Ministry of Finance of the Republic of Latvia

Convergence Programme of the Republic of Latvia

2005-2008

November 2005

Contents

1. Overall Policy Framework and Objectives

Latvia's Convergence Programme clearly reflects the objective of Latvian government to ensure compliance of the fiscal policy with the Stability and Growth Pact and to become a full-fledged Member State of the European Economic and Monetary Union.

The goal of the government's economic strategy is to ensure an improvement of the welfare of population by achieving convergence with the average EU level within a foreseeable period.

In order to attain the above, Latvia needs to preserve high and sustainable economic growth. The key economic policy areas to achieve these objectives are:

- ensuring macroeconomic stability;
- creation of a favourable environment for business and functioning of the economy;
- stimulating creation of an effective and competitive sectoral structure;
- diminishing social and economic disparities and ensuring sustainable development.

One of significant government's instruments for ensuring economic development is implementation of a sound fiscal policy. The Cabinet of Ministers has undertaken to review the national fiscal and budget policy framework, ensuring efficient and transparent spending of the government budget. In order to achieve spending efficiency, the adequacy of the existing resources to meet the operational priorities set by the government is analysed, previous spending is evaluated and efficient use of the budgetary resources is ensured.

The Declaration of the prospective operation of the Cabinet of Ministers defines the following fiscal policy objectives to be implemented in the medium-term:

- implement a fiscal policy aimed at stable macroeconomic growth and low inflation. Ensure gradual improvement of the fiscal outlook in the years to follow;
- consistently ensure implementation of the Maastricht criteria in Latvia;
- introduce medium-term (3–5 years) budgeting. In order to ensure targeted development and efficient spending of the government budget, introduce strategic planning in ministries and base budget formulation on financing of action policy objectives and results in line with this planning;
- implement clear and understandable tax policy and reduce the overall tax burden on the employed by raising the level of income exempt from the personal income tax and tax relief for dependants, at the same time improving tax collection;
- in cooperation with the Bank of Latvia, ensure successful Latvia's integration into the euro area.

2. Economic Outlook

2.1. Current Economic Development

Latvia displays constantly accelerating economic growth rates. During the last five years, the annual economic growth averaged 7.5 percent, amounting to 8.5 percent in 2004.

The year 2004 was marked by a rapid rise in economic activity relating to Latvia's accession to the European Union and the expected further investment-friendly macroeconomic development and stability. High private consumption was still determined by the rapidly growing income of population as well as improved lending opportunities. Investment growth was also affected by the monetary environment favourable for taking loans. Moreover, there were also significant foreign direct investment inflows in the economy. Several supply side factors in combination with sustainable domestic demand underpinned increase of the inflation rate. Domestic demand for consumer and investment goods was supported also by higher import growth. Although 2004 was marked by high export growth, Latvia's balance of foreign trade and current account of the balance of payments deteriorated.

In the first half of 2005, Latvia's real gross domestic product (GDP) increased by 9.3% year-on-year. In the first quarter, the GDP grew by 7.3%, whereas in the second quarter by 11.4%, which is historically the highest growth figure. The economic growth in the first half of 2005 was determined by the persistently high domestic demand as well as an improvement in the balance of foreign trade. The high GDP growth in the second quarter was the result of a decline in the imports of goods and accelerated growth in other sectors.

The rise of the **private consumption** is supported by both improvement of employment and increasing real income as well as low interest rates. In 2004, with the inflation growing fast, the real income of population remained lower than productivity growth, whereas this year shows a high increase of nominal wages and salaries which offsets the delay in the growth of real wages and salaries caused by inflation.

The real growth of **investment** in 2004 by 23.8% was determined by several one-off events, including those relating to the accession to the European Union, as well as active construction, real estate market development and corporate investment in production capital. This year, many trends from the previous year continue, but a lower growth of the investment volume (16.8% in the first half of the year) is the result of climbing investment prices. Improvement of welfare and low interest rates are supportive for an increase in the number of housing market deals and construction of new residential buildings.

In the first half of 2005, the growth rates of **exports** exceeded those of **imports**. Exports were still dominated by wood and articles of wood, base metals and articles of base metals, mineral products. The rise in the exports of food industry (by 58.6%), machinery and electric appliances (by 43.2%) and base metals and articles of base metals (by 42.4%) was especially high. In the first half of 2005, imports of machinery and mechanical appliances, electrical equipment continued to be strong, whereas the significant rise in imports of mineral products by 80.6% was primarily driven by a global increase in energy prices.

The robust export growth rates in the first half of 2005 reduced Latvia's trade deficit and the **current account deficit** of the balance of payments declined to 10.8% of GDP (13% of GDP in 2004). The improvement of the current account was supported also by the shrinking of the income account deficit due to rapidly growing wages and salaries of those employed abroad. Although the growth of foreign direct investment reached an all-time-high in the first quarter of 2005, overall in the first half of 2005 direct investment decreased as compared to the respective period of 2004.

Analysing the increase of value added **by areas of activity**, all economic sectors demonstrate balanced growth. Construction sector reported very high growth rates in the last years. In the first half of 2005, the volume of construction increased by 16% due to intensive construction of infrastructure objects, sports centres, residential buildings and production premises. High consumption of the population promotes the development of the services sector, and the retail trade and wholesale sector continues to report persistently high growth rates (a 17.1% increase in the first half of 2005). Transport sector growth is affected by a rise in passenger and freight turnover, whereas communications sector is supported by new communication operators entering the market, tightened competition and reduced tariffs. Thus, transport and communications sector picked up by 15.2% in the first half of 2005. Better international recognition of Latvia and affordable air traffic opportunities underpinned a rapid increase in the number of foreign tourists, and the value added of the hotels and restaurants grew by 13% in the first half of 2005. Expansion of financial intermediation and business services by 8.3% and 6.5%, respectively, was facilitated by the high activity of the business environment and real estate market as well as the continuing rapid lending development. Lower growth was experienced in industry, partly as a result of the adverse impact of the January 2005 storm on forestry and related sectors.

Labour market continued to develop along positive trends in the first half of 2005, with the employed population increasing by 1% year-on-year and the share of job-seekers (unemployment according to the ILO definition) declining to 9.2% of the economically active population at the end of the second quarter. The number of employed decreased in several production sectors, while rapidly increasing in the services sectors. Significant disparities in employment level among Latvia's rural districts and towns remain a negative sign. Thus, at the end of the second quarter of 2005 the number of unemployed registered by the State Employment Agency in Riga stood at 4.4% of the economically active population, whereas in some districts of East Latvia it exceeded 20%. Nevertheless, the results of continuous labour survey reveal that the rate of job-seekers is higher in urban areas than in rural areas (10.0% and 7.4%, respectively). This can be partly explained by fact that the category of employed persons includes persons for whom a significant source of income is work in home garden or personal farm, producing for exclusively individual consumption. Although the rate of job-seekers has reached a historical low (9.2%), it has to be taken into account that 5.7% of the economically inactive population are potential job-seekers that have lost any hope of finding a job or do not know where and how to look for it.

In the first half of 2005, average **gross monthly wage and salary** of those employed in the economy grew by 16.5%, totalling 235 lats. Such a rise in wages and salaries related to both climbing consumer prices as well as the overall economic development. The high growth of the nominal wages and salaries notwithstanding, the rise of the real wages and salaries by 9.3% exceeded that of the **productivity** by a mere 8.3%.

2.2. Macroeconomic scenario

Macroeconomic development scenario envisages solid and high economic growth in the medium-term. The forecasts are based on the assumption that the favourable development trends observed this year will persist also in the nearest future. Expected real GDP growth in 2005 is 8.4%, whereas in 2006 it reaches 7.5%. In the medium-term, the GDP growth is forecast at the level of that of long-term potential output (7% per annum).

Table 1. Growth and related factors

	ESA code	2004	2004	2005	2006	2007	2008
		millions of lats	rate of change (%)				
1. Real GDP (at 2000 prices)	B1*g	6269.1	8.5	8.4	7.5	7.0	7.0
2. Nominal GDP	B1*g	7345.8	16.3	16.2	13.8	11.8	11.0
Components of real GDP							
3. Private consumption expenditure	P3	4024.0	9.3	8.5	8.0	7.5	7.0
4. Public consumption expenditure	P3	1075.7	2.1	2.4	2.4	2.4	2.0
5. Gross fixed capital formation	P51	2017.0	23.8	14.7	9.5	9.0	9.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	252.0	5.4	3.2	1.9	1.1	0.8
7. Exports	P6	2553.9	9.4	18.6	14.3	10.5	8.5
8. Imports	P7	3653.5	16.6	11.4	10.2	8.8	8.0
Contribution to real GDP growth							
9. Final domestic demand		-	13.0	10.6	8.8	8.3	8.0
10. Changes in inventories and net acquisition of valuables	P52+P53	-	0.7	3.2	1.5	0.9	0.1
11. External balance of goods and services	B11	-	-5.2	0.9	0.3	-0.4	-0.9

2.2.1. Real sector

In the medium-term, the economic growth of the European Union will have a favourable effect on Latvia's export sector, whereas high domestic demand will be ensured by growing investment and private consumption. The global economic development trends will remain positive, although several risks relating to the global prices on energy and potential disease pandemics threats persist.

GDP by expenditure

Private consumption will remain one of the key drivers of the economic development also in the medium-term, and its growth rate will be on the level of the GDP growth. Stable and high private consumption will be determined by employment growth and rising wages and salaries. The growth of the real wages and salaries will be in line with the productivity increase, but, considering the expected high productivity growth, the rise in the real income of population will be comparatively high. Monetary aggregates will remain favourable for both consumption and investment in the nearest years, which does not support accumulation of savings.

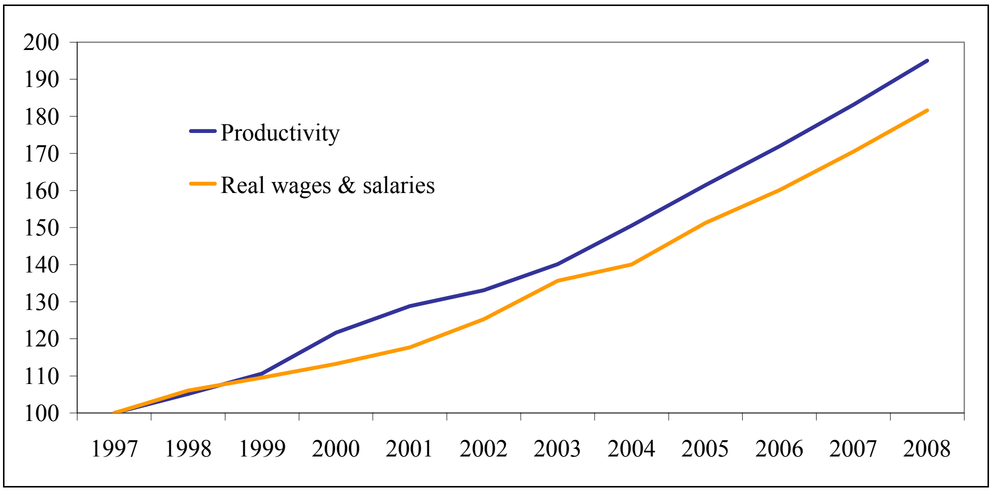


Chart 1. Increase of productivity and real wages and salaries, 1997=100

The real growth of **public consumption** will be approximately 2% in the medium-term. Such a modest growth will be primarily determined by a limited expansion of the existing and new functions of the public sector.

In the medium-term, the growth of GDP will be significantly affected by expanding **gross fixed capital formation**. Macroeconomic development scenario provides that investment growth will be faster than that of the GDP. Investment-friendly environment will be the result of dynamic economic development promising high return on investment, as well as stable and predictable macro-economic outlook. High level of investment will be also determined by the need to replace the existing fixed assets by new and much better quality ones as well as the need to raise the production capacity in line with the demand. Support from the European Union funds will promote infrastructural development and make sectors like agriculture more attractive to business.

Macroeconomic development scenario envisages constant growth of the foreign trade turnover. It is expected that the trends observed in 2005 will continue in the medium-term and the growth rate of **exports** will exceed that of the **imports**. The trade deficit of goods will decrease gradually, as an increase in the share of high value added goods in exports is expected, although the growth rates of imports of intermediate consumption goods will also remain high. The growth of real wages and salaries in line with that of the productivity, persistently high imports of capital investment as well as the national policy aimed at promotion of exports will have a favourable effect on competitiveness of the external sector. The services surplus has a tendency to shrink, as a result of increasingly higher number of foreign trips made by Latvia's residents. This tendency could persist also in the medium-term, although the number of tourists coming to Latvia will also grow at the same rapid rate, potentially encouraged by several events, like organising 2006 World Hockey Championships in Latvia.

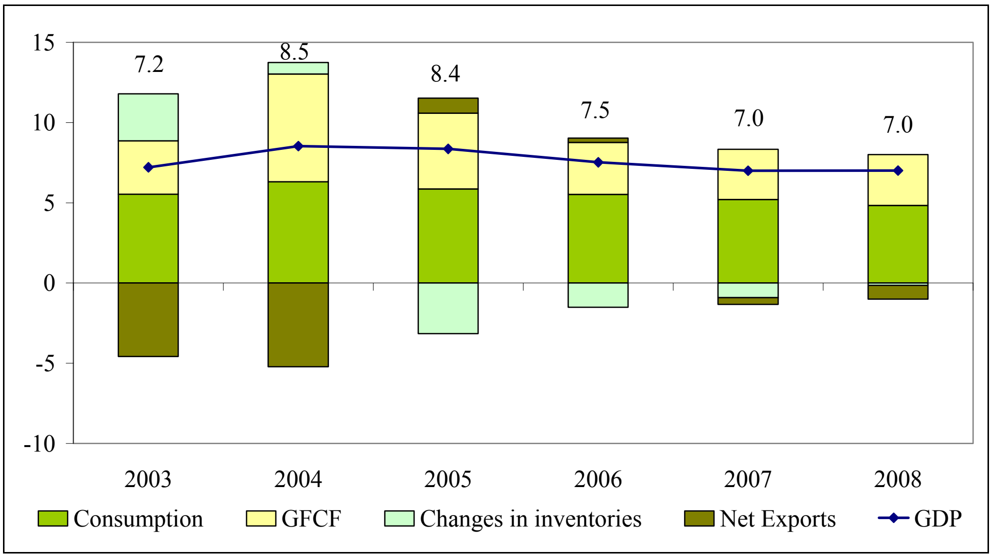


Chart 2. Contribution to GDP growth, %

GDP by sector

Industry accounts for a significant share of the foreign trade. Regardless of the comparatively sluggish economic recovery of the EU countries and various unexpected events experienced in the previous years, industry has preserved its competitiveness and relatively high growth rates. In the medium-term, the annual growth rate of the sector will be 7.8%, facilitated by further investment in production modernisation, including through attracting the EU funding, more favourable EU growth trends as well as economic policy measures aimed at developing business capacity, production of higher value added products and promotion of innovations.

During the last years, especially high growth rates were observed in **construction,** and it can be expected that it will remain one of the most dynamic sectors also in the medium-term. The development of the sector is determined by a high demand for construction of infrastructure objects, production and residential buildings. The high external competitiveness of the sector will promote also the exports of services.

