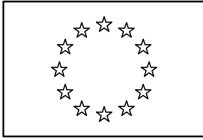

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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CONVERGENCE PROGRAMME OF THE REPUBLIC OF LATVIA (2004-2007)

AN ASSESSMENT

Table of contents

SUMMARY AND CONCLUSIONS 3

1. INTRODUCTION 6

2. MACROECONOMIC DEVELOPMENTS 6

   2.1. Macroeconomic scenario 6

   2.2. External accounts 7

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY 8

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES 9

   4.1. Budgetary developments until 2003 9

   4.2. Programme overview 10

   4.3. Targets and adjustment in 2004 12

   4.4. Targets and adjustment in 2005 and beyond 13

   4.5. Debt ratio 13

5. THE QUALITY OF THE PUBLIC FINANCES 14

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES 15

7. ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME 18

SUMMARY AND CONCLUSIONS[1]

The first Latvian convergence programme, covering the period 2004-2007, was submitted on 14 May. The programme incorporates plans for joining ERM II at the beginning of 2005, shortly after changing the exchange rate peg from the SDR to the euro on 1 January. Adoption of the euro is targeted for 2008, after fulfilment of the convergence criteria by 2007. The document incorporates the measures in the budget for 2004 and draws upon the August 2003 pre-accession economic programme (PEP) covering the period 2003-2006.

The programme complies only partly with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2]. In particular, some of the data are not yet fully in line with ESA95 standards and general government debt and deficit figures should be treated with caution, since the data submitted in the March 2004 fiscal notification were not validated by Eurostat; in general, serious questions persist over the quality and consistency of the underlying data.

Following an impressive 6.2% average growth over the five years 1999-2003, with growth of 7.5% achieved in 2003, the macroeconomic scenario envisages annual GDP growth averaging 6.6% in the programme period. For 2004 and 2005, compared with the Commission spring 2004 forecasts, the Latvian authorities are more optimistic as regards GDP growth, projecting growth in each year of 6.7%, against 6.2% in each year projected by the Commission. The difference mainly stems from particularly strong private consumption and investment growth foreseen by the Latvian authorities. Strong growth of domestic demand is expected to continue in the medium-term; although not unrealistic, this does not seem to be entirely consistent with the assumption of a large current account deficit remaining stable over the programme period (8.5-9.0% of GDP). Projected growth in the two latter years of the programme eases slightly to 6.5%, which again may be considered plausible but insufficiently cautious to underpin medium-term fiscal planning. In addition to vulnerability to external demand shocks, risks to growth stem from structural constraints. Overall, the macroeconomic projections are plausible though leaning towards the optimistic side.

To achieve the Bank of Latvia's price stability objective, the currency (lats) has been pegged to the SDR at a fixed rate since 1994, with a normal fluctuation band of ±1 percent. In consequence the lats depreciated against the euro from early 2002, with some partial reversal since early this year. The exchange rate peg to the SDR has successfully contributed to the disinflation process in Latvia. Between 1999 and 2002, HICP inflation was modest, averaging 2.3 percent per year. However, since summer 2003, inflation has been rising, influenced by increases in administratively regulated prices (particularly energy tariffs, rents and healthcare fees), indirect tax adjustments and lagged effects of exchange rate developments. For 2003 HICP inflation reached 2.9%, up from 2.0% in 2002. Inflation rose further in the first quarter of 2004 and reached 6.2% in May, making improbable the attainment of both the programme's 4.5% and the Commission's 4.0% forecast HICP inflation rate for 2004. Inflation is nevertheless expected to decrease

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1 This assessment has been carried out on the basis of information available as of 16 June 2004.

2 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

gradually and to be around 3% from 2006. Although the Latvian authorities consider the inflation pick-up in 2003 and 2004 to be of a temporary nature, mainly resulting from a combination of one-off factors, the Bank of Latvia recently increased the refinancing rate by 0.5 percentage points to 3.5% to prevent current high inflation rates from impacting adversely on inflation expectations. The short-term interest rate differential against the euro area remains above 200 basis points while the long-term bond yield differential amounts to around 100 basis points.

The budgetary objectives stated in the programme are to ensure compliance with Treaty obligations on government deficits and eventually to reduce the deficit so as to attain balanced budget in the long term. Nevertheless, in the programme period the general government deficit is projected to remain at about 2% of GDP, and with some deterioration in 2004 relative to 2003 due to a worsening of the central government balance. A sharp reduction of the budget deficit is rejected in the programme on the grounds of expenditure needs related to EU and NATO memberships and to investment in human and physical capital. The programme envisages slight reductions in the revenue- and expenditure-to-GDP ratios over the period to 2007. On the revenue side this is not fully explained, particularly for 2006 and 2007, since no further changes to the tax system are envisaged after tax cuts in 2004, collection efficiency is assumed to strengthen over the programme period and significant EU funding should be received by the end of the period. On the expenditure side, additional outlays linked to NATO membership and implementation of partly EU-financed spending plans together account in 2004 for about 0.7 percentage points of GDP in net terms. These increases are expected to be more than offset by firm expenditure control focused on the reduction of transfers.

Achieving the budgetary targets is plausible, although the medium-term fiscal scenario is not exempt from risks. On the downside these stem mainly from potentially lower than projected output growth; moreover general doubts attach to the successful implementation of the strategy given the evidence of an unreliable statistical base and weaknesses in administrative capacity. Pressures on expenditure are expected to intensify during the programme period – mainly owing to high investment needs, the transition costs of public sector reform and the need to co-finance EU assistance. In this context, actions planned to achieve consistency between budgetary plans and policy programmes, to prioritise expenditure and to improve the management of municipal finances and of the healthcare system seem appropriate. Against these downside risks, the deficit projections for 2004 and 2005 are broadly in line with the Commission spring 2004 forecast, while as noted above over the longer period there is some evidence of pessimism regarding revenue prospects, including that the budget should be recording significant net receipts of EU funding by the end of the period. Overall, risks attached to the budgetary targets seem broadly balanced. On the other hand, these targets do not provide a safety margin against breaching the 3% of GDP threshold and the lack of movement closer towards fiscal balance seems insufficiently ambitious. Compared with the 2003 PEP, for instance, growth expectations have been revised upwards but the budget consolidation path has remained unchanged. If the programme's envisaged growth rates materialise, a faster reduction of the general government deficit would be desirable, particularly in view of the present current account deficit and domestic demand pressures. A more rapid transition to a close-to-balance budgetary position in line with the Stability and Growth Pact would also leave room for the automatic stabilisers to play freely if growth slowed down.

