

OPINION ON THE MINISTRY OF FINANCE'S 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) 2021-2024. (2021/24), which is planned to be submitted to the Cabinet of Ministers in April 2021. 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 3 at the end of this document).

Since Medium term budgetary framework 2021/23¹ (hereafter – MTBF 2021/23.) the MoF has changed the main macroeconomic indicator forecasts for 2021, 2022 and 2023 and estimated forecasts for 2024 (see Table 1).

	2021	2022	2023	2024
Real GDP growth, change in %	-2,1	+1,35	+0,03	-
SP 2021/24	3,0	4,49	3,2	2,8
MTBF 2021/23	5,1	3,14	3,1	-
Nominal GDP growth, change in %	-2,1	+1,1	0,0	-
SP 2021/24	4,4	6,4	5,2	5,0
MTBF 2021/23	6,5	5,3	5,2	-
Inflation (consumer prices), change in %	+0,2	0,0	0,0	-
SP 2021/24	1,4	2,0	2,0	2,0
MTBF 2021/23	1,2	2,0	2,0	-
GDP deflator, change in %	+0,1	-0,2	0,0	-
SP 2021/24	1,4	1,8	2,0	2,1
MTBF 2021/23	1,3	2,0	2,0	-
Potential GDP growth, change in %	-0,5	-0,3	-0,1	-
SP 2021/24	2,0	2,2	2,4	2,8
MTBF 2021/23	2,5	2,5	2,4	-
Output gap, change in %	+2,7	+4,2	+4,4	-
SP 2021/24	-2,9	-0,75	0,0	0,0
MTBF 2021/23	-5,6	-4,99	-4,4	-

Table 1. Macroeconomic forecast indicators changes since endorsement in June 2020².

At the Council meeting on 11 February 2021, the MoF has informed the Council about assumptions for macroeconomic forecasts and actual situation in national economy.

¹ [Par vidēja termiņa budžeta ietvaru 2021., 2022. un 2023. gadam \(likumi.lv\)](#)

² [15.06.2020. FDC OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST FOR 2020 AND 2021-2023 \(fiscalcouncil.lv\)](#)

	2021	2022	2023	2024
Real GDP growth				
MoF (Feb 2021)	3.0	4.5	3.2	2.8
BoL (Dec 2020)	2.8	5.3	3.7	–
EC (Feb 2021)	3,5	3,1	–	–
IMF (Oct 2020)	5.2	5.1	4.9	3.5
Nominal GDP growth				
MoF (Feb 2021)	4.4	6.4	5.2	5.0
BoL (Dec 2020)	–	–	–	–
EC (Feb 2021)	–	–	–	–
IMF (Oct 2020)	6.7	6.9	6.8	5.6
Consumer prices (inflation)				
MoF (Feb 2021)	1.4	2.0	2.0	2.0
BoL (Dec 2020)	1.1	1.6	1.7	–
EC (Feb 2021)	1,5	1,9	–	–
IMF (Oct 2020)*	1.8	2.2	2.3	2.2
GDP deflator				
MoF (Feb 2021)	1.4	1.8	2.0	2.1
BoL (Dec 2020)	–	–	–	–
EC (Feb 2021)	–	–	–	–
IMF (Oct 2020)	–	–	–	–
Output gap				
MoF (Feb 2021)	-2.9	-0.7	0.0	0.0
BoL (Dec 2020)	–	–	–	–
EC (Feb 2021)	–	–	–	–
IMF (Oct 2020)	–	–	–	–

Table 2. Key macroeconomic indicator forecasts by various institutions, % y-o-y. Data sources: MoF³, BoL⁴, EC⁵, IMF⁶.

* Inflation, average consumer prices

wide vaccination campaign of the population as a precondition for a resumption of strong economic growth, expected at the end of summer 2021. In turn, the EC forecasts 3.1% GDP growth in 2022, assuming that the largest contribution to growth will come from private consumption and exports.

The MoF predicts that the recovery of various sectors from the crisis is will be uneven. The second wave of Covid-19 has undermined the 2021 recovery scenario.

The economic recovery will be long-lasting and uneven, and the Covid-19 crisis has had a structural impact on the economy, thus changing its economic potential. Uncertainty in external markets will continue to weigh on export prospects and economic sentiment.

The tourism industry and related companies could reach the level of 2019 no earlier than 2024. After the sharp decline in 2020, the transportation sector is expected to return to 2016/2017 level no earlier than in 2022. The construction sector could recover rapidly in 2022 due to increased investment in the absorption of EU funds and the EU Recovery and Resilience Facility, which could lead to overheating of the sector.

The MoFs inflation forecasts for 2021 is higher than BoL, and lower than EC and IMF. According to MoF, inflation will rise in 2022 reaching 2%, which is the upper line of the EU target value. According to the European Central Bank's baseline assessment, the pandemic impact on the economy will reflect in weak inflation dynamic in the EU as a whole.⁷

MoF's forecasts for real GDP growth in 2021 are more cautious than forecasted by the European Commission (*hereinafter - EC*) and the International Monetary Fund (*hereinafter - IMF*), however, it is 0.2% higher than forecast by the Bank of Latvia (*hereinafter - BoL*). The latest IMF forecast for Latvia was published in October 2020 and is optimistic, but since then the situation has deteriorated and risks have increased. See Table 2.

