.4	2.9	2.7	2.7	2.7
Potential GDP growth	2.2	2.2	2.2	2.2	2.1
Output gap	-1.8	-1.1	-0.6	-0.2	0.0

Source: MoF

[10] Latvia Long-Term Ratings Lowered To 'A' On Econom | S&P Global Ratings (spglobal.com)
[11] Latvia University think tank LV PEAK Economic Barometer 1 (5) LV_PEAK_BAROMETRS_ENG.pdf (lu.lv)