ANNEX 2. COUNCIL'S ENDORSEMENT OF MOF MACROECONOMIC PROJECTIONS (15 FEBRUARY 2019)

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) 2019/22, which is scheduled to be submitted to the Cabinet of Ministers on mid-April 2019. 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, 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 a comprehensive understanding of the developments in Latvia's economy.

The Council has a mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarised in Table 2 at the end of this document).

	2019	2020	2021	2022
Real GDP growth				
MoF (Feb 2019)	**3.2**	**3.0**	**2.9**	**2.9**
BoL (Dec 2018)	3.5	3.1	–	–
EC (Jan 2019)[1]	3.1	2.6	–	–
EC (Oct 2018)[2]	3.2	2.9	–	–
IMF (Oct 2018)	3.3	3.1	3.0	3.0
Nominal GDP growth				
MoF (Feb 2019)	**6.4**	**5.9**	**5.5**	**5.5**
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018)[2]	5.4	5.7	–	–
IMF (Oct 2018)	5.8	5.7	5.5	5.3
Inflation				
MoF (Feb 2019)	**2.5**	**2.2**	**2.1**	**2.0**
BoL (Dec 2018)	2.9	2.5	–	–
EC (Jan 2019)[1]	2.7	2.1	–	–
EC (Oct 2018)[2]	2.7	2.4	–	–
IMF (Oct 2018)	2.4	2.4	2.4	2.3
GDP deflator				
MoF (Feb 2019)	**3.1**	**2.8**	**2.5**	**2.5**
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018)[2]	2.1	2.7	–	–
IMF (Oct 2018)	2.9	3.2	3.1	3.0
Output gap				
MoF (Feb 2019)	**1.4**	**1.0**	**0.7**	**0.4**
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018)[2]	2.1	1.3	–	–
IMF (Oct 2018)	–	–	–	–

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

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). However, the inflation rate is forecasted lower (in comparison to forecasts by BoL, and EC[1] for 2019) but the nominal GDP growth – higher (even by 1,0 percentage points in comparison to EC).

Although the output gap estimate is increased for the whole-time horizon in comparison to the previous forecast by MoF, it remains below the EC forecast. Both forecasts indicate a likely decline in real GDP growth below potential growth.

In 2018, the financial and transport sectors performed better than expected, we also saw high confidence indicators (above the long-term average) and investments

[1] European Commission Winter 2019 Economic Forecast. Available at: *https://ec.europa.eu/info/sites/info/files/economy-finance/ip096_en.pdf*, accessed on 07.02.2019.

(especially in construction sector, financed by the European Funds). However, in addition to historically low unemployment (since 2009) pushing up wages, **risks of weaker external trade and lower external demand are emerging**[2], together with warnings of reputation crisis in banking sector if prevention of money laundering will not be introduced at the level recommended by the MONEYVAL[3].

The Council endorses the nominal and real GDP growth forecast for SP 2019/22 with comments. Compared to the previous forecast in October 2018, which was prepared for the MTBF 2019/21, the real GDP growth rate has been raised by 0.2 percentage points for 2019 with no changes for upcoming years (Chart 1). However, negative risks at global extent have increased, resulting in weaker external trade and lower external demand; it could slow down the real economic growth below the forecasted level for 2019.

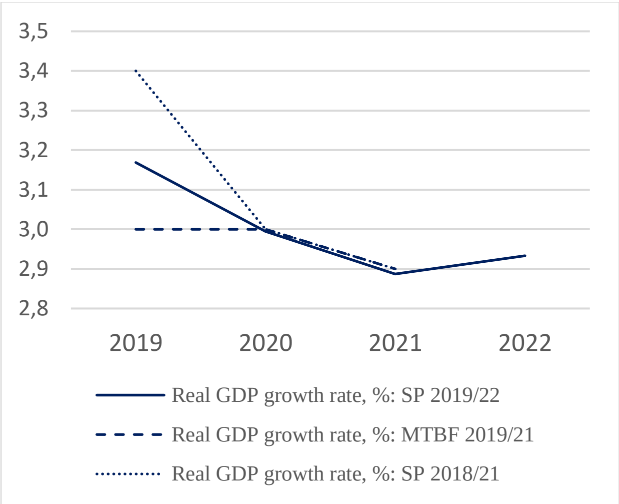

Chart 1 Forecast for real GDP growth, y-o-y. Data source: MoF.

