LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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16.02.2017. No 1-08/202

To ______ No ______

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On the endorsement of the macroeconomic indicator forecast with comments

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

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*, stipulates that the draft annual state budget and draft medium term budget framework (hereafter – MTBF) shall be based on independent macroeconomic forecasts that are prepared or endorsed by independent bodies.

According to the Memorandum of Understanding (hereafter – MoU)[1] between the MoF and the Council, signed on 8 February 2016 (with the amendment on 27 July 2016), the Council shall assume the responsibility of the independent body and endorse the MoF macroeconomic forecasts twice a year – (i) while preparing the Stability Programme, and (ii) the annual state budget and the MTBF.

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[1] Memorandum of Understanding, available:
http://fiscalcouncil.lv/files/uploaded/FDP_1_09_969_20160729_MoU_FDC_MoF_consolidated.pdf, accessed on 16.02.2017.

The macroeconomic forecast for Latvia's Stability programme 2017-2020 (hereafter – horizon period) was provided to the Council by the MoF on 6 February 2017. The macroeconomic forecast was discussed at the Council meeting with the MoF on 9 February 2017. An update of the potential GDP forecasts was received by the Council on 13 February.

In general, the Council does not object to the use of MoF's macroeconomic projections as the basis for Latvia's Stability Programme 2017-2020.

With this letter the Council endorses the MoF's macroeconomic projections for (i) real GDP and nominal GDP, (ii) potential GDP growth and the output gap, (iii) inflation and GDP deflator, as the basis for Latvia's Stability programme 2017-2020. The Council's opinion about macroeconomic forecasts can be found in the annex attached to this letter.

The Council recommends improving the sensitivity analysis of the macroeconomic development scenario for Latvia's Stability Programme 2017/20, assessing the impact of the materialisation of the risks associated with a lower level of investment on macroeconomic indicators and the budget balance. The recommendation stems from the previous years' experience with the substantial delays with resolving issues related to the administration of EU funds. This is one of the key reasons for stagnating investments and the severe recession in the construction sector in 2016.

When preparing the interim report on Latvia's Stability Programme 2017-2020, the Council will also prepare a section on the macroeconomic outlook. The opinion provided in the Annex will serve as the basis for this section. However, 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 colleagues from the MoF.

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 Latvia's Stability Programme (hereafter – SP) 2017/20, which is scheduled to be submitted to the Saeima in mid-April 2017. 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 SP and the medium term budget framework (hereafter – 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 as comprehensive as possible understanding of the developments in Latvia's economy. 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.

	2017	2018	2019	2020
Real GDP growth				
MoF (Feb 2017)	**3.2**	**3.4**	**3.2**	**3.0**
BoL* (Dec 2016)	3.0	-	-	-
EC (Feb 2017)	2.8	3.0	-	-
IMF (Oct 2016)	3.4	3.7	3.9	3.9
Nominal GDP growth				
MoF (Feb 2017)	**5.2**	**5.2**	**6.0**	**5.7**
BoL (Dec 2016)	-	-	-	-
EC (Feb 2017)	-	-	-	-
IMF (Oct 2016)	5.0	5.8	6.0	6.0
Inflation				
MoF (Feb 2017)	**2.3**	**2.0**	**2.0**	**2.0**
BoL (Dec 2016)	1.6	1.7	-	-
EC (Feb 2017)	1.9	2.0	-	-
IMF (Oct 2016)	1.7	2.0	2.0	2.0
GDP deflator				
MoF (Feb 2017)	**1.9**	**1.8**	**2.6**	**2.6**
BoL (Dec 2016)	-	-	-	-
EC (Feb 2017)	1.5	2.6	-	-
IMF (Oct 2016)	1.6	2.0	2.0	2.0
Output gap				
MoF (Feb 2017)	**-0.2**	**0.3**	**0.7**	**0.7**
BoL (Dec 2016)	-	-	-	-
EC (Feb 2017)	1.6	1.4	-	-
IMF (Oct 2016)	-	-	-	-

Table 1 Key macroeconomic indicator forecasts by various institutions, % y-o-y. Data sources: MoF, BoL, EC, IMF.
**Seasonal and calendar adjusted.*

The MoF macroeconomic forecast is largely in line with the forecasts of the European Commission (hereafter – EC), the International Monetary Fund (hereafter – IMF) and the Bank of Latvia's (hereafter – BoL) (Table 1). GDP growth will increase in 2017 after a slowdown in 2016, and so will inflation after several years of insignificant changes in the price level.

