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LATVIA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Latvia's convergence programme was submitted on 29 November.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 22 February 2008. Comments should be sent to Gatis Eglitis and Balazs Forgo (Gatis.Eglitis@ec.europa.eu, Balazs.Forgo@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2007 forecast, (ii) the code of conduct ("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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Latvia, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2007-2010, was submitted on 29 November 2007.

Following a sustained period of high growth since the mid-nineties, Latvia's real GDP increased at double-digit rates in 2005-2007. Growth has primarily been driven by a powerful credit boom boosting private consumption and real estate investment, with net external borrowing surpassing 20% of GDP since 2006. Monetary conditions have been accommodative, given a high degree of euroisation in the framework of a narrowly pegged exchange rate within ERM II. Adding to the overheating from the demand side, labour shortages have contributed to the emergence of a wage-price spiral, with very high wage growth outstripping productivity, leading to the highest inflation in the EU and rapidly deteriorating competitiveness. From mid-2007 some slowdown has become visible in the housing market and in domestic consumption, but insufficient to remove the downside risks to the economy. In this context fiscal policy has insufficiently tackled the emerging vulnerabilities. Key to addressing internal and external imbalances will be a more ambitious fiscal stance; adherence to an appropriate medium-term budgetary framework; prioritizing public expenditure and re-examining taxation instruments to avoid demand stimulus in sectors which do not significantly strengthen the economy's medium- and long-term supply potential, particularly real estate; and a more responsible public sector wage growth. To foster the catching up process, structural reforms and removal of bottlenecks directed towards strengthening the supply side of the economy are needed.

The macroeconomic scenario underlying the programme envisages a soft landing with real GDP growth gradually decreasing from 10.5% in 2007 to 6.8% by 2010. According to the programme, domestic demand will remain the main growth contributor, although it is expected to slow significantly from 2007 to 2008. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. However, the envisaged slowdown of domestic demand is far from assured and the programme's economic scenario is attended by very high risks for macroeconomic stability, with a more abrupt slowdown being a distinct possibility. Furthermore, without a larger adjustment of aggregate demand and supply than depicted in the programme, the country's external position would not be sustainable in the longer run. The programme's projections for inflation, which appear to be plausible, show that Latvia will be moving further away from nominal convergence at least until 2008. Moreover, uncertainties remain large due – inter alia – to ongoing volatility in energy and other commodity prices and to how the current wage-price spiral may evolve. Restraining public sector compensation is critically important for achieving a reduction in whole-economy wage growth which would be necessary to break the current cost-price dynamics and arrest rapidly deteriorating cost competitiveness.

For 2007, the previous programme targeted a budget deficit of 1.3% of GDP, while the new update estimates the outcome at a surplus of 0.3% of GDP. The autumn forecast projected a budget surplus of 0.9% of GDP for 2007, close to the provisional result (a surplus of 0.8%[1]). The improvement relative to the previous programme's target reflects

[1] Based on the national methodology estimate for the 'consolidated national budget', assuming a balanced budget of the local government sub-sector.

higher than expected revenues, partly offset by higher-than budgeted expenditure growth. The structural deficit, calculated according to the commonly agreed methodology, is estimated to have improved from about 1% of GDP in 2006 to ½% in 2007. Nevertheless, budgetary policy in 2007 was only partly in line with the invitation in the Council opinion of 27 March 2007 on the previous update of the convergence programme[2], as the background of continuing high demand and risks to stability show that fiscal policy remained short of that required. Nevertheless, there has been some progress in limiting the previously usual surge in end-of-year spending by public institutions, following guidelines to this end adopted by the government in November 2007.

The main goal of the budgetary strategy of the programme is to foster macroeconomic stability by continuing to respect the medium-term objective (MTO) of a structural deficit of 1% of GDP by a growing margin over the programme period. Compared to the previous programme, which planned to achieve the MTO only from 2008 onwards, the new update broadly confirms the envisaged consolidation path but from a much better budgetary starting position against a broadly unchanged macroeconomic scenario. According to Commission services' calculations on the basis of information in the programme, the structural balance is projected to improve from a deficit of ½% of GDP in 2007 to a surplus of ½% of GDP in 2008 and by ½ percentage point per year in 2009-2010. Two-thirds of the rise in the headline surplus by almost 1 percentage point of GDP owes to an increase in the revenue-to-GDP ratio and the remaining third to a fall in the expenditure-to-GDP ratio. On the revenue side, the projected increase in indirect taxes and "other revenues" as a share of GDP more than offsets a projected decline in social contributions due to the ongoing pension reform. Restraint in expenditure on public consumption and compensation of employees relative to GDP (which is not assured by measures described in the programme) is assumed to provide budgetary room for proposed increases in social payments, including in the areas of pensions and parent benefit, and public investment.

According to the assessment by the Commission services, the budgetary outcomes could be much worse than projected in the programme. There are significant risks for overall macroeconomic stability stemming from the wide external imbalance and the currently overheated state of the economy. Were the credit-financed, domestically-driven growth to slow abruptly, the budget could come under strong pressure, as the programme's revenue projections are based on the assumption of continuing high consumption and favourable labour market conditions. The projected reduction in the expenditure ratio seems difficult to achieve in the absence of underpinning measures. As medium-term expenditure ceilings for ministries and public institutions were introduced only in 2007, it is not yet possible to judge their effectiveness. The track record of recent years rather points to overruns as high nominal growth has created the opportunity each year to spend extra revenues in the framework of a supplementary budget. Finally, the programme counts on receipts related to the privatization of Lattelecom (amounting to a total of 0.5% of GDP), subject to considerable uncertainty.

In view of the above risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO throughout the programme period, excluding the possible case of a severe growth downturn. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact, but should be tightened given the size of the economic imbalances and the heightened responsibility of fiscal policy due to the limited

[2] OJ C 89, 24.4.2007, p.15

scope of monetary policy under a quasi-fixed exchange rate regime within ERM II. The likelihood of a better-than-estimated 2007 outturn should be used to aim for a much higher surplus position in 2008.

Latvia appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing 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 and improving the budgetary position as planned in the convergence programme update would contribute to limiting the risks to the long-term sustainability of public finances.

Latvia's national reform programme identifies 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 is that Latvia has made some progress in implementing its national reform programme in 2005-5007, in particular in the areas of knowledge and innovation and SMEs and entrepreneurship. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Latvia is recommended to give highest priority to the challenges in the areas of fiscal policy; research and innovation policy, labour supply and productivity. In addition, Latvia should focus on the areas of better regulatory environment and access to childcare.

The convergence programme seems to be consistent with the October 2007 implementation report of the National Reform Programme (NRP). The implementation report identifies securing macroeconomic stability as the main challenge with implications for public finances and allots a major role to the strengthening of fiscal discipline and budgetary planning procedures. While the programme contains a qualitative assessment of the overall impact of the NRP within the medium-term fiscal strategy, it does not provide detailed information on the direct budgetary costs/savings associated with the reforms envisaged in the NRP. The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines in the area of budgetary policies in the context of the Lisbon strategy. However, the projected fiscal stance does not contribute adequately to countering overheating and promoting economic sustainability.

In terms of progress in implementing its ERM II commitments, the authorities have done little to strengthen the fiscal stance and restrain domestic demand, although some steps have been taken to curb credit growth. The March 2007 anti-inflation plan was a step in the right direction but fell short of the measures needed to stabilise the economy and to achieve a sustainable reduction in inflation. Further structural reforms are needed to address the weak supply-side of the economy and worsening competitiveness. The economic stabilization plan currently under consideration by the Latvian authorities is likely to include further fiscal and tax measures, as well as steps to improve the business environment and competitiveness.

The overall conclusion is that the programme aims to reduce economic imbalances and excessive demand pressure by setting slightly increasing but overall modest surplus targets for 2008-2010, in excess of the MTO. However, the risks to the achievement of the budgetary targets are high primarily due to large macroeconomic uncertainty and a track record of slippages from expenditure plans. Moreover, a considerably tighter stance of fiscal policy is urgently needed to meet the programme's aims in a context of an economy subject to risks to stability - stemming from inflationary pressures, deteriorating cost competitiveness and sharply increasing net foreign liabilities. While medium-term expenditure ceilings have been introduced, they remain to be tested. As regards the long-term sustainability of public finances Latvia is assessed to be at low risk.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Nov 2007**	**11.9**	**10.5**	**7.5**	**7.0**	**6.8**
	COM Nov 2007	11.9	10.5	7.2	6.2	n.a.
	CP Jan 2007	*11.5*	*9.0*	*7.5*	*7.5*	*n.a.*
HICP inflation (%)	**CP Nov 2007**	**6.6**	**10.1**	**12.5**	**7.2**	**4.9**
	COM Nov 2007	6.6	9.6	9.8	6.0	n.a.
	CP Jan 2007	*6.6*	*6.4*	*5.2*	*4.2*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Nov 2007**	**2.0**	**2.8**	**1.3**	**-0.3**	**-1.7**
	COM Nov 2007[2]	2.1	2.7	0.8	-1.7	n.a.
	CP Jan 2007	*1.8*	*1.3*	*-0.5*	*-2.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2007**	**-21.1**	**-23.5**	**-20.3**	**-18.3**	**-16.4**
	COM Nov 2007	-19.9	-22.2	-18.9	-18.0	n.a.
	CP Jan 2007	*-17.4*	*-17.2*	*-16.3*	*-15.8*	*n.a.*
General government balance (% of GDP)	**CP Nov 2007**	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**
	COM Nov 2007	-0.3	0.9	0.8	0.5	n.a.
	CP Jan 2007	*-0.4*	*-1.3*	*-0.9*	*-0.4*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**0.2**	**0.7**	**1.0**	**1.2**	**1.5**
	COM Nov 2007	0.2	1.3	1.2	0.9	n.a.
	CP Jan 2007	*0.2*	*-0.8*	*-0.4*	*0.1*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Nov 2007**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**
	COM Nov 2007	-0.8	0.2	0.5	1.0	n.a.
	CP Jan 2007	*-0.9*	*-1.7*	*-0.8*	*0.2*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2007**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**
	COM Nov 2007	-0.8	0.2	0.5	1.0	n.a.
	CP Jan 2007	*-0.9*	*-1.7*	*-0.8*	*0.2*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**10.6**	**9.4**	**8.3**	**7.2**	**6.4**
	COM Nov 2007	10.6	10.2	7.8	6.4	n.a.
	CP Jan 2007	*10.7*	*10.5*	*10.6*	*9.4*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 9.8%, 9.8%, 9.3% and 8.9% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. The most recent programme update provides no information on one-off and other temporary measures; according to the Commission services' autumn forecast, there are no one-off and other temporary measures.

Source:
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The fourth update of the Latvian convergence programme[3], covering the period 2007-2010, was submitted on 29 November 2007. The Latvian Cabinet[4] approved the convergence programme on 28 November 2007, after when it was sent to the Budget and Financial Affairs committee as well as the European Affairs committee of the Latvian Parliament. There is no formal parliamentary approval of the convergence programme in Latvia.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Latvia, with a particular focus on Country-specific topic. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. Section 8 reviews progress in implementing Latvia's ERM II commitments. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON FISCAL POLICY AND DEMAND PRESSURES IN THE LATVIAN ECONOMY

Latvia has recorded one of the highest GDP growths in the EU for several years, but this has become marred by the emergence of an extremely large external imbalance, high inflation and other symptoms of overheating. The first section below provides an overview of recent economic performance, highlighting some important characteristics of Latvia's economic growth where budgetary policy challenges identified in last year's technical assessment (i.e. stabilisation and efficiency) remain highly relevant. This section also suggests that fiscal policy should prepare for less favourable times ahead, with lower growth in domestic demand. Public finance has a heightened responsibility in Latvia due to the limited scope of monetary policy under a quasi-fixed exchange rate regime[5]. The second section therefore analyzes the impact of the booming economy on public finances and the role public finance should play in this situation.

2.1. Demand pressure in the Latvian economy

[3] The English translation of the programme was sent on 7 January 2008.

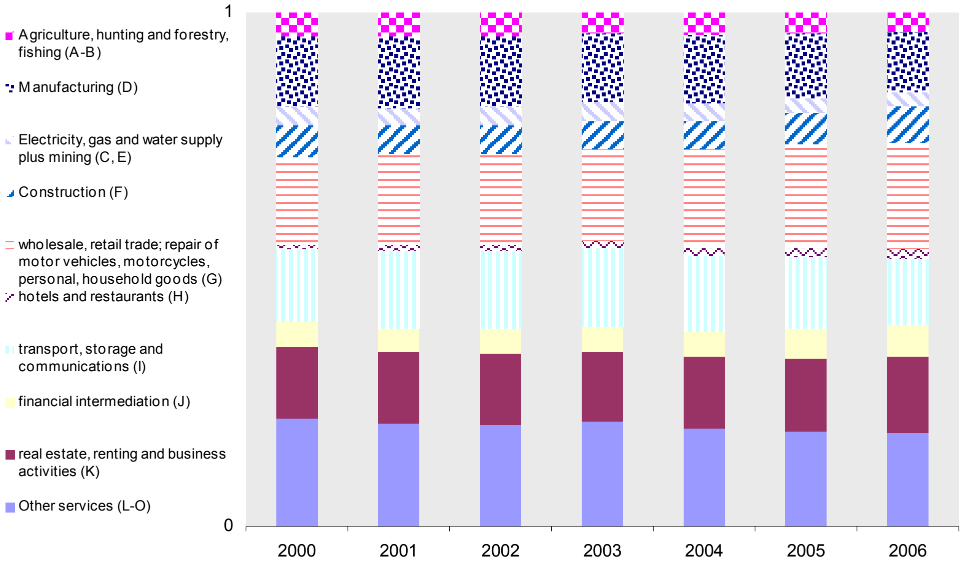
[4] Towards the end of the previous government's period of office. The same four coalition parties made up a new government in December 2007.

[5] Latvia has a long tradition of pegging the exchange rate of its currency, the lats, from 1994 to the SDR and from 2005 to the euro. In May 2005, Latvia entered ERM II, unilaterally adopting a +/- 1% fluctuation corridor around the central parity.

2.1.1. Composition of GDP

The Latvian economy has grown considerably in the period 2000-2006. From the output side, growth was fastest in those sectors satisfying domestic demand, i.e. retail and wholesale, financial intermediation and real estate, renting and business activities. The share of the construction sector remained relatively small (reaching 6.8% of total gross value-added (GVA) in 2006), despite stepped-up infrastructure development, other public investment projects and a boom in the housing market (Figure 1). Although the GVA of the manufacturing sector grew by an annual real growth rate of 6.2% over the 2003-2006 period, the share of this sector within the total GVA of the economy slightly decreased.