Participation in the single EU market facilitates the development of **agriculture** significantly. The income of the sector will be notably increased by convergence of prices on agricultural products and higher productivity. Support from the EU funds will also improve the rural infrastructure and assist in production modernisation. More moderate growth of the sector will be determined by slower growth in forestry, as the optimum volume of timber cutting has been almost reached and further development of the sector will be driven by increasing efficiency.

It can be expected that ***private services*** will be one of the fastest growing sectors in the medium-term. An increase in the share of private services in the structure of GDP can be also anticipated. The development of private services will depend on the development of various services sectors.

Regardless of various past factors impeding growth, transport and communications sector has managed to preserve high growth rates. The year 2005 is marked by especially tight competition in communications services as a result of new mobile operators entering the market. Therefore, it can be expected that prices will decline and the range of provided services will expand in the medium-term. Transport sector also holds many unused opportunities, and further infrastructural development and diversification of services will support an increase in both freight and passenger transportation volumes. Sectoral development will be fostered by both growing foreign trade of Latvia as well as development of exports to the CIS countries and global trade.

Dynamic growth rates can be expected in business and financial services, with the overall economic and real estate market activity remaining high. There is a growth potential also in tourism.

Stable and high private consumption will also foster further development of the trade sector; nevertheless, the growth rates will decelerate with the market becoming more saturated.

Comparatively low real growth at about 3.0% per annum is forecast in ***public services***.

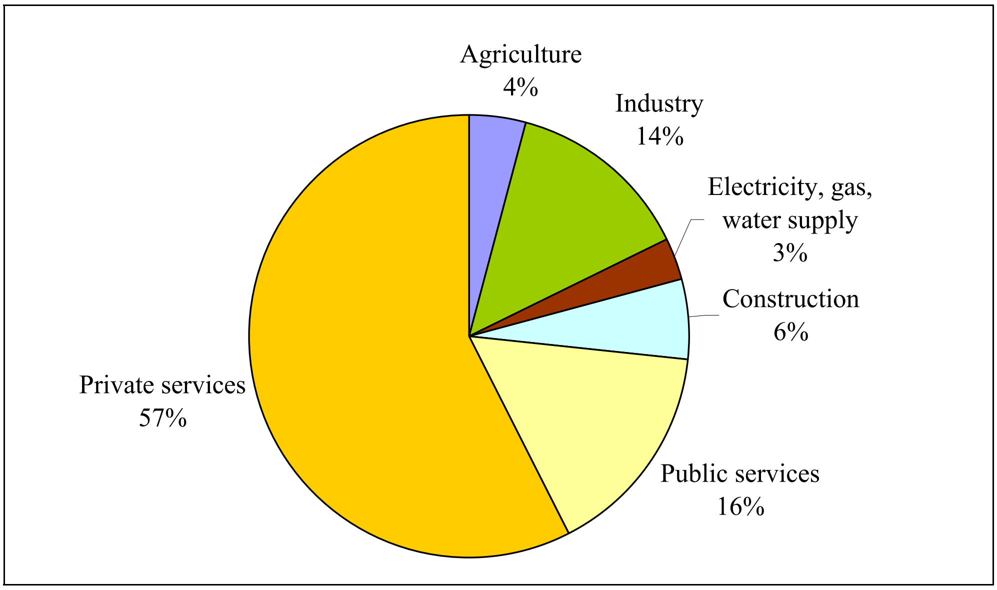


Chart 3. GDP by sector in 2004, %

Employment

Demographic situation in Latvia is aggravated primarily by the low birth rates and comparatively high death rates. In 2004, population decreased by 0.55% year-on-year. As a result of natural movement, population declined by 11.7 thousand, with emigration exceeding immigration by 1.1 thousand persons.

Analysing the demographic trends, relatively stable growth of the economically active population can be predicted in the programming period. Moreover, in this period large cohorts of young, well-educated people born in 1980s will join the labour market. The number of economically active population will be increased also by raising the retirement age for female.

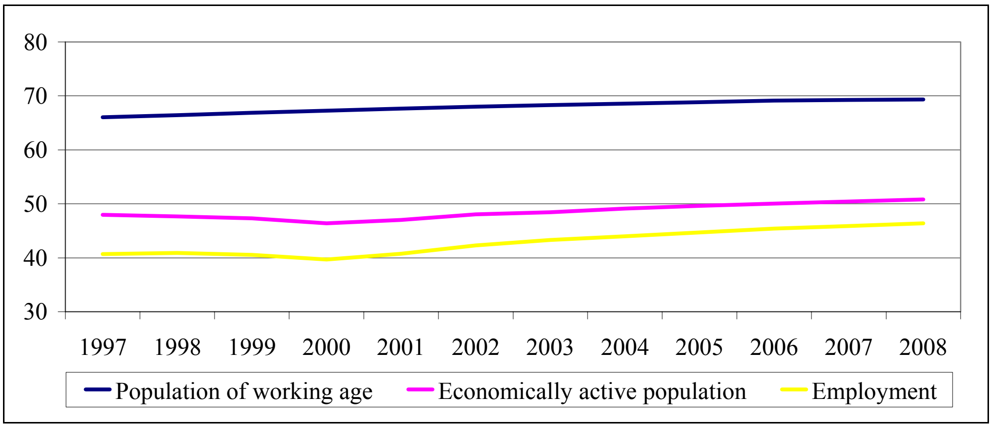


Chart 4. The ratio of working-age, economically active and employed population to total population, %

Currently, the labour market development is characterised by several positive trends (growing economic activity and employment, decreasing unemployment).

Macroeconomic development scenario envisages a gradual decline in level of job-seekers (unemployment according to the ILO definition) to 8.7% in 2008 and stable growth of employment in the medium-term. Moreover, the tendency for the officially registered unemployment to converge with the number of job-seekers will persist.

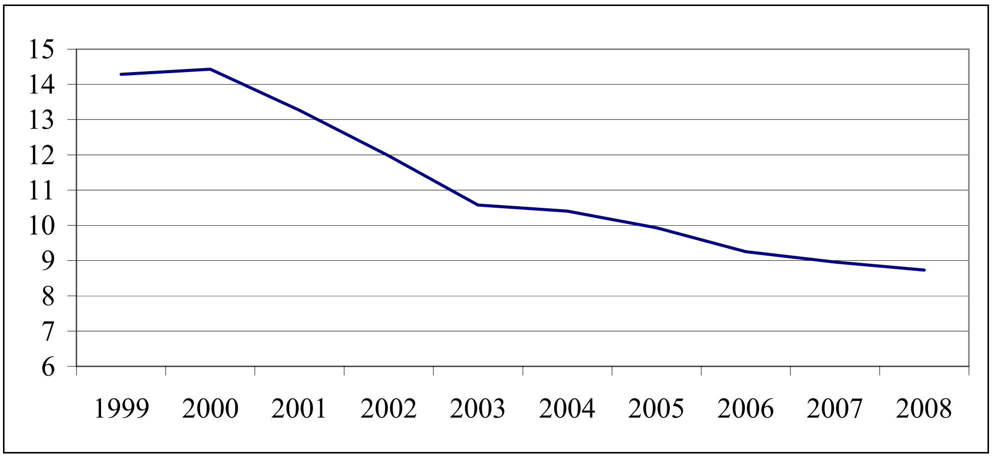


Chart 5. Job-seekers, % of economically active population

Due to rapid economic growth, employment rate in Latvia increases year-by-year and reached 62.3% in 2004. As compared to 2000, employment rate has grown by almost 5 percentage points. Latvia's national Lisbon Programme 2005–2008 features an objective to increase the employment rate to 65%.

Table 2. Employment rate (%)

	2000	2001	2002	2003	2004	2008*
Employment rate (15–64)	57.5	58.6	60.4	61.8	62.3	65.0
Employment rate for female (15–64)	53.8	55.7	56.8	57.9	58.4	61.0
Employment rate for senior people (55–64)	36.0	36.9	41.7	44.1	48.0	49.0

**Target set in Latvia's national Lisbon Programme 2005 –2008*

The main problems of Latvia's labour market, which impede a more rapid improvement of the situation, relate to pronounced regional disparities concerning employment and unemployment, i.e. a high unemployment rate in districts further from Riga, and at the same time shortage of qualified labour in Riga. Increased unemployment rates characteristic of young people, persons after childcare leave, persons with poor knowledge of Latvian and other socially marginalised risk groups is another topical problem of Latvia's labour market. Problems relate also to a relatively high level of unregistered employment in some economic sectors, diminishing the size of social security benefits and preventing from reduction of tax burden which has an especially adverse impact on low-income population. Qualifications of some labour force groups also do not meet the requirements of the labour market.

Latvia's employment policy measures and priorities to address the problems of Latvia's labour market are as follows[1]:

- promote economic activity in the least developed regions and more intensively address the issue of undeclared employment by improving business environment, promoting business start-ups, providing state aid, in order to mitigate regional disparities;
- increase net wages and salaries for low-income employees by raising the minimum wage and reducing the tax burden on low wages and salaries, in order to stimulate the population to operate within the framework of a formal economy and integrate themselves into the labour market;
- improvement and harmonisation of the performance of the State Employment Service, in order to improve the quality of the delivered active employment measures by expanding their range and to improve labour market competitiveness of unemployed, especially the set target groups;
- provide more education and training opportunities, especially to persons with low qualifications, as well as develop life-long education, at the same time improving the quality of education and developing vocational orientation measures.

The national economic growth and ongoing regional, labour market and other reforms, including the ones financed from the EU structural funds assistance, will enable gradual solving of the existing labour market problems.

2.2.2. Inflation

In the first nine months of 2005, inflation remained comparatively high. On average, the level of consumer prices was 6.5% higher than in the first nine months of 2004. The growth rates of prices in the given period remained on the level of the previous year, increasing by 5.9% from the beginning of the year, which is only 0.1 percentage point less than in the respective period of the previous year. Although the first half of the year was marked by a slight decrease of inflation caused by comparatively smaller changes in indirect taxes and administered prices as compared to the respective period of 2004, rapid boost of oil prices on the global market underpinned a further increase of inflation in the third quarter.

The rather high inflation rate was still primarily determined by the supply side factors, which can be seen from the decline of the core inflation from 7.4% in November 2004 to 4.9% in July 2005, whereas in August and September it reached 5.1% and 5.6%, respectively, mainly as a result of rising prices on clothing and footwear, catering services, solid fuel and higher education services. Contribution of the core inflation to the average inflation of the first nine months of 2005 amounted to 4.0 percentage points, and its growth rate in the respective period is still an average of 5.4% lower than the overall inflation growth. Nevertheless, it has to be noted that core inflation largely reflects also expenditure

[1] Measures and priorities have been described in Latvia's national Lisbon Programme 2005–2008.

components, e.g. processed food where the price rise is notably affected by climbing energy prices, convergence of prices on agricultural products within the region; public catering where the price rise can be explained by higher prices on food or transport services where the price increase is largely driven by the rise in fuel prices. Overall, the increase of prices on processed and unprocessed food constitutes 40% of the total inflation.

The increase in fuel prices amounted to 1.1 percentage points or one sixth of the total average inflation in the given period, including the global oil price developments, as well as review of tax rates in line with appreciation of the euro at the end of 2004 (the value of excise tax amounted to 35% of the total price of fuel). The impact of administered prices was relatively lower than in 2004, i.e. 0.7 percentage point or 0.3 percentage point lower and amounted to 10.8% of the total inflation. It included significant changes in the prices of relatively small groups of consumer goods, e.g. in January, rent of residential premises increased in line with amendments to the law “On Rent of Residential Premises”; in April, patient fees were increased based on the new Cabinet of Ministers regulations “Procedure for Organising and Financing Healthcare”, whereas in August the natural gas tariffs were raised due to the price rise on behalf of suppliers (“Gazprom”), reacting to global market developments, which had only a slight direct impact on inflation (share in consumer basket amounted to 0.57%). Due to higher energy prices as well as unfavourable weather conditions during harvesting, the contribution of unprocessed food in total inflation has grown to 0.8 percentage point, comparing to 0.5 percentage point in 2004 overall.

2005 inflation was affected also by the euro appreciation effects prior to the lats repegging from the SDR to the euro, which can partly explain the difference from inflation rates in other new member states with a similar exchange rate mechanism.

With the economy developing buoyantly and the general level of income rising, the increase of consumer prices gradually starts to be affected also by the demand side factors. Evaluation of inflation developments in some groups of goods and services reveals that the prices of some services where the demand side factors play a relatively larger role have also grown. For example, financial, personal care, tourism, recreation and cultural services as well as goods and services relating to housing improvement and maintenance, except household equipment, have grown significantly this year, pushing the average nine months inflation up by 0.9 percentage point. Nevertheless, it has to be noted that the growing demand in some groups of goods relates with the significant increase in the number of tourists coming to Latvia. The increase of service prices can be also partly explained by the cost factors.

It can be expected that the average inflation will reach 6.8% in 2005 and in the next years will gradually decline to 3.5% in 2008. The decrease will be underpinned by several factors: a slower growth of oil prices in the next years, convergence of food prices with the level of other countries of the region, waning of the delayed effects of the 2004 euro appreciation and expected gradual deceleration of the growth rate of unit labour costs as compared to the high growth rate of this year. Inflation rate will be additionally reduced by growing competition, promoted by tighter national competition and business development policies and the effects of the EU single market. Nevertheless, a certain inflation inertia will be determined by the robust domestic demand and inflation expectations which rose shortly before Latvia's accession to the EU and at the moment have declined only slightly. Moreover, the increase of administered prices will have a significant effect on the inflation of the next years. For example, the expected effect from raising gas tariffs (both direct and indirect) will increase the 2006 inflation by 0.7 percentage point and the 2007 inflation by 0.6 percentage point. Ongoing harmonisation of indirect taxes will also exert an upward pressure on inflation in the years to come. It has to be noted that inflation forecasts are based on approved and politically prescribed economic, fiscal and monetary policy plans; therefore, they do not reflect the potential additional measures to reduce inflation taken in the future.

As regards the trend for the harmonised index of consumer prices (HICP), it can be expected that in 2005 the HICP will reach 6.9%, and in the period from 2006 to 2008 will develop identically to the national CPI. The difference in the amount of 0.1 percentage point in 2005 is primarily caused by the difference in shares of transport, catering and hotels services in the national and harmonised consumer price index baskets.

