3. In Focus

Impressive consolidation gives no reason for complacency

As a result of focused work during the last two months of 2011, the Budget 2012 was prepared in due time for its adoption and before the completion of the European Commission and IMF review mission. In a concerted effort of the Ministry of Finance, the Bank of Latvia, the international lenders and other stakeholders, differences were resolved and a budget aiming to contain the budget deficit under the Maastricht threshold of 3% of GDP was agreed.

The sizeable adjustments in the Budget 2012 amounting to nearly 1% of GDP are even more impressive as they top the 17% of GDP consolidation measures implemented since November 2008. The commitment of the government to go through with a series of austerity measures in order to bring the public finances on a sustainable path has been truly remarkable and the success achieved has earned praise from economic observers, international financial institutions and heads of state.

This last effort concludes a period of close guidance in fiscal matters by our international partners. It also provides the opportunity for Latvia to stand on its own feet as the international assistance programme conditions have been satisfied and the budget deficit is now under the threshold provided by the euro area accession criterion. However, the opportunity to implement a completely independent budget policy does not mean an opportunity to return to the "old ways", i.e. to spending increases. Quite the contrary, even a low deficit does not help to run down the debt accumulated in the recent crisis mitigation efforts. The fulfilment of the above-mentioned minimum criteria may also be at risk taking into account the fairly low safety margin and adverse external economic developments.

In the near future, the downside risks to meeting the budgetary targets are related to the deterioration of the economic situation in Europe. The macroeconomic forecasts on which the Budget 2012 – including the revenue targets – was based projected a 2.5% GDP growth. However, the intensification of the debt crisis in Europe has translated into downward revisions to growth projections in many trade partner countries that will have a bearing on growth in Latvia. At this point, it seems very likely that the economic growth will turn out to be lower than projected at the time of the budget preparation: current forecasts indicate that the GDP growth could be closer to 1%. Consequently, revenue underperformance and hence a higher than projected deficit can be expected. This would mean that to remain on the undertaken path and, more formally, to fulfil the Maastricht criterion for the budget deficit in 2012 corresponding measures on the expenditure side will be required. Should the unfavourable growth projections materialise to a full extent the current expenditure plans might need to be reviewed as early as in spring. For that reason, a list of areas and expenditure items where additional cuts could potentially be carried out should be prepared to avoid hurried last minute decisions.

In a slightly longer-term view, prudent management of public finances and adherence to publicly declared commitments is crucial to tangibly demonstrate fiscal sustainability, considering the need to refinance the sizeable public debt maturing in a 3–4 years time. Sound public finances and Latvia confidently remaining on the path towards sustainability will provide benefits in the form of easier access to credit on better terms.

Having prepared the Budget 2012 that complies with the Maastricht criterion is not the end but just the beginning of a journey that Latvia has undertaken towards sustainable public finances of our own design and in our own interest. To minimise the imminent and longer-term risks to the implementation of the sound budget plans the government has to stand ready to mitigate any adverse impact of unfavourable economic developments on the budget balance.