Figure 1: Composition of the annual gross value added



Source: CSB[6]

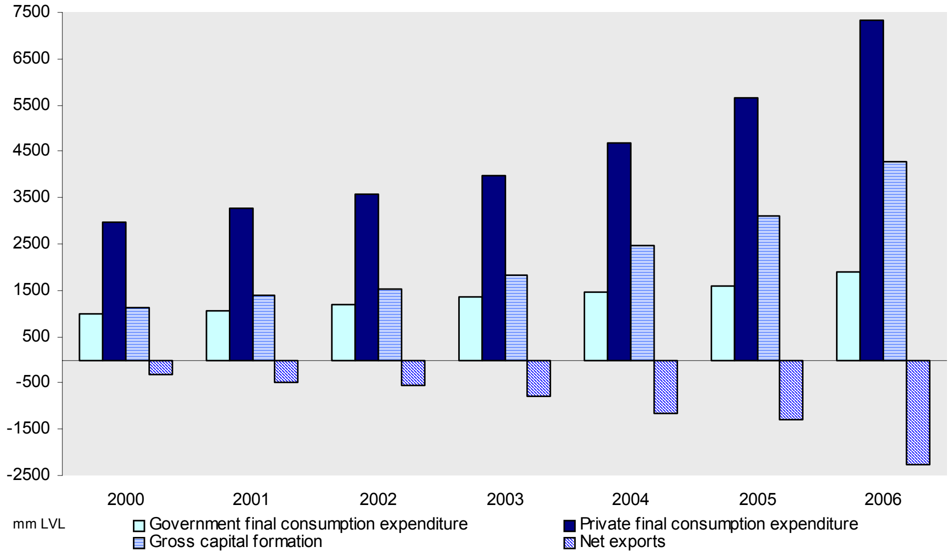
On the expenditure side, private consumption shows a major expansion over the past five years (Figure 2). A marked reduction in net exports is also apparent, but cannot be attributed exclusively to consumption, because gross fixed capital formation (GFCF) was also rapidly rising. However, in Latvia's case, GFCF presumably includes an over-proportionate amount of items closely related with private consumption[7] and potentially non-productive items such as investment in real estate. In any event, the widening external balance indicates that the supply side of the economy was not able to react to the rapid, strong increase in domestic demand. Furthermore, the weight of investment into sectors not contributing to expanding tradeable capacity within total GFCF was relatively high[8].

Figure 2: Composition of the annual GDP from the expenditure side

6 CSB, i.e. Central Statistical Bureau, the national statistical bureau of Latvia

7 E.g. expensive cars are typically purchased as company cars (appearing as corporate investment)

8 This statement is based on official statistics on the composition of 'non-financial investment by kind of activity' and on the sectoral analysis of FDI shown below.



Source: CSB

2.1.2. Net lending position of institutional sectors

The net lending position of the economy as a whole – the external deficit - rapidly deteriorated from 2003, due overwhelmingly to the activities of the private sector (Figure 3). The corporate sector invested heavily throughout the period against a background of not particularly high sectoral savings. The investment rate[9] of non-financial corporations was the second highest in the EU in 2005 and the sector's investment to GDP ratio was the highest. Nevertheless, levels of capital are relatively low in absolute terms and the above-mentioned characteristics of investment should be noted. From 2005 the external deficit was aggravated when the household sector also became a substantial net borrower. The household saving rate of Latvia has been traditionally one of the lowest in the EU. In 2005, it stood at the very low level of 1.1%[10], both due to the country's relatively low income levels and to households' optimistic expectations about their future permanent income. On the other hand, fixed investment by households - traditionally also very low - greatly increased in 2005 and presumably also in 2006[11], as households invested more in dwellings.

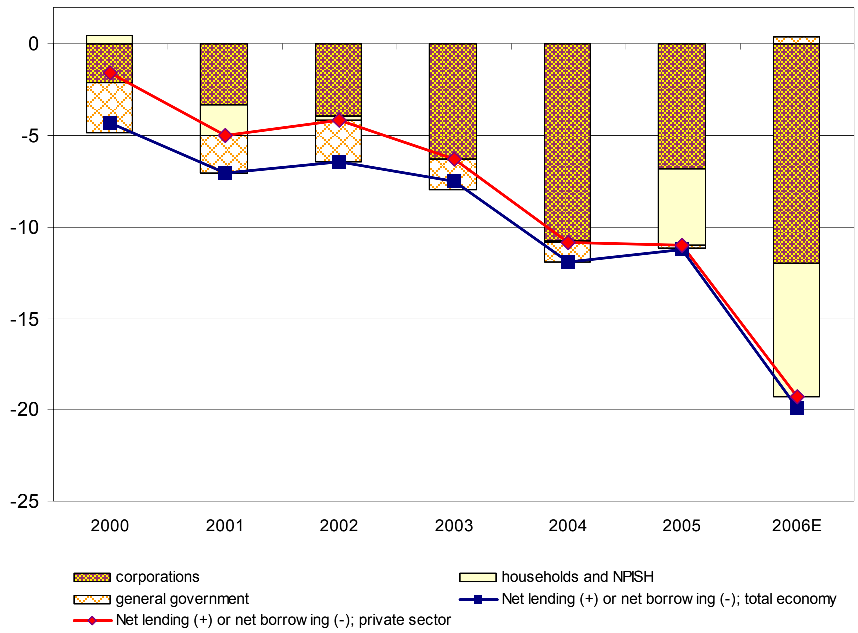
After significant net borrowing positions in the first years of the decade, the general government sector achieved a broadly balanced position both in 2005 and 2006, despite a substantial pick-up in investment, which increased from 2.4% of GDP in 2003 to 4.3% of GDP by 2006.

Figure 3: Net lending position of the institutional sectors (in percentage of GDP)

[9] Relative to gross value added of non-financial corporations.

[10] Relative to gross disposable income; 2006 estimated.

[11] No data yet available for 2006.



Source: Ameco, Spring Forecast

2.1.3. Bank lending

The large negative net lending position of the private sector was made possible by the abundant availability of commercial bank loans which played an increasingly important role in financing the economic growth. Over the last three years loans to households have expanded at an annual growth rate of 70-80%, while from 2005 loans to corporations grew annually by 50%. Accordingly, the loan to GDP ratio[12] increased rapidly to approaching 90% of GDP in 2006 (Figure 4), with first signs of moderation in credit growth only in the second half of 2007.

Loan currency denomination represents a significant balance sheet risk for the corporate and household sectors. With a low perception of exchange rate risk, the share of foreign currency lending to residents increased from a share of over 50% in 2003 to over 80% in mid-2007 (mostly in euro).

At the end of 2006, 44% of outstanding loans were attributable to the household sector of which around four-fifths were for housing – a sharp rise compared to the 55% share in 2002. Debt and interest service ratios increased strongly and household sector debt is now high when compared to other countries**.** Measured against gross disposable household income, outstanding debt has surpassed 70%, more than doubling since 2002. Household sector interest payments at the end of 2006 were close to 3% of GDI, up from the 1% recorded in 2002. The Latvian household sector had thus become more indebted than most other recently acceding Member States, with only Estonia displaying similar debt levels.

About 40% of the banks' loan portfolio towards non-financial corporations was closely associated with the real estate sector[13].

[12] As measured by loans provided to residents by the Latvian banking sector; this excludes loans provided to residents directly by non-residents.

[13] The statistics of Latvian Financial and Capital Market Commission were used for this analysis. The sum of loans issued to the sectors of 'Construction' and 'Operations with real estate, lease and other commercial activity' were taken as exposure closely related with the real estate sector.

Combining these two channels[14], banks' total exposure to the real estate sector at the end of 2006 was about 48% of GDP, up more than 15 percentage points from 2005. Consequently, developments on the bank lending market were very closely related to the real estate market, with the real estate sector being responsible for about 82% of the increase in total loan stock in 2006 (and for 69% in 2005).

Box 1: The macroeconomic effects of rapid financial convergence

EU membership and strong presence of foreign banks accelerated financial convergence in most RAMS. This has improved availability of credit to domestic borrowers, including households. As a result, many RAMS are going through periods of rapid private credit growth, in many cases financed through external borrowing by their commercial banks. Private credit growth has been particularly strong in the Baltic countries and Bulgaria in recent years, ranging from 37.4 to 61.3 percent in the twelve months to September 2007.

Recent research in the European Commission points to a mechanism through which financial convergence may also influence real exchange rate and current account trends in RAMS. Results of stochastic dynamic general equilibrium model-based simulations show that improved access to credit, while leaving TFP growth unchanged, leads to a persistent real appreciation and a widening of the current account deficit in the short to medium run —just like in the case of the Balassa-Samuelson (B-S) effect*. The longer-run implications are, however, markedly different from those of the B-S effect, where the real appreciation is due to a productivity shock in the tradable sector. The appreciation of the real exchange rate is not permanent. In the longer run, when the impact of the improved access to credit is over, the real exchange rate returns to a level that is slightly more depreciated than in the baseline. The current account balance also starts to improve and in the long run returns to the same level as in the baseline. The faster the financial convergence the larger the swings in the real exchange rate and the current account balance are likely to be.

These results also indicate the vulnerabilities rapid financial development and integration can create in RAMS. When prices are sticky the exchange rate regime matters in the short run: a fixed exchange rate regime generates a larger current account deficit than a flexible exchange rate regime. That is, the dynamics will depend on several factors, and trade-offs between these. These factors include the stickiness of prices, the extent of unhedged balance sheet exposures, and the degree of nominal flexibility afforded by the exchange rate regime.

* Székely, István P. and Maxwell Watson (2007), Growth and Economic Policy: Are There Speed Limits to Real Convergence?, Economic Papers, European Commission DG ECFIN, forthcoming.

2.1.4. Real estate market

Demand for residential and commercial real estate increased rapidly after the EU-accession, facilitated by financial deepening. However, due to the poor housing heritage from the Soviet period and under-investment in the years after independence, the stock of residential properties was at a very low level, both in terms of quantity and quality.

As the supply side was unable to expand in line with the rapid increase in demand, prices boomed, especially during 2005 and 2006[15], putting Latvia at the global top in terms of annual house price increases[16]. Although high prices attracted investments into the sector

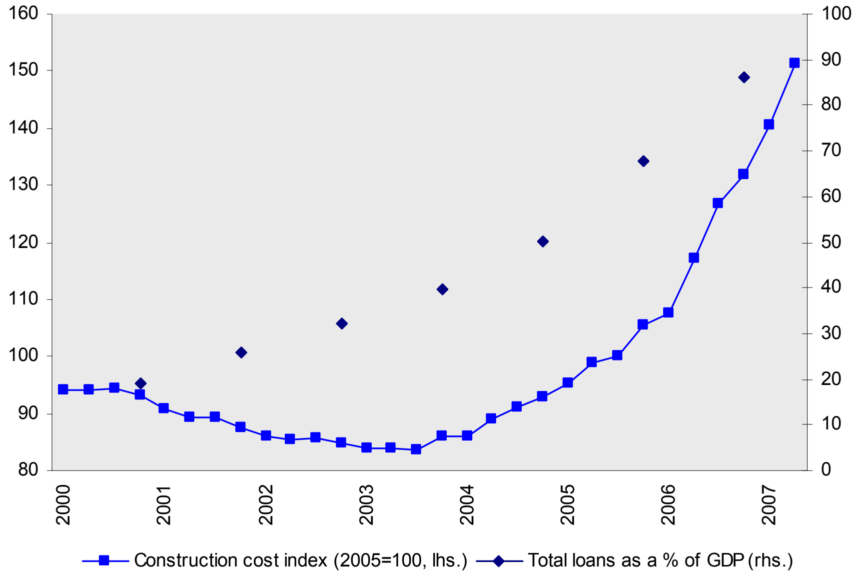
[14] I.e.: lending to households and to non-financial corporations.

[15] The price information is from Central Statistical Bureau (CSB) and private real estate companies Latio, Ober-Haus and Knight Frank.

[16] Knight Frank Global House Price Index.

only with a time lag, the expansion that took place drove up construction costs (Figure 4), especially wages. Furthermore, increasing public orders in the construction sector on the demand side and emigration of a significant part of its potential workforce on the supply side aggravated the rise in construction costs.

Figure 4: Outstanding loans to residents and construction cost index



Source: BoL[17], CSB

2.1.5. Labour market, wage developments and inflation

The size of the labour force was relatively stable in the period 2000-05, but in 2006 abruptly increased by 2.8%[18]. In this year, employment grew by about 5% and the rate of unemployment continued its gradual decrease, to just under 6%. Emigration to old EU Member States taking an estimated 5-10% of the labour force since EU-entry, lack of regional mobility within Latvia and skills mismatches contributed to adverse cost and price developments and supply-side constraints in the economy. High demand for more labour to satisfy the booming domestic demand led to very high wage increases in construction and service sectors, with its impact radiating to the whole economy. Wages in the public sector, which for several years followed private sector wage increases, started to outpace and even pull private sector wages from 2006. According to official statistics, wages in the public sector in 2007 were higher than in the private sector, but under-reporting of private sector wages was one of the main cited justifications for recent sizeable increases in the minimum wage (to double from LVL 80 in 2005 (EUR 113) to LVL 160 by 2008). Nominal ULC growth in the total economy was around 15% in both 2005 and 2006 and the level of labour productivity has remained one of the lowest in the EU, at an estimated 51% of the EU average in 2006 (but up from 44% in 2004).

Inflows of non-EU migrant labour have started to play some role in easing labour market constraints. Recent data on work permit registrations from third countries show that in the ten months of 2007 over 4,000 permits (around 0.35% of the labour force) were issued, twice as many as in the whole of 2006; however, the true number of unregistered third country workers is almost certainly much higher.

[17] BoL stands for Bank of Latvia

[18] This was due to the rapid growth in domestic demand, but presumably regularisation of working relationships of the grey economy also played a role.

HICP inflation in Latvia has been over 6% since 2004, but in 2007 increased to well over 10%. High inflation reflects several factors, primarily a progressive build-up of domestic demand pressures against a background of rapid economic growth, fast credit growth and tighter conditions in the labour market. In the first period after EU accession the depreciation in the nominal effective exchange rate prior to the re-pegging of the lats to the euro on 1 January 2005 also had an upward impact on prices. , The impact of EU accession in raising excise taxes, higher energy and food prices also played a role.. Higher inflationary expectations (due to the above factors) and a developing wage price spiral increasingly contributed to the accelerating development of prices in 2006-2007.

2.1.6. External position

The scale of the credit-financed domestic consumption boom of recent years has negative consequences for a genuine catching-up process not only from the stability point of view, but also because the booming construction and service sectors divert resources from sectors which could expand the tradeable capacity. This is reflected in poor export performance – the volume growth of exports in GDP was only around 5% in 2006, compared with an 18% increase in imports. The result was a trade deficit in 2006 of 25% of GDP (current account deficit of 21%, combined current and capital account deficit of 20% of GDP).

