Fiskālās disciplīnas padome

Fiscal Discipline Council Opinion on the Finance Ministry's macroeconomic forecasts

2023 and medium-term budgetary framework 2024-2026.

Preamble

This document gives an opinion of the Fiscal Discipline Council (hereinafter - Council) on the macroeconomic forecasts developed by the Ministry of Finance (hereinafter - MoF) for the period 2023-2026. The forecasts will be used as the basis for the development of the medium-term budgetary framework (hereinafter - MTBF) for 2024-2026 (2024./26.), which is planned for submitting to the Cabinet in October 2023. To support the Government's work on the the medium-term budgetary framework and the development of the Stability Programme – an agreement was reached on early approval by the Council for the MoF macroeconomic forecasts.

Under the Cooperation Agreement signed on 8 February 2016, the Council is responsible for the approval of the MoF macroeconomic forecasts. During the forecast approval procedure, detailed MoF forecast data were submitted to the Council, including scenarios for the development of the gross domestic product ("GDP") and individual GDP components.

At the meeting of the Council on 13 of June 2023, the MoF informed about the assumptions and changes in the updated macroeconomic forecasts since 10th of February 2023. The Council asked questions to MoF on forecasting assumptions and the justification for individual indicators and received replies from the MoF.

Formulation of the opinion on macroeconomic indicators is the duty of the Council, in accordance with the scope of the indicators specified in Section 20 of the Fiscal Discipline Law (indicators are collected in Table 2 at the end of this document). The members of the Council, considering the materials and explanations provided by the MoF, adopted a decision on the approval of the forecasts based on an internal discussion.[1]

<u>Overview of the situation</u>

MoF forecasts, since the beginning of 2023, have improved and are currently cautiously optimistic. GDP growth rates are projected a little higher than in SP 2023/26, but more cautious than in earlier forecasting iterations at the second half of 2022. On the other hand, the inflation forecast has remained almost unchanged and shows a steeper drop of it rate during this year. Table 1 summarizes current macroeconomic indicators forecasts of MoF and

[1] Minutes of the meeting of the Council at 13th of June, 2023download (fdp.gov.lv)

other institutions, data sources: MoF[2], BoL (Bank of Latvia)[3], EC (European Commission)[4], IMF (International Monetary Fund)[5]. Currently, the latest alternative macroeconomic forecasts are available from the European Commission, which was published in May 2023. Comparing the MoF **real GDP forecast** with the EC forecast for 2023, the MoF forecast is more cautious than EC, by 0.4 percentage points in 2023 and by 0.3 percentage points in 2024. Overall, the GDP forecasts created by the MoF are more cautious than both the EC and BoL and the IMF forecasts.

The inflation forecasts of the MoF shows a slower decrease in its level than expected in the EC. For 2023, the MoF forecasts a 10% inflation rate, while the EC projection is by 0.7 percentage points lower. The inflation rate forecast by the MoF for 2024 is 0.5 percentage points higher than in the EC forecasts. Overall, both institutions expect that inflation will start to fall sharply in 2023 and will reach 2-3% by the end of this year, but core inflation will remain high.

MoF's forecasts do not contradict the current dynamics of economic indicators of the first quarter. Also latest data in May[6], which shows the economic sentiment, is consistent with the MoF's hypotheses of further development.

	2023	2024	2025	2026
Real GDP Growth				
MoF (Jun .2023)	1,0	2,5	2,9	2,9
BoL (March 2023)	0,5	3,7	3,3	
EC (May 2023)	1,4	2,8	–	–
IMF (Apr. 2023)	0,4	2,9	3,4	3,4
Nominal GDP growth				
MoF (Jun .2023)	11,0	5,5	6,2	5,8
BoL (March 2023)	–	–	–	–
EC (May 2023)	–	–	–	–
IMF (Apr. 2023)	10,3	6,6	6,1	6,0
Inflation (CPI)				
MoF (Jun .2023)	10,0	2,2	2,5	2,3
BoL (March 2023)	10,0	2,7	2,6	
EC (May 2023)	9,3	1,7	–	–
IMF (Apr. 2023)	9,7	3,5	2,8	2,5
Deflator				
MoF (Jun .2023)	9,9	2,9	3,2	2,8
BoL (March 2023)	–	–	–	–
EC (May 2023)	8,9	2,7	–	–
IMF (Apr. 2023)	–	–	–	–

Table 1 Forecasts for key macroeconomic indicators of different institutions,%.

