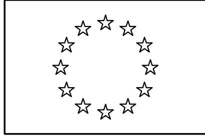

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 1.2.2006
SEC(2006) 110 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 updated convergence programme of Latvia, 2005-2008

(presented by the Commission)

EN EN

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Latvia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Latvia and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

---

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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] "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.

Assessment

(1) The third updated Latvian convergence programme was sent to the Commission on 30 November and covers the period 2005 to 2008. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. The programme has gaps in the optional data prescribed by the new code of conduct (in particular, data are not given for labour productivity and hours worked).

(2) Over the last decade, annual real GDP growth in Latvia has averaged over 6%, marking an impressive recovery after the transition-related economic disruption. Real GDP in 2005 is expected to have finally exceeded the pre-1991 level. This growth performance has been characterised by strong productivity developments and more recently also by employment growth. However, evidence of overheating from developments in the external imbalance, inflation and credit expansion has mounted. High external imbalances have left Latvia reliant on capital inflows, and the foreign debt-to-GDP ratio has risen. The programme update projects real GDP growth ease to 7.5% in 2006, down from 8.4% in 2005, followed by a further slight deceleration to 7.0% in both 2007 and 2008. Private consumption and investment are expected to remain the main driving forces of growth, while net exports contributions are expected to turn modestly positive. Overall, projected GDP growth is plausible when compared to the Commission services autumn forecast (to 2007) and to calculations of potential growth. Using the commonly agreed method, on the basis of the figures in the updated programme, indicates that potential GDP growth should remain high but on a slightly declining trend in the medium term; a negative output gap would appear from 2007 onwards. However, the calculation of potential growth (and therefore of the output gap) needs to be interpreted with caution for countries going through a rapid catching-up process. By contrast, the programme's projection for HICP inflation (declining rapidly from 6.9% in 2005 - the highest among the Member States - to 3.5% in 2008) and the current account deficit (declining from 13.0% of GDP in 2004 to 8.0% of GDP in 2008) both seem optimistic, assessed in particular against the Commission services' autumn forecast. Overall, the macroeconomic scenario presents non-negligible risks, to which attention should be given in the context of the convergence process.

(3) Since the lats entered ERM II on 2 May 2005 it has remained well within the fluctuation band of plus or minus one percent declared by the Latvian authorities against the central rate. Spreads of 3-month money rates for lats vis-à-vis the euro came down markedly in the course of the year from over 100 basis points in early January to around 40 basis points in late November. Money market spreads increased sharply in late December, but this seems to have been due to temporary liquidity factors related to the increase in the reserve ratio from 6 to 8% effective from 24 December 2005. For most of 2005 spreads of sovereign bonds vis-à-vis euro area benchmarks have remained at low levels of around 50 basis points.

(4) In its opinion of 8 March 2005, the Council endorsed the budgetary strategy presented in the previous update of the convergence programme, covering the period 2004-2007. While not giving policy invitations, the Council nevertheless considered that the assessment of the appropriate fiscal position was dependent on its contribution to demand pressures in the economy being appropriate to consolidating the moderation in inflation from its then recent peak. As regards budgetary implementation in 2005, the Commission services' autumn 2005 forecast estimated a general government deficit of

1.2% of GDP (based on GDP growth of 9.1%) against a target set in the previous update of the convergence programme of 1.6% of GDP (with GDP growth of 6.7%). However, recent data on a cash basis on the execution of the government budget indicates that the outcome will be even stronger. Hence, the 2005 deficit outturn is very likely to be lower than the present update's estimated general government deficit for 2005 of 1.5% of GDP (based on real GDP growth of 8.4%).

(5) Based on the very cautious estimate of the 2005 outturn for the general government deficit, the update aims at a modest reduction of the deficit later in the programme period. The update foresees the deficit remaining at 1.5% in 2006, declining to 1.4% in 2007 and 1.3% in the final year, 2008. Both revenue- and expenditure-to-GDP ratios are planned to increase over the programme period (by 2 p.p.). Public investment and not separately identified "other expenditure" are set to increase the most and social transfers other than in kind to decrease the most. The primary balance is set to decrease by 0.1 percentage point over the same period. The November 2005 update broadly confirms the previous update's planned adjustment, both as regards modest scale and timing, in spite of a considerably stronger macroeconomic scenario in the most recent update.

(6) Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance, i.e. the cyclically-adjusted budget balance net of one-off and other temporary measures, is planned to improve only slightly over the programme period (by about ¾ percentage points of GDP). The planned fiscal effort is back-loaded and concentrated in years in which the output gap is estimated to be negative. The update identifies a medium-term objective (MTO) for the budgetary position, as meant in the Stability and Growth Pact, of a structural deficit of "around 1% of GDP", and aims at achieving this position in the final year of programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO could be judged to be at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term. However, taking into account the risks to sustainable economic convergence highlighted above, a more demanding MTO would seem appropriate.