The programme foresees the debt-to-GDP ratio increasing from 15.3% of GDP in 2003 to 17.7% of GDP in 2007. The main driving force of the growing debt ratio is the primary deficit. With the exception of 2004, stock-flow adjustments are projected to be small. Through the programme period, the contribution of interest outlays remains broadly at the 2003 level, while nominal GDP growth has a substantial debt ratio-reducing effect. This debt projection appears plausible, given the other programme assumptions.

The programme provides a brief overview of the government's structural reform programme which focuses on improving the business and investment environment and on increasing labour market flexibility and employment. It also outlines measures which largely reflect the Broad Economic Policy Guidelines in those fields. Furthermore, the programme mentions the priority measures underlying the fiscal consolidation, namely to increase fiscal efficiency, improve budgetary procedures and tighten expenditure control. However, in order to assess the planned measures in more detail, further information would be needed.

Latvia is relatively well-placed to meet the budgetary costs of an ageing population although risks of long-term budgetary imbalances cannot be ruled out. The prospects for the long-term sustainability of public finances have been improved by the implementation of a three-pillar pension reform. This is further reinforced by the very low level of general government debt. Nevertheless, risks related to revenue losses due to the pension reform and to financing the restructuring of the healthcare system should be monitored in order to intervene promptly if necessary to stem deficit-increasing pressures. Moreover consolidation needs to be pursued further if the primary balance is to contribute to stemming the increase in public debt.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**7.5**	**6.7**	**6.7**	**6.5**	**6.5**
	COM	7.5	6.2	6.2	n.a.	n.a.
	PEP	*6.5*	*6.1*	*6.0*	*6.0*	*n.a.*
HICP inflation (%)	**CP**	**2.9**	**4.5**	**3.7**	**3.0**	**3.0**
	COM	2.9	4.0	3.5	n.a.	n.a.
	PEP	*2.6*	*2.8*	*3.0*	*3.0*	*n.a.*
General government balance (% of GDP)	**CP**	**-1.8**	**-2.1**	**-2.2**	**-2.0**	**-2.0**
	COM	-1.8	-2.2	-2.1	n.a.	n.a.
	PEP	*-2.9*	*-2.4*	*-2.2*	*-2.0*	*n.a.*
Primary balance (% of GDP)	**CP**	**-0.9**	**-1.2**	**-1.3**	**-1.2**	**-1.2**
	COM	-1.0	-1.4	-1.3	n.a.	n.a.
	PEP	*-2.3*	*-1.5*	*-1.5*	*-1.3*	*n.a.*
Government gross debt (% of GDP)	**CP**	**15.3**	**16.2**	**16.8**	**17.3**	**17.7**
	COM	15.6	16.1	16.3	n.a.	n.a.
	PEP	*19.1*	*17.0*	*17.4*	*17.4*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. INTRODUCTION

The first Latvian convergence programme, covering the period 2004-2007, was approved by the Latvian Cabinet of Ministers on 6 May and submitted on 14 May. The convergence programme was prepared by the Ministry of Finance in consultation with the Bank of Latvia, the Ministry of Economy, Ministry of Welfare and Ministry of Transport. It complies only partly with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". In particular, some of the data are not yet fully in line with ESA95 standards and, more in general, serious questions persist over the quality and consistency of the underlying data, since the data submitted in the March fiscal notification were not validated by Eurostat[3]. The programme nevertheless follows closely the model structure recommended in the Code of Conduct and compares favourably with the 2003 PEP in terms of information provided.

The objectives of Latvia's fiscal policy are to ensure compliance with Treaty obligations on general government deficits and eventually to reduce the deficit. However, there are no immediate plans to move decisively towards the authorities' stated long-term goal of a balanced budget. The actual deficit is expected to rise slightly above 2% of GDP in 2004 and to narrow only very moderately in 2005-2007. A sharp reduction of the deficit is rejected on the grounds of the needs to accommodate spending pressures arising from EU and NATO memberships and to build up human and physical capital. For the period to 2006 the deficit targets remain close to those of the August 2003 pre-accession economic programme (PEP). The debt-to-GDP ratio is projected to increase from 15.3% of GDP in 2003 to 17.7% of GDP in 2007.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The macroeconomic scenario provided in the programme envisages annual average GDP growth of 6.6% in the period 2004-2007. For 2004 and 2005, compared with the Commission spring 2004 forecasts, the Latvian authorities are more optimistic as regards GDP growth, projecting GDP growth in each year of 6.7%, against 6.2% in each year projected by the Commission. The difference mainly stems from particularly strong private consumption and investment growth foreseen by the Latvian authorities. Strong growth of domestic demand is expected to continue in the medium term; although not unrealistic, this does not seem to be entirely consistent with the assumption of a large current account deficit remaining stable over the programme period (8.5-9.0% of GDP). Projected growth in the two latter years of the programme eases slightly to 6.5%, which again may be considered plausible but insufficiently cautious to underpin medium-term fiscal planning.

[3] The general government debt and deficit figures should be treated with caution, since the data submitted in the March 2004 fiscal notification were not validated by Eurostat. The current methodology used by the Latvian authorities is not fully consistent with ESA95 accounting standards and suffers from low source data reliability. The issues are discussed in the status report presented to the EFC on information requirements in EMU, EFC/ECFIN/ESTAT/202/04 of 25.05.04.

Despite the generally bright macroeconomic outlook, the labour market situation is not expected to improve markedly in the programme period, emphasising the need for comprehensive labour market reform. Employment is projected to increase only moderately and unemployment barely declines, remaining above 10%[4] in 2007.

