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REPORT FROM THE COMMISSION

Latvia

Report prepared in accordance with Article 104(3) of the Treaty

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1. INTRODUCTION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever the deficit of a Member State exceeds the 3% of GDP reference value. This report analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report assesses recent and current budgetary developments in Latvia and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government. It is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure”[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that this report has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

According to the convergence programme update submitted by the Latvian authorities on 14 January 2009, the general government deficit in Latvia is estimated to have reached 3.5% of GDP in 2008, due to the severe economic downturn in the second half of 2008, thus exceeding the 3% of GDP reference value, while general government gross debt stood at 19.4% of GDP in 2008, well below the 60% of GDP reference value[2], but on a growing trend.

Table 1: General Government deficit and debt [a]

	2002	2003	2004	2005	2006	2007	2008		2009		2010	
							COM	MS[b]	COM	MS[b]	COM	MS[b]
General Government balance	-2,3	-1,6	-1,0	-0,4	-0,2	0,1	-3,5	-3,5	-6,3	-5,3	-7,4	-4,9
General government gross debt	13,5	14,6	14,9	12,4	10,7	9,5	16,0	19,4	30,4	32,4	42,9	45,4

Notes:
[a] In percent of GDP
[b] January 2009 update of the convergence programme
Source : *Commission services'Interim Forecast January 2009 and January 2009 update of the convergence programme*

The figure for the 2008 deficit provides *prima facie* evidence on the existence of an excessive deficit in Latvia in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Latvia with the adoption of this report. Section 3 of the report examines the deficit criterion and Section 4 the debt criterion. Section 5 deals with public investment and other relevant factors. The document takes into account the Commission services’ January 2009 interim forecasts, released on 19 January.

1 OJ L 209, 2.8.1997, p.6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5). The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 The Commission services' January forecast underestimated gross debt in 2008. The debt projections for 2009-2010 assume full drawdown of the international financial assistance, as scheduled by the involved parties.

3. Deficit criterion

In 2008, the general government deficit is estimated to have reached 3.5%[3] of GDP and in 2009 is planned to reach 5.3% of GDP.

Although in excess of 3%, the difference is the maximum deviation allowing to consider the deficit-to-GDP ratio still close to the Treaty reference value.

The excess over the 3% of GDP reference value can be regarded as exceptional. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' January 2009 interim forecast, real GDP growth in Latvia is projected to be strongly negative in the years 2008 and 2009 (-2.3% and -6.9% respectively, a stronger contraction than the Latvian authorities' forecast in the January 2009 convergence programme update). The recession reflects the sharp adjustment in the real estate market which has spread to the wider economy and has been amplified by the financial crisis and global slowdown, including the much lower growth prospects in Latvia's main trading partners (Lithuania, Estonia, Russia).

Table 2: Macroeconomic and budgetary developments [a]

	2002	2003	2004	2005	2006	2007	2008		2009		2010	
							COM	MS[b]	COM	MS[b]	COM	MS[b]
Real GDP (% change)	6,5	7,2	8,7	10,6	12,2	10,3	-2,3	-2,0	-6,9	-5,0	-2,4	-3,0
Potential GDP (% change)[c, d]	6,7	6,8	7,2	7,3	6,7	5,5	3,4	3,9	1,4	2,2	0,5	1,1
Output gap (% of potential GDP)[c, d]	-1,9	-1,5	-0,1	3,0	8,3	13,2	7,0	5,9	-1,8	-1,6	-4,7	-5,6
General government balance	-2,3	-1,6	-1,0	-0,4	-0,2	0,1	-3,5	-3,5	-6,3	-5,3	-7,4	-4,9
One-off and other temporary measures	-	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Government gross fixed capital formation	1,3	2,4	3,1	3,4	4,7	5,9	5,6	5,4	5,9	6,0	6,2	6,8
Cyclically-adjusted balance[c]	-1,7	-1,2	-1,0	-1,2	-2,5	-3,6	-5,4	-5,1	-5,8	-4,9	-6,1	-3,3
Cyclically-adjusted primary balance[c]	-1,0	-0,5	-0,3	-0,6	-2,0	-3,1	-4,8	-4,5	-4,6	-3,4	-4,2	-1,8
Structural balance[c, e]	-	-1,3	-1,0	-1,2	-2,5	-3,6	-5,4	-5,1	-5,8	-4,9	-6,1	-3,3
Structural primary balance[c]	-	-0,6	-0,3	-0,6	-2,0	-3,1	-4,8	-4,5	-4,6	-3,4	-4,2	-1,8

