COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Latvia, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission. In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 do not participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

The first convergence programme of Latvia, covering the period 2004-2007, was submitted on 14 May 2004 and assessed by the Council on 5 July 2004. Latvia submitted an update of its convergence programme on 30 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[3]. This evaluation warrants the following assessment:

- The first update of the Latvian convergence programme, covering the period 2004-2007, was adopted by the Latvian Cabinet of Ministers on 28 December and submitted to the Commission on 30 December 2004. The programme is based on the economic projections in the 2005 budget law presented to the Parliament on 13 December 2004 and adopted by the Parliament on 20 December. The updated programme broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". However, the ESA95 classification of data on the composition of the general government revenue and expenditure needs to be improved.

- In the update, GDP growth of 8.1% is estimated for 2004 and 6.7% foreseen for 2005, with domestic demand, in particular investment and private consumption, continues to expand vigorously. For 2006 and 2007, GDP growth is set only slightly lower (6.5% in both years). Export growth has picked up strongly, reflecting global economic recovery and a positive impact from Latvia's accession to the EU; nevertheless, this has been outpaced by

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1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM(2002) 668, 27.11.2002.

the growth of imports accompanying the surge in domestic demand. The growth contribution of net exports in the immediate term is set to be negative and the wide current account deficit to narrow only marginally. Unemployment is projected to fall only gradually despite the strong growth of economic activity. Overall, on the basis of currently available information, the macroeconomic scenario seems plausible and is broadly in line with the Commission services' evaluation including the autumn 2004 forecast.

- To achieve the Bank of Latvia's price stability objective, from 1994 the currency (lats) was pegged to the SDR, with a normal fluctuation band around the central rate of ±1%. The Latvian authorities plan to join ERM II in early 2005 and aim for euro adoption at the earliest on 1 January 2008. On 1 January 2005, as a step in this strategy, the lats was re-pegged at market rates from the SDR to the euro, with a normal fluctuation band around the new central rate also of ±1%. Local currency interbank rates have fallen closer towards euro area levels following the re-pegging. The long-term bond yield vis-à-vis the euro area fluctuated during 2004 in the range of a premium of ½-1 percentage point. Up until 2003 HICP inflation was relatively low. In the course of 2004, however, HICP inflation accelerated substantially, peaking at 7.8% in August before easing slightly during the final quarter and averaging 6.2% for the year. The authorities consider inflation developments in 2004 to have been of a temporary nature; they expect CPI inflation to decline from 6.2% in 2004 to 3.0% in 2006.In 2005 inflation will continue to be influenced by increasing administratively regulated prices and indirect tax rate harmonisation measures. Nevertheless, due to favourable base effects, and provided that overheating is avoided, inflation should decrease gradually, though with the likelihood of slightly higher inflation than foreseen by the national authorities.

- The programme update aims at keeping the deficit below the 3% of GDP reference value in each programme year, with the general government budget deficit gradually falling from a programme estimate of 1.7% of GDP in 2004[4] to 1.4% of GDP in 2007. Reflecting the impact of EU transfers and associated spending, both expenditure and revenues are projected to peak in 2005, at 39.3% and 37.7% of GDP respectively, and thereafter gradually to decline to 36.5% and 35.1% of GDP respectively by 2007. The medium-term adjustment in public finances is based on a reduction of both the revenue and the expenditure ratios. The primary balance improves over the programme period, with the total expenditure ratio falling due to a decreased primary expenditure ratio and to some extent interest payments. The primary expenditure ratio falls mainly as a result of lower ratios of transfers and subsidies while at the same time allowing for an increase in the investment ratio. The revenue ratio falls as a consequence of tax reductions, mainly on income, lowering the tax burden moderately. While the overall strategy remained unaltered as compared with the May 2004 programme, the projected budget deficits have been revised downwards from around 2% of GDP each year in the former programme.

