FISCAL DISCIPLINE COUNCIL OF THE REPUBLIC OF LATVIA

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Council meeting minutes No 4 (72)

Riga 10th of June 2024.

Chairwoman:
Chairwoman of Fiscal Discipline Council – I.Šteinbuka

Participants of the meeting:

Vice-Chairman of the Fiscal Discipline Council	M.Āboliņš
Member of the Fiscal Discipline Council	A.Jakobsons
Member of the Fiscal Discipline Council	U.Kāsiks
Member of the Fiscal Discipline Council	J.Priede
Secretariat -	
Fiscal Discipline Council secretary	N.Malnačs
Fiscal Discipline Council macroeconomics expert	V.Zaremba
Fiscal Discipline Council lawyer	I.Jansone

Invited participants 1st item of the agenda:

Ministry of Finance Director of Economic analysis department	I.Vasaraudze
Ministry of Finance Deputy Director of Economic analysis department, Head of Macroeconomic analysis division	D.Stikuts
Ministry of Finance senior expert of Economic analysis department	A.Jurša
Ministry of Finance Deputy Head of Unit of Macroeconomic analysis division	I.Vēja

Taking minutes:
Fiscal Discipline Council lawyer I.Jansone
The meeting starts at 15:00

I.Šteinbuka opens the meeting.
Fiscal Discipline Council (Council) chairwoman I.Šteinbuka opens the meeting and announces the agenda.

The meeting takes place in partly remote mode via *MS Teams.*

1. Presentation of macroeconomic projections

Reporting: I.Vasaraudze, D.Stikuts,

The Ministry of Finance (MoF) presents the updated macroeconomic forecasts for 2024-2028, highlighting the changes made since February 2024 to the forecasts for the Stability Program 2024-2028.
The Ministry reports a slight improvement in business sentiment, including the external environment, which gives hope for an export recovery. However, the latest data indicate that confidence indicators in the Latvian manufacturing sector remain negative, with low demand being a significant limiting factor for businesses.

The recovery of exports is hindered by the sluggish economic growth of trading partners, which has been influenced by the ECB's interest rate policy. Furthermore, it is not anticipated that interest rate reductions will occur swiftly.
Despite the slight increase in the unemployment rate at the end of 2023, the labor market remains active overall. However, the number of vacancies has slightly decreased, reflecting the current slow economic dynamics.
Ministry representatives highlight the decline observed in the construction and transport sectors, as well as the risks associated with the insufficient pace of EU fund acquisition. The increase in wages suggests that the gap between productivity and labor costs will widen, which is an unfavorable factor for economic growth.
I.Šteinbuka asks about the feasibility of keeping the deficit below 3%, given the slow economic growth, the need to increase security expenditures, and the risks associated with financing AirBaltic and RailBaltic. The updated forecasts from the Bank of Latvia estimate a deficit of 3.8% for this year and 3.5% for the next year.
I.Vasaraudze acknowledges that the situation is complicated. The macroeconomics projections will be forwarded to the Fiscal Policy Department for processing, and the updated fiscal projections from the Ministry of Finance, along with the deficit projections, will be available during the budget hearings in Cabinet. Currently, the deficit is projected to remain below 3%, albeit with a very narrow margin. Regarding the Bank of Latvia's forecasts, it is important to note that, firstly, it is based on different accounting methodologies, and secondly, we have different calculations for the deflator and nominal GDP, which impact the ratio of any indicator to nominal GDP.
N. Malnačs notes that since the beginning of the year, the rapid increase in wages within the public sector is cause for concern regarding the future sustainability of such a level of wages. However, the primary question is how changes in the wage growth rate will impact other macroeconomic variables?
I. Vasaraudze explains that this wage increase is attributable to the first months of the year and such high increases are more likely one-off events rather than permanent trends.
I. Vēja adds that such high rates of wage growth were caused by the introduction of the new wage model for state administration employees, wage increases for teachers, and a one-off factor—reward measures for internal affairs employees, which are implemented every five years.
M. Āboliņš comments that it is necessary to examine the documents governing the entire scope of public sector remuneration. It presents an unfavorable situation for the budget if, while increasing the wages of high earners, the rest of the wages across the entire public sector are indexed simultaneously.

Discussion of projections, assumptions and risks of macroeconomic environment.

A discussion ensues among those present regarding the forecasts, assumptions, and risks identified by macroeconomic analysts. The following risks should be highlighted in the Council's opinion:

- The highly tense and uncertain security situation in the region persists, hybrid attack risks intensify.
- Weak lending and regional insecurity constrain entrepreneurs' ability to attract investments for business development and innovation.
- S&P has downgraded Latvia's long-term credit rating due to security challenges, sluggish economic growth, and fiscal risks. This downgrade jeopardizes investment inflows and potentially increases the costs of financing public borrowing.
- The sharp wage growth is driven by labor market constraints and the increased cost of living that arose during periods of high inflation. However, this wage growth is not related to productivity gains, resulting in higher business costs, reduced competitiveness, and limited investment funds. Additionally, it encourages the prevalence of envelope wages in the private sector, hindering faster economic growth.

- The accelerated wage growth in the public sector is driven by wage increases for teachers and the implementation of a new wage model for public sector employees. However, this could pose a significant fiscal burden if tax revenue growth does not keep pace with public sector wage increases.
- The Ministry of Finance is developing a tax reform aimed at reducing the tax burden on labor without decreasing total tax revenues. However, recent experiences in Estonia highlight the risks associated with tax reform, as significant deviations in expected tax revenue impacts are possible.
- Slow economic growth may not generate sufficient budgetary resources to maintain the budget deficit and public debt within acceptable limits, particularly given the high priority of defense spending and the increasing demand for state financial support for RailBaltica and AirBaltic.
- Risks associated with the operations of public joint-stock companies, particularly in the transport sector (such as the capitalization of AirBaltic and the construction of RailBaltica), remain significant and are escalating.

Decided:
1.1. Take note of the information submitted by MoF on macroeconomic projections.

I. Šteinbuka for;
A. Jakobsons for;
M. Āboliņš for;
U.Kāsiks for;
J.Priede for.

2. Internal discussion on macroeconomic projections

Those present discuss the forecasts submitted by the Ministry of Finance and commented on by the creators of macroeconomic projections. Key takeaways:

- The Council has no significant objections to the macroeconomic forecasts submitted by the Ministry of Finance. The Council considers them appropriate to the existing economic situation.

Decided:
2.1. Approve the macroeconomic forecasts submitted by the MoF.
2.2. Request the Council's macroeconomic expert, V. Zaremba, to formulate a summary opinion on the discussions held at the meeting.
2.3. Instruct the Secretariat of the Council to prepare and send the Council's opinion to the FM, in compliance with the concluded Agreement on Cooperation with MoF.

I. Šteinbuka for;
A. Jakobsons for;
M. Āboliņš for;
U. Kāsiks for:
J. Priede - for.

the meeting of 10th of June 2024 closed at noon. 17:00.

Chairwoman of the Council I. Šteinbuka

Meeting Secretary I. Jansone

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