

Summary

1. The Fiscal Discipline Council assesses the Stability Program for 2022/2025 at a time of extremely high uncertainty, when economic development and fiscal policy depend on the results of the war in Ukraine and the dynamics of the adoption of related sanctions. The possibility of a new Covid-19 outbreak in autumn also retains the potential to affect public finances. The fiscal indicators of the stability program are based on the Sanctions scenario macroeconomic forecasts (March) prepared by the MoF and approved by the Council on 7 March¹. However, the projections are highly indicative and may deviate significantly from projected values due to potential economic downturn and significantly higher inflation.
2. According to the Sanctions scenario, the Latvian economy will not experience a recession, however, economic growth this year and in the following years is forecasted to be slower - 2.1% in 2022, 2.5% in 2023, and 3.4% in 2025. Although the Ministry of Finance forecasts 8.5% inflation this year, it is expected to decline sharply to 3.5% in 2023.
3. Compared to the forecasts of the Ministry of Finance, Bank of Latvia's forecasts updated on 30 March² are even more pessimistic - GDP growth is forecasted to remain at 1.8% level this year and 3.2% next year. Inflation forecast, on the other hand, is 9.5% this year, however, as in the forecasts of the Ministry of Finance, is expected to fall sharply to 3.7% next year.
4. In the context of the Sanctions scenario, the factors determining Latvia's macroeconomic development depend on recently rising energy prices, changes in the structure of exports and imports and changes in trading partners. Moreover, certain sectors will be affected by material supply chain disruptions (fertilizers, metals, wood). The cumulative effect of the Sanctions scenario will negatively affect Latvian companies whose business is related to exports and imports from Russia, Belarus and Ukraine, which may cause a wave of corporate bankruptcies.
5. **In line with the current EU fiscal policy guidelines³, it is necessary to start the transition to a generally neutral fiscal position starting from 2023. The guidelines follow the principle that the fiscal consolidation should not be unjustifiably delayed but should also avoid a situation where excessive consolidation could have a negative impact on growth and thus on debt sustainability. However, considering the recent political developments and their economic consequences and risks, it is likely that the EU will adopt a new fiscal framework for the coming years, which in the autumn would require a revision of the fiscal strategy developed by the MoF. However, in Council's opinion, the following reasons suggest that the Ministry of Finance has developed a fiscal strategy in line with Regulation 2022/25:**

(1) The proposed fiscal strategy in MoF's SP 2022/25 envisages a gradual fiscal consolidation of the deficit on the basis of national legislation (Articles 11 and 12 of

¹ <https://www.fdp.gov.lv/lv/jaunums/fiskalas-disciplinas-padome-ir-apstiprinajusi-korigetas-makroekonomikas-prognozes-stabilitates-programmas-izstradei-2022-2025-gadam>

² [Monetārā politika - Prognozes \(bank.lv\)](https://bank.lv/monetarā-politika-prognozes)

³ COMMUNICATION FROM THE COMMISSION TO THE COUNCIL (02.03.2022) Fiscal policy guidance for 2023 [com_2022_85_1_en_act_en.pdf \(europa.eu\)](https://eur-lex.europa.eu/com-2022-85_1_en_act_en.pdf)

- the FDL) and, from 2023, on compliance with EU regulation (EU Council Regulation Nr. 1175/2011 which amends Council's Regulation Nr. 1466/97, Article 5).
- (2) Based on the above-mentioned fiscal rules, the structural deficit will be corrected by 1% in 2023, including 0,5% direct fiscal adjustment and 0,5% correction of accumulated structural balance deviations. In the coming years (2024 and 2025), the direct consolidation of the structural deficit by 0.5% of GDP per year will continue. Thus, the Sanctions scenario, which is currently the most appropriate for the current economic situation, envisages a structural balance of -2.5% of GDP in 2023, -2% of GDP in 2024 and -1.5% of GDP in 2025.
 - (3) A gradual return to sustainable deficit is taking place from 2023 to 2025 in a balanced manner, with no aim to reach the structural deficit target of -0.5% of GDP in 2025 of the FDL, but to make a targeted consolidation in accordance with the economic situation, reaching a deficit target of -1.5% of GDP in 2025.
6. In general, the Council positively evaluates the country's fiscal policy for 2021, which was implemented in very difficult circumstances. The GDP grew by 4.8% in 2021, by one percentage point more than it was forecasted in June last year. Significant GDP growth in nominal terms (11.8%) improved the fiscal performance as well. The GG deficit reached 7.2% of GDP in 2021, despite the forecasted deficit of 9.3% of GDP in June. According to preliminary estimates, government debt reached 44.8% of GDP at the end of the year, however, the MTBF forecast for 2022/24 was 49% of GDP.
 7. The impact of state aid measures to deal with the negative effects of the Covid-19 crisis on the GGBB in 2021 is estimated to be 2.1 billion euros, or 6.5% of GDP, which is more than a year ago (0.96 billion or 3.3% of GDP). The Council had already expressed its concerns in previous reports that some support measures in 2021 had not been sufficiently targeted and were more politically motivated rather than economically motivated. However, 2021 is a year of relatively good economic growth, lower deficits and public debt, which indicates that the fiscal policy was successful in general.
 8. Also in this year, the significant support is already planned for businesses and citizens in the context of the Covid-19 crisis (0.66 billion euros) and rising energy prices (0.36 billion euros). The total support is already planned at more than 1 billion euros (2.8% of GDP). There is a high probability that these programs will have to be extended, as well as new ones created due to the arrival of Ukrainian refugees in Latvia. For example, the budgetary impact of the support mechanisms related to electricity prices has only been calculated for the first half of the year. It is very likely that the rise in energy prices will be permanent, and compensation will be needed both this autumn and next year which at present is not included in the fiscal calculations. **The Council calls on the government to create only well-targeted support instruments avoid general warm-up measures that could further increase inflation.**
 9. The 2022/25 SP envisages several one-off measures that do not affect the structural budget: (i) COVID-19 pandemic mitigation measures - period 2022-2024; (ii) measures to reduce energy price increases - period 2022; (iii) Defense investments - operating period 2023-2025. In previous years, Covid-19 support measures were treated as one-off measures and applied as such. Measures to reduce the rise in energy prices are related to soften the social and economic consequences of a period when the energy market is volatile, but the socially and materially vulnerable population groups may experience temporary difficulties in meeting their basic household needs.