- The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, assumptions about the tax intensity of economic activity seem somewhat pessimistic, suggesting that revenues could be better than expected. Indeed, Latvia has established a track record of cautious forecasting, with repeated overshooting of fiscal targets over the past few years. Furthermore, as regards budgetary control, a special procedure exists which could facilitate relatively rapid in-year adjustment in the event of

[4] More recent information for central government cash accounts suggests a lower estimate of the general government budget deficit.

budgetary developments going off-track On the other hand, given the commitment of expenditures predicated on support from EU funding, the achievement of the deficit targets is conditional on the receipt of such funds in government revenues. Tight expenditure discipline (including in managing partly EU-funded projects) might be difficult given weaknesses in administrative capacity.

- In the light of this risk assessment, the budgetary stance in the programme is insufficient to achieve the close-to-balance-or-surplus medium-term objective of the Stability and Growth Pact within the programme period. Furthermore, even though the programme outlines a relatively ambitious consolidation path, it may provide insufficient margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. However, it is sufficient to maintain the debt-to-GDP ratio at a very low level.

- The debt ratio is estimated at 14.2% of GDP in 2004, clearly well below the 60% of GDP Treaty reference value. The slight increase in the debt ratio over the programme period, to 15.0% of GDP in 2007, mainly results from persisting deficits, substantially offset by nominal GDP growth.

- The programme briefly reviews the government's structural reform programme which focuses on measures to improve the business environment, competitiveness and development of energy and communication sectors, the education and healthcare systems, on active labour market policies as well as the promotion of innovation and research. The programme also outlines measures to strengthen further the budget process through a multi-annual budgeting framework, and to increase the transparency and reliability of the nominal expenditure ceilings through systematic evaluation mechanisms. The reforms, most of which are already underway or concerning which legislation is being prepared, can reasonably be expected to improve the growth conditions of the Latvian economy: by raising productivity and strengthening incentives to work, facilitating job creation and discouraging tax evasion, as well as improving fiscal discipline both with line ministries and at local government level.

- Latvia appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, despite the projected budgetary costs of an ageing population. The relatively low debt ratio in Latvia, the pension reform measures enacted, including the introduction of the funded pillar, and the accumulation of assets in the funded pension scheme will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and the budgetary impact of the pension reform. Reforms in the field of health and long-term care could, however, involve higher expenditures. A risk to sustainability may emerge in the long run. Latvia's relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that may arise.

- Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines (BEPGs) in the area of public finances. Under the challenge to address the sizable current account deficit, Latvia was recommended to reduce the general government deficit in a credible and sustainable way within a multi-annual framework. In the light of the narrowing current account deficit foreseen in the programme, the lower than previously budgeted deficit in 2004 and the consolidation path foreseen in the update are in line with the recommendation in the BEPGs. However, this assessment is conditional on the favourable development of the external balance and is thus subject to further monitoring. Furthermore, as was pointed out

in the Council Opinion on the programme of last May, assessment of the appropriate fiscal position is also dependent on demand pressures in the economy, even if it is difficult to determine the country's position in the business cycle; the assessment is also therefore conditional on macroeconomic policy being appropriate to consolidating the moderation in inflation from its recent peak.

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Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated convergence programme of Latvia and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Latvia, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [8 March 2005] the Council examined the updated convergence programme of Latvia, which covers the period 2004 to 2007. The programme broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". However, the ESA95 classification of data on the composition of the general government revenue and expenditure needs to be improved. Accordingly, Latvia is invited to achieve compliance with the requirements of the code of conduct.

(2) The macroeconomic scenario underlying the programme envisages real GDP growth, estimated at 8.1% in 2004, remaining strong over the rest of the programme period, averaging 6.6% per year. On the basis of currently available information, this scenario seems to reflect plausible growth assumptions. The programme's projections for inflation appear slightly on the low side.

(3) The programme update aims at keeping the deficit below the 3% of GDP reference value in each programme year with the general government budget deficit gradually falling from an estimated 1.7% of GDP in 2004 to 1.4% of GDP in 2007. In 2005 both revenue and expenditure ratios increase sharply, linked to EU accession. Thereafter, the medium-term adjustment in public finances is based on a reduction of both the

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[5] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

revenue and the expenditure ratios. The primary expenditure ratio falls mainly through lower ratios of transfers and subsidies while at the same time allowing for an increase in the investment ratio. The revenue ratio falls through tax reductions, mainly on income, lowering the tax burden moderately.

