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# LATVIA: MACRO FISCAL ASSESSMENT

## AN ANALYSIS OF THE JANUARY 2009 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not.

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 18 February 2009. Comments should be sent to Balazs Forgo (balazs.forgo@ec.europa.eu) and Gatis Eglitis (gatis.eglitis@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' January 2009 interim 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 18 February 2009. The ECOFIN Council is expected to adopt its opinion on the programme on 10 March 2009.

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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**

## 1. INTRODUCTION

This document assesses the January 2009 update of Latvia's convergence programme. It takes into account all currently available information, notably the Commission services' January 2009 Interim Forecast and the Latvian authorities' Economic Stabilisation and Growth Revival Programme[1], adopted in December 2008. The programme, which was submitted on 14 January 2009, to reflect the budgetary amendments passed by the parliament on 12 December, covers the period 2008-2011. The Latvian Cabinet approved the convergence programme on 13 January 2009, 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.

## 2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

Following a sustained period of high growth since the end-1990s, largely based on domestic demand, Latvia's real GDP increased at double-digit rates in 2005-2007, well over potential. Growth was primarily driven by a powerful credit expansion boosting private consumption and real estate investment, but this ended by mid-2007, as overvalued real estate prices could no longer be sustained. During these years, the high domestic demand created serious overheating pressures and the structure of the economy shifted from the tradeable sector to the non-tradeables, undermining the external sustainability of the economy. The global financial crisis amplified the shock of the reversal of Latvia's own lending and house price boom by tightening credit availability and conditions. The concomitant downturn on the export markets has hit the tradables sector, already weakened by huge domestic cost increases over the previous years. Latvia's financial markets and banking sector came under significant pressure from October 2008 onwards, sparked by difficulties at the largest locally-owned bank (Parex).

Against this background, the economy entered into recession in 2008, with another two years of deep recession expected by the Commission services’ January 2009 forecast. Estimates of the output gap[2] indicate that the adjustment will be large, with the gap moving from strongly positive in 2007 (+13% of potential output) to +7% in 2008 and turning negative in 2009 and 2010 (-2% and -5%, respectively). The downturn led to rapidly deteriorating labour market conditions and to falling tax revenues over the last months of 2008. Accordingly, the Latvian economy is assessed to have entered economic 'bad times' in late 2008 and to remain in bad times over the forecast horizon.

The confrontation by an abrupt and severe banking sector and external financing crisis prompted the Latvian authorities to seek international financial assistance at the end of 2008[3]. Outline agreement in December on multilateral financial assistance of EUR 7.5bn is conditional on major fiscal consolidation, relative to the 14 November budget, as well as financial system and structural reforms.

Access to large foreign financial assistance is expected to stabilize the Latvian financial system and permit orderly unwinding of the still large current account deficit. However, domestic prices, in particular private (and public) sector wages, will have to adjust to restore

[1] http://www.mk.gov.lv/en/aktuali/zinas/2008/12/12122008-01/

[2] 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 rapid structural change.

[3] The EUR 7.5bn financing package is jointly funded by the EU, IMF, World Bank, EBRD, Nordic countries, Czech Republic, Estonia and Poland and is provided to Latvia in several instalments up to Q1 2011, in a front-loaded manner.

the cost competitiveness of the economy, which is needed to put Latvia on a stronger footing for a sustainable export-led recovery. This will be a challenging task in an environment of coincident growth downturns in main trading partners (Lithuania, Estonia, Russia) and the nominal depreciation of the currencies of some key trading partners (Russia, Ukraine, Sweden, UK) and competitor countries (Russia, Ukraine, Poland etc.). Government policies should facilitate the strengthening of the supply side of the economy and the shift of economic resources to the tradable sector by wide-ranging structural reforms making efficient use of EU funding.

Reflecting the rapid economic downturn, budget revenues sharply deteriorated in 2008. VAT receipts fell dramatically during the last months of the year, indicating that tax elasticities are turning very unfavourable in this recession. Revenues from other major tax categories held out better on the back of high inflation, but this effect also faded over the second half of 2008, as inflation started to drop. Despite its low public debt ratio, Latvia does not appear to have any available 'fiscal space'[4], given the adjustment need stemming from the country's high imbalances.

On 12 December, the Parliament adopted amendments to the 2009 budget, aiming for fiscal consolidation relative to the envisaged unchanged policy outcome in 2009[5] by cutting public sector average wages and employment and by increasing VAT and excise taxes[6]. In addition, the government undertook to present to the Parliament a fully-fledged supplementary budget law for 2009 consistent with the December budget outline by end-March 2009. Further fiscal consolidation is planned for 2010, and the medium-term fiscal framework is anchored on the ambition of achieving in 2011 a general government deficit of no more than 3% of GDP, consistent with the Maastricht deficit convergence criterion. This is also in line with the European Economic Recovery Plan agreed in December 2008 by the European Council that stipulates that countries like Latvia, facing significant external and internal imbalances, aim budgetary policy at correcting macroeconomic imbalances.

The Latvian authorities are planning to adopt a package of measures to support the business sector through reducing administrative burdens and improving access to finance. Further support to the recovery would come from continued public and private investment in the framework of EU Structural Funds' projects. The authorities have committed to ensuring a timely and determined implementation of Structural Fund programmes. The measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

**Measures to help stabilize the financial system**

With a view to stabilising the financial sector, Latvia raised the deposit guarantee coverage from the lats equivalent of €20 000 to €50 000. In November 2008, the government took a controlling share of Parex Bank and provided liquidity support to the bank. Latvia is currently developing the legal framework for using public financial resources to support financial institutions.

[4] The 'fiscal space' indicates a country's capacity to finance desired budgetary programmes as well as service its debt without compromising macroeconomic stability and fiscal sustainability.

[5] The 2009 budget as it was approved on 14 November 2008.

[6] These indirect tax increases are partly offset by a 2% cut in the headline rate of the personal income tax.

## 3. MACROECONOMIC SCENARIO

According to the January 2009 update of the convergence programme, the recession will deepen in 2009 and continue in 2010, with a recovery expected only in 2011 (Table 1). Domestic demand is set to fall sharply over 2008-2010, but the negative impact on growth will be partly absorbed by net exports. In fact, net exports are expected to make a strong positive contribution to GDP growth but this reflects falling imports rather than a strong performance of exports, which remain subdued given the global slowdown and the competitiveness losses sustained by Latvia in recent years. The impact of the December 2008 stabilization programme does not seem to be fully incorporated in the macroeconomic projections of the convergence programme update[7]. Compared to the Commission services' January forecast, the programme’s macroeconomic outlook appears to be based on favourable growth assumptions in 2009 and plausible growth assumption thereafter[8].

The output gaps[9] of the programme, as recalculated by Commission services based on the information in the programme following the commonly agreed methodology indicate the sharp cyclical downturn in the economy. This is accompanied by falling inflation, deteriorating labour market conditions and a narrowing external deficit. In 2009, the programme's employment projections appear somewhat optimistic[10]. In addition the net external borrowing projections are slightly cautious, but this appears to be consistent with a less negative output outlook. The inflation projections of the programme appear plausible. Overall, the programme's macroeconomic assumptions appear sanguine for 2009 and plausible thereafter.

In view of the high uncertainty related to the global financial crisis and the ongoing correction of unbalanced growth in the previous years in Latvia, the macroeconomic scenario of both the programme and the Commission services' forecast is subject to considerable downside risks[11]. However, the downside risks are limited by the foreign financial assistance to Latvia, which is expected to ensure stability of the domestic financial system and of government financing during the painful adjustment process.

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[7] In particular, the volume and price figures on public consumption seem to be inconsistent with data in standard Table 2 of the convergence programme update.

[8] One could nuance this analysis further, by saying that the programme's growth assumption is somewhat cautious for 2010 and somewhat favourable for 2011, - but given the current uncertainties, the differences to the Commission services forecast (and to the estimated potential growth in 2011) do not appear significant.

[9] 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 rapid structural change (in particular, the composition of GFCF is ignored). 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.

[10] I.e. the employment fall in 2009 in the programme is smaller than in the Commission services' January forecast

[11] Fourth quarter GDP contracted by 10.5% y-o-y according to flash estimate by the CSB.

**Table I: Comparison of macroeconomic developments and forecasts**

| | 2008 | | 2009 | | 2010 | | 2011 |
|---|---|---|---|---|---|---|---|
| | COM | CP | COM | CP | COM | CP | CP |
| Real GDP (% change) | -2.3 | -2.0 | -6.9 | -5.0 | -2.4 | -3.0 | 1.5 |
| Private consumption (% change) | -7.0 | -6.3 | -13.0 | -7.5 | -5.0 | -6.0 | -0.6 |
| Gross fixed capital formation (% change) | -9.0 | -10.0 | -14.0 | -12.0 | -1.0 | -8.5 | 1.0 |
| Exports of goods and services (% change) | 1.5 | 4.5 | -0.8 | -3.0 | 3.7 | 2.1 | 3.7 |
| Imports of goods and services (% change) | -8.6 | -6.1 | -13.8 | -9.5 | 1.2 | -5.2 | 0.4 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | -8.1 | -8.0 | -14.3 | -9.5 | -3.5 | -7.0 | 0.0 |
| - Change in inventories | -0.6 | 0.0 | -0.7 | -0.1 | 0.0 | 0.0 | 0.0 |
| - Net exports | 6.3 | 5.9 | 8.1 | 4.6 | 1.1 | 4.1 | 1.5 |
| Output gap[1] | 7.0 | 5.9 | -1.8 | -1.6 | -4.7 | -5.7 | -5.3 |
| Employment (% change) | 1.0 | -0.5 | -5.1 | -2.8 | -2.8 | -3.0 | 1.2 |
| Unemployment rate (%) | 6.5 | 7.0 | 10.4 | 11.2 | 11.4 | 11.4 | 10.8 |
| Labour productivity (% change) | -3.3 | -1.5 | -1.9 | -2.2 | 0.4 | 0.0 | 2.7 |
| HICP inflation (%) | 15.3 | 15.4 | 6.8 | 5.9 | 2.4 | 2.2 | 1.3 |
| GDP deflator (% change) | 13.0 | 11.6 | 3.6 | 4.0 | 1.4 | 1.8 | -0.2 |
| Comp. of employees (per head, % change) | 20.0 | 21.5 | 1.0 | 1.0 | 1.0 | -3.3 | -0.3 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -13.0 | -13.4 | -4.6 | -5.4 | -3.4 | -2.6 | -2.3 |

Note:

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

*Source* :

*Commission services' January 2009 Interim economic forecasts (COM); Convergence programme (CP)*

## 4. BUDGETARY STRATEGY

### 4.1. Budgetary implementation in 2008

According to both the Commission services' interim forecast and the convergence programme update, the general government deficit is expected to reach 3.5% of GDP in 2008[12], compared to a planned surplus of 0.7% of GDP in the previous update[13]. This significantly worse-than-expected outturn reflects both a considerable tax shortfall and a higher expenditure to GDP ratio, which was however due to the denominator effect (i.e. lower than expected nominal GDP growth).

In contrast to a nominal GDP growth of around 10%, revenue is estimated to have increased by only 5.5% year-on-year according to the January interim forecast compared to a projected increase of 20.3% in the previous convergence programme update. Tax revenue shortfalls reflect the loss revenues related to real estate and the lending boom and lower-than-expected economic activity more generally. There was a shift to a less tax-rich composition of

[12] More recent information suggests that the budget deficit in 2008 might have been higher than this. In view of the reported breach of the Treaty reference value, the Commission prepared on 18 February 2008 a report under Article 104.3 of the Treaty.

