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Economic and Fiscal Challenges: Case of Latvia

Fiscal Discipline Council of Republic of Latvia
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Baltic-Nordic IFIs meeting 2023, Tallinn

Slow Economic Growth in the EU and Baltics

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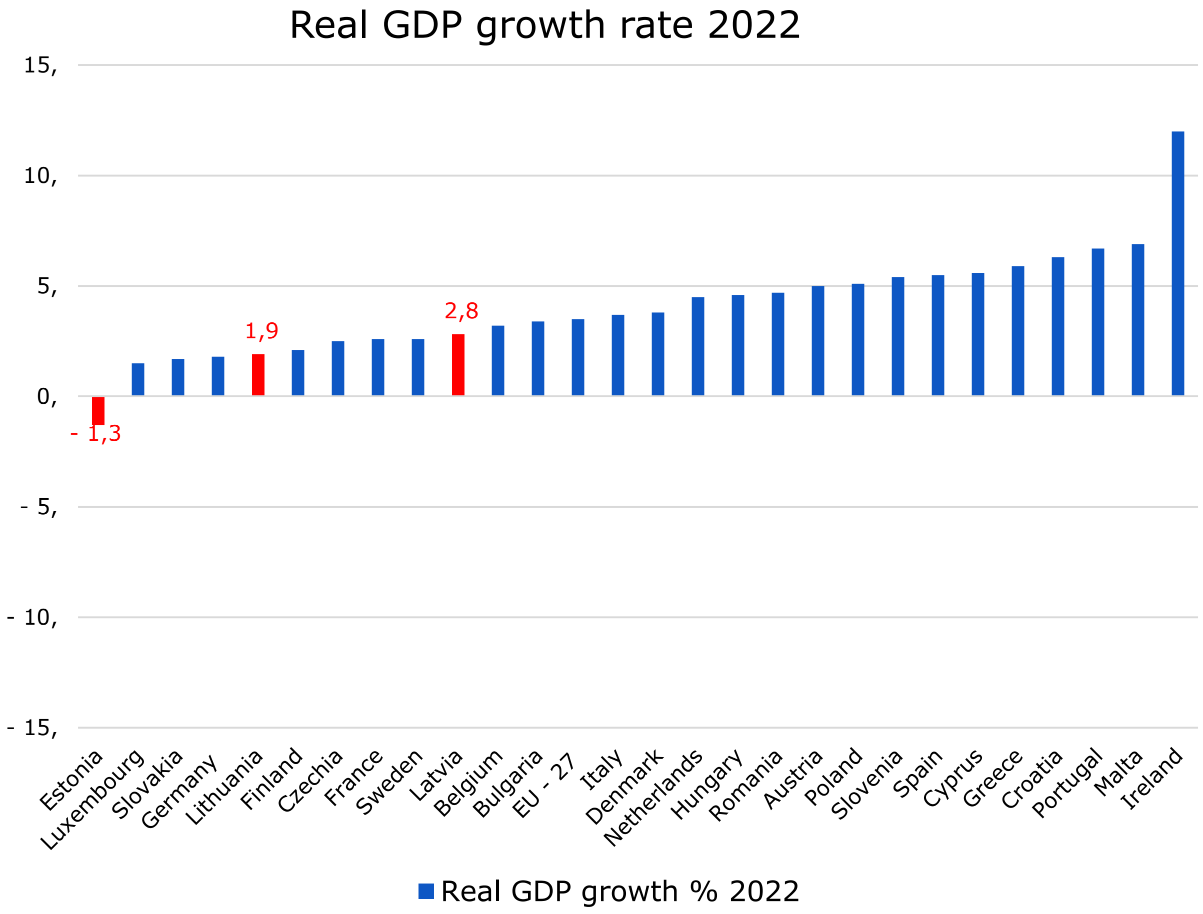
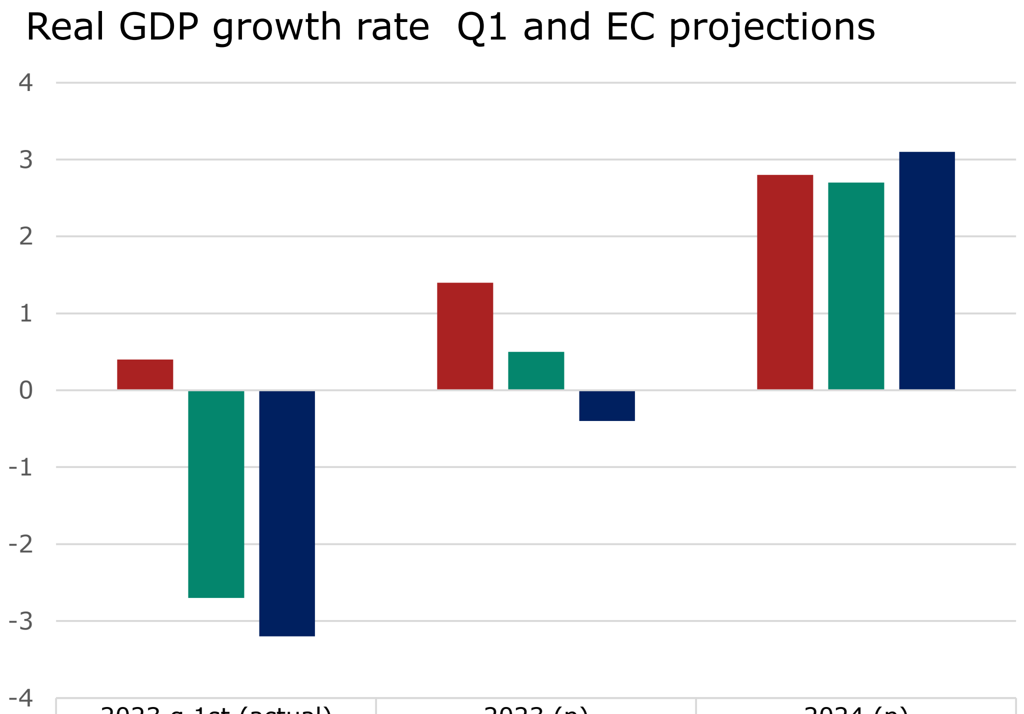