References in the programme to risks to the macroeconomic scenario are brief. However, the authorities are well aware that Latvia is particularly sensitive to changes in external demand and its terms of trade. Weaker than expected external demand could be a further factor calling into question the envisaged slight improvement of the current account balance, both in terms of lower real exports and in terms of lower export prices (a large share of Latvian exports consists of timber and wood products, which might experience sharp price changes). In addition to vulnerability to external demand shocks, risks to growth stem from structural constraints (such as low geographic mobility of labour force resulting from poor transport infrastructure and concentration of investment in the capital area). Overall, the macroeconomic projections are plausible though leaning towards the optimistic side.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	CP	COM	CP	COM	CP	COM	CP	COM	CP
Real GDP (% change)	7.5	7.5	6.2	6.7	6.2	6.7	n.a.	6.5	n.a.	6.5
Contributions:										
- Final domestic demand	8.6	9.2	8.4	9.6	8.1	8.8	n.a.	8.7	n.a.	8.0
- Change in inventories	1.2	2.4	0.0	-1.6	0.0	-1.2	n.a.	-1.2	n.a.	-0.7
- External balance on g&s	-2.3	-4.2	-2.2	-1.3	-1.9	-0.8	n.a.	-1.0	n.a.	-0.9
Employment (% change)	0.7	1.8	0.5	1.0	0.5	1.0	n.a.	0.5	n.a.	0.5
HICP/CPI inflation[1] (%)	2.9	2.9	4.0	4.5	3.5	3.7	n.a.	3.0	n.a.	3.0
GDP deflator (% change)	2.4	5.2	2.0	4.3	1.8	3.8	n.a.	3.4	n.a.	3.3
Current account (% of GDP)	-9.1	-9.2	-10.1	-9.0	-10.9	-8.8	n.a.	-8.4	n.a.	-8.5

[1] HICP: COM; CPI: CP
Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM)

2.2. External accounts

The current account deficit has been on an increasing trend since 1995 and in 2003 exceeded 9% of GDP. This widening is the combined result of a large and increasing trade deficit and declining surpluses on the income balance. The trade deficit reached around 18% of GDP in 2003, despite strong exports growth. The services balance has remained positive, mainly reflecting transit earnings, and in 2003 was equal to about 30% of the trade deficit or some 5% of GDP. In terms of sectoral counterparts the current account deficit corresponds to a persistent negative general government net lending balance (between 1995 and 2003 -1.8% of GDP), and increasing saving of the private sector offset by higher and more rapidly increasing private sector investment (up from 13% of GDP in 1995 to 24% of GDP in 2003).

Containing the current account deficit, amounting to 9.2% in 2003, will be contingent on generating adequate national savings, since the structural part of the current account deficit reflects the domestic savings-investment gap arising from the need for

[4] Harmonized unemployment rate *(Eurostat definition).*

technological innovation and catching up[5]. Though the level of domestic savings is increasing, its growth is still insufficient to meet rising investment needs. Public sector savings, given the policy stance represented in the programme, are not expected to increase markedly in the medium-term and there is no clear sign that private sector savings will increase to close the gap. This emphasises the importance of maintaining a prudent fiscal policy and of pursuing structural reforms that will increase the productive including export capacity of the economy.

The programme projections for the current account balance imply large net inflows of foreign capital throughout the programme period. So far, financing the current account deficit appears to have been unproblematic, with substantial inflows provided by foreign direct investment (FDI)[6]; portfolio flows have remained minor. However, the structure of financing of the external account deficits has recently changed. In 2003 financing was mainly via net inflows of short-term capital, while FDI inflows dropped from around 5.5% of GDP in 2000 to around 3.0% (39% of the current account deficit). FDI flows – particularly reinvested earnings and loans from parent companies – can be volatile. With few large-scale privatizations remaining, attracting new investment – particularly in areas that will enhance export capacity and help to narrow the large trade imbalance – is of increased importance.

The scale of the current account deficit and the implied sectoral savings-investment imbalances suggests that alternative scenarios for their evolution could be studied. Such analysis could cover the composition of capital inflows, domestic credit growth, foreign currency debt dynamics and associated macroeconomic and financial stability issues. In this context, it would also be useful to examine the broader ramifications of growth, interest rate or exchange rate shocks on fiscal and external sustainability. If credit continues to expand rapidly, prudential vigilance will remain important to ensure that imbalances in the private sector reflect sound resource allocation.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

The primary objective of the Bank of Latvia's monetary policy is to maintain price stability. To achieve this objective, the lats has been pegged to the SDR basket of currencies at a fixed rate since 1994. The normal fluctuation band around the fixed exchange rate is ±1 percent.

The exchange rate peg to the SDR has successfully contributed to the disinflation process in Latvia. Between 1999 and 2002, HICP inflation was modest, averaging 2.3 percent per year. Since mid-2003, inflation has been picking up to rates above 3 percent and average annual HICP inflation rose to 2.9 percent in 2003 from 2.0 percent in 2002. In 2004, HICP inflation accelerated further and reached 6.2 percent in May.

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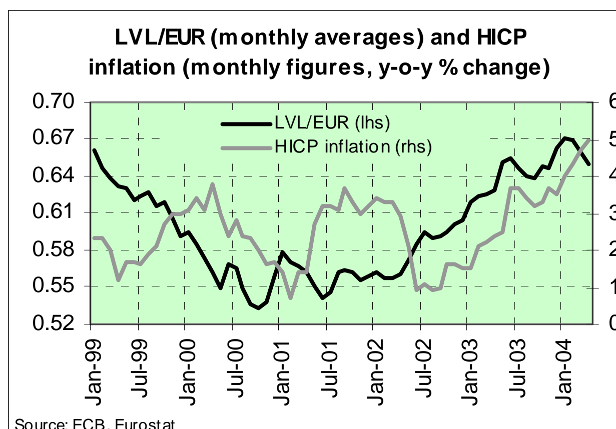
[5] Labour productivity in Latvia is the lowest in the EU (under 40 per cent of the EU-15 average). Some of the underlying reasons include limited research and development activity, low capital deepening and a still relatively low level of physical infrastructure. All these factors contribute to Latvia being specialized in relatively low-tech sectors and in transit activities with low value-added.