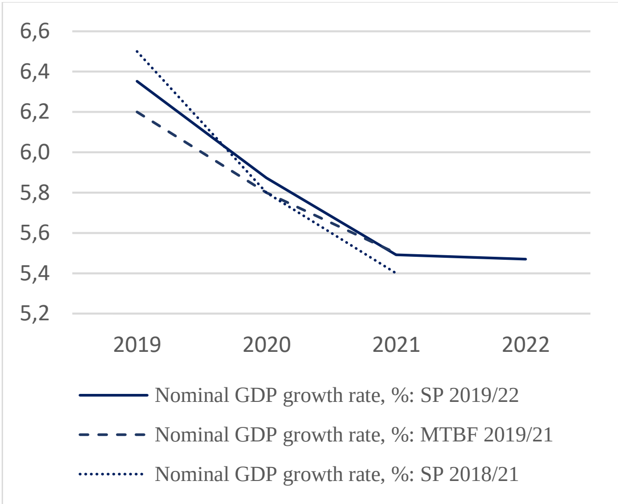

Chart 2 Forecast for nominal GDP growth, y-o-y. Data source: MoF.

The Council endorses the GDP deflator and the change in the consumer price index (hereafter – CPI) (inflation) forecast for the SP 2019/22 with comments. Since October 2018, there are no changes made to the inflation forecast (Chart 3), however, as already in previous endorsements, the Council emphasizes that the pressure on the wage growth from the labour market remains high and therefore inflation outcome might be above the current forecast, particularly for years 2020 and 2021. The CPI forecasts by the EC (2019) and Bank of Latvia are higher for both 2019 and 2020.

[2] European Commission Autumn 2018 Economic Forecast. Available at: *https://ec.europa.eu/info/sites/info/files/economy-finance/ip089_en_0.pdf* , accessed on 07.02.2019.
[3] The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism - MONEYVAL, July 2018. Anti-money laundering and counter-terrorist financing measures. Available at: *https://rm.coe.int/moneyval-2018-8-5th-round-mer-latvia/16808ce61b*, accessed on 07.02.2019.
"After the peak in 2017 of the economic growth in European Union (hereafter – EU), growth has moderated with emerging external demand risks and weaker external trade (domestic demand remains strong)."

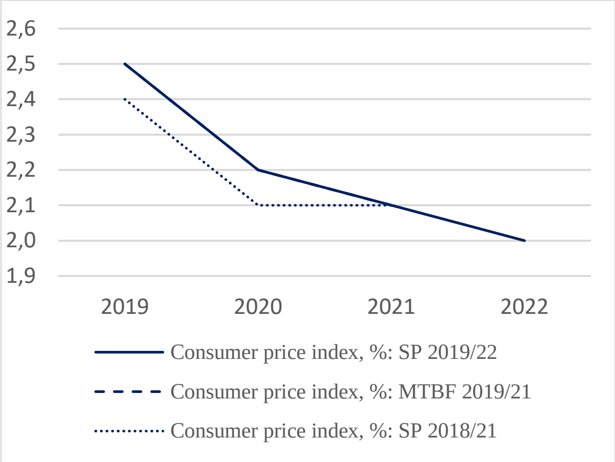

Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

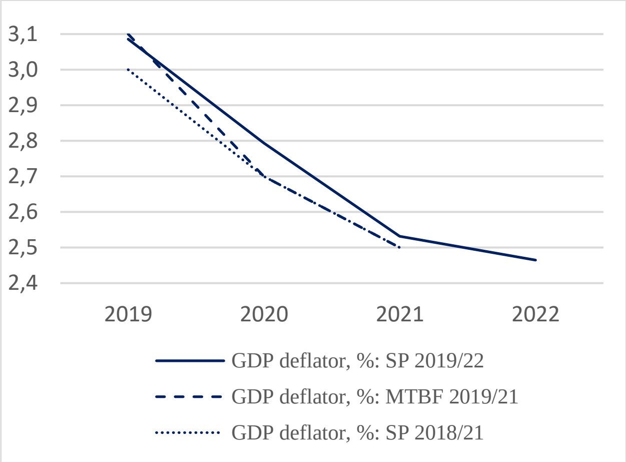

Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the potential GDP growth and output gap forecasts for the SP 2019/22 with comments. Potential GDP growth has been revised upwards by 0.1 percentage points for 2019 and 2020, and for 0.2 percentage points for 2022. A 3.0% growth rate has been set for 2023, 2.9% for 2024, 2025 and 2026 (the expanded time horizon is necessary for further calculations of the expenditure benchmark). The Council agrees that the current output gap is larger-positive than previously forecasted, in fact, it could be even larger, knowing the risks of, e.g., price acceleration above the inflation rate currently forecasted by MoF that would deteriorate the productivity and result in lower economic growth potential as well as widening positive output gap. While MoF argues that there are positive structural changes in the labour market, the Council points out that the structural unemployment is high, therefore labour market continues to restrict the potential GDP growth.