Source: Eurostat



	2023 q 1st (actual)	2023 (p)	2024 (p)
Latvija	0,4	1,4	2,8
Lithuania	-2,7	0,5	2,7
Estonia	-3,2	-0,4	3,1

Latvija Lithuania Estonia

Source: Stat. offices of LV, EE, LT and projections of EC

Latvia is in 5th place from the low end in terms of GDP purchasing power parity

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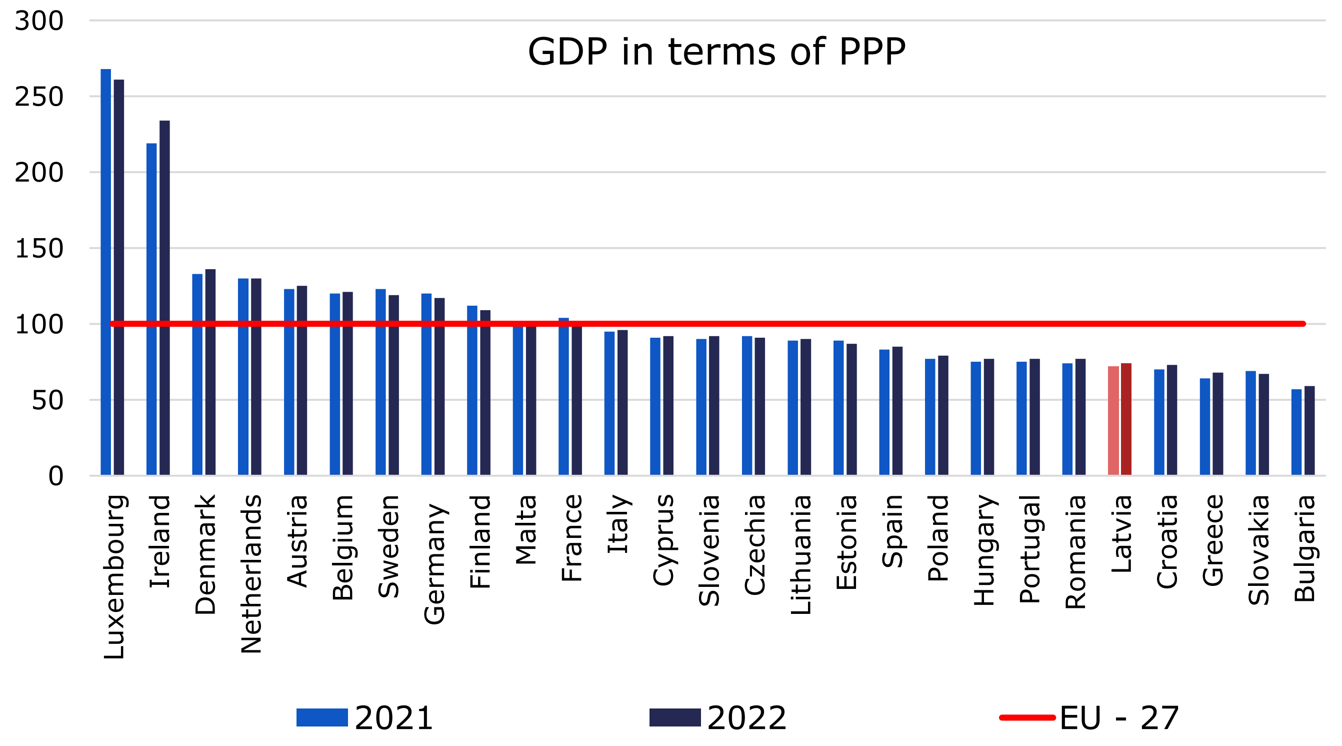
