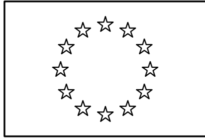
EN



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.7.2009
SEC(2009) 921 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Latvia

EXPLANATORY MEMORANDUM

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

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.

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 the long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

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).

---

[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.

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".

On the basis of the 14 January 2009 update of the convergence programme submitted by the Latvian authorities[2], subsequently validated by Eurostat[3], and taking into account the Commission services' January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Latvia on the 18 February 2009[4].

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

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

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. In particular, it 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 in the December 2008 amended budget, to the level of detail available at the time of the forecast, 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 to worsen further to 7.4% of GDP in 2010. Therefore, the deficit criterion in the Treaty was not considered fulfilled.

Since the Commission's adoption of the report, data notified by the Latvian authorities in April 2009, subsequently validated by Eurostat, 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 in 2008, 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. As regards this latter qualification, the deficit resulted from a severe economic downturn in the sense of the Treaty and the Stability and

2 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

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

4 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.

Growth Pact: the Commission services' spring 2009 forecast projected real GDP growth in Latvia to be strongly negative in 2009, with output contracting by 13.1%, after falling by 4.6% in 2008; more recent information points to an even larger contraction in 2009, of the order of 18%. 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 budget, the deficit was 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 further consolidation plans indicated by the authorities for 2010, and assuming their full implementation, the general government deficit might reach around 10% of GDP in 2009 and 9% in 2010[5]. Thus the recent developments confirm that the deficit criterion in the Treaty is not fulfilled.

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, still well below the 60% of GDP reference value. 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, depending on whether and to what extent the government assumes further debt in respect of financial sector stabilisation needs, the gross debt ratio may exceed the 60% of GDP reference value in 2012 even with sufficient corrective action.

In line with the provisions in the Stability and Growth Pact, due consideration should be given to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. 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.

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. Considered on their own merit, the relevant factors present a mixed picture.

[5] The impact of the temporary redirection of the social contribution payments from the second pillar pension system is included in these estimates.

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).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), and also subsequent economic and budgetary developments, is of the opinion that an excessive deficit exists in Latvia. This opinion, adopted by the Commission on 2 July 2009, is addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Latvia with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which “should be completed in the year following its identification unless there are special circumstances”. Article 2(6) of the Regulation implies that the “relevant factors” considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a “minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation”.

In the case of Latvia, special circumstances are considered to exist. From the turn of the previous decade, Latvia entered a sustained period of high growth, 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 rapid increase in domestic demand created serious overheating pressures and the structure of the economy shifted from the tradeables sector to the non-tradeables, undermining the external sustainability of the economy. The global financial crisis has amplified the shock of the reversal of Latvia's own lending and house price boom by tightening credit availability and conditions. Furthermore, the concomitant downturn in external markets with much lower growth prospects in Latvia's main trading partners (Lithuania, Estonia, Russia, other EU countries), has hit the tradeables sector. The depreciation of the currencies of certain important trading partners has added to the competitiveness losses of previous years. Latvia's financial markets and banking sector have come under significant pressure from October 2008 onwards, sparked by difficulties at the largest locally-owned bank (Parex).

The confrontation with an abrupt and severe banking sector and external financing crisis prompted the Latvian authorities to seek international financial assistance at the end of 2008[6]. The agreement of December 2008 on multilateral financial assistance of up to €7.5bn is conditional on major fiscal consolidation as well as financial system and structural reforms, as

[6] The up to EUR 7.5bn financing package is jointly funded by the EU, IMF, World Bank, EBRD, Nordic countries, Czech Republic, Estonia and Poland and is provided to Latvia in several instalments up to Q1 2011, in a front-loaded manner.

also outlined in the "Economic Stabilisation and Growth Revival Programme" adopted by the authorities in December 2008. The Latvian Parliament adopted an amended budget for 2009 on 12 December 2008, subsequently reflected in the January 2009 convergence programme update. This set out a medium-term fiscal programme designed to reduce the general government budget deficit to no more than the Treaty reference level of 3% of GDP by 2011, notably including for 2009 significant per capita wage reductions and staffing cuts in the public sector, deep reductions in other expenditure and increased rates of indirect taxation, including VAT and excise taxes (while the personal income tax was reduced).

In the context of the much deeper than expected deterioration in global and domestic economic conditions, however, implementation of the December 2008 measures was insufficient to prevent by mid-2009 a clear and wide divergence of progress with fiscal consolidation relative to the December 2008 plan, and further measures were urgently needed.

Subsequently, following a much greater than expected deterioration in economic and budgetary conditions in the first half of 2009, the government proposed additional measures for 2009, adopted by Parliament on 16 June, and a revised multi-annual perspective with further cumulative consolidation measures for 2010-12 targeting a reduction in the general government deficit to under 3% of GDP by 2012. An avowed objective of the June 2009 decisions has been to pave the way for extensive structural reforms in the public sector, notably as regards education and healthcare, to underpin a return to sustainable public finances and competitive economic structure in the medium term.

The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework. Considering the Commission services' spring 2009 deficit forecast for 2009 and 2010, subsequent economic and budgetary developments and the existence of special circumstances, Latvia should correct the excessive deficit by 2012 at the latest. Against the background of the assessment of the current budgetary position made in the context of the Balance of Payments assistance to Latvia, this would imply an annual average fiscal effort of at least 2¾ percentage points of GDP over the period 2010-2012, and would be consistent with general government deficit targets of no more than 10% of GDP in 2009, no more than 8.5% of GDP in 2010 and no more than 6% of GDP in 2011.

