COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.3.2007
SEC(2007) 291 final

Recommendation for a

COUNCIL OPINION

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

on the updated convergence programme of Latvia, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL 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. The 2005 reform of the Pact acknowledged its 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 Stability and Growth 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Latvia, submitted on 12 January 2007, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

Latvia is a catching-up country undergoing structural transformation with very high economic growth, and which has been making substantial progress in closing the gap with EU-25 income per head. It faces relatively high inflation reflecting the convergence process, product

[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

and factor market rigidities and more recently an increasingly evident overheating. Unemployment has fallen (though is still at a high level in some regions) and labour shortages have appeared in key sectors. Labour market participation is low. Taken together with demand pressures, labour supply constraints, exacerbated by significant outward migration and a progressively declining working-age population, have resulted in upward wage pressure. Consequently, although labour productivity is growing, unit labour costs are increasing more rapidly than in Latvia's main trade partners, thus undermining competitiveness. High trade deficits in goods are only partly compensated by surpluses in services. Behind the external deficit lies a structural private sector saving-investment gap: increasing saving of the private sector has been outweighed by higher and more rapidly increasing private sector investment. High external imbalances imply reliance on equally-large financial inflows, mainly in the form of bank credit, and their scale has led to the gross external debt-to-GDP ratio having risen to a very high level. From a viewpoint of long-term sustainability, public finances in Latvia appear healthy, in view of the low public debt ratio and relatively high potential output growth in the long term. However, from a macro-financial stability perspective, while nominal general government deficits have remained moderate in recent years, these mask significant demand injections through expenditure financed with EU funds and in the current context of evident overheating the underlying pro-cyclical fiscal stance is of great concern.

2.2. The assessment in the Council opinion on the previous programme

On 14 February 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. Due to "the need to ensure sustainable convergence, including by reducing the external imbalance and containing inflation, the Council invited Latvia to pursue more ambitious budgetary positions than planned, including for 2006, 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”".

2.3. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Latvia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 17 October 2006. Latvia's national reform programme identified as key challenges/priorities: securing macro-economic stability; stimulating knowledge and innovation; developing a favourable and attractive environment for investment and work; fostering employment; and improving education and skills.

The Commission’s assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Latvia is making progress in the implementation of its National Reform Programme, in particular in the micro-economic and employment areas. However, policy responses to address the macro-economic key challenge are less comprehensive.

Against the background of strengths and weaknesses identified, Latvia was recommended to pursue a more restrictive fiscal policy; take action in the areas of R&D and innovation; and promote labour supply and productivity by improving mobility, education and training.

[2] Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "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.

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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[5], 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 [27 March 2007] the Council examined the updated convergence programme of Latvia, which covers the period 2006 to 2009[6].

(2) The macroeconomic scenario underlying the programme envisages a soft-landing of the economy, with real GDP growth slowing from 11.5% in 2006 to 8.0% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. Nevertheless, there is a significant probability of much less favourable macroeconomic developments in view of large external imbalances and the overheated state of the Latvian economy. The programme’s projections for inflation appear to be on the low side.

(3) For 2006, the Commission services’ autumn 2006 forecast estimated the general government deficit at 1.0% of GDP, against a target of 1.5% of GDP set in the previous update of the convergence programme. The updated programme presents a deficit estimate of 0.4% of GDP, which is plausible in view of the higher than

[5] 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

[6] Following the formation of a new government in November 2006, after a general election in October, the update was submitted six weeks beyond the 1 December deadline set in the code of conduct.

expected revenues and despite the impact of budgetary amendments adopted in October 2006, which increased expenditures by an estimated 1.5% of GDP.

(4) The main goal of the medium-term budgetary strategy is to gradually improve the fiscal outlook and achieve a balanced budget by 2010. This goal will require a considerable consolidation effort after the deterioration in 2006 and 2007 by almost 1½ percentage point of GDP. The envisaged adjustment in 2008 and 2009 is identical in the headline and in the primary balance, respectively 0.4 and 0.5 percentage points of GDP. Compared to the previous update, the planned budgetary targets are more stringent, but the adjustment remains back-loaded against a more favourable macroeconomic scenario. After the significant loosening of the expenditure-to-GDP ratio in 2007, the programme envisages consolidating the budget during 2008-2009 by increasing the revenue-to-GDP ratio by 0.4 percentage points each year, while keeping broadly constant the expenditure-to-GDP ratio. The revenue-to-GDP ratio is planned to increase due exclusively to higher "other" revenues, which represents an increased inflow of EU funds. Accordingly, the expenditure ratio for the gross fixed capital formation component is increasing, broadly offset after 2007 by a decline in "other" expenditures (which in the programme includes part of consumption expenditure) by ¾ percentage points in 2008 and in social transfers by ½ percentage points in 2009.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to deteriorate from a deficit of 1% of GDP in 2006 to a deficit of 1¾% of GDP in 2007 and to improve to a surplus of ¼% by 2009. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP, which the programme aims to achieve around 2008, as in the previous update. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) The risks to the budgetary projections in the programme appear broadly balanced for 2007, but the budgetary outcomes could be worse than projected in the programme from 2008, due to risks to the macroeconomic scenario. The budgetary strategy relies on an increase in the revenue-to-GDP ratio and on declines in the ratios to GDP of social transfers and "other expenditure" (which in the programme includes part of consumption expenditure), which could have been better substantiated, taking into account that according to the update a formal medium-term framework for the planning and control of public finances is planned to be introduced from 2008 onwards.

(7) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2008, as envisaged in the programme. However, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. Except for 2007, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that the adjustment should be higher in good economic

times and could be lower in bad economic times. Nevertheless, 2007 is clearly a year of moving away from the MTO in economic good times, which is not in line with the Stability and Growth Pact. A stronger structural adjustment path frontloaded during the programme period would be appropriate to support a stable macroeconomic convergence process and the mitigation of risks of imbalanced economic growth.

(8) 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 MTO. The medium-term budgetary strategy outlined in the programme embodies a temporary deviation from the adjustment path towards the MTO in 2007. The programme notes that the ongoing pension reform will gradually reduce social security contributions in the general government balance and that the contribution to the second-pillar pension scheme will increase from 0.4% of GDP in 2006 to 1.7% of GDP by 2009. The deterioration of the structural balance foreseen in the programme, adjusting for the impact of the phased implementation of the pension reform, would be of ½% of GDP in 2007 followed by improvements of 1½% in 2008 and 1¼% in 2009. While the net costs of the pension reform can be taken into account when assessing the adjustment path towards the MTO, the adjustment in 2007, even taking into account such costs, is not in line with the Pact. On the other hand, the healthcare reform and public investment projects mentioned in the programme do not qualify as structural reforms on which a temporary deviation can be based, as these measures are insufficiently detailed and the significant beneficial impact on the long-term sustainability of the public finances is not demonstrated in the programme.

(9) Government gross debt is estimated to have reached 10.7% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 1.3 percentage points over the programme period to reach 9.4% of GDP by 2009.

(10) The long-term budgetary impact of ageing in Latvia is lower than the EU average, with age-related expenditure projected to fall as a share of GDP over the coming decades, influenced by the expenditure-reducing impact of the reform of the pension system. The current level of gross debt is very low in Latvia and improving the structural budgetary position as planned in the convergence programme update would contribute to contain the risks to the long-term sustainability of public finances. Overall, Latvia appears to be at low risk with regard to the sustainability of public finances.

(11) The convergence programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage significant increase in public investment and the convergence programme further expands on measures to be implemented in order to improve the institutional features of the public finances, including the introduction of the multi-annual budgetary framework.

(12) The budgetary strategy in the programme is only partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the projected fiscal stance does not contribute adequately to promoting greater sustainability of the external account.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[7]. However, some inconsistencies exist with regards to standard Table 2.