[6] Backed by a stable economy, low to moderate taxes and a liberal trade and capital account regime, Latvia has raised its FDI stock from 9% of GDP in 1995 to over 30% of GDP in 2003.

Recent developments in inflation have been influenced by increases in administratively regulated prices, indirect tax adjustments and lagged effects of exchange rate developments. Compared to the average level in 2002, in 2003 the lats was around 10 percent weaker vis-à-vis the euro and import prices rose by almost 8 percent. Taking into account the high trade integration between Latvia and the EU, the planned re-pegging to the euro (see below) should help to moderate substantial swings in import prices and contribute to price stability.



In early 2004, residents' fear of rising prices connected to EU accession increased the demand and price for some basic commodities such as salt and sugar. In addition, higher oil prices, a new round of administrative price increases and rising excise duties on fuel and petrol may add to inflationary pressures. The most recent data make likely that the Commission spring 2004 and the convergence programme projections for HICP inflation in 2004 (4.0% and 4.5% respectively) will both be exceeded.

The authorities consider inflation developments in 2003 and 2004 to be of a temporary nature, mainly resulting from a combination of one-off factors, and project CPI inflation to decline gradually to 3 percent in 2006/07. Nevertheless, to prevent current high inflation rates from impacting adversely on inflation expectations, the Bank of Latvia recently increased the refinancing rate by 0.5 percentage points to 3.5 percent. Prior to this, the refinancing rate had been lowered on several occasions since the mid-1990s, with the latest rate cut to 3.0 percent occurring in September 2002. The short-term interest rate differential against the euro area remains above 200 basis points while the long-term bond yield differential amounts to around 100 basis points.

The authorities' strategy with respect to euro adoption recognises that, given legal and procedural constraints, the earliest time when Latvia could join the euro area is 1 January 2008. To meet the requirements of ERM II membership, the authorities intend to change the existing peg to the SDR basket to a peg to the euro on 1 January 2005, using the EUR/LVL market exchange rate on that date to ensure nominal exchange rate stability and a smooth transition for markets. Immediately thereafter, Latvia plans to join ERM II. Within ERM II, Latvia intends unilaterally to limit exchange rate fluctuations to ±1 percent around the central rate. The authorities are of the view that such a narrow fluctuation band will facilitate preservation of price stability and convergence of interest rates. Moreover, they consider that, given the small size of Latvian financial markets, a narrow band will be helpful in preserving exchange rate stability and avoiding financial market uncertainty.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

The general government deficit figures of the last five years (table 3) show considerable variations, partly reflecting exceptional factors (notably the Russian crisis in 1998). Adjusting for such factors suggests that fiscal consolidation efforts were considerable from 1999 but weakened again in the run-up to the October 2002 general election. Fiscal

consolidation efforts during this latter period were of a rather ad-hoc nature and not firmly embedded in a medium-term fiscal framework. The government pursued a policy of corporate income tax reductions, which were only partly offset by increased non-tax revenues. Compensating measures on the expenditure side were limited and were not of a structural nature. For instance, attempts were made to impose uniform caps on expenditure increases for all budgetary posts or, alternatively, to reduce expenditure for all posts by a fixed percentage; these measures were unsuccessful. In 2002 the general government deficit increased to 2.7% of GDP, up from 1.6% in 2001, and significantly above the initial target set by the government (1.4% of GDP). Higher expenditure in 2002 reflected supplementary spending of main ministries approved at the end of the year, as well as a higher than expected deficit of the local governments; significant public sector wage increases contributed to the latter.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

	1998	1999	2000	2001	2002	2003
General government balance	-0.7	-5.3	-2.7	-1.6	-2.7	-1.8
General government gross debt	10.6	13.7	13.9	16.2	15.5	15.3
Source: *Commission services*						

In 2003, the general government deficit narrowed to 1.8% of GDP, about one percentage point lower than the targeted deficit of 2.9% set in the 2002 PEP. The over-achievement of the target was mainly due to better-than-expected tax and contribution revenues, reflecting improvements in tax collection as well as higher than expected growth, and occurred despite a reduction of the main social insurance contribution rate from 35% to 33%. Expenditure control by the government was tight and total expenditure did not reach the initially allocated amount. The reduction in the general government deficit also owed to an improvement in the balances of both the local government and the social security sectors. This end-result was particularly positive in the light of the fiscal slippage of 2002.

4.2. Programme overview

The key objective of medium-term fiscal policy defined in the convergence programme is stated to be a “gradual reduction of the general government budget deficit”, although the deficit is projected to remain at about 2% of GDP throughout the programme period, and with some deterioration in 2004 relative to 2003 due to a worsening of the central government balance. Compared with the 2003 PEP, projected growth has been revised upwards, but the budget consolidation path has remained unchanged. The debt-to-GDP ratio is projected to increase by 2.4 percentage points from 15.3% of GDP in 2003 to 17.7% of GDP by 2007.