Achievement of the revised programme is subject to considerable risks. These relate principally to the high uncertainty regarding the impact on Latvia of the global financial crisis and international policy responses to it, the ongoing correction of economic imbalances in Latvia and, given their intended scale and scope, the uncertain impact of the stabilisation measures undertaken in Latvia on the levels of activity, labour market participation and recourse to social protection arrangements, and thus on the overall consolidation path.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Latvian convergence programme prepared prior to the abrogation of the excessive deficit procedure could usefully be devoted to this issue.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010	2011	2012
Real GDP (% change)	**CP Jan 2009**	**10.3**	**-2.0**	**-5.0**	**-3.0**	**1.5**	n.a.
	COM Spring '09	10.0	-4.6	-13.1	-3.2	n.a.	n.a.
	COM June 2009[5]	-	-4.6	-18.0	-4.0	1.5	3.8
HICP inflation (%)	**CP Jan 2009**	**10.1**	**15.4**	**5.9**	**2.2**	**1.3**	n.a.
	COM Spring '09	10.1	15.3	4.6	-0.7	n.a.	n.a.
	COM June 2009[5]	-	15.3	3.1	-3.5	-2.5	0.2
Output gap[1] (% of potential GDP)	CP Jan 2009	12.2	5.9	-1.6	-5.7	-5.3	n.a.
	COM Spring '09[2]	15.0	6.6	-7.9	-10.6	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2009**	**-21.8**	**-13.4**	**-5.4**	**-2.6**	**-2.3**	n.a.
	COM Spring '09	-20.6	-12.1	0.7	0.8	n.a.	n.a.
	COM June 2009[5]	-	-12.1	3.8	6.3	5.5	5.2
General government balance (% of GDP)	**CP Jan 2009**	**0.1**	**-3.5**	**-5.3**	**-4.9**	**-2.9**	n.a.
	COM Spring '09	-0.4	-4.0	-11.1	-13.6	n.a.	n.a.
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2009**	**-3.3**	**-5.1**	**-4.9**	**-3.3**	**-1.4**	n.a.
	COM Spring '09	-4.5	-5.8	-9.0	-10.7	n.a.	n.a.
Structural balance[3] (% of GDP)	**CP Jan 2009**	**-3.3**	**-5.1**	**-4.9**	**-3.3**	**-1.4**	n.a.
	COM Spring '09	-4.5	-5.8	-9.5	-11.5	n.a.	n.a.
Government gross debt (% of GDP)	**CP Jan 2009**	**9.5**	**19.4**	**32.4**	**45.4**	**47.3**	n.a.
	COM Spring '09[4]	9.0	19.5	34.1	50.1	n.a.	n.a.

Notes:
[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on thebasis of the information in the programmes.
[2] Based on estimated potential growth of 5.3%, 2.9%, 0.6% and -0.2% respectively in the period 2007-2010.
[3] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in the most recent programme or in the Commission services' spring forecast.
[4] Excluding potential future financial system stabilisation costs.
[5] Projections after the May/June joint review mission.

Source:

Convergence programme (CP); Commission services' spring 2009 forecasts (COM); Commission services' calculations.

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Latvia

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Latvia,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[7] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[8] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact in 2005 sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It 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.

(5) 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. Having taken into account its report in accordance with Article 104(3)

---

[7] OJ L 209, 2.8.1997, p. 6.

[8] OJ L 332, 31.12.1993, p. 7.

and having regard to the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Latvia. The Commission therefore addressed such an opinion to the Council in respect of Latvia on 2 July 2009[9].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Latvia, this overall assessment leads to the following conclusions.

(7) According to the April 2009 EDP notification, the general government deficit in Latvia reached 4.0% of GDP in 2008, thus exceeding the 3% of GDP reference value and not close to it. The excess over the reference value can, however, be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. 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' spring 2009 forecast, real GDP growth in Latvia is projected to be strongly negative in 2009, with output 13.1% after falling by 4.6% in 2008; more recent indicators point 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, i.e. 5.3% of GDP in 2009, 4.9% of GDP in 2010 and below 3% in 2011 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 adopted in December 2008, the deficit would 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 indicated by the authorities for 2010, and assuming their full implementation, the general government deficit may reach around 10% of GDP in 2009 and 8.5% in 2010 and 6% in 2011[10]. Therefore, although the excess of the 2008 deficit over the reference value appears exceptional, the deficit was not close to reference value and the excess cannot be considered temporary. Thus the deficit criterion in the Treaty is not fulfilled.

(8) General government gross debt stood at 19.5% of GDP in 2008, still well below the 60% of GDP reference value. 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 exceed the 60% of GDP reference value in 2012 even with sufficient corrective action.

[9] 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

[10] The impact of the temporary redirection of the social contribution payments from the second pillar pension system is included in these estimates.

(9) 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.

(10) According to Article 2(4) of Council Regulation (EC) No 1467/97, “relevant factors” can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Latvia, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Latvia.

Article 2

This decision is addressed to the Republic of Latvia.

Done at Brussels,

For the Council
The President