Fiskālās disciplīnas padome

Surveillance report on Stability program 2023/2026 summary

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Summary

1. The Fiscal Discipline Council evaluates the Stability Program for years 2023/26 at a time of high uncertainty - when economic development and fiscal policy both in the European Union and in Latvia depend on the course of the war in Ukraine and the global geopolitical situation.
2. The prices of energy resources in the international markets have stabilized and gas consumption has decreased both due to the warm winter and the economy of consumption, which has improved the economic and fiscal outlook of the EU and Latvia in 2023, however, high uncertainty remains.
3. The fiscal indicators of the stability program is based this year's macroeconomic forecasts approved at the Council meeting on February 10[1], although in times of uncertainty, economic and fiscal indicators may significantly deviate from the forecasted values.
4. According to the FM macroeconomic forecasts approved by the Council, there will be no real GDP growth in 2023, but growth will be quite slow in the following years - in 2024 the GDP will grow by 2% and a significant increase is not expected in the following years either. On the other hand, the latest forecasts of the Bank of Latvia[2], published in March, assume that GDP growth will be 0.5% this year, and over 3% in the following years, which will be stimulated by the recovery of private consumption and the volume of investments entering the economy.
5. The latest statistical indicators do not introduce optimism about the dynamics of Latvian economic development. A slowdown or decline can be observed in several sectors: the volume of industrial production decreased by 9.8% in January, compared to January of the previous year, but compared to December - the decrease is 3.3%; in construction the decline continues[3] from the 3rd quarter of 2021. Latvia's GDP is still stabilized by the contribution of exports; however, the latest data show a decrease in the growth rate, which reflects both an unfavorable external environment and a possible drop in competitiveness due to high inflation. The pace of lending to companies is low: in 2022, compared to 2021, the amount of loans issued to companies increased by 2%, but in the last three years it decreased by 3% on average.
6. Inflation, according to FM forecasts, will reach the level of 10% in 2023, but will significantly decrease to 2.2-2.5% in 2024 and the following two years. The forecasts published by the European Commission in February[4] are similar to the FM estimates in terms of both inflation and GDP indicators.
7. Current macroeconomic indicators show that inflation in Latvia is still the highest in the Eurozone, although in March, according to Eurostat's rapid assessment, inflation decreased to 17.3%, which is the biggest decrease in the last year. However, there are concerns that inflation is taking a root. Its sustainability is determined by the increased production costs due to the energy crisis and the characteristics of the consumer basket,

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[1] Available: https://www.fdp.gov.lv/lv/media/4228/download?attachment , viewed 29/03/2023
[2] Bank of Latvia. Updated macroeconomic forecasts 31.03.2023. Predictions | Bank of Latvia
[3] In January, the volume of industrial production decreased by 9.8% | Official statistics portal
[4] European Commission forecasts , 13.02.2023, available at: Economic forecast for Latvia (europa.eu)

where goods with limited demand elasticity prevail. The inflation decomposition performed by the Bank of Latvia shows that 1/3 of inflation cannot be explained by these objective factors[5]. It is possible that the price increase is facilitated by the lack of competition in Latvia's narrow market conditions, which determines the pressure on the price increase from the supply side. For a large part of the population of Latvia, almost half of the consumption basket consists of food and housing costs, which the population is forced to buy even in conditions of high price levels. On the consumption side, it can be seen that the gross salary of employees increased by 8% in the previous year, which lags the rate of inflation (17.2%); therefore, the real income of employees has significantly decreased during the year. Data on the median wage of the working population in 2022 shows that 50% of the population earns less than 1,081 euros before tax, or 806 euros net, which is too to allow rising consumer prices. Demand, in the conditions of disproportionately high prices, should fall, but it happens too slowly. The persistence of inflation can be explained by a large shadow economy and envelope wages, which significantly increase demand. However, the decline in demand is felt as retail sales growth is one of the slowest in recent months.

8. Eurostat data show that Latvia's GDP per capita, according to purchasing power parity standards, significantly lags behind Lithuania and Estonia, with Latvia ranking 5th lowest in the EU. GDP growth rates, which form the basis of the Stability Program, do not allow reducing the lag behind neighboring countries, bringing welfare closer to the EU average and significantly increasing budget resources. Therefore, the government's main challenge is to achieve faster economic growth than in the Stability Program scenario. This is possible if investments increase significantly.

9. With increased intensity, a large amount of funds will flow into the Latvian economy from the EU's multi-year budget, including from the Recovery and Resilience Facility (RRF) and the Cohesion Fund. Timely and effective implementation of RRF, promoting productivity and competitiveness, is one of the conditions for a breakthrough in Latvia's economy. In EC's assessment, RRF's investments will have both a direct impact and a multiplier effect. The largest impact on the gross domestic product will be achieved by RRF in 2026, when it could be 1.3%-2%[6], besides, there will already be a return on the investments of previous years. It seems that the Ministry of Finance scenario is cautious and allows for the lack of capacity to absorb the EU structural fund and ANM funds in time.

