Fiskālās disciplīnas padome

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SUMMARY

1. On 9th of December 2023, the Saeima adopted the Law on the State budget for 2024 and the budget Framework for 2024, 2025 and 2026. The law foresees general government budget deficit in 2024 about 1.3 billion EUR or by 2.8% of GDP. The Council broadly expresses a positive assessment the draft budget but notes the existence of several risks that can rapidly worsen fiscal outcomes. The Council also disagrees that the increase in budget expenditure for the defence sector is classified as one-off, as defence expenditure is unlikely to stabilise at current levels amid geopolitical tensions. The Council considers that, as a result of the interpretation of defence expenditure, the increase in budget expenditure appears to be lower. Valdis Dombrovskis, Executive Vice President of the EC, also expresses a similar view on budget expenditure growth, indicating that "the prepared budget plan is not fully in line with the EC recommendations on expenditure growth – it is faster than recommended"[1].
2. Currently, the risks affecting economic development and fiscal outcomes can be divided into three groups: *geopolitical, macroeconomic* and *fiscal*, all of which can both reduce the growth potential of the already fragile economy and worsen the budget balance and increase public debt.
3. **Geopolitical conditions determine the uncertainty of economic development.** As a result of the pandemic and the consequences of war, aggregate demand of key partner countries continues to decrease (or at least not growing), which in turn negatively affects Latvia's export opportunities. In the context of geopolitical risks, it is also important to increase expenditure on defence and internal security, which has already had a significant impact on the structure of public spending. As geopolitical environment deteriorates, these expenditures may increase in the long term, which will consequently reduce budgetary resources for social and other sectors.
4. Export and import data reflect the economic downturn both in Latvia and in partner countries. Currently available data show that the export value of goods has decreased by 11.4% in 11 months, and there is a similar decrease in physical terms – the volume of exported goods has decreased by 10.4%. Exports of services have increased by 5.5% in 11 months, but there is a downturn in the period September-November, with average exports of services falling by 2.9% in those months.
5. Remarkably that Latvia's export directions have not changed as significantly as might be expected in the current geopolitical context – the share of exports to Russia has increased by 0.5 percentage points in 11 months of 2023. By comparison, the share of exports to Estonia decreased by 0.4 percentage points and to Lithuania by 0.3 percentage points. Exports to EU countries fell by 12% in 11 months, while the share of Latvian exports to EU countries, which is around 69% in total, has decreased by 0.4 percentage points compared to 2022.
6. **Macroeconomic risks.** The ECB's policy of combating inflation and raising interest rates continues to hold the economic breakthrough potential in the risk area. While the downward trend in inflation is currently clearly marked, the dynamics of inflation

1https://www.lsm.lv/raksts/zinas/ekonomika/21.11.2023-dombrovskis-latvijas-budzeta-plana-izdevumu-pieaugums-ir-straujaks-par-ek-rekomendeto.a532466/

are strongly influenced by the short-term inflation expectations of consumers and producers[2]. Currently, some bank experts are forecasting interest rate cuts over the course[3,4] this year, while some are maintaining the opposite view, pointing out that it is still too early to rely on the first indicators of inflation reduction[5]. Latvia's competitiveness in the eyes of international evaluators has fallen significantly and it remains behind Lithuania and Estonia for a long time. Latvia is behind its neighbours in both the previous year and this year; moreover, if Latvia was 35th place in 2022, this year's drop is to 51st place[6]. Latvia's assessment in the EU innovation index improved slightly - 56.97, in the previous year it was 56.3; however Latvia is the third of the end in the EU (EU average index – 108.47)[7]. Under the sub-sections of the innovation index, Latvia, according to the number of new doctors of science, is in the last place and 8th place from the end - in the qualification of human resources. In view of the ageing population and structural problems in the labour market, this factor will also hinder the country's competitiveness in the long term.

7. Lagging behind in economic development from neighbouring countries. Currently, several structural factors cause Latvia's national economy to lag behind neighbouring countries, including more limited access to credit, lower added value of manufactured goods and services and limited availability of highly skilled labour force. However, in 2023 the Latvian economy is showing better GDP results than Lithuania and Estonia: compared to Lithuania and Estonia, Latvia's GDP decreased the least on average in three quarters of 2023 (-0.4%), Lithuania's GDP growth was (-0.5%), but Estonia (-3.7%).
8. For nearly the whole of 2023, the situation in the economy was generally worsened by the decline of large manufacturing sectors such as wood industry (drop in production volume – 7.9%), manufacture of fabricated metal products (– 6.7%) and manufacture of non-metallic mineral products or building materials (– 17.2%). In the manufacturing industry, from the five largest sub-sectors in terms of share, only two have performed an increase in the volume of production - it is the production of food products, which increased by 6.1% in November, and the production of computers, electronic and optical equipment, in which the production increased by 6% in November, but on average in 11 months by 24.5%. The sector has also been the most successful in 11 months. There is a risk that the development of manufacturing will also be slow in the medium term.
9. Despite the slowdown in exports and demand, the labour market remains strong. Unemployment in the EU and the euro area is also low and unemployment rates are at historic lows in 15 years. The actual unemployment rate in Latvia was 6.4% in November, but the data published by State unemployment agency on the registered unemployment rate shows that it was 5.7% in December. The main risk in Latvia is the lack of employees in several sectors. As the labor force deficit persists, pressure from employees to raise pay will increase.
10. Average gross wages and salaries of employees increased by 11.8% in the 3 rd quarter of 2023, but by 12% on average in the three quarters. Wage growth has outpaced inflation and shows that overall consumer purchasing power will improve, which will

[2] How managing Inflation expectations can Help economies ACHIEVE a softer Landing (imf.org)
[3] Rate lifting cycle is over, at least one rate cut possible next year | Press releases | Media space | Citadele Group (cblgroup.com)
[4] Luminary Bank is forecasting a fall in interest rates next year (tvnet.lv)
[5] Time to think about cutting interest rates? | articles | macroeconomics
[6] World Competitiveness ranking 2023 - IMD Business School for Management and leadership Courses
[7] EIS 2023 - RIS 2023 | Research and Innovation (europa.eu)

be seen in future quarters data. However, it would also widen the pay and productivity gap, eroding the country's competitiveness[8].