Both MoF and BoL forecast faster economic growth for 2022, but at the same time, the European Commission and the International Monetary Fund forecast slower growth in 2022 compared to 2021. The EC forecasts that the economic recovery will be limited in the first half of 2021, as the Covid-19 containment measures are expected to be lifted only gradually. The EC emphasizes

³ Finanšu ministrija 2021. gadam prognozē ekonomikas izaugsmi 3,0% apmērā | Finanšu ministrija (fm.gov.lv)

⁴ Monetārā politika - Prognozes (bank.lv)

⁵ ecfm forecast winter 2021 lv en.pdf (europa.eu)

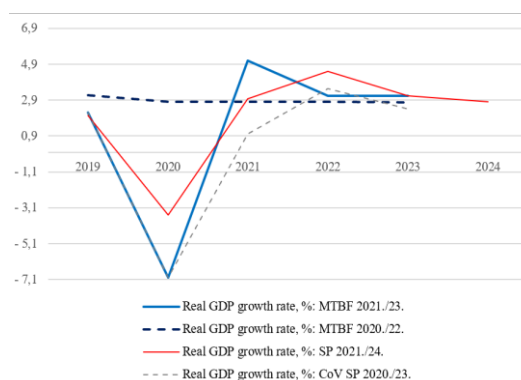
⁶ International Monetary Fund, World Economic Outlook Database, October 2020

⁷ PRESS CONFERENCE (europa.eu)

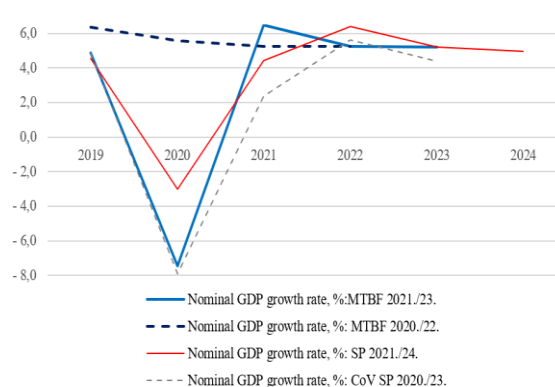
The MoF's forecasts of output gap were changed in 2020 two times, due to the sharp decline of the economy and also according to annual revisions of national accounts at the Central Statistics Bureau. Both the audits of the historical time series of the CSB and the structural changes in the economy as a whole affected the forecasts for potential GDP growth in the coming years, forcing to forecast it a slower pace. The potential of GDP will be affected not only by the uneven recovery of sectors, but also by negative demographic changes and the possible emigration of the population after the Covid-19 crisis. The Ministry of Finance has adapted its forecasting models to changes in the structure of the economy but emphasizes that the current methodology is insufficient to reflect the current structural changes in the economy, and forecasting work is still carried out under conditions of high uncertainty.

Based on the economic developments to date and the MoF assumptions underlying the forecasts the Council has made its decision regarding the endorsement of the forecasts as described below.

The Council endorses the real GDP growth forecast for SP 2021/24. Compared with the previous forecast in June 2020, which was prepared for the development of the MTBF 2021/23, the real GDP growth rate has been reduced by 2.1% in 2021 and raised by 1.3% in 2022, and by 0.03% in 2023. The real GDP growth for 2024 projected by 2.8%. (see Chart 1).



*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 nominal GDP growth forecast for the SP 2021/24. Comparing to MTBF 2021/23, the MoF has reduced the nominal GDP growth forecast for 2021 by 2.1% and raised for 2022 by 1.1%, forecasts for 2023 remained without changes at 5.2% level. Nominal GDP growth forecast for 2024 estimated by 5% (see Chart 2).

The Council endorses the change in the consumer price index (hereafter – CPI) (inflation) forecast for the SP 2021/24. For 2021 CPI forecast has been raised by 0.2%; however, CPI for 2022, 2023 remains the same at 2% level. CPI for 2024 projected at 2% level. (see Chart 3).