Table 3. Changes in consumer prices

	2004	2005	2006	2007	2008
	actual	forecast			
HICP changes (year-on-year)	6.2	6.9	5.6	4.3	3.5
CPI changes (year-on-year)	6.2	6.8	5.6	4.3	3.5

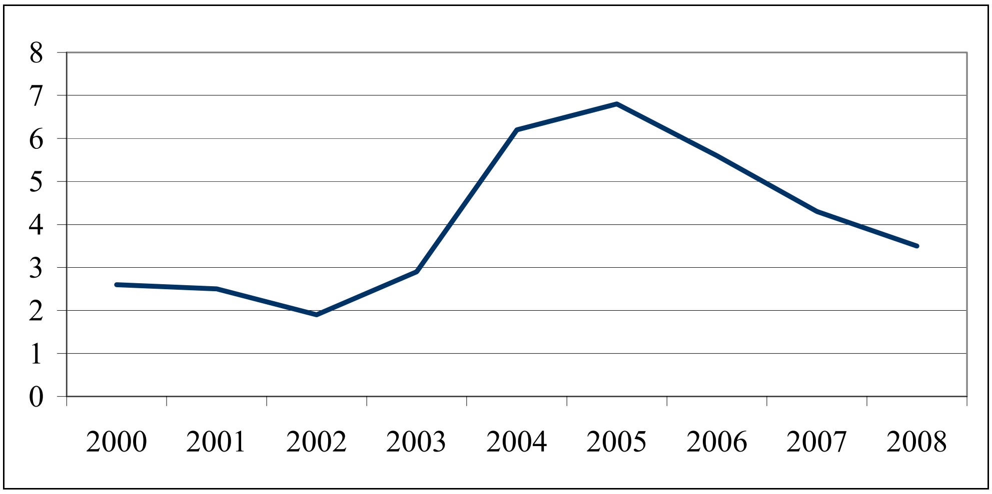


Chart 6. Consumer price index developments in 2000 –2008, %

2.2.3. Monetary and Exchange Rate Policy

Latvia's medium-term monetary and exchange rate policy largely relates to the monetary integration plans. The status of the new Member States provides that until adoption of the euro they have to implement such an exchange rate strategy that is in line with the interests of all the European Union Member States. Latvia repegged the lats from the SDR currency basket to the euro on 1 January 2005. The lats were pegged to the euro (1 EUR = 0.702804 LVL) based on the euro reference rates established by the European Central Bank on December 30, 2004, SDR currency basket formula and the previous lats peg to the SDR basket, setting an exchange rate fluctuation band at +/-1% of the peg rate. The exchange rate was repegged without any turbulence on the foreign exchange market. Latvia joined the Exchange Rate Mechanism II on May 2, 2005, undertaking a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity rate within the framework of the ERM II.

Fixed exchange rate as well as the repeg of the currency is justified not only by Latvia's movement towards participation in the European Monetary Union, but also from the point of view of the main objective of the Bank of Latvia, i.e. ensuring price stability, as, considering the small size and high degree of openness of Latvia's economy, the exchange rate channel plays a significant role in price-setting and, therefore, a fixed exchange rate policy is well-suited for Latvia's economy. Moreover, the European Union is the main trade partner of Latvia and the euro is the most significant currency in foreign trade settlements in Latvia. The role of the euro in Latvia's financial system has also grown considerably in the last years.

In order to implement the monetary policy effectively and without shocks to the financial sector, the Bank of Latvia adjusts monetary policy implementation instruments to the European Central Bank practice. Currently, the Bank of Latvia already uses the same indirect monetary policy instruments based on free market principles as the ECB and in the future, when joining the EMU, only the significance of some instruments in implementation of the monetary policy and procedural elements will have to be reviewed.

Duration of participation in the ERM II will depend on the ability of Latvian economy to meet the convergence criteria and the evaluation of the involved institutions of Latvia's readiness to join the EMU. The target of Latvia's government to join the EMU in 2008 remains unchanged. In order to mitigate macroeconomic risks relating to the rapid economic growth of Latvia, the Bank of Latvia has used its monetary policy instruments on several occasions: In 2004, the refinancing rate was raised from 3.0% to 4.0% (with repegging of the lats to the euro, the effectiveness of interest rate instruments in Latvia has diminished), whereas the minimum reserve ratio for the banks was raised from 3.0% to 4.0% in 2004, and in August 2005 from 4.0% to 6.0%.

2.2.4. External sector

Table 4. Key items of the balance of payments (% of GDP)

	2002	2003	2004	2005	2006	2007	2008
Current account	-6.7	-8.2	-13.0	-10.0	-8.9	-8.1	-8.0
Direct investment	2.7	2.3	4.4	3.7	3.8	3.9	4.1
Changes in reserve assets*	0.0	-0.6	-2.9	-3.1	-2.2	-1.7	-1.6
Changes in other assets:							
Net portfolio and other investment (including statistical discrepancy)	4.0	6.5	11.5	9.4	7.3	5.9	5.5

** A minus sign points to an increase in reserve assets*

The deficit of the current account of the balance of payments is rather high in Latvia, which is determined by economic restructuring and technology modernisation needs. Although the level of savings has a tendency to grow gradually, investment growth is much more rapid.

In 2004, the current account deficit reached 13.0% of GDP, and its growth was largely determined by the significant imports of goods at the beginning of the year, promoted by price increase expectations for some groups of goods following the EU accession as well as implementation of several one-off large investment projects which pushed the imports of capital goods up notably. In the first half of 2005, with the effect of the above-mentioned one-off measures fading, the current account deficit shrank to 10.8% of GDP. Similarly as in the previous years, the current account deficit was determined by the negative trade balance; nevertheless, this year the trend that started in 2004 for the exports of goods growth rate to exceed that of the imports continued. Increasingly improving access to the EU countries' markets (especially new Member States after the EU enlargement) as well as return on investment made in the previous years in the exporting sectors largely supported acceleration of the exports of goods growth rates, reaching 34.3% in the nominal and 22.3% in the real terms in the first eight months of 2005 in comparison with the respective period of 2004. At the same time, imports of goods reached 25.3% in the nominal and 10.5% in the real terms.

The trade balance of services is positive in Latvia and partly offsets the negative trade balance of goods. According to preliminary data, exports grew by 23.6% in the first eight months of 2005, whereas the growth rate of imports was much higher at 41.7%. Shrinking of the positive services balance was determined by increasing negative balance of both individual and business trips and a decline in the positive balance of other services. The surplus of transportation services increased. It can be expected that the balance of services will improve moderately in the years to come, due to positive trends in several groups of services: renewal of Latvia's shipping fleet, rapid development of car transportation and the already observed increase in the number of tourists as well as significant investment in tourism.

In the first half of 2005, the income deficit shrank, with the amount of residents' wages and salaries gained abroad going up. The surplus of current transfers continued to rise due to availability of the EU funding and an increase in transfers received by the private sector.

The financing structure of the current account deficit points to foreign investors' confidence in further economic growth and government policy implemented in Latvia. Rapid economic growth, accession to the EU and favourable geographical position facilitated foreign direct investment inflows into Latvia. In 2004, net foreign direct inflows totalled 4.4% of GDP. In the first six months of 2005, FDI inflows decreased to 3.5% of GDP; nevertheless, the reduction was largely determined by one-off factors like repayment of dividends accumulated in course of several years to some large foreign direct investors, resulting in the amount of reinvested earnings shrinking in the second quarter of 2005. Overall, the share of the long-term capital in financing of the current account deficit has grown significantly in the last years, and in the first six months of 2005 net FDI and long-term capital inflows, primarily in the form of bank borrowing from parent banks abroad, covered the current account deficit fully. The capital account surplus also has a tendency to grow in course of time, which can be explained by the inflows of the EU funding in Latvia.

It can be expected that the current account deficit of the balance of payments could reach 10.0% of GDP this year and gradually decline to 8.0% in 2008, due to the expected gradual deceleration of domestic demand growth rates and positive contribution of net exports to growth, with the growth rates of exports remaining higher than those of the imports in the years to follow. Nevertheless, overall the current account deficit will remain high in the medium-term driven by several factors. Firstly, foreign capital inflows into Latvia will be comparatively high in the next years, supported by both FDI and foreign financing attracted by the banking sector, and inflows from the EU funds, which will not enable to domestic demand growth rates to decelerate significantly. Secondly, the expected buoyant growth of exports will underpin also a rapid rise in the imports of intermediate consumption goods, and, looking from this aspect, fundamental changes can be expected only in the medium-term when the structure of exports changes notably, with the share of high value added goods expanding significantly.

3. General Government Balance and Debt

3.1. Fiscal Policy and General Government Balance

The fiscal policy implemented by the government is aimed at stable macroeconomic growth, ensuring gradual improvement of the fiscal outlook. A significant task of the government's fiscal policy is creating a balanced budget. It is forecast that the general government deficit will decrease gradually in the medium-term. For the purpose of successfully attaining the above objective, ministries introduce strategic planning, which will ensure that the budget is orientated towards financing of objectives and results.

The task of the government within the framework of the fiscal policy is to achieve a maximum balance between the amount and structure of the government's budgetary revenue and expenditure, favourable to economic development.

The main tasks of the fiscal policy implemented by the government are as follows:

- the budget expenditure policy must be aimed at economic development and addressing social problems;
- gradual reduction of the general government deficit;
- ensuring long-term sustainability of public finances.

The next year's budget is aimed at improvement of welfare of population, EU and NATO integration, effective spending of the granted EU funds in full amount, at the same time balancing the state aid to the social needs of the population. The most significant budgetary priority is the funds planned as the national co-financing for the EU funds as well as for ensuring the administrative capacity relating to the administrative, technical, financial management and control of the EU projects. Through efficient and effective spending of the EU funds' money, significant support to business development, improvement and development of national infrastructure will be provided.

2006 central government budget provided for additional financing for the following significant priorities and priority measures:

- 40.0 million lats for the programme "National defence, security and NATO integration";
- 33.1 million lats for raising the wages and salaries of teachers;
- 31.1 million lats for healthcare, including 8.3 million lats for compensation of medication, 5.1 million lats for elimination of waiting-lists and other measures;
- 30.8 million lats for the State Road Fund;
- 13 million lats for scientific development and ensuring competitiveness;
- 12 million lats for strengthening the system of interior affairs;
- 9.2 million lats for building the institutional capacity of public administration;
- 6.4 million lats for strengthening the judicial system;
- 5.6 million lats for raising the minimum wage from 80 to 90 lats starting from January 1, 2006;
- 3.3 million lats for increasing the childbirth benefit;

- 2.7 million lats for raising the average wage and salary of medical personnel.

The government considers that a significant pre-requisite of sustainable economic development and ensuring Latvia's competitiveness is improvement of the quality of education and science; therefore, 2006 budget provides a significant raise of teachers' wages and salaries, securing higher prestige for the profession and attracting young professionals, as well as large amount of support from the government is channelled to healthcare.

In 2006, the general government deficit is forecast at 1.5% of GDP. In the medium-term, a gradual decline of the general government deficit to 1.3% of GDP in 2008 is forecast. With a gradual shrinking of the budget deficit, it is forecast that it will amount to 1.0% of GDP in 2010.

Table 5. General government budget (millions of lats)

	2004	2005	2006	2007	2008
	actual	estimate	forecast		
Revenue	2588.3	3017.5	3505.7	4065.5	4509.7
Expenditure	2658.2	3141.3	3647.2	4212.1	4660.3
Balance	-69.9	-123.8	-141.5	-146.6	-150.6

In the previous years, the general government deficit was primarily dependent on the deficit in the central government budget. According to forecasts, in the medium-term the central government deficit will decline gradually from 2.2% of GDP in 2005 to 1.5% of GDP in 2008. A gradual reduction of the central government deficit is forecast because:

1) additional financing is required to implement the government programmes in the field of education and interior affairs as well as implementation of a socially responsible policy, in order to improve the life quality of Latvia's population;

2) considerable short-term funding is required in order to implement the reforms and public investment necessary to ensure the medium-term and long-term sustainability of the nation;

3) additional financing is required to ensure implementation of international agreements and the EU legislation as well as to build the administrative capacity in EU funds management;

4) it is necessary to ensure the national co-financing for drawing financing from the European Union funds, agricultural policy, rural development and European Community programmes and initiatives;

5) in the period of time up to 2008, expenditure in the amount of 2% of GDP has to be planned in the central government budget for national defence, security and NATO participation.

Latvia has prepared a **Development Plan** for attracting and spending the EU structural instruments funding (Single Programming Document), providing for an operational strategy and measures for spending the structural funds in Latvia. 2006 budget continues implementation of the priorities started in 2005 in compliance with the objectives set in the Development Plan (support to business development, public infrastructure development and improvement, environmental improvement, human resources development and promotion of employment, promotion of agricultural and rural development).

The financial position of the social security budget has improved significantly in the last years. If in 2002 this budget ran a surplus in the amount of 0.3% of GDP, in 2004 the surplus amounted already to 1.0% of GDP. In the medium-term, the social security budget will preserve a surplus; nevertheless, it will decline from 0.9% of GDP in 2005 to 0.4% of GDP in 2008. Shrinking of the surplus will be driven by a decrease in the size of social security contributions, as social security contributions to the funded pension scheme will grow. At the same time, several amendments to legislation were introduced in 2005, which will impact on the social security budget expenditure in the medium-term.

In line with amendments to the law "On State Social Security", a procedure for recalculating pensions was established concerning security contribution arrears accumulated in the period from January 1, 1991 to March 13, 2001. Based on a personal request, pensions are recalculated starting from April 1, 2005. For a person having accumulated a security period within the above-mentioned period of time but having no registered security contributions, these contributions are calculated from the minimum wage and salary set by the Cabinet of Ministers in the given period of time.

Taking into account the existing economic conditions in Latvia and the situation on the labour market, on June 9, 2005, the Parliament passed amendments to the law "On State Pensions" providing for an extension of the early retirement opportunity up to July 1, 2008. Consequently, a person with a security record of at least 30 years still has an opportunity to retire requesting an old-age pension two years prior to the retirement age stipulated in the law "On State Pensions".

On October 20, 2005, the Parliament passed amendments to the law "On State Pensions" which take effect on January 1, 2006.

<u>The most significant amendments to the law "On State Pensions":</u>

- **monthly additional payments to the old-age pension for those who have small pensions**, depending on the possibilities of the central government social security budget. Additional payments to the old-age pension will be granted to those pensioners whose pension is below 105 lats and whose total security record is at least 30 years. When estimating the size of additional payments, those years of the security record that have accumulated before December 31, 1995 will be taken into account. The average additional payment to the old-age pension could be about 6.63 lats in 2006. About 30 million lats will be required to pay the additional payments in 2006.
- **up to December 31, 2009**, state pensions below a three-fold state social security benefit will be reviewed on April 1 and October 1. When reviewing the pensions on April 1, the actual consume price index will be taken into account, while in October 1 – the actual consume price index and 50% of the real percentage increase of social contribution wage. Pensions over three-fold state social security benefit but below five-fold state social security benefit have will be reviewed annually, on October 1, based on the actual consumer price index;
- **from January 1, 2010 to December 31, 2014** all state pensions below three-fold state social security benefit have will be reviewed annually, on October 1, based on the actual consumer price index and 50% of the real percentage increase of social contribution wage. Pensions over three-fold state social security benefit but below five-fold state social security benefit have will be reviewed annually, on October 1, based on the actual consumer price index and 25% of the real percentage increase of social contribution wage.
- loss of supporter pension for each child will be set in the amount of at least 65% of the state social security benefit (45 lats in 2006, 35 lats in 2005), i.e. 29.25 lats (currently for each child it may not be below 50%, i.e. 17.50 lats);

- in case of any contributions made or having to be made after granting or recalculating the old-age, I, II category of disability pensions, starting from January 1, 2006, pensions may be recalculated regardless of the number of months that have been worked (currently at least 12 months), whereas starting from January 1, 2007, in cases when a person has worked after having been granted (recalculated) a pension and accumulated pension capital, he/ she may recalculate the pension once every year, regardless of the number of months that have been worked (currently once every three years).