The overall conclusion is that the worsening of the budgetary position in 2007 is not in line with a prudent fiscal policy aimed at ensuring sustainable convergence, including by reducing the external imbalance and containing inflation. In the subsequent years, the programme envisages progress towards the MTO in a context of strong growth prospects, but the budgetary targets are not ambitious and there are risks to their achievement from 2008 onwards.

In view of the above assessment, Latvia is invited to:

(i) reduce the risks of macroeconomic instability by achieving a significantly better budgetary target for 2007 and by adopting as soon as possible measures – as part of a broader reform strategy – leading to further consolidation beyond the MTO in subsequent years;

(ii) establish a clearer and more binding medium-term framework for the planning and control of public finances.

[7] In particular the data on the subcomponents of the stock-flow adjustment and some elements of the long-term sustainability of public finances table are missing.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Jan 2007**	**10.2**	**11.5**	**9.0**	**7.5**	**7.5**
	COM Nov 2006	10.2	11.0	8.9	8.0	n.a.
	CP Nov 2005	*8.4*	*7.5*	*7.0*	*7.0*	*n.a.*
HICP inflation (%)	**CP Jan 2007**	**6.9**	**6.6**	**6.4**	**5.2**	**4.2**
	COM Nov 2006	6.9	6.7	5.8	5.4	n.a.
	CP Nov 2005	*6.9*	*5.6*	*4.3*	*3.5*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2007[1]**	**0.0**	**1.8**	**1.3**	**-0.5**	**-2.0**
	COM Nov 2006[5]	-0.2	1.1	0.4	-1.0	n.a.
	CP Nov 2005[1]	*0.8*	*0.4*	*-0.5*	*-1.1*	*n.a.*
General government balance[6] (% of GDP)	**CP Jan 2007**	**0.1**	**-0.4**	**-1.3**	**-0.9**	**-0.4**
	COM Nov 2006	0.1	-1.0	-1.2	-1.2	n.a.
	CP Nov 2005	*-1.5*	*-1.5*	*-1.4*	*-1.3*	*n.a.*
Primary balance[6] (% of GDP)	**CP Jan 2007**	**0.7**	**0.2**	**-0.8**	**-0.4**	**0.1**
	COM Nov 2006	0.7	-0.4	-0.7	-0.7	n.a.
	CP Nov 2005	*-0.7*	*-0.8*	*-0.6*	*-0.6*	*n.a.*
Cyclically-adjusted balance[6] (% of GDP)	**CP Jan 2007[1]**	**0.1**	**-0.9**	**-1.7**	**-0.8**	**0.2**
	COM Nov 2006	0.2	-1.3	-1.3	-0.9	n.a.
	CP Nov 2005[1]	*-1.7*	*-1.6*	*-1.3*	*-1.0*	*n.a.*
Structural balance[2,6] (% of GDP)	**CP Jan 2007[3]**	**0.1**	**-0.9**	**-1.7**	**-0.8**	**0.2**
	COM Nov 2006[4]	0.2	-1.3	-1.3	-0.9	n.a.
	CP Nov 2005	*-1.7*	*-1.6*	*-1.3*	*-1.0*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2007**	**12.1**	**10.7**	**10.5**	**10.6**	**9.4**
	COM Nov 2006	12.1	11.1	10.6	10.3	n.a.
	CP Nov 2005	*14.9*	*13.6*	*13.7*	*14.7*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] There are no one-off and other temporary measures in the programme.
[4] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[5] Based on estimated potential growth of 9.3%, 9.6%, 9.6% and 9.5% respectively in the period 2005-2008.
[6] The net costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.3% of GDP in 2005, 0.4% of GDP in 2006, 0.6% of GDP in 2007, 1.3% of GDP in 2008 and 1.5% of GDP in 2009. The year-on year change in the structural balance foreseen in the programme, adjusting for the impact of the phased implementation of the pension reform, would be a worsening of 0.6% of GDP in 2007, an improvement of 1.6% in 2008 and 1.2% in 2009.

Source:
Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations