Fiskālās disciplīnas padome

Monitoring report N. 21

Period 14.04.2023-12.07.2023

Summary

1. At the beginning of June, the Ministry of Finance has updated the macroeconomic forecasts that were approved by the Council 13th of June[1]. Considering that inspite of the pessimistic forecast at the beginning on the year, the GDP grew by 0.4% in the first quarter, the MoF and other Latvian and international institutions revised the GDP forecasts for 2023 in a cautiously optimistic direction. For this year, MoF has forecasted GDP growth at 1%[2], but the forecasts of other Latvian and international institutions (IMF[3], BoL[4], EC[5], LV PEAK[6]) for this year are in the range from 0.4% to 1.4%. MoF has increased the real GDP forecast for 2024 as well, predicting a 2.5% increase. The forecasts of other institutions are in the range from 2.8% to 3.1%. In general, the Ministry of Finance forecasts GDP growth of no higher than 2.9% in the medium term, which is relatively low and does not reflect the government's ambitious economic transformation goals.
2. MoF's updated inflation forecast remained unchanged for this year and for the next two years as well. The MoF forecasts 10% inflation for this year, which is higher than the one predicted by the European Commission[5] (9.3%) in May and by the Bank of Latvia[4] (8.5%) in June. However, as of next year, the MoF and most forecasters[3,4,5,6] have estimated inflation in the range of 1.7% - 4%.
3. Eurostat's flash assessment data show that the inflation in Latvia is confidently decreasing but is still higher than in the Euro zone. Annual inflation in the Eurozone is expected to be 5.5% in June, decreasing from 6.1% in May[7]. Annual inflation in Latvia in June, according to Eurostat's flash assessment, was expected at the level of 8.1%, decreasing by 4.2 percentage points compared to May, which is the fastest decrease in the Baltic States. The latest CSB data show that in June the inflation rate in Latvia decreased even faster - to 7.2%. Observing the structure of inflation, it can be seen that, in general, the largest price increase has been overcome in the entire consumption basket and there is a definite inflation decline. Although the increase of housing maintenance and food prices is slowing down, it is still one of the highest components in the inflation structure. Despite slower inflation, prices continue to rise on average and the cost of living remains a significant challenge for a large part of society.
4. Registered unemployment published by the State employment agency (SEA) was 5.5% at the end of June and it has not changed since May. The limited availability of labor is felt in many sectors. The MoF, BoL and LV PEAK has emphasized the labor force shortages as one of the most significant risks for raising productivity and economic breakthrough, underlining both negative demographic trends and structural problems in the labor market. In the conditions of labor shortages, MoF[2], BoL[4] and LV PEAK[6] forecasts a relatively rapid increase in the average gross wage: this year from 8% to 12%, and next year from 7.5-8.2%.
5. Currently available statistical data show that the average monthly gross salary in the first quarter, compared to the corresponding period of the previous year, increased by

[1] Makroekonomiskās prognozes 2023 un VTBI 2024-2026 | Fiskālās disciplīnas padome (fdp.gov.lv)
[2] FM aktualizētās makroekonomikas prognozes: Tautsaimniecības un budžeta izpildes analīze | Finanšu ministrija (fm.gov.lv)
[3] Starptautiskais valūtas fonds (WEO, apr. 2023) World Economic Outlook, April 2023: A Rocky Recovery (imf.org)
[4] Makroekonomiskās prognozes | 2023. gada jūnijs | Latvijas Banka
[5] Eiropas komisija European Economic Forecast, Spring 2023 (europa.eu)
[6] LV_PEAK_BAROMETRS_LV_08062023.pdf (lu.lv)
7 Inflation in the euro area - Statistics Explained (europa.eu)

12.4%. The number of paid working hours, compared to the first quarter of the previous year, increased by 9.8%, thus, the increase in gross wages by 2.6 percentage points is ahead of the increase in paid working hours. As such a situation develops, the negative impact on competitiveness may intensify. Currently, the increase in wages partially compensates for the decline in working income, which occurred against the background of previously high inflation, however, it increases the risk for the development of a spiral of wages and inflation.