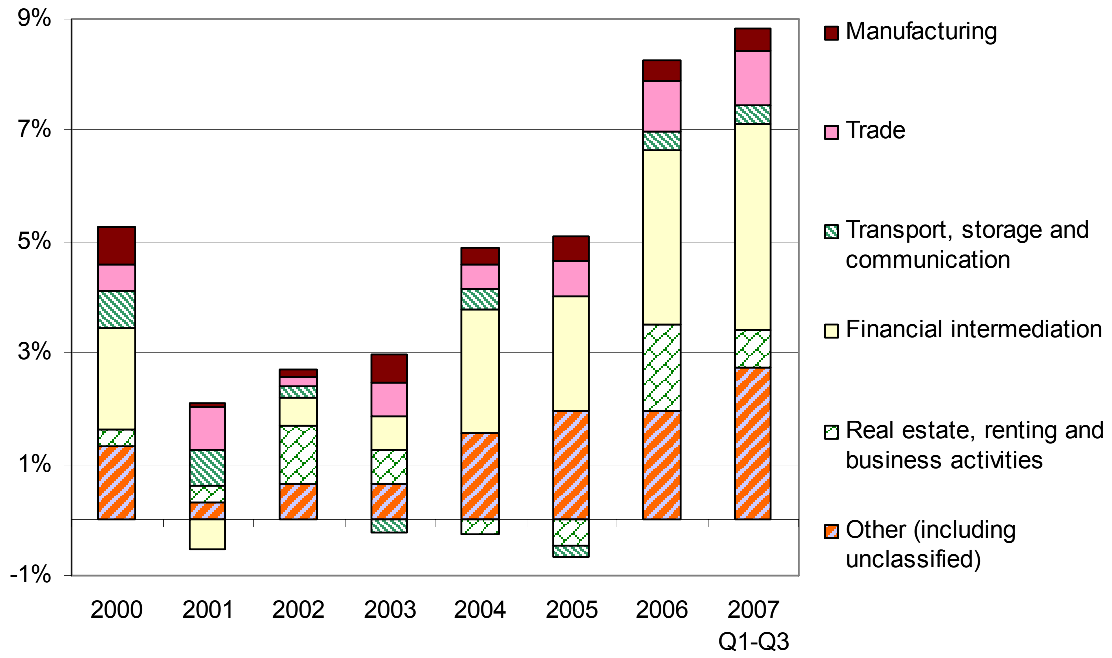
Exports are still dominated by commodity products and re-exports, with only limited evidence of moving up the technology ladder[19]. Hence, export revenues are exposed to volatile global commodity price developments (mainly prices of wood and metals). Furthermore, unfavourable real exchange rate developments (based e.g. on unit wage costs in manufacturing) had a negative effect on the external competitiveness of the economy. However, a recovery of exports in the first part of 2007 was driven by manufactured goods which stood at odds not only with the above described problems of the supply side, but also with the reportedly very low increase in manufacturing output in the same period[20]. The overall conclusion on progress in strengthening the supply side is therefore mixed, but it can be concluded that the current domestic cost developments pose serious challenges to producers of tradeable goods and services.

On the financial side, over the past few years, the sharply deteriorating external balance was financed mainly through the banking sector, typically through loans from the parent banks or syndicated loans. The inflow of FDI increased also significantly after EU-accession, but its sectoral analysis reveals (Figure 5) that investments were mainly made in the real estate and service sectors, thriving on the unsustainable boom in domestic demand. The share of manufacturing within total FDI inflows remained tiny, indicating a limited increase in production capacity for tradeable goods.

Figure 5: FDI inflow by kind of activity (in % of GDP)

[19] See, for example, World Bank (2007), EU8+2 Regular Economic Report, January.

[20] Recent strong export growth in value terms has come mainly from a large increase in prices and not volumes as companies forgo gaining market shares in order to sustain their profitability. However, statistics may underestimate ongoing quality improvements in product structure, leading to an overstatement of price growth



Source: *BoL*

Net external liabilities of Latvia amounted to close to 70% of the GDP at the end of 2006 (up from around 60% of GDP at the end of 2005) with about 80% of the gross external liabilities being debt.

2.2. Challenges for fiscal policy in the booming economic environment

The below section analyses the impact of the booming economy on public finances and reviews the challenges public finances face in contributing to greater stability. Public finance has a heightened responsibility in Latvia due to the limited scope of monetary policy under a quasi-fixed exchange rate regime. Fiscal policy tightening serves as a direct contributor to reducing the aggregate domestic saving-investment imbalance, as a communication of adjustment need to domestic agents and as a signal of policy credibility internationally.

2.2.1. Revenue side

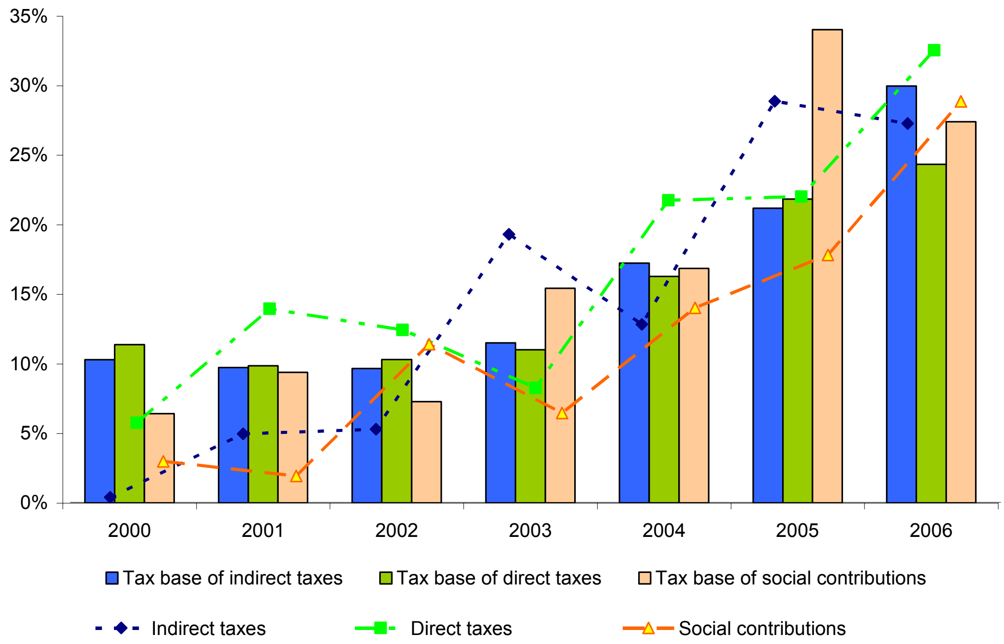
General government revenues have increased more than GDP, with the ratio up from 33.2% of GDP in 2003[21] to 37.0% in 2006. The shares of individual revenue components within total revenues have remained fairly stable since 2003: the only changes were due to the share of social contributions that declined somewhat (partly due to discretionary measures), compensated by an increase in capital revenues.

Over the past few years, probably the most significant change in taxation has been the gradual reduction of the corporate income tax rate from 25% in 2001 to 15% in 2004. Despite this, corporate income tax revenues grew rapidly in the 2004-2006 period, due to the extraordinary boom in domestic demand and in financial services. Other tax changes

[21] The period till 2003 was marked by fundamental changes in taxation, e.g. the gradual reduction of the social security contribution payable by the employers and the corporate income tax (CIT) rate, and by the reduction of the real estate tax in 2000.

which took place also pointed in the direction of an easing tax burden[22]. However, also in these cases the impact on revenues was counterbalanced by the favourable economic environment and by improved tax administration. Therefore, besides the discretionary measures, structural changes in the economy and improved tax collection explain why the relationship between the development of the main tax categories and their potential tax bases[23] was not very strong (Figure 6).

Figure 6: **Annual change in main revenue items and in respective potential tax bases**



Source: *Eurostat*

Some of the factors contributing to overheating were addressed by the government's Plan to Combat Inflation (anti-inflation plan) adopted in March 2007, e.g. by increasing taxation on real estate transactions and on purchases of very expensive cars. Although these measures can be deemed rather soft, they were well-targeted and have altered the expectations of market participants[24] and thereby contributed to a slow-down in domestic demand growth. However, to increase the efficiency of the anti-inflation plan, further measures could be taken: increasing taxes on housing capital gains and stamp duties on

[22] Concerning the personal income tax (PIT), the non-taxable minimum and the monthly allowance for dependents were increased. Plans to lower the PIT rate from 25% to 15% were scrapped in 2006. Excise tax rates were increased in the framework of EU accession. There were several smaller changes in the VAT rules (e.g. in 2004 the reduced VAT rate was lowered from 9% to 5%, the EU started to receive some tax revenues directly from Latvia, from 2007 the range of products with a reduced VAT was widened).

[23] The potential tax base (i.e. the proxy for the tax base) of indirect taxes is private consumption, of direct taxes it is the GDP and for social contributions it is wages and salaries (or D.11., for this last category for 2006 the estimate of the Commission Services Spring Forecast was used). The idea behind using the assumed potential tax base is to link the development of tax revenues with the development of the main economic variables.

[24] It is very difficult to delimit to what extent the measures of the anti-inflation plan, the signalling of government intentions regarding a need for a slow-down or autonomous business decisions have led to the moderation on the real estate and lending markets, - but certainly all these factors have played a role.

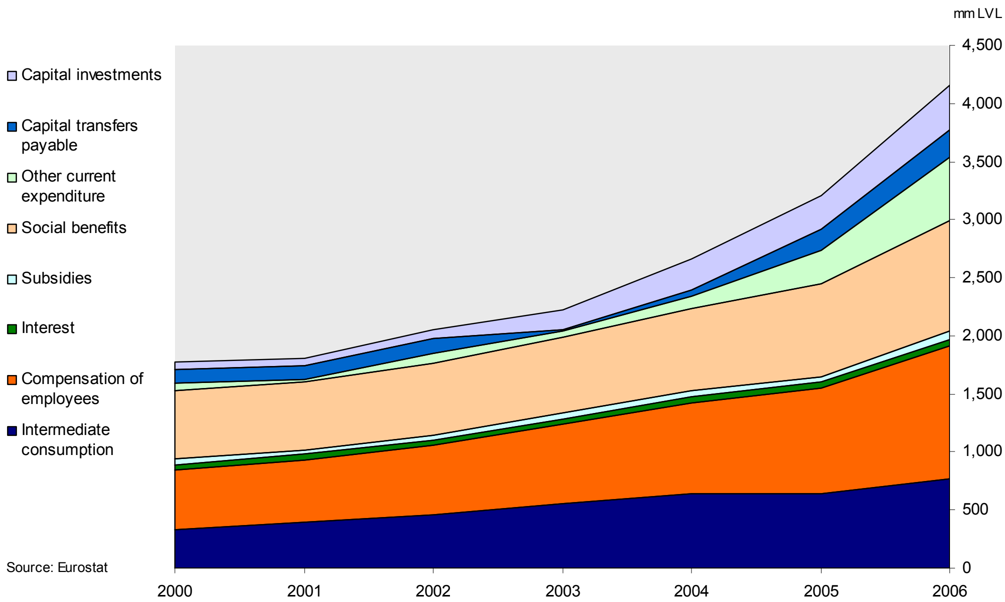
new mortgages and reducing tax wedge on labour, after evaluating the impact of these measures on inflation and the labour market. Furthermore, the two could go only in parallel, as reducing taxes in itself would add to the already too high domestic demand.

2.2.2. Expenditure side

Similarly to the developments observed with nominal GDP and general government revenues, public expenditures have also greatly increased (Figure 7). The total expenditures to GDP ratio increased from 34.8% of the GDP in 2003 to 37.2% in 2006. The biggest share in government expenditures in 2006 was made up by government consumption (45.6%) and social transfers other than in kind (21.5%); capital expenditure accounted for some 19.0%, while interest payments made up only about 1% of total government expenditure[25].

Public finances were also not immune to the negative consequences of overheating, as the real value of public expenditures was eroded by increasing wage and price inflation. In an overheating environment increases in public sector expenditure should be limited to an extent which allows for a sufficient improvement in the structural balance. By doing so, fiscal policy would preserve more flexibility for the time when domestic demand will eventually slow down and would instantly ease inflationary pressure in the economy[26]. There is also a difficult balancing act between having to provide public goods (transport and other infrastructure, R&D etc) and social transfers in a rapidly growing economy on the one hand and avoiding adding further to the demand pressures in an overheating economy. On balance, it would lower, , the risks associated with catching-up if expenditure growth were more conservative.

Figure 7: Development of the nominal expenditures of the general government



Therefore, prioritising public investment and holding back projects which have a lower contribution to a real catching-up is a prudent way of managing expenditure in the

[25] In 2003, the respective shares of the four categories were 61.7%, 27.2%, 8.1% and 2.0% of total expenditure.

[26] Automatic stabilisers are weak in Latvia given the small size of the public sector and the specific tax and expenditure structure.

situation of economic overheating and large external imbalances. This would help relieve pressures – or at the minimum not exacerbate them - in sectors and regions where overheating pressures are most rife. At the same time public expenditure should be concentrated towards those areas which can contribute to the strengthening of the supply side of the economy.

The behaviour of public sector wages is one of the drivers of wage growth in Latvia. Wage increases are motivated by the need to retain staff and strengthen administrative capacity. However, excessive wage increases have an unfavourable impact on cost inflation and the financing need of the public sector. Therefore, a challenge is to limit the growth of public employees' earnings under current conditions of overheating, most credibly in the context of overall wage restraint.

2.3. Concluding messages for fiscal policy

The assessment of the previous convergence programme update of Latvia identified both stabilisation and efficiency challenges for budgetary policy. In this context, stabilisation covered two areas: avoiding adding further to demand pressures in the economy and the need for an effective medium-term budgetary planning. In terms of stabilization, - given the limited scope monetary policy has under a quasi-fixed exchange rate regime and free capital movements - fiscal policy has a heightened role to play in Latvia. On the other hand, it would be unrealistic to expect fiscal policy to fully absorb the excess demand which has appeared in the economy over the past few years. Still, the background of high demand and risks to stability indicates that the fiscal policy has been short of that required and has to play a stronger role in tackling the emerging vulnerabilities.

The above analysis shows that fiscal policy might have to be substantially adjusted to prepare for upcoming years with lower economic growth. In a less favourable environment the ability to adhere to approved budget laws without amending them with additional expenditures will be essential. Budgetary expenditure might even have to be adjusted downwards, if revenue forecasts are not met.

Regarding medium-term budgetary planning, Latvia made progress in 2007 with the introduction of a medium-term budgetary framework which sets expenditure target ceilings for three years in breakdown by ministries and other central government institutions. This can serve as an instrument that would contribute to sticking to budgetary targets and thereby to implement a tighter fiscal policy. However, the effectiveness of this framework to contribute in anchoring fiscal policy will largely depend on the plausibility of the scenario on which the revenue forecasts were made and the commitment to expenditure restraints made.

Lastly, as the above sections show, the weakness of supply side of the economy will remain for some time to come and will require efforts on a broader scale than only fiscal policy measures. Still, by carefully prioritizing public expenditure and re-examining taxation instruments to avoid demand stimulus in sectors which do not significantly strengthen the economy's medium- and long-term supply potential, the production capacity for tradable goods could be strengthened significantly. Other instruments, e.g. restraint in difining public sector wages, would also contribute to preserving the external competitiveness of the economy.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

3.1. Economic activity

The growth assumptions of the November 2007 update of the convergence programme represent a relatively soft-landing of the Latvian economy[27] with real GDP growth gradually decreasing from 10.5% in 2007 to 6.8% by 2010 (Table 1). According to the programme, domestic demand will remain the main growth contributor, although it is expected to slow significantly from 2007 to 2008. Net exports contribute negatively to growth throughout the 2008-2010 period, however to a much lesser extent than in 2007.

The projected slowdown in real GDP growth implies weakening cyclical conditions, as measured by the output gaps recalculated by Commission services based on the information in the programme[28].

The programme's growth projections represent a marked slowdown from the overheated growth of the past few years presented in Section 2 above, though the real GDP growth projected for 2010 is still at the average level of the 1996-2005 period (see Annex 2). The contribution of domestic demand and net exports to growth in 2010 is foreseen to fall close to the average of the 1996-2005 period.