According to data published by the CSB in May, real GDP was EUR 7.3 billion in Q1 2023. Compared to Q1 2022, GDP grew by 0.4% (seasonally adjusted data), but compared with the previous quarter, an increase was of 0.6%. The largest contribution to GDP growth was investment (+1.8%), while the other contributions were relatively modest: household consumption (+0.3%), government consumption (+0.9%), while the export contribution decreased by 0.3%. First-quarter GDP growth was largely driven by the activity rebound in the construction and tourism sectors. GDP in terms of production by type of activity shows that major investments in growth are related to the construction sector (+17%), accommodation and catering services (+27%), arts and entertainment services (+19.5%). Since the pandemic there has been a sustained contribution of information and communication services to GDP, the added value of these services increased by 12.2% in the first quarter.

[2]FM updated macroeconomic forecasts: Tautsaimniecības un budžeta izpildes analīze | Finanšu ministrija (fm.gov.lv)
[3]Bank of Latvia forecasts 31.03.2023, available: Forecasts | Bank of Latvia, see 12.06.2023
[4]EUROPEN Comission forecasts, 15.05.2023, available: European Economic Forecast, Spring 2023 (europa.eu), see 12.06.2023
[5]International Monetary Fund (Apr., 2023), World Economic Outlook, April 2023: A Rocky Recovery (imf.org), see 12.06.2023
[6] LV_PEAK_BAROMETRS_LV_08062023.pdf (lu.lv)

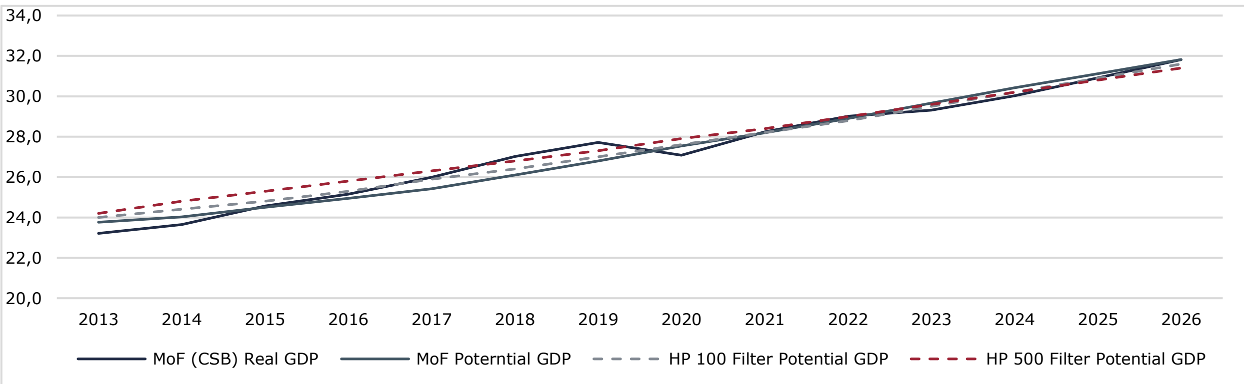
GDP growth was slowed down by the limited performance of manufacturing industries. In the first quarter, the production volume of the mining industry decreased by 26%, there was a 6% decrease in electricity and gas supply, which is related to energy saving measures and 5% reduction in manufacturing. The manufacturing industry was negatively affected by the decrease in production in the wood industry (-12%), in the production of construction materials (-20%) and metal products (-11%)[7].

The high inflation rate in the first quarter remained a major factor in macroeconomic imbalances, but the restrictive monetary policy has started to slow down inflation. Already in May, inflation has fallen to 12.1%. However, there is still a risk of inflation/wage spiralling: a rapid rise in average gross wages, a tight labour market and inflation decelerating more slowly than expected. In the first quarter, inflation remained at 20% and its decline was slower than in the EU, even despite the ECB's tight monetary policy. While the pace of price increases for food and housing began to ease, it was still high enough to negatively affect household consumption. In the first quarter of this year, the prolonged pressure on employees to raise their wages resulted at sharp increase in gross wages by 12.3%. Similar increases were seen earlier in 2021 during the worst period of the pandemic, while on average over the 10-year period gross wage growth remained below 7.4%. The labor market remains tight. The unemployment rate continued to fall in the first quarter - the actual unemployment rate was 6.4%, while registered 6.2%, despite a downturn in several sectors of the economy. The latest data on registered unemployment in May shows that it has decreased to 5.5%.

Assessment of the Latvian economic cycle

The Council's experts give their assessment of the state of play of the Latvian economy during its economic cycle. This evaluation uses the Hodrick-Prescott statistical filter method with a smoothing parameter of 100 and 500. The statistical filter method has been used to separate short-term and long-term fluctuations in GDP and to provide an understanding of the economic potential, thereby allowing the calculation of a comparable output gap value that can be used for MoF’s forecasts assessment. Figure 1 shows that, in the period from 2013 to 2026, the closest to the FM calculation is the potential GDP obtained by the HP (100) method.

Figure 1. Real GDP (actual and projected), MoF estimated potential GDP and Council estimated potential GDP with HP 100 and HP 500.

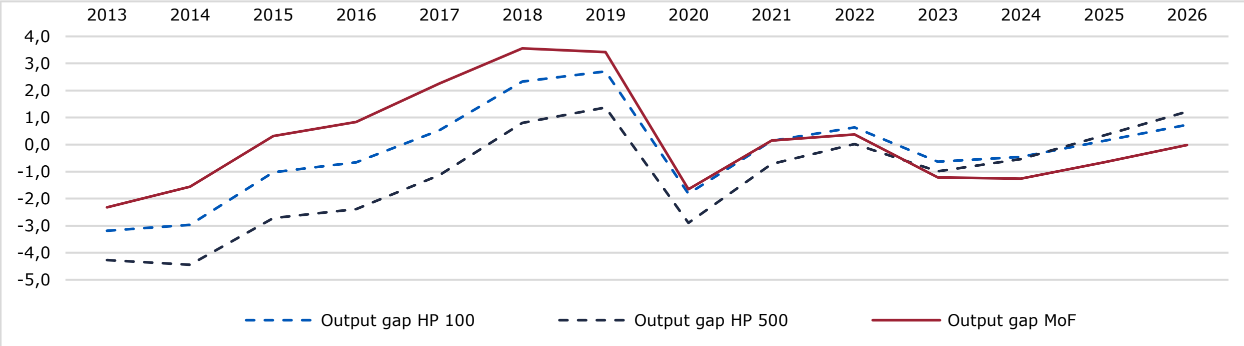


Source: MoF, CSB and FDC calculations

[7] Quarter I of 2023 / monitoring of macroeconomic indicators (in Latvian)download (fdp.gov.lv)

It should be noted that in previous Council assessments[8,9],[10] it was concluded that, in the period from 2013 to 2026, the results of various statistical filtering methods basically follow a similar trajectory as MoF data. It was also noted that the output gap estimated by the MoF and the Council using HP filters is very close, however, the output gap in the Council's assessment has been consistently higher, which is also observed in this iteration of forecasting, see Figure 2.

Figure 2. Comparison of output gap calculation results - MoF forecast and Council assessment with HP 100 and HP 500.