10. Considering the fact that the EC SGP exception clause will no longer be valid in 2024 and the new EU economic regulation will not be valid yet, the European Commission has published a communication to member states with recommendations for fiscal policy for 2024[7]. These guidelines include elements of both the existing regulation and the planned regulation. Later (in June), the EC will also publish specific recommendations for countries, which will include both quantitative indicators and qualitative guidelines. **In general, the fiscal policies of the EU member states in 2024 should ensure medium-term debt sustainability and promote sustainable and inclusive economic growth. The EC calls for fiscal goals to be included in the country's stability programs, which would ensure the general government debt at a**

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[5] Bank of Latvia. Presentation of updated macroeconomic forecasts on March 31 (slide 32) Bank of Latvia reviews macroeconomic forecasts Bank of Latvia reviews macroeconomic forecasts | Predictions | Macroeconomics

[6] The Latvian recovery and resilience plan and productivity / Valerie Vandermulen / PowerPoint Presentation (lu.lv)

[7] Available at: https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/fiscal-policy-guidance_en , accessed 28/03/2023

sustainable level and ensure the deficit of the general government of no more than 3% of GDP.

11. The Council generally approves the country's fiscal policy in 2022, which was very difficult from an economic and political point of view. The fiscal policy of the Ministry of Finance in the coming years will be based on the achievement of the minimum planned structural balance of the general government (0.5% of GDP) stipulated in the Law on Fiscal Discipline. In general, the Council supports such a fiscal policy and it should ensure the achievement of the fiscal goals set by the EU; however, there is concern over the excessively active application of the one-time expenditure concept, which theoretically reduces the structural balance, but may result in a significant nominal budget deficit and increasing national debt. The balance of GGB planned by the FM for the following years corresponds to the trend of reducing the budget deficit and also to a 3% deficit threshold. The GGB deficit is forecast at 4% in 2023, 2.5% in 2024, 2.2% in 2025 and 0.7% in 2026, assuming no change in fiscal policy. The new EU economic regulation may require amendments to the FDL.
12. The impact of state support measures (Covid-19, Energy support, Ukrainian refugees, gas purchase) on the 2022 GGBB is estimated at 2.88 billion or 4.8% of GDP, which in nominal terms is more than a year ago (2.1 billion euros), but as a percentage of GDP, less (6.2% of GDP). The Council had previously expressed concern in its reports that some support measures in 2022 were not sufficiently well targeted and were more politically than economically motivated. Also in 2023, a significant support program is planned in connection with the Covid-19 crisis (102 million euros, 0.2% of GDP), the rise in energy resource prices (607 million euros, 1.5% of GDP), Ukrainian refugees (103 million euros, 0.2% of GDP). Total support is estimated at 812 million euros (1.9% of GDP).
13. In 2022/2023 heating season, the support provided for mitigating the increase in energy prices was only partially targeted, moreover, it did not promote energy efficiency. In fact, most of the support instruments end their operation this year in April. The current energy market prices allow us to predict that the prices of the next heating season will be slightly lower than the previous ones (after state support). However, there is a risk of market shocks, which will result in continued social tension and pressure on the government to continue support measures, especially if without state support the tariff increase will be significant.
14. In 2022, under the influence of high inflation, the revenues of the consolidated general budget increased by 13.7% compared to the previous year, reaching 14.3 billion euros. The main source of general budget income - tax revenues increased by 15.2% in 2022 and the tax collection plan was overfilled by 13.4%. During the first two months of 2023, the tax collection trend is also positive. This year, according to the budget law, the tax income of the consolidated general budget is forecast at 12.3 billion euros, which is 6.5% more than what was collected in 2022. FDP's tax forecast for this year's total budget is 12.6 billion euros, 2.6% more than FM's forecast.
15. The government has started work on the tax reform and the Minister of Finance has declared the goal of the reform - to increase budget revenues. The Council reminds that international studies rate Latvia's tax system relatively highly [8]. In addition, the stability

[8] Tax foundation report available: https://files.taxfoundation.org/20221013150933/International-Tax-Competitiveness-Index-2022.pdf?_gl=1*1sf5c3g*_ga*MTY2NDg0NDI5OC4xNjc1MjYyNTky*_ga_FP7KWDV08V*MTY3NTI2MjU5My4xLjAuMTY3NTI2MjU5LMyjA42MC4w , viewed on 01.02.2023

and immutability of the tax system are values in themselves, especially in times of high uncertainty. Relatively little is collected in taxes in Latvia, in relation to GDP [9], compared to other EU countries, but the need for additional funding is significant. Also in 2022, the tax burden of the general budget decreased to 29.6% of GDP, a year ago it was 29.9%. Consequently, any reduction in tax revenues would be offset by other tax revenues. In conditions of uncertainty, as at present, tax reform can lead to unexpected negative fiscal and economic consequences. For example, a tax cut, against a background of high inflation, could increase demand, thereby contributing to a rise in prices. Therefore, before the planned tax changes, it would be necessary to carefully assess the short-term and long-term economic, fiscal and social effects of the reform. At the same time, it is necessary to strengthen measures to reduce the shadow economy.