In its latest economic forecast the EC emphasises that economic growth in the EU in 2016, although moderate, was broadly persistent and performed in line with projections despite a number of unfavourable events in 2016, such as terrorist attacks, the UK's vote for Brexit, the US election results and uncertainty that followed. However, a number of factors that are expected to hamper growth in 2017 are mentioned: the investment weakness, the remaining slack in the labour market, and political uncertainty attendant to the upcoming elections in a number of the EU member states[1].

The Council endorses the real GDP growth forecast for the horizon period. MoF has revised downwards both real and nominal GDP growth forecasts compared to the forecasts for the MTBF 2017/19. The real GDP growth rate has been

[1] European Economic Forecast. Winter 2017. Last accessed on 14 February 2017. Available: https://ec.europa.eu/info/publications/european-economic-forecast-winter-2017_en

reduced by 0.3 percentage points to 3.2% for 2017, unchanged at 3.4% for 2018 and lowered by 0.2 percentage points to 3.2% for 2019 (Chart 1). The forecasted growth rate for 2020 (3.0%) is even lower.

Real GDP growth for 2016 was substantially lower than expected, which was largely caused by a recession in the construction sector, which dropped by 18.2% in current prices compared to 2015. This is reflected in the total investment figure and is at least partly explained by the delay in the inflow of EU funds into the economy. Similarly, a decrease in freight and cargo sector, especially railways and ports, contributed to slower than planned GDP growth in 2016. On the positive side, exports (in volumes) showed good results, and there were tentative signs of renewed activity in the lending sector in the last two quarters. Moreover, stable confidence indicators in Latvia (with the exception of a deterioration in consumer confidence in December 2016) and a positive economic sentiment in Latvia's main export countries suggest better real GDP growth results in 2017.

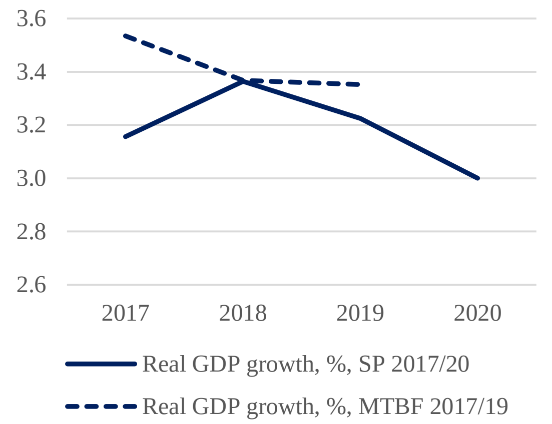

Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

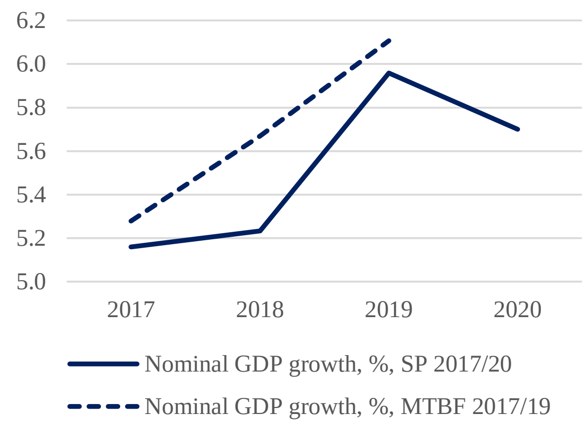

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

At the same time, the Council points to the risk of lower than planned EU funds disbursement in the economy. The progress of the disbursement has been poor compared to the plans during the last three years and continual postponement of the disbursement is one of the key reasons for stagnating investments and the severe recession in the construction sector. The latest MoF data show that on 1 January 2017 only 5.5% of the total EU funding for 2014-2020 had been actually paid out for the projects.