Latvia's economic growth currently is in upswing of economic cycle close to its maximum growth level. Although, in 2019, the slowdown of economic growth is probable because of raising risks, the economy will continue to growth in upcoming years. During this time, the Government should implement a restrictive fiscal policy and create a buffer for next – turning downwards – phase in the economic cycle.

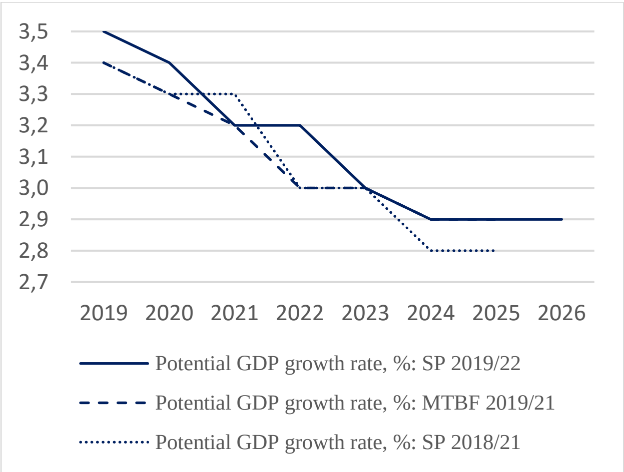

Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

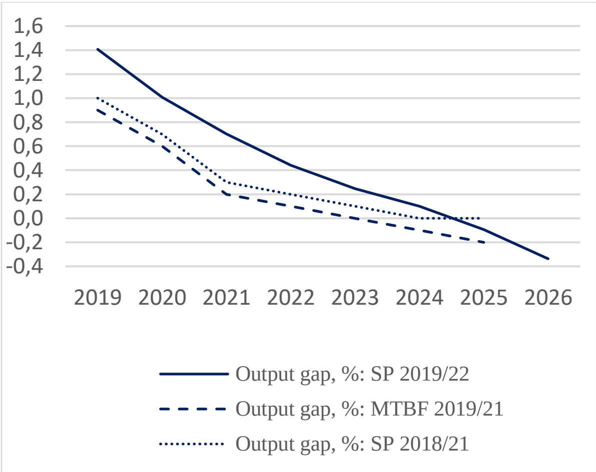

Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2019	2020	2021	2022
Real GDP growth	**3.2**	**3.0**	**2.9**	**2.9**
Nominal GDP growth	**6.4**	**5.9**	**5.5**	**5.5**
Inflation (consumer prices)	**2.5**	**2.2**	**2.1**	**2.0**
GDP deflator	**3.1**	**2.8**	**2.5**	**2.5**
Potential GDP growth	**3.5**	**3.4**	**3.2**	**3.2**
Output gap	**1.4**	**1.0**	**0.7**	**0.4**

Table 2 Macroeconomic forecast indicators endorsed by the Council. Data available also in MS Excel[4].

Broadly, the Council considers the MoF's macroeconomic forecasts to be realistic and endorses them.

The Council would like to point out that the SP2019/22 should include the sensitivity analysis, where following negative risks are assessed: decreasing unemployment contributing to wage growth and inflation, unfavourable external circumstance for external trade and lower external demand, effect of Brexit; as well as reputation risks in banking sector. As in the spring forecast last year, the Council has attached an evaluation of yearly macroeconomic forecasts (in MS Excel[5]). The Council encourages the MoF to continue to improve both the sensitivity analysis and the evaluation of previous forecast's deviations.

The Council is also looking forward to MoF's assessment (that is going to be prepared in May 2019) of tax-reform started in 2017 results, incl. effect on economic cycle.

In addition, the Council has introduced a new monitoring tool – the heatmap (available online: http://fiscalcouncil.lv/cycle-heatmap), to follow on changes of main indicators characterizing the economic cycle. From the analysis it is possible to observe a clear "heating" of the composite index since beginning of 2017, and especially in 2018Q2 and 2018Q3, which is characterized by tension in labour market, historically high capacity utilization in manufacturing industries, high demand in construction, industry and services, as well as above the long term average house price index and economic sentiment (see Annex[6]).

[4] Macroeconomic indicators. Available: *http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macroeconomic_forecasts_opinion_Ann2.xlsx*, accessed on 15.02.2019.
[5] Evaluation of the annual macroeconomic forecasts. Available: *http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macroeconomic_forecasts_opinion_Ann3.xlsx*, accessed on 15.02.2019.
[6] Heatmap and recognition of economic cycles. Available: *http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macroeconomic_forecasts_opinion_Ann4.pdf*, accessed on 15.02.2019.