Over the programme period revenue and expenditure shares are projected to decrease by around 1% of GDP. On the revenue side this is not fully explained, particularly for 2006 and 2007, since the tax system is assumed to be stable after further tax cuts in 2004, collection efficiency is assumed to strengthen over the programme period and significant EU funding should be received by the end of the period. On the expenditure side the programme projects strong increases due to the obligations of NATO membership and to implementation of spending plans linked to receipt of EU funding (the net impact of both together is estimated to amount to about 0.7% of GDP in 2004). Firm expenditure control is assumed to operate in parallel, for which there is little recent evidence; in general successful management of the implied rapid increases in expenditure will be challenging given indications of administrative weaknesses. The actions planned to reach the

authorities' fiscal objectives nevertheless seem appropriate, in particular the intentions to integrate budgetary programmes and policy programmes, to prioritise expenditure and to improve the management of municipal finances and of the healthcare system. The deficit projections for 2004 and 2005 are broadly in line with the Commission's spring 2004 forecast.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
General government balance					
CP	**-1.8**	**-2.1**	**-2.2**	**-2.0**	**-2.0**
COM	-1.8	-2.2	-2.0	n.a.	n.a.
PEP	*-2.9*	*-2.4*	*-2.2*	*-2.0*	*n.a.*
General government expenditure					
CP	**38.1**	**37.6**	**38.1**	**37.2**	**37.3**
COM	43.3	41.8	40.4	n.a.	n.a.
PEP	*45.1*	*44.7*	*44.4*	*44.2*	*n.a.*
General government revenues					
CP	**36.3**	**35.6**	**35.9**	**35.2**	**35.3**
COM	41.5	39.6	38.4	n.a.	n.a.
PEP	*42.2*	*42.3*	*42.2*	*42.2*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Achieving the budgetary targets thus seems plausible, although the medium-term fiscal scenario is not exempt from risks. On the downside, these stem mainly from potentially lower than foreseen output growth; moreover, general doubts attach to the successful implementation of the strategy given the evidence of an unreliable statistical base and weaknesses in administrative capacity. On the upside, as noted above, over the longer period there is some evidence of pessimism regarding revenue prospects, including that the budget should be recording significant net receipts of EU funding by the end of the period. Overall, risks attached to the budgetary targets seem broadly balanced. However, these targets do not provide a safety margin against breaking 3% of GDP threshold and the lack of movement closer towards fiscal balance seems insufficiently ambitious. If the programme's envisaged growth rates materialised, a faster reduction of the general government deficit would be desirable, particularly in view of the present current account deficit and domestic demand pressures.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	Change: 2007-2003
Revenues	36.3	35.6	35.9	35.2	35.3	**-1.0**
of which:						
- Taxes & social security contributions	31.4	29.5	29.5	29.2	28.9	**-2.5**
- Other (residual)	4.9	6.0	6.4	5.9	6.4	**1.5**
Expenditure	38.1	37.6	38.1	37.2	37.3	**-0.8**
of which:						
- Primary expenditure	37.2	36.7	37.2	36.4	36.5	**-0.8**
of which:						
Gross fixed capital formation	1.7	1.7	1.8	1.8	1.9	**0.2**
Collective consumption	9.9	10.1	10.4	10.4	10.8	**0.9**
Transfers & subsidies	11.4	10.6	10.5	10.1	9.7	**-1.8**
Other (residual)	14.2	14.3	14.5	14.1	14.1	**-0.1**
- Interest payments	0.9	0.9	0.9	0.8	0.8	**-0.1**
Budget balance	**-1.8**	**-2.1**	**-2.2**	**-2.0**	**-2.0**	**-0.2**
Primary balance	**-0.9**	**-1.2**	**-1.3**	**-1.2**	**-1.2**	**-0.3**
Sources: *Convergence programme; ECFIN calculations*						

4.3. Targets and adjustment in 2004

The budget for 2004, passed by parliament in November last year, targeted a general government deficit of 2.1% of GDP; this target is confirmed by the convergence programme. However, compared to the then forecast deficit of 2.9% of GDP for 2003, the 2004 budget target would have represented a narrowing of the deficit by almost 1 percentage point of GDP. In light of the actual 2003 outcome of a deficit of 1.8%, the same target now amounts to a small deterioration of the budgetary position stemming from a decrease in the revenue-to-GDP ratio (0.7 percentage points) not completely offset by a reduction in the expenditure-to-GDP ratio (0.5 percentage points). The budget 2004 reflects most of the government's structural reform agenda for the current legislative period, both on the revenue and expenditure sides, most notably strengthening tax collection efficiency, financing the ongoing public sector reform and meeting obligations of NATO and the EU membership. Also, the authorities plan to finance some projects that comply with the recognized economic policy priorities of increasing competitiveness and supporting employment growth and development of human resources and infrastructure with support from EU funds.

On the revenue side, the budget incorporates ongoing tax reform, including a reduction of the corporate income tax rate from 19% in 2003 to 15% (see section 5). It is also expected that revenues from customs duties will decline. The tax burden, including social security contributions, is expected to decline further to 29.5% of GDP, partly compensated by a higher GDP share of non-tax revenues mostly linked to receipts of EU funding.

On the expenditure side, reform measures are expected to lead to sustained savings in mandatory expenditure categories, whereas expenditure increases are, to a large extent, implemented in more discretionary areas. The most important reform areas are pensions and public administration. As a result of the reforms, the GDP share of cash social

transfers is planned to decrease by 0.7 percentage points compared to the 2003 outcome, while collective consumption spending is planned to increase by 0.2 percentage points. The GDP share of gross fixed capital formation is foreseen to remain at the 2003 level of 1.7% of GDP.

4.4. Targets and adjustment in 2005 and beyond

The programme envisages a further slight increase of the general government budget deficit of 0.1 percentage point of GDP in 2005, followed by an improvement of 0.2 percentage points to 2.0% of GDP in 2006. The budget balance remains unchanged at 2.0% of GDP in 2007. The lack of fiscal consolidation envisaged over these years is ascribed to the limited room for fiscal manoeuvre due to the cost of economic restructuring and partly EU-financed spending plans. The absorption of project-related EU funds is expected to require a reallocation of and increase in expenditures within national budgets in order to co-finance and pre-finance the projects. The Latvian authorities are cautious regarding net inflows of EU funds especially in their 2004-2005 budget assumptions, estimating that the additional EU funds-related expenditure together with NATO membership obligations will account in 2004 for about a net 0.7% points of GDP. The authorities expect that cash flows from EU funds will match project co-financing and pre-financing expenditures within the national budget by 2006, thus reducing pressure on the budget balance from this source.