In 2002, local government budget ran a deficit in the amount of 0.9% of GDP. In 2003, the financial discipline of the local governments improved significantly, and, as a result of that, the deficit declined to 0.1% of GDP. It forecast that a small deficit will persist in the local government budget also in the medium-term, as the local governments need to continue improvements of the local infrastructure, repairs of cultural and educational institutions, as well as ensure pre-financing for the EU funds financing. It has to be noted that the process of local government mergers has not been fully completed yet. If the local governments merge more intensively, creating local governments (territories) that are more capable of economic development and financially stronger, the financial development of the local governments could be even more successful in the years to come, as by forming larger local governments it is possible to use the existing financial resources more efficiently and attract additional resources.

Table 6. Development of the general government budget

	ESA code	**2004**	**2004**	**2005**	**2006**	**2007**	**2008**
		millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
2. Central government	S.1311	-140.3	-1.9	-2.2	-2.2	-1.8	-1.5
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-6.1	-0.1	-0.1	-0.2	-0.1	-0.1
5. Social security funds	S.1314	76.6	1.0	0.9	0.9	0.6	0.4
General government (S13)							
6. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
7. Total expenditure	TE	2658.2	36.2	36.8	37.5	38.8	38.7
8. Net lending/borrowing	EDP B.9	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
9. Interest expenditure*	EDP D.41	55.1	0.7	0.7	0.7	0.7	0.7
10. Primary balance		-14.8	-0.2	-0.7	-0.8	-0.6	-0.6
Selected components of revenue							
11. Total tax (11=11a+11b)		1457.8	19.8	20.1	21.4	22.5	23.3
11a. Taxes on production and imports	D.2	872.5	11.9	12.0	13.1	13.9	14.4
11b. Current taxes on income, wealth etc	D.5	585.3	8.0	8.1	8.3	8.7	9.0
12. Social contributions	D.61	661.0	9.0	8.8	8.8	8.6	8.1
13. Property income	D.4	56.0	0.8	0.7	0.4	0.4	0.4
14. Other revenue**		413.6	5.6	5.7	5.4	5.9	5.6
15. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
Tax burden (D.2+D.5+D.61+D.91 – D.995)***		2131.8	29.0	29.2	30.5	31.2	31.7
Selected components of expenditure							
16. Collective consumption	P.32	767.7	10.5	11.6	11.7	11.6	11.5
17. Total social transfers	D.62 + D.63	695.1	9.5	9.4	9.3	9.0	9.0
17a. Social transfers in kind	D.63	11.5	0.2	0.1	0.1	0.1	0.1
17b Social transfers other than in kind	D.62	683.6	9.3	9.3	9.2	8.9	8.9
18.=9. Interest expenditure	EDP D.41	55.1	0.7	0.7	0.7	0.7	0.7
19. Subsidies	D.3	38.4	0.5	0.5	0.4	0.4	0.4
20. Gross fixed capital formation	P.51	111.3	1.5	2.3	2.5	2.9	3.3
21. Other expenditure		990.6	13.5	12.3	13.0	14.1	13.8

	ESA code	2004	2004	2005	2006	2007	2008
		millions of lats	% of GDP				
22.=7. Total expenditure	TE	2658.2	36.2	36.8	37.5	38.8	38.7
Compensation of employees	D.1	775.6	10.6	11.1	11.4	11.4	11.3

* excluding FISIM
** including D.91
*** including those collected by the EU

3.2. Medium-Term Objective and Budgetary Implications of Structural Reforms

Reform of the Stability and Growth Pact implemented in 2005 introduced changes to the procedure and methodology for setting fiscal policy objectives in the European Union Member States. In order to strengthen the growth and development-oriented nature of the Pact and take into account the different economic and budgetary positions of the EU Member States, the Council has agreed that the Member States have to set their own medium-term (general government budget position) objectives based on pre-defined basic principles.

Based on the Council's decision[2], medium-term objectives of the Member States are defined in cyclically adjusted terms and they must provide:

- a sufficient safety margin with respect to the 3% of GDP deficit limit;
- quick progress towards sustainability, taking into account the impact of population ageing on the government budget;
- taking into account the above-mentioned principles, they should allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.

The Council has set additional restrictions in setting the medium-term objectives for the euro area and the ERM II Member States, considering the need for a more open and restrictive fiscal policy, in order to promote the long-term stability of the single currency:

- the country-specific medium-term deficit target have to be in a range between -1% of GDP for low debt / high potential growth counties and balance or surplus for high debt / low potential growth countries.

Member States whose actual budgetary position have not yet reached their medium-term objectives have to take steps to achieve it over the cycle, net of one-off and temporary measures. For the Euro area and ERM II Member States annual adjustment must be 0.5% of GDP as a benchmark. Their adjustment effort must be higher in good times; it could be more limited in bad times. Structural reforms that have a verifiable positive impact on the long-term sustainability of public finances may be taken into account when defining the adjustment path.

Taking into account the updated Stability and Growth Pact, methodology guidelines approved by the Economic and Finance Committee, commitments following from participation in the ERM II and the national policy aimed at ensuring the macro-economic

[2] Council decision "Improving implementation of the stability and Growth Pact"

stability, Latvia's Convergence programme defines the medium-term objective for the cyclically adjusted balance of the general government budget as 1% of the GDP.

Such amount of deficit is considerably lower than the 3% of GDP reference value prescribed by the Maastricht criteria as well as half better than the minimal benchmark for the budgetary balance, which for Latvia, taking into account past output volatility and the budgetary sensitivity to output fluctuations, has been estimated as -2.1% of GDP. Thus, the defined Latvia's medium-term objective, providing sufficient safety margin with respect to the 3% deficit limit over the cycle, at the same time provides an opportunity to implement more active budgetary policy, promoting convergence of Latvia's level of development with the EU average.

The costs of structural reforms and increase of public investment results in Latvia's government budget expenditure rising. Nevertheless, this expenditure is essential for ensuring the medium-term and long-term sustainability of Latvia's government budget and raising the economic potential.

Pension and healthcare reforms have to be mentioned as the most significant reforms with a clearly measurable impact on the government budget in the medium-term and long-term.

A larger impact on the government budget balance in the medium-term is expected from the pension reform, as up to 2010 the share of the state social security rate transmitted into the state funded pension scheme will gradually grow (from current 2% to 10% in 2010). Accordingly, this amount of collected social security contributions will not be included in the general government budget balance. It is expected that in 2006 the contributions to the state funded pension scheme will amount to 0.4% of the GDP. In 2007, they will increase to 0.7% of GDP, whereas in 2008 to 1.5% of GDP. Such a drop in revenue will be partly offset by pension expenditure within the programming period growing at a slower rate than the GDP as a result of the ongoing raising of the retirement age, due to the pension indexation formula and a lower number of population within the pre-retirement cohorts. Moreover, in the long-term the implemented pension reform will enable to ensure the sustainability of the pension system, regardless of a significant increase in the number of pensioners and growing demographic burden, as part of the required pensions will be paid out through the funded pension scheme.

Of other most important reforms, the healthcare reform has the most transparent relationship between the rising expenditure of today and sustainability of the future financing. Its task is to improve the quality of services and create a sustainable financing model for the sector. Currently, the most significant problem in healthcare financing is that various age and social groups of population are not ensured an equal access to healthcare services, as a large part of health expenditure is covered by the population itself. Alongside with restrictions on accessibility of services, the insufficient quality of services is a topical problem as well. Inefficient healthcare spending relates to difficult access to high-quality healthcare services due to the inefficient regional dislocation of the network of in-patient treatment institutions. Latvia has inherited a large number of healthcare service providers whose services are dominated by the most expensive services (in-patient services), whereas the number and territorial dislocation of out-patient service providers is insufficient.

In accordance with the healthcare system reform programme, the number and dislocation of in-patient, out-patient and emergency medical service providers is being optimised, thus making services closer and ensuring equally high quality healthcare services to population throughout the territory of Latvia. Within the framework of the above programme, it is planned to reduce the current number of hospitals from 112 to 46 by merging, transforming or closing the existing hospitals. At the same time, creation of 20 new primary care doctor's (general practitioners) practices is planned as well as transformation and improvement of 50 primary care doctor's (general practitioners) practices, thus providing medical assistance as close as possible to the population. In order to establish high-quality emergency medical assistance (EMA) system in Latvia that would be accessible to the population and cost-effective, it is planned to introduce a uniform system structured and functioning based on universal principles for EMA teams and operative management, and patient or victim hospitalisation management, thus ensuring the implementation of the principle that "the closest team of EMA arrives on the scene", so that the patient or victim is delivered to the best suited hospital in due time. In implementing the programme and ensuring the quality of services, special attention has to be paid also to the issue of human resources. By establishing a work pay, social guarantees and professional risk insurance system for medical personnel in the healthcare sector, which facilitates the attraction of labour force, as well as by developing standards for the number of beds and patients per doctor by speciality and per nurse, based on the above-mentioned policy planning document, it is planned to achieve that the number of medical personnel employed in the healthcare system in Latvia aged 25–40 will increase by 5%, the number of in-patients per medical person will decrease, the work pay of doctors will increase to about two average wages and salaries in the economy and 70% of persons having obtained education in the field of health will work in healthcare.

These and other healthcare reform measures, although ensuring more efficient spending of the existing resources and, therefore, partly covering also the costs of reforms, still require an increase of the government financing. The amount of healthcare financing increase planned for 2006 exceeds 30 million lats or 0.3% of GDP, whereas additional provisions for implementation of the reform's tasks will have to be made in 2007 and 2008 budgets as well. Successful reform implementation will ensure the adequacy of the healthcare in light of the ongoing population aging process and, consequently, also the expected changes in the demand for health services, as well as a higher quality of the healthcare services.

Another essential objective of the state reforms is raising the economic development potential. Here an important role alongside with ensuring adequate legislation and favourable business environment is played also by public investment. It is planned to increase the general government spending on gross fixed capital by 1% of GDP by 2008 (in comparison with 2005).

The above-listed reform expenditure provides for a gradual rather than immediate convergence of the general government budget balance with the set medium-term objective. The expected future gains from the implemented reforms outweigh the costs and justify the selected deficit reduction plan. Moreover, a significant increase of resources is planned also in other reform areas, where to reflect and estimate the temporary expenditure and long-term gains is not that simple.

3.3. Structural Balance

Assessment of the cyclically adjusted budget balance (CABB) plays a significant role in the fiscal coordination and budgetary surveillance under the Stability and Growth Pact. The cyclical budget position to potential GDP is taken into account when assessing the countries' fiscal stance. The European Commission has prepared a common methodology for assessing the potential GDP, as well as cyclical sensitivities of the general government budget are estimated based on an adopted OECD methodology.

Assessment of Latvia's potential GDP by production function was prepared using the macro-economic scenario discussed in the Convergence Programme. Taking into account the limitations of the actual economic data time series, for the purpose of analysis, quarterly data from 1995 to the second quarter of 2005 were used, extending the data series by forecasts up to the end of 2006, according to the methodology.

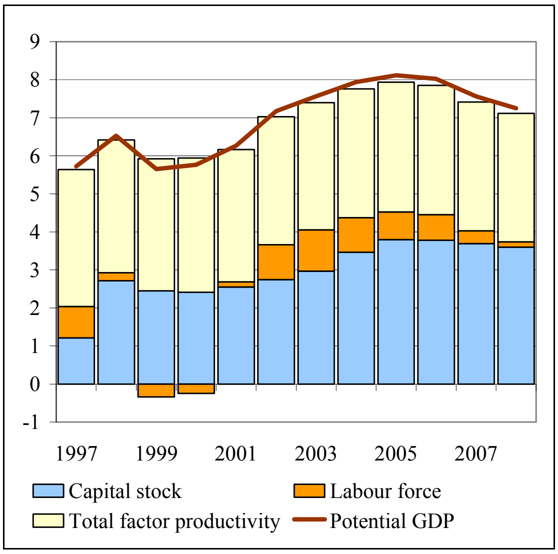


Chart 7. Contribution to the potential GDP growth, %

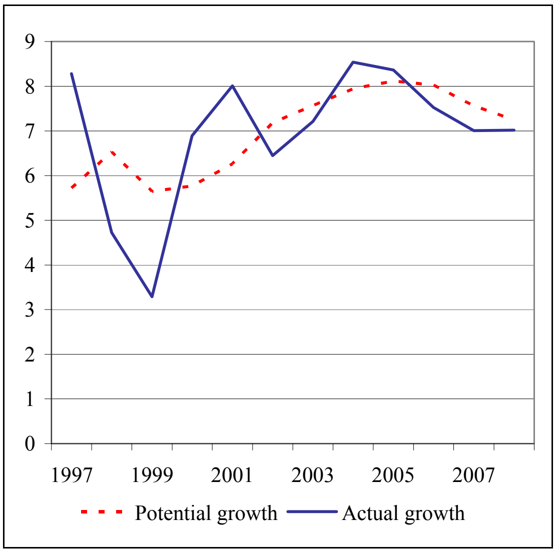


Chart 8. Actual (forecast) and potential GDP growth, %

During the last years, both the average actual growth of the economy as well as the potential growth have increased. Potential GDP growth has been facilitated by improved employment and investment into the economy. In 2004 and 2005, the actual economic growth exceeded the potential growth, and the positive output gap was accumulated. Nevertheless, an output gap in the amount of 0.5% of the potential GDP in 2005 is a comparatively small one. In the years to come, a lower growth of the potential GDP is expected, determined by a lower rise in employment and more moderate capital investment.

Lower employment growth in the medium-term will be affected by the decline in the number of working age population and smoothing of the natural unemployment rate (NAIRU) at the certain level.

In the last years, investment growth rates were considerably higher than that of GDP; therefore, using the production function method, it is difficult to forecast the same growth tendency also in the medium-term. Due to that, medium-term forecasts of investment are based on the national forecasts, which still envisage high investment growth rates, albeit with a tendency to decline.

Total factor productivity is an important component of Latvia's production function. The initially low level of capital stock of the economy and comparatively low GDP per capita corresponds to a situation where high economic growth is facilitated by increasing productivity and where is high return on investment. Economic growth will remain largely based on productivity growth also in the future.

Overall, the actual GDP growth in the medium-term will be close to the potential GDP growth and the output gap will disappear. Although an output gap in the amount of -0.7% of GDP is forecast for 2008, it is an insignificant figure, considering the high growth rates of the economy and uncertainties relating to the production function estimation.

Assessment of the cyclically adjusted budget balance is based on the cyclical sensitivity of the general government budget to output gap calculated by the Commission, which is 0.28 in Latvia's case. Taking into account the positive output gap, in 2004 and 2005 the cyclically adjusted budget deficit is higher than the actual, while in 2007 and 2008 it is expected to be lower than the planned general government deficit. In 2008, the cyclically adjusted budget deficit will amount to 1.1% of GDP.