Table 1: Comparison of macroeconomic developments and forecasts

[27] The external outlook behind the programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecast. Significant differences exist in interest rate assumptions, with the programme's figures being higher for short-term rates and the autumn forecast figures being higher for long-term rates.

[28] However, as indicated in the previous section and in last year's assessment, potential growth – and hence output gap – estimates have to be interpreted with special caution in the case of Latvia and other catching-up countries.

	2007		2008		2009		2010
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	10.5	10.5	7.2	7.5	6.2	7.0	6.8
Private consumption (% change)	17.5	17.6	8.0	7.4	5.0	6.5	6.4
Gross fixed capital formation (% change)	14.0	13.9	6.0	8.8	7.0	7.9	7.5
Exports of goods and services (% change)	10.0	9.5	9.0	9.1	9.7	7.6	7.5
Imports of goods and services (% change)	18.6	22.1	7.8	8.9	6.8	7.5	7.4
Contributions to real GDP growth:							
- Final domestic demand	17.9	18.0	8.7	9.2	6.8	8.2	7.9
- Change in inventories	0.0	2.4	0.0	0.7	0.0	0.9	1.0
- Net exports	-7.5	-9.9	-1.5	-2.4	-0.5	-2.1	-2.1
Output gap[1]	2.7	2.8	0.8	1.3	-1.7	-0.3	-1.7
Employment (% change)	2.0	2.2	0.8	1.0	0.4	0.2	0.1
Unemployment rate (%)	5.8	5.6	5.5	5.2	5.6	5.3	5.3
Labour productivity (% change)	8.3	6.8	6.3	6.4	5.8	6.8	6.7
HICP inflation (%)	9.6	10.1	9.8	12.5	6.0	7.2	4.9
GDP deflator (% change)	15.7	12.3	10.5	11.7	6.5	8.1	6.0
Comp. of employees (per head, % change)	31.0	29.3	21.0	18.1	15.0	13.7	11.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-22.2	-23.5	-18.9	-20.3	-18.0	-18.3	-16.4

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)

For 2007, projected GDP growth is identical with the Commission services' autumn 2007 forecast, but from 2008 is somewhat higher in the programme than in the autumn forecast. This difference is much less material though than the large correction foreseen by both the programme and the autumn forecast from the growth rates of 2005-2007.

The update indicates lower private consumption growth for 2008 and higher for 2009 than does the Commission services' autumn 2007 forecast, reflecting the expectation of a more rapid but less deep adjustment in this expenditure component.

Gross fixed capital formation in 2008-2009 is foreseen higher in the update than in the autumn forecast, but even in the former the slowdown from 2007 is marked.

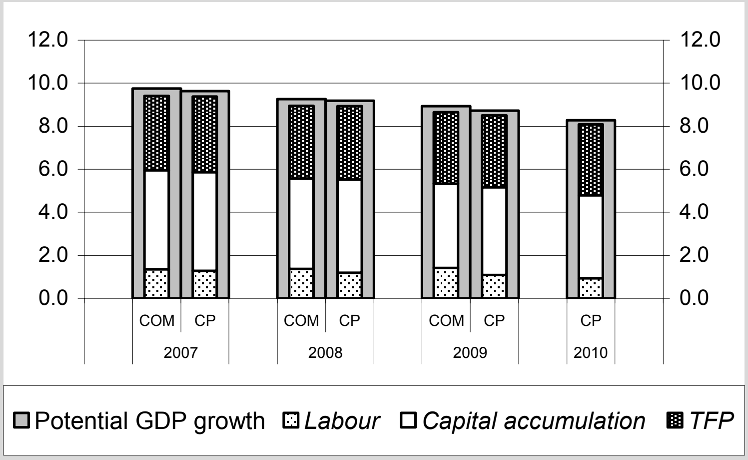
In line with the above, the updated convergence programme projects higher import growth for 2008-2009 than the autumn forecast. Furthermore, export growth is foreseen lower in 2009 by the programme leading to a more negative contribution by net exports to GDP growth and thus to an even less sustainable external position than the one depicted by the autumn forecast. The programme expects that the foreign borrowings of the banking sector will remain the main financing source of the external deficit.

The programme's macroeconomic assumptions are overall plausible, but this is attended by very high risks for macroeconomic stability (most notably through persistently high inflation and external imbalances). Nevertheless, the development of the country's external position in the longer run would clearly not be sustainable and therefore an adjustment in net external borrowing larger than depicted in the programme seems inevitable either within or outside the programme period.

Box 2: Potential growth and its determinants

Commission services' calculations applying the commonly agreed method on the programme's macroeconomic scenario indicate that potential GDP growth is expected throughout the programme period to remain well above the average actual growth of the 1996-2005 period. These potential growth figures are in line with the potential growth estimates derived from the Commission services' autumn 2007 forecast. The programme implies a somewhat lower contribution from labour and slightly higher contribution from capital than in the autumn forecast, but the two share the common view that capital accumulation and TFP would remain the main future contributors to potential growth[29].

Potential growth and its determinants



Applying the commonly agreed method for the macroeconomic scenario of the programme, the existing large positive output gap is seen to decrease from 2008 (Table 1). By 2009, output will fall below its potential and by 2010 the negative output gap will approach 2%. The projections of the Commission services' autumn forecast imply an even faster cyclical downturn in 2008-2009, with the difference between the two output gap estimates growing to 1½ percentage point by 2009[30]. It should, however, be repeated that output gap figures in general must be interpreted with special caution in the case of an economy such as Latvia's, as potential growth is difficult to determine for an economy subject to a rapid catching-up process. This is underscored by the fact that the output gap estimates have been quite unstable in view of new data and data revisions, even when applying the same methodology.

3.2. Labour market and cost and price developments

The projected labour market developments outlined in the programme are broadly in line with the trends of the past five years and also with the Commission services' autumn forecast. According to the programme, the share of the working-age population within the total Latvian population will continue to increase. However, the size of the working-age population will decrease due to continuing emigration following the country's EU entry and to ageing effects. The share of the economically active population is projected

[29] The usual caveat for the quality of the potential growth estimation - due to an ignorance of the GFCF-composition – holds.

[30] The difference stems both from lower potential growth estimates and higher actual growth projections in the programme than in the autumn forecast.

to increase slowly towards 70% during the programme period. According to the programme, employment grew in 2007 by 2.2% and is projected to increase further although at a more modest pace than in 2006-2007 (by 1% in 2008 by 0.2% in 2009 and by 0.1% in 2009). Consequently, the labour content of GDP growth is expected to be small relative to productivity growth, which is foreseen at well over 6% throughout the programme period. The unemployment rate is projected to bottom in 2008 and slightly increase in 2009, - just as in the scenario of the autumn forecast[31]. This development would be in line with the foreseen change in cyclical conditions.

In an environment of a tight labour market and significant price increases, the programme foresees continued high, albeit gradually slowing, nominal wage growth in the programme period. However, these projections are somewhat lower than those of the autumn forecast and appear to be rather optimistic - especially for 2007 and 2008 - in view of latest data and developments. Real wages as implied in the programme do not diverge further from productivity growth. However, this (i.e. wage growth falling in line with productivity growth) is far from being assured under current circumstances and it is still open how the economy will be able to cope with the negative consequences (i.e. reduced cost competitiveness) of the too rapid wage growth in 2006-2007[32].

The programme foresees inflation at 10.1% in 2007, 12.5% in 2008 and 7.2% in 2009, well above the figures of the autumn forecast, as the programme was able to take into account some more recent data and information[33]. Upward pressure on inflation is set to remain strong in 2008 from further increases in administered prices, excise duties and a fledging wage-price spiral impacting non-regulated service- and other prices. Volatile energy and other commodity prices represent a further risk factor. Overall, the programme's inflation projections seem plausible, but the risks are clearly skewed to the upside.

3.3. Macroeconomic challenges

Latvia’s real GDP increased at double-digit rates in 2005-2007. However, as detailed in Section 2 above, growth has primarily been driven by a powerful credit boom boosting private consumption and real estate investment, with the external imbalance surpassing 20% of GDP since 2006. Adding to the overheating from the demand side, labour shortages have contributed to the emergence of a wage-price spiral, with increasingly rapid wage growth outstripping productivity, leading to inflation having become the highest in the EU and deteriorating competitiveness. From mid-2007 some slowdown has become visible in the housing market and in domestic consumption, but insufficient to remove the downside risks to medium-term prospects. Monetary conditions have been accommodative in a context of a high degree of euroisation in the framework of a narrowly pegged exchange rate within ERM II[34].

The programme foresees the easing of strong domestic demand pressures and an end to a period of economic overheating with a significant correction in the growth rate of private

[31] The 0.4 percentage point difference between the 2008 unemployment rate figure of the programme (5.2%) and the autumn forecast (5.6%) is mainly due to the difference between the figures for 2007.

[32] Part of the statistically recorded wage growth can be explained by improving wage reporting.

[33] The m-o-m price increases over the last quarter of 2007 have caught most forecasters by surprise.

[34] See section 8 for a detailed assessment of progress in implementing the ERM II commitments

consumption and real wage growth falling to be in line with productivity growth in 2008. This is expected by the programme to be the consequence of the government's stabilisation efforts in the form of the anti-inflation plan and of private sector cyclical development restraining credit growth. However, in view of Commission services' autumn forecast, such favourable changes to the economic growth patterns of previous years remains a challenge[35] and it is also questionable whether wage growth will be brought in line with productivity growth to address the external competitiveness issue. Furthermore, lingering huge external imbalances remain part of the programme's macroeconomic scenario which would further increase the already very high external vulnerability of the Latvian economy. This would be reflected in the balance sheet positions of the household and corporate sectors which are already highly exposed to foreign currency, interest rate and refinancing risks[36]. Therefore, the macroeconomic scenario of the November 2007 update of the convergence programme is accompanied by very high risks which call for particular prudence in the setting of fiscal policy.

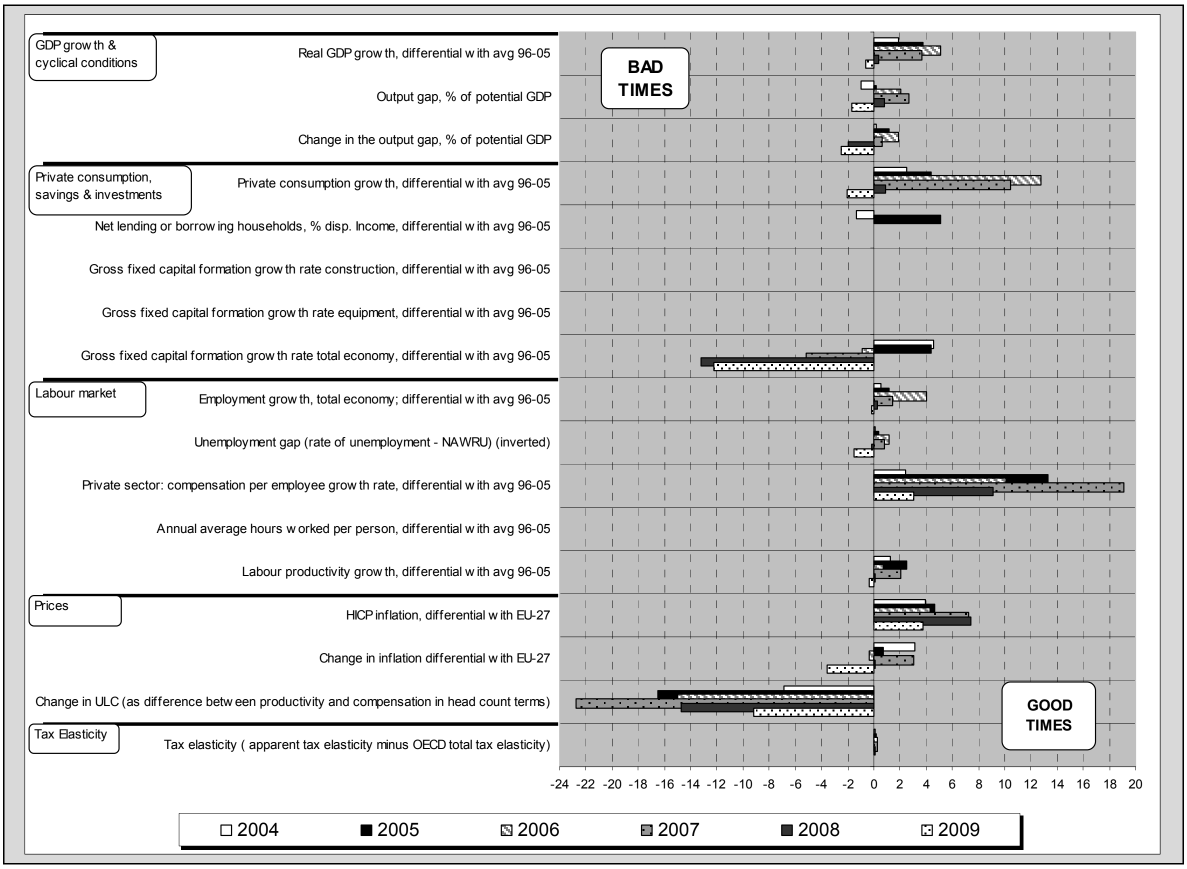
Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times which turn neutral by 2009 taking into account tax elasticities. Although the current positive output gap is expected to become negative by 2009, other conditions, such as several labour market measures and tax elasticities are foreseen by the autumn forecast to remain favourable. However, the risks to sustainability highlighted in this assessment imply that good or even neutral conditions during the whole programme period are far from assured.

Good versus bad times

[35] The programme notes that the government is working on the development of an 'Economic Stabilisation Plan'.

[36] Even if the external imbalance were reduced and the debt ratio stabilised, external debt service costs would be quite heavy with lower growth.



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[37]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than

[37] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

Table 2: Budgetary implementation in 2007

		2006		2007	
		Planned CP Jan 2007	**Outcome** CP Nov 2007	**Planned** CP Jan 2007	**Outcome** CP Nov 2007
Revenue (% of GDP)		37.5	37.0	38.2	37.3
Expenditure (% of GDP)		37.9	37.2	39.5	37.0
Government balance (% of GDP)		-0.4	-0.3	-1.3	0.3
Nominal GDP growth (%)				17.1	24.2
Nominal revenue growth (%)				19.3	25.2
Nominal expenditure growth (%)				22.0	23.5
Revenue surprise compared to target (% of GDP)				**-0.9**	
Of which [1] *:*	1. Base effect			-0.5	
	2. GDP growth effect on the denominator			-1.8	
	3. Revenue growth effect			1.5	
	Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1 [2]			*-0.3*	
Expenditure surprise compared to target (% of GDP)				**-2.5**	
Of which [1] *:*	1. Base effect			-0.7	
	2. GDP growth effect on the denominator			-1.8	
	3. Expenditure growth effect			0.4	
Government balance surprise compared to target (% of GDP)				**1.6**	
Of which:	1. Base effect			0.2	
	2. GDP growth effect on the denominator			0.0	
	3. Revenue / expenditure growth effect			1.1	

Notes:

[1] A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
Commission services

For 2007, the previous programme initially targeted a budget deficit of 1.3% of GDP. In March 2007, as part of the anti-inflation plan, the government decided to aim for a balanced budget. In September the parliament approved a new target for 2007: a surplus of 0.4% of GDP. The autumn forecast projected a budget surplus of 0.9% of GDP for 2007, which is very close to the provisional result of a 0.8% of GDP fiscal surplus for the consolidated national budget which can be used as a proxy for the general government balance, assuming a balanced budget of the local government sub-sector. In sectoral terms, the provisional outcome combines a sizable surplus (roughly 2.7% of GDP) on the social security balance, offset by a large deficit of the central government sector (around 1.9% of GDP). Subsequently to this provisional result, it appeared that the local government sub-sector had a financial deficit of LVL 33 million in 2007, which is estimated to translate into a deficit of 0.4% of GDP under ESA. Thus the 2007 nominal fiscal outcome is about 1½ percentage points better than initially planned. According to the programme, the structural balance, recalculated by Commission services' on the basis of the information in the programme according to the commonly agreed methodology, too is estimated to have improved slightly from a deficit of 1% of GDP in 2006 to a ½% deficit in 2007. It must be noted, however, that the evaluation of the fiscal stance is constrained by measurement problems, which result in a presumably significant positive bias in the current economic situation, i.e. the structural balance and its improvement is overestimated.