However, the inclusion of these measures in the one-off measures, which do not affect the structural balance, is still debatable, as all indications are that the increase in energy prices is steady, so that support may be needed in the coming years as well. Defense investment is not entirely justified by the definition as a one-off measure, but the Council recognizes that investment in the country's military security is crucial in this historic period, since it ensures the country's territorial security, as well as physical and material security of its population. **The Council will give its opinion on the inclusion of the above measures in the "one-off" category, which do not affect the structural balance, in the autumn, when there is a possibility for greater political, economic and fiscal clarity, as well as adoption of new EU-level guidelines.**

10. Latvia still has one of the lowest debt levels in the EU. Stable fiscal policy during the crisis allowed the Treasury to borrow on favorable terms in the international financial markets. The credit rating agency R&I left Latvia's rating at a high "A" level in December, while Fitch left it with an "A-" rating in February, despite the challenging fiscal conditions. This is a positive assessment of the country's fiscal policy. However, it should be considered that although the interest rates remain low, especially in relation to inflation, the era of low interest rates is coming to an end and public debt service will no longer be free.
11. The Council highly appreciates the successful trend of the tax revenue collection. In 2021, compared to the previous year, the revenue of the consolidated general budget increased by 10.9%, reaching 12.5 billion euros. The main source of revenue for the general budget - tax revenue in 2021 - increased by 11.4%, and the tax collection plan was outperformed by 7.4%. The trend in tax collection in the first two months of 2022 is also positive, of course, also due to relatively high inflation.
12. This year, the economy of Latvia and other EU countries will receive a large amount of financial resources from the EU multi-annual budget including the Recovery and Resilience Facility (RRF). The timely and effective implementation of the RRF is one of the conditions for Latvia's economic recovery and will allow it to make significant investments in increasing economic productivity in the coming years. It is also necessary to continue the fight against the shadow economy.
13. Although the risks associated with war in Ukraine remain prevalent during this period, the government needs to continue monitoring and managing fiscal risks, in particular risks related to state aid, the financial sector and the governance of the state joint stock companies. This year's Saeima elections may create a desire to increase spending on support measures that have little connection to the declared policy goals or are poorly targeted.
14. Considering the current set of risks to the economy, the Council agrees to the MoF's approach that rapid compliance with the Fiscal Discipline Law and the structural balance requirement would require significant fiscal consolidation measures that would limit the response to the two most important risks to economic stability: (1) the rising prices of energy resources and their socio-economic consequences, (2) the threat to national security in circumstances of Russia's military aggression in the region and (3) a new wave of Covid-19. Based on the winter macroeconomic forecast, the Commission considers that the transition from a stimulating fiscal policy in 2020-2022 to a neutral common fiscal policy, can be implemented from 2023, while maintaining the readiness to respond to the changing economic situation.

- 15. The Council emphasizes that today's situation is different from 2020, when the Covid-19 crisis began. The budget deficit is already relatively large, and inflation is high. The trade balance has deteriorated, and the economy is likely to enter a recessionary phase. In addition, the fiscal stimulus will increase inflationary pressures, which is why support mechanisms should be very well targeted. Moreover, investment in energy projects to reduce dependency on energy is desirable as well. Support mechanisms that subsidize consumption do not address the energy deficit issue: the government should avoid costly and too general support measures.**