EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 07.04.2010
Ares(2010)149006

LATVIA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE JANUARY 2010 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called ‘stability programme’ for countries that have adopted the euro as their currency and ‘convergence programme’ for those that have not. The most recent update of Latvia’s convergence programme was submitted on 29 January 2010.

The attached technical analysis of the programme prepared by the staff and under the responsibility of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 24 March 2010. Comments should be sent to Balazs Forgo (balazs.forgo@ec.europa.eu) or Julien Rousselon (julien.rousselon@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services’ autumn 2009 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 10 November 2009) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

Based on this analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 24 March 2010. The ECOFIN Council is expected to discuss the opinion on the programme on 16 April 2010.

* * *

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/sgp/index_en.htm

TABLE OF CONTENTS

1. INTRODUCTION

This document assesses the January 2010 update of the Latvia's convergence programme, which was submitted on 29 January 2010[1] and covers the period 2009-2012. The programme is based on the State budget law for 2010 adopted by the Parliament on 1 December 2009 and the government's Economic Stabilisation and Growth Revival Programme adopted in December 2008 in the context of Latvia's request for international financial assistance.

This assessment is structured as follows. Section 2 discusses the key challenges for public finances in Latvia. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts[2]. Section 4 analyses budgetary implementation in 2009, the budgetary plans for 2010 and the medium-term budgetary strategy. It also assesses risks attached to the budgetary targets. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses institutional features of public finances. Section 7 assesses the smooth participation in ERMII. Finally, Section 8 concludes with an overall assessment of the programme. The annex provides a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme.

[1] The English version of the programme was submitted on 24 February 2010.

[2] This assessment uses the Commission services' 2009 autumn forecast, as published on 3 November 2009, as a benchmark. However, more recent information that has become available has also been taken into account to assess the risks to the programme scenarios. In the case of Latvia the autumn forecasts were not including the fiscal impact of the 2010 budget, which entails large differences.

Table 1. Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	**CP Jan 2010**	**-4.6**	**-18.0**	**-4.0**	**2.0**	**3.8**
	COM Nov 2009	-4.6	-18.0	-4.0	2.0	n.a.
	CP Jan 2009	*-2.0*	*-5.0*	*-3.0*	*1.5*	*n.a.*
HICP inflation (%)	**CP Jan 2010**	**15.4**	**3.5**	**-3.7**	**-2.8**	**0.0**
	COM Nov 2009	15.3	3.5	-3.7	-1.2	n.a.
	CP Jan 2009	*15.4*	*5.9*	*2.2*	*1.3*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2010**	**9.5**	**-8.8**	**-10.7**	**-7.8**	**-3.8**
	COM Nov 2009[2]	9.2	-9.1	-10.7	-7.0	n.a.
	CP Jan 2009	*5.9*	*-1.6*	*-5.7*	*-5.3*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2010**	**-10.8**	**8.2**	**10.7**	**10.4**	**8.0**
	COM Nov 2009	-11.5	8.9	8.0	6.1	n.a.
	CP Jan 2009	*-13.4*	*-5.4*	*-2.6*	*-2.3*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2010**	**34.7**	**33.8**	**36.2**	**38.6**	**39.4**
	COM Nov 2009	34.6	34.9	33.4	32.9	n.a.
	CP Jan 2009	*35.1*	*32.5*	*35.0*	*37.7*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2010**	**38.8**	**43.8**	**44.7**	**44.6**	**42.4**
	COM Nov 2009	38.8	43.8	45.7	45.1	n.a.
	CP Jan 2009	*38.6*	*37.7*	*39.9*	*40.7*	*n.a.*
General government balance (% of GDP)	**CP Jan 2010**	**-4.1**	**-10.0**	**-8.5**	**-6.0**	**-2.9**
	COM Nov 2009	-4.1	-9.0	-12.3	-12.2	n.a.
	CP Jan 2009	*-3.5*	*-5.3*	*-4.9*	*-2.9*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2010**	**-3.4**	**-8.7**	**-6.1**	**-2.7**	**0.3**
	COM Nov 2009	-3.4	-7.6	-9.9	-8.3	n.a.
	CP Jan 2009	*-2.9*	*-3.7*	*-3.5*	*-1.4*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2010**	**-6.7**	**-7.6**	**-5.5**	**-3.9**	**-1.8**
	COM Nov 2009	-6.7	-6.4	-9.3	-10.2	n.a.
	CP Jan 2009	*-5.1*	*-4.9*	*-3.3*	*-1.4*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2010**	**-6.7**	**-7.6**	**-5.5**	**-3.9**	**-1.8**
	COM Nov 2009	-6.7	-7.0	-10.2	-10.2	n.a.
	CP Jan 2009	*-5.1*	*-4.9*	*-3.3*	*-1.4*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2010**	**19.5**	**34.8**	**55.1**	**59.1**	**56.8**
	COM Nov 2009	19.5	33.2	48.6	60.4	n.a.
	CP Jan 2009	*19.4*	*32.4*	*45.4*	*47.3*	*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 1.6%, -1.4%, -2.3% and -2.1% respectively in the period 2008-2011

[3]Cyclically-adjusted balance excluding one-off and other temporary measures.

Source :
Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations

2. KEY CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

This section describes recent economic and budgetary developments for Latvia, which form the background against which the current programme assessment should be viewed, and outlines the key challenges to be addressed by future economic policies.

From the turn of the century, Latvia entered a sustained period of high growth, 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 and a number of measures was applied by the government (the so called Anti-inflation plan) in order to curb inflation and stabilise economy. During these years, the rapid increase in domestic demand created serious overheating pressures and the structure of the economy shifted from the tradable sector to non-tradables, undermining the external sustainability of the economy. The global financial crisis amplified the shock of the reversal of Latvia's domestic lending and house price boom by tightening credit availability and conditions. The concomitant downturn in external markets, including Latvia's main trading partners (Lithuania, Estonia, Russia and other EU countries), hit the tradables sector. The depreciation of the currencies of certain principal trading partners added to the competitiveness losses of 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 Banka).

The confrontation with 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]. The agreement of December 2008 on multilateral financial assistance of up to €7.5bn is conditional on major fiscal consolidation as well as financial system and structural reforms, as also outlined in the "Economic Stabilisation and Growth Revival Programme" adopted by the authorities in December 2008. Subsequently, following a much larger than expected deterioration in economic and budgetary conditions in the first half of 2009, the government proposed additional measures for 2009 targeting a reduction in the general government deficit to under 3% of GDP by 2012. An avowed objective of the June 2009 decisions has been to pave the way for extensive structural reforms in the public sector, notably as regards education and healthcare, to underpin a return to sustainable public finances and competitive economic structure in the medium term.

Towards the second half of 2009, the export-oriented part of the economy stabilised and started to show some early signs of a recovery. However, the fall of domestic demand remained very severe, due mainly to a sharp deterioration on the labour market. Credit growth in the private sector turned negative in November 2008 and has remained so. The deleveraging process was exacerbated by the impact of credit rating agency downgrades, deepening the downturn on the property market and causing financing difficulties even for firms with viable business models. However, the large disbursements of international financial assistance, the rigorous implementation of the 2009 budget and the successful preparation of the 2010 budget with the necessary amount of further fiscal consolidation measures helped to stabilise confidence and improved market sentiment towards Latvia. The external account balance, substantially negative in the boom years and financed by capital imports associated with the banking sector, leading to a rapid increase in net external liabilities, reached in 2009 an estimated surplus of over 8% of GDP, and is set to remain in significant surplus over the programme period.

The main challenge for economic policy remains economic stabilisation and a return to a well-founded catching-up process. Economic stabilisation in Latvia depends to a great extent on anchoring long-term expectations for which the implementation of the planned fiscal consolidation path is crucial. However, economic stabilisation also hinges directly on taking structurally-sound and socially equitable fiscal measures and also on progress in restructuring the economy towards the tradable sector. In view of the significant

[3] The financing package of up to EUR 7.5bn 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 end-2011, in a front-loaded manner.

deterioration in external competitiveness during the boom years, there is probably still some further need for domestic price adjustment and productivity improvement. Efficient use of EU structural funds should contribute to the strengthening of the tradeables sector and cushion the recession. Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Therefore, it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth in the areas of budgetary and public sector management and to raise skill levels as part of the effort to raise productivity.

The above-mentioned developments led the Council to adopt on 7 July 2009 a decision that Latvia had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2012 (for more details regarding this procedure, see box 1 in paragraph 4.1).

3. MACROECONOMIC OUTLOOK

Against the background of the current macroeconomic situation and the main policy challenges set out in the previous section, this section makes an assessment of the plausibility of the macroeconomic scenario underpinning the public finance projections of the programme.

The central macroeconomic scenario of the programme is almost fully in line with the Commission Services' autumn forecast[4] and corresponds to the scenario that underpinned the planning of the 2010 budget. The rate and composition of real GDP growth is practically the same as the one of the Commission Services' autumn forecast. After an estimated 18% real fall in output in 2009, real GDP is expected to decrease by 4% in 2010 and to grow by 2% in 2011 and 3.8% in 2012. In view of more recent information since the autumn forecast[5] the growth projection of the programme for 2011 might appear somewhat cautious, but not significantly so relative to the level of uncertainty regarding Latvia's short-term growth prospects. On the other hand, in comparison to the potential growth estimates of the autumn forecast, the 2012 growth projection appears somewhat favourable, although close to other post-crisis potential growth estimates for Latvia[6].

Domestic demand is projected to contract further in 2010, although the large negative annual figures for private consumption and GFCF growth reflect to a large extent the carry-over effect of 2009. However, domestic demand is still expected to fall, reflecting the decline in the purchasing power of households, tightened credit conditions and the impact of fiscal consolidation. A further hit will come to the euro-indebted private sector

4 Accordingly, the external outlook behind the programme’s macroeconomic scenario is practically identical with the external outlook in the Commission services’ autumn 2009 forecast

5 In the context of the December 2009 review of Latvia's balance of payments assistance, the GDP growth projection for 2011 was raised to 2.7%, but GDP projections of other years were left unchanged.

