ANNEX 2. COUNCIL'S OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST (16 JUNE 2016)

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 Latvia's medium term budget framework (hereafter – MTBF) 2017/19, which is scheduled to be submitted to the Saeima on 15 October 2016. An early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the efforts of the Government during the preparation of the annual Stability Programme and the MTBF.

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, which are outlined below. During the endorsement process the Council was presented with detailed information on MoF's forecast, such as the gross domestic product (hereafter – GDP) structure and development scenarios of GDP components. The Council has consulted with external experts to gain an understanding of the current status and developments in the labour market as well as economy as a whole. 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.

	2016	2017	2018	2019
Real GDP growth				
MoF	**2.5**	**3.5**	**3.4**	**3.4**
BoL	2.0	3.0	-	-
EC	2.8	3.1	-	-
IMF	2.5	3.6	3.8	3.8
Nominal GDP growth				
MoF	**2.8**	**5.3**	**5.7**	**6.1**
BoL	-	-	-	-
EC	-	-	-	-
IMF	3.0	5.2	5.8	5.9
Inflation				
MoF	**0.0**	**1.6**	**2.0**	**2.5**
BoL	-0.4	1.3	-	-
EC	0.2	2.0	-	-
IMF	0.2	1.7	2.0	2.0
GDP deflator				
MoF	**0.3**	**1.7**	**2.2**	**2.7**
BoL	-	-	-	-
EC	1.0	2.2	-	-
IMF	0.5	1.5	1.9	1.9
Output gap				
MoF	**-1.1**	**-0.3**	**0.2**	**0.7**
BoL	-	-	-	-
EC	1.8	1.8	-	-
IMF	-	-	-	-

Table 1 Key macroeconomic indicator forecasts by various institutions, % y-o-y. (MoF forecast from 8 June 2016; BoL forecast from 10 June 2016; EC forecast from May 2016; IMF forecast from May 2016). Data sources: MoF, BoL, EC, IMF.

The MoF macroeconomic forecasts are largely in line with those of the European Commission (hereafter – EC) and International Monetary Fund (hereafter – IMF), but more optimistic than the Bank of Latvia's (hereafter – BoL) forecast. (Table 1). The divergence of views between MoF and EC on the output gap persists: while EC sees Latvia's economy as currently performing slightly above its potential, MoF foresees a small negative output gap for 2016 and 2017.

Latvia continues to experience a general trend of downward revisions of the forecasts for both real and nominal GDP growth compared to the forecasts in the Stability Programme 2016/19 and MTBF 2016/18. It must be noted that the majority of the countries worldwide, including most of Latvia's main trading partners, experience a decline in forecasted economic growth. High uncertainty persists regarding both the current macroeconomic conditions and future growth prospects. EC expects moderate European economic growth to be still mainly supported by domestic demand, slightly balanced by increasingly active investment sector due to the expected pick up of the Investment Plan for Europe, however, economic growth is not expected to accelerate significantly in Europe as a whole[1].

The Council endorses the real GDP growth forecast for the horizon period. Compared to the previous forecast prepared for the Stability programme 2016/19, the real GDP growth rate has been reduced by 0.5 percentage points to 2.5% for 2016, but raised by 0.2 percentage points to 3.5% for 2017 and broadly unchanged for the other years of the horizon period, namely 2018 and 2019 at 3.4% annually (Chart 1).

Data for the first quarter of 2016 suggest that the economy is developing at a considerably slower pace than was expected at the beginning of 2016 when the previous macroeconomic projections were being developed by the MoF. The main reason for the sharp reduction is the protracted stagnation in the investment sector, explained by the delay in the inflow of EU funds into the economy, which strongly affects the construction sector, which experienced a 19% drop in the first quarter of 2016, compared to the first quarter of 2015. Similarly, slow-down in retail growth, decreasing wholesale turnover and cargo turnover in Latvia's ports contributed to slower GDP growth compared to the earlier forecasts.

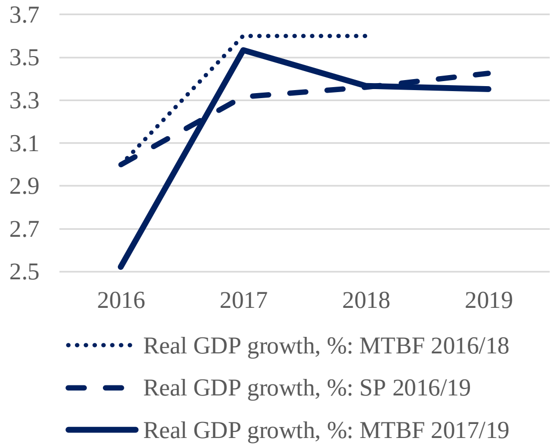

Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

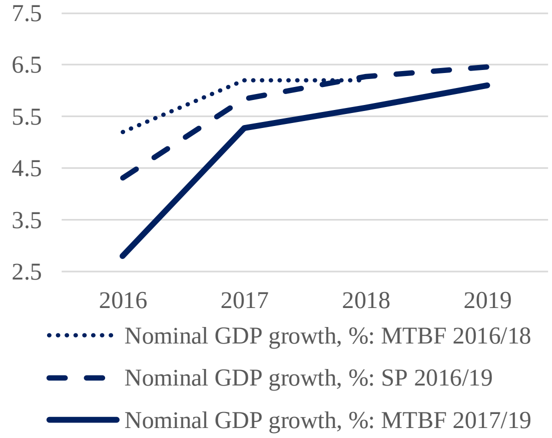

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

One of the assumptions underlying the current real GDP growth forecast is related to the investment sector growing rapidly in 2017 due to the expected inflow of EU funds into the economy. The Council points at a risk of slower investment pickup than MoF projects, considering the historic trends, which show that most of the payments to contractors will take place towards the end of seven year planning period, which corresponds to 2018-2022 in the current period.

The Council considers the current real GDP growth forecast by MoF to be broadly realistic. High wage growth and still low energy prices provide for moderate real GDP growth.

The Council endorses the nominal GDP growth forecast for the horizon period. The MoF has lowered the nominal GDP growth forecast for the horizon period (Chart 2). The nominal GDP forecast for 2016 has experienced the sharpest decline by 1.5 percentage points down to 2.8%; for the other years the decline being 0.5, 0.6 and 0.3 percentage points respectively compared to the Stability Programme 2016/19. Real GDP growth being revised downwards just slightly, the downward revision of nominal GDP forecast decline is mainly related to considerable downward revisions of inflation and GDP deflator forecasts.

[1] European Economic Forecast. Spring 2016. Available: *http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip025_en.pdf*. Last assessed on 9 June 2016.

The Council endorses the change in consumer price index (hereafter – CPI) (inflation) forecast for the horizon period. The Council supports the downward revision in the inflation forecast from 0.4% in the Stability Programme 2016/19 to 0.0% currently for 2016, from 2.0% to 1.6% for 2017 and from 2.5% to 2.0% for 2018 (Chart 3). The forecast for 2017 and 2018 is slightly higher than what the European Central Bank projects for Europe as a whole (1.3% for 2017 and 1.6% for 2018)[2], which can be explained by ongoing price convergence.

The Council endorses the GDP deflator forecast for the horizon period. The Council notes the GDP deflator revision for 2016 to more realistic levels compared to earlier MoF's forecasts, namely, from 1.3% to 0.3% in 2016, and from 2.4% to 1.7% for 2017 (Chart 4). This has been caused by the reduction of forecasted changes in price levels for all GDP components – reduced forecasts for both private and public consumption deflators, as well as switching the deflators for gross capital formation and exports from positive to negative numbers, which is partly off-set by a negative projected imports deflator.

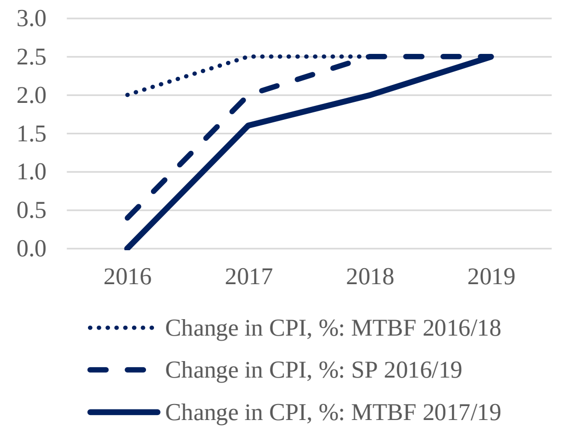

Chart 3 Forecast for inflation, y-o-y. Data source: MoF.

