EN

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
SEC(2009) 192 final

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Latvia, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Latvia, submitted on 14 January 2009, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");

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

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. . In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows: "The overall conclusion is that the programme aims to reduce economic imbalances and excessive demand pressure by setting slightly increasing but overall modest surplus target 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." In view of the above assessment Latvia was invited to contribute to reducing overheating pressures and risks to macroeconomic instability by (i) "aiming for significantly more ambitious budgetary targets in 2008 and beyond than foreseen in the programme, notably by fully saving any revenue overperformance and respecting the expenditure ceilings"; (ii) "within the overall public sector expenditure limits set within the medium-term budget planning framework, 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" and (iii) "adopt further policies to contain inflationary pressures, including through a responsible public sector wage-setting, thus contributing to the sharp reduction in whole-economy wage growth necessary to break the current cost-price dynamics and rapidly worsening cost competitiveness".

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Latvia, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 March 2009] the Council examined the updated convergence programme of Latvia, which covers the period 2008 to 2011.

(2) 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 tradeables sector to 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 further tightening credit availability and conditions, reinforcing the steep decline of domestic demand over the course of 2008. In the context of the exchange rate peg, monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate. The concomitant downturn on export markets has hit the relatively small tradables sector, already weakened by extremely large domestic cost increases over the previous years. Reflecting the rapid economic

[3] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

downturn, budget revenues sharply deteriorated in 2008, entailing an estimated 4 percentage point of GDP impact on the budget balance. As market sentiment increasingly turned against emerging markets, funding constraints led to the government's decision to turn to international institutional financing. Subject to the implementation of an agreed policy programme, Latvia has been granted very substantial international financial assistance from the EU, IMF and other lenders (in total, up to EUR 7.5 billion over the period to the first quarter of 2011)[4]. In line with the commitments made to the providers of international assistance, Latvia's fiscal policy is geared towards supporting the adjustment needed in view of the country's high imbalances.

(3) The macroeconomic scenario underlying the programme envisages that real GDP, after an estimated fall of 2% in 2008, will contract by 5% in 2009 and a further 3% in 2010, before a very weak recovery to a growth rate of 1.5% in 2011. Assessed against currently available information[5], the macroeconomic scenario is based on favourable growth assumptions in 2009, but thereafter the demand and output scenario is plausible. The programme's projections for inflation appear realistic. Net external borrowing projections of the programme are slightly cautious, but appear consistent with the programme's outlook for demand and output.

(4) For 2008, the general government deficit is estimated at 3.5% of GDP in the Commission services' January 2009 interim forecast, against a target of a surplus of 0.7% of GDP set in the previous update of the convergence programme[6]. This significantly worse-than-expected outturn reflects essentially a considerable tax shortfall. Tax payments of businesses and private individuals declined towards the end of the year, due to acute liquidity problems in the economy.

(5) On 12 December 2008, the Latvian Parliament adopted an amended budget for 2009, which was in line with the conditionality of the EU balance of payments assistance and with the requirements of other international lenders. The main measures include VAT and excise taxes increases and a significant cut in total expenditures, notably public sector wages, relative to the original 2009 budget adopted on 14 November 2008. This will be followed by a detailed supplementary budget by the end of March 2009 and by action on the local government level to revise their budgets, in order to achieve the 2009 general government deficit target. Automatic stabilisers have a generally small impact in Latvia, but during the current recession tax receipts are particularly affected.