Table 7. Cyclic development

% of GDP	ESA code	**2004**	**2005**	**2006**	**2007**	**2008**
1. GDP growth at constant prices	B1g	8.5	8.4	7.5	7.0	7.0
2. Actual budget deficit	B9	-1.0	-1.5	-1.5	-1.4	-1.3
3. Interest expenditure	D41	0.7	0.7	0.7	0.7	0.7
4. Potential GDP growth		7.9	8.1	8.0	7.6	7.2
contribution:						
- employment		0.9	0.7	0.7	0.3	0.1
- capital		3.5	3.8	3.8	3.7	3.6
- overall production factor productivity		3.4	3.4	3.4	3.4	3.4
5. Difference between potential and actual GDP as a % of the potential GDP		0.3	0.5	0.1	-0.5	-0.7
6. Cyclic component of the budgetary deficit		0.1	0.1	0.0	-0.1	-0.2
7. Cyclically adjusted deficit (2-6)		-1.1	-1.6	-1.5	-1.3	-1.1
8. Cyclically adjusted primary balance (7-3)		-0.4	-0.9	-0.8	-0.6	-0.4

3.4. Government Debt

The objective of the government debt management is to ensure the funds required for the purpose of financing the government budget deficit and refinancing of the government's debt commitments at the lowest possible costs and advantageous terms by hedging the financial risks and taking into account the development of the Latvian state capital market and all financial system.

Objectives, basic principles and tasks of the central government debt portfolio and borrowing management within the framework of the medium-term government debt management are established by Latvian government debt management strategy (hereinafter – Strategy) approved by the Minister of Finance. In accordance with the Strategy, the management of the government's debt portfolio is prudent and oriented at hedging and prevention of financial risks, allowing for the use of financial derivatives listed within the Strategy only for the purpose of ensuring risk management. Approach to the management of the government's borrowing, in turn, is focussed on ensuring borrowing opportunities, liquidity, beneficial terms and conditions for borrowing. Selection of the types of financial instruments that may be used in government debt management and raising the funds required for financing as well as the terms and conditions is governed by the guidelines approved within the Strategy, providing the optimum government debt portfolio parameters to be adhered to currency profile of the debt, maturity profile, weighted average interest rate fixation period and the share of fixed interest rate in the debt portfolio. The measures planned for ensuring the resources required to finance the government deficit and debt commitments within the current year and the selection of the most appropriate instruments is governed by the annual Plan for attracting resources approved by the Minister of Finance, which is developed based on the guidelines established in the Strategy and is agreed with the Ministry of Finance and the Bank of Latvia.

It is expected that within the time period of up to 2008, the financial resources required for financing of the government deficit and refinancing the government's debt commitments will be attracted both on the domestic as well as external financial market. Although the fiscal criteria established in the Maastricht agreement have been complied and the fiscal policy implemented by the government is aimed at gradual reduction of the fiscal deficit in the government budget ensuring a balanced budget in the medium-term, the limits of new borrowing depend also one the maturity profile of the existing government debt commitments and their repayments in the next years.

Latvia’s government debt management has been historically aimed at development of the domestic government securities market ensuring favourable terms and conditions for attracting funding at relatively low costs. Regardless of the fact that with the foreign exchange risk on euro borrowing diminishing considerably following the lats repegging to the euro at the beginning of 2005 the lats and the euro interest rates have converged even further (especially on longer-term securities) reducing the borrowing costs, a slight gap between the lats and the euro interest rates still exists. Therefore, in order to ensure compliance of the government debt portfolio composition with the targets set in the Strategy, the financing strategy of the next years could possibly be aimed at refraining from increasing the amount of outstanding domestic government securities, at the same time taking into account the developments of Latvia's government securities market. Out of the domestic government securities, medium- and long-term government bonds (3, 5 and 10 years) could be used for financing from 2006 to 2008 and could be offered within the framework of issue programmes, as well as Treasury notes (6- and 12-month maturity). With the planned euro implementation in Latvia approaching, it is possible that smaller, less liquid bond issues will be consolidated into larger, more liquid security issues, thus activating the secondary circulation of the government securities. In addition to the above-mentioned financial instruments, in case of a need, to ensure short-term financial liquidity short-term loans and credit facilities offered by domestic financial institutions will be used, as well as introduction of additional financial instruments is possible. The amounts and issue calendar will be decided depending on the cash flows forecast in the relevant government budget execution period.

Drawing from foreign financial markets is anticipated, by using borrowing from international financial institutions, private or public offer security issues and credit facilities and short-term loans from foreign commercial banks. Eurobond issue is the most effective instrument to attract large amounts of funding by way of increasing the existing Eurobond issue amounts or issuing new, more liquid securities; therefore, the possibilities to use the Eurobond instrument in the period of time from 2006 to 2008 are being assessed. Nevertheless, the time of borrowing, amounts and maturities will depend on the actual government budget execution figures, financial market developments, government debt portfolio indicators and other influencing factors. One of the most significant factors when taking a decision on issuing Eurobonds would be the potential amount of issue, as increasing the amount of a new or tag-on issue to at least 500 million euro would increase the liquidity of the securities and ensure an opportunity to launch this instrument on international securities trading platforms. In accordance with the concluded agreements, use of borrowing from international financial institutions to finance central and local government investment projects will continue, and it is also expected that the borrowing possibilities offered by the European Investment Bank for the purpose of ensuring co-financing for measures financed from the European Union policy instruments will also be used.

Latvia's government debt is one of the lowest among the new European Union Member States, and it is expected that it will remain lower than 15% of GDP in the medium-term, which is well below the Maastricht agreement criterion for the general government debt (60% of GDP).

Table 8. Development of the general government debt

% of GDP	ESA code	**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt		14.7	13.1	14.9	13.6	13.7
2. Changes in gross debt		0.1	-1.6	1.8	-1.3	0.1
Contribution to changes in gross debt						
3. Primary balance		0.2	0.7	0.8	0.6	0.6
4. Interest expenditure	D41	0.7	0.7	0.7	0.7	0.7
5. Stock-flow adjustment		1.2	-1.0	2.0	-1.1	0.2
of which: - Differences between cash and accruals		0.3				
- Net accumulation of financial assets		0.6				
incl. privatisation revenue		0.1				
- Valuation effects and other		0.3				
p.m. implicit interest on debt		5.5	5.5	5.0	5.3	5.2
Other relevant variables						
6. Liquid financial assets		3.5				
7. Net financial debt (7=1-6)		11.2				

4. Sensitivity Analysis and Comparison with the Previous Programme

4.1. Sensitivity Analysis

Sensitivity analysis looks at the impact of changes in economic development on the financial position of a country. Sensitivity analysis is conducted for the 2006 central government budget and medium-term budget perspective discussed in the Convergence Programme. In addition to the basis macro-economic scenario, an optimistic and a pessimistic scenario is modelled, where the medium-term GDP growth rates are forecast 1 percentage point higher and lower, respectively.

As Latvia is a small and open economy, its key risks mainly relate to the external economic environment. Changes in the economy of the main trade partners or unexpected developments in the foreign trade conjuncture may impact also on the internal structure of a national economy (population income, consumption, employment and investment).

Macroeconomic scenarios have been developed, assuming that the price indices remain unchanged. The volume of public consumption in all scenarios has been preserved unchanged as well.

The optimistic scenario assumes that a stronger external demand will facilitate higher growth rates for Latvian exports and production. Higher domestic economic activity will create additional demand for labour, and higher labour productivity will enable more rapid growth rate for wages and salaries. Increased employment and wages and salaries would raise the purchasing power of the population, and a more optimistic perception of the development of the domestic and external economic environment would promote the growth of consumption and investment. Foreign trade balance, in turn, would improve only slightly, considering import-intensity of exports and also a higher domestic demand. With the economic activity strengthening, it is forecast that mainly the personal income tax and social security contributions revenue could grow at a faster rate, as the size of these two taxes is primarily dependent on an increase of wages and salaries and employment. As a result of a more rapid economic development, income tax revenue (D.5) could grow by about 7.5 million lats. Actual social security contributions (D.611), in turn, could increase by 9–10 million lats. It has to be noted that the growth rates of those taxes are comparatively high already; therefore, no especially sharp increase is anticipated.

Under the pessimistic scenario, the assumptions concerning deterioration of the external economic environment comparing with the basis scenario, have an opposite effect to that in the optimistic scenario. Income tax revenue (D.5) could decrease by about 8 million lats. Actual social security contributions (D.611), in turn, could decrease by 10–11 million lats.

Table 9. Macro-economic indicators of the basis scenario

		2006	2007	2008
Real GDP (at 2000 prices)	growth (%)	7.5	7.0	7.0
Employment (persons)	growth (%)	1.0	0.5	0.5
Unemployment rate	%	8.0	7.8	7.7
Average wages and salaries in the economy	growth (%)	11.8	11.1	10.2
Current account balance	% of GDP	-8.9	-8.1	-8.0

Table 10. Macro-economic indicators of the optimistic scenario

		2006	2007	2008
Real GDP (at 2000 prices)	growth (%)	8.5	8.0	8.0
Employment (persons)	growth (%)	1.3	0.7	0.7
Unemployment rate	%	7.8	7.4	7.2
Average wages and salaries in the economy	growth (%)	12.4	11.9	11.0
Current account balance	% of GDP	-8.7	-7.8	-7.6

Table 11. Macro-economic indicators of the pessimistic scenario

		2006	2007	2008
Real GDP (at 2000 prices)	growth (%)	6.5	6.0	6.0
Employment (persons)	growth (%)	0.5	0.3	0.3
Unemployment rate	%	8.4	8.2	8.0
Average wages and salaries in the economy	growth (%)	11.3	10.2	9.4
Current account balance	% of GDP	-9.1	-8.5	-8.4

Deceleration of imports could adversely affect the growth rates of the value added tax revenue (D.211). Alongside with slower growth rates for wages and salaries, domestic demand, which also is to be considered one of the most important macro-economic indicators driving the value added tax revenue, will weaken as well.

Taking into account that the majority of excise goods are considered inflexible, it is assumed that changes in the consumption of these goods will be insignificant. Therefore, overall it is not forecast that the total excise duty revenue will change significantly as a result of deceleration or acceleration of economic growth rates.

Sensitivity analysis does not look at the potential impact of interest rate developments on the national budgetary and debt position, as Latvia's debt ratio to GDP is comparatively low and, with the existing exchange rate regime, local interest rates are largely dependent on the monetary policy of the European Central Bank. Fixed exchange rate mechanism also does not allow the lats to fluctuate against the euro, which could have an impact on the financial position of the country.

4.2. Comparison with December 2004 Convergence Programme

Table 12. Comparison with December 2004 Convergence Programme forecasts

	ESA code	2004	2005	2006	2007	2008
Real GDP growth (%)	B1g					
December 2004		8.1	6.7	6.5	6.5	-
November 2005		8.5	8.4	7.5	7.0	7.0
Changes		0.4	1.7	1.0	0.5	-
General government net lending (% of GDP)	B0.9					
December 2004		-1.7	-1.6	-1.5	-1.4	-
November 2005		-1.0	-1.5	-1.5	-1.4	-1.3
Changes		0.7	0.1	0.0	0.0	-
General government gross debt (% of GDP)						
December 2004		14.2	14.5	14.8	15.0	-
November 2005		14.7	13.1	14.9	13.6	13.7
Changes		0.5	-1.4	0.1	-1.4	-

At the end of 2004 and in the first half of 2005, the actual GDP growth exceeded the initial forecasts, resulting in an upward revision of the forecasts. Potential GDP growth estimates based on the latest statistical data, rapid growth of investment and improved estimation methods, also suggest that the medium-term economic growth rates will be higher than revealed by the previous macro-economic development scenario.

In 2004, the actual general government budget execution results were better than initially forecast. With social security contributions revenue picking up quickly, a considerable surplus accumulated in the social security budget. Local government budget deficit was lower than planned, which can be largely explained by the actual personal income tax collections exceeding the planned ones.

The divergence of the government debt from the previous forecast is determined by the actual budget execution and a more optimistic outlook of the development of the main macro-economic indicators in the medium-term, as well as changes in the central government debt management strategy.

5. Quality of Public Finances

5.1. Revenue of the General Government Budget

Tax policy previously implemented in Latvia was basically aimed at establishing such a system that would facilitate economic growth, ensuring competitiveness and attraction of investment as well as eliminating conditions fostering distortion of competition. The implemented tax policy was mainly focussed on gradual decreasing of the corporate income tax rate. As a result of the implemented policy, Latvia's corporate income tax rate currently stands at 15%, being one of the lowest rates in the European Union. In the medium-term, the tax policy measures will be primarily aimed at improving the welfare of population.

Personal Income Tax

Estimates show that the income of population continues to bear a very heavy tax burden. In 2004, 51.2% of the total tax revenue was from labour taxes. The non-taxable minimum remained unchanged from 1997 to 2004, and, as a result of that, tax burden actually increased, especially on lower-income population. In 2005, the non-taxable minimum was increased from 21 to 26 lats per month, whereas relief for dependants from 10.50 to 18 lats per month. Gradual raising of the non-taxable minimum exempt from the personal income tax and relief for dependants is a tax policy measure that has been mentioned in Latvia's national Lisbon Programme 2005–2008. It is forecast that the implementation of this measure will improve the motivation of the employed and financial attractiveness of employment.

It is planned to continue increasing of the non-taxable minimum exempt from the personal income tax and relief for dependents also in the medium-term.

Table 13. Raise of the non-taxable minimum and relief for dependents, in lats

	2006	2007	2008
Monthly non-taxable minimum, lats	32	40	50
Monthly tax relief for a dependent, lats	22	28	35
Personal income tax reduction, in millions of lats	21.3	24.9	33.5
Personal income tax reduction, % of GDP	-0.2	-0.2	-0.3

In order to improve the welfare of population as well as to partly compensate the decline in actual revenue caused by inflation growth, in addition to raising the personal income tax reliefs, the minimum monthly wage is gradually increased. In 2006, the minimum wage will be raised from 80 lats to 90 lats per month.

In 2006, raising of teachers' wages and salaries will continue. Wages and salaries will be raised for those employed in the system of interior affairs, medical personnel, those employed in the sector of culture, public prosecutors and employees of prosecutor offices as well as judges and court employees. In order to raise the motivation of those employed in public administration and reduce staff turnover and attract qualified personnel, additional financial resources are envisaged for ensuring the institutional capacity of public administration. Raising of wages and salaries of those employed in the public sector will promote an increase of both personal income taxes and social security contributions.

Social Security Contributions

According to the ESA 95 requirements, social security contributions channelled to the state funded pension scheme are not treated as general government budget revenue.

In accordance with the law "On State Funded Pensions", up to January 1, 2007 the rate of contribution into the state funded pension scheme is 2%. Starting from January 1, 2007, the rate of contribution will be gradually raised and, as a result of that, the social security contribution revenue in the funded pension scheme will grow significantly, pushing the social security budget revenue down accordingly. In line with the provisions of the Law, the rate of contributions will be raised from 2% in 2006 to 8% in 2008.

Table 14. Social security contributions to the state funded pension scheme

Year	Rate of contribution	Social security contributions transferred to the funded pension scheme, in millions of lats	Social security contributions transferred to the funded pension scheme, % of GDP
From January 1, 2005	2%	28.6	0.3
From January 1, 2006	2%	35.5	0.4
From January 1, 2007	4%	80.9	0.7
From January 1, 2008	8%	182.6	1.5

Excise Tax

In compliance with the transition period granted to Latvia, the excise tax on cigarettes will be gradually raised until January 1, 2010, thus ensuring that the rates of excise tax on tobacco products are harmonised with the minimum EU rates. When raising the excise tax rate on tobacco products, the prices of cigarettes will be increased accordingly, resulting in a forecast decline in cigarette consumption. Nevertheless, it is forecast that revenue from excise tax on tobacco products will grow, as the increase of rates will compensate the decline in consumption. Starting from 1 January 2006, the rate of excise tax on smoking tobacco will also be raised. Overall, raising of the excise tax on tobacco products in 2006 will increase the excise tax revenue by 9.1 million lats.