The difference between the autumn forecast figure and the previous programme's target reflects higher tax revenues in all major tax categories – particularly direct taxes – over and above what was budgeted in 2006 for 2007, on the basis of significantly higher-than-expected economic growth[38], which, however, were partly offset by higher-than budgeted expenditure growth, mostly on grants for local governments to develop regional infrastructure, social allowances and public sector wages. Furthermore, there has been some progress in limiting the previously usual surge in end-of-year spending by public institutions, as a result of guidelines that the government adopted in November on public procurement procedures and on financing of programmes and sub-programmes in December[39].

The Council opinion on the 2006 update of the convergence programme invited Latvia to reduce the risks of macroeconomic instability by implementing vigorously measures to achieve a significantly better budgetary target for 2007 than foreseen in the programme, as part of a broader reform strategy. Also it was recommended that measures to enhance consolidation beyond the MTO be implemented as soon as possible. After a slight deficit in 2006, the budgetary outcome in 2007 is expected to be better than foreseen in the 2006 programme update by about 1½ percentage points. While this represents good progress, the background of high demand and risks to stability indicate that the stance of fiscal policy still remained short of that required.

4.2. The programme’s medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme’s budgetary strategy

Table 3: Evolution of budgetary targets in successive programmes

[38] Particularly higher growth in components of domestic demand.

[39] In December 2006 expenditures of public institutions accounted for 18.6% of total yearly expenditures and were almost three times bigger than average monthly spending in the January-October period.

		2006	2007	2008	2009	2010
General government balance (% of GDP)	**CP Nov 2007**	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**
	CP Jan 2007	*-0.4*	*-1.3*	*-0.9*	*-0.4*	*n.a.*
	COM Nov 2007	-0.3	0.9	0.8	0.5	n.a.
General government expenditure (% of GDP)	**CP Nov 2007**	**37.2**	**37.0**	**36.8**	**36.7**	**36.7**
	CP Jan 2007	*37.9*	*39.5*	*39.5*	*39.4*	*n.a.*
	COM Nov 2007	37.2	37.2	37.6	37.0	n.a.
General government revenue (% of GDP)	**CP Nov 2007**	**37.0**	**37.3**	**37.4**	**37.7**	**37.9**
	CP Jan 2007	*37.5*	*38.2*	*38.6*	*39.0*	*n.a.*
	COM Nov 2007	37.0	38.1	38.4	37.5	n.a.
Structural balance[1] (% of GDP)	**CP Nov 2007**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**
	CP Jan 2007	*-0.9*	*-1.7*	*-0.8*	*0.2*	*n.a.*
	COM Nov 2007	-0.8	0.2	0.5	1.0	n.a.
Real GDP (% change)	**CP Nov 2007**	**11.9**	**10.5**	**7.5**	**7.0**	**6.8**
	CP Jan 2007	*11.5*	*9.0*	*7.5*	*7.5*	*n.a.*
	COM Nov 2007	11.9	10.5	7.2	6.2	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. There are no one-off and other temporary measures according to the latest update of the programme or the Commission services' autumn forecast.

Source:
Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

The main goal of the budgetary strategy is to foster macroeconomic stability by continuing to respect the medium-term objective (MTO), which is a structural deficit of 1% of GDP and has been achieved since 2006, by a growing margin over the programme period. In particular, according to Commission services' calculations on the basis of information in the programme, the structural balance is projected to improve from a deficit of ½% of GDP in 2007 to a surplus of ½% of GDP in 2008 and by ½ percentage point per year in 2009-2010 on the back of relatively strong economic growth, increasing tax revenues and further consolidation of public finances. For 2008, however, the planned impact of the Lattelecom privatization is a factor of uncertainty (Section 4.3), as corporate income tax revenues (LVL 47.8 mln) and dividend receipts (LVL 36.9 mln) are budgeted in relation to this event as deficit improving items in 2008 totalling 0.5% of GDP. The fiscal stance based on the recalculation by the Commission services is restrictive over the whole programme period. Compared to the previous programme, which planned to achieve the MTO only from 2008 onwards, the new update broadly confirms the envisaged consolidation path but from a much better starting position against a broadly unchanged macroeconomic scenario. However, considering that the commonly agreed methodology tends to overestimate the potential growth rates for an economy such as Latvia's with high real estate investment, the surplus of the structural balance, appropriate for the current situation, should be significantly larger.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**37.0**	**37.3**	**37.4**	**37.7**	**37.9**	**0.6**
of which:						
- Taxes on production and imports	12.7	12.8	13.0	13.1	13.1	**0.3**
- Current taxes on income, wealth, etc.	8.4	8.9	8.7	8.9	8.9	**0.0**
- Social contributions	8.9	9.0	8.4	8.4	8.5	**-0.5**
- Other (residual)	7.0	6.6	7.3	7.3	7.4	**0.8**
Expenditure	**37.2**	**37.0**	**36.8**	**36.7**	**36.7**	**-0.3**
of which:						
- Primary expenditure	36.7	36.6	36.5	36.4	36.4	**-0.2**
of which:						
Compensation of employees	10.1	9.7	9.2	8.9	8.8	**-0.9**
Intermediate consumption	6.4	5.8	5.3	5.1	4.9	**-0.9**
Social payments	8.5	8.7	9.0	9.1	9.2	**0.5**
Subsidies	0.6	0.5	0.5	0.4	0.4	**-0.1**
Gross fixed capital formation	4.3	4.8	5.4	5.6	6.0	**1.2**
Other (residual)	6.8	7.1	7.1	7.3	7.3	**0.2**
- Interest expenditure	0.5	0.4	0.3	0.3	0.3	**-0.1**
General government balance (GGB)	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**	**0.9**
Primary balance	**0.2**	**0.7**	**1.0**	**1.2**	**1.5**	**0.8**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**	**0.9**
Output gap[1]	2.0	2.8	1.3	-0.3	-1.7	**-4.5**
Cyclically-adjusted balance[1]	-0.9	-0.5	0.4	1.1	1.7	**2.2**
Structural balance[2]	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**	**2.2**
Change in structural balance		*0.4*	*0.8*	*0.7*	*0.6*	
Structural primary balance[2]	-0.4	-0.1	0.7	1.4	2.0	**2.1**
Change in structural primary balance		*0.3*	*0.7*	*0.7*	*0.6*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:
Convergence programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The general government surplus is expected to increase from 0.3% of GDP in 2007 to 1.2% of GDP in 2010 on the back of relatively strong economic growth, increasing tax revenues and further consolidation of public finances. Two-thirds of the rise in the nominal surplus by almost 1 percentage point of GDP over the programme period owes to an increase in the revenue-to-GDP ratio and the remaining third from a cut in the expenditure-to-GDP ratio. According to the programme, the revenue-to-GDP ratio is expected to increase from 37.3% of GDP in 2007 to 37.9% of GDP in 2010, while the expenditure-to-GDP ratio is planned to decrease slightly from 37.0% in 2007 to 36.7% of GDP in 2010. On the revenue side, the rise in indirect taxes (excise duties) and "other revenues" as a share of GDP (the latter not explained in the programme, but probably reflecting expectations about increasing EU inflows) would more than offset the projected decline in social contributions. Restraint in expenditure on public consumption and compensation of employees relative to GDP (which is not assured by measures described in the programme) is assumed to provide budgetary room for increases in social payments and public investment.

According to the programme, the surplus of the social security fund is to deteriorate from an estimated 2.3% of GDP surplus in 2007 to 1.8% of GDP surplus in 2009, mainly due to an increase in the share of social contribution accruing to the funded pension scheme and to the introduction of the parent benefit. However, the surplus of the fund is foreseen to gradually improve to 2% of GDP by 2010. As in earlier years, social security fund surpluses are foreseen to cover deficits in the central government budget. Local governments are projected to present a slight deficit in the 2008-2010 period due to the recognition of the Riga Southern Bridge project as a transaction with an above-the-line impact.

The programme foresees significant investment plans to increase the long-term growth potential. Accordingly, public investment is expected to rise by 1.2% percentage points relative to GDP over the programme period. However, the expenditure savings, i.e. compensation of employees and intermediate consumption that should reduce the overall expenditure ratio are not detailed in the programme. The programme does not specify any one-off or other temporary measures.

Box 4: The budget for 2008

On 8 November the Latvian parliament adopted the 2008 state budget (consolidated central government and social security budget), projecting a surplus of 1.0% of GDP. This is more ambitious than the "balanced budget" announced in the March 2007 anti-inflation plan for 2008 and an improvement of about 2% of GDP for 2008 and 1.5% of the GDP for 2009 over the targets of the January 2007 convergence programme update. The figures of the medium-term budgetary framework were also approved envisaging a budget surplus of 1.2% of GDP in 2009 and 1.5% in 2010.

Although it seems rather likely that planned nominal revenue increase in 2008 will be achieved on the back of relatively strong GDP growth and higher than projected inflation, pressure will be high on the government to increase public expenditures due to very high inflation. The previous government has made efforts to restrict public sector wage growth by allowing an increase in the wage bill only of those institutions, including local government, where the average wage per employee is below the average wage of the public sector.

Progress has been made by introduction of a medium-term budgetary framework, which sets expenditure target ceilings for three years broken down by ministries and other central government institutions. The concept of a long-term stabilisation reserve has been introduced.

Some of the main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Increase in the personal income tax-free threshold from LVL 50 (EUR 70) per month to LVL 80 (EUR 115) per month and the setting of income tax rebates for dependents at LVL 56 (EUR 80) per month (LVL 107 mln or -0.6% of GDP);	o Reform of the national armed forces and NATO integration related requirements (LVL 110.7 mln or 0.6% of GDP) o Co-financing for EU and other financial instruments (LVL 435 mln or +2.4% of GDP);
o Increase of the statutory minimum	o Indexation of the pensions (LVL

wage from LVL 120 (EUR 168) per month to LVL 160 (EUR 230) per month (LVL 70.7 mln or +0.37% of GDP); o Increase in excise duties on oil and tobacco products (LVL 56.6 mln or +0.3% of GDP).	160.2 mln or +0.9% of GDP); o Increase of salaries for public sector employees (LVL 112 mln or +0.6% of GDP); o Finalisation of the administrative territorial reform (LVL 56 mln or +0.3% of GDP).

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

Table 5: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM[1]	CP	CP
Revenue	**37.0**	**38.1**	**37.3**	**38.4**	**37.4**	**37.5**	**37.7**	**37.9**
of which:								
- Taxes on production and imports	12.7	12.7	12.8	12.6	13.0	12.2	13.1	13.1
- Current taxes on income, wealth, etc.	8.4	9.1	8.9	9.0	8.7	9.1	8.9	8.9
- Social contributions	8.9	9.4	9.0	9.4	8.4	9.4	8.4	8.5
- Other (residual)	6.9	6.9	6.6	7.4	7.3	6.8	7.3	7.4
Expenditure	**37.2**	**37.2**	**37.0**	**37.6**	**36.8**	**37.0**	**36.7**	**36.7**
of which:								
- Primary expenditure	36.8	36.8	36.6	37.2	36.5	36.6	36.4	36.4
of which:								
Compensation of employees	10.1	10.7	9.7	10.7	9.2	10.7	8.9	8.8
Intermediate consumption	6.4	6.1	5.8	5.9	5.3	5.5	5.1	4.9
Social payments	8.5	8.0	8.7	8.2	9.0	8.3	9.1	9.2
Subsidies	0.6	0.6	0.5	0.6	0.5	0.5	0.4	0.4
Gross fixed capital formation	4.3	5.0	4.8	5.5	5.4	5.8	5.6	6.0
Other (residual)	6.8	6.4	7.1	6.4	7.1	5.8	7.3	7.3
- Interest expenditure	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3
General government balance (GGB)	**-0.3**	**0.9**	**0.3**	**0.8**	**0.7**	**0.5**	**1.0**	**1.2**
Primary balance	**0.2**	**1.3**	**0.7**	**1.2**	**1.0**	**0.9**	**1.2**	**1.5**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.3**	**0.9**	**0.3**	**0.8**	**0.7**	**0.5**	**1.0**	**1.2**
Output gap[2]	2.1	2.7	2.8	0.8	1.3	-1.7	-0.3	-1.7
Cyclically-adjusted balance[2]	-0.8	0.2	-0.5	0.5	0.4	1.0	1.1	1.7
Structural balance[3]	**-0.8**	**0.2**	**-0.5**	**0.5**	**0.4**	**1.0**	**1.1**	**1.7**
Change in structural balance		*1.0*	*0.4*	*0.4*	*0.8*	*0.5*	*0.7*	*0.6*
Structural primary balance[3]	-0.4	0.6	-0.1	1.0	0.7	1.3	1.4	2.0
Change in structural primary balance		*1.0*	*0.3*	*0.4*	*0.7*	*0.4*	*0.7*	*0.6*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

As assessed in Section 2 and 3 above, even if the macroeconomic outlook is deemed to be plausible, there are significant risks for overall macroeconomic stability stemming from the extremely wide external imbalance and the current overheated state of the economy. Were the credit-financed, domestically-driven rapid growth of the Latvian economy to slow down abruptly, the budget could come under great pressure, as current expectations of future budgetary revenues are based on the assumption of continuing high consumption and labour market conditions favourable to high tax revenue. Furthermore, in the current inflationary environment, pressure is likely to remain high on the government to increase expenditures.

The update includes a section on the sensitivity of the public finances with respect to changes in economic activity compared to the central scenario. However, this analysis does not capture the impact of the possible realization of risks mentioned in the above sections (i.e. an abrupt decline in domestic consumption and investment). Under the programme's pessimistic scenario, GDP growth is assumed to be one percentage point lower in 2008 than under the central scenario, resulting in lower revenues by about 0.2% of GDP.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 2.0 percentage point deviation from the real GDP growth projections in the programme over the 2008-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), indicate that, by 2010, the cyclically-adjusted balance is 1.4 percentage point of GDP below the central scenario. Hence, in the case of a persistently slightly lower real growth, additional measures of around 1.4 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario. However, potentially even this simulation falls short of addressing the real level of risks.

With the exception of the measures concerning the social security fund budget, the expenditure-side measures - and their budgetary impact - are not very detailed in the programme, especially beyond 2008. The projected reductions in the ratios to GDP of expenditure on compensation of employees (from 10.1% in 2006 to 8.8% by 2010) and intermediate consumption (from 6.4% in 2006 to 4.9% in 2010) appears implausible - or at least very difficult to implement - in an environment of high inflation and tight labour market such as in the programme's macroeconomic scenario. Public sector trade unions pressed strongly – and successfully - for larger wage increases before the approval of the 2008 budget.

No one-offs or other temporary measures are planned in the programme. However, corporate income tax revenues (LVL 47.8 mln) and dividend receipts (LVL 36.9 mln) are budgeted in relation to the planned Lattelecom privatization as deficit improving items in 2008 totalling 0.5% of GDP, a transaction that clearly has a non-recurrent nature. However, this budget receipt represents a significant risk for the achievement of the fiscal target of 2008. First, it is very difficult to see how a privatization can have such a significant impact on the fiscal balance: the sale of financial assets has to be recorded as a financial transaction, and therefore should have no impact on general government net lending/net borrowing[40]. Secondly, the privatization might take place differently as envisaged at the time of drawing up the budget or not even take place in 2008 (as it did not take place in 2007 despite earlier plans). Moreover, even though the bulk of the privatization receipts is planned to be accumulated in the stabilisation reserve fund, it is a risk that this money will incite further expenditure.

The programme provides sufficient information about the planned personal income-, value-added and excise tax changes, with their expected budgetary impact thoroughly analyzed. Table 6 shows that, according to the programme, the tax-to-GDP ratio falls in 2008 and increases slightly in 2009-2010. Compared with the Commission services' autumn forecast, the tax revenue projections embody somewhat less optimistic assumptions about the development of tax intensity of economic activity in 2008, and more optimistic assumptions for 2009. For 2008 the difference can be traced back mainly to a difference in the expectations about the social contributions to GDP ratio. In 2009 the difference between the changes in the tax to GDP ratio is mainly due to the

[40] The details of the transaction are not fully known and may also involve transaction(s) by the private sector. According to ESA rules privatization proceeds (both direct and indirect privatization) have no impact on net lending / net borrowing of the general government. ESA also excludes from the deficit taxes paid by government owned companies in relation to privatization.

discretionary and elasticity component, but the programme does not contain information which would explain the reasons for this more positive view.

Table 6: Assessment of tax projections

	2008			2009			2010
	CP	**COM**	**OECD**[3]	**CP**	**COM**[1]	**OECD**[3]	**CP**
Change in tax-to-GDP ratio (total taxes)	-0.7	-0.3	-0.6	0.3	-0.3	-0.4	0.1
Difference (CP – COM)	-0.4		/	0.6		/	/
of which [2] *:*							
- discretionary and elasticity component	*-0.2*		*/*	*1.0*		*/*	*/*
- composition component	*-0.3*		*/*	*-0.2*		*/*	*/*
Difference (COM - OECD)	/	0.3		/	0.1		/
of which [2] *:*							
- discretionary and elasticity component	*/*	*-0.7*		*/*	*-0.4*		*/*
- composition component	*/*	*1.4*		*/*	*0.7*		*/*
p.m.: Elasticity to GDP	0.9	0.9	0.9	1.1	0.9	0.9	1.0

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

Source:
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

As discussed in Section 2, Latvia has introduced the use of medium-term expenditure ceilings for ministries and public institutions as of 2007 by setting nominal ceilings for the 2008-2010 period. Accordingly, it is difficult to assess the actual enforcement of these ceilings. Furthermore, in the current situation accurate forecasting is a challenge and the GDP growth scenario on which the budget expenditure ceiling figures for the 2008-2010 period are based seems somewhat optimistic[41]. However, if actual GDP growth were more favourable or inflation higher than in this scenario[42], then the framework could have a positive impact, especially in reinforcing currently weak automatic stabilisers. Further information on the working of the medium-term budgetary framework can be found in Section 6.

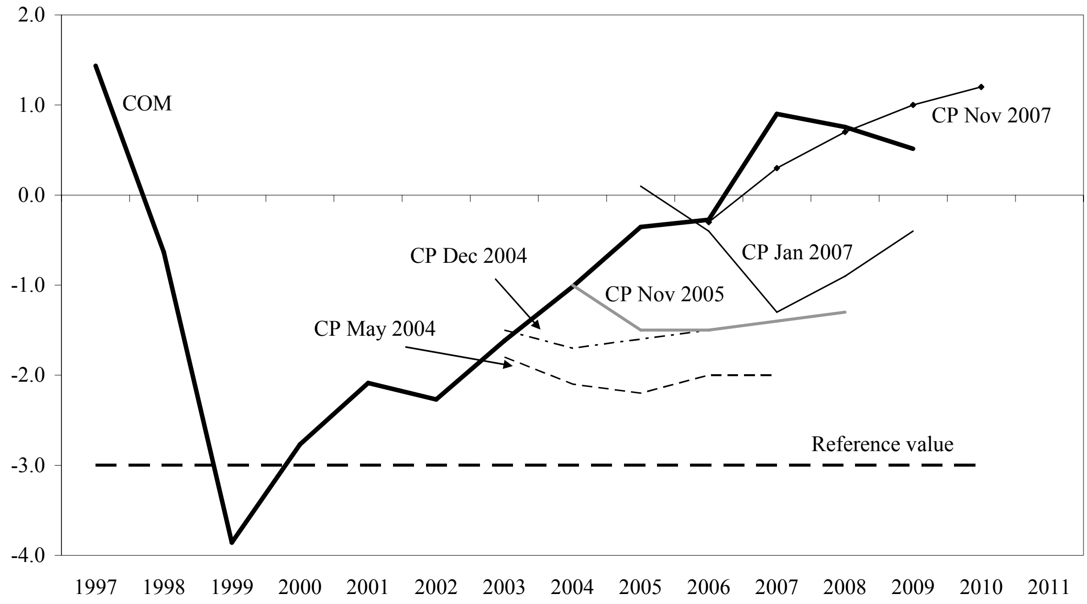
As can be seen from Figure 8, the Latvian government has until now always respected and even exceeded its budgetary targets. However, the capacity for expenditure restraint has not been seriously tested in recent years, as high nominal growth has created the opportunity each year to spend extra revenues in the framework of a supplementary budget. Going forward, it would have serious effects on public finances if the identified risks to macro-economic stability materialized. Under such circumstances, it might become necessary to draw up supplementary budget initiatives in order to ensure the

[41] The growth assumptions of this scenario were somewhat higher than those presented in the latest update of the programme. Higher inflation will however most likely compensate lower real growth figures.

[42] This is clearly the case with regards inflation, as the 2008-2010 ceilings were based on annual average inflation of 6.3% in 2008, 4.2% in 2009 and 3.2% in 2010.

achievement of planned fiscal targets or at least to stick to set expenditure targets in an inflationary environment.

Figure 8: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

Without ignoring the experience of the previous years, when deficit outturns were regularly better than expected due to higher than expected GDP growth, the imbalanced nature of economic growth represents a major risk, as a possible abrupt slowdown of the Latvian economy would have serious repercussions on household income and expenditure, the major source of tax revenues. The risk of a deviation from the programme's macroeconomic scenario to the negative side is much more likely and severe than of one to the positive side. The tax intensity of economic activity might fall sharply under a potential abrupt-slowdown scenario. Furthermore, in the current high inflation environment, reliance on expenditure restraint will be crucial and difficult. For 2008, the planned impact of the Lattelecom privatization is an additional factor of uncertainty inasmuch as privatization, while not scoring as increasing revenue on an ESA basis, might incite further expenditure.

The overall balance of risks to the achievement of budgetary targets is negative, hence budgetary outcomes could be worse than projected.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 7: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	in line	in line

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 2% of GDP for Latvia). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.
Source: Commission services

In view of the risk assessment, the budgetary stance in the programme seems sufficient, - excluding the possible case of a severe growth downturn -, to maintain the MTO throughout the programme period as envisaged in the programme. The structural balance is improving and therefore pro-cyclical fiscal policy is avoided in good economic times. Therefore, the fiscal policy stance implied by the programme is in line with the Stability and Growth Pact throughout the period. Nevertheless, the fiscal stance should be tightened given the size of the economic imbalances and commitments made under ERM II entry (see Section 8). As highlighted before, public finance has a heightened responsibility in Latvia due to the limited scope of monetary policy under a quasi-fixed exchange rate regime. Considering that the commonly agreed methodology tends to overestimate the potential growth rates for an economy such as Latvia's with high real estate investment[43], the structural surplus[44] appropriate for the current situation should be significantly larger. This rationale calls for a much stronger fiscal effort in 2008 than the one envisaged by the programme, especially in light of the better-than-estimated 2007 outturn.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

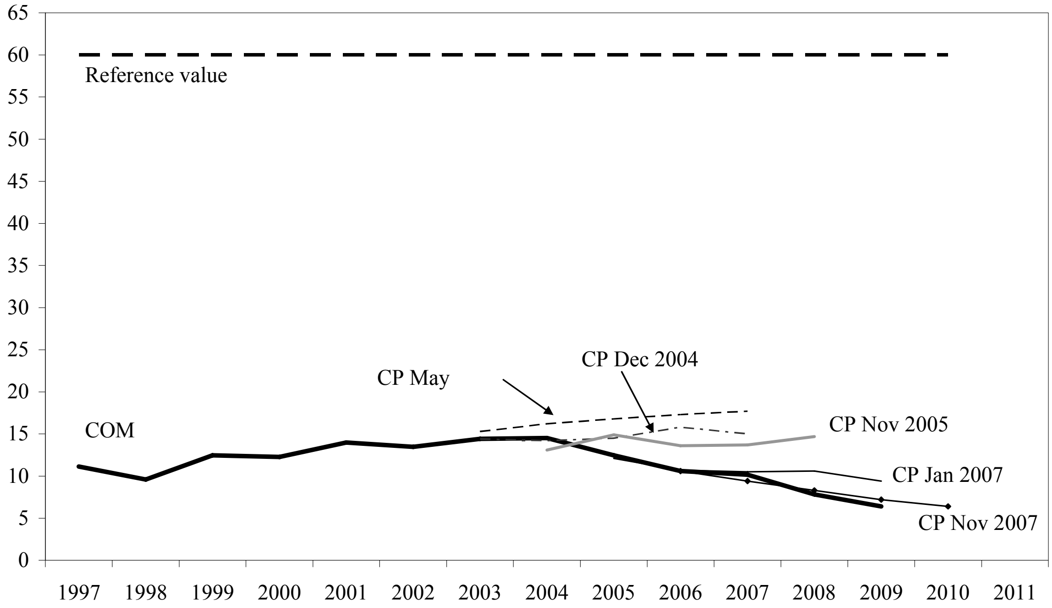
As can be seen from Figure 9 and Table 8, the gross debt ratio is low and well under the Treaty reference level. The gross debt ratio is set at 9.4% of GDP for 2007, according to the programme, and 10.2% of GDP, according to the autumn forecast. The main reason for the difference between the 2007-estimates of the programme and the autumn forecast

[43] See Section 2-3.

[44] Applying the output gap figures derived with the commonly agreed methodology.

is the postponement of a major Eurobond previously planned to be issued in 2007. The programme projects for 2008-2010 the debt ratio to fall further to 6.4% of GDP in 2010.

Figure 9: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

Table 8: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**13.7**	**10.6**	**10.2**	**9.4**	**7.8**	**8.3**	**6.4**	**7.2**	**6.4**
Change in the ratio	-0.4	-1.9	-0.4	-1.2	-2.3	-1.1	-1.4	-1.1	-0.8
Contributions[2]*:*									
Primary balance	**0.6**	**-0.2**	**-1.3**	**-0.7**	**-1.2**	**-1.0**	**-0.9**	**-1.2**	**-1.5**
"Snow-ball" effect	**-1.1**	**-1.8**	**-1.7**	**-1.6**	**-1.1**	**-1.2**	**-0.5**	**-0.9**	**-0.5**
Of which:									
Interest expenditure	0.7	0.5	0.4	0.4	0.4	0.3	0.3	0.2	0.3
Growth effect	-1.0	-1.2	-0.9	-0.9	-0.6	-0.6	-0.4	-0.5	-0.4
Inflation effect	-0.7	-1.1	-1.3	-1.1	-0.9	-0.9	-0.5	-0.6	-0.4
Stock-flow adjustment	**0.1**	**0.3**	**2.8**	**1.2**	**0.0**	**1.2**	**0.0**	**1.0**	**1.2**
Of which:									
Cash/accruals diff.	0.0	-0.4		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	-0.3	0.7	2.8	n.a.		n.a.		n.a.	n.a.
Privatisation	*-0.3*	*-0.7*		*n.a.*		*n.a.*		*n.a.*	*n.a.*
Val. effect & residual	0.4	0.0		n.a.		n.a.		n.a.	n.a.

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

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

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 (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The main reason for the difference between the 2008 gross debt-to-GDP figures of the programme and the autumn forecast is the postponement of a major Eurobond previously planned to be issued in 2007 to 2008. The timing, amount and maturity of the bond will depend on the central government budget execution figures, domestic and international financial market developments, central government debt portfolio indicators and other factors.

The debt projections in the programme are subject to the same risks as those set out above in Section 4.3 for the net lending position[45]. Nevertheless, given its relatively low level, public debt is not a major concern for Latvia.

5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and

[45] Furthermore, financial receipts from the planned Lattelecom privatization are to be put into the stabilization reserve fund and as such have no direct impact on the gross debt figures.

make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 9 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology[46]. Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 9: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**Change up to 50**
Total age-related spending	17.5	14.6	14.6	16.0	16.2	16.2	-1.3
- Pensions	6.8	4.9	4.9	5.6	5.9	5.6	-1.2
- Healthcare	5.1	5.5	5.8	5.9	6.1	6.2	1.1
- Long-term care	0.4	0.4	0.5	0.5	0.6	0.7	0.3
- Education	4.9	3.5	3.2	3.7	3.3	3.5	-1.4
- Unemployment benefits	0.3	0.2	0.2	0.2	0.2	0.2	-0.1
Property income received	0.7	0.6	0.6	0.6	0.6	0.6	-0.1

Source: Economic Policy Committee and Commission services.

The projected dynamics in age-related spending in Latvia is below the EU average, falling by 1.3% of GDP between 2004 and 2050. This is mainly due to the projected decline in pension expenditure falling by a similar amount as a share of GDP over the projection period, due to the large pension reform enacted, in particular the introduction of the fully-funded pension scheme. The increase in healthcare expenditure is projected to be 1.1 p.p. of GDP, slightly below the EU average. For long-term care spending, the projected increase of 0.3 p.p. of GDP up to 2050 is below the EU average.

Table 10: Sustainability indicators and the required primary balance

	2007 scenario			**Programme scenario**		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	0.2	1.5	1.8	-2.0	-0.7	1.8
of which:						
Initial budgetary position (IBP)	0.2	0.3	-	-1.9	-1.9	-
Debt requirement in 2050 (DR)	-0.9	-	-	-1.0	-	-
Long-term change in the primary balance (LTC)	0.9	1.2	-	0.9	1.2	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 1½p.p. of GDP.[47] The sustainability gap is slightly higher

46 See the accompanying "methodological paper" for a description of the property income projections.

47 The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 0.2% of GDP.

than in last year's assessment by about ¼p.p. of GDP, essentially due to a lower starting level of age-related expenditure according to the Ageing report.[48]

The initial budgetary position is slightly positive and therefore, in view of the low debt level, almost sufficient to stabilize the debt ratio over the long-term. According to both sustainability gaps, the long-term budgetary impact of ageing is limited.