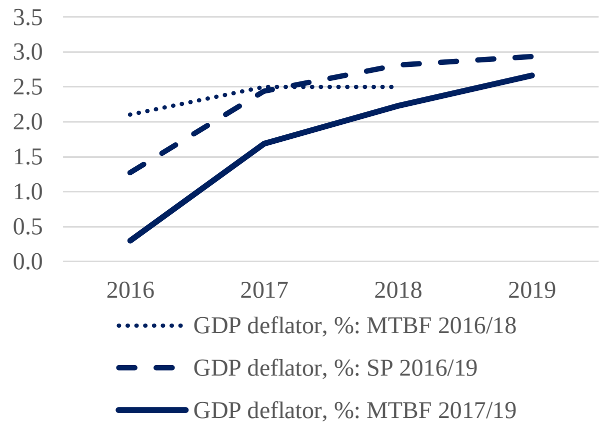

Chart 4 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council endorses the potential GDP growth and output gap forecast for the horizon period. The Council notes that the MoF's forecasts of the potential GDP growth result into increasingly negative output gaps for 2016 and 2017 and less positive output gaps for 2018 and 2019 than forecasted previously (Charts 5 and 6).

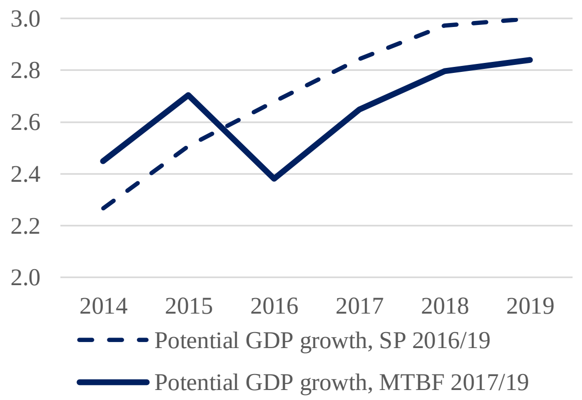

Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

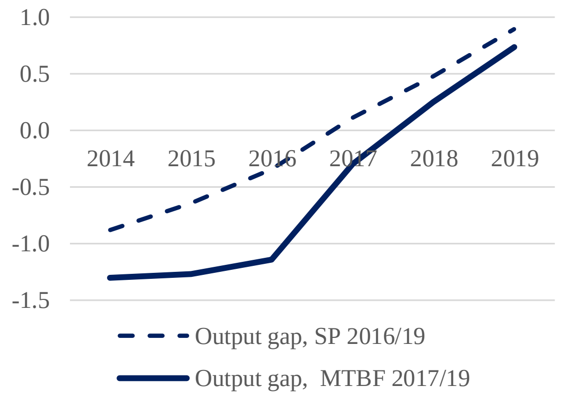

Chart 6 Output gap, % of potential GDP. Data source: MoF.

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[2] European Central Bank. June 2016 Eurosystem staff macroeconomic projections for the euro area. June 2016. Available: *https://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201606.lv.pdf?b5b8e2d20d82a0ff9ec84aef99e767c4* Last assessed on 9 June 2016.

The Council notes MoF's explanation that the 0.3 percentage point reduction in the potential GDP growth for 2016 is related to the persistent idleness in the investment sector. According to the production function, this translates into lower potential capital level than previously estimated. The reduced forecast for potential GDP growth for the other years by 0.2 percentage points annually is explained by the base effect of the downward revision of potential GDP growth for 2016.

	2016	2017	2018	2019
Real GDP growth	**2.5**	**3.5**	**3.4**	**3.4**
Nominal GDP growth	**2.8**	**5.3**	**5.7**	**6.1**
Inflation	**0.0**	**1.6**	**2.0**	**2.5**
GDP deflator	**0.3**	**1.7**	**2.2**	**2.7**
Potential GDP growth	**2.4**	**2.6**	**2.8**	**2.8**
Output gap	**-1.1**	**-0.3**	**0.2**	**0.7**

Table 2 Macroeconomic forecast indicators endorsed by the Council.