Starting from January 1, 2006, the rate of excise tax on beer will be raised, resulting in an increase of excise tax revenue by 0.6 million lats.

Corporate Income Tax

In 2004, rate reduction notwithstanding, corporate income tax revenue grew 36.1%, and it is forecast that in 2005 the growth rate of corporate income tax will also exceed 30%. Starting from 2006, no corporate income tax relief will be applied to the big investment projects and relief applied to companies employing convicts.

The rapid rise of corporate income tax revenue was determined by successful company performance which is confirmed by a significant increase in total turnover and profit. In 2004, the total corporate net turnover (excluding operation of financial institutions) grew 23% in comparison with 2003, whereas the corporate profit after taxes climbed from 349 million lats in 2003 to 683 million lats in 2004.

Good financial operational results are reported by the sector of commercial banks. According to information provided by the Financial and Capital Market Commission, both in 2004 overall as well as in the first quarter of 2005 all banks have worked with profit. Moreover, the increase of profit after taxes totalled 107.5% in the first quarter of 2005 over the respective period of 2004.

Real Estate Tax

Until December 31, land, buildings and constructions are subject to real estate tax. The tax base for land is its cadastre value, whereas buildings and constructions are taxed with the real estate tax based on their average annual book value or stock-taking value. Starting from January 1, 2007, constructions will not be subject to real estate tax, and, as a result of that, the real estate tax may decrease by 10 million lats or 0.1% of GDP.

Table 15. Fiscal impact of main tax policy changes (% of GDP)

	2006	**2007**	**2008**
Excise tax revenue (raising the rate on tobacco products and beer)	0.1	0.1	0.1
Personal income tax revenue (raising the non-taxable minimum and relief for dependents)	-0.2	-0.2	-0.3
Real estate tax revenue (changes in tax base)		-0.1	
Social security contributions revenue (raising the rate of contributions payable into the funded pension scheme)	-0.4	-0.7	-1.5
Total impact of tax policy changes:	-0.5	-0.9	-1.7

Based on the medium-term economic development trends and expected changes in legislation, it is forecast that overall the growth rates of tax revenue in the general government budget will exceed the GDP growth rates at current prices, and, according to the forecast, the ratio of tax to GDP will go up from 28.8% in 2004 to 31.5% in 2008.

Table 16. Tax revenue in general government budget (S.13) (millions of lats)

	Code (ESA 95)	**2004**	**2005**	**2006**	**2007**	**2008**
Tax revenue						
1. Taxes on production and imports	D.2	872.5	1028.2	1272.9	1505.8	1734.2
2. Current taxes on income, wealth etc	D.5	585.3	688.8	810.2	939.8	1080.0
3. Social contributions	D.61	661.0	753.3	856.3	936.6	977.9
Of which actual social contributions	*D.611*	*647.6*	*739.8*	*842.7*	*922.8*	*963.9*

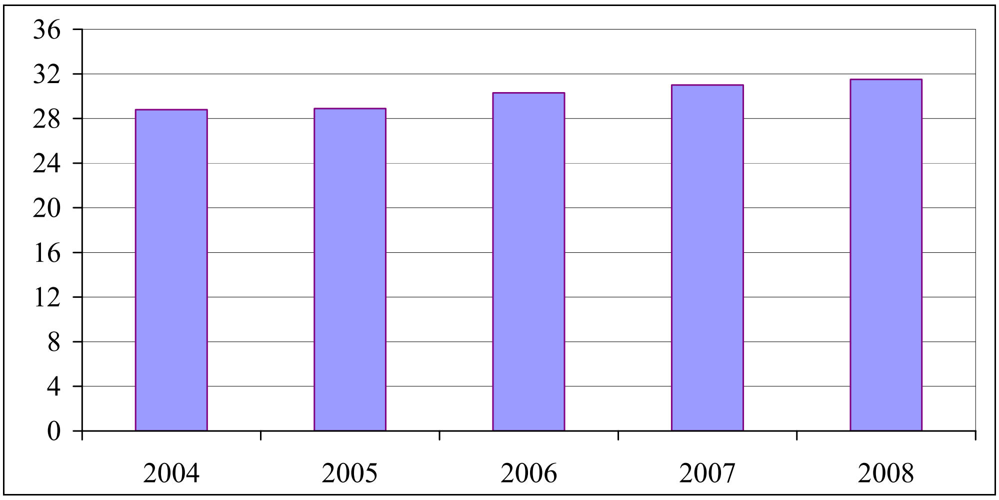


Chart 9. Tax revenue, % of GDP

Analysis of tax revenue by economic function reveals that in the period of time from 1995 to 2003 the major share of revenue in Latvia (50.9%) was comprised of labour taxes, which was roughly consistent with the overall situation in the EU, where the average figure was 51.3%. Consumption taxes amounted to 36.9% of total tax revenue, which was considerably above the EU average (28.3%), but consistent with the taxation system of the new EU Member States (35.7% on average). A minor share of tax revenue is comprised of capital taxes – in 1995–2003, 12.3% on average, which is considerably lower than the EU average (20.7%).

In the medium-term, no significant changes in the structure of taxes are forecast; nevertheless, it is expected that, as a result of raising the non-taxable minimum exempt from the personal income tax, the share of employment taxes will gradually shrink, whereas the share of consumption and capital taxes will expand.

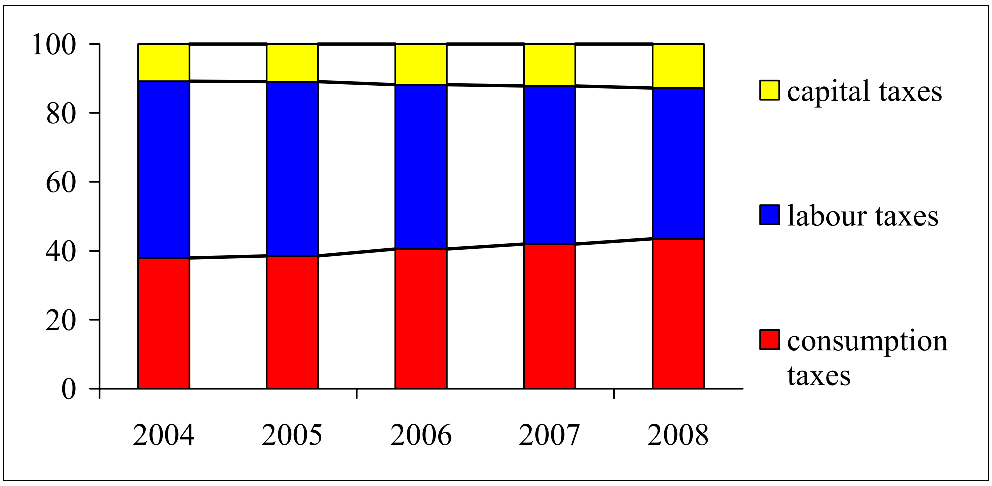


Chart 10. Tax revenue by economic function, % of total tax revenue

5.2. Expenditure of the General Government Budget

Latvian government has adopted Medium-term Guidelines for Macroeconomic Development and Fiscal Policy 2006–2010, which is a report on management of the public resources in the medium-term, with clearly identified priority measures. The guidelines outline the expenditure on priority measures of the general government budget, total general government budget revenue and maximum allowable level of the general government deficit.

One of significant instruments for promoting economic development is implementation of a sound fiscal policy. The Cabinet of Ministers has undertaken to review the national fiscal and budget policy framework, ensuring efficient and transparent spending of the government budget. In order to achieve spending efficiency, the adequacy of the existing resources to meet the operational priorities set by the government is analysed, previous spending is evaluated and efficient use of the budgetary resources is ensured.

Taking into account that Latvia has become a full-fledged member of the EU and the NATO, the Cabinet of Ministers has set the following main priorities in the general government budget for 2006:

- modernisation of social security system, ensuring its accessibility to population coming from various social groups and with varying economic possibilities, envisaging funding for satisfying the social needs, and ensure timely disbursements to population;
- improvement of the healthcare system by raising the quality of medical services and their accessibility to population, resulting in establishment of a functional healthcare system;
- strengthening of the social system, providing social benefits to the population;
- strengthening of education, raising the quality of education, scientific development and ensuring competitiveness;

- EU and NATO integration, making full use of the provided opportunities and successfully defending the national interests;
- Effective spending of the EU policy instrument funding granted to Latvia in full amount, ensuring national development and growth;
- ensuring the institutional framework for administration of law enforcement bodies, by creating a transparent internal control and monitoring system, create a strong legislative framework and improve material and technical provisions of personnel as well as ensure the capability of the interior affairs system institutions to cooperate with international organisations.

As one of the most important operational areas of the government in 2006 is ensuring acceleration of the national growth rates, a special attention is paid to making maximum use of the opportunities provided by the European Union and development of knowledge intensive sectors. In implementation of these objectives, the government has made provisions for the national financing required to draw financing from the EU funds as well as for ensuring the administrative, technical and financial management and control of projects.

2006 budget provides for an additional allocation of 31.1 million lats for improvement of the healthcare system, which will enable launching of reforms in the field of healthcare aimed at improvement of the quality of provided services and efficient use of the available resources. 13 million lats have been planned for scientific development and ensuring competitiveness, including promotion of applied science, to achieve economic growth.

With joining the NATO, Latvia has become a full-fledged member of the alliance, providing security to Latvia’s population. The Law on Financing of National Defence provides that in the period of time up to 2008, annual government budget financing in the amount of 2% of GDP will be planned for national defence, security and NATO integration. Such an amount of financing is required to implement the reform of the National Armed Forces and comply with the NATO integration related requirements. In 2006, it is planned to spend 183.8 million lats on national defence, security and NATO participation.

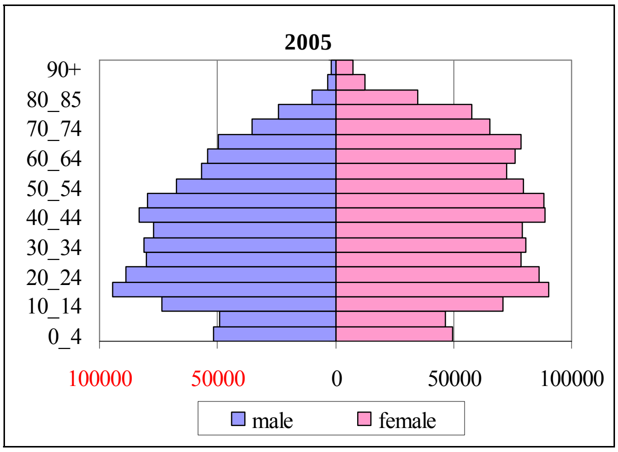
The amount of financing for national defence beyond 2008 will depend of the technical and equipment investment needs, in order to continue attracting funding from the NATO to finance Latvia's defence.

In order to attain the government's objective of reducing the budgetary deficit, ministries and other central government institutions must spend the government budget funding as effectively and efficiently as possible. Next steps in the future medium-term budget formulation process require an evaluation of the government budget proposals for 2006–2010 submitted by ministries and legislation from the perspective of the financial resources available in the government budget. Implementation of institutional action strategy in public administration has started, with each ministry developing their strategic planning documents, incorporating the most important priorities and integrating tasks prescribed in other documents. Institutional action strategy will be the key document in developing the government budget and establishing priorities.

6. Sustainability of Public Finances

Latvia's population started to shrink in 1990, with both natural movement of population (balance of birth and death rates) as well as cross-country migration changing radically from positive to negative. Overall, at the beginning of 2005 Latvia's population amounted to 2.31 million and was 362 thousand (14%) smaller than 15 years ago (incl. a decline in population by 171 thousand due to natural movement of population). In the last years, the rate of decline in population has decelerated; nevertheless, it is expected that this tendency will prevail in Latvia in the long-term as well. According to Eurostat forecasts[3], by 2050 Latvia's population will decrease by another 19% and amount to a mere 1.87 million. The forecasts are based on the assumption that the birth rate will increase from the current 1.3 to 1.6, which still is not enough to stabilise the number of population. The negative balance of natural movement will decrease also due to growing life expectancy of population. According to the forecast, net migration will remain negative until 2020, when it will become positive, with Latvia's economy reaching a higher level of development.

Alongside with changes in the number of population, age profile of population will also change significantly. The share of young people will gradually contract, determined by the birth rate which is constantly below the natural reproduction threshold and a decrease in the number of female of fertile age. In the age group of 0–14 years, in 2050 the number of population will be 19% lower than in 2005. Moreover, as opposed to other age groups, changes in the number of youngsters are more pronounced already now as a result of the 10 year long low birth period. Working age (15-64) population will decrease by 30% or 475 thousand by 2050, whereas the number of senior people (65+) will grow by 28% or 107 thousand, including the number of very old people (80+) will increase more than twice or by 86 thousand by 2050. This suggests that the increase in the number of above working age population will be primarily the result of higher life expectancy.



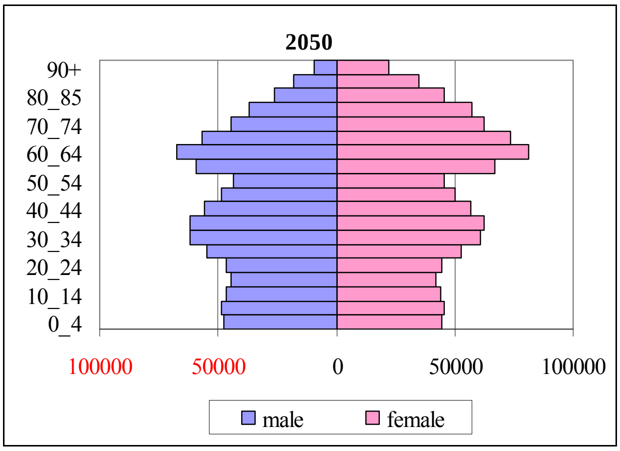


Chart 11. Changes in population by age groups

Labour force and employment[4] will basically develop, based on changes in the number of working age population. Nevertheless, it will also be significantly affected by changes in participation and employment rates.

Changes in participation rate are affected by various factors, the most significant being the social (duration and quality of education, the role of female in the society etc.), demographic (birth rate, age profile), institutional (retirement age etc.) and economic (labour

[3] Hereinafter the basis scenario of the Eurostat demographic forecast EUROPOP2004 is discussed.

[4] Latvia's employment and macroeconomic assumptions are based on the ones approved by the Aging Working Group of the EU Economic Policy Committee.

demand, income level etc.) ones. In the next years, gradual rising of the participation rate, especially in the older groups of employed (over 55) is forecast, and these are the only groups where a real increase in the number of employed is expected by 2050. Unemployment will decrease gradually; nevertheless, in order to keep the forecasts prudent, it is assumed that it will be at least 7%[5].

Overall, these factors determine that the number of employed in 2050 will be 22% lower in comparison with 2005. Nevertheless, contrary to the demographic indicators, it is expected that the number of employed will continue to rise gradually until 2012 and start shrinking only after that (falling back to the level of 2005 in 2020).

