OPINION ON THE MINISTRY OF FINANCE'S EXTRAORDINARY REVISED MACROECONOMIC FORECAST

This document provides the opinion of the Fiscal Discipline Council (hereinafter - the Council) on the macroeconomic forecasts developed by the Ministry of Finance (hereinafter - the MoF), which will be used as a basis for the Latvian Stability Program (hereinafter - SP) 2020-2023. (2020/23), which is planned to be submitted to the Cabinet of Ministers in April 2020. In order to support the work on the development of the annual documents - SP and Medium-Term Budget Framework (hereinafter - MTBF), an agreement was reached on early approval by the Council of the macroeconomic forecasts of the Ministry of Finance.

Through the Memorandum of Understanding, signed on 8 February 2016, the MoF has requested and Council has accepted a responsibility to endorse MoF's macroeconomic forecasts underpinning fiscal projections. 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 1 at the end of this document).

Due to the **extraordinary situation** connected with COVID-19 outbreak, the Ministry of Finance has revised the macroeconomic development forecasts, envisaging a deviation from scenario projected for Stability Program 2020/2023 at the February 2020, and endorsed by Council.[1].

On 3 April, this year the Council received updated macroeconomic forecasts (hereinafter - CoV SP 2020/23), which include the consequences of the impact of the COVID-19 crisis and which will be used to develop the Stability Program 2020-2023.
In accordance with point 4.9. of the Memorandum of Understanding, the Council complements its opinion on macroeconomic forecasts endorsed in February, as macroeconomic developments deviate from the previously agreed scenario due to the pandemic.

The Council and the MoF discussed the forecasts in the form of a written consultation, asked questions and received explanations from the MoF representatives. Based on currently available information, the Council is delivering an opinion on key macroeconomic indicators.

The Council expresses its opinion on the real GDP forecast in CoV SP 2020/23 scenario and notes that compared to the previous forecast in February 2020 (SP 2020/23), real GDP growth has been reduced by 9.2% for 2020 and by 1.8% in 2021, expecting GDP growth of 1.02%. The GDP growth forecast for 2022 exceeds the previously forecast value by 0.7% p. The growth rate for 2023 remains unchanged compared to the forecast estimated in February (Figure 1). The Council considers that, in an environment of high uncertainty, decline of GDP (-7%) is a relatively conservative assessment, given that the recovery of some sectors may be difficult and delayed. Recovery processes of exporting industries depend on other countries will be particularly sensitive. On March 26, the Bank of Latvia announced a forecast of a decline in real GDP (-6.5%) for 2020, however, in later publications it noted that the decline might be even lower. The Council notes that a more prudent assessment of the fall in GDP (-8 to -9%) would be a safer option, as it would allow a more prudent assessment of fiscal options and avoid excessive and rapid increases in government debt.
The Council considers that, in the current context of high uncertainty, -7% is not enough prudent choice.

[1] 17.02.2020. Macroeconomic forecast endorsement: https://fiscalcouncil.lv/17022020-macroeconomic-forecast-endorsement

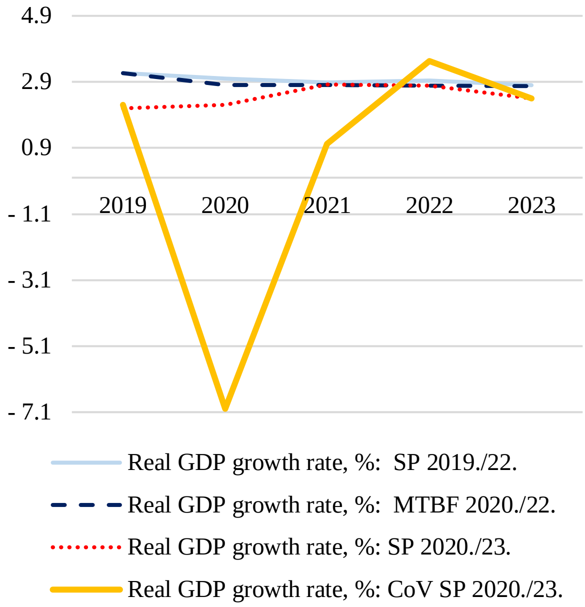

Chart 1 Forecast for real GDP growth, y-o-y. (curve CoV SP 2020.23. - COVID_19 crisis scenario) Data source: MoF.