Latvia’s challenge is to get out of the low- and middle-income trap, which is possible only by productivity increasing.



Source: Eurostat

Productivity Gap vis-a-vis EU Remains Wide

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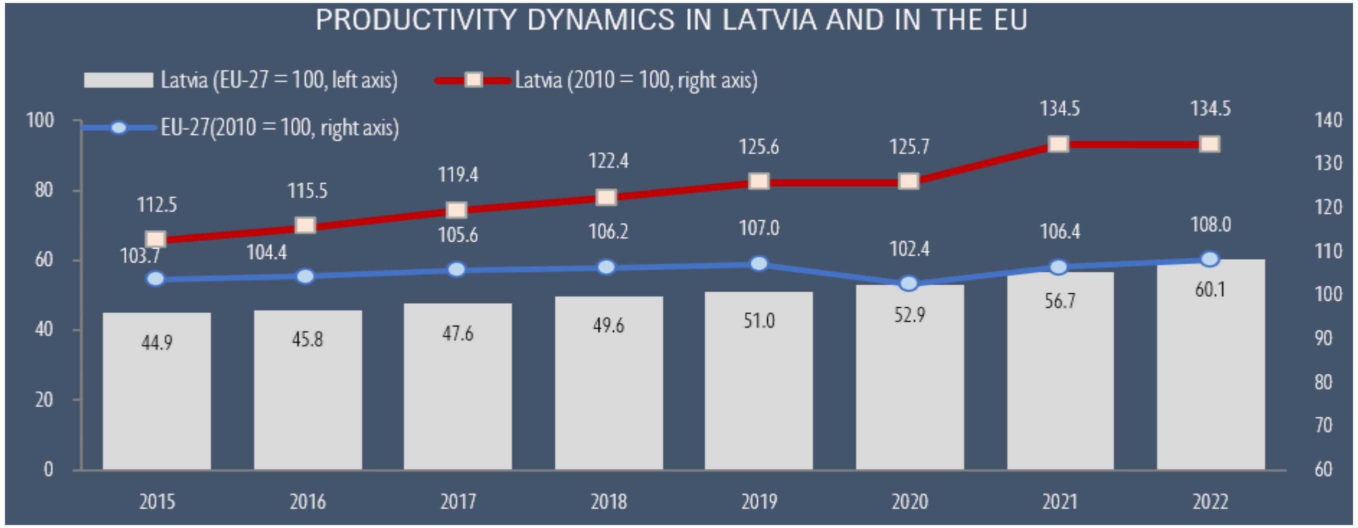
- Intensive pressure to raise wages. In 2017 - 2021, labor costs in Latvia have increased by 46.2%, or three times faster than productivity.