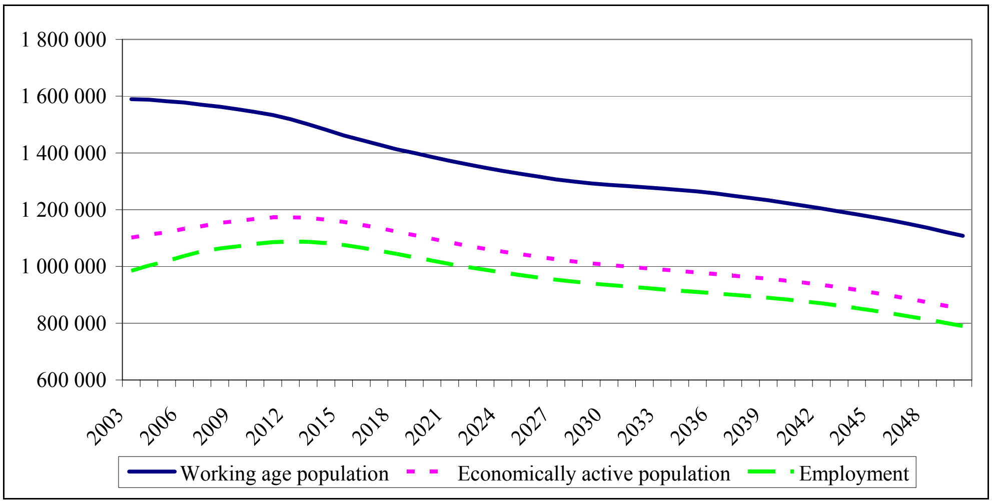


Chart 12. Working age population and employment in 2003 –2050, persons

In the last years, Latvia's economy has achieved high growth rates driven by a rapid increase in investment and productivity. Estimates based on production function method suggest that the development will be equally dynamic and buoyant in the medium-term as well, additionally facilitated by policies aimed at the EU Member States cohesion. Regardless of the fact that the decline of employment will start to exert an adverse impact on growth already from 2013, the average GDP growth in the period of up to 2050 is expected almost twice as high as in the EU15 countries, ensuring convergence of the living standards with the EU average.

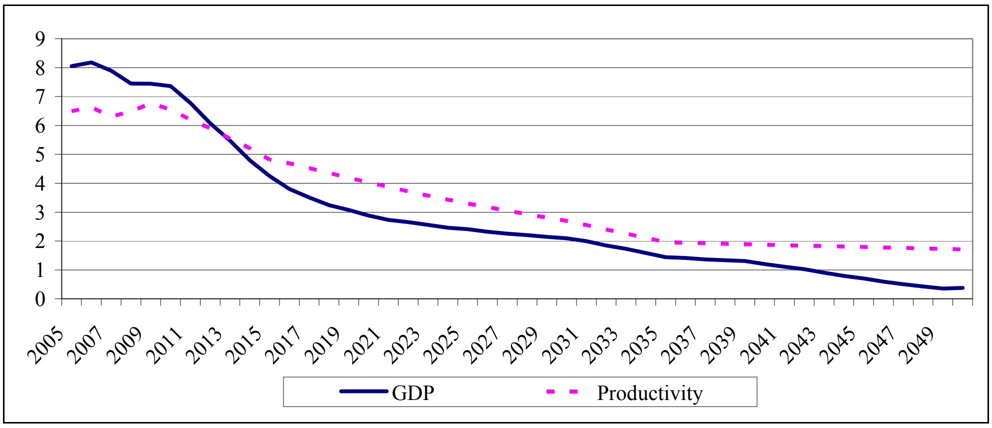


Chart 13. GDP and labour productivity growth at constant prices, %

Changes in the number of population and especially in age profile will exert a significant impact on the government budget, as the working age population will shrink and social expenditure will grow.

[5] EU15 NAIRU

In order to address the financial problems of the pension system that may be caused by the emerging demographical changes, Latvia launched a pension reform already in 1996 by raising the retirement age and creating the state mandatory non-funded, social security contributions-based generation solidarity pension scheme and further-on implementing the state mandatory funded pension scheme (in 2001) and creating the legislative framework for the private pension scheme (in 1998). Although all these pension tiers are already operational, various transition provisions will still be in effect for a certain period of time, affecting both the existing as well as the new pensioners.

The current and perspective costs of implementing the pension system reform are fully outweighed by long-term gains, enabling the employed to cope with the growing demographical burden, at the same time preserving a sufficiently high income substitution level for pensioners as well as ensuring sustainability of the pension budget.

Pension expenditure of the government budget estimated based on the above-mentioned demographical and macroeconomic assumptions are expected to be by 0.8% of GDP lower in 2050 than in 2005, whereas the expenditure of the funded pension scheme will rise to 2.7% of GDP. At the same time, pension contributions to the government budget will shrink, as already starting from 2010 half of the contributions will be channelled to the funded pension scheme. Therefore, starting from 2030 it is expected that contributions to the pension budget will be lower than the amount of expenditure and also that the annual level of deficit in this budget will not exceed 0.5% of GDP. It has to be noted that in the period beyond that, improvement of the situation and a decrease in the burden on the pension system relating to both gradual improvement of birth rates and a decline in death rates in the working-age group can be expected. Stabilisation of the situation in a more distant future is pre-determined also by the fact that the pension system will be fully functional by then (i.e. passed the transition period). Forecasts show that all pensions will become contribution-based generation solidarity pensions only around 2080.

At the same time, accumulated assets of the state funded pension scheme will pick up significantly during the next 50 years and will serve as a driving force for economic development.

The above estimates suggest that the stability of the pension system can be preserved even under less favourable demographic and macroeconomic assumptions.

Table 17. Sustainability of the pension system

% of GDP	2005	2010	2020	2030	2050
Old-age pension expenditure	6.4	4.9	5.0	6.0	8.3
Tier 1 pensions	6.4	4.9	4.9	5.6	5.6
Tier 2 pensions	0.0	0.0	0.1	0.4	2.7
State social security contributions for old-age pensions	8.3	8.4	8.3	8.4	8.5
Tier 1 pensions	7.9	6.1	5.6	5.4	5.4
Tier 2 pensions	0.4	2.3	2.7	3.0	3.1
Accumulated assets of state funded pension scheme	1.0	7.7	28.7	50.9	75.4

Analysis of health care expenditure suggests that bigger expenditure relates to senior people, especially during the last years of their lives. Therefore, the increase in the number and share of old and very old people may create an additional demand for healthcare services paid from the government budget. In 2003, the government expenditure on healthcare amounted to 5% of GDP. Assuming that the current expenditure structure by age groups will remain unchanged in the future, it can be expected that the government healthcare expenditure will grow to 5.9% of GDP by 2050. The previous experience, however, suggests that the demographic changes have not been the only reason for changes in the healthcare expenditure. Factors like public health condition, economic development, technological progress, changes in healthcare financing and organisation system etc. have been of an equal importance. The impact of those factors may both increase the pressure on the healthcare expenditure as well as dampen the effects of the adverse demographical changes.

Long-term care services are primarily focussed on older people and, therefore, aging of the population could affect the size of the given expenditure covered from the government budget significantly. Nevertheless, although under the impact of demographic factors it could grow by more than 40% by 2050, it will only amount to 0.52% of GDP as compared to the current 0.36% of GDP. The fact that the long-term care expenditure is low is pre-determined by the limited central and local government resources to be spent for this purpose as well as traditions and the system of community values. Therefore, with these factors changing, a more rapid expansion of the long-term care services and, consequently, also expenditure could still be expected.

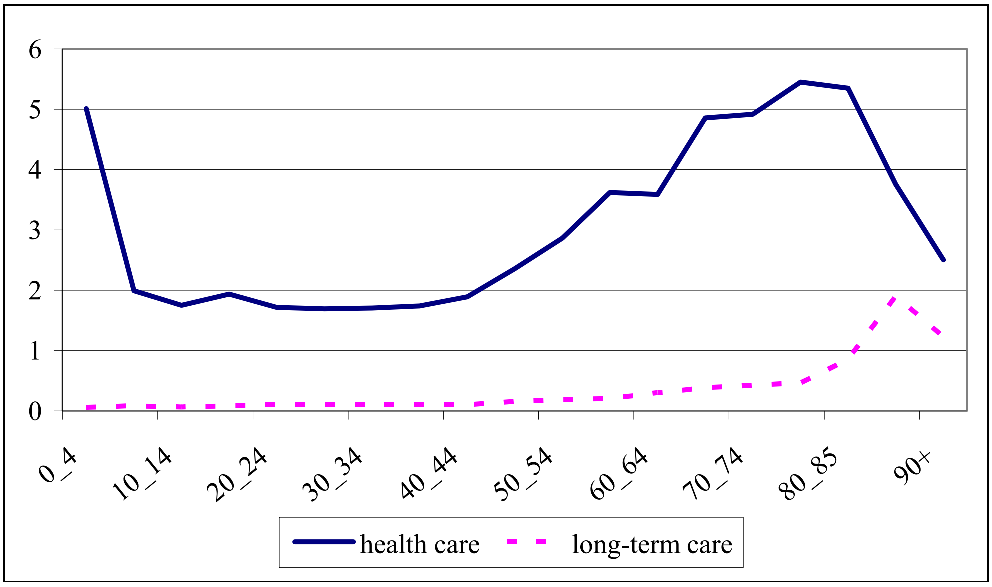


Chart 14. Healthcare and long-term care expenditure by age group, % of GDP per capita in 2003

Education services are primarily delivered to children and youths. Demographic changes within this age group have the most significant impact on education expenditure. The number and share of children and youths in Latvia has been on a constant decline already since 1990, which has become especially rapid after 1995. The cohorts of low birth rate years have already reached school-age, and the number of school students will continue to shrink in the next years as well. In comparison with 2000, the number of school-age population will be almost 30% lower in 2010. This suggests that the demographic factor will promote a decrease in education expenditure per recipient of education services, provided that the relative amount of education expenditure per recipient of education services remains unchanged. Consequently, the government expenditure for education could decrease from 5.2% of GDP[6] in 2002 to 3%–3.5 % of GDP after 2010, when stabilisation of the birth rate level is expected. Thus, as opposed to the pension and healthcare systems, the impact of demographic changes on the education system is much quicker, and the biggest changes are expected within the period of time up to 2015.

[6] ISCED levels 1-6, except pre-school education

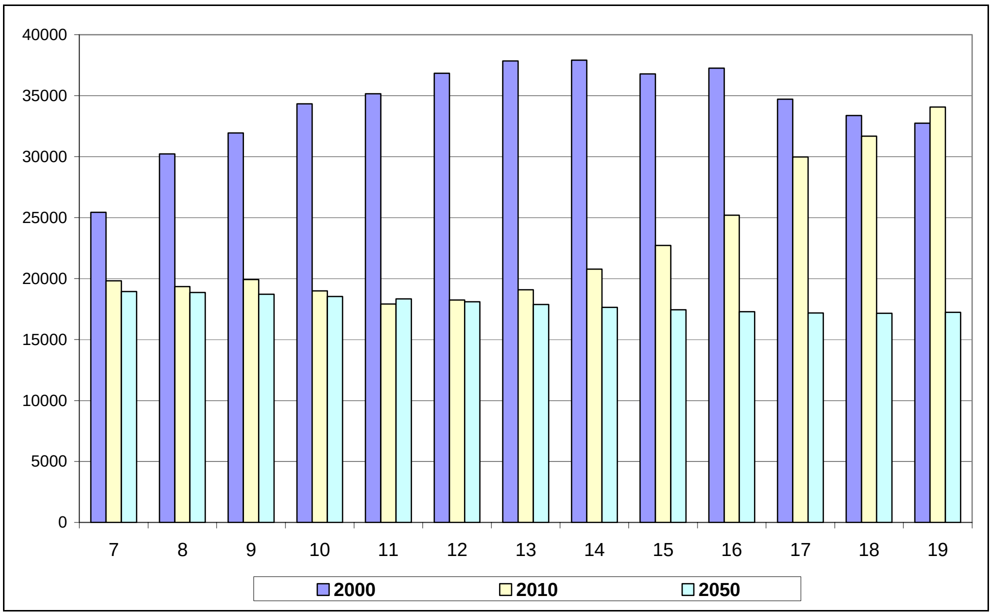


Chart 15. Number of population aged 7 –19 in 2000, 2010 and 2050

In addition to that, based on the methodology approved by Aging Working Group of the Economic Policy Committee, sustainability estimates take into account changes in public expenditure on unemployment benefits. Considering that the macroeconomic assumptions provide for a decline in unemployment rate in Latvia, these changes will have a positive effect on the government balance; nevertheless, due to the modest size, the impact will be insignificant (expenditure will decrease from 0.3% of GDP to 0.2% of GDP).

The reform of the pension system and the impact of a decline in the number of children on education expenditure are the key factors determining that, given a no-change of the current policy, population aging tendencies will have no adverse impact on public finances. Only after 2015, public expenditure directly relating to the age profile of population will deteriorate the general government balance.

Thus, the estimates of the system of public finances based on Eurostat's demographic forecasts and the macroeconomic assumptions approved by the Aging Working Group of the Economic Policy Committee for Latvia, do not point to significant risks and confirm the positive long-term effect of the pension reform. At the same time, they also reveal that all the potential developments in public policies and financing need to be carefully considered, as the expected demographic changes are very dramatic and any policy adjustments may bear significant long-term consequences.

Table 18. Sustainability of public finances

% of GDP	2005	2010	2020	2030	2050
Total expenditure	36.8	37.8	37.7	39.1	39.3
of which: age-related expenditure	16.3	13.8	13.8	15.1	15.3
Pension expenditure	6.4	4.9	4.9	5.6	5.6
Social security pension	6.4	4.9	4.9	5.6	5.6
Old-age and early pensions	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	0.7	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Healthcare	5.2	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.4	3.3	3.1	3.5	3.3
Other age-related expenditure	0.3	0.3	0.2	0.2	0.2
Interest expenditure					

Total revenue	35.3	36.9	36.5	36.3	36.2
of which: pension contributions	7.9	6.1	5.6	5.4	5.4
Pension reserve fund assets					
of which: consolidated state pension fund assets (assets other than government liabilities)					
Assumptions					
Labour productivity growth	6.5	6.5	4.0	2.7	1.1
Real GDP growth	8.1	7.4	2.,9	2.1	0.4
Participation rate males (20–64)	84.4	87.6	89.,6	89.5	87.6
Participation rate females (20–64)	72.6	76.2	79.0	79.8	76.6
Total participation rates (20–64)	78.2	81.7	84.1	84.5	82.0
Unemployment rate	9.1	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.5	17.4	18.4	21.3	26.1

7. Institutional Features of Public Finances

The Constitution of the Republic of Latvia (Satversme) stipulates that the Parliament (Saeima) decided on the budget for government expenditure and revenue every year, before the start of the next financial year. The draft budget is submitted to the Parliament by the Cabinet. Budget is an instrument for implementing national policies with financial methods. The budgetary process consists of four main stages, i.e. drafting of the budget, discussion of the draft budget and approval on legislative level, budget execution and implementation monitoring. The process of budget formulation, execution and monitoring is governed by the Law on Budget and Financial Management as well as other related legislative acts (Cabinet regulation, instructions, methodologies etc.).