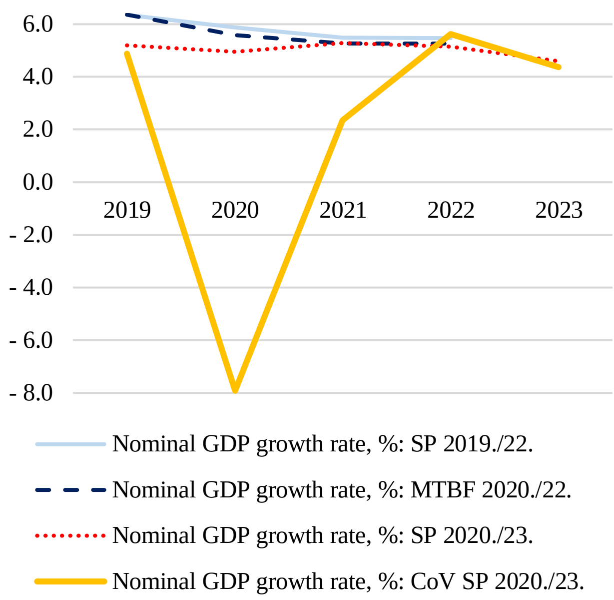

Chart 2 Forecast for nominal GDP growth, y-o-y. (curve CoV SP 2020.23. - COVID_19 crisis scenario) Data source: MoF.

The Council expresses its opinion on the nominal GDP forecast in CoV SP 2020/23. Compared to the forecast in February 2020 (SP 2020/23), the updated nominal GDP forecast for 2020 has been reduced by 12.9% and for 2021 by 2.9%. The forecast for 2022 exceeds earlier (February) forecast by 0.5% percent points, while for 2023 the forecast has been reduced by 0.2% percent points (Figure 2).
Both real and nominal GDP growth rates in CoV SP 2020/23. Forecast reflects a rapid economic recovery scenario. Such a scenario is unlikely for Latvia, as a small open economy, and the economy cannot be expected to recover easy and rapidly. The OECD estimates that COVID-19 lockdown measures have reduced economic activity in developed countries by 20-30% and reduce GDP growth by 2% each month[2]. Thus, the scenario proposed by the Ministry of Finance reflects the expectation that the crisis will be short and will be followed by a relatively rapid economic recovery (see Note[3]).

If the MoF's forecasts are realized, the share of VTBL 2020/2022 expenditures will significantly exceed the financial possibilities of the budget. According to the preliminary assessment, maintaining the planned level of expenditures and revenues of VTBL 2020/2022, and taking into account the fiscal impact of COVID-19 mitigation measures, the general government budget balance could reach -5.5% of deficit in 2020. Keeping the planned amount of expenditures for 2021 and 2022 unchanged, the deficit will reach more than -4% in these years. The Council therefore draws attention to the potential need to plan budgetary expenditure restraint measures in a timely manner from 2021 onwards, already assessing priority, sustainable sectors and envisaging expenditure restraint measures as part of the exit strategy.

The Council expresses its opinion on the consumer price index (CPI) forecast and notes that, compared to the forecasts of SP 2020/2023; the CPI has been reduced by 1.9%p. for 2020 and by 0.4%p. for 2021. CPI adjustments for 2022 and 2023 saved without changes (Figure 3). Compared to the Bank of Latvia's forecasted inflation for 2020 (0.5%), the MoF's assumptions are slightly more cautious

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[2] OECD https://www.oecd.org/newsroom/oecd-updates-g20-summit-on-outlook-for-global-economy.htm

[3] **Note:** In the Council members discussion was expressed, that MoF's forecasts assessing from the point of view of GDP levels, a mild "U" or "L" type scenario is rather visible. The economy recovery at 2021/2022. is relatively weak and likely to return to 2019 levels only in 2023. In turn, assessing the GDP growth from the point of view of growth rates, a V-type scenario can be seen.

Consumption is generally projected to be cautious, but if the crisis persists for more than six months, the unemployment rate will continue to rise and employers' ability to maintain wages will remain more limited, which could lead to deflation in some months of 2020.