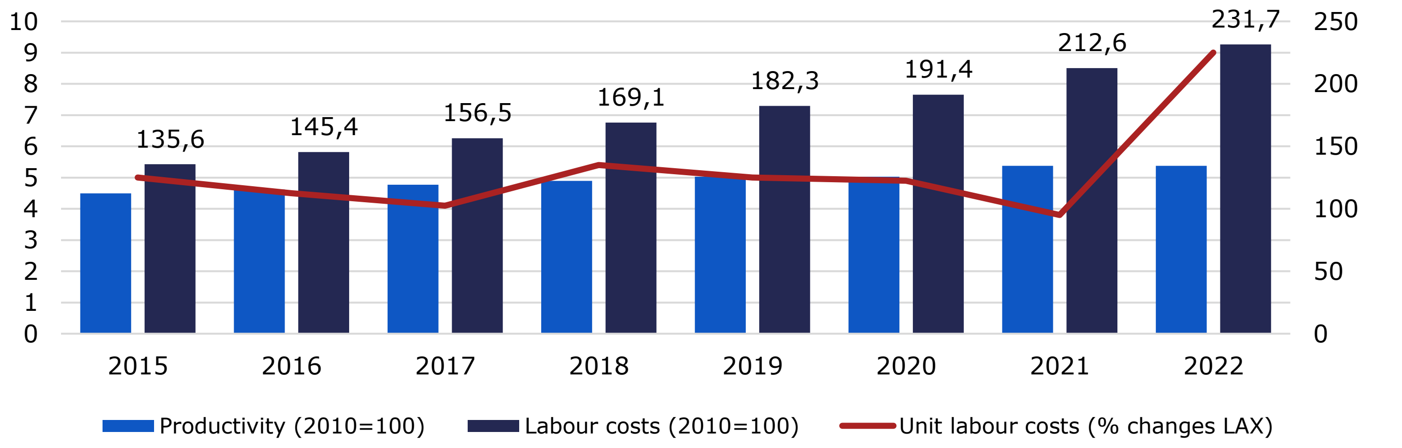
- Shortage of labor force. Pressure on wages - in the first quarter of 2023, wages grew faster than in the whole of 2022 (+12.3%).

- **Investments & innovations** - the key engine of an economic breakthrough.



Source: Eurostat

Latvia - labour costs, productivity and ULC



Source: Eurostat

Inflation continues to be the dominant factor of macroeconomic imbalances

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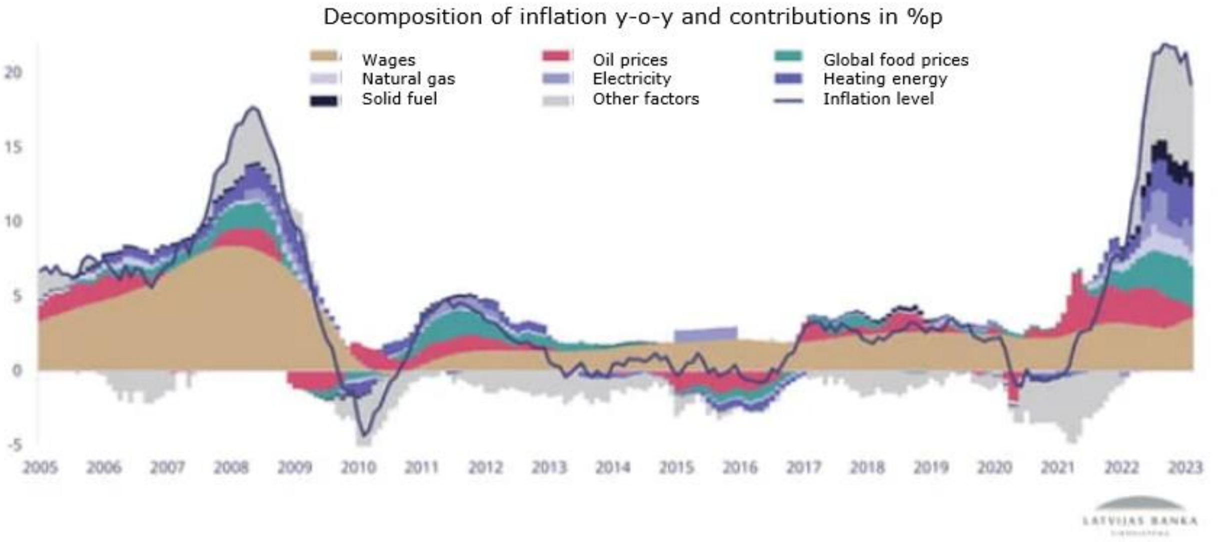
- *Main reasons*: high energy prices, increased production costs and consumer basket, where goods and services with limited demand elasticity prevail.

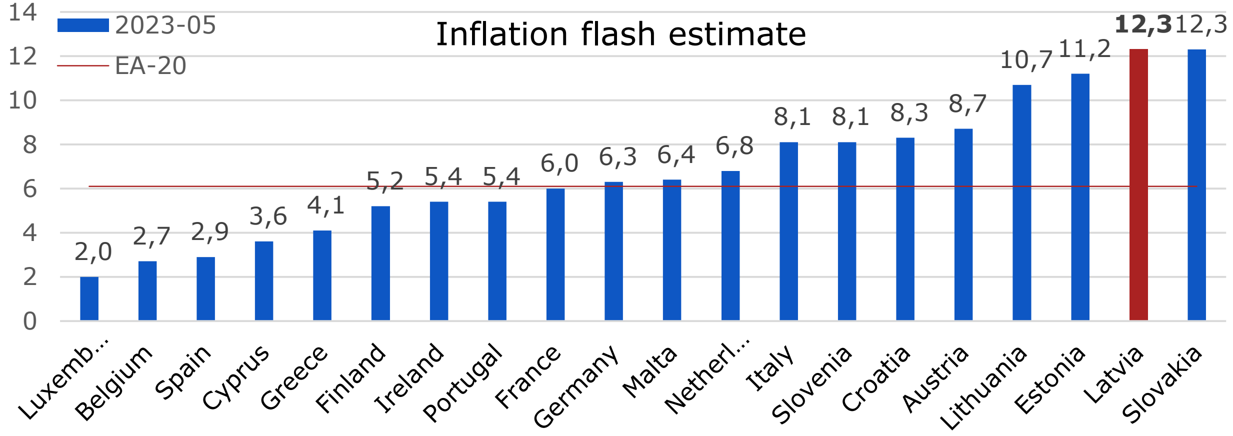
- The inflation decomposition (BoL) shows that 1/3 of inflation cannot be explained by these factors.

- Fiscal Discipline Council hypothesis: the lack of competition (supply side) and «envelope wages» (demand side).

- Core inflation continues to be high both in EA and Baltic states.



Source: BoL estimetes



Source: Eurostat

EU deficit level has started to normalize during the 2022, with the gradual phasing out of support measures. How to achieve state debts reduction?

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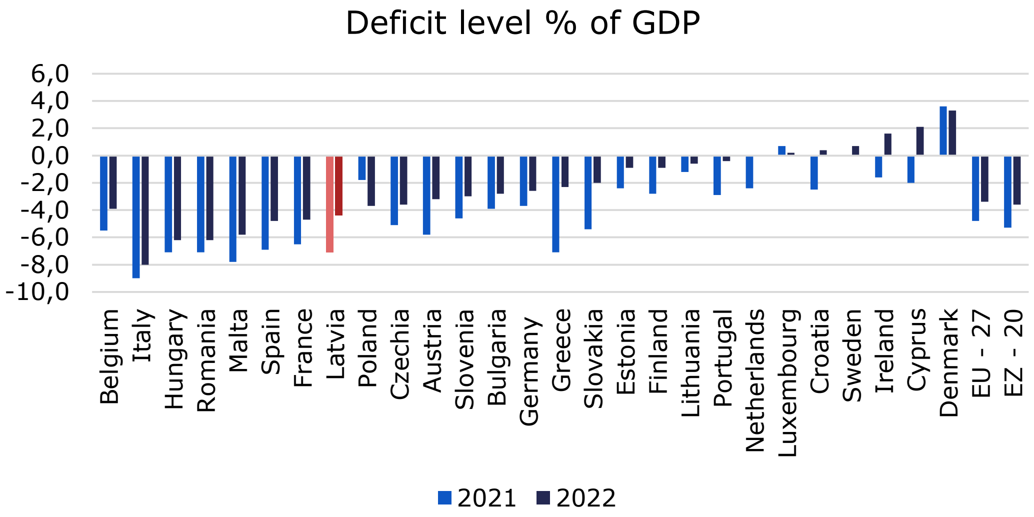
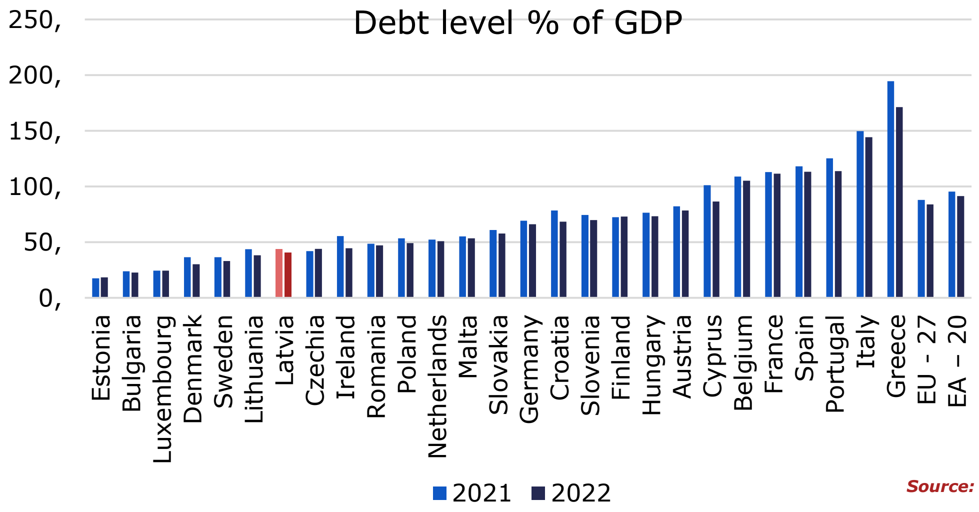
- Euro area deficit level is at 3.6% of GDP.
- Latvia reached 4.4% of GDP in 2022, down from 7.0% in 2021 due to substantially less pandemic-related support.



Source: Eurostat

- State debt in Euro area reached 91.6%.
- Debt level in Latvia is one of the lowest in the EU but the highest in the Baltics.



Source: Eurostat

Members states had started the transition to the new fiscal framework in very unequal starting positions