Notes:
[a] In percent of GDP
[b] January 2009 update of the convergence programme
[c] 'MS' columns, as recalculated by Commission services on the basis of the information presented by the January 2009 update of the convergence programme
[d] Output gap and potential growth figures must be interpreted with special caution in case of an economy undergoing rapid structural change, such as Latvia's.
[e] Cyclically-adjusted balance excluding one-off and other temporary measures
Source : Commission services'Interim Forecast January 2009 and January 2009 update of the convergence programme

The excess over the 3% of GDP reference value cannot be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact[4]. The Commission services' January 2009 interim forecast projects that, taking into account the measures for the current year in the budget – including the amendments in December 2008 - for 2009, the deficit would widen from 3.5% of GDP in 2008 to 6.3% of GDP in 2009 and worsen further to 7.4% of GDP in 2010 on a no-policy change basis. According to the January 2009 convergence programme update, the deficit is targeted to increase to 5.3% of GDP in 2009 before decreasing (based however on yet to be specified consolidation measures) to 4.9% of GDP in 2010 and to a value below 3% of GDP in 2011.

In sum, the deficit in 2008 is close to the 3% of GDP reference value[5] and the excess over the reference value is exceptional, but it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

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3 More recent information suggests that the deficit might have been higher than this in 2008.
4 Neither in 2008, nor in 2009.
5 More recent information suggests that the deficit might have been higher than this in 2008.

4. DEBT CRITERION

The sharp increase in 2008 in the general government debt ratio (from 9.5% of GDP in 2007 to 19.4% of GDP) is a result of, in addition to the impact of the deficit, the financial sector stabilization measures undertaken by the government late in the year, in particular the increase in government borrowing to enable it to provide liquidity to Parex bank, which was partly nationalized after large drains on its deposit base. General government gross debt, while not exceeding the 60% of GDP reference value during the programme period, is projected to be on a rapidly growing trend (rising to 32.4% of GDP in 2009 and 45.4% of GDP in 2010). This assumes full take-up of the international financial assistance being extended to Latvia during the period up to 2011.

5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration. Finally, Article 2(5) of the Regulation provides that the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar should be considered in all assessments in the framework of the excessive deficit procedure. In 2000, Latvia adopted such a reform, which is implemented in stages, leading to a progressive increase in costs.

In view of the above provisions, the following five subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; (4) other factors considered relevant by the Commission and (5) pension reforms as mentioned above.

5.1. Medium-term economic position

Cyclical conditions and potential growth. Following a sustained period of high growth since the end-1990s, largely based on domestic demand, Latvia's real GDP increased at double-digit rates in 2005-2007, well over potential. Growth was primarily driven by a powerful credit expansion boosting private consumption and real estate investment, but this ended by mid-2007, as overvalued real estate prices could no longer be sustained. During these years, the structure of the economy shifted from the tradeable sector to the non-tradeables, undermining the external sustainability of the economy and resulting in serious overheating pressures. The Commission services' January 2009 interim forecast envisages a contraction of Latvian GDP by 6.9% in 2009 and by 2.4% in 2010 with net external borrowing projected to decrease from 13% of GDP in 2008 to 4.6% of GDP in 2009 and 3.4% of GDP in 2010. Accordingly, net exports are expected to make a strong positive contribution to GDP growth but this reflects falling imports rather than a strong performance of exports, which remain depressed given the global slowdown and the cost competitiveness losses sustained in recent years. Inflation is projected to fall in 2009 and 2010, but VAT and excise tax increases in early-2009 slow the improvement in the headline figure. Commission services' calculations according to the commonly agreed methodology show a marked deceleration in the rate of potential growth, from an average 6.5% in the period 2005-2007 to 1.4% in 2009 and further weakening in 2010. Estimates of the output gap confirm the scale of the adjustment, with the gap moving from strongly positive in 2007 (+13% of potential output) to +7% in 2008 and turning negative in 2009 and 2010 (-2% and -5%, respectively)[6]. As market sentiment increasingly turned against emerging markets, funding constraints - which emerged in relation to the financial problems of Parex Bank - led to the government's decision to turn to international institutional financing. The outline agreement in December on multilateral financial assistance of EUR 7.5bn[7] is conditional on major public finances consolidation as well as financial system- and structural reforms, as represented in the authorities' "Economic stabilisation and growth revival programme"[8], adopted by Parliament in December 2008.