Source: MoF and FDC calculations

Comparing the output gap estimated by the Council using HP 100 and HP 500 with MoF calculations, it can be concluded that opinion of the Council in general is in line with MoF regarding to the years 2023 and 2024, when the output gap is estimated as negative.

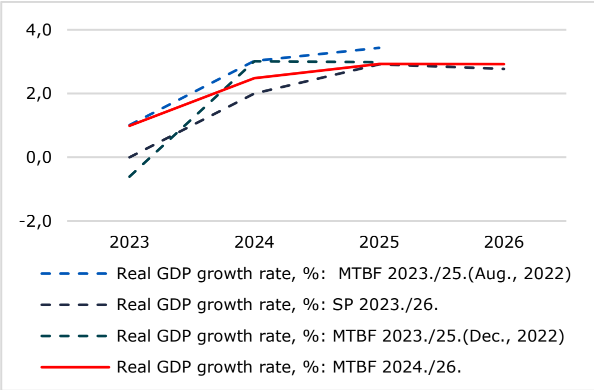
Comparison of current and previous MoF forecasts

Below, a comparison is given between the forecasts for SP 2023/26 and update for June 2023 and VTBI 2024./26. Based on past economic developments and the MoF assumptions underpinning the forecasts, the Council has adopted a decision on the endorsement of the forecasts described below.

The Council approves the real GDP growth forecast for 2023 and MTBF for 2024./26. Compared with the previous SP 2023/26 forecast, the real GDP forecast was adjusted upward by 1 %p. for 2023 and by 0.5 %p. for 2024. The forecast was unchanged for 2025, which projected GDP growth by 2.9%, while the forecast for 2026 was adjusted upwards by 0.1 %p (see page Figure 3).

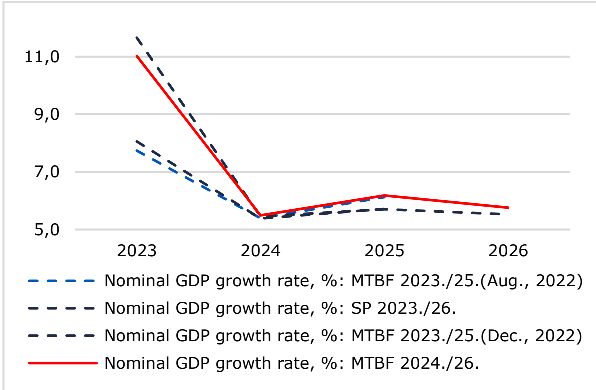
[8] 14.02.2022Approval of macroeconomic forecasts | Fiscal Discipline Board (fdp.gov.lv)
[9] 12.08.2022. Macroeconomic forecasts for 2022 and VTBI 2023/25 .| Fiscal Discipline Board (fdp.gov.lv)
[10] Adjusted Macro Forecasts 2022 and VTBI 2023-2025 (1.12) | Fiscal Disciplinary Board (fdp.gov.lv)

Figure 3. Real GDP growth forecast.



Source: MoF.

Figure 4. Nominal GDP growth forecast.

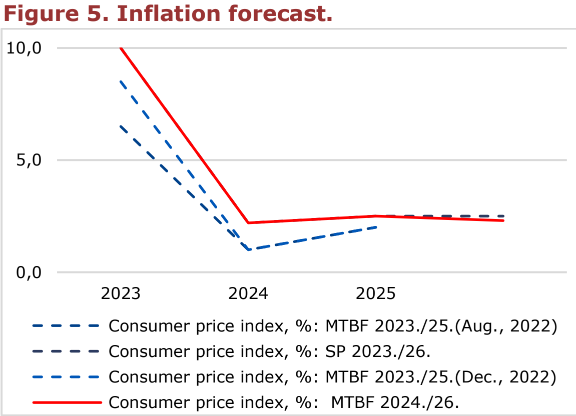


Source: MoF.

The Council approves the nominal GDP growth forecast for 2023 and MTBF for 2024./26. Compared to the previous SP 2023/26 forecast, the nominal GDP forecast for 2023 was reduced by 0,6 %p. The forecast has not changed for 2024 and is 5.5%. For 2025, the forecast was increased by 0,5 %p. and for 2026 by 0,2 %p. (see page Figure 4).

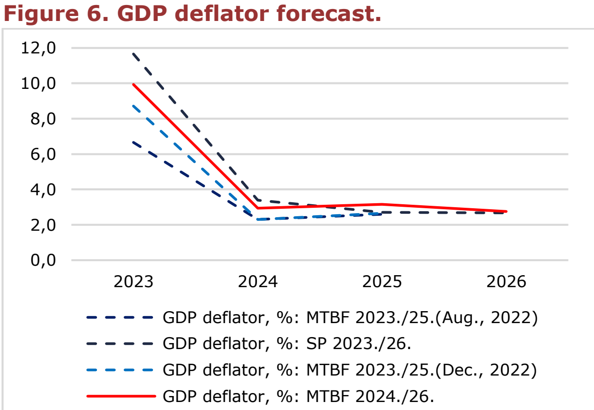
The Council approves the inflation forecast for 2023 and MTBF 2024./26. The inflation forecast for the period 2023-2025 has not changed compared to SP 2023/2026 and are 10%, 2.2% and 2,5% respectively. Forecast for 2026 decreased by 0,2 %p. (see page Figure 5).

Figure 5. Inflation forecast.



Source: MoF.

Figure 6. GDP deflator forecast.



Source: MoF.

The Council approves the forecast of the GDP deflator for 2023 and MTBF for 2024./26. Compared with the previous SP 2023/26 forecast, the GDP deflator forecast for 2023 is dropped down by 1.7 %p. Forecast for 2024 dropped by 0.4 %p. Deflator forecast for 2025 increased by 0.5 %p. and for 2026 by 0,1% (see page Figure 6).

The Council approves the forecast for potential GDP growth for 2023 and MTBF for 2024./26. The forecast for potential GDP growth, compared with previously SP 2023/26, has been adjusted upward by 0.6 %points for 2023 and 2024. The forecast for 2025 has been increased by 0,2 %p. and rised by 0,1 %p. for 2026 (see page Figure 7).

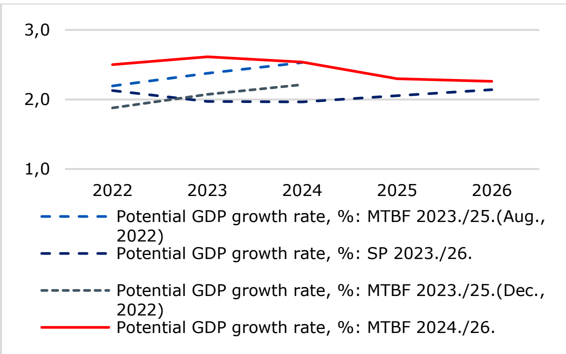
The Council approves the output gap forecast for 2023 and MTBF for 2024./26 with comments. The output gap, compared to the previous forecast SP 2023/26, has been adjusted upward by 0.2 %p. for 2023 and 2024. The output gap forecast for 2025 has been lowered by 0.1 %p. The forecast for 2026 has not been changed and is about 0%. (see figure 8).

Given, that the output gap rate has a significant impact on the future direction of fiscal policy, the Council approves the value of the output gap predicted by the MoF with comments and hold the right to supplement its opinion in cases if economic development significantly deviates from the projected scenario. The value of the output gap projected by the MoF for the years 2023 and 2024 does not significantly differ from the Council's view about the ratio of real GDP to potential GDP. The Council acknowledges that in the closing years of the medium term (2025, 2026) these values may be in a positive or negative range, depending on the applied assessment method, which is different for the MoF and the Council.

The Council draws attention to the fact that the European Commission has increased the assessment of the output gap in its latest forecasts and predicts it to be minimally negative (-0.3%)[11] for the 2024, with a tendency to approach a positive or zero value after 2026.