Consequently, the Council is uncertain regarding the realisation of the current plan for the disbursement of EU funds. The government should devote all efforts to accelerate implementation of EU co-financed projects and hence streamline the inflow of public financing into the economy. Council notes that there has been substantial progress in adopting the Government regulations required for starting the selection and implementation of the projects. At the same time the risks for smooth implementation of EU co-funded investments might come from quality issues in the project pipeline and respective delays in project implementation (e.g. delays with the procurement procedures, cost increases and respective amendments to projects etc.). This is of particular importance because the macroeconomic development scenario prepared by the MoF relies on the assumption of recovery of the construction and investment sectors.

In addition to the risk of project quality, it should be taken into account that the ability of the construction sector to absorb large amount of financing may turn out to be insufficient. The Council has previously noted the possible bottleneck effect that can affect the construction sector as EU financing becomes available for investments. This is due to the fact that the sector as a whole has been weakened, and part of the firms and labour have switched to projects abroad, which may result in a limited ability of the sector to absorb the funding timely and effectively.

<u>Therefore, the Council recommends to assess and quantify the impact of investment falling behind the forecasted amount on macroeconomic indicators and budget balance for the horizon period</u>.

The Council endorses the nominal GDP growth forecast for the horizon period. The MoF has slightly lowered the nominal GDP growth forecast for all years of the horizon period (Chart 2). 2018 has experienced the sharpest decline in the forecast by 0.5 percentage points to 5.2%.

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the horizon period. The Council supports the upward revision in the inflation forecast from 1.6% in the MTBF 2017/19 to 2.3% currently for 2017, and the forecasted inflation level at 2.0% for 2018-2020 (Chart 3). The actual change in the CPI show a 2.9% average annual inflation in January 2017, which makes the forecast of 2.3% average annual inflation cautiously realistic. The forecast for all the years is slightly higher than what the European Central Bank projects for Europe as a whole (1.3% for 2017 and 1.5% for 2018 and 1.7% for 2019)[2], which can be explained by ongoing price convergence.

The Council endorses the GDP deflator forecast for the horizon period. The GDP deflator has been raised by 0.3 percentage points to 1.9% for 2017, mainly due to an upward revision in the consumer price index and a decrease in the imports deflator (Chart 4). At the same time, the GDP deflator for 2018 is revised down by 0.4 percentage points to 1.8% due to decreased government consumption and capital formation deflators. GDP deflators for 2019 and 2020 are projected at the 2.6% level.

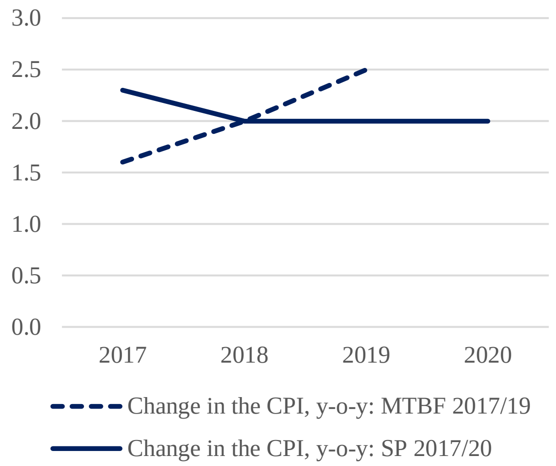

Chart 3 Forecast for inflation, y-o-y. Data source: MoF.

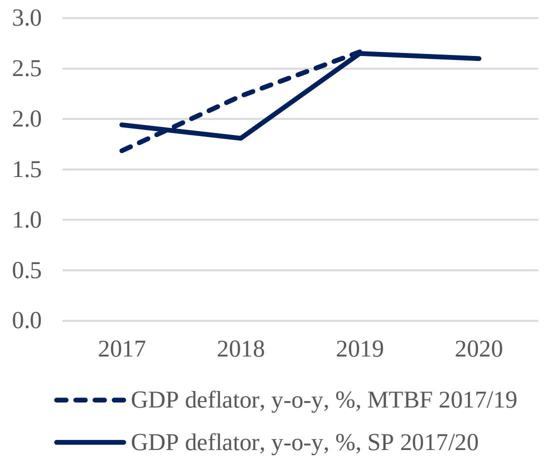

Chart 4 Forecast for GDP deflator, y-o-y. Data source: MoF.