(6) The main goal of the medium-term budgetary strategy in the programme is to reduce the government deficit in 2011 to below the Maastricht treaty budget deficit reference value of 3% of GDP, in order to achieve a successful transition to euro adoption. The latest programme update does not envisage achieving the medium-term objective (MTO), set as a structural deficit of 1% of GDP, during the programme period. The headline deficit is projected to improve from 5.3% of GDP in 2009 to 4.9% of GDP in 2010 and to 2.9% of GDP in 2011. This consolidation is to be achieved by increasing

---

4 See Council decision 5255/09.

5 The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then. .

6 The programme update estimates the deficit outcome for 2008 at 3.5% of GDP. In view of this, the Commission prepared a report under Article 104(3) of the Treaty.

revenue from 32.5% of GDP in 2009 to 37.7% of GDP in 2011, supported by significant increases in indirect tax revenues to GDP in 2011 and large increases in other revenue ratios in 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. General government gross debt stood at 19.4% of GDP in 2008, well below the 60% of GDP reference value, but on a growing trend. The debt projections for 2009-2010 assume full drawdown of the international financial assistance, as scheduled by the involved parties.

(7) The budgetary outcomes in the programme are subject to downside risks. This concerns all programme years: in 2009 the chief risk is that GDP could be lower than projected in the programme. The amended budget will be detailed in proposals due to be presented to Parliament by end-March. In 2010 and 2011 the planned fiscal consolidation is not underpinned by detailed measures. Furthermore, financial sector stabilization operations might become necessary over the programme horizon with a potentially significant impact on public finances.

(8) 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 the medium-risks to the sustainability of public finances and would be important to improve the market view on Latvia. Measures to support financial sector stabilisation in Latvia could have a negative impact on the long-term sustainability of public finances, primarily via their impact on government debt.

(9) The fiscal outturns posted by Latvia over the past few years can partly be explained by the institutional weaknesses of its fiscal framework. In the context of the 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. Moreover, 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 a comprehensive public financial management review.

(10) 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.

(11) In line with the European Economic Recovery Plan agreed in December 2008 by the European Council, Latvia, as a country facing significant external and internal imbalances, has aimed its budgetary policy at correcting such imbalances. Taking into account the absence of scope for fiscal manoeuvre and the need to correct economic imbalances, the planned restrictive fiscal stance from 2009 until 2011 appears to be an

adequate response to the economic situation. Specific measures have been taken to support the adjustment process in the tradable sector of economy. A significant cut in public sector wages, which should contribute to overall wage adjustment and to correcting external imbalances, has been implemented. 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.

(12) 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. According to the convergence programme, the fiscal stance as measured by the change in the structural balance is estimated to be mildly restrictive in 2009 and restrictive thereafter. Considering the absence of space for fiscal manoeuvre and the need to correct economic imbalances, this appears appropriate, although the fiscal stance in 2009 could be more restrictive if needed to reach the targeted headline deficit. In the context of Latvia's ERM II membership and the need to improve the economy's cost competitiveness, the authorities have facilitated the alignment of private sector wages with productivity by reducing public sector compensation levels and are also reducing public employee headcounts. The budgetary scenario in the programme appears to be consistent, though subject to risks, with the commitments made in the context of EU balance-of-payments assistance of bringing the deficit under 3% by 2011. However, the programme does not provide sufficiently detailed information on the measures needed to achieve the targeted figures in 2010 and 2011.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all compulsory and most of the optional data[7].

The overall conclusion is that Latvia is currently in a severe economic downturn following years of above-potential economic growth. The global financial crisis has amplified the shock of the reversal of Latvia's own lending and house price boom by tightening credit availability and conditions, reinforcing the steep decline of domestic demand over the course of 2008. The concomitant downturn on export markets has hit the relatively small tradeables sector, already weakened by huge domestic cost increases over the previous years. The headline deficit exceeded the 3% of GDP Maastricht reference value in 2008. This was the result of having followed expansionary fiscal policy during the years of above potential growth and of the very sharp slowdown in 2008. The programme targets general government deficits of around 5% of GDP in 2009 and 2010 and below 3% in 2011. Taking into account risks of lower demand and output in 2009 and lack of information underpinning the revenue-based consolidation in 2010 and 2011, the budgetary outcome could be worse than projected in the programme. Taking into account the absence of scope for fiscal manoeuvre and the need to

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

correct economic imbalances, the planned restrictive fiscal stance from 2009 until 2011 appears to be an adequate response to the economic situation.

In view of the above assessment, the commitments made in the framework of international financial assistance, and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Latvia is invited to:

(i) submit to Parliament by the end of March 2009 the details of the supplementary budget adopted on 12 December 2008; take further measures if needed to achieve the targeted general government deficit in 2009 and continue the targeted fiscal consolidation thereafter;

(ii) rigorously implement public sector nominal wage reductions to facilitate the alignment of whole-economy wages with productivity, thereby improving cost competitiveness;

(iii) strengthen fiscal governance and transparency, by improving the medium-term budgetary framework and reinforcing Ministry of Finance spending controls, and strengthen financial market regulation and supervision;

(iv) strengthen the supply side of the economy by wide-ranging structural reforms and by making efficient use of available EU structural funds.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**CP Jan 2009**	**10.3**	**-2.0**	**-5.0**	**-3.0**	**1.5**
	COM Jan 2009	10.3	-2.3	-6.9	-2.4	n.a.
	CP Nov 2007	*10.5*	*7.5*	*7.0*	*6.8*	*n.a.*
HICP inflation (%)	**CP Jan 2009**	**10.1**	**15.4**	**5.9**	**2.2**	**1.3**
	COM Jan 2009	10.1	15.3	6.8	2.4	n.a.
	CP Nov 2007	*10.1*	*12.5*	*7.2*	*4.9*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2009**	**12.2**	**5.9**	**-1.6**	**-5.7**	**-5.3**
	COM Jan 2009[2]	13.2	7.0	-1.8	-4.7	n.a.
	CP Nov 2007	*2.8*	*1.3*	*-0.3*	*-1.7*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2009**	**-21.8**	**-13.4**	**-5.4**	**-2.6**	**-2.3**
	COM Jan 2009	-20.8	-13.0	-4.6	-3.4	n.a.
	CP Nov 2007	*-23.5*	*-20.3*	*-18.3*	*-16.4*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2009**	**37.7**	**35.1**	**32.5**	**35.0**	**37.7**
	COM Jan 2009	37.6	36.0	34.1	34.7	n.a.
	CP Nov 2007	*37.3*	*37.4*	*37.7*	*37.9*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2009**	**37.7**	**38.6**	**37.7**	**39.9**	**40.7**
	COM Jan 2009	37.6	39.5	40.4	42.1	n.a.
	CP Nov 2007	*37.0*	*36.8*	*36.7*	*36.7*	*n.a.*
General government balance (% of GDP)	**CP Jan 2009**	**0.1**	**-3.5**	**-5.3**	**-4.9**	**-2.9**
	COM Jan 2009	0.1	-3.5	-6.3	-7.4	n.a.
	CP Nov 2007	*0.3*	*0.7*	*1.0*	*1.2*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2009**	**0.5**	**-2.9**	**-3.7**	**-3.5**	**-1.4**
	COM Jan 2009	0.6	-2.9	-5.1	-5.5	n.a.
	CP Nov 2007	*0.7*	*1.0*	*1.2*	*1.5*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2009**	**-3.3**	**-5.1**	**-4.9**	**-3.3**	**-1.4**
	COM Jan 2009	-3.6	-5.4	-5.8	-6.1	n.a.
	CP Nov 2007	*-0.5*	*0.4*	*1.1*	*1.7*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2009**	**-3.3**	**-5.1**	**-4.9**	**-3.3**	**-1.4**
	COM Jan 2009	-3.6	-5.4	-5.8	-6.1	n.a.
	CP Nov 2007	*-0.5*	*0.4*	*1.1*	*1.7*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2009**	**9.5**	**19.4**	**32.4**	**45.4**	**47.3**
	COM Jan 2009	9.5	16.0	30.4	42.9	n.a.
	CP Nov 2007	*9.4*	*8.3*	*7.2*	*6.4*	*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 5.5%, 3.4%, 1.4% and 0.5% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in the most recent programme or in the Commission services' January interim forecast.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.