Every year, before formulation of the next year's budget the government decides on the most important priorities as well as sets the maximum expenditure amount allowable for each ministry based on information about the forecast revenue. The Ministry of Finance informs ministries and other central government institutions about the basic principles to be applied in drafting the budget proposals, the basic principles of medium-term expenditure planning, the medium-term forecast of economic outlook as well as the financial restrictions to be complied with when preparing the budget estimates. Ministries, other central government institutions and their subordinated institutions plan expenditure broken down by programme and sub-programme, where each programme and sub-programme comprises measures aimed at achieving a specific objective. When preparing a government budget proposal, a ministry complies with the requirement that the existing financing should be primarily used to finance the priorities approved by the government. The most important priority this year and also in the years to follow is to ensure financing required for implementation of projects co-financed from the EU funds.

The draft law on government budget and explanations thereof are submitted to the Cabinet. In case of any issues that have not been resolved in the process of reviewing the budget proposals, these are submitted by the heads of the relevant line ministries to the Cabinet for review. After the draft budget has been reviewed by the Cabinet, the Cabinet decides on submission of the draft law on government budget to the Parliament.

The Cabinet submits to the Parliament for adoption the annual draft law on government budget, explanations thereof, accompanied by a package of related draft laws and medium-term development and fiscal policy framework by October 1 of the current year. After the budget law is approved by the Parliament, it is signed by the President of the Republic of Latvia.

The next stage of the budget process is budget execution. It consists of collecting the planned revenue and incurring expenditure in compliance with the provisions of the law on budget. The main institutions in charge of ensuring budget execution are the Treasury and the State Revenue Service. Each budget institution plans the spending of the appropriation granted to it by way of an estimate. The budget institutions have the responsibility to ensure that the actual expenditure does not exceed the planned expenditure, thus ensuring efficient spending of the financing. When the financial year has ended, the government prepares a report on government budget execution and submits it to the Parliament for reviewing, together with an opinion of the State Audit Office. The State Audit Office's opinion provides information about the compliance of the budget institution's spending with the reported data, highlights gaps and provides recommendations for eliminating them. The concerned budget institutions prepare an action plan for implementation of the State Audit Office's recommendations.

In order to achieve more effective and efficient use of the available resources and ensure implementation of already ongoing programmes, ministries introduce strategic planning, which will ensure that the budget is oriented towards financing of objectives and results.

The strategic planning is introduced gradually in Latvia. Government budget programmes are restructured in accordance with the functions and national policies to be implemented by the ministries. In accordance with the Rules of Procedure of the Cabinet, ministries have to submit budget proposals based on the institutional action strategy programme structure already starting from 2007 budget.

Within the framework of implementation of the institutional action system, a system of results and performance indicators is required as a part of this system. “Key concepts of the results and performance indicator system” have been developed (approved by the Cabinet of Ministers March 13, 2003 decree No. 162). These key concepts prescribe methodologies how to link the system of results and performance indicators with strategic planning, as a necessary component of the strategic planning. The purpose of implementing the system of results and performance indicators is to provide the financial policy management with adequate information on the expected policy outcomes, by measuring alternative policies and types of their implementation in order to take the final decision. Consequently, attainment of the performance indicators will become a criterion for judging the success of implementation of one or another policy, linking the responsibility for meeting the performance targets directly with further financing of the specific policy or measure.

In order to increase the responsibility of budget institutions for efficiency and effectiveness of spending, in 2005 a provision was incorporated into the Law on Budget and Financial Management stipulating that ministries and other central government institutions submit to the Cabinet an informative report on spending of the central government budget funding granted in the reporting year, on achievement of the performance indicators for the implemented policies and operational results and a clarification on deviations from the approved performance indicators of programmes and sub-programmes.

In order to inform the community about the objectives and results of an institution's operation as well as the spending of the central government budget funds granted in the previous year, ministries and other central government institutions and all their subordinated institutions financed from the central government budget as well as local governments prepare annual public report by July 1 of the year following the reporting year and publish information about approval of the annual public report and the possibilities to read full text of the report in the official newspaper “Latvijas Vēstnesis”. This ensures accountability for spending to the community.

To ensure monitoring of the budgetary spending and enable the required analysis by administrative, functional and economic categories, the budgetary expenditure is classified based on economic and functional categories. The budgetary revenue is classified based on the classification of budgetary revenue, in order to provide an insight of the types of revenue and their shares in the overall block of revenue.

Economic development trends are analysed regularly and an assessment of the potential impact on the government budget revenue is prepared. It has to be realised that slow economic growth creates a situation where budget revenue shrinks, while the government expenditure remains unchanged. Taking into account the potential adverse impact of a sluggish economic development, a special procedure has been stipulated by Latvian legislation. Pursuant to Part II of Article 25 of the Law on Budget and Financial Management, the Minister of Finance reports on the required suspension or reduction of expenditure allocations, if it is expected that the government deficit will exceed the target deficit approved in the annual state budget law. Within seven days of receiving the report, the Cabinet decides on suspension or reduction of allocations and no later than within three working days submits proposals concerning amendments to the annual state budget law to the Parliament for review.

Annex

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		millions of lats	rate of change, %				
1. Real GDP (at 2000 prices)	B1*g	6269.1	8.5	8.4	7.5	7.0	7.0
2. Nominal GDP	B1*g	7345.8	16.3	16.2	13.8	11.8	11.0
Components of real GDP							
3. Private consumption expenditure	P.3	4024.0	9.3	8.5	8.0	7.5	7.0
4. Government consumption expenditure	P.3	1075.7	2.1	2.4	2.4	2.4	2.0
5. Gross fixed capital formation	P.51	2017.0	23.8	14.7	9.5	9.0	9.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	252.0	5.4	3.2	1.9	1.1	0.8
7. Exports of goods and services	P.6	2553.9	9.4	18.6	14.3	10.5	8.5
8. Imports of goods and services	P.7	3653.5	16.6	11.4	10.2	8.8	8.0
Contributions to real GDP growth							
9. Final domestic demand		-	13.0	10.6	8.8	8.3	8.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.7	3.2	1.5	0.9	0.1
11. External balance of goods and services	B.11	-	-5.2	0.9	0.3	-0.4	-0.9

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change, %				
1. GDP deflator			7.1	7.3	5.8	4.5	3.7
2. Private consumption deflator			6.0	6.5	5.3	4.0	3.5
3. HICP			6.2	6.9	5.6	4.3	3.5
4. Public consumption deflator			6.1	6.0	6.0	5.0	5.0
5. Investment deflator			5.7	8.6	6.5	5.0	4.5
6. Export price deflator (goods and services)			11.0	7.0	3.5	3.0	3.0
7. Import price deflator (goods and services)			8.9	8.0	4.0	3.0	3.0

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change, %				
1. Employment, thousands of people		1018	1.1	1.0	1.0	0.5	0.5
2. Employment, hours worked		-	-	-	-	-	-
3. Unemployment rate (%)			10.4	9.9	9.3	9.0	8.7
4. Labour productivity[7]			7.4	7.3	6.5	6.5	6.5
5. Labour productivity[8]		-	-	-	-	-	-
6. Compensation of employees at current prices, millions of lats	D.1	2983.4	17.7	16.5	12.7	11.3	10.5

[7] Real GDP per person employed
[8] Real GDP per hour worked

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-12.0	-8.8	-7.7	-7.0	-7.0
of which: - Balance on goods and services		-16.0	-14.1	-12.6	-11.9	-11.7
- Balance of primary incomes and transfers		3.0	4.1	3.7	3.7	3.6
- Capital account		1.1	1.2	1.2	1.1	1.1
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-11.0	-7.3	-6.2	-5.6	-5.7
3. Net lending/borrowing of general government	EDP B.9	-1.0	-1.5	-1.5	-1.4	-1.3
4. Statistical discrepancy		0.6	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008
		millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
2. Central government	S.1311	-140.3	-1.9	-2.2	-2.2	-1.8	-1.5
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-6.1	-0.1	-0.1	-0.2	-0.1	-0.1
5. Social security funds	S.1314	76.6	1.0	0.9	0.9	0.6	0.4
General government (S13)							
6. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
7. Total expenditure	TE	2658.2	36.2	36.8	37.5	38.8	38.7
8. Net lending/borrowing	EDP B.9	-69.9	-1.0	-1.5	-1.5	-1.4	-1.3
9. Interest expenditure (excl. FISIM)	EDP D.41	55.1	0.7	0.7	0.7	0.7	0.7
10. Primary balance		-14.8	-0.2	-0.7	-0.8	-0.6	-0.6
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		1457.8	19.8	20.1	21.4	22.5	23.3
11a. Taxes on production and imports	D.2	872.5	11.9	12.0	13.1	13.9	14.4
11b. Current taxes on income, wealth, etc	D.5	585.3	8.0	8.1	8.3	8.7	9.0
12. Social contributions	D.61	661.0	9.0	8.8	8.8	8.6	8.1
13. Property income	D.4	56.0	0.8	0.7	0.4	0.4	0.4
14. Other income		413.6	5.6	5.7	5.4	5.9	5.6
15=6. Total revenue	TR	2588.3	35.2	35.3	36.1	37.4	37.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		2131.8	29.0	29.2	30.5	31.2	31.7
Selected components of expenditure							
16. Collective consumption	P.32	767.7	10.5	11.6	11.7	11.6	11.5
17. Total social transfers	D.62 + D.63	695.1	9.5	9.4	9.3	9.0	9.0
17a. Social transfers in kind	P.31 =D.63	11.5	0.2	0.1	0.1	0.1	0.1
17b. Social transfers other than in kind	D.62	683.6	9.3	9.3	9.2	8.9	8.9
18.=9. Interest expenditure	EDP D.41	55.1	0.7	0.7	0.7	0.7	0.7
19. Subsidies	D.3	38.4	0.5	0.5	0.4	0.4	0.4
20. Gross fixed capital formation	P.51	111.3	1.5	2.3	2.5	2.9	3.3
21. Other expenditure		990.6	13.5	12.3	13.0	14.1	13.8
22=7. Total expenditure	TE	2658.2	36.2	36.8	37.5	38.8	38.7
Pm: compensation of employees	D.1	775.6	10.6	11.1	11.4	11.4	11.3

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2003**	**2007**
1. General public services	1	4.8	4.9
2. Defence	2	1.3	2.0
3. Public order and safety	3	2.4	2.5
4. Economic affairs	4	3.5	3.4
5. Environmental protection	5	0.4	0.5
6. Housing and community amenities	6	0.9	1.0
7. Health	7	3.3	4.0
8. Recreation, culture and religion	8	1.4	1.7
9. Education	9	6.2	6.8
10. Social protection	10	10.8	12.0
11. Total expenditure	TE	35.0	38.8

Table 4. General government debt developments

% of GDP		**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt		13.1	14.9	13.6	13.7	14.7
2. Change in gross debt ratio		-1.6	1.8	-1.3	0.1	0.1
Contributions to changes in gross debt						
3. Primary balance		0.2	0.7	0.8	0.6	0.6
4. Interest expenditure		0.7	0.7	0.7	0.7	0.7
5. Stock-flow adjustment		1.2	-1.0	2.0	-1.1	0.2
of which: - Differences between cash and accruals		0.3				
- Net accumulation of financial assets		0.6				
of which: *- privatisation proceeds*		0.1				
- Valuation effects and other		0.3				
p.m. implicit interest rate on debt		5.5	5.5	5.0	5.3	5.2
Other relevant variables						
6. Liquid financial assets		3.5				
7. Net financial_debt (7=1-6)		11.2				

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Real GDP growth (%)	B1g	8.5	8.4	7.5	7.0	7.0
2. Net lending of general government	B9	-1.0	-1.5	-1.5	-1.4	-1.3
3. Interest expenditure	D41	0.7	0.7	0.7	0.7	0.7
4. Potential GDP growth (%)		7.9	8.1	8.0	7.6	7.2
contributions:						
- labour		0.9	0.7	0.7	0.3	0.1
- capital		3.5	3.8	3.8	3.7	3.6
- total factor productivity		3.4	3.4	3.4	3.4	3.4
5. Output gap		0.3	0.5	0.1	-0.5	-0.7
6. Cyclical budgetary component		0.1	0.1	0.0	-0.1	-0.2
7. Cyclically-adjusted balance (2-6)		-1.1	-1.6	-1.5	-1.3	-1.1
8. Cyclically-adjusted primary balance (7-3)		-0.4	-0.9	-0.8	-0.6	-0.4

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008
Real GDP growth (%)	B1g					
Update of December 2004		8.1	6.7	6.5	6.5	-
Update of November 2005		8.5	8.4	7.5	7.0	7.0
Difference		0.4	1.7	1.0	0.5	-
General government net lending (% of GDP)	B.9					
Update of December 2004		-1.7	-1.6	-1.5	-1.4	-
Update of November 2005		-1.0	-1.5	-1.5	-1.4	-1.3
Difference		0.7	0.1	0.0	0.0	-
General government gross debt (% of GDP)						
Previous update		14.2	14.5	14.8	15.0	-
Current update		14.7	13.1	14.9	13.6	13.7
Difference		0.5	-1.4	0.1	-1.4	-

Table 7. Long-term sustainability of public finances

% of GDP	2005	2010	2020	2030	2050
Total expenditure	36.8	37.8	37.7	39.1	39.3
Of which: age-related expenditures	16.3	13.8	13.8	15.1	15.3
Pension expenditure	6.4	4.9	4.9	5.6	5.6
Social security pension	6.4	4.9	4.9	5.6	5.6
Old-age and early pensions	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	0.7	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Health care	5.2	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.4	3.3	3.1	3.5	3.3
Other age-related expenditures	0.3	0.3	0.2	0.2	0.2
Interest expenditure					
Total revenue	35.3	36.9	36.5	36.3	36.2
of which: from pensions contributions (or social contributions if appropriate)	7.9	6.1	5.6	5.4	5.4
Pension reserve fund assets					
Of which: consolidated public pension fund assets (assets other than government liabilities)					
Assumptions					
Labour productivity growth	6.5	6.5	4.0	2.7	1.1
Real GDP growth	8.1	7.4	2.9	2.1	0.4
Participation rate males (aged 20-64)	84.4	87.6	89.6	89.5	87.6
Participation rates females (aged 20-64)	72.6	76.2	79.0	79.8	76.6
Total participation rates (aged 20-64)	78.2	81.7	84.1	84.5	82.0
Unemployment rate	9.1	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.5	17.4	18.4	21.3	26.1

Table 8. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate (annual average), LVL	4.2	3.0	3.0	3.0	3.0
Long-term interest rate (annual average), LVL	4.9	3.9	3.5	3.5	3.5
USD/€ exchange rate (annual average)	1.24	1.25	1.23	1.24	1.24
Nominal effective exchange rate (ES), rate of change %	6.1	-0.8	-1.7	0.5	0.5
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.6
EU GDP growth	2.4	1.5	2.1	2.4	2.4
Growth of relevant foreign markets	12.1	9.0	9.0	8.4	8.4
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.4
Oil prices, (Brent, USD/barrel)	37.8	56.4	65.6	63.5	63.5