On the revenue side, limited scope for increases, and thus not calling into question recent tax changes, is taken by the programme as given. Accordingly, there are no significant major tax changes planned for 2005 and later. In this context it is therefore somewhat surprising that the programme foresees a further drop in the GDP-share of taxes and social security contributions by a cumulative 0.6 percentage points in 2006 and 2007; this appears pessimistic. The GDP-ratio of non-tax revenues is budgeted to increase by 0.4 percentage point, essentially driven by transfers from the EU. Taking all these factors into account, the total revenue-to-GDP ratio is forecast to fall by some 0.3 percentage points between 2004 and 2007.

Hence, the limited fiscal consolidation from 2004 to 2007 relies fully on decrease in the expenditure-to-GDP ratio to match the projected reduction in the revenue share – with the total (and primary) expenditure-to-GDP ratio declining by 0.3 (0.2) percentage points. Apart from capital expenditure and with the notable exception of collective consumption expenditure (including the wage bill), which is set to increase by 0.7% of GDP, all major expenditure categories are set to contribute to this consolidation effort, most notably social transfers (a GDP-ratio reduction of almost 1.0 percentage point).

The current government has already implemented the main part of its structural reform agenda for the legislature 2002-2006. Hence, the budget planning process for the years 2005 to 2007 takes place in a much more stable legislative environment. The relatively modest programme targets should therefore be attainable, with the single most important threat being an unforeseen slowdown of growth.

4.5. Debt ratio

The debt-to-GDP ratio, while projected to increase over the programme period, remains very low. With the exception of 2004, stock-flow adjustments are projected to be small and much lower than in the recent past (such as during the Russian crisis in 1998). The primary deficit remains the main driver of the modest increase in the debt ratio. The contribution of interest outlays stays close to the 2003 level. Nominal GDP growth has a

substantial debt ratio-reducing effect throughout the period. Overall, the projection seems plausible given its component assumptions, with vulnerabilities arising from the possibilities of lower than expected nominal growth, higher than expected interest rates and some exchange rate risk.

The debt remains vulnerable to exchange rate shocks despite the marked reduction in the share of foreign debt in total debt (less than half of public debt was denominated in foreign currency, mostly euro, in 2003 against almost two thirds in 2001).[7] In terms of interest rate shocks, however, an increase in the average weighted interest rate of the government debt portfolio would raise debt servicing costs by relatively little, given the low debt ratio[8].

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	15.6	15.3	16.0	16.2	16.1	16.8	17.3	17.7
Change in debt ratio (1 = -2+3+6)	0.0	-0.2	0.4	0.9	0.0	0.6	0.5	0.5
Contributions:								
- primary balance (2)	-0.9	-0.9	-1.4	-1.2	-1.2	-1.3	-1.2	-1.2
- snow-ball effect (3 = 4+5)	-0.7	-0.9	-0.4	-0.6	-0.5	-0.7	-0.7	-0.8
- interest expenditure (4)	0.9	0.9	0.8	0.9	0.7	0.9	0.8	0.8
- nominal GDP growth (5)	-1.6	-1.8	-1.2	-1.5	-1.2	-1.6	-1.5	-1.6
- stock-flow adjustment (6)	-0.2	-0.2	-0.6	0.3	-0.7	0.0	0.0	0.0

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations

Concerning contingent liabilities, all outstanding government guarantees have been risk-assessed by the authorities. Furthermore, the issuance of new guarantees has been strictly limited.

5. THE QUALITY OF THE PUBLIC FINANCES

Given the absence of significant budgetary adjustment in the programme, issues of public finance quality centre on procedural and structural reform. On the revenue side current tax policy is aimed at reducing the tax burden on businesses, in turn to facilitate economic development and promote the competitiveness of the economy. Accordingly, the corporate income tax rate has been progressively reduced from 25% in 2000 to 15%

[7] The programme estimates that a depreciation of the lats by 10 basis points against the euro, would result, *ceteris paribus*, in an increase in the debt ratio by 1.1 percentage points; the proposed repegging against the euro will reduce this vulnerability substantially.

[8] According to the programme, interest rates higher by 1 percentage point would increase debt servicing costs, by around 0.7‰ of GDP

in 2004, and the main social insurance contribution rate has been reduced from 38% of gross wages in 1996 to 33% in 2003, of which about a quarter is paid by employees and the rest by employers. Also, it is expected that revenues from customs duties will decline, as it is expected that only a quarter of goods subject to customs duty before Latvia's accession will remain taxable. Nonetheless, a broadening of the VAT base should outweigh some of the loss in the direct taxes revenues. Altogether, the tax revenue-to-GDP ratio of 31.4% in 2003 is foreseen to decline further to 28.9% of GDP by 2007.

Improving tax administration and collection standards and fighting tax evasion are indicated as priorities in the programme. To this end the State Revenue Service has implemented an electronic system supporting comprehensive analysis and control of tax revenues. The auditing process and inspections have become regular and more comprehensive, helping to fight tax evasion. Similarly, broadening the tax base, by streamlining numerous allowances and tax exemptions, could boost revenues by bridging the gap between nominal and effective tax rates.

On the expenditure side, the room for savings seems limited, with the need for continued institution-building and strengthening of public administration to ensure efficiency; in the near term these will probably increase pressures for additional funding.

As regards budgetary control, a special procedure exists which could facilitate adjustment in the event of budgetary developments going off-track.[9] The effectiveness of this procedure has been tested and proved to be effective during the Russian crisis in 1998.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The convergence programme examines the sustainability of public finances, including demographic and macroeconomic assumptions as well as projections for public expenditures on pensions, healthcare and education up to 2050.

According to the demographic projections[10], Latvia's future demographic prospects are unfavourable. Although the currently low fertility rate is expected to increase (from 1.2 in 2002 to 1.6 in 2050) and the currently negative migration balance is projected to be in equilibrium by 2025, a significant increase in life expectancy (8.4 years for men and 4.3 years for women in the period 2002-2050) contributes to a rapid increase in the old-age dependency ratio and by itself a consequent worsening of the long-term sustainability of public finances.

