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Statement by Mr. Buissé on Republic of Latvia
(Preliminary)
Executive Board Meeting
September 11, 2023

We thank Staff for their clear and insightful reports in the context of Latvia´s Article IV consultation. We also thank Mr. Vasiliauskas and Ms. Allika for their informative Buff statement.

After a strong post-pandemic rebound, the Latvian economy has slowed down following the inflation and energy shocks arising from the spillovers of Russia's war of aggression against Ukraine, but has nevertheless shown remarkable resilience in the face of unprecedented shocks. Growth is expected to pick up again, but maintaining the convergence process requires boosting productivity. In this context, fiscal policies should remain flexible in case adverse risks materialize, but also aim to achieve prudent fiscal positions over the medium term, while supporting the tightening of monetary policy and investment. A timely implementation of Latvia's Recovery and Resilience Plan is crucial to ensure sustainable growth, with a focus on increasing the supply of highly-skilled labor, improving the business environment, boosting investment, and accelerating the green transformation. Finally, the current macroprudential stance is appropriate.

Macroeconomic Developments

We agree that growth is expected to pick up again as inflation gradually declines, although short-term risks are tilted to the downside. We broadly agree with Staff's macroeconomic projections, which, taking account of different cut-off dates, are consistent with those of the EU institutions. Although the 2023Q2 GDP outturn has surprised on the downside, we expect growth to rebound in 2024 and beyond as slowing inflation boosts consumption, supported by strong real wage growth in the context of a very tight labor market. However, as productivity has not been increasing in line with real wages, we share Staff's concerns regarding external competitiveness, and agree that structural policies should aim at boosting productivity. A large inflow of EU-funded public investments should be another positive factor supporting GDP

growth over the short and medium term. We also agree that the short-term economic outlook is subject to substantial risks, both external and domestic. These relate not only to geopolitical developments and Latvia's vulnerability to global shocks, but also domestic factors reflecting demand-supply strains, such as persistent labor shortages.

Fiscal policy

Although fiscal policies should remain flexible, fiscal-structural reforms would help Latvia achieve prudent medium-term fiscal positions over the medium term. Latvia's nationally-financed primary current expenditure is expected to provide an expansionary contribution to the fiscal stance, driven by the expenditure measures included in the 2023 budget package. In our view, a neutral contribution to the fiscal stance would have been more appropriate. At the same, time, we agree with Staff that fiscal policy should remain flexible if adverse risks materialize, also taking account of the country's relatively low debt ratio. However, future energy support measures, if needed, should be better targeted. We also agree that Latvia should make use of the Recovery and Resilience Facility to boost investment, in particular for the green and digital transitions and for energy security, while maintaining nationally-financed public investment, as currently planned. Over the medium term, Latvia should achieve prudent medium-term fiscal positions, in line with the National fiscal discipline law. In this context, we agree that broadening taxation has the potential to increase tax revenue and provide additional fiscal space for public spending, in particular in healthcare and social protection.

Structural Policies

We agree with the structural challenges identified by Staff, which require accelerating the implementation of the RRP. We agree with Staff on the importance of improving the supply of high-skilled labour, with a focus on digital skills, and we would also highlight the challenges linked to the high prevalence of the shadow economy, and the low adequacy of social protection and the healthcare system. We also concur on the need to boost investment, but we would put the focus on improving access to finance for SMEs and on further improving the insolvency procedures. Notwithstanding the authorities' efforts to reduce the regulatory burden in product and services markets, further efforts are also needed, as planned in the RRP. The green transition is also a key priority of the RRP, with a large part of the funding allocated to measures supporting climate change objectives. In this regard, accelerating the deployment and use of domestical renewable energy sources and improving Latvia's electricity grid to accommodate a greater uptake of renewables; continuing to reduce the overall reliance on fossil fuels, including by extending carbon pricing to emissions not covered by the EU ETS; and strengthening energy efficiency through new financing measures, would not only contribute to achieving Latvia's climate objectives, but would also strengthen energy security, in line with the RRP and the REPowerEU Plan.

Financial Sector Policies

We share Staff's view that the current macroprudential stance in Latvia is broadly appropriate, and that Authorities could consider building further buffers. We agree that considering heightened risks, continued monitoring of financial sector vulnerabilities is important. At the same time, we also note that the Latvian banks are profitable, household debt is relatively low, and financial and real estate dynamics during the upturn in recent years were less pronounced than in other Baltic states. In this context, increases in buffers could still be considered to further boost resilience, duly taking into account the risk of procyclicality as the financial cycle turns, and therefore welcome the Authorities' decision to gradually implement a positive neutral countercyclical capital buffer.