The Council endorses the potential GDP growth and output gap forecast for the horizon period. While the potential GDP growth estimate for 2017 has been reduced from 2.6% to 2.5% compared to the projection in the MTBF 2017/19. The economy of Latvia is expected to perform rather close to its potential in 2017 and 2018, while a positive output gap is expected to start slowly opening after 2018 (Charts 5 and 6).

[2] December 2016 Eurosystem staff macroeconomic projections for the euro area. Last assessed on 13 February 2017. Available: https://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201612.en.pdf?29929e44e31cc1d35e6d01f2d9f5a341http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip025_en.pdf

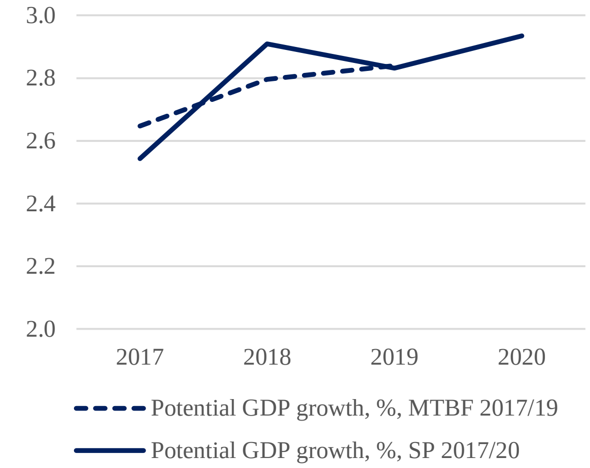

Chart 5 Potential GDP growth, %, y-o-y. Data source: MoF.

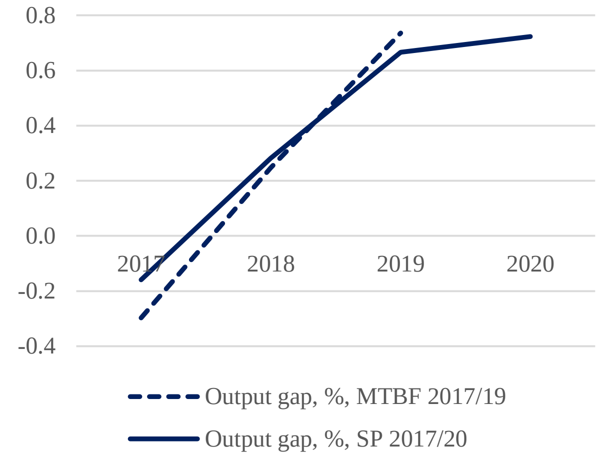

Chart 6 Output gap, % of potential GDP. Data source: MoF.

The Council notes MoF's explanation that the reduction in the potential growth rate for 2017 is related to the accumulated effect of weakening of the investment sector. This translates into lower potential capital level than previously estimated.

	2017	2018	2019	2020
Real GDP growth	**3.2**	**3.4**	**3.2**	**3.0**
Nominal GDP growth	**5.2**	**5.2**	**6.0**	**5.7**
Inflation	**2.3**	**2.0**	**2.0**	**2.0**
GDP deflator	**1.9**	**1.8**	**2.6**	**2.6**
Potential GDP growth	**2.5**	**2.9**	**2.8**	**2.9**
Output gap	**-0.2**	**0.3**	**0.7**	**0.7**

Table 2 Macroeconomic forecast indicators endorsed by the Council.

Broadly, the Council considers the MoF’s macroeconomic forecast to be realistic. At the same time, the Council concludes that both downside risks (persistent delay in EU funds disbursement) and upside risks (credit growth recovery combined with EU funds inflow) for the forecast are present. Therefore, the Council recommends improving sensitivity analysis of the macroeconomic development scenario for Latvia's Stability programme 2017/20, assessing the impact of the materialisation of the risks mentioned above on macroeconomic indicators and the budget balance.

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