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COMMISSION OPINION

on the existence of an excessive deficit in Latvia

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THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

1. 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. However, for those Member States, in particular outside the euro area, facing significant external and internal imbalances, the Plan made clear that budgetary policy should essentially aim at correcting such imbalances. 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.

2. The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. 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, and thereby ensuring long-term sustainability of public finances.

LEGAL BACKGROUND

3. 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.

4. 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)

[1] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on 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/other_pages/other_pages12638_en.htm.

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).

5. Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also 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".

6. On the basis of the 14 January 2009 update of the convergence programme submitted by the Latvian authorities and taking into account the Commission services' January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Latvia on 18 February 2009[2].

7. Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 February 2009.

8. Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the conclusions of its report under Article 104(3) and (ii) the opinion of the Economic and Financial Committee on this report. On the basis of these elements, the Commission has established a number of considerations for Latvia.

CONSIDERATIONS CONCERNING LATVIA

9. Latvia experienced large domestic and external imbalances over the last years. The external deficit of Latvia exceeded 20% of GDP in 2006-2007, while a wage-price spiral drove HICP inflation to well over 10% in 2007-2008. In view of these imbalances and the adverse effect of the global financial turmoil on the economic and financial situation in Latvia, putting the financial stability of the country at serious risk, the authorities requested multilateral financial assistance in December 2008[3]. This assistance is conditional on the implementation by the Latvian authorities of a comprehensive economic policy programme. In particular, fiscal consolidation is a cornerstone of the adjustment programme anchored to the current

[2] All EDP-related documents for Latvia can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2

[3] The total EUR 7.5 billion medium-term financial assistance package over the period up to 2011, in support of the "Economic Stabilisation and Growth Revival Programme" adopted by the Latvian authorities on 12 December 2008, comprises Community assistance of up to EUR 3.1 billion under the Balance of Payments (BoP) facility for Member States, bilateral loans from several EU countries, totalling EUR 2.3 billion, complemented by loans being provided by the IMF (around €1.7 billion supported by a Stand-by arrangement), the WB and the EBRD.

currency peg and to the accession to the euro area. The targets for the budget deficit under the programme supported by the Community balance of payments assistance were set at 5.3% of GDP in 2009, 4.9% of GDP in 2010 and below 3% in 2011.

10. According to the convergence programme update submitted by the Latvian authorities on 14 January 2009, the general government deficit in Latvia was estimated to have reached 3.5% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) adopted in February considered that the deficit was close to the 3% of GDP reference value and that the excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. As regards this latter qualification, the deficit resulted from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact: the Commission services' January 2009 interim forecast (the latest Commission services forecast then available) projected real GDP growth in Latvia to be strongly negative in the years 2008 and 2009, output contracting by 2.3% and 6.9% respectively. However, the excess over the reference value could not be considered temporary. According to the Commission services' interim forecast, taking into account budgetary measures for 2009 based on the December 2008 amended budget[4], the deficit was forecast to widen from 3.5% of GDP in 2008 to 6.3% of GDP in 2009, and on a no-policy change basis worsen further to 7.4% of GDP in 2010. Therefore, the deficit criterion in the Treaty was not considered fulfilled.

11. Since the Commission's adoption of the report, data notified by the Latvian authorities in April 2009[5], subsequently validated by Eurostat[6], and the Commission services' spring 2009 forecast reinforce the report's conclusion regarding the non-fulfilment of the Treaty deficit criterion. In 2008 the general government deficit in Latvia is estimated to have reached 4.0% of GDP, thus exceeding and not close to the 3% of GDP reference value. The excess over the reference value could, however, still be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact: the Commission services' spring 2009 forecast projects real GDP growth in Latvia to be strongly negative in the years 2008 and 2009, with output contracting by 4.6% and 13.1% respectively; more recent information points to an even larger contraction in 2009, of the order of 18%. Consequently, the targets set last December under the framework of the Community balance of payments assistance programme have become unrealistic. However, the excess over the reference value cannot be considered temporary. According to the Commission services' spring forecast, taking into account budgetary measures for 2009 based only on the amendments in December 2008 amended budget, the deficit is forecast to widen from 4.0% of GDP in 2008 to 11.1% of GDP in 2009, and on a no-policy change basis worsen further to 13.6% of GDP in 2010. After adoption of the package of new consolidation measures by the Latvian authorities in June 2009, and also considering those indicated by the authorities for 2010, and assuming their full

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4 To the level of detail available at the time of the forecast.

5 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Latvia can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables

6 Eurostat news release No 56/2009 of 22 April 2009.

implementation, the general government deficit may amount to around 10% of GDP in 2009,8.5% in 2010 and 6% in 2011[7]. Thus the recent developments confirm that the deficit criterion in the Treaty is not fulfilled.

12. The data notified by the Latvian authorities in April 2009 and subsequently validated by Eurostat show that general government gross debt stood at 19.5% of GDP in 2008, well below the 60% of GDP reference value[8]. It is nevertheless projected to be on a rapidly growing trend (in the Commission services' spring forecast, rising to 34.1% of GDP in 2009 and 50.1% of GDP in 2010, assuming full take-up of the international financial assistance being extended to Latvia during the period up to 2011). Taking account of the new consolidation measures adopted in June 2009 and further consolidation plans indicated by the authorities for 2010-12, and depending on whether and to what extent the government assumes further debt in respect of financial sector stabilisation needs, the gross debt ratio may increase above the 60% of GDP reference value in 2012 even with sufficient corrective action.

13. The budgetary impact of the fully funded pillar of the systemic pension reform introduced by the Latvian government will be considered, in line with the provisions of the Stability and Growth Pact. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on Commission services' estimates, the total cost of such a reform undertaken in Latvia amount to 1.6% of GDP in 2008, and - due to the temporary reduction of contributions from 8.0% to 2.0% in 2009, - 0.4% in 2009 and in 2010. The social contribution rate transferred to the fully funded second pillar is planned to be increased to 4% in 2011 and to 6% in 2012, which is projected to increase the total cost of the reform in 2011-2012 respectively to 0.8 and 1.2 percentage points of GDP. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. Since in 2008 the deficit was not close to the reference value, and for 2009 and 2010 the deficit forecast by the Commission services remains not close to the reference value, the cost of the pension reform cannot be taken into account.

14. In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report “relevant factors”. According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Latvia, the double condition is not met and the "relevant factors" cannot therefore be taken into account. Considered on their own merit, the relevant factors in the current case present a mixed picture.

15. The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

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[7] The impact of the temporary redirection of the social contribution payments from the second pillar pension system (see numbered paragraph 12) is included in these estimates.

[8] In the Commission's February 2009 report the ratio was 19.4%.

CONCLUSION

16. The monitoring of the budgetary situation in Latvia and, in particular, the examination of the compliance with the criteria laid down in Article 104(2) has led the Commission to prepare a report in accordance with Article 104(3) of the Treaty. The Commission, having taken into account its report and the opinion of the Economic and Financial Committee, and also subsequent economic and budgetary developments, is of the opinion that an excessive deficit exists in Latvia.