



LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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To No

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On the endorsement of the macroeconomic indicator forecast

According to Section 20 of the Fiscal Discipline Law (hereafter – FDL) medium-term macroeconomic forecasts, including forecasts of growth rate of the gross domestic product (hereafter – GDP), deflator forecasts of the GDP and forecasts of growth rate of the potential GDP shall be developed by the Ministry of Finance (hereafter – MoF). According to the Section 28, Part 2 of the FDL, the Fiscal Discipline Council (hereafter – Council) shall perform an independent assessment of potential GDP and nominal GDP calculation by the MoF.

According to Article 4, Part 4 of the *Regulation (EU) Nr.473/2013 (21 May 2013) of the European Parliament and the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*, annual state budget draft and medium term budget framework (hereafter – MTBF) draft shall be based on independent macroeconomic forecasts that are prepared or endorsed by independent bodies.

According to the Memorandum of Understanding (hereafter – MoU)¹, signed on 8 February 2016, the Council should assume the responsibility of the independent body and endorse the MoF macroeconomic forecasts twice a year – while preparing the Stability programme, and the annual state budget and while preparing the MTBF.

¹ Memorandum of Understanding, available:
http://fiscalcouncil.lv/files/uploaded/FDP_1_09_281_20160208_MoU_FDC_MoF.pdf

A part of the macroeconomic forecast for Latvia's Stability programme 2016-2019 (hereafter – horizon period) was provided to the Council by the MoF on 5 February 2016. This was followed by additional information on February 8. The macroeconomic forecast was discussed at the Council meeting with the MoF on 9 February 2016.

According to subsection 4.6.3 of the MoU, if the Council's opinion on macroeconomic indicators significantly diverges from the opinion of MoF, the Council should outline conditions that would allow the Council to endorse the forecasts of macroeconomic indicators. On 9 February 2016 in response to the discussed macroeconomic forecast the Council provided its preliminary opinion that inter alia included the possible rejection grounds. The Council has identified the shortcomings with regard to the projections of the potential GDP and appropriate argumentation.

On 10 February 2016 the MoF provided the updated macroeconomic forecast taking into account the Council's comments. On 12 February 2016 an additional consultation was held between the Council and the MoF, after which the MoF provided the final version of the macroeconomic forecast on 15 February 2016.

With this letter the Council endorses the MoF macroeconomic projections for the purpose of Latvia's Stability programme 2016-2019 particularly real and nominal GDP growth, potential GDP growth and output gap, inflation and GDP deflator for the horizon period. The Council provides opinion on the macroeconomic forecasts (see Annex 1).

When preparing the interim report on the Latvia's Stability Programme 2016 -2019, the Council will also prepare section on macroeconomic outlook and output gap. The opinion provided in the Annex will serve as a basis for this section nevertheless the Council reserves the right to update it with the latest information.

The Council expresses its gratitude for the smooth co-operation and data exchange with the MoF colleagues.

Annex: *Opinion on the Ministry of Finance's macroeconomic forecast* on 4 pages.

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OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST

This document presents the opinion of the Fiscal Discipline Council (hereafter - the Council) on the macroeconomic forecast prepared by the Ministry of Finance (hereafter – MoF) that will be used for drafting the Latvia's Stability Programme 2016-2019 (hereafter – SP 2016/19) planned to publish on 12 April 2016. Early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed to support the effort in the Government in preparation of annual documents - the stability program and the medium-term budget framework. The preparation process involves multiple consecutive iterations, including but not limited to the preparation of the revenue estimates and fiscal estimates.

According to the Memorandum of Understanding (hereafter – MoU), signed on 8 February 2016, the Council has a responsibility to endorse MoF's macroeconomic forecast. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators that are outlined below. During the endorsement process the Council were presented with detailed information on MoF's forecast, such as gross domestic product (hereafter – GDP) structure and development scenarios of GDP components. The Council has also analysed developments in the labour market. The Council endorses the forecast for the indicators according to the scope of Article 20 of the Fiscal discipline law. The endorsed indicators are summarised in the Table 2 at the end of this document.