In order to counter the adverse demographic developments and consequently, the budgetary implications of an ageing population, the Latvian authorities have designed a number of measures to be undertaken during the programme period and beyond. Most

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[9] According to Article 25(2) of the 1994 law "On Budgetary and Financial Management", the Minister of Finance informs the Cabinet about a delay or decrease in the allocation of expenditure, if it is expected that the budget deficit will exceed the level approved in the annual state budget law. Within the period of seven days following reception of the report from the Minister, the Cabinet of Ministers makes a decision on a delay or decrease in the allocations, and not later than within three working days submits proposals on necessary amendments to the annual state budget law to the Parliament.

[10] The methodology used to derive long-term implications of ageing is to be comprehensively revised and application of a revised method could yield less comforting results.

importantly, pension reform is now completed in terms of legislation. It comprises a pay-as-you-go (PAYG) pension scheme (first pillar), the state-funded pension scheme (with contributions invested in securities, second pillar) and private voluntary pension schemes (third pillar). However, implementation of the reform is not yet completed. For example, the retirement age will continue to increase gradually until 2008, having a positive effect for the budget. Other parametric changes to the new pension system include the transition to pension indexation based on the consumer price index for the PAYG pillar (having a negative budgetary impact relative to the previous unindexed system), and a redirection of a part of social security contributions from the first pillar to the second pillar in 2010. Concerning healthcare, restructuring of the system is required if the quality of medical and long-term services is to be upgraded and cost efficiency of the system is to be improved to cater for the ageing population. Also, the healthcare financing reform has yet to be implemented. The entire healthcare reform is planned to be completed by 2007.

The programme considers increasing labour productivity to be one of the key conditions for ensuring the long-term sustainability of public finances, planned to be addressed by numerous measures contained in the forthcoming National Employment Plan 2004-2005. This plan envisages a large number of employment promotion measures and activities as well as provides a budget to finance them. It is expected that a large share of such funding would be obtained via EU structural funds and the European Social Fund. Currently, the Latvian labour market is characterised by low employment and high unemployment rates, which differ considerably across the regions and across age groups. Even though overall employment has shown modest improvements over the last five years, employment of older age groups has declined. Therefore, measures aimed at increasing labour productivity should be buttressed by measures to encourage employment, especially among older workers.

The programme presents long-term projections for age-related expenditures. Overall, age-related expenditures are foreseen to increase relatively moderately by 2.7% points of GDP between 2005 and 2050, as projected increases in pension expenditures (2.8% points of GDP) and healthcare costs (0.5% points of GDP) are partly offset by a decrease in education outlays (0.6% points of GDP). In addition, the government debt-to-GDP ratio is planned to remain very low over the programme period.

However, risks of budget imbalances in the future cannot be ruled out. As discussed above, the programme budgetary strategy implies only marginal budgetary consolidation over the medium term. As regards pension reform, the revenue loss to the first pension pillar, resulting from a redirection of a part of social security contributions to the second pillar, will lead to a deficit in the first pillar. While expected increases in birth and employment rates should result in an improvement of the situation over the long-run, it is crucial to monitor implementation of the reform. Finally, costs of the required healthcare system reform should also be noted. Given the relatively low tax burden, an increase in taxes would need to be considered if the evolution of budgetary balances falls short of plans.

Summing up, Latvia is relatively well-placed to meet the budgetary costs of an ageing population, although risks of long-term budgetary imbalances cannot be ruled out. The implementation of pension reform, including parametric changes and the establishment of a soon-to-be completed multi-tier pension system, has improved the prospects for the long-term sustainability of public finances. This is further reinforced by very low level of general government debt. Nevertheless, risks related to revenue losses from the pension

reform and financing the restructuring of the healthcare system should be monitored in order to intervene promptly to stem deficit-increasing pressures.

7. ANNEX

Summary tables derived from the 2004 convergence programme of Latvia

Table 1. Growth and associated factors

	ESA Code	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	B1g	7.5	6.7	6.7	6.5	6.5
GDP *level* at *current* market prices (mio. Euro)	B1g	9106	9737	10800	11893	13086
GDP deflator		5.2	4.3	3.8	3.4	3.3
CPI (average annual) change		2.9	4.5	3.7	3.0	3.0
Employment growth*		1.8	1.0	1.0	0.5	0.5
Labour productivity growth**		5.5	5.6	5.6	6.0	6.0
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	8.9	8.4	7.8	7.5	7.0
2. Government consumption expenditure	P3	3.0	2.0	2.0	2.0	2.0
3. Gross fixed capital formation	P51	10.6	11.7	10.6	10.5	9.1
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	5.7	4.5	3.4	2.4	1.8
5. Exports of goods and services	P6	6.8	7.5	8.2	8.1	8.2
6. Imports of goods and services	P7	13.0	8.0	7.7	7.8	7.7
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		9.2	9.6	8.8	8.7	8.0
8. Change in inventories and net acquisition of valuables (=4)	P52+ P53	2.4	-1.6	-1.2	-1.2	-0.7
9. External balance of goods and services (5-6)	B11	-4.2	-1.3	-0.8	-1.0	-0.9

** Number of employed, national definition*
*** Increase in the ratio of GDP at constant prices against the number of employed*