11. The efforts of the world's advanced economies fighting the inflation were fruitful. A relatively sharp decline in inflation has begun (annual inflation in the USA was 3.4% in December and inflation in the Euro area was 2.9% and 0.6% in Latvia[9]). Falling inflation has also reduced long-term bond yields, crucial for several countries with high debt and slow economic growth. Communication from both the ECB and representatives of the USA Fed has shifted rhetoric and no further interest rate hike is expected. Even more so, representatives of the USA Fed have hinted at a possible three rate cuts this year. ECB representatives have also promised rate cuts over the summer.
12. In Latvia, the increase in consumer prices, since the first quarter of 2023, has started to decelerate convincingly. Price developments, on average against the previous 12 months, show an 8.9% increase in prices, but this indicator is on a downward trend.
13. Forecasting, in the face of high uncertainty and macro-economic risks, has become the "new normal" and interferes with budgetary planning. Macro projections made in early 2023 proved overly optimistic and currently it obvious that 2023 ends not with a minimal growth, but with a recession seen for three consecutive quarters. Overall, Latvia faces a challenging year, in which there are still hopes of recovering slow growth. The latest GDP projections are between 2% (BoL) and 2.4% (EC). A more cautious forecast is by LV PEAK experts[10], who expect growth of 1.8%.
14. **Fiscal risks.** Overall recent years successful fiscal policy is in danger because of fiscal risks stemming from the activities of the state joint stock companies. Despite the Council's remarks, none of these risks have a fiscal risk buffer in the 2024 budget. AirBaltic have to repay or refinance bonds in the amount of 200 million euros in July of this year, which is difficult considering the company's improving but still fragile financial condition and geopolitical situation. The privatisation of the company promised by the EC will also be difficult. State Audit Office has repeatedly pointed[11],[12] weaknesses in the oversight of AirBaltic, which have the effect of reducing the ability of the State, as shareholder, to fulfil its strategic goals. The implementation of the RailBaltica project in Latvia is also facing difficulties – the planned costs of the project have increased greatly from the initial assessment, there is uncertainty with the source of financing and the main sponsor of the project, the European Commission, has expressed concerns regarding the implementation of the project.
15. The amount of taxes collected in 2023 has increased by 9%, or EUR 1 million, compared to 2022. In the Budget law of 2023, the tax revenue plan projected total budget revenues about 12.3 billion EUR, or 6 % more than was collected in 2022. This plan has been fully implemented, plus a 3% overrun. Economic stagnation has not had a comprehensive negative impact on general budget revenues, however it was reflected in a significantly slower rate of tax revenue growth. The slowdown in revenue growth was also influenced by the fall in inflation and also by the shrinking purchasing power of the population, which was reflected in the 3 times slower growth rate of VAT revenue compared to 2022.

[8]https://www.lvpeak.lu.lv/fileadmin/user_upload/lu_portal/lvpeak.lu.lv/lu_domnica_lv_peak/lvpeak_ekonomikas_barometrs/2023/lv_peak_barometrs_lv_2023_ii.pdf
[9]https://ec.europa.eu/eurostat/databrowser/view/PRC_HICP_MANR__custom_423086/bookmark/table?lang=en&bookmarkId=6f2a5933-7185-4e78-b8eb-3f93c1436a24
[10]LV_PEAK_BAROMETRS_LV_2023_II.pdf (lu.lv)
[11]Intermediate message form (lrvk.gov.lv)
[12]https://titania.saeima.lv/livs/saeimashappening.nsf/0/7ee6d5367db8a405c2258aa00047b98c?opendocument

16. At the end of the third quarter, Latvia's general government debt amounted to 41.1% of GDP, according *to Eurostat* data. Overall, 2023 debt is projected at 39.9% of GDP. Latvia's debt is the seventh lowest among EU countries. The general government debt projected by the Treasury is 41% for 2024, 41.1% for 2025 and 41% of GDP for 2026.
17. Despite Latvia's relatively favourable conditions (good credit rating and relatively low debt), debt servicing costs are also increasing in Latvia – in 2023 it was around 233 million EUR or (0.7% of GDP), it is expected that this year it will be already 381 million EUR or (0.9% of GDP)[13], in accordance to the Draft budget plan of Latvia for 2024. In 2026, expenses for debt servicing could exceed 500 million euros. The Treasury has estimated it would have to borrow around €3 billion (6.6% of GDP) in financial markets this year, both to refinance existing debt and to cover the deficit, so maintaining responsible fiscal policies is important to borrow on favourable terms in financial markets.

    Last December, the Economic and Financial Affairs Council agreed on the new fiscal framework. According to Bruegel, the[14] new regulation is significantly better overall than the previous one. The new framework has yet to be approved by the European Parliament. The current fiscal framework consists of the Fiscal discipline law, the provisions of which have been fully operational since 2023, and from the provisions of the Stability and Growth Pact, which again provides for a fiscal deficit ceiling from 2024 onwards. Currently, the basic principle of Latvia's fiscal policy strategy is to maintain the general government structural deficit at 0.5% of GDP level.

[13]https://www.fm.gov.lv/lv/media/15702/download?attachment
[14]https://www.bruegel.org/first-glance/assessing-ecofin-compromise-fiscal-rules-reform