(7) The budgetary outcome could be worse than projected in the programme. On the positive side, a cautious track record for budgetary planning suggests that outcomes could be better than targeted (as was the case in 2004 and is also expected by the Commission services for 2005). In particular, growth forecasts as well as assumed tax elasticities underlying the budget have hitherto usually proved on the low side. In addition, budgeted expenditures have not always been fully executed, mainly due to delays in implementation of projects partly financed by EU funding. On the other hand, tax elasticities in the present update appear on the high side; moreover, the programme refers to several (proposed) social policy measures which would result in increased expenditure, whereas the programme projects the ratio of such expenditure to fall.

(8) In view of this risk assessment, the budgetary strategy outlined in the programme may not be sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. Also, set

against the assessment that the 2005 outturn is likely to have been substantially stronger than assumed in the programme, and possibly close to the MTO, the budgetary target for 2006 could imply a departure from the MTO by up to roughly 0.5% of GDP in 2006 and also 2007. Moreover, if a stronger 2005 outturn is confirmed and the target for 2006 is maintained, there is also a concern that the fiscal stance in 2006 would then be expansionary and inappropriate, given that the 2005-06 period may qualify as "good times". For euro area and ERM II Member States, the SGP requires an annual improvement in the structural balance of at least 0.5% of GDP (as a benchmark), with a higher adjustment in periods of good times. A stronger structural adjustment path than planned would also seem appropriate to ensure a stable macroeconomic convergence process.

(9) According to the Stability and Growth Pact, "major structural reforms" with a verifiable impact on the long-term sustainability of the public finances should be taken into account when defining the adjustment path to the programme's MTO or for allowing a temporary deviation from the programme's MTO. The programme notes that the ongoing pension reform and introduction of a second pillar, in particular, will gradually reduce social security contributions in the general government balance compared to the 2004 level. The net cost of the pension reform is estimated in the programme at 0.25% of GDP in 2005, rising progressively to 1¼% of GDP in 2008. This could allow a temporary deviation from the required yearly adjustment path of 0.5% of GDP towards the programme's MTO because the structural reforms on which it is based are sufficiently detailed in the programme and have a significant beneficial impact on the long-term sustainability of the public finances. Moreover compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact appears ensured as regards the provision of a safety margin against breaching the 3% of GDP deficit reference value in all years of the programme. Nevertheless, the suggestion above for a more demanding pace of adjustment towards the programme's MTO than implied by the programme seems feasible given that in the early programme years the estimated net cost of the pension reform is modest.

(10) The debt ratio is estimated at 14.9% of GDP in 2005, well below the 60% of GDP Treaty reference value. The debt ratio is projected to decrease very slightly over the programme period, to 14.7% of GDP in 2008, with the effects of deficits substantially dampened by high nominal GDP growth.

(11) With regard to the sustainability of public finances, Latvia appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The currently very low level of gross debt is projected to remain below the 60% reference value throughout the 2005-2050 projection period. Latvia's pension reform launched in 1996 contributes significantly to contain the budgetary impact of an ageing population..

(12) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority. Nonetheless, the potential role of the fiscal stance in delivering key objectives, in particular containing inflation and addressing the external account imbalance has not been sufficiently explored.

(13) The National Reform Programme of Latvia, submitted on 21 October 2005, in the context of the renewed Lisbon strategy for growth and jobs, identifies securing macro-economic stability as the main challenge with implications for public finances and to that end allots a major role to the strengthening of fiscal discipline and budgetary planning procedures. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The public finance measures envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme. As mentioned above, the convergence programme outlines measures to support growth and employment by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority.

In view of the above assessment, and in the light of the need to ensure sustainable convergence, including by reducing the external imbalance and containing inflation, it would be appropriate for Latvia to consider the achievement of more ambitious budgetary positions than currently planned, notably by bringing forward the attainment of the MTO set in the programme, maintaining it during the programme period, and avoiding pro-cyclical fiscal policies in “good times”.

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 updated convergence programme of Latvia, 2005-2008

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[3], 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:

(1) On [14 February 2006] the Council examined the updated convergence programme of Latvia, which covers the period 2005 to 2008.