(4) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, assumptions about the tax intensity of economic activity seem somewhat pessimistic, suggesting that revenues could be better than expected. On the other hand, given the commitment of expenditures predicated on EU funding, the achievement of the deficit targets is conditional on the receipt of such funds in government revenues. Tight expenditure discipline (including in managing partly EU-funded projects) might be difficult given weaknesses in administrative capacity.

(5) In view of this risk assessment, the budgetary stance in the programme is insufficient to achieve the close to balance or surplus medium-term objective of the Stability and Growth Pact within the programme period. Furthermore, it may provide insufficient margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. However, it is sufficient to maintain the debt-to-GDP ratio at a very low level.

(6) The debt ratio is estimated at 14.2% of GDP in 2004, well below the 60% of GDP Treaty reference value. The slight increase in the debt ratio over the programme period, to 15.0% of GDP in 2007, mainly results from persisting deficits, substantially offset by nominal GDP growth.

(7) The budgetary strategy outlined in the programme puts Latvia in a relatively favourable position with regard to long-term sustainability of the public finances, despite the projected budgetary costs of an ageing population. The relatively low debt ratio, the pension reform measures enacted, including the introduction of the funded pillar, and the accumulation of assets in the funded pension scheme will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and on the budgetary impact of the pension reform. Reforms in the field of health and long-term care could, however, involve higher expenditures. A risk to sustainability may emerge in the long run. Latvia's relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that may arise.

(8) The economic policies outlined in the programme are broadly consistent with the country-specific broad economic policy guidelines (BEPGs) in the area of public finances. Under the challenge to address the sizable current account deficit, Latvia was recommended to reduce the general government deficit in a credible and sustainable way within a multi-annual framework. In the light of the narrowing current account deficit foreseen in the programme, the lower-than-projected budget deficit in 2004 and the consolidation path foreseen in the update are in line with the recommendation of the BEPGs. However, this assessment is conditional on the favourable development of the external balance and is thus subject to further monitoring. Furthermore, as was pointed out in the Council Opinion on the programme of last May, assessment of the appropriate fiscal position is also dependent on demand pressures in the economy, even if it is difficult to determine the country's position in the business cycle; the assessment is also therefore conditional on macroeconomic policy being appropriate to consolidating the moderation in inflation from its recent peak.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP Dec 2004**	**8.1**	**6.7**	**6.5**	**6.5**
	COM Oct 2004	7.5	6.7	6.7	n.a.
	CP May 2004	*6.7*	*6.7*	*6.5*	*6.5*
CPI inflation[1] (%)	**CP Dec 2004**	**6.2**	**4.3**	**3.0**	**3.0**
	COM Oct 2004	6.8	4.7	3.5	n.a.
	CP May 2004	*4.5*	*3.7*	*3.0*	*3.0*
General government balance (% of GDP)	**CP Dec 2004**	**-1.7**	**-1.6**	**-1.5**	**-1.4**
	COM Oct 2004	-2.0	-2.8	-2.9	n.a.
	CP May 2004	*-2.1*	*-2.2*	*-2.0*	*-2.0*
Primary balance (% of GDP)	**CP Dec 2004**	**-0.9**	**-0.9**	**-0.8**	**-0.7**
	COM Oct 2004	-1.2	-2.0	-2.0	n.a.
	CP May 2004	*-1.2*	*-1.3*	*-1.2*	*-1.2*
Government gross debt (% of GDP)	**CP Dec 2004**	**14.2**	**14.5**	**14.8**	**15.0**
	COM Oct 2004	14.6	15.4	16.6	n.a.
	CP May 2004	*16.2*	*16.8*	*17.3*	*17.7*

Note:
[1] The programme presents only CPI inflation projections and not HICP.
[2] Commission services calculations on the basis of the information in the programme.
Sources:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations.