

# Ilmārs Rimšēvičs: Review of the Latvian economy and challenges for the future

Introductory statement by Mr Ilmārs Rimšēvičs, Governor of the Bank of Latvia, at the press conference, Riga, 4 December 2015.

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*The charts can be found at the Bank of Latvia's [website](#).*

This is the moment where we look back on the past year and identify the tasks and challenges for the future. Many of us are making resolutions for the next year: to have healthier lifestyles or learn something new. But it is also a good time to look back at what was and was not accomplished this year.

## **1. First, about the Eurosystem monetary policy decisions made yesterday in Frankfurt and their impact on Latvia.**

Yesterday, at the meeting of the Council of the European Central Bank, the current evaluation of and predictions for the economic situation of the euro area, the dynamic of gross domestic product and inflation as well as lending trends were all discussed. (chart)

Analysis by economists indicates that euro area growth supported by monetary policy measures is continuing this year. In the third quarter, the rate of GDP quarterly growth dropped slightly, yet it was by 0.3% higher than in the second quarter. External trade, which was slower than forecast earlier, impeded faster growth. That is by and large explained by the weaker growth prospects of such developing countries as China and Russia as well as others. (chart)

Inflation in October increased to 0.1%, primarily on account of rising core inflation: the latter reached the highest level since August 2013. The rise in inflation was fostered by domestic demand and weakening of the euro exchange rate. (chart)

Yesterday the Eurosystem announced the latest forecasts for the euro area economic development. Overall, changes are small. According to those, the euro area GDP this year could increase by 1.5%, in 2016. gadā by 1.7% and in 2017 by 1.9%. Growth will continue to depend on private consumption and investments, yet it is expected that export growth will diminish under the impact of a weaker external demand. Risks are related to the deterioration of the external environment.

Inflation forecasts in the euro area have been adjusted slightly downward: in 2015, the total inflation of the euro area is expected at 0.1%, in 2016 it will rise by 1.0% and in 2017 by 1.6%. Domestic demand will continue to foster price rises, yet the direct and indirect effects of prices will impede returning the inflation indicator to the goal declared by the Eurosystem, i.e. under 2%, but close to that figure.

The extraordinary monetary policy measures implemented by Eurosystem continue to be an important factor stabilizing the euro area. The conditions for borrowing have become more favourable both for enterprises and households. The dynamic of loans granted in the euro area continues to improve, yet the speed of recovery is low. Therefore, at the 3 December meeting of the ECB council we decided on several measures:

- to further reduce the overnight deposit facility interest rate to minus 0.30%;
- to extend the Expanded Asset Purchase Programme to the end of March 2017;
- to reinvest the principal amounts of the securities purchased within the Expanded Asset Purchase Programme once their term of maturity has set in;
- to include amongst the purchasable assets also secure, investment grade debt securities emitted by local governments;

- to continue to conduct refinancing operations with a set interest rate and full allotment at least to the end of the last reserve requirement period of 2017.

The decision taken by the ECB Council will mean even cheaper resources at the disposal of Latvian commercial banks, households and enterprises. I hope that this loan money will reach households and businesses without an additional surcharge. The costs of servicing the Latvian government debt will also continue to drop, which will mean additional savings – and it would be essential not to consume those but to direct them toward implementing structural reforms, thus increasing the country's competitiveness. Instead of additional borrowing to make use of the low interest rates, it is important to reduce the public debt, which would have a positive impact on the budget as well. But I will turn to that in a little while. (chart)

Latvijas Banka has continued with the Expanded Asset Purchase Programme by purchasing securities emitted by the government of Latvian and international organizations in the amount of 1.44 billion euro over eight months of this year. The purchases of Latvian government securities by Latvijas Banka and ECB had reached 630 million euro by the end of October.

## **2. And now let's turn to Latvian economic growth**

Analyses by sector and other criteria indicate that the Latvian economy is growing in accordance with earlier predictions and the rate of this growth could be characterized as moderate. Given the complicated situation in the external environment, such a result can be considered as satisfactory, however, taking the long view and considering the aspect of convergence of Latvian economy, this provides no cause for optimism.

Historical data indicate that growth of the Latvian economy in the post-crisis period is becoming slower and it does not go unnoticed that we are facing problems of a structural nature. These represent increasing obstacles, including:

- The drop in competitiveness of goods and services exporters in the international markets,
- slowing of the growth of the local lending market,
- delaying reforms in education and healthcare,
- and finally, fiscal policy.

### **2a. Now about the most topical theme in Latvian economy – the principles for drafting the budget.**

At the beginning of September I was asked what mark I would give to the 2016 draft budget. At that time I said that the draft deserves an eight, given the timely manner in which the finance minister and prime minister managed to develop and move along the draft as well as the determination of the government not to give in to the huge wave of expenditure demands by ministries, which would have washed away the prudent budget policy worked out with so much difficulty during the crisis years. I regret to say that I was too much of an optimist. Right now, the budget only deserves a "6". First, in two months several measures were implemented that were a serious blow to the business environment and the confidence of entrepreneurs in the stability and sustainability of the tax system. Second, in the conditions where the risks of the external economic environment have increased but the Latvian economy is still posting positive growth, the forming of a fiscal risk reserve has been rejected and a number of new, unexpected expenditure items have appeared. Needless to say that (given the non-existence of the fiscal reserve), we are most concerned about the 80 million demand related to "airBaltic".

All the shortcomings notwithstanding, the 2016 budget has been adopted and we will have to live with it. So right now it is important to not lose time and review the budget drafting process, so that we could adopt the kind of budget for 2017 that would create a stable foundation for the development of Latvian economy in the future. Several principles should be observed in this work. (chart)

Number one, stability; number two, a budget without a deficit and, number three, a zero budget.

First of all, **stability** is essential for the Latvian business environment, for attracting investments and for resuming lending. The proposal of auditing the tax system should be supported, making clear once and for all, that once the taxation system is put in order, we are not going to manipulate it for at least one general election cycle. Thus a practice of a stable and transparent tax system would be established – a system that, instead of being changed every year, is maintained stable for at least four years.

Second, there is the worrisome tendency of the last twenty years: we have had a budget surplus for only one year; the rest of the time, we have lived on debt, increasing the external debt. I would like to remind you of a simple equation: **budget deficit=greater public debt=higher taxes**. Living with a budget deficit, we enter a Catch-22 situation: the public debt is increasing and to service it greater funds are needed, but, to find these funds, taxes have to be raised. The raising of taxes has a negative influence on the business environment, it is an obstacle to investment and creates uncertainty about the future both for businesses and households, thus having a negative impact both on economic growth and the budget itself.

We should **finish with the business of spending state funds in amounts covering several months in December**. It has become common that all year long there is a surplus in the budget but then “suddenly” December arrives and state administration begins to spend money, which means that we end the year with substantial deficit, usually higher than what was planned at the beginning of the year.

Third,

- the promise should be kept of establishing a working group for **zero budget**, to which we are ready to delegate our experts; that is work that must be done independently of what is happening with the coalitions, governments etc. Any budget activity must be evaluated from the beginning – by evaluating the relevance of positions, instead of increasing the base for the next years without carefully evaluating the expenditure of previous years. In this work, there should be no red lines: the budget base should be evaluated in all ministries, including the priority ones, whose expenditure was not curtailed for 2016. There must be no vetos or taboos!
- The current lack of discipline has consequences for the future and the Fiscal Discipline Law and establishing fiscal discipline are an example. Regarding 2016, no prior commitments were honoured, which means that for **2017, a greater fiscal reserve will have to be formed**. In view of the optimistic predictions, which have been included in the budget but which may have to be corrected – because of lower inflation, among other things – forming the fiscal reserve will be very important.
- Under the current circumstances, **structural reforms in education and healthcare systems** gain even more importance. It is my great hope that in 2016, serious reforms will take place in both of these areas, in order to improve Latvia's competitiveness, and that measures will concurrently be taken to explain to the population why such reforms are necessary and what positive effect they will have on our economy in the future.

Why am I discussing budget matters at this time? We are worried about the obvious fact that all possibilities for organizing the budget have been exhausted. It is said that Latvia can no longer sustain tax revenues at the level of 28% of GDP and that the budget is overall too small. Thus groundwork has been laid for the raising of taxes next year. Under such circumstances, the Latvian business environment would be seriously endangered and, with it, any successful economic development in the future.

We have at least six months till the drafting of the next budget begins and I hope that the Ministry of Finance and the Government will launch a serious discussion for us to see what the Government is spending overall and whether the only way to improve the budget situation is to continue brutally raising the taxes.