(2) Over the last decade, annual real GDP growth in Latvia has averaged over 6%. This growth performance has been characterised by strong productivity developments and more recently also by employment growth. However, high external imbalances have left Latvia reliant on capital inflows, and the foreign debt-to-GDP ratio has risen. Inflation has picked up since mid-2003 and remains above 6%, eroding the external competitiveness of the economy and posing a threat to growth. The macroeconomic scenario underlying the programme envisages that real GDP growth will ease from 8.4% in 2005 to 7.2% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation and the current account deficit appear to be on the low side.

(3) The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct[4].

---

[3] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

(4) The estimated general government deficit for 2005 in the present update is 1.5% of GDP based on GDP growth of 8.4%. This means a slightly lower deficit and a significantly better growth performance than foreseen in the previous programme (deficit of 1.6% of GDP, growth of 6.7%). The Commission services' autumn forecast estimated a deficit of 1.2% of GDP based on GDP growth of 9.1%. However, recent data on the execution of the government budget on a cash basis indicate that the outcome will be even better than put forward in the update and the Commission services' autumn forecast.

(5) The Council Opinion on the previous update adopted on 8 March 2005 contained no policy invitations. However, it stated that the assessment of the consolidation path and of the appropriateness of the fiscal position was conditional on the favourable development of the external balance, on demand pressures in the economy, and on the moderation in inflation from its then recent peak.

(6) The updated programme aims at a modest reduction of the general government deficit. The update foresees a general government deficit of 1.5% in 2005, 1.5% in 2006, 1.4% in 2007 and 1.3% in the final year, 2008. The primary balance is set to decrease by 0.1 percentage point over the same period. Both revenue and expenditure to GDP ratios are planned to increase over the programme period (by 2.1 p.p. and 1.9 p.p. respectively). Public investment and not separately identified "other" expenditure increase the most (from 2.3% of GDP in 2005 to 3.3% of GDP in 2008 and from 12.3% of GDP to 13.8% of GDP in 2008, respectively) and social transfers other than in kind decrease the most (from 9.3% of GDP in 2005 to 8.9% of GDP in 2008). Compared with the previous update, the November 2005 update broadly confirms the planned adjustment, although the growth outlook is considerably stronger.

(7) Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance, i.e. the cyclically-adjusted budget balance net of one-off and other temporary measures, is planned to improve only slightly over the programme period (by about ¾ percentage points of GDP). The planned fiscal effort is back-loaded and concentrated in years in which the output gap is estimated to be negative. The update identifies a medium-term objective (MTO) for the budgetary position, as meant in the Stability and Growth Pact, of a structural deficit of "around 1% of GDP", and aims at achieving this position in the final year of programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO could be judged to be at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term. However, taking into account the risks to sustainable economic convergence highlighted above, a more demanding MTO would seem appropriate.

(8) The budgetary outcome could be worse than projected in the programme. Even though the growth forecasts and assumed tax elasticities underlying past budgets have usually proved cautious, the latter is no longer necessarily the case in the current programme

---

[4] The programme has gaps in the optional data prescribed by the new code of conduct (in particular, data are not given for labour productivity and hours worked).

as its assumed tax elasticities seem favourable. Furthermore, the programme refers to several (proposed) social policy measures which would increase such expenditure rather than decrease it, as projected in the programme.

(9) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. Also, as stated above, a more ambitious strategy than that set in the programme would be desirable. The pace of the adjustment towards the programme's MTO implied by the programme is not in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times. In particular, a possible deterioration in the structural balance in 2006, implied by maintaining the 2006 target if the 2005 outcome is significantly stronger than expected, would correspond to significant fiscal easing in a context of continuing very high demand pressures and relevant stability risks.

(10) According to the Stability and Growth Pact, "major structural reforms" with a verifiable impact on the long-term sustainability of the public finances should be taken into account when defining the adjustment path to the programme's MTO or for allowing a temporary deviation from the programme's MTO. The programme notes that the ongoing pension reform and introduction of a second pillar, in particular, will gradually reduce social security contributions in the general government balance compared to the 2004 level. The net cost of the pension reform is estimated in the programme at 0.25% of GDP in 2005, rising progressively to 1¼% of GDP in 2008. This could allow a temporary deviation from the required yearly adjustment path of 0.5% of GDP towards the programme's MTO because the structural reforms on which it is based are sufficiently detailed in the programme and have a significant beneficial impact on the long-term sustainability of the public finances. Moreover compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact appears ensured as regards the provision of a safety margin against breaching the 3% of GDP deficit reference value in all years of the programme. Nevertheless, the suggestion above for a more demanding pace of adjustment towards the programme's MTO than implied by the programme seems feasible given that in the early programme years the estimated net cost of the pension reform is modest.

(11) The debt ratio is estimated at 14.9% of GDP in 2005, well below the 60% of GDP Treaty reference value. The debt ratio is projected to decrease very slightly over the programme period, to 14.7% of GDP in 2008, with the effects of persistent deficits substantially dampened by high nominal GDP growth.

(12) With regard to the sustainability of public finances, Latvia appears to be at low risk on grounds of the projected budgetary costs of ageing populations[5]. The currently very low level of gross debt is projected to remain below the 60% reference value throughout the 2005-2050 projection period. Latvia is implementing a pension reform launched in 1996 which contributes significantly to contain the budgetary impact of ageing populations.

---

[5] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the convergence programme outlines measures to support jobs and growth by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority. Nonetheless, greater focus is needed on delivering the key objectives, such as containing inflation, addressing the external account imbalance and increasing activity rates by promoting an inclusive labour market.

(14) The National Reform Programme of Latvia, submitted on 21 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies securing macro-economic stability as the main challenge with implications for public finances and to that end strengthening of fiscal discipline and budgetary planning procedures are to play the major role. The budgetary implications of the limited number of concrete reform measures specified in the National Reform Programme are reflected in the budgetary projections of the convergence programme. The public finance measures envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme. As mentioned above, the convergence programme outlines measures to support growth and employment by changes in the revenue and expenditure structure (especially a shift of the tax burden from direct to indirect taxation and a cut in transfers) and by making public investment a spending priority

In view of the above assessment, and in the light of the need to ensure sustainable convergence, including by reducing the external imbalance and containing inflation, the Council is of the opinion that it would be appropriate for Latvia to consider the achievement of more ambitious budgetary positions than currently planned, notably by bringing forward the attainment of the MTO set in the programme, maintaining it during the programme period and avoiding pro-cyclical fiscal policies in “good times”.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Nov 2005**	**8.5**	**8.4**	**7.5**	**7.0**	**7.0**
	COM Nov 2005	8.3	9.1	7.7	7.1	n.a.
	CP Dec 2004	*8.1*	*6.7*	*6.5*	*6.5*	*n.a.*
HICP inflation (%)	**CP Nov2005**	**6.2**	**6.9**	**5.6**	**4.3**	**3.5**
	COM Nov 2005	6.2	6.8	6.0	4.8	n.a.
	CP Dec 2004	*6.2*	*4.3*	*3.0*	*3.0*	*n.a.*
Output gap (% of potential GDP)	**CP Nov 2005**[3]	**0.5**	**0.8**	**0.4**	**-0.5**	**-1.1**
	COM Nov 2005[5]	0.1	0.8	0.3	-0.7	n.a.
	CP Dec. 2004[3]	*1.6*	*0.9*	*0.0*	*-0.5*	*n.a.*
General government balance[1] (% of GDP)	**CP Nov. 2005**	**-1.0**	**-1.5**	**-1.5**	**-1.4**	**-1.3**
	COM Nov 2005	-1.0	-1.2	-1.5	-1.5	n.a.
	CP Dec.2004	*-1.7*	*-1.6*	*-1.5*	*-1.4*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2005**	**-0.2**	**-0.7**	**-0.8**	**-0.6**	**-0.6**
	COM Nov 2005	-0.2	-0.5	-0.8	-0.8	n.a.
	CP Dec 2004	*-0.9*	*-0.8*	*-0.8*	*-0.7*	*n.a.*
Cyclically-adjusted balance= Structural balance[2] (% of GDP)	**CP Nov. 2005**[3]	**-1.1**	**-1.7**	**-1.6**	**-1.3**	**-1.0**
	COM Nov 2005[4]	-1.0	-1.5	-1.6	-1.3	n.a.
	CP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2005**	**13.1**	**14.9**	**13.6**	**13.7**	**14.7**
	COM Nov 2005	14.7	12.8	13.0	13.2	n.a.
	CP Dec 2004	*14.2*	*14.5*	*15.8*	*15.0*	*n.a.*

Notes:

[1] The net costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.27% of GDP in 2005, 0.37% of GDP in 2006, 0.62% of GDP in 2007 and 1.32% of GDP in 2008.

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures. The year-on year improvement in the cyclically-adjusted balance foreseen in the programme, adjusting for the impact of the phased implementation of the pension reform, would be 0.2% of GDP in 2006, 0.6% in 2007 and 1.0% in 2008, an average of 0.6% in the period 2006-2008. Since there are no other one-off and temporary measures specified in the programme, the cyclically-adjusted balance and the structural balance are identical.

[3] Commission services calculations on the basis of the information in the programme.

[4] There are no one-off and other temporary measures in the Commission services' forecast.

[5] Based on estimated potential growth of 7.9%, 8.3%, 8.3% and 8.2% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.