6. As the volumes of industrial production decreased by 8.8%, especially in the wood industry (13.7%), a decrease in the export of goods was also observed. In the first five months, the volume of goods exports decreased by 3.3% compared to the first five months of 2022, while the volume of imports decreased by 4.3%.
7. Positive trends in tax collection continue on the background of relatively high inflation. The revenues of the consolidated budget in the first 5 months of this year were 6.38 billion euros, which is 11.4% more than a year ago. VAT has been collected by 25% more than a year ago in the relevant period. The tax revenue plan of the budget for 2023 looks conservative - revenues in the total budget are planned at 12.3 billion, only 747.3 million or 6.3% more than what was collected in 2022. FDC tax revenues forecasts exceeds MoF's forecasts that are used for this year budget by approximately 2.6%.
8. The government continues work on the development of the tax reform. The goals of the reform are declared to be both the reduction of the labor tax burden and the increase of the collected taxes in face of the ever-increasing budget funding requirements. Tax policy makers have a difficult task to balance these two goals, providing clear rules of the game for entrepreneurs, simplifying the tax system and at the same time reducing the risk to the fiscal sustainability of the state budget. The Council draws attention to the fact that starting next year, Estonia will introduce changes in the tax system, increasing the tax burden. VAT will increase from 20% to 22%, and several reduced VAT rates will also be abolished. Excise rates for alcohol and cigarettes will be increased, while introducing a single non-taxable minimum rate of 700 euros.
9. The government support measures for Covid-19 and energy resource price increases have almost completely ended in Latvia. However, ideas about new forms of state support are already on discussion. The Council reminds that both the IMF and the EC[8,9], in their recommendations emphasize that Latvia should promote fiscal sustainability. For example, support instruments for the increase in energy prices are renewable only if there are high energy prices again they must be targeted and not universal. Support instruments should also promote investments in energy efficiency. The Council fully agrees with these recommendations.
10. Interest rates continues to rise in the world. The ECB increased the main interest rates once again on June 15, but the FED decided to keep its interest rates at the previous level during its last meeting on June 15. The ECB has indicated that it plans to raise interest rates in the future, and the probability of an increase in US interest rates is also relatively high. Despite Latvia's relatively favorable conditions (good credit rating and relatively low debt), debt servicing costs in Latvia are also increasing this year: 153 million euros were spent on it in five months, which is 25% more than in the corresponding period of previous year. However, in general, the situation with debt servicing remains positive - Latvia can borrow in the international markets in the long term with a yield of securities below 4%.

8 https://www.imf.org/en/News/Articles/2023/06/13/mcs061323-republic-of-latvia-staff-concluding-statement-2023-article-iv-mission
9 IMMC.COM%282023%29614%20final.LAV.xhtml.1_LV_ACT_part1_v2.docx (europa.eu)

11. Currently, there is a transitional period of fiscal regulation, when national legislation is already in force, but the EU regulation is still partially functioning and being transformed. The legal framework for fiscal regulations for 2024 provides that the general exception clause of the Stability and Growth Pact (SGP), which has been in force for four years in a row (since 2020), will be abolished. It is expected that the SGP from 2024 will also be supplemented by the renewed European fiscal and economic governance legal framework. Its norms regarding the permissible budget deficit level (-3% of GDP) and general government debt level (60% of GDP) are not expected to be revised.
12. The Latvian government has submitted the Stability Program 2023-2026 to EC in April this year and received a set of recommendations[10] from the EC Council at the end of May. The FDC wants to draw attention to the recommendations that directly affect the planning of the fiscal framework for 2024. In case there is a need for support measures due to high energy resource prices in autumn, only vulnerable households and some energy-intensive companies could apply for support. At the same time, incentives for energy saving should be strengthened. The state of Latvia's budget in 2022 already attracted attention of the EC, as the general government budget deficit at the end of 2022 was 4.7% and exceeded the reference value of 3%. The Commission has not currently proposed to start excessive deficit procedures in the spring of 2023. However, the Commission announced that it will propose to the EC Council in the spring of 2024 to start deficit-based excessive deficit procedures based on data of 2023 year performance. Latvia should take this into account on implementing the budget 2023, as well as in preparing process of budget plan for 2024. Latvia has been recommended to limit the nominal growth of net primary expenses to 3% in 2024.
13. Latvia still has a reasonable and one of the lowest debt levels in the EU. At the end of 2022, Latvia's debt was 40.8 % of GDP, or 8,500 euros per inhabitant. Considering that most of the intensive state support instruments are no longer used, the use of "Contingency funds" has also decreased significantly this year. In the first two quarters of this year only 5.1 million euros or 6.5% of this year's planned funding were used.
14. To solve the financing problem of the health care sector, the Prime Minister issued a resolution to find funding for the sector - by redistributing the budget appropriations of other ministries and departments, setting the goal to find additional funding in the amount of 140 million, which would provide 12% of the state budget. Funding was largely found, however, the method of increasing the appropriation for contingencies, which will increase the general government budget deficit, is debatable. The Council believes that the financing problems of the health sector cannot be solved "spontaneously" but must be solved in a systematic way. Also, the idea of revising the distribution of mandatory state social contributions, transferring more money to the health sector, has also been publicly voiced. The Council opposes such an idea, because the problem of lack of funding in the health sector should not be solved at the expense of the fiscal sustainability of the pension system, especially considering the aging of society and demographic trends.

[10] IMMC.COM%282023%29614%20final.LAV.xhtml.1_LV_ACT_part1_v2.docx (europa.eu)