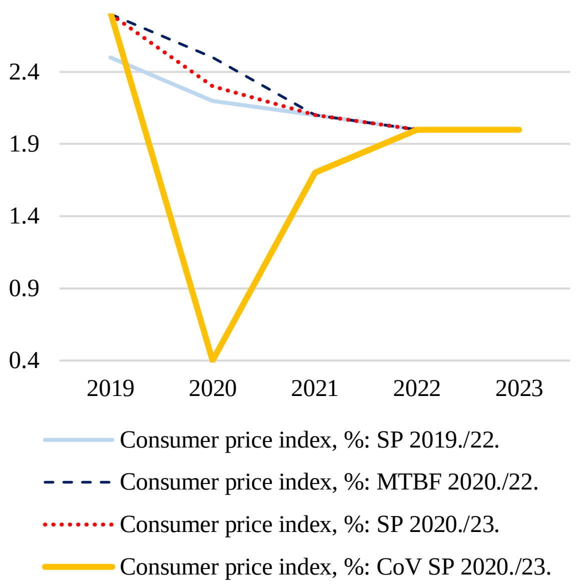

Chart 3 Forecast for inflation, y-o-y.
(curve CoV SP 2020.23. - COVID_19 crisis scenario) Data source: MoF.

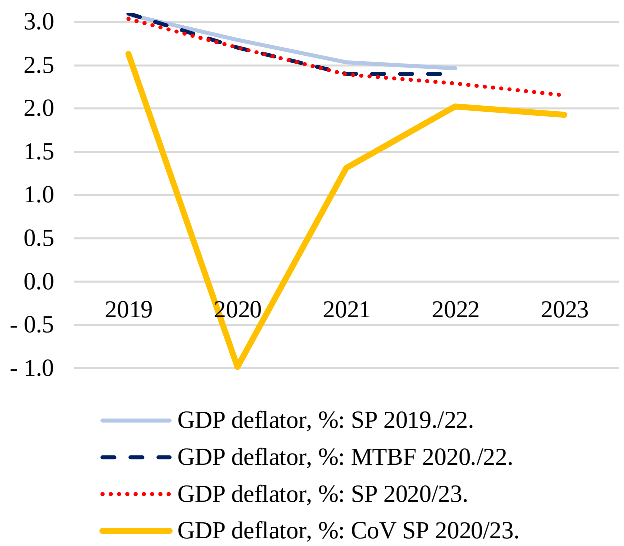

Chart 4 Forecast for GDP deflator, y-o-y.
(curve CoV SP 2020.23. - COVID_19 crisis scenario) Data source: MoF.

GDP deflator forecast CoV SP 2020./23. forecasts has been reduced compared to SP 2020/23 for the whole forecast period. It is forecasted that the deflator value will decrease by 3.7% for 2020, by 1.1% for 2021, by 0.3% for 2022, and by 0.2% for 2023 (Figure 4).

The Council expresses its opinion on the forecast of the potential GDP and output gap for Cov SP 2020/23. Estimation of potential GDP growth compared to Compared to the SP 2020/23 forecasts approved in February have not changed (Figure 5).
Compared to the SP 2020/23 in the updated macroeconomic forecasts, the output gap has been reduced by 9.2% for 2020, by 10.8% for 2021, by 10.2% for 2022, and reduced by 10.1% for 2023(Figure 6).

Assuming that only a weak economic recovery is expected in 2021 and 2022, the effects of the COVID-19 crisis can be expected to have a structural effect on the economy, which may also affect the potential of the economy as a whole. There are currently no new indications that the potential of the economy has been irreversibly lost, but in the future, it will be affected by changes in the transport sector that began before the COVID-19 crisis, especially in the port segment. The assessment of potential GDP and the output gap will need to be revised in the light of more recent data, which will allow a return to the GDP forecast in June 2020.

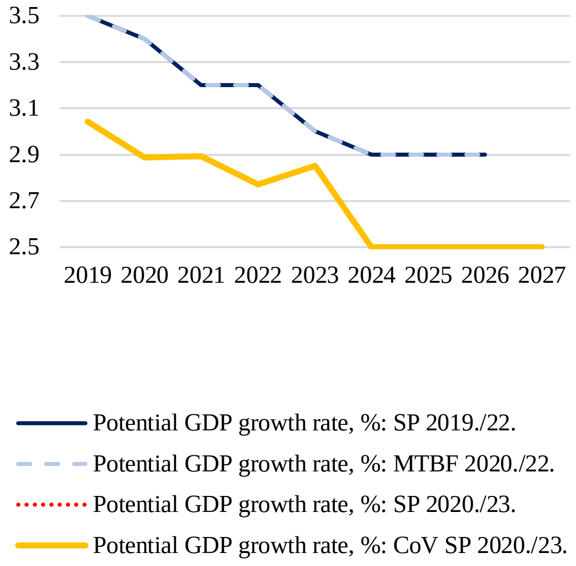

Chart 5 Potential GDP growth, %, y-o-y.
(curve CoV SP 2020.23. - COVID_19 crisis scenario)
Data source: MoF.