16. Latvia still has one of the lowest debt levels in the EU. In accordance with Treasury estimates, the amount of debt of the Republic of Latvia was 40.8% of GDP, or 15.9 billion euros in 2022. Treasury predicts that in 2023 the debt as a percentage of GDP will begin to decrease to 39.6%, but in the following years it will increase minimally - by 0.1 percentage point. In 2024, the debt is forecasted at 39.7% and in 2025 at 39.8% of GDP, but in 2026 it will decrease to 38.9%. A moderate level of debt has allowed Latvia to maintain a high credit rating for many years, and Latvia is a country with free access to financial markets. Global rating agencies highly evaluate Latvia's credit rating - Moody's (A3) [10], Fitch (A-) [11]and R&I (A) [12]and determine a stable future assessment. However, the S&P Global agency, maintaining Latvia's credit rating at a high level (A+) in 2022, has changed the future assessment from stable to negative [13]. The agency has emphasized the risks related to the war in Ukraine, high inflation and the related direct and indirect costs to the Latvian budget. Considering the negative geopolitical background in the region, there is a risk that future assessments for Latvia may be lowered, which, in connection with increased interest rates, may make the future servicing of the national debt more expensive.

17. GDP in terms of purchasing power parity shows that in Latvia in 2022, the real expenditure per inhabitant was 26.1 thousand EUR, in Lithuania 31.7 thousand EUR, but in Estonia 30.6 thousand euro. Latvia lags significantly behind its Baltic neighbors, but lags behind the EU average by more than 9 thousand euros. At the same time, the national debt per inhabitant in Estonia is 4.2 thousand EUR, but in Latvia 8 thousand, in Lithuania a little over 8 thousand. This illustrates that increasing public debt does not increase the welfare of citizens in the long run. The future challenge of Latvia's economy is to accelerate growth, because only GDP growth will provide a stable basis for budget growth. To achieve this goal, it is necessary to increase both own investments and effectively invest EU funds, including the opportunities provided by the Recovery and Resilience Facility. RRF's funding envelope is set at 1.826 billion euros. Within the framework of this mechanism, it is planned to carry out reforms and improve the infrastructure in Latvia. A little more than one billion euros is planned to be invested in green transition and digital transformation projects, or 38% and 21% of the total

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[9] Eurostat data: https://ec.europa.eu/eurostat/databrowser/view/gov_10a_taxag/default/table?lang=en , accessed 01.02.2023
[10] Moody's confirms Latvia's credit rating at the current A3 level Moody's confirms Latvia's credit rating at the current A3 level State Treasury
[11] Fitch Ratings maintains Latvia's credit rating at "A-" level Fitch Ratings maintains Latvia's credit rating at "A-" level State Treasury
[12] S&P Global Ratings changes the future assessment of Latvia's "A+" credit rating from stable to negative S&P Global Ratings changes the future assessment of Latvia's "A+" credit rating from stable to negative State Treasury
[13] S&P Global Ratings changes the future assessment of Latvia's "A+" credit rating from stable to negative S&P Global Ratings changes the future assessment of Latvia's "A+" credit rating from stable to negative State Treasury

investments. In addition, 196 million euros have been earmarked for increasing productivity.

18. The period of high uncertainty continues, which affects most countries of the world and is acutely felt in the Baltic States and the EU, where high inflation and geopolitical tensions stifle growth. As global risks increase, balancing growth-enhancing policies with restrictive fiscal and monetary instruments becomes increasingly challenging. In the opinion of the Council, the main risks in the national economy of Latvia are as follows:

- Lack of investment and limited crediting of companies, which will slow down the growth of the national economy, the competitiveness of companies and exports,
- The limited capacity to absorb intensive funding from EU funds, respecting the deadlines and not making the estimates more expensive,
- In the conditions of the influx of EU funds, the risk of overheating of the construction industry - due to insufficient labor resources,
- The risk of long-term slow growth or economic stagnation, if there is not enough investment and the economic transformation does not achieve the goals (although the probability of recession has now decreased),
- The entrenchment of inflation, which reduces the purchasing power of the population (private consumption) and well-being,
- Inflation/wage spiral risk, when unemployment is low with slow growth, upward pressure on wages is high. The review of budget expenditures by the government shortly after the approval of the budget law signals that the pressure to increase expenditures in health care and education will not decrease and that it will not be possible to completely solve it with structural reforms,
- Widening of the wage and productivity gap, which threatens the competitiveness of the economy,
- Slowdown of exports, which reduces the growth of the national economy,
- The aging of the population and the poor state of health, which will require a significant increase in funding for health care and social protection every year, which will not threaten fiscal sustainability only in conditions of rapid GDP growth.

Global risks also continue to affect Latvia, among which the main ones are the continuation and aggravation of the geopolitical confrontation. Global financial sector risks are also increasing due to the very rapid rise in interest rates over a short period of time, which has recently caused turbulence in financial markets.