The MoF macroeconomic forecasts are largely in line with those of the European Commission (hereafter – EC) and International Monetary Fund (hereafter – IMF) (Table 1).

	2016			2017			2018			2019		
	MoF	EC	IMF	MoF	EC	IMF	MoF	EC	IMF	MoF	EC	IMF
Real GDP growth	3.0	3.1	3.3	3.3	3.2	3.7	3.4	n/a	3.9	3.4	n/a	3.9
Nominal GDP growth	4.3	n/a	5.1	5.8	n/a	6.1	6.3	n/a	6.2	6.5	n/a	6.1
Inflation (CPI)	0.4	0.4	1.8	2.0	2.0	2.3	2.5	n/a	2.2	2.5	n/a	2.0
Output gap	-0.3	1.8	-0.5	0.1	1.6	-0.3	0.5	n/a	0.1	0.9	n/a	n/a

Table 1 Key macroeconomic indicator forecasts by various institutions, % y-o-y. (MoF forecast from 15 February 2016; EC forecast from 4 February 2016; IMF forecast from October 2015). Data sources: MoF, EC, IMF.

Latvia is currently experiencing downward revisions of the forecasts for both real and nominal GDP growth compared to the forecasts in the medium-term budget framework (hereafter – MTBF) 2016/18. The development prospects of Latvia's economy, similar to the global economy, are characterised by uncertainty: while the euro exchange rate, interest rates and oil prices create favourable conditions for economic development, the effect of slow-down in the emerging economies hampers economic growth globally.

The Council endorses the real GDP growth forecast for the horizon period.

Compared to the previous forecast prepared for the MTBF 2016/18, the growth rates have been slightly reduced for 2017 and 2018 to 3.3% and 3.4% respectively, while the growth rate for 2016 has remained unchanged at 3.0% (Chart 1). The Council considers the real GDP growth forecast by MoF to be realistic.

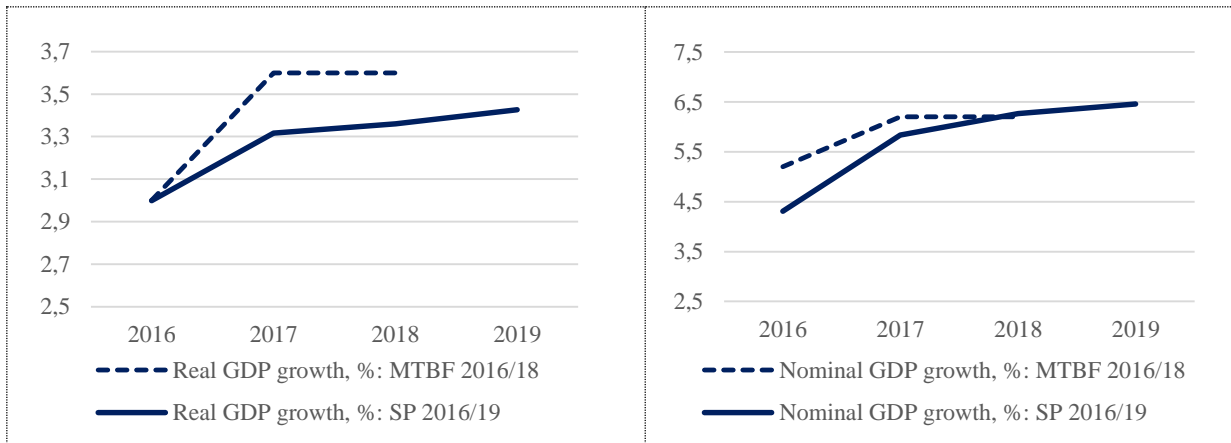


Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

The Council notes the following reasons for downward revision of the real GDP growth forecast by MoF:

- relatively slow growth in Latvia's major export markets (Lithuania, Estonia and Europe in general);
- the continued effect of geopolitical uncertainties in Russia and in Ukraine, and the Middle East that impact Latvia's economic development both directly and indirectly;
- the protracted slow-down of the global economy (including the indirect effects of growth slow-down in China and the economic downturn in Finland);
- the substantial reduction of the formerly significant export market of Russia. However, the reorientation towards new export markets has turned out to be successful for exporters.