Recent structural reforms. Latvia has made slow progress with structural reform measures over the recent years, with no significant budgetary impact except for the territorial reform, which will lead to a more streamlined municipal structure of the country. The "Economic stabilisation and growth revival programme" includes structural reform measures supported in the context of the Lisbon strategy, such as the active labour market and life long learning policies, greater involvement of private sector actors in R&D and innovation activities, export promotion measures and removal of administrative burdens for businesses. Latvia plans to reform its education system in order to increase efficiency and to improve the quality of the services provided.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Latvia experienced economic good times in recent years as assessed by strong growth and large positive output gaps. However, the economic situation deteriorated rapidly: Latvia entered economic bad times in late 2008 and is projected to remain there during the forecast horizon of the Commission services' January 2009 forecast. Despite the slight improvement in the nominal balance, the structural balance deteriorated markedly between 2004 and 2008 (from -1% to -5½% of GDP). Windfall revenues were typically spent through the process of intra-year supplementary budgets and no reserves were created for worse times. According to the Commission services' January 2009 interim forecast, the structural balance is projected to worsen slightly further in 2009 and 2010, despite the discretionary measures introduced in December 2008 to limit the budget deficit through tax increases and expenditure cuts[9]. The budgetary position departed from the medium-term objective (a 1% of GDP deficit in structural terms) in 2005 and has been moving further away from it; it is projected to diverge further in 2009 and 2010[10].

6 Output gap figures in general must be interpreted with special caution in the case of an economy such as Latvia's, as potential growth is difficult to determine for an economy subject to rapid structural change (in particular, the composition of GFCF is ignored in commonly agreed method). This is underscored by the fact that the output gap estimates have been quite unstable in view of new data and data revisions, even when applying the same methodology.

7 The EUR 7.5bn financing package was jointly negotiated by the EU, IMF, WB and several European countries and is provided to Latvia in several installments up to Q1 2011, in a front-loaded manner.

8 http://www.mk.gov.lv/en/aktuali/zinas/2008/12/12122008-01/

9 According to the information in the January 2009 convergence programme update, as recalculated by Commission services, the structural balance would improve slightly in 2009 and significantly in 2010.

10 See footnote number 4.

Public investment. Government investment as a share of GDP is high in Latvia and the rise in the public investment ratio, from around 3% of GDP in 2004 to 5½% in 2008 was larger than the increase in general government deficit (from 1% to 3½% of GDP). However, the change in the public investment ratio was less pronounced than the deterioration in the structural balance (from 1% to 5½% of GDP). According to the Commission services' forecast, in 2009 and 2010, the public investment ratio will remain about equal to the general government structural deficit ratio, but it would become lower than the headline deficit.

Quality of public finances. General government expenditure has risen from 36% of GDP in 2004 to 39% in 2008, still one of the lowest in the EU. Besides public investment which was boosted by contributions from EU-funds, government consumption, and particularly compensation of employees has been growing very rapidly (nominally doubling between 2004 and 2007). Public sector wage growth became a driver of private sector wage increases, contributing to economic overheating and indirectly to the loss in cost competitiveness of the private sector. The policy programme adopted by the Latvian authorities in December 2008, aims – inter alia – at consolidating the budget by reducing average remuneration in the public sector in nominal terms by 15% in 2009 relative to the original 14 November 2008 budget and by further 2% per year in 2010 and 2011. On the other hand, after falling from 2004 to 2008, the share of social transfers other than in kind is expected to increase within total expenditure, as social transfers are planned to be safeguarded during the economic adjustment process.

Long-term sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, as a result of the pension reforms already enacted. However, the budgetary position in 2008, as estimated in the programme, has worsened considerably compared with the starting position of the previous programme and compounds the budgetary impact of population ageing. Reducing the primary deficit over the medium term, as foreseen in the programme, would contribute to reducing medium-risks to the sustainability of public finances and would be important to improve the market view on Latvia. Measures to support financial sector stabilisation in Latvia could have a negative impact on the long-term sustainability of public finances, primarily via their impact on government debt.

5.3. Other factors put forward by the Member State

In a letter of 26 January 2009, the authorities of Latvia listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities. The letter also draws attention to the action taken since the adoption of the 2009 budget on 14 November. In particular, it mentions that the government adopted the "Economic stabilisation and growth revival programme" with the goal of stabilizing the economy, resolving possible problems with liquidity, restoring long-term stability through strengthening the banking sector, avoiding fiscal imbalances and pursuing a stable and unchanged currency policy. Furthermore, the letter recalls that in December 2008, the Parliament endorsed changes in the 2009 budget, with 7% of GDP in measures to limit the deterioration in the budget deficit. Finally, the letter states that the international financial assistance of 7.5 billion euro[11] will give the necessary impulse to implement the "Economic stabilisation and growth revival programme" to withstand short-term liquidity pressures while improving the competitiveness and supporting an orderly correction of imbalances in the medium-term, hence bringing the economy back on a sound and sustainable footing.

[11] See Council Decision 5252/09 and 5255/09.

5.4. Other factors considered relevant by the Commission

Recent public finance developments in Latvia are also influenced by the following factors in the area of budgetary institutions and procedures. The medium-term budgetary framework was too weak to help avoid pro-cyclical fiscal policy during the years of above potential growth in 2004-2007. Macroeconomic forecasts underlying budgetary planning have systematically underestimated growth in the upward phase of the cycle. Unplanned tax receipts were spent in the form of intra-year supplementary budgets and no savings were accumulated in a stabilisation reserve fund. In the downward phase of the cycle, the situation with budgetary forecasting has reversed: revenue underperformance relative to plans in part was determined by overestimation of economic growth, which has hindered a timely adaptation of fiscal policy to the new environment. In the framework of the Latvian authorities' "Economic stabilisation and growth revival programme" the Budget and Financial Management law will be amended to strengthen provisions on financial responsibility, transparency and accountability and the medium term budgetary framework will be made operational. A special committee will be established to monitor wage restraint and to issue recommendations to ensure that wages evolve in a way to restore competitiveness.

With a view to stabilising the financial sector, Latvia raised the deposit guarantee coverage from the lats equivalent of € 20,000 to € 50,000. In November 2008, the government took a controlling share of Parex Bank and provided liquidity support to the bank. Latvia is currently developing the legal framework for using public financial resources to support financial institutions.

5.5. Systemic pension reforms

In 2001, Latvia started a pension reform introducing a mandatory, fully funded second-pillar in accordance with the law "On State Funded Pensions". The initial rate of social contribution accruing into the state funded pension scheme was 2% of the gross wage of participants. Starting from 2007, the rate of contribution was raised to 4% and from 2008 to 8%. A further scheduled increase to 9% in 2009 was postponed to 2010 and from 9% to 10% in 2010 to 2011, due to the serious budget revenue shortfall at the end of 2008.