Table 2. General government budgetary developments

% of GDP	ESA95 Code	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending by sub-sectors							
1. General government	S13	-2.7	-1.8	-2.1	-2.2	-2.0	-2.0
2. Central government	S1311	-1.6	-2.1	-2.6	-2.6	-2.2	-2.2
3. State government	S1312	na	na	na	na	na	na
4. Local government	S1313	-0.9	-0.4	-0.2	-0.2	-0.2	-0.2
5. Social security funds	S1314	-0.2	0.7	0.7	0.6	0.4	0.3
General government							
6. Total receipts	ESA95	36.1	36.3	35.6	35.9	35.2	35.3
7. Total expenditures	ESA95	38.8	38.1	37.6	38.1	37.2	37.3
8. Budget balance	B9	-2.7	-1.8	-2.1	-2.2	-2.0	-2.0
9. Net interest payments		0.9	0.9	0.9	0.9	0.8	0.8
10. Primary balance		-1.8	-0.9	-1.2	-1.3	-1.2	-1.2
Components of revenues							
11. Taxes	D2+D5	21.2	21.4	19.8	20.0	19.7	19.5
12. Social contributions	D61	10.3	10.0	9.7	9.5	9.5	9.4
13. Interest income	D41	na	na	na	na	na	na
14. Other		4.6	4.9	6.0	6.4	5.9	6.4
15. Total receipts	ESA95	36.1	36.3	35.6	35.9	35.2	35.3
Components of expenditures							
16. Collective consumption	P32	9.7	9.9	10.1	10.4	10.4	10.8
17. Social transfers in kind	D63	0.7	0.8	0.7	0.6	0.6	0.6
18. Social transfers other than in kind	D62	11.4	10.4	9.7	9.7	9.2	8.8
19. Interest payments	D41	0.9	0.9	0.9	0.9	0.8	0.8
20. Subsidies	D3	0.8	0.9	0.9	0.9	0.9	0.9
21. Gross fixed capital formation	P51	1.5	1.7	1.7	1.8	1.8	1.9
22. Other		14.5	14.2	14.3	14.5	14.1	14.1
23. Total expenditures	ESA95	38.8	38.1	37.6	38.1	37.2	37.3
Operative data, which may change during improving methodology							

Table 3. General government debt developments

% of GDP	ESA95 Code	**2003**	**2004**	**2005**	**2006**	**2007**
Gross debt level		15.3	16.2	16.8	17.3	17.7
Change in gross debt		-0.2	0.9	0.6	0.5	0.4
Contributions to change in gross debt						
Primary balance		0.9	1.2	1.3	1.2	1.2
Interest payments	D41	0.9	0.9	0.9	0.8	0.8
Nominal GDP growth	B1g	-2.0	-1.8	-1.8	-1.7	-1.7
Other factors influencing the debt ratio [1]		0.0	0.6	0.2	0.2	0.2
Of which: Privatisation receipts		-0.1	-0.1	-0.1	-0.1	-0.1
p.m. implicit interest rate on debt		7.4	7.0	6.0	5.4	5.0

Table 4. Cyclical developments

% of GDP	ESA95 Code	**2003**	**2004**	**2005**	**2006**	**2007**
1. GDP growth at constant prices	B1g	7.5	6.7	6.7	6.5	6.5
2. Actual balance	B9	-1.8	-2.1	-2.2	-2.0	-2.0
3. Net Interest payments	D41	0.9	0.9	0.9	0.8	0.8
4. Potential GDP growth		7.4	6.8	6.5	6.4	6.3
5. Output gap		-0.2	-0.2	0.0	0.1	0.2
6. Cyclical budgetary component		-0.1	-0.1	0.0	0.0	0.0
7. Cyclically-adjusted balance (2-6)		-1.7	-2.0	-2.2	-2.0	-2.0
8. Cyclically-adjusted primary balance (7-3)		-0.9	-1.1	-1.3	-1.2	-1.3

Table 5. Divergence from previous update

% of GDP	ESA95 Code	**2003**	**2004**	**2005**	**2006**	**2007**
GDP growth	B1g					
previous update [1]		6.5	6.1	6.0	6.0	na
latest update [2]		7.5	6.7	6.7	6.5	6.5
Difference		1.0	0.6	0.7	0.5	na
Actual budget balance	B9					
previous update [1]		-2.9	-2.4	-2.2	-2.0	na
latest update [2]		-1.8	-2.1	-2.2	-2.0	-2.0
Difference		1.1	0.3	0.0	0.0	na
Gross debt levels						
previous update [1]		19.1	17.0	17.4	17.4	na
latest update [2]		15.3	16.2	16.8	17.3	17.7
Difference		-3.8	-0.8	-0.6	-0.1	na

[1] PEP 2003
[2] CP, May 2004

Table 6. Long-term sustainability of public finances [1]

% of GDP	2005	2010	2020	2030	2050
Total expenditure					
Old age pensions	6.2	4.8	5.3	5.9	9.0
Health care (including care for the elderly)	4.0	4.1	4.1	4.2	4.5
Interest payments	na	na	na	na	na
Total revenues	na	na	na	na	na
Of which: Tax on net pension payments	9.5	8.0	7.4	7.1	7.1
National pension fund assets	0.9	6.2	29.2	60.7	101.9
Assumptions [4]					
Labour productivity growth	5.6	4.5	3.6	2.5	2.0
Real GDP growth	6.7	4.7	2.2	2.3	0.1
Participation rate males (aged 20-64)	na	na	na	na	na
Participation rates females (aged 20-64)	na	na	na	na	na
Total participation rates (aged 20-64)	na	na	na	na	na
Unemployment rate	9.2	8.0	5.0	5.0	5.0

Table 7. Basic assumptions[1] (to be transmitted to the EFC and the Commission together with the SCP update[2])

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)[3]	na	na	na	na	na
Long-term interest rate (annual average)[3]	na	na	na	na	na
USA: short-term (3-month money market)	na	na	na	na	na
USA: long-term (10-year government bonds)	na	na	na	na	na
USD/€exchange rate[3] **(annual average)**	1.13	1.25	1.24	na	na
Nominal effective exchange rate (euro area)	11.8	4.2	-0.2	na	na
Nominal effective exchange rate (EU)	12.8	6.9	-1.1	na	na
Exchange rate vis-à-vis the €(annual average)[3]	0.65	0.67	0.67	na	na
World excluding EU, GDP growth	4.4	5.1	4.7	na	na
US	na	na	na	na	na
Japan	na	na	na	na	na
EU-15 GDP growth	0.8	2.0	2.4	na	na
Growth of relevant foreign markets	6.7	9.2	8.3	na	na
World import volumes, excluding EU	7.3	9.7	8.5	na	na
World import prices, (goods, in USD)	na	na	na	na	na
Oil prices, (Brent, USD/barrel)	28.5	31.1	28.9	na	na
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	na	na

[1]. Provision of data on variables in bold characters is a requirement. Provision of data on other variables is optional but highly desirable.
[2]. Member States may include their basic assumptions in their SCP updates if they so wish.
[3]. Purely technical assumptions