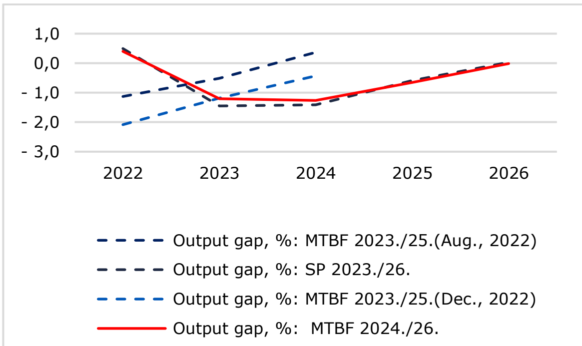
The Ministry of Finance has currently forecasted output gap higher than in February of this year, however, regarding the year 2024, the output gap is estimated to be lower than the EC and is (-1.3%). As the economy faces a set of different risks in the current geopolitical situation, it is currently challenging to determine, whether it will be in a positive or negative range for 2026, however the Council is inclined that it will be minimally positive. The Council draws attention to the correction mechanism contained in Article 11 of the Fiscal Discipline Law, which is closely related to the value of the output gap. The Council already stated in the Surveillance report SP 2023/26[12] that the accumulated deficits in 2021 as a % of GDP exceeds the amount determined by the FDL (-0.5%) and as the output gap becomes positive, this correction procedure should be implemented in budgetary planning for medium term.

Figure 7. Forecast for potential GDP growth,%.



Source: MoF.

Figure 8. Output gap,% of potential GDP forecast.



Source: MoF.

[11] European Economic Forecast, Spring 2023 (europa.eu) European Economic Forecast, Spring 2023 (europa.eu)
[12] Uzraudzības starpziņojums SP 2023./2026. gadam | Fiskālās disciplīnas padome (fdp.gov.lv)

Conclusions

The Council broadly endorses the MoF macroeconomic forecasts for 2023 and MTBF 2024./26. and consider them reasonable to the actual economic situation. However, the Council aware of the current set of hard-to-predict risks that can rapidly undermine economic performance.

The Council notice the following risks:

- the still very tight security situation in the region,
- increasing constraints on labour availability and the formation of an inflation/wage spiral,
- availability of financial resources for business development and innovation,
- the slowdown in global economic growth,
- possible increase in the cost of energy resources during the heating period,
- domestic political risks and the rise of populism and social tension,
- possible overheating of the construction sector due to limited labour resources,
- delays in the implementation of EU funds projects, and in particular the implementation of RFF plan,
- rapid rise of the interest rates as a result of monetary policy, which will slowing down the economy.

The identified risks largely in line with the risk assessment of the LV PEAK think tank, based on an expert survey[13].

The Council appreciates the work of the MoF in elaborating and justifying macroeconomic forecasts. However, the Council repeatedly calls to expand the set of macroeconomic indicators. The Council still maintains the opinion[14] that for a comprehensive evaluation of the impact of macroeconomic forecasts, the scope of the evaluated indicators should be expanded to include indicative indicators of the state debt and budget deficit.

Table 3.

Macroeconomic forecasting indicators approved by the Council,%. Data is also available in MS Excel form

Macroeconomic indicators	2023	2024	2025	2026
Real GDP growth	1,0	2,5	2,9	2,9
Nominal GDP growth	11,0	5,5	6,2	5,8
Inflation (Consumption prices)	10,0	2,2	2,5	2,3
GDP deflator	9,9	2,9	3,2	2,8
Potential GDP growth	2,6	2,5	2,3	2,3
Output gap	-1,2	-1,3	-0,7	0,0

Source: MoF

[13] LV_PEAK_BAROMETRS_ENG_13062023.pdf (lu.lv)
[14] 14.06.2021. Finanšu ministrijas makroekonomikas prognožu apstiprināšana vidējā termiņa budžeta ietvaram | Fiskālās disciplīnas padome (fdp.gov.lv)