Table 3: Illustration of the impact of the net cost of systemic pension reform in Latvia

% of GDP, exc. lines for d. scale	2004	2005	2006	2007	2008	2009	2010	2011
Government balance*	-1,0	-0,4	-0,2	0,1	-3,5	-5,3	-4,9	-2,9
Cost (total)**	0,3	0,3	0,4	0,8	1,7	1,4	1,7	2,0
Cost (stage 1)	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3
Cost (stage 2)			<0.1	<0.1	<0.1	<0.1	<0.1	<0.1
Cost (stage 3)				0,4	0,4	0,4	0,4	0,4
Cost (stage 4)					0,9	0,6	0,9	0,9
Cost (stage 5)								0,3
Degressive scale (stage 1)	40%	20%						
Degressive scale (stage 2)			100%	80%	60%	40%	20%	
Degressive scale (stage 3)				100%	80%	60%	40%	20%
Degressive scale (stage 4)					100%	80%	60%	40%
Degressive scale (stage 5)								100%
Cost to be considered (stage 1)	0,1	0,1						
Cost to be considered (stage 2)			<0.1	<0.1	<0.1	<0.1	<0.1	
Cost to be considered (stage 3)				0,4	0,3	0,3	0,2	0,1
Cost to be considered (stage 4)					0,9	0,5	0,5	0,4
Cost to be considered (stage 5)								0,3
Cost to be considered (total)	0,1	0,1	0,0	0,5	1,3	0,8	0,7	0,8
Adjusted government balance***	-0,9	-0,3	-0,2	0,6	-2,2	-4,5	-4,2	-2,1

* according to the January 2009 convergence programme update
** estimates provided by the member state
*** government balance adjusted by the pension reform cost to be considered

Source: Commission services

According to preliminary data, in 2008 the contributions to the state funded pension scheme increased to 1.7% of the GDP from 0.8% of GDP in 2007. The systemic pension reform, according to the Pact provision[12] on how to take into account the cost of such reform, is estimated to have the most notable impact - over 1% of GDP - on the general budget balance in 2008 (Table 3). However, it should only be considered for adjusting the government balance in the case when the deficit exceeds the reference value, while remaining close to it[13].

6. CONCLUSIONS

The general government deficit in Latvia is estimated to have reached 3.5% of GDP in 2008, above, but close to the 3% of GDP reference value[14]. The deterioration of the fiscal position in 2008 was mainly due to lower tax revenues, reflecting primarily lower domestic demand and not to additional stimulation measures in response to the recession. Since the deficit is above but close to the reference value, according to the Stability and Growth Pact due consideration should be given to the impact on the deficit of Latvia's implementation of its pension reform. For 2008 taking account of the net cost of the reform would produce an adjusted deficit of below 3% of GDP. However, given the deficits projected in the Commission services' January 2009 interim forecast for 2009 and 2010, the excess in 2008 over the 3% of GDP reference value cannot be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact.

From 2009, in line with the EERP and with the authorities' economic stabilisation plan adopted in December 2008 in response to the international financial assistance extended to Latvia, Latvia, as a country facing significant external and internal imbalances has aimed its budgetary policy more clearly at correcting such imbalances. Nevertheless, the general government deficit in Latvia is still projected in the Commission services' January 2009 interim forecast to reach some 6% and 7% for 2009 and 2010 respectively, above and not close to the 3% of GDP reference value. . The excess over the reference value in 2008, which within the meaning of the Treaty and the Stability and Growth Pact cannot be considered temporary suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt, from a level well below the 60% of GDP reference value, is expected to rise substantially during the programme period, though not to exceed the reference level within the period.

In line with the Treaty, this report has also examined “relevant factors”. Given that the deficit in 2008 does not satisfy the double condition of closeness and temporariness, these factors cannot according to the Stability and Growth Pact be taken into account in the steps leading to the decision on the existence of an excessive deficit. Considered on their own merit, the relevant factors in the current case present a mixed picture.

The existence of a severe economic downturn, the implementation of a recovery plan and the financial sector support package, with potential public finance implications, increase the need to undertake enhanced surveillance under the EDP.

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12 EC No 1467/97, Article 2(7), see also the 2007 Public Finance Report (pages 124-129).

13 In this sense Table 3 is only illustrative, as the degressive scale clause is not applicable when the deficit is not close to 3% of GDP: therefore, the degressive scale clause is not necessarily relevant for some of the years in the table. In any event, the government deficit adjusted by the pension reform cost in 2009 and 2010 would be above 3%.

14 More recent information suggests that the deficit might have been higher than this in 2008.