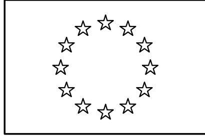

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
SEC(2004) 821 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Latvia, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Latvia's convergence programme covering the period 2004-2007 was submitted on 14 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> 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". 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.

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[1] OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[2] Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

[3] COM(2002) 668 final, 27.11.2002.

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 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: 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)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Latvia and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997**

On the convergence programme of Latvia, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[4], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July] 2004 the Council examined the convergence programme of Latvia, which covers the period 2004 to 2007. 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". In particular, some data are not yet fully in line with ESA95 standards and 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 budgetary strategy underlying the programme aims to ensure compliance with Treaty obligations on general government deficits and eventually to reduce the deficit towards balance in the long term. Nevertheless, over the programme period the 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. The programme envisages maintaining a primary deficit of the order of 1% of GDP consistent with a slight reduction in both the revenue and expenditure ratios over the programme period. On the revenue side this is not fully explained, particularly for 2006 and 2007, since no further changes are envisaged after tax cuts in 2004 and collection efficiency is assumed to strengthen over the programme period. On the expenditure side this is assumed to result from firm expenditure control focusing on a reduction of transfers, while allowing for additional outlays linked to the obligations of NATO membership and to implementation of partly EU-financed spending

[4] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

plans. The two latter together account in 2004 for about 0.7 percentage points of GDP in net terms. The debt ratio, although increasing, at 17.7% of GDP in 2007, remains very low.

The macroeconomic scenario underlying the programme seems to reflect rather favourable growth assumptions. In particular, the evolution of growth in the medium term projected in the programme could be slightly on the high side given structural constraints and the vulnerability of the economy to external shocks. The projection for inflation for 2004 is likely to be overshot but for later years appears realistic.

The programme's targets for the general government deficit are below the 3% of GDP reference value in each year. However, they are unambitious and are inconsistent with a position of close to balance within the programme period. Risks to the budgetary outcome seem broadly balanced. The possibly optimistic growth forecast noted above is a negative risk for the envisaged budgetary targets, while confidence in the programme is tempered by the evidence of poor data quality. This is countered by some apparent pessimism in revenue forecasts, particularly in the later programme years. The budgetary stance in the programme does not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

Latvia is relatively well-placed to meet the budgetary costs of an ageing population. 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. However, the risk of long-term budgetary imbalances cannot be ruled out. Timely implementation of measures aimed at containing age-related expenditure, together with a fiscal consolidation so as to secure an adequate primary surplus is essential to ensure that the public finances are on a sustainable footing.

* * *

In view of the above, if the growth rates envisaged in the programme materialise, Latvia is recommended to make faster progress towards a close-to-balance budgetary position, particularly in view of its large current account deficit and domestic demand pressures. Furthermore, Latvia is urged to improve the reliability and robustness of source data and methodologies used to ensure better adherence to ESA95 standards. Finally, the Latvian authorities are encouraged to proceed with the public sector reforms aimed at administrative capacity, thus increasing efficiency of the tax collection and strengthening expenditure control.

Key projections from the convergence programme of Latvia

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	7.5	6.7	6.7	6.5	6.5
Employment growth (%)	1.8	1.0	1.0	0.5	0.5
HICP inflation (%)	2.9	4.5	3.7	3.0	3.0
General government balance (% of GDP)	-1.8	-2.1	-2.2	-2.0	-2.0
Government gross debt (% of GDP)	15.3	16.2	16.8	17.3	17.7