The programme plans a structural primary budgetary consolidation of around 2p.p. of GDP between 2007 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by eliminating the S2 sustainability gap ("programme scenario"). The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the convergence programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is around 1.8% of GDP, close to the structural primary balance at the end of the programme period.

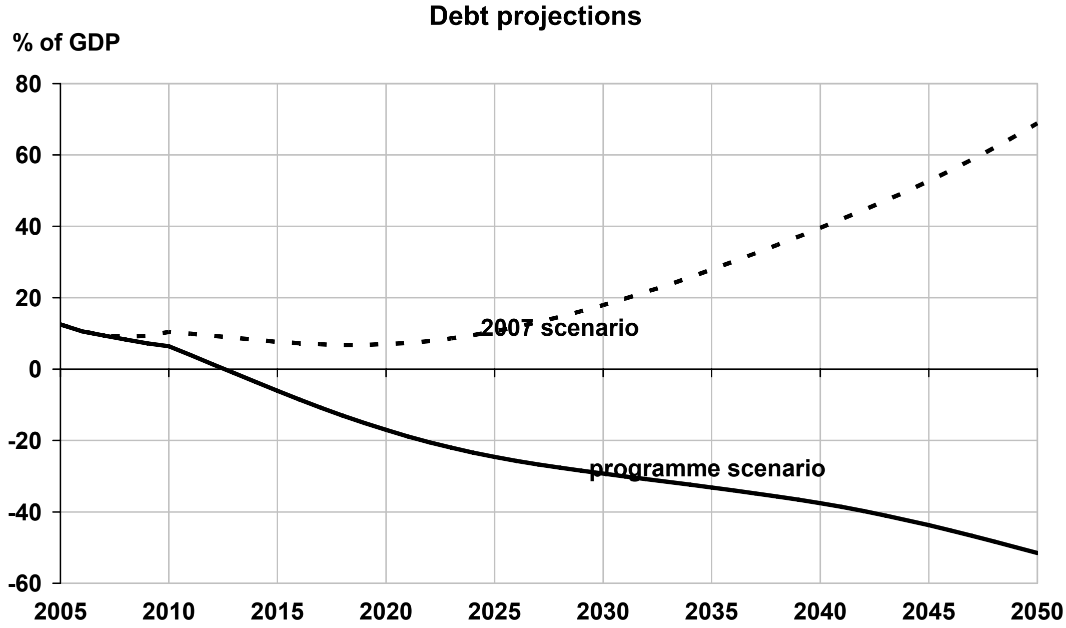
The sustainability gap indicators would increase by up to 0.1p.p. of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 10[49]. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at 9.4% of GDP in 2007. In both the "2007 scenario" and the "programme scenario", the debt ratio is projected to remain below the 60% threshold over most of the projection period.

48 Indeed, the calculations of the sustainability are made assuming that age-related expenditure increase as a share of GDP after the end of the programme period (which is 2010 this year and was 2009 last year) and age-related expenditure is decreasing significantly over the medium-term in Latvia according to the Ageing report.

49 It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 10: Long-term projections for the government debt ratio



<u>Source</u>: *Commission services*

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, as mentioned above, Latvia has a very low stock of debt, just below 10% of GDP in 2007, and this is planned to decline further in accordance with the implementation of the budgetary strategy as presented in the convergence programme update.

Second, the programme point to somewhat different long-term projections than those of the Ageing report, but the increase in age-related expenditure between the end of the programme period and 2050 is very close (+1.5p.p. of GDP instead of 1.6p.p. of GDP). Those new projections would therefore not change the overall assessment.

Finally, a recent improvement in the level of pension[50] should increase pension expenditure by around 0.15p.p. of GDP in 2009 and 2010. The programme does not however provide information as regards the cost of this measure over the longer term.

5.2.3. Assessment

Latvia appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing 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 budgetary position as planned in the convergence programme update would contribute to limiting the risks to the long-term sustainability of public finances.

[50] More exactly the monthly bonus to the old-age pension for each year of insurance record accumulated up to 31 December 2005 will be raised as of 1 June 2008 (from 19 santims to 40 santims).

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

According to the programme, structural reforms are ongoing in the sectors of healthcare, pensions, research and education, territorial reform, and an ambitious public investment programme is being implemented. The pension reform is expected to have the most notable impact on the government budget balance in the medium-term, as up to 2010 the share of the state social security contributions transmitted into the state funded pension scheme will gradually grow (from 2% in 2006 to 10% in 2010). In compliance with the "Law on State Funded Pensions", from 1 January 2008 the rate of contribution to the state funded pension scheme will be at least 8% (4% in 2007) of the contribution object stipulated in the law "On State Social Insurance". It is expected that in 2008 the contributions to the state funded pension scheme will increase to 1.5% of the GDP in comparison with 0.8% in 2007 (1.6% of GDP in 2009, 1.8% of GDP in 2010). The programme states that this drop in social security budget revenue will be partly offset by pension expenditure growing at a slower rate due to rising of the retirement age, pension indexation formula and a lower share of population within the pre-retirement cohorts.

Healthcare reform will also exert a notable impact on the medium-term budget position. The programme foresees spending in the healthcare sector to increase from roughly 4% of GDP in 2004 to 5½% of GDP in 2009. The objective of the reform is to ensure further development of an integrated healthcare system by optimising the number and assignment of service providers, thereby raising the quality of the delivered healthcare services, cost-efficiency and effective availability to patients. It is planned to complete the reform in 2010, when 11 regional and 22 local hospitals are scheduled to be operational in Latvia. Each of the regional hospitals would provide services to at least 100 000 inhabitants, whereas each local hospital to at least 25 000 patients. According to the programme, 2008 central government budget stipulates an increase of 0.3% of GDP for spending on healthcare promotion.

The central government budget also includes expenditure required to implement the regional reform. In compliance with the provisions of the Law on Administrative and Territorial Reform, an administrative and territorial reform of the local governments will be implemented by the 2009 elections of the local governments, with a view to establishing administrative territories capable of economic development and more effective fund raising. On 4 September 2007, the government approved a new administrative and territorial division, providing for the creation of nine major cities and 96 territories. According to the programme, the 2007 budget includes funding of 0.2% of GDP earmarked for implementation of the territorial reform, and in 2008 0.3% of GDP.

The programme reports a planned increase in government spending on gross fixed capital formation by 1.2% of GDP by 2010 in comparison with 2007, to 6.0% of GDP. Measures to promote knowledge and innovations are based on the Law on Scientific Activity providing for an annual increase of central government spending on scientific activity by 0.15% of GDP.

As regards institutional features of the public finances, the quality of the budgetary process has been improved by establishing a medium-term budgeting. Starting from 2007, a three-year macroeconomic development and fiscal policy framework is to be prepared containing a medium-term macroeconomic outlook, government fiscal policy objectives, central government budget revenue forecasts, maximum total central government expenditure threshold, and maximum spending limits for each ministry and other central government institutions. Setting up of the long-term stabilisation reserve fund, where all central government revenue exceeding the provisions of the annual state budget and privatisation receipts is to be transmitted, is also a step in the right direction.

According to the programme, growth of central government budget expenditure and spending on wages is to decrease, as the Cabinet of Ministers has decided that in 2008-2010 funding will only be provided to those direct government administration institutions where the average wage of employees is lower than the average wage of public sector employees as a whole. Similarly, local governments have committed themselves to limiting wage growth for those categories of employees whose income exceeds the average wage in public sector and not to increase their wage bill by more than 10% in comparison with 2007. This is a step in the right direction and might prevent excessive public sector wage growth in 2008 (as happened in 2007). It remains to be seen whether this will be complemented with a promised reform of the current untransparent remuneration system of public servants, where a large part of earnings comes as additional-work-contract payments, and an elimination of standing public sector vacancies – most of them artificial and used as a device to increase the wages of existing workers.

Overall, with slowing economic growth and continuously increasing wages and inflation, the government will have to seek ways to negotiate with the public sector trade unions wage growth limits in 2008 and onwards, even if this means postponing or altering earlier commitments. A low or moderate wage growth in public sector could reduce stimulus for further private sector wage growth, thus facilitating a return of economy-wide wage growth to sustainable rates.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

Structural and public finance measures mentioned in the convergence programme are generally in line with the 2005 NRP and its October 2007 implementation report. The implementation report of the NRP 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 convergence programme contains a qualitative assessment of the overall impact of the National Reform Programme within the medium-term fiscal strategy. However, the convergence programme does not provide systematic information on the direct budgetary costs/savings associated with the main reforms envisaged in the NRP. The two programmes seem to be consistent.

Box 5: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Latvia's national reform programme[51] and is summarised as follows.

Latvia's national reform programme identifies as key challenges/priorities: securing macro-economic stability; stimulating knowledge and innovation; developing a favourable and attractive

[51] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

environment for investment and work; fostering employment; and improving education and skills.

The Commission's assessment is that Latvia has made some progress in implementing its National Reform Programme over the 2005-2007 period. The Programme presents a clear strategy and covers all policy areas, but a more integrated approach based on improved synergies between the different areas is necessary.

Against the background of strengths and weaknesses identified, the Commission recommends that Latvia takes action in the areas of: budgetary and fiscal policy; research and innovation policy; labour supply and growth of productivity.

Against the background of progress made, the Commission encourages Latvia to focus on the areas of better regulatory environment and childcare access.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendation, adopted by the Council in March 2007. The budgetary strategy in the stability programme is partly consistent with the country-specific recommendation.

Table 11: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].	X			
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.		X		
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.	X			
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X			
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".				
Source: *Commission services*				

Table 12: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendation				
Maintain economic and budgetary sustainability by pursuing a more restrictive fiscal policy, so as to contribute to the prevention of overheating and a careful prioritisation of expenditure		X		
Source: *Commission services*				

8. PROGRESS IN IMPLEMENTING THE ERM II COMMITMENTS

On 2 May 2005 Latvia joined ERM II, thus linking its currency to the euro. In order to ensure a smooth participation in ERM II, upon entry it undertook commitments covering a broad range of areas, such as fiscal policy, financial supervision/credit growth and structural reforms (see box). The convergence programme update does not contain a specific discussion of the follow-up of these ERM II commitments.

Box 6: ERM II commitments of Latvia

The agreement on participation of the Latvian lats in ERM II is based on a firm commitment by the Latvian authorities to achieve a sustainable reduction in inflation. The authorities recognise that strengthening the fiscal stance will be instrumental to this end, while it would also contribute to an orderly and substantial reduction of the current account deficit. The authorities will closely monitor macroeconomic developments together with the responsible EU bodies. To help reduce the external imbalance and contain it at a sustainable level, the authorities will take measures to restrain domestic demand and they will remain vigilant concerning risks of excessive domestic credit growth. Continued effective financial supervision will assist the authorities in promoting prudent credit policies and in limiting credit risk in the banking system. The authorities will also promote wage developments that are supportive to reducing inflationary pressures. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and safeguard the overall competitiveness of the economy.

- **Fiscal policy**

A main emphasis of the ERM II communiqué was on strengthening the fiscal stance. The government budget balance has gradually improved, leading to a general government surplus in 2007. The more favourable outturn mainly stemmed from higher-than-expected revenues due to stronger economic activity and improved tax collection. The structural balance too is estimated to have improved from a deficit of 1% of GDP in 2006 to a ½% deficit in 2007. General government debt decreased to below 10% of GDP by the end of 2007.

Box 7: Plan to combat inflation

On 6 March 2007, within the framework of a comprehensive **plan to combat inflation,** the government set more ambitious fiscal objectives than those in the January 2007 update of the convergence programme. Medium-term fiscal targets were set to be more ambitious, including the adoption of the objective of balanced budgets for 2007 and 2008 and surpluses in the following two years. In addition, the government committed itself not to spend additional revenue in the form of supplementary budgets.

Furthermore, the anti-inflation plan introduced several measures to slow domestic demand. These aim, inter alia, at increasing control over lending, curbing the speculative aspect of the real estate market, and reducing the purchases of luxury cars. The first set of measures, expected to produce results in the short-run, have been effective from 1st July 2007 (some already since mid-April).

- **Measures to contain credit growth and strengthening financial supervision**

Since ERM II entry the Bank of Latvia has raised the **reserve requirements** for MFIs in two steps between July and November 2005, from 4% to 8%, compared with 2% in the euro area. In addition, the Bank of Latvia **expanded the compulsory reserve base**. As of 24 January 2005, banks' liabilities to foreign commercial and central banks have been included in the compulsory reserve base to equalize the conditions for their ability to compete given the variety of their sources for attracting resources. As of 24 May 2006 the reserve base was again broadened – without raising the reserve ratio further – by extending the compulsory reserve requirement to also cover bank liabilities with a set term over two years. This measure was taken in order to help slow down the rapid increase in lending as one of the factors contributing to high inflation.[52] More specific measures to **limit credit growth** were proposed in the context of the government plan to reduce inflation and have been partly implemented. This relates in particular to requirements for checking loan applications against statements of legal income for natural persons and for minimum down payments. As a result, there has been some slowing in the growth of annual borrowing – from around 60% year-on-year at the beginning of 2007 to 34.2% y-o-y in December. This notwithstanding, the credit-to-GDP ratio continued to increase in the course. In addition, several fiscal measures were proposed to dampen the growth of **real estate** prices and mortgages. These include the introduction of a personal income tax on real estate sales and higher fees for registration ownership of real estate and registration of mortgages starting with the third property.

In the area of **supervision**, some efforts have been undertaken to enhance cross-border supervision, which is important given the high degree of foreign control of the Latvian financial sector. In 2006, the central banks of Estonia, Latvia, Lithuania and Sweden signed a memorandum of understanding on cross-border arrangements for financial supervision and crisis management. At the beginning of 2007, the Financial and Capital Market Commission signed two multilateral agreements on joint decisions concerning two banking groups with headquarters located in Sweden regarding permission to use the IRB approach for capital requirement calculation. The close cooperation includes jointly organised on-site inspections with involvement of the Swedish, Estonian and Lithuanian supervisory authorities.

- **Wage developments**

Wage growth has picked up markedly since ERM II entry, to more than 30% annually in 2007. The behaviour of wages is explained by tightening labour market conditions reflecting high demand pressures and the fact that Latvia's EU accession has resulted in significant outward migration. According to official statistics, the average wage level in the public sector is higher than in the private sector, although this is largely explained by higher skills and better wage reporting in the public sector (see Section 6). Nevertheless,

[52] The bulk of bank lending takes place in foreign currency (mainly euro). Around ¾ of the outstanding stock of credit is denominated in foreign currency.

in the first three quarters of 2007, wage growth was faster in the public- than in the private sector.

The level of **labour productivity** remains one of the lowest in the EU at an estimated 51% of the EU average in 2006 (but up from 44% in 2004). To try to ease labour market constraints, Latvia opened its labour market to the new Member States entering the EU in 2007, but it is unlikely that this will have a significant impact.

- **Structural reforms and other measures**

Latvia's NRP identified macroeconomic stability, knowledge and innovation, the development of favourable environment for investment and work, fostering employment and improving education and skills as key priorities. Among the strengths of the programme are measures to facilitate the start-up and financing of innovative SMEs and to support labour market performance. However, progress in securing macroeconomic stability and preventing overheating has been limited and the R&D strategy and measures to increase labour supply and workforce skills have been weak. Overall, Latvia's efforts to reinforce its business environment have been lacklustre: in 2007, Latvia ranked 24th in the IBRD Doing Business Index and 41st in the Heritage Foundation Index of Economic Freedom. On the positive side, Latvia is implementing pension and healthcare reform.

Conclusion: Excess domestic demand and waning competitiveness increase the risk of a hard landing of the economy. Contrary to the commitments undertaken on ERM II entry, the authorities have insufficiently strengthened the fiscal stance or undertaken other measures to restrain domestic demand, including by curbing credit growth. The anti-inflation plan goes in the right direction but falls short of the measures needed to stabilise the economy. Further structural measures should strengthen the supply side of the economy. An **Economic Stabilization Plan**, containing in its draft form further fiscal measures, as well as steps to improve business environment and competitiveness, is expected to be adopted by the government shortly. The draft plan stipulates further fiscal consolidation to achieve at least balanced budgets in medium term, changes in tax policy to support manufacturing, reduced corporate tax rate for reinvested earnings, elimination of public sector job positions that have been maintained artificially, reduction of "red-tape" for entrepreneurs, improvement of competition, implementation of export guarantee system, state support for entering new export markets, development of new technology transfer centres, as well as several other activities.

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The update closely adheres to the code of conduct as far as its table of contents is concerned. However, the programme does not provide specific information on the fulfillment of the commitments undertaken by Latvia upon its entry into the ERM II system.

(ii) Data requirements

As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps. In particular, the data on capital taxes ((Table 2 Line 12c), the subcomponents of the stock-flow adjustment (Table 4, breakdown for line 5, line 6, line 7) and some elements of the long-term sustainability of public finances table (Table 7) are missing.

The tables on the following pages show the data presented in the November 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The CP…	**Yes**	**No**	**Comments**
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.		X	Mentions the parliament's involvement in formation of budget, but not with regard to the CP
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	The Council opinion was presented to the Budget and Financial Affairs committee as well as the European Affairs committee of the Latvian Parliament.
b. Economic outlook			
… uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.		X	
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.		X	
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.	X		
… explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation.	X		

The CP…	Yes	No	Comments
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		More so in case of revenue side measures
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			n/a
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			n/a
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		The sensitivity analysis is not fully sufficient to address the risks faced by the Latvian economy.
… analyses how changes in assumptions would affect budget and potential growth.		X	
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.		X	
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.
Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	*7881.3*	11.9	10.5	7.5	7.0	6.8
2. Nominal GDP	B1*g	*11264.7*	24.3	24.2	20.0	15.6	13.3
Components of real GDP							
3. Private consumption expenditure	P.3	*5417.2*	19.8	17.6	7.4	6.5	6.4
4. Government consumption expenditure	P.3	*1153.2*	4.0	5.0	3.0	2.5	2.5
5. Gross fixed capital formation	P.51	*2950.1*	18.3	13.9	8.8	7.9	7.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*11.7*	3.5	0.8	-0.8	-1.2	-1.1
7. Exports of goods and services	P.6	*3268*	5.3	9.5	9.1	7.6	7.5
8. Imports of goods and services	P.7	*4918.9*	17.5	22.1	8.9	7.5	7.4
Contributions to real GDP growth							
9. Final domestic demand		-	19,9	18.0	9.2	8.2	7.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.2	2.4	0.7	0.9	1.0
11. External balance of goods and services	B.11	-	-8.1	-9.9	-2.4	-2.1	-2.1

Table 1b. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		-	11.1	12.3	11.7	8.1	6.0
2. Private consumption deflator		-	8.5	10.7	12.0	7.2	4.9
3. HICP[1]		-	6.6	10.1	12.5	7.2	4.9
4. Public consumption deflator		-	15.8	25.3	14.0	8.5	5.0
5. Investment deflator		-	18.0	16.4	9.0	8.0	6.0
6. Export price deflator (goods and services)		-	9.2	12.4	10.0	7.0	5.0
7. Import price deflator (goods and services)		-	9.5	7.0	6.5	4.5	2.8

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*1087.6*	5.0	2.2	1.0	0.2	0.1
2. Employment, hours worked[2]		*1909.4*	0.0	0.2	0.2	0.2	0.2
3. Unemployment rate (%)[3]		-	6.9	5.6	5.2	5.3	5.3
4. Labour productivity, persons[4]		-	6.2	6.8	6.4	6.8	6.7
5. Labour productivity, hours worked[5]		-	11.9	10.3	6.2	6.8	6.6
6. Compensation of employees	D.1	*4845*	27.7	36.3	19.2	13.9	12.1
7. Compensation per employee, lats		*302*	23.0	29.3	18.1	13.7	11.9

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-21.1	-23.5	-20.3	-18.3	-16.4
of which : - Balance on goods and services		-22.1	-24.0	-21.7	-20.0	-18.5
- Balance of primary incomes and transfers		-0.2	-0.8	0.1	0.4	0.7
- Capital account		1.2	1.3	1.3	1.3	1.4
2. Net lending/borrowing of the private sector	B.9	-21.4	-23.8	-21.0	-19.3	-18.6
3. Net lending/borrowing of general government	EDP B.9	-0.3	0.3	0.7	1.0	1.2
4. Statistical discrepancy		0.6	0.2	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-30.9*	-0.3	0.3	0.7	1.0	1.2
2. Central government	S.1311	*-224.4*	-2.0	-1.9	-0.5	-0.7	-0.6
3. State government	S.1312						
4. Local government	S.1313	*-36.4*	-0.3	0.0	-0.3	-0.1	-0.2
5. Social security funds	S.1314	*229.9*	2.0	2.3	1.5	1.8	2.0
General government (S13)							
6. Total revenue	TR	*4162.9*	37.0	37.3	37.4	37.7	37.9
7. Total expenditure	TE[1]	*4193.8*	37.2	37.0	36.8	36.7	36.7
8. Net lending/borrowing	EDP B.9	*-30.9*	-0.3	0.3	0.7	1.0	1.2
9. Interest expenditure	EDP D.41	*52.2*	0.5	0.4	0.3	0.3	0.3
10. Primary balance[2]		*21.4*	0.2	0.7	1.0	1.2	1.5
11. One-off and other temporary measures[3]		*0*	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*2377.7*	21.1	21.7	21.8	22.0	22.0
12a. Taxes on production and imports	D.2	*1430.1*	12.7	12.8	13.0	13.1	13.1
12b. Current taxes on income, wealth, etc	D.5	*947.7*	8.4	8.9	8.7	8.9	8.9
12c. Capital taxes	D.91						
13. Social contributions	D.61	*1005.7*	8.9	9.0	8.4	8.4	8.5
14. Property income	D.4	*64.2*	0.6	0.7	0.9	0.7	0.7
15. Other[4]		*715.4*	6.4	5.9	6.3	6.5	6.7
16=6. Total revenue	TR	*4162.9*	37.0	37.3	37.4	37.7	37.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			30.4	31.1	30.6	30.8	30.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*1861.1*	16.5	15.5	14.5	14.0	13.7
17a. Compensation of employees	D.1	*1142.5*	10.1	9.7	9.2	8.9	8.8
17b. Intermediate consumption	P.2	*718.6*	6.4	5.8	5.3	5.1	4.9
18. Social payments (18=18a+18b)		*954.2*	8.5	8.7	9.0	9.1	9.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*52.8*	0.5	0.5	0.4	0.3	0.3
18b. Social transfers other than in kind	D.62	*901.4*	8.0	8.2	8.6	8.8	8.9
19=9. Interest expenditure	EDP D.41	*52.2*	0.5	0.4	0.3	0.3	0.3
20. Subsidies	D.3	*72.2*	0.6	0.5	0.5	0.4	0.4
21. Gross fixed capital formation	P.51	*484.5*	4.3	4.8	5.4	5.6	6.0
22. Other[6]		*769.5*	6.8	7.1	7.1	7.3	7.3
23=7. Total expenditure	TE[1]	*4193.8*	37.2	37.0	36.8	36.7	36.7
p.m.: Government consumption (nominal)	P.3	*1910.4*	17.0				

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	5.1	4.9
2. Defence	2	1.3	1.3
3. Public order and safety	3	2.1	2.1
4. Economic affairs	4	4.9	5.1
5. Environmental protection	5	0.8	0.8
6. Housing and community amenities	6	0.7	0.7
7. Health	7	3.9	4.2
8. Recreation, culture and religion	8	1.2	1.3
9. Education	9	6.2	6.5
10. Social protection	10	9.9	10.0
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	36.1	36.7

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		10.6	9.4	8.3	7.2	6.4
2. Change in gross debt ratio		-1.9	-1.2	-1.1	-1.1	-0.8
Contributions to changes in gross debt						
3. Primary balance[2]		0.2	0.7	1.0	1.2	1.5
4. Interest expenditure[3]	EDP D.41	0.5	0.4	0.3	0.3	0.3
5. Stock-flow adjustment		-2.2	-0.9	-0.4	-0.1	0.4
of which:						
- Differences between cash and accruals[4]		-0.4				
- Net accumulation of financial assets[5]		-0.6				
of which:						
- privatisation proceeds		0.1				
- Valuation effects and other[6]		0.0				
p.m.: Implicit interest rate on debt[7]		4.6	4.4	4.2	3.8	4.1
Other relevant variables						
6. Liquid financial assets[8]		2.9				
7. Net financial debt (7=1-6)		7.6				

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)		11.9	10.5	7.5	7.0	6.8
2. Net lending of general government	EDP B.9	-0.3	0.3	0.7	1.0	1.2
3. Interest expenditure	EDP D.41	0.5	0.4	0.3	0.3	0.3
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		10.0	9.9	9.1	8.3	8.0
contributions:						
- labour		1.6	1.8	1.0	0.6	0.5
- capital		4.4	4.3	4.5	4.2	4.0
- total factor productivity		3.7	3.5	3.4	3.3	3.4
6. Output gap		1.5	2.1	0.7	-0.5	-1.5
7. Cyclical budgetary component		0.4	0.6	0.2	-0.1	-0.4
8. Cyclically-adjusted balance (2 - 7)		-0.7	-0.3	0.5	1.1	1.6
9. Cyclically-adjusted primary balance (8 + 3)		-0.2	0.1	0.8	1.4	1.9
10. Structural balance (8 - 4)		-0.7	-0.3	0.5	1.1	1.6

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010
Real GDP growth (%)						
Previous update		11.5	9.0	7.5	7.5	-
Current update		11.9	10.5	7.5	7.0	6.8
Difference		0.4	1.5	0.0	-0.5	-
General government net lending (% of GDP)	EDP B.9					
Previous update		-0.4	-1.3	-0.9	-0.4	-
Current update		-0.3	0.3	0.7	1.0	1.2
Difference		0.1	1.6	1.6	1.4	-
General government gross debt (% of GDP)						
Previous update		10.7	10.5	10.6	9.4	-
Current update		10.6	9.4	8.3	7.2	6.4
Difference		-0.1	-1.1	-2.3	-2.2	-

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure		36.2	39.0	38.9	40.3	40.5
Of which: age-related expenditures		17.2	13.8	13.8	15.1	15.3
Pension expenditure		6.8	4.9	4.9	5.6	5.6
Social security pension		6.8	4.9	4.9	5.6	5.6
Old-age and early pensions		5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)		1.1	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)						
Health care		5.1	5.3	5.4	5.5	5.9
Long-term care *(this was earlier included in the health care)*		0.4	0.4	0.4	0.4	0.5
Education expenditure		4.6	3.3	3.1	3.5	3.3
Other age-related expenditures		0.3	0.3	0.2	0.2	0.2
Interest expenditure						
Total revenue		35.3	39.0	38.6	38.4	38.5
Of which: property income						
Of which : from pensions contributions (or social contributions if appropriate)		7.1	6.1	5.6	5.4	5.4
Pension reserve fund assets						
Of which : consolidated public pension fund assets (assets other than government liabilities)						
Assumptions						
Labour productivity growth		6.4	6.5	4.0	2.7	1.1
Real GDP growth		7.5	7.4	2.9	2.1	0.4
Participation rate males (aged 20-64)		83.4	87.6	89.6	89.5	87.6
Participation rates females (aged 20-64)		71.9	76.2	79.0	79.8	76.6
Total participation rates (aged 20-64)		77.4	81.7	84.1	84.5	82.0
Unemployment rate		9.8	7.6	7.0	7.0	7.0
Population aged 65+ over total population		16.2	17.4	18.4	21.3	26.1

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	4.4	8.7	10.0	8.5	7.0
Long-term interest rate (annual average)	4.1	5.3	5.3	5.1	5.0
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.26	1.36	1.42	1.42	1.42
Nominal effective exchange rate	0.0	-0.3	-0.3	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-	-	-	-	-
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4
Growth of relevant foreign markets	9.5	7.3	6.8	6.6	6.6
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key indicators that summarise the past economic performance of Latvia. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

	Latvia						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	6.8	5.4	8.2	10.6	11.9	10.5	3.8	3.6	4.1	4.8	6.3	6.0
Contributions to real GDP growth:												
Domestic demand	*8.8*	*6.6*	*11.0*	*10.8*	*20.0*	*17.9*	*4.4*	*4.6*	*4.1*	*4.1*	*7.3*	*7.8*
Net exports	*-2.0*	*-1.2*	*-2.8*	*-0.2*	*-8.1*	*-7.5*	*-0.5*	*-1.0*	*-0.1*	*0.8*	*-0.9*	*-1.8*
Real GDP per capita (PPS; EU27 = 100)	40	35	45	52	57	62	47	45	49	52	54	56
Real GDP per capita (% change)	7.6	6.4	8.9	11.2	12.5	11.0	4.1	3.8	4.4	4.9	6.4	6.1
Prices, costs and labour market												
HICP inflation (%)	4.2	4.3	4.1	6.9	6.6	9.6	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	6.2	6.0	6.4	8.7	7.0	8.3	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	-0.8	-1.1	-0.4	4.6	2.7	4.6	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	0.6	-0.5	1.7	1.7	4.6	2.0	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	13.3	15.6	11.0	8.9	6.8	5.8	11.3	9.7	12.9	11.9	9.9	7.8
Competitiveness and external position												
Real effective exchange rate (% change)	2.9	6.2	-0.5	7.7	12.1	17.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change)[1]	1.5	-0.7	3.7	10.5	-5.2	1.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-7.7	-6.5	-8.8	-11.2	-19.9	-22.2	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
Public finances												
General government balance (% of GDP)	-1.4	-1.3	-1.5	-0.4	-0.3	0.9	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	12.8	11.9	13.8	12.5	10.6	10.2	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP)[2]	n.a.	n.a.	-0.8	-0.4	-0.8	0.2	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
Financial indicators												
Short-term real interest rate (%)[3]	0.5	1.9	-0.6	-6.5	-6.0	-6.9	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%)[3]	0.2	n.a.	0.2	-5.7	-6.3	-9.0	n.a.	n.a.	n.a.	n.a.	1.6	1.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source:
Commission services