[13] See Table 1 in Annex 2.

economic activity than in previous years, which was the consequence of the end of a cyclical real-estate and lending bubble. Furthermore, tax payment of businesses and private individuals declined towards the end of the year, due to acute liquidity problems in the economy. Expenditure according to the interim forecast is expected to have increased by around 16%, rather than the planned rise of 19.4% in the previous programme update, as a result of government efforts to limit the budget deficit in view of the revenue shortfall.

### 4.2. Near-term budgetary strategy

On 14 November 2008 the Parliament adopted a 2009 state budget with a forecast deficit of 1.5% of GDP, based on a projected 1% GDP contraction. This budget was based on optimistic macroeconomic scenario and was subsequently revised in the framework of discussions with the IMF and the Commission. The Latvian Parliament adopted an amended budget for 2009 on 12 December 2008. This will be followed by a detailed supplementary budget by the end of March 2009. The 12 December 2008 budget, which is reflected in the January 2009 convergence programme update, set a medium-term fiscal programme designed to reduce the general government budget deficit to not more than the Treaty reference level of 3% of GDP by 2011, notably including:

(i) targeting a 2009 general government deficit of 5.3% (4.9% in 2010);

(ii) within medium-term budgetary ceilings, reduction of average public sector remuneration in nominal terms in 2009 by at least 15% relative to the original 14 November 2008 budget and a further 2% in 2010-2011; this should also apply to local governments, government agencies and state-owned companies;

(iii) continue measures started in 2008 to reduce employment in central government ensuring at least 5% reduction by the end of 2008 and total reduction of 10% by the end of June 2009;

(iv) the elimination of general bonuses, performance bonuses, vacation bonuses, management contracts, additional payments for work in high intensity conditions, and similar such payments;

(v) reduction of subsidies (excluding social support) and expenditure on goods and services by 25% relative to the original 14 November 2008 budget[14];

(vi) ring fencing of EU-funded project spending.

On the revenue side, the amended 2009 budget stipulates increases in the standard and reduced rates of VAT from 18% to 21% and from 5% to 10% respectively, along with excise tax increases on alcohol, tobacco, petrol, and certain non-alcoholic beverages and coffee. These indirect tax increases are being partly offset by a 2% cut in the headline rate of the personal income tax (from 25% to 23%).

In addition, on 29 December 2008 the Cabinet of Ministers adopted regulation Nr. 882 on "Fiscal discipline and monitoring measures." According to the regulation, the ministries have to form a 10% appropriation reserve from the budget resources allocated in 2009. A fiscal discipline monitoring committee under the Ministry of Finance has been formed.

[14] These terms are meant under national methodology, - in ESA they broadly corresponds to transfers and intermediate consumption.

**Table II. Main budgetary measures for 2009**

| Revenue measures[1] | Expenditure measures[2] |
|---|---|
| • Increase of standard VAT rate from 18% to 21%; increase of reduced VAT rates from 5% to 10% and abolishment of the reduced tax rate on particular products; decrease of the number of goods and services subject to reduced VAT rate (+1.92% of GDP);<br>• Increases of excise taxes on alcohol, tobacco, petrol, and certain non-alcoholic beverages (+0.74% of GDP);<br>• Maintaining the rate of social contribution accruing into the state funded pension scheme at 8% and increasing the minimal wage (+0.34% of GDP);<br>• Reducing personal income tax rate from 25% to 23%; increasing of minimal wage from 160 LVL to 180 LVL; increasing of threshold of personal tax-exemption from 80 LVL to 90 LVL, etc. (-0.63% of GDP). | • Reduction in compensation of employees (-1.2% of GDP);<br>• Reduction in intermediate consumption (-0.7% of GDP);<br>• Increase in social payments (+2.1% of GDP) |
| Note:<br>[1] Estimated impact on general government revenue<br>[2] Estimated impact on general government expenditure<br>Source: Commission services and the latest convergence programme update | |

**Table III: Composition of the budgetary adjustment**

| (% of GDP) | 2007 | 2008 | | 2009 | | 2010 | | 2011 | Change: 2008-2011 |
|---|---|---|---|---|---|---|---|---|---|
| | COM | COM | CP | COM | CP | COM[1] | CP | CP | CP |
| **Revenue** | **37.6** | **36.0** | **35.1** | **34.1** | **32.5** | **34.7** | **35.0** | **37.7** | **2.6** |
| *of which:* | | | | | | | | | |
| - Taxes on production and imports | 12.9 | 11.6 | 11.7 | 12.4 | 13.2 | 12.1 | 13.7 | 15.4 | 3.7 |
| - Current taxes on income, wealth, etc. | 9.7 | 10.0 | 10.2 | 7.4 | 7.1 | 8.0 | 7.4 | 7.2 | -3.0 |
| - Social contributions | 9.5 | 9.5 | 9.5 | 9.0 | 8.0 | 8.8 | 7.8 | 7.7 | -1.8 |
| - Other (residual) | 5.5 | 4.9 | 3.7 | 5.3 | 4.2 | 5.8 | 6.1 | 7.4 | 3.7 |
| **Expenditure** | **37.6** | **39.5** | **38.6** | **40.4** | **37.7** | **42.1** | **39.9** | **40.7** | **2.1** |
| *of which:* | | | | | | | | | |
| - Primary expenditure | 37.1 | 38.8 | 38.0 | 39.2 | 36.2 | 40.2 | 38.4 | 39.1 | 1.1 |
| *of which:* | | | | | | | | | |
| Compensation of employees | 11.3 | 12.9 | 11.6 | 11.7 | 10.0 | 11.9 | 9.9 | 9.6 | -2.0 |
| Intermediate consumption | 6.4 | 7.1 | 6.4 | 6.4 | 5.6 | 6.5 | 5.7 | 5.7 | -0.7 |
| Social payments | 8.0 | 8.7 | 8.8 | 10.8 | 10.2 | 11.9 | 11.7 | 12.2 | 3.4 |
| Subsidies | 0.6 | 0.6 | 0.6 | 0.7 | 0.6 | 0.7 | 0.6 | 0.6 | 0.0 |
| Gross fixed capital formation | 5.9 | 5.6 | 5.4 | 5.9 | 6.0 | 6.2 | 6.8 | 7.3 | 1.9 |
| Other (residual) | 4.7 | 3.9 | 5.2 | 3.7 | 3.9 | 3.0 | 3.8 | 3.7 | -1.5 |
| - Interest expenditure | 0.5 | 0.6 | 0.6 | 1.2 | 1.5 | 1.9 | 1.5 | 1.6 | 1.0 |
| **General government balance (GGB)** | **0.1** | **-3.5** | **-3.5** | **-6.3** | **-5.3** | **-7.4** | **-4.9** | **-2.9** | **0.6** |
| **Primary balance** | **0.6** | **-2.9** | **-2.9** | **-5.1** | **-3.7** | **-5.5** | **-3.5** | **-1.4** | **1.5** |
| One-off and other temporary measures | 0.0 | 0.0 | n.a. | 0.0 | n.a. | 0.0 | n.a. | n.a. | n.a. |
| **GGB excl. one-offs** | **0.1** | **-3.5** | **n.a.** | **-6.3** | **n.a.** | **-7.4** | **n.a.** | **n.a.** | **n.a.** |
| Output gap[2] | 13.2 | 7.0 | 5.9 | -1.8 | -1.6 | -4.7 | -5.6 | -4.9 | -10.8 |
| Cyclically-adjusted balance[2] | -3.6 | -5.4 | -5.1 | -5.8 | -4.9 | -6.1 | -3.3 | -1.5 | 3.6 |
| **Structural balance[3]** | **-3.6** | **-5.4** | **-5.1** | **-5.8** | **-4.9** | **-6.1** | **-3.3** | **-1.5** | **3.6** |
| *Change in structural balance* | | *-1.9* | *-1.5* | *-0.3* | *0.3* | *-0.3* | *1.5* | *1.8* | |
| Structural primary balance[3] | -3.1 | -4.8 | -4.5 | -4.6 | -3.4 | -4.2 | -1.8 | 0.1 | 4.6 |
| *Change in structural primary balance* | | *-1.7* | *-1.4* | *0.2* | *1.2* | *0.4* | *1.5* | *1.9* | |

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' January 2009 interim forecasts (COM); Commission services' calculations*

### 4.3. 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.

Considering the renewed Stability and Growth Pact, the responsibilities arising from ERMII membership, as well as national policy aimed at ensuring macroeconomic stability, in 2005 the Convergence Programme of Latvia set the medium-term objective (MTO) at structural deficit of 1% of GDP for the next 4 years. However, notwithstanding uncertainties surrounding estimates of the output gap, the budgetary position departed from the medium-term objective in 2005. The convergence programme plans to keep the structural deficit broadly unchanged in 2009 and then to move strongly towards the MTO in 2010 and 2011. In particular, according to Commission services' calculations on the basis of information in the programme, the structural balance is projected to stay around -5% of GDP in 2009 and to improve to -3¼% in 2010 and to -1½% of GDP in 2011. The update does not envisage achieving the MTO over the programme period[15].

The central budgetary objective is reaching the Maastricht treaty budget deficit reference of below 3% of GDP in 2011 to achieve a successful transition to euro. This is to be achieved by increasing revenue from 32.5% of GDP in 2009 to 37.7% of GDP in 2011 (35% in 2010), supported by significant increases in indirect tax revenues to GDP in 2011 and gradual large increases in the other revenue to GDP ratio over 2010 and 2011. At the same time, the level of expenditure to GDP is planned to increase, but to a lesser extent, from 37.7% of GDP in 2009 to 39.9% in 2010 and 40.7% in 2011.

The fiscal stance, as measured by the change in the structural balance, as recalculated by the Commission services, is planned to be mildly restrictive in 2009 and restrictive in 2010 and 2011[16].

### 4.4. Risks to the budgetary targets

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors.

As assessed in Section 3 above, in view of the high uncertainty related to the global financial crisis and the ongoing correction of economic imbalances in Latvia, the macroeconomic scenario of the programme is subject to considerable downside risks. Even though the downside risks to the financial system are limited by the foreign financial assistance to Latvia, lower economic growth and thereby worse than expected labour market conditions could lead to lower budget revenues and thus to higher deficits than planned[17].

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 seem to reflect adequately the potential downward risks to the economy. Under the programme's pessimistic scenario, GDP growth is assumed to be two percentage point lower in 2009 than under the central scenario, resulting in lower revenues by about 0.2% of GDP. This however, appears to be an underestimation of the resulting revenue shortfall under such a scenario, even considering a standard very low sensitivity of revenues.

Tax receipts data for the second half of 2008 indicate that tax receipts are particularly effected during the current recession. Accordingly, the outlook for taxes is very uncertain, which can jeopardize the success of the discretionary revenue increasing measures adopted in December 2008. In particular, it is quite unsure whether the planned VAT increases in 2009 will produce the expected results.

Budgetary measures related to 2009 are sufficiently spelled out in the programme, but there is a risk that the revenue side will develop worse than planned and restraint on the expenditure side will require a high level of political commitment and social support. The measures backing the budgetary adjustment in 2010 and 2011, which is based on revenue increases, are

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[15] This is based on the recalculated potential growth figures.

[16] However, according to the Commission services' January 2009 forecast, prepared under the no policy change assumption it is projected to be mildly expansionary over the whole programme period.

[17] as it is the case e.g. in the Commission services forecasts

not clearly spelled out in the programme. In particular, the measures behind the planned increase in the ratio of indirect tax revenues to GDP in 2011 and the gradual large increases in the other revenue to GDP ratio over 2010 and 2011 are not sufficiently explained.

As can be seen from Figure 2 in Annex 2, the Latvian government has until 2007 always respected and even exceeded its budgetary targets set in earlier convergence programme updates. However, the capacity for expenditure restraint has not been tested in the years between 2004-2007, as high nominal growth created the opportunity each year to spend extra revenues in the framework of a supplementary budget. In 2008, as the economic environment turned unfavourable, revenue shortfalls appeared after consequent years of revenue windfalls.

Overall, there is a risk that the budgetary outcomes could be worse than targeted in the January 2009 programme update. This concerns all programme years: in 2009, the macroeconomic projections of the programme are less negative than those in the Commission services' January 2009 forecast and the planned fiscal consolidation in 2010 and 2011 is not backed up by detailed measures. Moreover, since the January interim Commission forecast, new information points to a more severe fall of GDP.

As mentioned before, the Latvian government decided to nationalize Parex bank and to provide liquidity support for the bank in 2008. Further financial sector stabilization operations might become necessary over the programme horizon, with potential impact on public finances, - but there is no concrete information on this subject in the programme.

## 5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

### 5.1. Debt developments

The sharp increase in public debt in 2008 indicates the impact of the financial sector stabilization measures of the government, in particular the increase in government borrowing to enable it to provide liquidity to Parex bank, which was partly nationalized after large drains on its deposit base. The Commission services' interim forecast has a lower debt estimate for the end of 2008 than the convergence programme update, but this difference appears to stem from underestimating security issues in the domestic financial market in November-December 2008, - the biggest part of which was made to support the Latvian financial system.

The EUR 7.5bn international financing package provided to Latvia in several instalments up to Q1 2011, in a front-loaded manner, by the EU, IMF, World Bank and several European countries is expected to lead to a further rapid accumulation of public debt over 2009-2010. However, to the extent that the assistance will not be utilized for budgetary needs[18] it is expected to increase financial assets of the government sector[19]. Both the convergence programme and the Commission services' forecast assumes that the financial assistance will be fully taken up by Latvia. However, some instalments might not be drawn or drawn fully, in which case there will not be a need for further institutional financial support to Latvia. The debt ratio is expected to stay well below 60% of GDP, as Latvia is aiming to consolidate its budget deficit below 3% of GDP by 2011.

[18] i.e. financing of the budget deficit and refinancing of maturing debt

[19] In general, capital injections into financial institutions to shore up the financial system are expected to be recorded as transactions between financial assets of the government sector, and would therefore be neutral in terms of liabilities.

**Table IV: Debt dynamics**

| (% of GDP) | average 2002-06 | 2007 | 2008 | | 2009 | | 2010 | | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| | | | COM | CP | COM | CP | COM | CP | CP |
| **Gross debt ratio**[1] | **13.2** | **9.5** | **16.0** | **19.4** | **30.4** | **32.4** | **42.9** | **45.4** | **47.3** |
| Change in the ratio | -0.7 | -1.1 | 6.5 | 9.9 | 14.3 | 13.0 | 12.5 | 13.0 | 1.9 |
| *Contributions* [2] *:* | | | | | | | | | |
| **1. Primary balance** | **0.5** | **-0.6** | **2.9** | **2.9** | **5.1** | **3.7** | **5.5** | **3.5** | **1.4** |
| **2. "Snow-ball" effect** | **-1.2** | **-1.5** | **-0.3** | **-0.2** | **1.7** | **1.8** | **2.2** | **1.8** | **0.9** |
| *Of which:* | | | | | | | | | |
| Interest expenditure | 0.6 | 0.5 | 0.6 | 0.6 | 1.2 | 1.6 | 1.9 | 1.4 | 1.5 |
| Growth effect | -1.1 | -0.9 | 0.2 | 0.2 | 1.1 | 1.0 | 0.7 | 1.0 | -0.7 |
| Inflation effect | -0.8 | -1.1 | -1.1 | -1.0 | -0.6 | -0.8 | -0.4 | -0.6 | 0.1 |
| **3. Stock-flow adjustment** | **0.2** | **1.1** | **3.9** | **7.2** | **7.5** | **7.5** | **4.9** | **7.7** | **-0.4** |
| *Of which:* | | | | | | | | | |
| Cash/accruals diff. | 0.0 | -0.3 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Acc. financial assets | -0.1 | 1.4 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Privatisation* | -0.4 | 0.0 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Val. effect & residual | 0.3 | 0.0 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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' January 2009 Interim economic forecasts (COM); Commission services' calculations*

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

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.[20]

Table 3 in Annex 2 shows that the projected increase in age-related spending is rising by 1.6% of GDP between 2010 and 2050, which is below the EU average. Sustainability indicators for two scenarios are presented in Table 4 in Annex 2. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)[21] would amount to 6.9% of GDP; about 5½ percentage points more than in last year's assessment, which is due to a significantly worse estimated structural

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20 Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy − Special Report* No. 1/2006. European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), *Public finances in EMU – 2008, European Economy* No. 4/2008.

21 The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

primary balance in the starting year. The starting budgetary position is not sufficient to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

In contrast to the "2008 scenario", which reflects the weakening of the budgetary position as a in response to the current economic crisis, the "programme scenario", which is based on the end-of-programme structural primary balance, shows a far smaller gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be somewhat mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in the Annex displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. They are summarized in Table 5 in the Annex.

Latvia appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, as a result of the pension reforms already enacted. However, the budgetary position in 2008, as estimated in the programme, has worsened considerably compared with the starting position of the previous programme and compounds the budgetary impact of population ageing on the sustainability gap. Reducing the primary deficit over the medium term, as foreseen in the programme, would contribute to reducing medium risks to the sustainability of public finances.

## 6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The currently fiscal deterioration experienced by Latvia is partly explained by the institutional weaknesses of its fiscal framework. This calls for an appropriate reform of the main elements of this framework in order to sustain the required fiscal consolidation over the medium-term. Fiscal rules currently in place should be strengthened by implementing more effective monitoring and enforcement mechanisms and widening its target definition. In turn, they should be complemented by a well-designed fiscal rule so as to tackle one of the main sources of deficit bias in Latvia, namely recurrent expenditure overruns.

Medium-term budgetary planning is a key element to ensure fiscal discipline within an overall budgetary strategy based on expenditure control. The current medium-term framework recently implemented shows some significant shortcomings that may considerably impair its effectiveness. This should primarily be addressed by reinforcing the binding character of spending ceilings and establishing more monitoring and enforcement mechanisms. The lack of budget centralisation and medium-term perspective in budgetary planning are particularly worrisome. Other institutional aspects, such as the reform of the fiscal links across government layers and its budgetary impact, also deserve attention.

In association with some of the providers of international financial assistance, measures are planned to be taken in the first half of 2009 to strengthen fiscal governance, increase transparency and improve public financial management inter alia by strengthening the budget formulation process, reinforcing the Ministry of Finance's spending controls, and making operational the medium-term budget framework. The Budget and Financial Management Law will be amended to strengthen the design and implementation of budgetary procedures. The revenue administration system will be reviewed with support from international technical assistance in the first quarter of 2009, to be followed by more comprehensive public financial management review assistance.

On 29 December 2008 the Cabinet of Ministers adopted regulation Nr. 882 on "Fiscal discipline and monitoring measures." According to the regulation, the ministries have to form a 10% appropriation reserve from the budget resources allocated in 2009. A fiscal discipline monitoring committee under the Ministry of Finance has been formed in parallel.

## 7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as endorsed by the European Council conclusions on the European Economic Recovery Plan (EERP) on 16 December 2008 and the overall fiscal stance (ii) the criteria for short-term action laid down the above mentioned Commission Communication, and (iii) the objectives of the Stability and Growth Pact.

In Latvia, the recent thrust of fiscal policy has been towards fiscal withdrawal rather than fiscal stimulus. Latvia pursued a pro-cyclical fiscal policy during the domestic demand boom years of 2005-2007, leading to a high structural deficit by 2008 (5% of GDP according to the most recent update of the convergence programme[22]. Windfall revenues were typically spent through the process of intra-year supplementary budgets and no reserves were created for worse times. Public sector wage growth became a driver of private sector wage increases, with comparable wage levels higher in the public sector.

The confrontation by an abrupt and severe banking sector and external financing crisis prompted the Latvian authorities to seek international financial assistance at the end of 2008. The Latvian authorities' ambitious policy programme[23] to tackle the difficult economic situation is based on the decision of maintaining the existing peg of the lats, as a key policy anchor going forward. The programme aims to address financial sector vulnerabilities, correct fiscal imbalances and improve competitiveness while maintaining the narrow-band exchange rate. The Latvian authorities aim to fulfil the Maastricht-criterion on the fiscal deficit by 2011. However, some targeted measures to support the adjustment process are being promoted, e.g. the shift of the tax burden from direct towards indirect taxes and increased support for exporting companies.

The fiscal stance is projected by the programme to be mildly restrictive in 2009 and restrictive thereafter. The fiscal multipliers are rather low for Latvia due to the relatively small size of the public sector and high degree of openness of the economy. Considering the need to adjust economic imbalances and the lack of available fiscal space to stimulate the economy, a restrictive fiscal stance for Latvia appears in the programme period appropriate although the fiscal stance in 2009 could be more restrictive if needed to reach the targeted headline deficit. Overall, Latvia has adopted a consolidation programme in line with the aim of reducing external and internal imbalances and with the requirements of the EU balance of payments assistance and the conditions of the other international lenders.

The MTO, defined as a structural deficit of 1% of GDP, is not projected to be reached by the programme horizon, but the programme is planning a rapid correction towards the MTO in 2010 and 2011. The programme is based on less negative macroeconomic scenario for 2009

[22] As recalculated by the Commission services

[23] The Economic stabilisation and growth revival programme, as noted above.

than the Commission services' January 2009 forecast. Furthermore, it does not provide sufficient information to back the revenue-based consolidation from 2010 onwards and financial sector stabilization operations might become necessary over the programme horizon with a potential impact on public finances. Overall, the budgetary outcomes are subject to significant downside risks.

## ANNEX 1. SPECIAL TOPIC: LATVIA'S EXTERNAL COMPETITIVENESS AND FISCAL POLICY MEASURES FOR ITS ENHANCEMENT

### 1. INTRODUCTION

International trade integration has a heightened importance for Latvia, as given the small size of its economy, only a limited variety of goods can be produced domestically. Therefore, even after the elevated demand for imports – partly due to overheating in the previous years and partly inherent for a country undergoing an economic catching-up – will have passed, imports to GDP should stay relatively high in the long-term to enable high living standards. This is only possible in a sustainable way, if exports will increase from current low levels and/or if the domestic value-added content in exports increases.

From mid-2007 domestic demand oriented growth drivers have faltered, thus the performance of goods' and services' exports will determine how successfully will Latvia overcome economic downturn and correct the large external imbalances. The government has proposed several measures to facilitate and encourage the adjustment towards the tradable sectors, but it is unclear how quickly and effectively these changes will improve external trade. In addition, a number of entrepreneurship and export enhancing measures are dependent on allocating enough budgetary resources to co-finance the Structural Funds' projects.

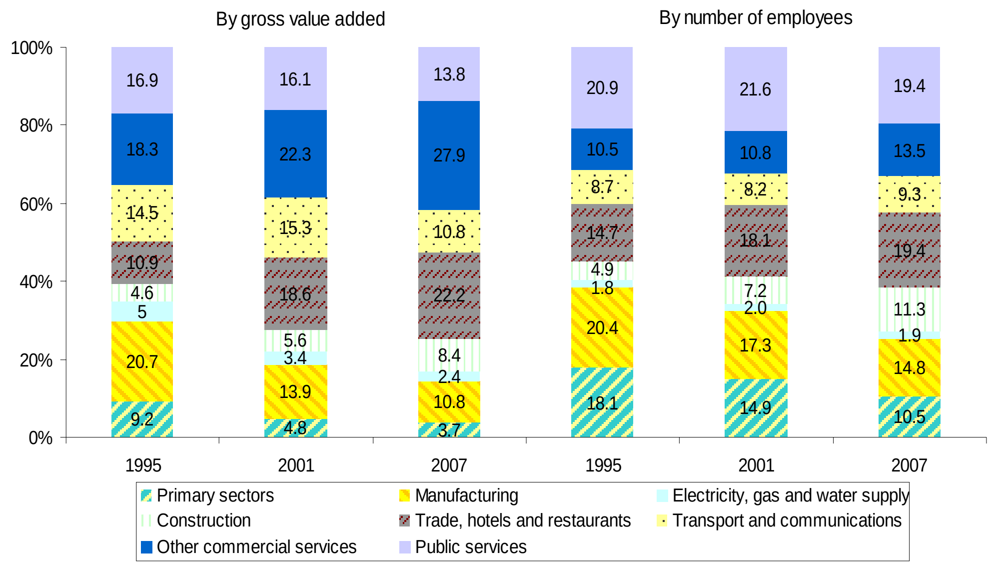
The first section below presents an overview of the structure of the economy and the developments of labour cost, industrial output and exports, which gives some background to the necessity and possibilities of tackling the competitiveness problem. The second section gives an overview of what the government does and plans to do to boost exports through fiscal measures and premeditates about the effectiveness of these efforts.

### 2. STRUCTURAL CHANGES IN THE ECONOMY

As the Latvian economy was going through significant structural changes from 1995 onwards, there was a clear shift from tradeable to non-tradeable sectors. Since 1995 the share of the primary sector and manufacturing, two of the key sectors in Latvia to ensure exports and substitution of imports, has shrunk substantially. The share of the primary sectors (i.e. mainly agriculture and forestry) in total GVA has shrunk notably (Figure 1). This is fully in line with expectations from a catching-up economy. In 2007, the share of primary sectors was still high in an EU-comparison. However, this level might be fitting even at a more developed stage to the low population density of Latvia, as given that there is more land available per person, the relative weight of agriculture and forestry can be larger in the economy than on average in other countries. The weight of the sector in employment is still large (around 10% in 2007).

Manufacturing has declined in total GVA from 20.7% in 1995 to below 11% by 2008. This negative development can be traced back to several factors such as an inherited unfavourable product structure, the flawed privatization process, lack of financing possibilities earlier in the nineties, strong boom of the service sector and, more recently, the rapid production cost increases in an overheating economy. The long distress of the traditional CIS markets, lack of FDI into the manufacturing sector and – especially after the EU-accession – emigration to richer EU member states are also among the reasons for this relative decline. In 2007, the share of employment in manufacturing was higher than in total GVA, with almost 15% of workers finding their job in this sector. This gap between the share in total employment and GVA was created in the wake of the Russian-crisis, suggesting that the crisis hit harder the more capital-intensive segments of manufacturing.

**Figure 1: Structure of the economy**




*Source: CSB and EU KLEMS*

The share of construction in total GVA did not increase significantly for a decade till 2005, but then rose sharply in 2005-2007 on the back of stepped-up infrastructure development, other public investment projects and a boom in the housing market.

Over the last decade, GDP growth has been highest in the service sector, especially in wholesale and retail sales, hotels and restaurants and other commercial services. Latvia's economy is dominated by the service sector, with its share reaching around 73.2% of the total GVA in 2007 (up from roughly 60% in 1995 and 72% 2001). However, the service part of the economy cannot be labelled fully as non-tradable, as export of services is quite significant in some segments such as transit, financial intermediation and tourism. However, export of services relative to total value added of services decreased significantly until 2002 and has remained relatively stable since then.

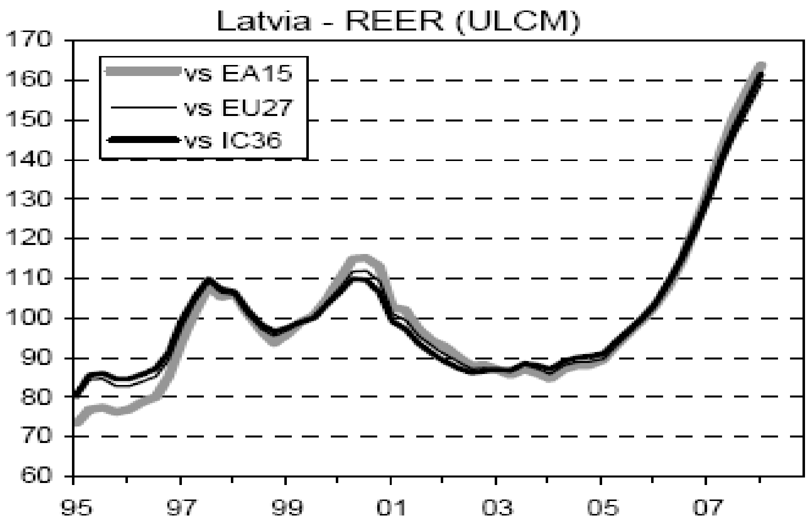
## 3. LABOUR COST DEVELOPMENT

From the EU accession until mid-2007, nominal wages grew in an accelerating manner. However, as the labour market tightened, an increasing part of private sector's registered wage increase stemmed from the legalization of wages, - the process whereby wages paid in the black and grey economy surface to tax authorities. Thus, in view of the legalization effect on private sector wage developments, public sector wage growth has been particularly large (Figure 3). This development – by fuelling wage pressure in the private sector both through its signalling role and direct competition for employees – contributed to the decrease in external competitiveness and continues to hinder the adjustment of private sector wages to the economic slowdown.

**Figure 2: Nominal growth of gross wages**


After a long period of relative stability, nominal unit labour costs (ULC) started to increase rapidly from 2004, with the manufacturing sector following the upward impact on wages of the boom in real estate and lending activities. Accordingly, the manufacturing ULC-based real exchange rate shows a dramatic deterioration from 2004 (Figure 4)[24].

**Figure 3: Relative cost indicators based on unit wage costs in manufacturing**




*Source: EC, Quarterly reports on price and cost competitiveness*

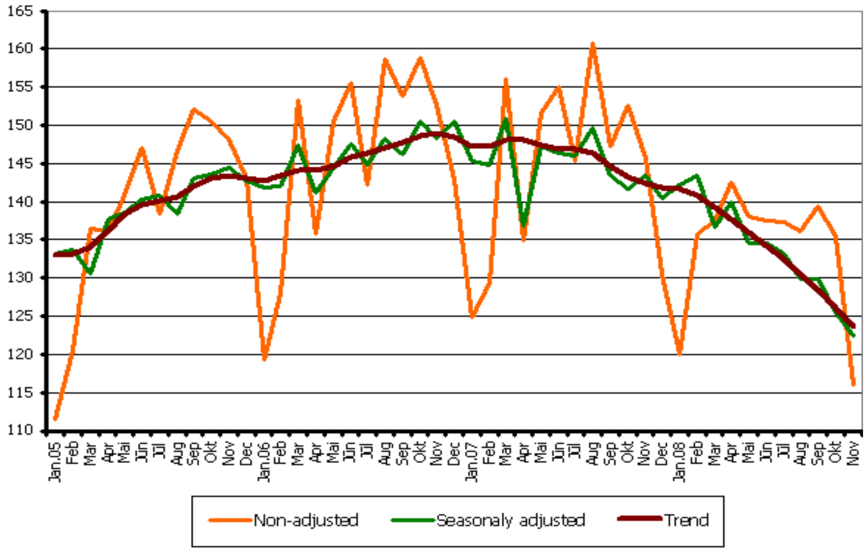
## 4. INDUSTRIAL OUTPUT

While the inflow of FDI increased significantly after the EU-accession, the share of manufacturing within total FDI inflows remained tiny. On the other hand, investment by domestic companies into the manufacturing sector has remained significant. This has been

[24] Subject to the caveat on legalization of wages

driving the restructuring from labour intensive to more capital intensive production. However, the share of low-tech, labour intensive manufacturing, which was hit most by unfavourable cost development, is large. Hence, the growth in more capital intensive segments could not counterbalance the negative impact of labour intensive sectors on total output. The trend of real industrial output turned negative at the end of 2006. Although the expected shift from domestic to export markets was taking place, conditions on some of Latvia's key export markets were also turning unfavourable simultaneously with the domestic downturn.

**Figure 4: Seasonally adjusted volume index of manufacturing (Jan 2005-Nov 2008)**




*Source: CSB*

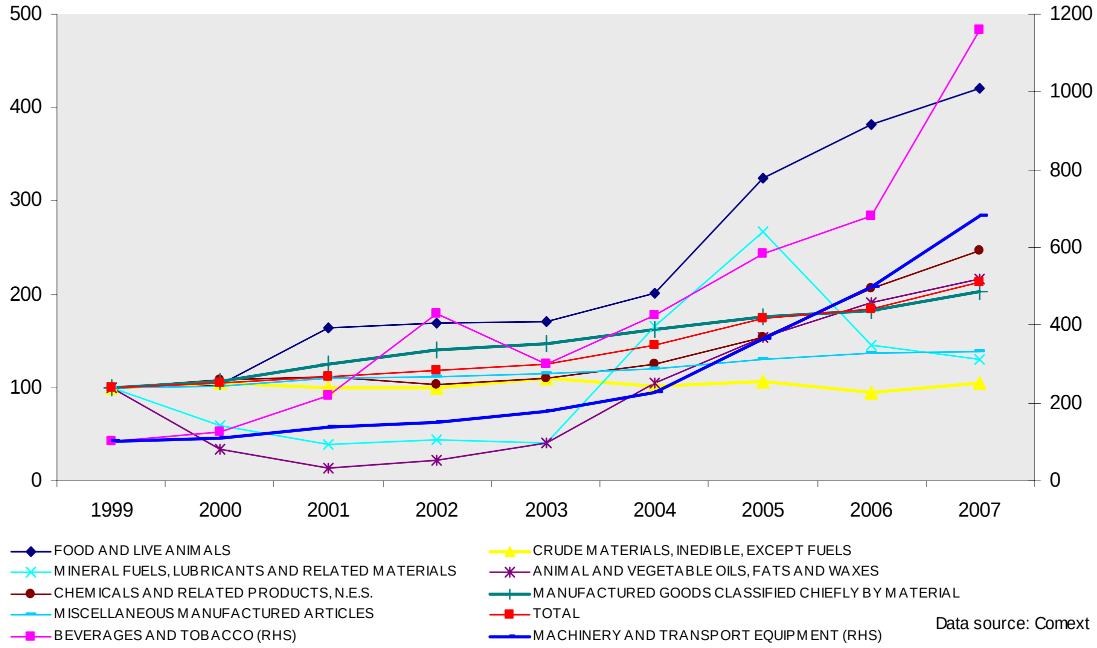
## 5. EXPORT PERFORMANCE: GOODS AND SERVICES

Latvia's export of goods and services has expanded on average by 18% nominally in the 2000-2007 period. However, neighbouring Baltic countries and other new member states have performed better. As a result, Latvia's export of goods and services ratio to GDP or export intensity was only around 41% in 2007 - the lowest level in the EU, except Poland and Romania (around 55% in Lithuania and 78% in Estonia). Following EU entry, the share of exports to the other two Baltic states within Latvia's total exports increased significantly, reaching surpassing 30% in 2007, - with the main merchandise export being chemical industry products, food, metals, transport vehicles and machinery. The CIS region has also recorded a larger share in Latvian exports since 2004, primarily due to stronger demand from Russia. The biggest increases were observed in exports of machinery, food, metals and chemical industry products. This demonstrates that Latvia has an export structure oriented significantly towards the Baltic states and the CIS countries, presumably for reasons of geography and historical integration.

However, Latvian exports are in general still dominated by low-to-medium tech and labour intensive traditional industries such as wood and metal processing and basic chemicals, for which retaining price and cost competitiveness is crucial. Furthermore, export revenues are largely exposed to volatile global commodity price developments. There is little evidence of moving up the technology ladder and the share of high-technology sectors in total manufacturing remains among the lowest in the EU[25]. The unfavourable export structure partly reflects poor performance in the fields of education and training, as well as poor transport infrastructure. Even though since 2004 the unfavourable real exchange rate development has had a negative effect on external competitiveness, particularly in the labour-intensive sector, the price and cost level in absolute terms is substantially lower than in the major trading partner countries.

However, despite the unfavourable product structure and the sharp decrease in relative cost competitiveness from 2004, Latvia's share in total exports of the EU-27 has doubled since 1999 (see chart below)[26]. The gain in share was continuous and the pace of it increased notably after Latvia joined the EU. The positive development was also widespread across product categories, with beverages, machinery and transport equipment, food and chemicals gaining the most. Meanwhile, the share of wood and textile products in Latvia's exports declined.

**Figure 5: Change in Latvia's share in the EU27's total exports by SITC (1999=100)**




Similarly, there has been a robust recovery in nominal exports since the beginning of 2007, which is at odds with the very low increase or even fall in manufacturing output. While nominal goods' export growth was above 20% in 2007, with continued strong growth in the first half of 2008[27], there has been a steady decline in manufacturing output since end-2006 (-1% in 2007). 2008, particularly, has experienced a steep drop in manufacturing volumes with significant loss of output in food, textile, wood, and mineral industries (-15.2% y-o-y in

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

[26] However, market share data is only an ex-post indicator of external competitiveness and as such it is not necessarily a good precursor for the future.

[27] However, October and November 2008 exports data points to very unfavourable development towards the end of the year.

November), suggesting that companies are struggling with higher input costs and weakening domestic and external demand.

What could explain this discrepancy between robust goods' exports growth and falling manufacturing output figures besides a somewhat different statistical composition? It seems that part of the strong export growth in value terms has come from a large increase in prices rather than volumes, particularly in wood, metal and food product sectors (together representing some 55% of goods' exports). Wood product prices, admittedly, have decreased since end-2007, while food and metal prices still remained rather high during 2008. However, a closer look at the falling export growth figures for the last few months suggests that the effect of rising export prices may be exhausted. Persistently positive terms-of-trade dynamics may prove to have been a temporary phenomenon, particularly as demand is weakening in most export markets – e.g. Estonia, Lithuania, Russia and the euro area. This notion is partly supported by the continuing moderation of price index growth of exported production; it has remained far below the local production price index for some time. Apparently, Latvian producers are finding it more difficult to pass on in export prices the increasing material and labour costs.

On the other hand, it must also be taken into account that low manufacturing output figures may have underestimated ongoing quality improvements in some sectors' product structure, leading to an underestimation of volume growth and an overstatement of price growth. Indeed, more recently exporting sectors appear to have undergone some rebalancing in response to changing economic conditions, as higher value-added sectors appear more resilient than lower value-added sectors. The moderation of domestic demand has stimulated local producers to reorient from domestic market towards export activities and enhance productivity.

Another reason for strong nominal export growth figures may have been the surging re-export levels in certain product groups like steel, electrical machinery and transport vehicles (transit trade, partly diverted from Estonia); however, the scope of re-export volumes is difficult to assess, as few data are available.

Exports of services have also expanded strongly over the last few years. Services' exports account for some 40-50% of merchandise exports: one of the highest figures among the new member states, showing that Latvia has been rather successful in utilising its geographical location as the centre of the Baltic States and a link between Russia/CIS and the West. Thus, when analysing Latvia's export performance and competitiveness, it is not sufficient to focus on export goods' structures and markets alone, as comparatively large export revenues are derived from transit and logistics services, as well as financial and tourism services.

Services' exports increased by more than 20% in 2006 and 2007, with transportation, financial and air transport services showing remarkable growth also in the first half of 2008. More than half of the export of services is made up of revenues from the transit sector. Cargo turnover in ports and volumes of goods transported by rail and on road have so far expanded strongly, mainly on the back of growing trade flows between the EU and Russia/CIS, as well as part of transit flows from Russia being diverted from Estonia to Latvian transit infrastructure. However, prospects for transit sector growth have deteriorated significantly during the second half of 2008 due to reduced East-West trade volumes and falling import demand in Russia and the other CIS countries..

As for financial services, Riga has often been considered the financial capital of the Baltics, holding around 41.4% of the Baltic banks' total assets, and the "Nicosia of the North" in terms of servicing financial flows from Russia and the CIS region. Providing financial services to non-resident clients has been a profitable business for several banks and has had a significant direct and indirect economic impact. Given EU membership, strong historic and cultural links to the former Soviet Union countries, a stable banking sector, and multilingual and increasingly professional bank specialists, this sector was set to grow strongly, especially in higher-value-added wealth management, private banking and brokerage services. However, the recent turmoil in Latvia's banking and financial sector, including the collapse of the Parex bank, which used to be considered the "flagship" in this business, have greatly worsened the prospects for the future.

## 6. GOVERNMENT MEASURES TO STIMULATE MANUFACTURING AND COMPETITIVENESS

In the framework of 2009 budget outline, the government has adopted a range of fiscal measures that are aimed at stimulating manufacturing, competitiveness and exports (see box below). Some of the proposed measures were first outlined in the March 2007 Anti-Inflation Plan and were later "re-planted" in the May 2008 Stabilisation Plan, thus it has taken almost two years to reach this point. While the measures are clearly a step in the right direction, they are, however, unlikely to offer early support to the ailing manufacturing sector and are fairly short of ambition. Most of them, including the more generous depreciation allowances and deductibility of interest payments up to the amount of reinvested earnings, will only benefit producers through reduced corporate income tax bills from 2010 onwards, as corporate tax is collected based on the previous year's corporate earnings.

**Box 1: Fiscal measures to foster manufacturing and exports**

Special regime for amortization of new technological equipment will be prolonged until 2013; the value-multiplying coefficient for amortization purposes will be increased from 1.2 to 1.5. This measure is intended to stimulate producers to invest in new manufacturing equipment.

To encourage replacement of inefficient and obsolete technologies, it is proposed to scrap CIT on profit obtained from selling of used technological equipment if new technological equipment is purchased to replace the old one within 12 months. The budgetary effect of this measure is estimated to be zero in 2009 and negative in 2010-2011 (-11 m EUR and -15 m EUR).

To encourage reinvested earnings, the taxable corporate income amount will be reduced by a sum of "virtual" interest payments that a tax payer would otherwise have to pay on a bank loan of similar size to the reinvested earnings (i.e., the CB's interest rates on loans to domestic actors will be used as a benchmark). So far, taxable income could only be reduced by amount of interest payments made on a bank loan; thus, increase of equity was comparatively less attractive. The budgetary effect of this measure is estimated to be zero in 2009 and negative in 2010-2011 (-20 m EUR and -23 m EUR, respectively).

Period during which the accrued losses can be transferred from one tax year to the next will be prolonged from 5 to 8 years, so that large-scale investments can be redeemed in a longer timeframe. The budgetary effect is estimated to be -7 m EUR in 2009 and -9 m EUR in 2010-2011.

To promote registration of patents and trade marks and to increase private sector investment in R&D activities, one of the measures sets value-multiplying coefficient for amortization purposes at 1.5 for non-material investments, which result in registration of patents or trade marks. The budgetary effect is estimated to be very small.

On the good side, measures supported by the EU funds might have a significant effect on boosting manufacturing and competitiveness in 2009 and onwards. There are a number of promising entrepreneurship-supporting programmes within the 2007-2013 Structural Funds' planning period. For example, a funding agreement with the European Investment Fund has been made regarding more than 180 million EUR that will be allocated to support small and medium-sized enterprises through a portfolio of financial products (30 million EUR for export guarantees; 50.5 million EUR for risk capital; 22.5 million EUR for technology transfer, etc). Latvia currently is the only country in the EU without a state-supported or a privately-administered export guarantee system; thus, exporters are at a disadvantage compared to their European competitors, who can access riskier markets and develop new products easier.

Also, the government has initiated a support programme for introduction of new products and technological processes in manufacturing activities. There are in total 115 million EUR available for the programme to be spent on purchase of technological equipment or patents and licences. Other EU-funds supported programmes are aimed at inter alia establishing "competence centres", attracting high skilled emigrants, and exploring new export markets.

It remains to be seen how effectively these programmes will be implemented and whether enough national co-financing will be available in light of the worsening budget situation. Also, access to bank financing or state-supported credit guarantees for entrepreneurs implementing Structural Funds'-supported projects will determine how effectively the allocated EU funding can be absorbed and tradable and export capacities improved.

## 7. CONCLUSIONS FOR FISCAL POLICY

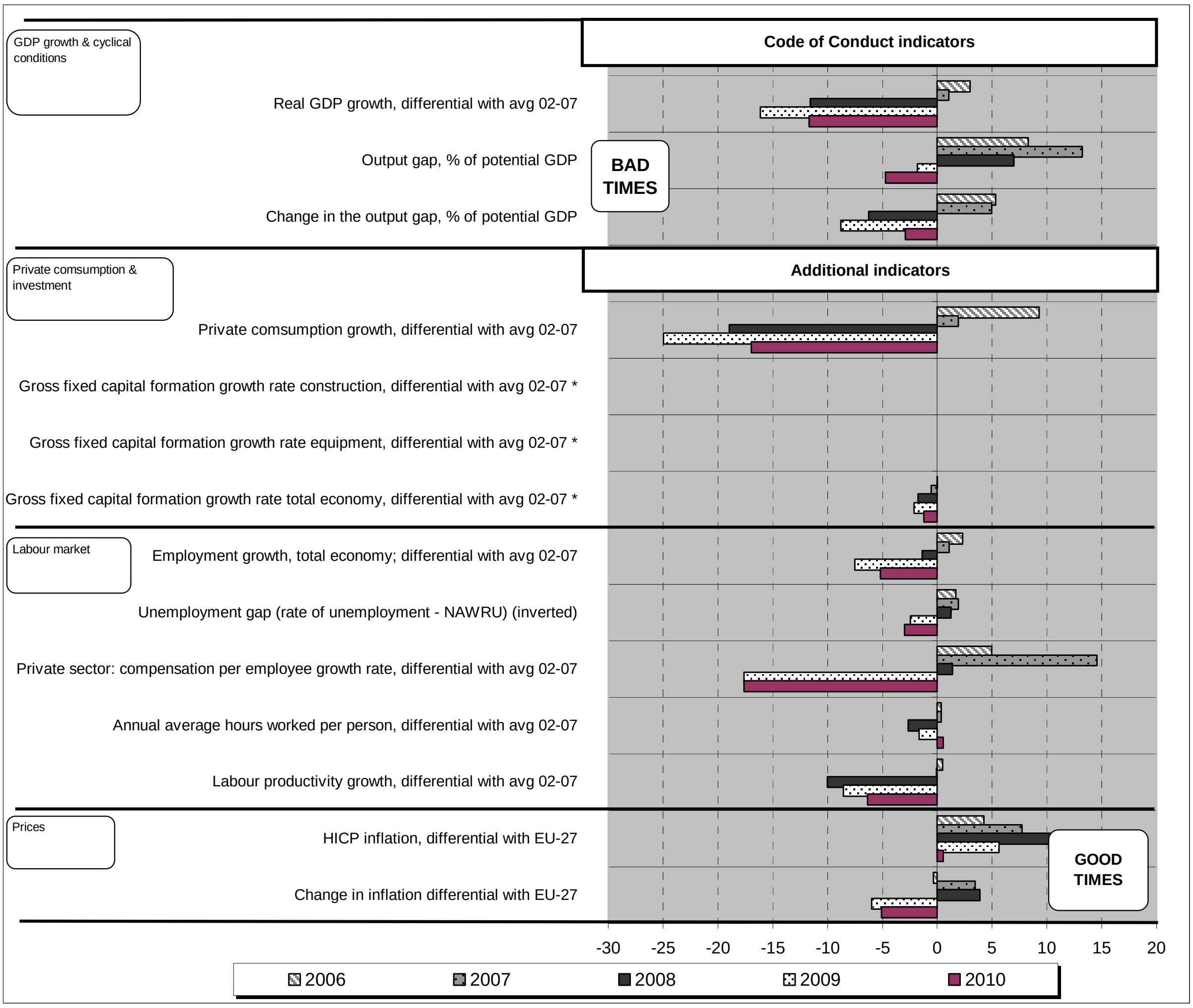
As the above analysis shows, a long-term shift took place in the Latvian economy towards the non-tradable segments over the last decade. In the short term, the structure of the economy will remain relatively rigid, and it will take years of investment into physical and human capital and market building before the impact of public policy measures is notable. Therefore, one can expect only limited short-term results from any structural measures aimed at promoting exports.

Still, there appears to be a strategic weakness in budgetary support for strengthening the supply side of economy, while the worsening budgetary situation is putting additional constraints on a fiscal response. Thus, if manufacturing and export sectors are really to become the major drivers of growth, there will be a need for more comprehensive and ambitious competitiveness-enhancing measures. The prospects seem more promising when entrepreneurship-supporting programs under the EU Structural Funds are taken into account. If public and private co-financing is made available and the programs are implemented effectively, the results might be encouraging.

Needless to add, a broad range of economic policy measures have to be utilized to facilitate the shift from domestic to export markets. Prudent fiscal policies, which encourage investors' confidence in the economy, and responsible public sector wage-setting, which affects the private sector wage developments, are only few of the measures needed to pave the way for a sustainable growth path in the future. Business environment as a whole needs to be improved.

## ANNEX 2. ADDITIONAL TABLES AND FIGURES

### Figure 1: Good and bad economic times




Source: Commission services' January 2009 forecast (COM) and successive convergence programmes

## Table 1: Budgetary implementation in 2008

| | 2007 | | 2008 | |
|---|---|---|---|---|
| | Planned CP Nov 2007 | Outcome COM | Planned CP Nov 2007 | Outcome COM |
| Government balance (% of GDP) | 0.3 | 0.1 | 0.7 | -3.5 |
| **Difference compared to target** | **-0.2** | | **-4.2** | |
| *Of which* : due to a different starting position end 2007 | | | -0.2 | |
| due to different revenue / expenditure growth in 2008 | | | -3.3 | |
| p.m. Denominator effect and residual [2,3] | | | -0.6 | |
| *p.m. Nominal GDP growth (planned and outcome)* | | | 20.0 | 10.4 |
| Revenue (% of GDP) | 37.3 | 37.6 | 37.4 | 36.0 |
| **Revenue surprise compared to target** [1] | **0.3** | | **-1.4** | |
| *Of which* : due to a different starting position end 2007 | | | 0.3 | |
| due to different revenue growth in 2008 | | | -4.2 | |
| p.m. Denominator effect [2] | | | 2.7 | |
| p.m. Residual [3] | | | -0.3 | |
| *p.m. Revenue growth rate (planned and outcome)* | | | 20.3 | 5.5 |
| Expenditure (% of GDP) | 37.0 | 37.6 | 36.8 | 39.5 |
| **Expenditure surprise compared to target** [1] | **-0.6** | | **-2.7** | |
| *Of which* : due to different starting position end 2007 | | | -0.6 | |
| due to different expenditure growth rate in 2008 | | | 1.0 | |
| p.m. Denominator effect [2] | | | -2.7 | |
| p.m. Residual [3] | | | -0.3 | |
| *p.m. Expenditure growth rate (planned and outcome)* | | | 19.4 | 16.0 |

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

*Source* : *Commission services*

## Table 2: Evolution of budgetary targets in successive programmes

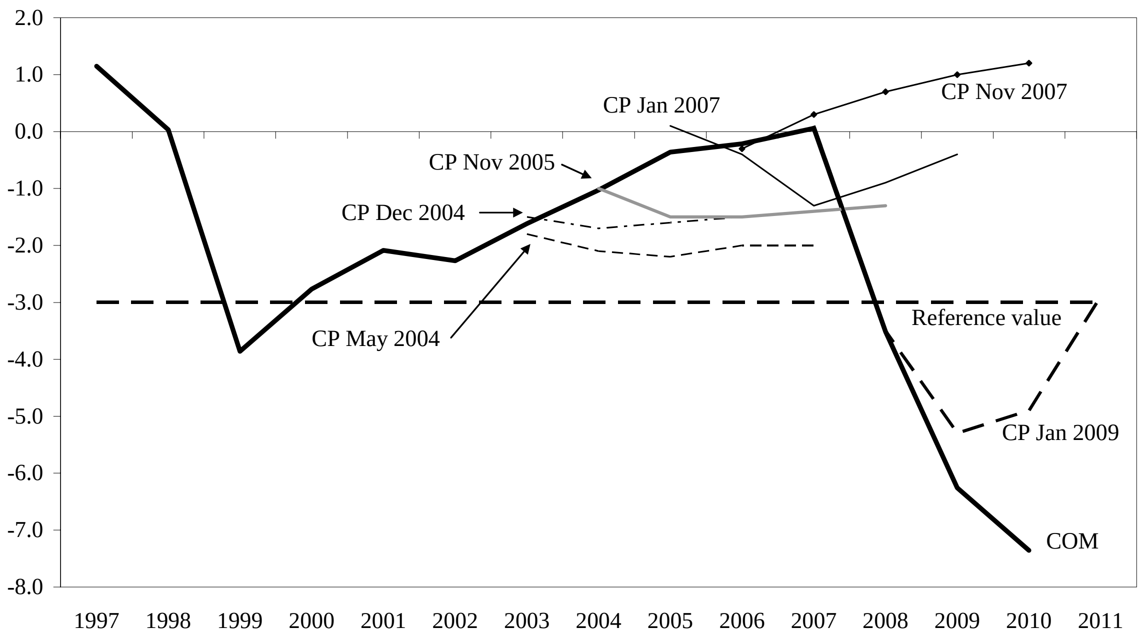
| | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| General government balance (% of GDP) | **CP Jan 2009** | **0.1** | **-3.5** | **-5.3** | **-4.9** | **-2.9** |
| | *CP Nov 2007* | *0.3* | *0.7* | *1.0* | *1.2* | *n.a.* |
| | COM Jan 2009 | 0.1 | -3.5 | -6.3 | -7.4 | n.a. |
| General government expenditure (% of GDP) | **CP Jan 2009** | **37.7** | **38.6** | **37.7** | **39.9** | **40.7** |
| | *CP Nov 2007* | *37.0* | *36.8* | *36.7* | *36.7* | *n.a.* |
| | COM Jan 2009 | 37.6 | 39.5 | 40.4 | 42.1 | n.a. |
| General government revenue (% of GDP) | **CP Jan 2009** | **37.7** | **35.1** | **32.5** | **35.0** | **37.7** |
| | *CP Nov 2007* | *37.3* | *37.4* | *37.7* | *37.9* | *n.a.* |
| | COM Jan 2009 | 37.6 | 36.0 | 34.1 | 34.7 | n.a. |
| Structural balance[1] (% of GDP) | **CP Jan 2009** | **-3.3** | **-5.1** | **-4.9** | **-3.3** | **-1.4** |
| | *CP Nov 2007* | *-0.5* | *0.4* | *1.1* | *1.7* | *n.a.* |
| | COM Jan 2009 | -3.6 | -5.4 | -5.8 | -6.1 | n.a. |
| Real GDP (% change) | **CP Jan 2009** | **10.3** | **-2.0** | **-5.0** | **-3.0** | **1.5** |
| | *CP Nov 2007* | *10.5* | *7.5* | *7.0* | *6.8* | *n.a.* |
| | COM Jan 2009 | 10.3 | -2.3 | -6.9 | -2.4 | 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 most recent programme or the Commission services' January 2009 interim forecast.

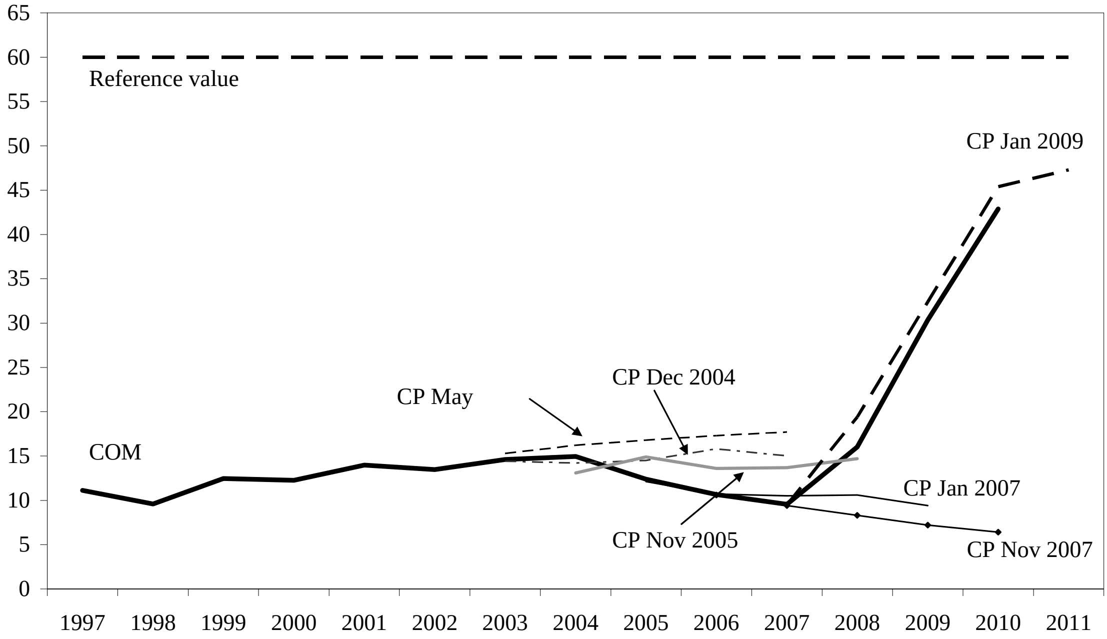
*Source :*
*Convergence programmes (CP); Commission services' January 2009 Interim economic forecasts (COM)*

## Figure 2: Government balance projections in successive programmes (% of GDP)




Source: Commission services' January 2009 interim forecast (COM) and successive convergence programmes

**Figure 3: Debt projections in successive programmes (% of GDP)**




Source: Commission services' January 2009 interim forecast (COM) and successive convergence programmes

**Table 3: Long-term age-related expenditure: main projections**

| (% of GDP) | 2004 | 2010 | 2020 | 2030 | 2040 | 2050 | Change 2010- 50 |
|---|---|---|---|---|---|---|---|
| **Total age-related spending** | **17.5** | **14.6** | **14.6** | **16.0** | **16.2** | **16.2** | **1.6** |
| - Pensions | 6.8 | 4.9 | 4.9 | 5.6 | 5.9 | 5.6 | 0.7 |
| - Healthcare | 5.1 | 5.5 | 5.8 | 5.9 | 6.1 | 6.2 | 0.7 |
| - 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 | 0.0 |
| - Unemployment benefits | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.0 |
| **Property income received** | **0.7** | **0.6** | **0.6** | **0.6** | **0.6** | **0.6** | **0.0** |

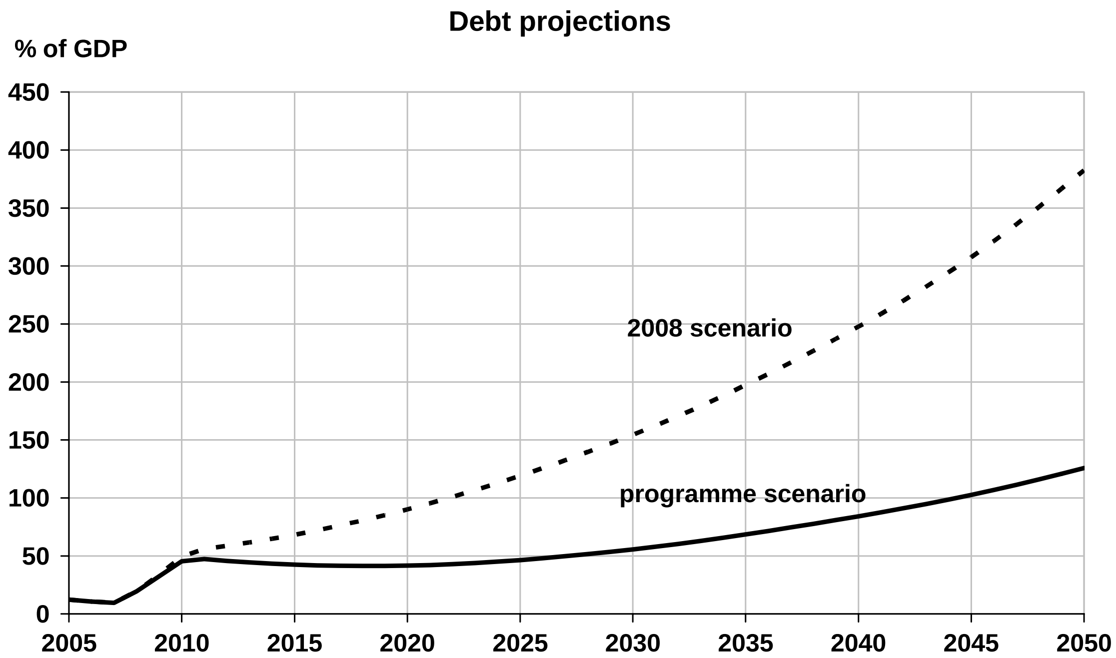
*Source: Economic Policy Committee and Commission services.*

**Table 4: Sustainability indicators and the required primary balance**

| | 2008 scenario | | | Programme scenario | | |
|---|---|---|---|---|---|---|
| | **S1** | **S2** | **RPB** | **S1** | **S2** | **RPB** |
| Value | 6.0 | 6.9 | 2.6 | 1.2 | 2.2 | 2.4 |
| *of which:* | | | | | | |
| Initial budgetary position (IBP) | 5.0 | 5.4 | - | 0.3 | 0.7 | - |
| Debt requirement in 2050 (DR) | -0.1 | - | - | -0.2 | - | - |
| Long-term change in the primary balance (LTC) | 1.1 | 1.5 | - | 1.1 | 1.5 | - |

*Source:* Commission services.

**Figure 4: Debt projections in successive programmes (% of GDP)**




*Note:* 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.

*Source:* Commission services.

**Table 5: Additional factors**

| | Impact on risk |
|---|---|
| Debt and pension assets | na |
| Decline in structural balance until 2010 in COM January forecast 2009 | na |
| Significant revenues from pension taxation | na |
| Alternative projection of cost of ageing | na |
| Strong decline in benefit ratio | na |
| High tax burden | na |
| Non-age related budgetary measures with intertemporal effect | na |

*Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.*

*'na': not applicable.*

*Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".*

*An explanation on these factors can be found in chapter IV of: European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006.*

*Source: Commission services.*

## Annex 3. Compliance with the code of conduct and tables from the programme

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.

As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps. In particular, the projections on government consumption (Table 2), the subcomponents of the stock-flow adjustment (Table 4, breakdown for line 5, line 6, line 7), some elements of the long-term sustainability of public finances table (Table 7) and some elements of the basic assumptions table (Table 8) are missing.

The tables on the following pages show the data presented in the January 2009 update of the 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.

**Table 1a. Macroeconomic prospects**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. Real GDP** | B1*g | *8717.3* | 10.3 | -2.0 | -5.0 | -3.0 | 1.5 |
| **2. Nominal GDP** | B1*g | *13957.4* | 24.9 | 9.4 | -1.2 | -1.3 | 1.3 |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P.3 | *6240.9* | 13.9 | -6.3 | -7.5 | -6.0 | -0.6 |
| **4. Government consumption expenditure** | P.3 | *1218.0* | 4.8 | 1.0 | -3.0 | -3.0 | 0.5 |
| **5. Gross fixed capital formation** | P.51 | *3143.7* | 8.4 | -10.0 | -12.0 | -8.5 | 1.0 |
| **6. Changes in inventories and net acquisition of valuables (% of GDP)** | P.52 + P.53 | *n.a.* | 4.7 | 2.0 | 2.0 | 3.8 | 3.9 |
| **7. Exports of goods and services** | P.6 | *3675.7* | 11.1 | 4.5 | -3.0 | 2.1 | 3.7 |
| **8. Imports of goods and services** | P.7 | *5748.1* | 15.0 | -6.1 | -9.5 | -5.2 | 0.4 |
| **Contributions to real GDP growth** | | | | | | | |
| **9. Final domestic demand** | | - | 13.4 | -8.0 | -9.5 | -7.0 | 0.0 |
| **10. Changes in inventories and net acquisition of valuables** | P.52 + P.53 | - | 1.8 | 0.0 | -0.1 | 0.0 | 0.0 |
| **11. External balance of goods and services** | B.11 | - | -4.8 | 5.9 | 4.6 | 4.1 | 1.5 |

**Table 1b. Price developments**

| | ESA Code | 2007 Level | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change | 2011 rate of change |
|---|---|---|---|---|---|---|---|
| **1. GDP deflator** | | *n.a.* | 13.3 | 11.6 | 4.0 | 1.8 | -0.2 |
| **2. Private consumption deflator** | | *n.a.* | 9.3 | 13.0 | 3.9 | 1.5 | 1.0 |
| **3. HICP**[1] | | *n.a.* | 10.1 | 15.4 | 5.9 | 2.2 | 1.3 |
| 4. Public consumption deflator | | *n.a.* | 30.3 | 16.5 | 3.9 | 1.5 | 1.0 |
| 5. Investment deflator | | *n.a.* | 15.0 | 8.4 | -0.1 | -0.8 | -2.5 |
| **6. Export price deflator (goods and services)** | | *n.a.* | 11.2 | 5.9 | -7.0 | 1.6 | 2.0 |
| **7. Import price deflator (goods and services)** | | *n.a.* | 5.8 | 4.9 | -6.8 | 3.1 | 2.7 |

[1] Optional for stability programmes.

**Table 1c. Labour market developments**

| | ESA Code | 2007 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| | | Level | rate of change | rate of change | rate of change | rate of change | rate of change |
| **1. Employment, persons**[1] | | *1119.0* | 2.9 | -0.5 | -2.8 | -3.0 | 1.2 |
| 2. Employment, hours worked[2] | | *46159670* | 1.2 | -0.6 | -2.9 | -3.0 | 1.4 |
| **3. Unemployment rate (%)**[3] | | *n.a.* | 5.7 | 7.0 | 11.2 | 11.4 | 10.8 |
| **4. Labour productivity, persons**[4] | | *n.a.* | 7.2 | -1.5 | -2.2 | 0.0 | 2.7 |
| 5. Labour productivity, hours worked[5] | | *n.a.* | 9.0 | -1.4 | -2.1 | 0.0 | 3.0 |
| **6. Compensation of employees** | D.1 | *6833.6* | 39.2 | 18.8 | -1.7 | -5.4 | 0.2 |
| **7. Compensation per employee** | | *398* | 31.5 | 21.5 | 1.0 | -3.3 | -0.3 |

[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 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **1. Net lending/borrowing vis-à-vis the rest of the world** | B.9 | -21.8 | -13.4 | -5.4 | -2.6 | -2.3 |
| *of which* : | | | | | | |
| - Balance on goods and services | | -21.8 | -13.9 | -7.3 | -4.9 | -4.5 |
| - Balance of primary incomes and transfers | | -2.1 | -0.9 | 0.0 | -0.5 | -1.0 |
| - Capital account | | 2.1 | 1.5 | 1.9 | 2.9 | 3.2 |
| 2. Net lending/borrowing of the private sector | B.9 | -21.9 | -9.9 | -0.1 | 2.3 | 0.6 |
| 3. Net lending/borrowing of general government | EDP B.9 | 0.1 | -3.5 | -5.3 | -4.9 | -2.9 |
| **4. Statistical discrepancy** | | -0.7 | -1.5 | 0.0 | 0.0 | 0.0 |

**Table 2. General government budgetary prospects**

| | ESA Code | 2007 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| | | Level | % of GDP | % of GDP | % of GDP | % of GDP | % of GDP |
| **Net lending (EDP B.9) by sub-sector** | | | | | | | |
| **1. General government** | S.13 | *8.7* | 0.1 | -3.5 | -5.3 | -4.9 | -2.9 |
| **2. Central government** | S.1311 | *-320.2* | -2.3 | -4.3 | -3.2 | -3.5 | -2.3 |
| **3. State government** | S.1312 | *n.a.* | n.a. | n.a. | n.a. | n.a. | n.a. |
| **4. Local government** | S.1313 | *-85.6* | -0.6 | -0.7 | -0.6 | -0.1 | -0.1 |
| **5. Social security funds** | S.1314 | *414.5* | 3.0 | 1.5 | -1.4 | -1.3 | -0.5 |
| **General government (S13)** | | | | | | | |
| **6. Total revenue** | TR | *5268.8* | 37.7 | 35.1 | 32.5 | 35.0 | 37.7 |
| **7. Total expenditure** | TE[1] | *5260.2* | 37.7 | 38.6 | 37.7 | 39.9 | 40.7 |
| **8. Net lending/borrowing** | EDP B.9 | *8.7* | 0.1 | -3.5 | -5.3 | -4.9 | -2.9 |
| **9. Interest expenditure** | EDP D.41 | *67.2* | 0.5 | 0.6 | 1.5 | 1.5 | 1.6 |
| **10. Primary balance[2]** | | *75.9* | 0.5 | -2.9 | -3.7 | -3.5 | -1.4 |
| **11. One-off and other temporary measures[3]** | | *n.a.* | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Selected components of revenue** | | | | | | | |
| **12. Total taxes** (12=12a+12b+12c) | | *3164.8* | 22.7 | 21.8 | 20.3 | 21.0 | 22.6 |
| **12a. Taxes on production and imports** | D.2 | *1805.4* | 12.9 | 11.7 | 13.2 | 13.7 | 15.4 |
| **12b. Current taxes on income, wealth, etc** | D.5 | *1357.2* | 9.7 | 10.2 | 7.1 | 7.4 | 7.2 |
| **12c. Capital taxes** | D.91 | *2.2* | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **13. Social contributions** | D.61 | *1325.4* | 9.5 | 9.5 | 8.0 | 7.8 | 7.7 |
| **14. Property income** | D.4 | *103.0* | 0.7 | 0.9 | 0.7 | 0.7 | 0.7 |
| **15. Other[4]** | | *675.5* | 4.8 | 2.9 | 3.5 | 5.4 | 6.8 |
| **16=6. Total revenue** | TR | *5268.8* | 37.7 | 35.1 | 32.5 | 35.0 | 37.7 |
| **p.m.: Tax burden** (D.2+D.5+D.61+D.91-D.995)[5] | | | 32.5 | 31.7 | 28.6 | 29.2 | 30.7 |
| **Selected components of expenditure** | | | | | | | |
| **17. Compensation of employees + intermediate consumption** | D.1+P.2 | *2481.8* | 17.8 | 17.9 | 15.6 | 15.6 | 15.2 |
| 17a. Compensation of employees | D.1 | *1606.6* | 11.5 | 11.6 | 10.0 | 9.9 | 9.6 |
| 17b. Intermediate consumption | P.2 | *875.2* | 6.3 | 6.4 | 5.6 | 5.7 | 5.7 |
| **18. Social payments** (18=18a+18b) | | *1126.6* | 8.1 | 8.8 | 10.2 | 11.7 | 12.2 |
| 18a. Social transfers in kind supplied via market producers | D.6311, D.63121, D.63131 | *70.8* | 0.5 | 0.6 | 0.6 | 0.7 | 0.7 |
| 18b. Social transfers other than in kind | D.62 | *1055.8* | 7.6 | 8.3 | 9.6 | 11.0 | 11.5 |
| **19=9. Interest expenditure** | EDP D.41 | *67.2* | 0.5 | 0.6 | 1.5 | 1.5 | 1.6 |
| **20. Subsidies** | D.3 | *89.9* | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| **21. Gross fixed capital formation** | P.51 | *792.1* | 5.7 | 5.4 | 6.0 | 6.8 | 7.3 |
| **22. Other[6]** | | *702.7* | 5.0 | 5.2 | 3.9 | 3.8 | 3.7 |
| **23=7. Total expenditure** | TE[1] | *5260.2* | 37.7 | 38.6 | 37.7 | 39.9 | 40.7 |
| p.m.: Government consumption (nominal) | P.3 | *2532.7* | 18.1 | n.a. | n.a. | n.a. | n.a. |

[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 | 2006 | 2011 |
|---|---|---|---|
| 1. General public services | 1 | 7.6 | 5.7 |
| 2. Defence | 2 | 1.6 | 1.5 |
| 3. Public order and safety | 3 | 2.5 | 2.6 |
| 4. Economic affairs | 4 | 4.1 | 6.9 |
| 5. Environmental protection | 5 | 1.1 | 1.2 |
| 6. Housing and community amenities | 6 | 0.8 | 0.6 |
| 7. Health | 7 | 3.9 | 3.9 |
| 8. Recreation, culture and religion | 8 | 1.0 | 1.3 |
| 9. Education | 9 | 5.5 | 5.6 |
| 10. Social protection | 10 | 9.8 | 11.4 |
| 11. Total expenditure (=item 7=23 in Table 2) | TE[1] | 37.9 | 40.7 |

[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 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **1. Gross debt[1]** | | 9.5 | 19.4 | 32.4 | 45.4 | 47.3 |
| **2. Change in gross debt ratio** | | -1.1 | 9.8 | 13.1 | 13.0 | 1.9 |
| **Contributions to changes in gross debt** | | | | | | |
| **3. Primary balance[2]** | | 0.5 | -2.9 | -3.7 | -3.5 | -1.4 |
| **4. Interest expenditure[3]** | EDP D.41 | 0.5 | 0.6 | 1.5 | 1.5 | 1.6 |
| **5. Stock-flow adjustment** | | -1.1 | 6.4 | 7.9 | 8.0 | -1.1 |
| *of which:* | | | | | | |
| - Differences between cash and accruals[4] | | -0.3 | n.a. | n.a. | n.a. | n.a. |
| - Net accumulation of financial assets[5] | | 1.4 | n.a. | n.a. | n.a. | n.a. |
| *of which:* | | | | | | |
| *- privatisation proceeds* | | 0.1 | n.a. | n.a. | n.a. | n.a. |
| - Valuation effects and other[6] | | 0.0 | n.a. | n.a. | n.a. | n.a. |
| **p.m.: Implicit interest rate on debt[7]** | | 5.7 | 6.3 | 7.7 | 4.5 | 3.5 |
| **Other relevant variables** | | | | | | |
| 6. Liquid financial assets[8] | | 4.0 | n.a. | n.a. | n.a. | n.a. |
| 7. Net financial debt (7=1-6) | | 5.5 | n.a. | n.a. | n.a. | n.a. |

[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 | **2007** | **2008** | **2009** | **2010** | **2011** |
|---|---|---|---|---|---|---|
| **1. Real GDP growth (%)** | | 10.3 | -2.0 | -5.0 | -3.0 | 1.5 |
| **2. Net lending of general government** | EDP B.9 | 0.1 | -3.5 | -5.3 | -4.9 | -2.9 |
| **3. Interest expenditure** | EDP D.41 | 0.5 | 0.6 | 1.5 | 1.5 | 1.6 |
| **4. One-off and other temporary measures[1]** | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 5. Potential GDP growth (%) | | 7.9 | 5.0 | 3.6 | 3.3 | 3.0 |
| contributions: | | | | | | |
| - labour | | 2.3 | 1.6 | 1.6 | 1.7 | 1.4 |
| - capital | | 4.3 | 3.2 | 2.4 | 1.9 | 1.6 |
| - total factor productivity | | 1.2 | 0.1 | -0.4 | 0.3 | 0.0 |
| 6. Output gap | | 4.9 | -2.1 | -10.2 | -15.7 | -16.9 |
| 7. Cyclical budgetary component | | 1.4 | -0.6 | -2.8 | -4.4 | -4.7 |
| 8. Cyclically-adjusted balance (2 - 7) | | -1.3 | -2.9 | -2.5 | -0.5 | 1.8 |
| 9. Cyclically-adjusted primary balance (8 + 3) | | -0.8 | -2.3 | -1.0 | 1.0 | 3.4 |
| 10. Structural balance (8 - 4) | | -1.3 | -2.9 | -2.5 | -0.5 | 1.8 |

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

**Table 6. Divergence from previous update**

| | ESA Code | **2007** | **2008** | **2009** | **2010** | **2011** |
|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | |
| **Previous update** | | 10.5 | 7.5 | 7.0 | 6.8 | n.a. |
| **Current update** | | 10.3 | -2.0 | -5.0 | -3.0 | 1.5 |
| **Difference** | | -0.2 | -9.5 | -12.0 | -9.8 | n.a. |
| **General government net lending (% of GDP)** | EDP B.9 | | | | | |
| **Previous update** | | 0.3 | 0.7 | 1.0 | 1.2 | - |
| **Current update** | | 0.1 | -3.5 | -5.3 | -4.9 | -2.9 |
| **Difference** | | -0.2 | -4.2 | -6.3 | -6.1 | - |
| **General government gross debt (% of GDP)** | | | | | | |
| **Previous update** | | 9.4 | 8.3 | 7.2 | 6.4 | n.a. |
| **Current update** | | 9.5 | 19.4 | 32.4 | 45.4 | 47.3 |
| **Difference** | | 0.1 | 11.1 | 25.2 | 39.0 | n.a. |

**Table 7. Long-term sustainability of public finances**

| % of GDP | 2000 | 2004 | 2010 | 2020 | 2030 | 2050 |
|---|---|---|---|---|---|---|
| Total expenditure | n.a. | 35.6 | 39.9 | 40.9 | 42.3 | 42.5 |
| Of which: age-related expenditures | n.a. | 17.2 | 13.8 | 13.8 | 15.1 | 15.3 |
| Pension expenditure | n.a. | 6.8 | 4.9 | 4.9 | 5.6 | 5.6 |
| Social security pension | n.a. | 6.8 | 4.9 | 4.9 | 5.6 | 5.6 |
| Old-age and early pensions | n.a. | 5.7 | 4.3 | 4.3 | 4.9 | 4.9 |
| Other pensions (disability, survivors) | n.a. | 1.1 | 0.6 | 0.6 | 0.7 | 0.6 |
| Occupational pensions (if in general government) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Health care | n.a. | 5.1 | 5.3 | 5.4 | 5.5 | 5.9 |
| Long-term care *(this was earlier included in the health care)* | n.a. | 0.4 | 0.4 | 0.4 | 0.4 | 0.5 |
| Education expenditure | n.a. | 4.6 | 3.3 | 3.1 | 3.5 | 3.3 |
| Other age-related expenditures | n.a. | 0.33 | 0.3 | 0.2 | 0.2 | 0.2 |
| Interest expenditure | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Total revenue | n.a. | 35.2 | 35.0 | 39.4 | 39.2 | 39.2 |
| Of which: property income | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Of which* : from pensions contributions (or social contributions if appropriate) | n.a. | 7.1 | 6.1 | 5.6 | 5.4 | 5.4 |
| Pension reserve fund assets | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Of which* : consolidated public pension fund assets (assets other than government liabilities) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Assumptions** | | | | | | |
| Labour productivity growth | n.a. | 6.4 | 6.5 | 4.0 | 2.7 | 1.1 |
| Real GDP growth | n.a. | 7.5 | 7.4 | 2.9 | 2.1 | 0.4 |
| Participation rate males (aged 20-64) | n.a. | 83.4 | 87.6 | 89.6 | 89.5 | 87.6 |
| Participation rates females (aged 20-64) | n.a. | 71.9 | 76.2 | 79.0 | 79.8 | 76.6 |
| Total participation rates (aged 20-64) | n.a. | 77.4 | 81.7 | 84.1 | 84.5 | 82.0 |
| Unemployment rate | n.a. | 9.8 | 7.6 | 7.0 | 7.0 | 7.0 |
| Population aged 65+ over total population | n.a. | 16.2 | 17.4 | 18.4 | 21.3 | 26.1 |

**Table 8. Basic assumptions**

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Short-term interest rate[1] (annual average)** | 8.6 | 8.2 | 8.5 | 7.0 | 6.0 |
| **Long-term interest rate (annual average)** | 5.3 | 6.3 | 6.5 | 6.0 | 5.0 |
| **USD/€ exchange rate (annual average) (euro area and ERM II countries)** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Nominal effective exchange rate** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **World excluding EU, GDP growth** | 5.6 | 3.7 | 2.2 | 2.8 | 3.3 |
| **EU GDP growth** | 2.9 | 1.5 | -0.2 | 0.6 | 1.2 |
| **Growth of relevant foreign markets** | 7.3 | 4.1 | 1.2 | 2.1 | 3.5 |
| **World import volumes, excluding EU** | 7.2 | 1.8 | -0.1 | 1.4 | 2.8 |
| **Oil prices (Brent, USD/barrel)** | 72.5 | 104.0 | 60.7 | 68.4 | 70.4 |

[1]If necessary, purely technical assumptions.

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