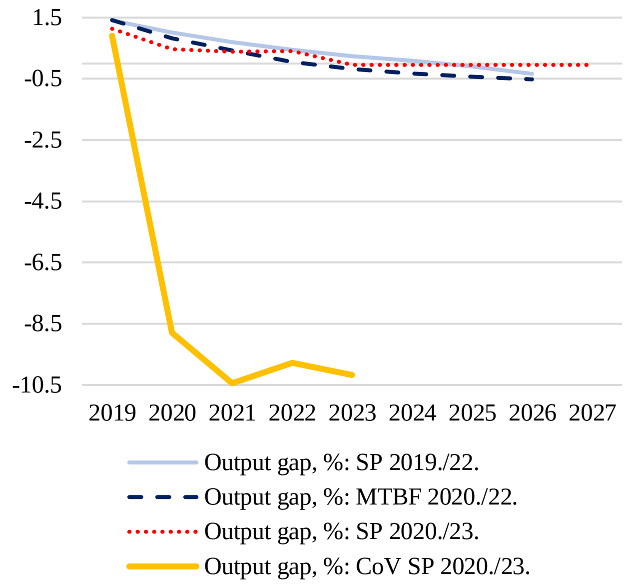

Chart 6 Output gap, % of potential GDP.
(curve CoV SP 2020.23. - COVID_19 crisis scenario)
Data source: MoF.

At present, different macroeconomic development, scenarios are needed, and in the current situation of uncertainty, it is necessary to be able to see and understand the fiscal consequences in the event of a prolonged recession.

Overall, the Council notes that a rapid economic recovery is not expected, especially in the tourism and related sectors. An example is the 2003 SARS outbreak, which had a major impact outside China. It is already clear that the COVID-19 outbreak is global and will have much more severe consequences.

It should already be borne in mind that there is a real possibility that the government debt level will reach around 44% of GDP at the end of the year. This possibility exists if GDP declines by 7% and grow even more.

	2019	2020	2021	2022	2023
Real GDP growth	2,2	-7,0	1,0	3,5	2,4
Nominal GDP growth	4,9	-7,9	2,4	5,6	4,4
Inflation (consumer prices)	2,8	0,4	1,7	2.0	2,0
GDP deflator	2,6	-1,0	1,3	2,0	1,9
Potential GDP growth	3,0	2,9	2,9	2,8	2,9
Output gap	0,9	-8,8	-10,4	-9,8	-10,2

Table 1. Macroeconomic forecast indicators endorsed by the Council.

In view of the rapid development of the COVID-19 crisis, the Council is committed to monitoring the development of the economic environment in Latvia by publishing a brief assessment of the situation twice a month on the Council's website.

www.fdp. gov.lv.

The main theses of the first monitoring report:

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(1) The Council broadly supports the Government's operational action to mitigate the effects of COVID-19 and considers that investment in strengthening the health care system, measures to support entrepreneurship and social support for the population are in line with international good practice in this crisis situation;

(2) The Council is concerned that the Low On Measures for the Prevention and Suppression of Threat to the State and Its Consequences Due to the Spread of COVID-19 does not provide for a time limit for support measures that threaten fiscal sustainability in general;

(3) The Council sees an imbalance in the level of support measures, with particular emphasis on the proportionally small support of 1% for strengthening the health care system;

(4) The Council notes that a discussion on medium-term budgetary objectives is already needed. Keeping the planned amount of expenditures for 2021 and 2022 unchanged, the deficit will reach more than -4% in these years. The Council therefore draws attention to the potential need to plan budgetary consolidation measures in a timely manner from 2021 onwards, already assessing priority, sustainable sectors and envisaging consolidation measures as part of the exit strategy.