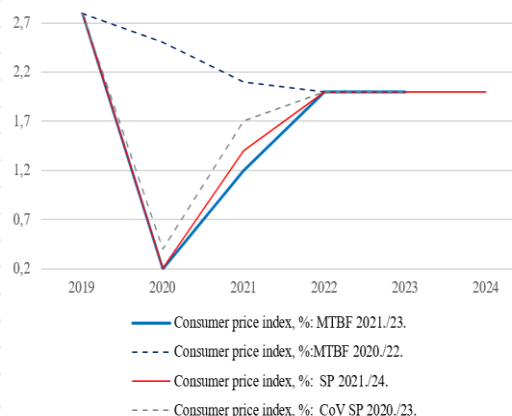


Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

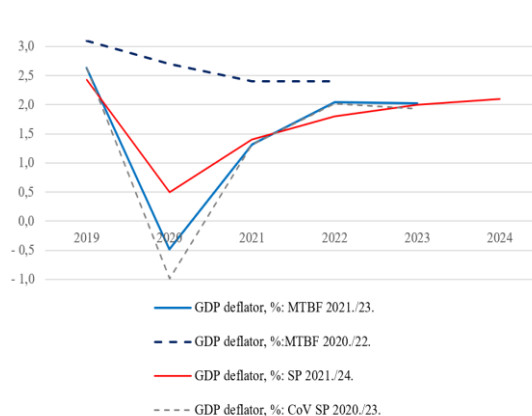


Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator forecast for the SP 2021/24. The GDP deflator forecast has changed compared to the MTBF 2021/23 forecast for 2021, where it has been revised upwards by 0.1% for 2021 and reduces by 0.2% for 2022. Deflator for 2023 remains the same at 2.1% level. Deflator for 2024 projected by 2.1% (see Chart 4).

The Council endorses the potential GDP growth forecast for the SP 2021/24 with comments. The potential GDP growth forecast has changed compared to the MTBF 2021/23 forecast, has been down-warded for all forecasting period as following: 2021 -0.6%; 2022 -0.5%; 2023 -0.3%. Potential GDP growth for 2024 projected at 2.8%. (see Chart 5). The Council sees high risks due to unfavourable demographic developments in the coming years, as well as the high risk of emigration following the Covid-19 crisis. The Council also warns of the possibility of bankruptcies of a large number of companies as early as 2021, which will exacerbate the current structural changes in the economy. Considering these factors, objective and urgent action is needed to increase economic potential and productivity through the effective use of economic recovery and resilience funds.

The Council endorses the output gap forecast for the SP 2021/24. Comparing with the forecasts developed for MTBF 2021/2023, output gap been up-warded for all forecasting period as following: 2021 2.7%; 2022 4.2%; 2023 4.4%. Output gap for 2024 projected at 0.0%. (see Chart 6).

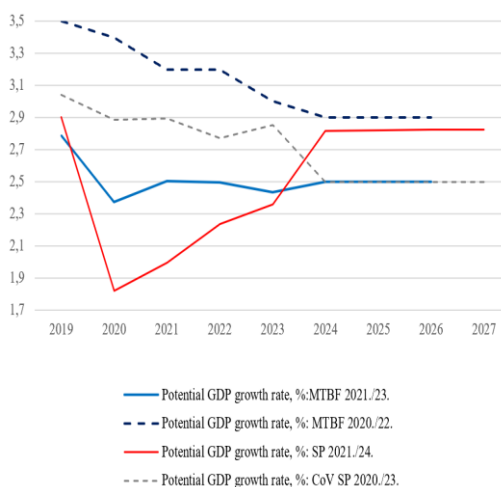


Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

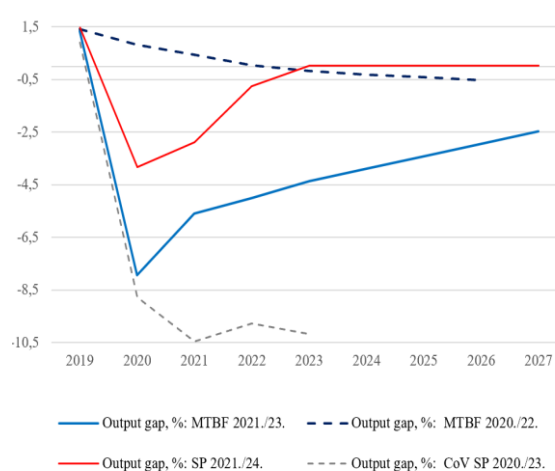


Chart 6 Output gap, % of potential GDP.
Data source: MoF.

Conclusions

In general, the Council endorses the MoF's macroeconomic forecasts for SP 2021/24. and assess them as acceptable under conditions of high uncertainty and downside risks.

The Council calls for an objective assessment of the risks involved and notes as the most important the following risks:

- (1) Delays in vaccination rates and low levels of public confidence, which may significantly delay the return of the economy to the pre-crisis level.
- (2) Inefficient use of economic recovery funds (EU funds and the Economic Recovery and Resilience Facility) inconsistent with the funds objectives of increasing economic potential and productivity.
- (3) Delays with launching RFF which will lead to uneven economic recovery and overheating in 2023/24 in certain sectors of the economy, in particular in construction.

Recommendations

The Council understands the high level of uncertainty in both the Latvian and global economies, therefore calls on the Ministry of Finance to take a flexible approach to forecast by observing current developments in the economy, and revising forecasts if necessary.

The Council welcomes the work of the MoF on adapting forecasting models to structural economic changes and calls for the ongoing work to be continued. Considering the increasing negative demographic changes and their fiscal implications, strategic action is needed to address the issue of labour shortage.

	2021	2022	2023	2024
Real GDP growth	3,0	4,5	3,2	2,8
Nominal GDP growth	4,4	6,4	5,2	5,0
Inflation (consumer prices)	1,4	2,0	2,0	2,0
GDP deflator	1,4	1,8	2,0	2,1
Potential GDP growth	2,0	2,2	2,4	2,8
Output gap	-2,9	-0,7	0,0	0,0

Table 3. Macroeconomic forecast indicators endorsed by the Council.