On the positive side, it is realistic to expect that the economy will benefit from the favourable euro exchange rate and oil prices, and that sturdy private consumption will continue supporting Latvia's GDP growth in the future. Also, it can be expected that the investment sector will regain activity with the launch of the European Investment plan and the launch of the European Structural funds new planning period.

The Council endorses the nominal GDP growth forecast for the horizon period.

Meanwhile, a risk for a lower nominal GDP outcome is present, despite the fact that the projected growth rates have already been slightly revised downwards, namely, from 5.2% to 4.3% for 2016 and from 6.2% to 5.8% for 2017 compared to the projections in the MTBF 2016/18 (Chart 2). This translates into a risk of lower nominal GDP levels than forecasted, leading to a lower tax base. The risk of the nominal GDP falling behind the forecasted figures is related to a possibility of a lower inflation outcome than forecasted.

The Council endorses the change in consumer price index (hereafter – CPI) (inflation) forecast for the horizon period, but at the same time emphasizes the need to maintain vigilance on inflation.

The Council supports the downward revision in the inflation (change in CPI) forecast for 2016 from 2.0% in the MTBF 2016/18 to 0.4% currently, and for 2017 from 2.5% to 2.0% respectively (Chart 3). Although the inflation forecast for 2017 has been revised downwards, the events abroad suggest a possibility of even lower price levels persisting into 2017: price

pressures from abroad remain subdued and there are clear signs that the low inflation period in Europe will last longer than it was expected².

The Council endorses the GDP deflator forecast for the horizon period.

The GDP deflator, similar to inflation, has been reduced for 2016, but has not been changed for 2017 and has been slightly increased for 2018 (Chart 4). The GDP deflator is forecasted at considerably higher rates than the inflation due to the effect of the government consumption deflator and the investment deflator. This is mainly explained by the forecasted increase in wage level.

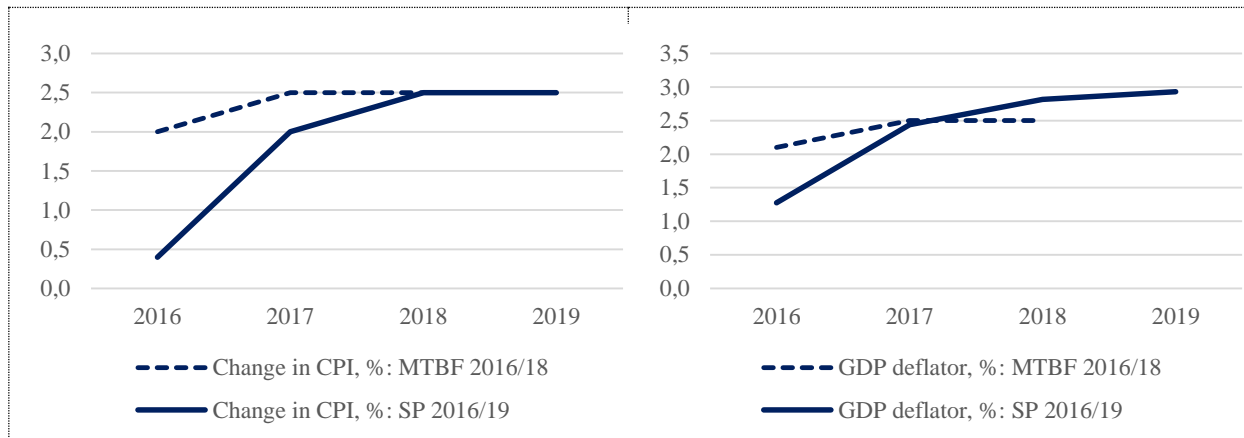


Chart 3 Forecast for inflation, y-o-y. Data source: MoF.

Chart 4 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council endorses the potential GDP growth and output gap forecast for the horizon period.

