FISCAL DISCIPLINE COUNCIL OF THE REPUBLIC OF LATVIA

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Fiscal discipline council
Potential and nominal GDP assessment working group.
Minutes No 1 (22)

Riga 1st of February 2024

The meeting is chaired by:
Inna Šteinbuka, chairwoman of the Fiscal Discipline Council, member of Potential and nominal GDP assessment working group.

Participants of the meeting:

Member of Fiscal Discipline Council (Head of working group)	J.Priede
Secretariat –	
Fiscal Discipline Council secretary	N.Malnačs
Fiscal Discipline Council macroeconomic expert	V.Zaremba
Fiscal Discipline Council lawyer-clerk	I.Jansone

Invited persons

Head of Monetary Policy Department, the Bank of Latvia	U.Rutkaste
Chief Economist of the Macroeconomic Analysis Division, Monetary Policy Department, the Bank of Latvia	D.Paula
Member of Fiscal Discipline Council	A.Jakobsons
Member of Fiscal Discipline Council	I.Golsts

Taking minutes:

Meeting secretary I.Jansone

The meeting starts at 10:00 AM and takes place in partly remote meeting mode via MS Teams.

Opening of the meeting - I. Šteinbuka opens the meeting and announces the meeting's agenda.

1. Base scenario for the development of the national economy of Latvia, including potential GDP growth and assumptions regarding output gap
Reporting: U.Rutkaste D.Paula

Mr Rutkaste before starting the presentation prepared by the Bank of Latvia, Mr. Rutkaste commented that the economic downturn, according to the latest CSB data, was slightly better than expected at the end of the year. Inflation is low and its fall is in line with the forecasted scenario. However, the result achieved in taming inflation remains very fragile. There are risks in the Middle Eastern region that can disrupt the energy-resources supply from Saudi Arabia, arising transportation costs and stimulate inflation. China's economic slowdown is currently a factor in limiting oil prices increasing, but things may change as its growth resumes. In general, monetary policy measures have ensured a fall in inflation,

however, the achieved result may be negatively affected by new geopolitical changes.
D.Paula reports on main developments in the Latvian economy in 2023 and presents forecasts for economic development in the coming years. She informs that BoL already started work on the forecast update, which will be shared in March of this year. D. Paula reports on developments in manufacturing and services sectors, causes of inflation and assumptions about the future development of inflation. Comments on factors that may have a positive impact on the economic potential in the coming years, including the investments from both EU funds and private companies. Explains the basic assumptions of current forecasts of the Bank of Latvia and possible changes in March 2024.
U. Rutkaste: regarding the impact of inflation in the Latvian economy - the biggest impact was not the increase in interest rates, but the euro exchange rate, to changes of which the Latvian economy reacts rapidly. In addition, Latvia's growth is slowed down by the slowdown of trade partners' economies and the subsequent lack of demand.

Discussion by those present on the subject of the agenda.

I. Šteinbuka asks for an additional explanation about private sector investments, which, considering the high-interest rates, have stopped, currently only EU funds are a relevant source of investment.
U. Rutkaste comments that in BoL opinion private sector investments are not that low. Such opinion on private investments was made by entrepreneurs when BoL visiting companies of various industries. Although the attractiveness of loans is currently low, some industries were able to earn and accumulate funds during COVID-19 and the energy crisis. Currently, in anticipation of a new cycle of economic growth, these funds are being used to increase production capacity.
J. Priede: continuing the question of investments, it can be seen that there are large companies in the national economy that can finance capital investments themselves and are co-financed from EU funds. But there is also a category of companies that do not have any of these options. A hypothesis has been raised in the banking environment that there are few suitable companies to which it would be useful to provide a loan. From the bank supply side, there is a question of whom to give a loan and what to consider a high-risk investment. How many companies are in Latvia that can apply for a bank loan?
U. Rutkaste: currently, the distribution in the market is such that one-third of companies would have no problem getting a loan, but two-thirds do not qualify for it for various reasons. In general, the number of companies in Latvia is very large, and a large part of them are those that are not creditworthy. In addition, a situation where the government tells commercial banks to provide a certain amount of funds to be given to entrepreneurs in the form of loans would not be possible in the free market. However, companies with high development potential are usually credited.
N. Malnačs: currently a support program for mortgage borrowers has been launched, however, commercial banks previously warned about possible legal proceedings against the state. How have the support measures for mortgage borrowers affected the Latvian financial sector and the economy as a whole? Have commercial banks started any actions in the context of legal proceedings?
U. Rutkaste: currently, some commercial banks have reviewed commission fees and changed rates for specific types of loans, however, it cannot be said for sure that this is a direct reaction to the decisions of the legislature. In general, the share of mortgage borrowers in the national economy is not so large that the macro-indicators will change significantly after the aid is paid out. For the time being, the significant impact of the decision has not yet been observed.
N. Malnačs: According to BoL December forecasts, this year GDP growth of 2% and inflation of 2% is expected, as well as a budget deficit of 4%. Considering a somewhat optimistic end of 2023, would BoL improve its GDP and inflation forecasts at this time? Why does BoL predict a higher budget deficit than MoF?
U. Rutkaste: overall, at the moment LB is still forecasting both 2% inflation and GDP growth, as the December forecasts were somewhat optimistic. A larger budget deficit could be caused by a faster demand for wages in the public sector, as well as LB has more

conservative tax revenue forecasts.
Decided:
1.1. Take note of the presentation by the Bank of Latvia on current developments in the Latvian economy.

I.Šteinbuka - votes for;
J.Priede - votes for.

2. Discussion on future options of cooperation

U. Rutkaste draws attention to current issues in fiscal policy.

- Currently, the new fiscal regulation is considering option that defence expenses will still be recognized as one-off measures that do not affect the size of the structural deficit. In that case, Latvia should be more decisive in increasing such expenses, it should follow Poland's example. However, at the same time, the use of funds allocated for national defense and compliance with the intended purpose must be strictly controlled.
- Shortly, a political discussion on reducing the tax burden on the workforce may be started, however, there are questions, what compensatory measures will be taken on the income side of the budget (VAT, Real estate tax)? There are concerns that the pension contributions could be diverted for today's expenditure. This is not permissible.
- Due to the adoption of the new EU fiscal regulation, the issue of harmonizing EU and national fiscal regulation will become relevant. Therefore, it is necessary to initiate an exchange of opinions between institutions related to this regulation promptly.

I. Šteinbuka, in relation with the above-mentioned issues, offers to expand consultative cooperation with the experts of the Bank of Latvia. The MoF has invited the Council to express an opinion on possible improvements in tax policy. Regarding the new fiscal regulation, it is currently agreed in the European Commission, but discussions are still expected in the European Council. It is now clear that the new regulation is more complex than the previous one and is also based on long-term macroeconomic forecasts, which is a risky approach given the lingering uncertainty. Regarding expenses for national defense, the Council has expressed the opinion that according to the EU methodology, such expenses cannot be recognized as one-off, but in general the geopolitical situation is sufficiently dangerous that the norms developed in "time of peace" should be improved.

Discussion of agenda points by those present.

Decided:
2.1. Continue cooperation and consultation in the identified areas of cooperation.

I.Šteinbuka - votes for;
J.Priede - votes for.

The meeting closed at 12:00.

1st of February 2024.

Chairwoman of the Fiscal Discipline Council I. Šteinbuka

Secretary of the meeting I.Jansone

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