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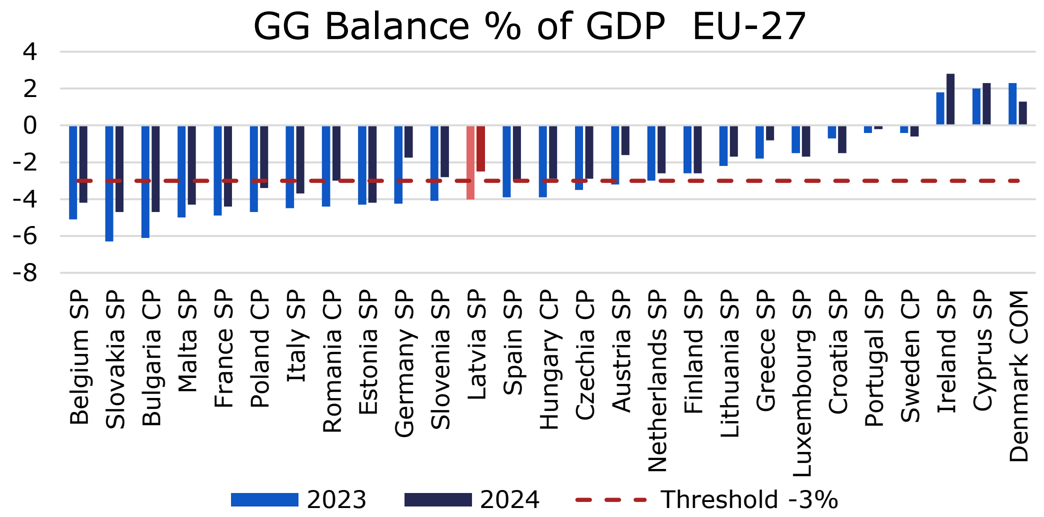
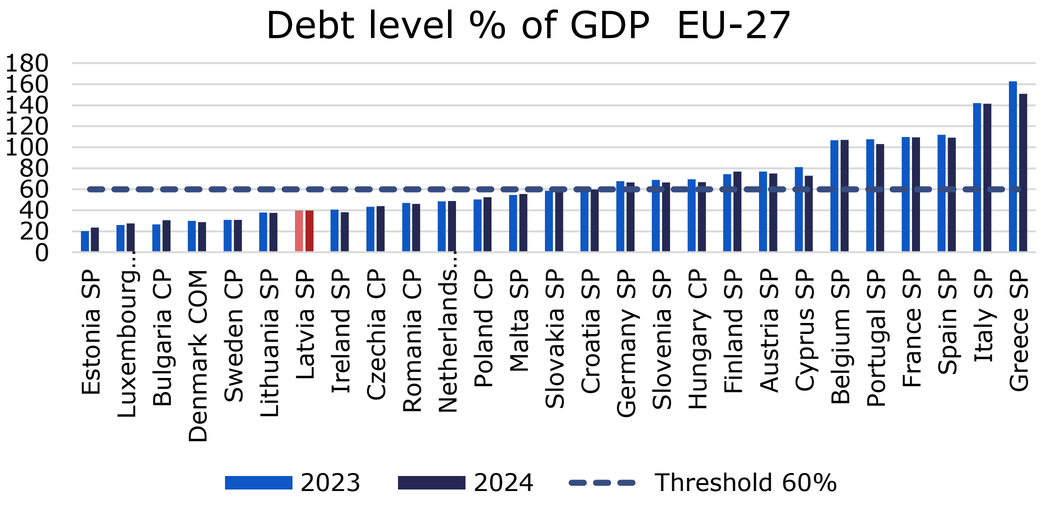
- Ireland, Cyprus and Denmark: budget surplus.
- In 2023 a deficit of 3% and above is planned for 17 countries.
- In 2024, almost all countries plan to reduce the deficit but 10 out of 27 exceed the 3% deficit threshold.
- *National debt*: in 2023 14 countries debt exceeds the 60% threshold.
- The average debt/GDP of the five largest EA economies (Germany, Spain, France, Italy, Netherlands) in 2023 is 96% (1% down in 2024).





Source: EC (SP-Stability Program, CP Convergence program, COM EC assessment)

EU Fiscal Policy Recomendations for Latvia

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- Ensure prudent fiscal policy. For the period beyond 2024, continue to pursue a medium-term fiscal strategy of gradual and sustainable consolidation, combined with investments and reforms.

- Improve access to finance for small and medium-sized enterprises through public lending and guarantee schemes.

- Preserve nationally financed public investment and ensure the effective absorption of RRF grants and other EU funds, in particular to foster the green and digital transitions.

Fiscal policy risks

- Domestic political risks – new government coalition.
- In 2024, the planned deficit is 2.5%. Will it decrease in the medium-run? Reforming the health care and education sectors requires more public spending. Increase of the cost of living is fueling social tension, populism and pressure on spending.
- Ongoing discussions on tax reform. Impact on budget?
- Slow growth and large shadow economy.
- The most intensive funding from RRF and EU funds is expected in 2024-2025. Dominant part of projects depends on the limited capacity of construction industry.
- Commercial bank lending in Latvia is weak and lagging behind EST and LT.

New Fiscal Regulation and Readiness of IFI

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- *New requirements*: increase of the IFI capacity.
  Risks: actual weakening of the role of the IFI.

- *Uncertainty*: the scope of policy-costing analysis and its implementation in practice.

- In Latvia, MoF is planning to revise Fiscal Deficit Law.
  Risks: instead of the analytical and advisory role of IFI only technical functions will remain.

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Thank you for your attention!!!

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