The potential GDP development was the most discussed part of the macroeconomic forecast during the endorsement procedure. During two rounds of consultations between the Council and the MoF, a mutual agreement was reached on the potential GDP trend and the resulting output gap scenario (Charts 5 and 6). While minor differences in opinions of the Council and the MoF still persist, the Council considers the current forecast acceptable for drafting the SP 2016/19.

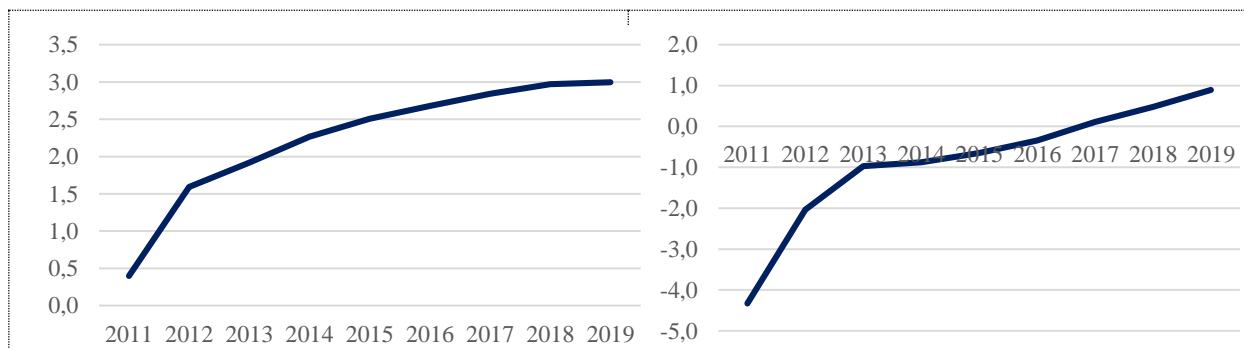


Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

Chart 6 Output gap, % of potential GDP. Data source: MoF.

² European Central Bank. *How central banks meet the challenge of low inflation*. 4 February 2016. Last assessed on 17 February 2016. Available: <https://www.ecb.europa.eu/press/key/date/2016/html/sp160204.en.html>

It should be mentioned that the EC's opinion on the output gap of Latvia's economy differs from that of MoF's (Table 1). The EC estimates a positive output gap of 1.8% for Latvia in 2016, slightly falling to 1.6% in 2017. This is explained by EC's approach to output gap estimation – a common methodology is used for all European Union countries. One of the key assumptions in EC's methodology that makes the output gap for Latvia positive is a higher potential unemployment rate than MoF estimates. The Council supports MoF's opinion that the optimal unemployment rate for Latvia's economy currently could be around 8%.

Several risks should be mentioned regarding the potential GDP and output gap developments:

- There is a risk of potential GDP growth slowing down in the medium term if structural reforms concerning the labour market (this includes education, especially tertiary education and vocational education, and healthcare) and other spheres are not implemented effectively.
- The Council sees the labour market of Latvia as warming up (this is substantiated by the low unemployment indicators for Latvia as a whole and in particular for Riga region, as well as the growth rate of wages exceeding that of labour productivity). This means that with the current trends in the labour market continuing, the economy of Latvia may develop an even more pronounced positive output gap than reflected in MoF's forecast over the horizon period.

	2016	2017	2018	2019
Real GDP growth	3.0	3.3	3.4	3.4
Nominal GDP growth	4.3	5.8	6.3	6.5
Inflation	0.4	2.0	2.5	2.5
GDP deflator	1.3	2.4	2.8	2.9
Potential GDP growth	2.7	2.8	3.0	3.0
Output gap	-0.3	0.1	0.5	0.9

Table 2 Macroeconomic forecast indicators endorsed by the Council.

The Council will continue close cooperation with the MoF and the respective government agencies towards the following objectives:

1. Developing a sensitivity analysis of the macroeconomic scenario, and adequate measures to limit the fiscal gap widening as the result of adverse macroeconomic developments.
2. Monitoring the developments in the labour market including average wage and unemployment level that together with other macroeconomic indicators may signal for the overheating of the economy.
3. Evaluating the government plans and their implementation towards increasing the potential GDP growth.