6 Cf. Cross-country study: Economic policy challenges in the Baltics: http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp58_en.pdf

once the ECB starts to raise euro area policy rates. On the other hand, progress with fiscal consolidation is to support the restoration of confidence towards the Latvian economy. Net exports are expected by the programme to keep a positive contribution to growth that would pull out the country from recession in the second half of 2010. Benefitting from the gradual correction in external competitiveness, investments are expected to contribute to growth positively over the medium-term.

The output gaps[7] of the programme, as recalculated by Commission services based on the information in the programme following the commonly agreed methodology indicate the severe downturn in the economy[8]. The output gap is to remain negative throughout the whole programme period. This promotes a deflationary process, with high unemployment and a large external surplus. In view of more recent information since the autumn forecast, the programme's employment and unemployment projections appear to be somewhat on the optimistic side. The net external lending projections appear also somewhat optimistic, given that a large part of the surplus is related to losses on FDI in the financial sector and to the trade surplus that could deteriorate more quickly once the economy emerges from the recession. On the other hand, the inflation projections of the programme appear somewhat on the low side for 2011, as imports and administered prices are likely to create some upward pressure on consumer prices. The envisaged nominal unit labour cost adjustment should serve to shift the economy towards the tradable sector.

Monetary and exchange rate assumptions of the programme are consistent with the macroeconomic scenario and the projected interest rate conditions seem to be in line with possible euro adoption in 2014.

Overall, the programme's macroeconomic assumptions appear plausible. However, in view of the high uncertainty related to the severe recession in Latvia – and the strength of the global recovery –, the macroeconomic scenario of the programme is subject to considerable risks in both directions.

7 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. The steep turnaround in the cycle adds further uncertainty to these estimates.

8 For Latvia, there is a significant difference between the output gap reported in the programme and the (recalculated) output gap on the basis of the programme information with the main deviation coming from the contribution of labour.

Table 2: Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	-18.0	-18.0	-4.0	-4.0	2.0	2.0	3.8
Private consumption (% change)	-22.0	-22.0	-11.0	-11.0	0.5	0.5	3.1
Gross fixed capital formation (% change)	-34.0	-34.0	-12.0	-12.0	3.0	3.0	7.0
Exports of goods and services (% change)	-17.5	-17.5	1.5	1.5	5.0	5.0	5.6
Imports of goods and services (% change)	-35.0	-35.0	-9.7	-9.7	2.6	2.6	5.2
Contributions to real GDP growth:							
- Final domestic demand	-27.9	-27.3	-12.3	-11.9	0.4	0.4	3.6
- Change in inventories	-3.4	-4.0	3.0	2.6	0.5	0.5	-0.1
- Net exports	13.3	13.3	5.3	5.2	1.1	1.2	0.3
Output gap[1]	-9.1	-8.8	-10.7	-10.7	-7.0	-7.8	-3.8
Employment (% change)	-11.9	-11.3	-5.6	-5.6	-0.2	-0.2	1.1
Unemployment rate (%)	16.9	16.9	19.9	20.0	18.7	18.9	17.5
Labour productivity (% change)	-6.9	-5.7	1.7	2.1	2.2	2.2	2.7
HICP inflation (%)	3.5	3.5	-3.7	-3.7	-1.2	-2.8	0.0
GDP deflator (% change)	-2.1	-2.1	-5.0	-5.0	-1.3	-2.2	0.4
Comp. of employees (per head, % change)	-12.0	-5.0	-8.0	-9.8	1.0	-0.2	2.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	8.9	8.2	8.0	10.7	6.1	10.4	8.0

Note:

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

Source:

Commission services' autumn 2009 forecasts (COM); Convergence programme (CP).

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first three parts discuss the budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy in the programme. The final part analyses the risks attached to the budgetary targets.

4.1. Budgetary implementation in 2009

Table 3 compares the projected outcome for the general government balance, revenue and expenditure (as a percentage of GDP) in 2009 as presented in the new convergence programme with the targets from the previous update of the programme. Differences between outcome and targets (excluding the impact of an unanticipated GDP developments which may have affected the ratio, referred to as the 'denominator effect') are decomposed into the impact of a different starting position (i.e. the outcome of 2008 may also have been different from that anticipated in the previous programme update) and the impact of differences in the revenue / expenditure growth rate from the planned growth rates[9].

[9] Mathematically, the difference in the revenue ratio in Table 3 can be expressed as:

$$\rho^o - \rho^p = \underbrace{\frac{1+r^p}{1+g^p}\Delta\rho_{-1}}_{\text{Base effect}} + \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta r}_{\text{Revenue growth effect}} - \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta g}_{\text{Denominator effect}} + \underbrace{\frac{\rho^o_{-1}(r^o g^p - r^p g^o)}{(1+g^o)(1+g^p)}}_{\text{Residual}}$$

where r is the growth rate of revenue and g is the growth rate of GDP. The subscript -1 refers to the previous year's value. Superscripts o and p refer to the outcome and the planned value respectively. Similar for the expenditure ratio.

The heavy toll the global crisis took on Latvian public finances explains why the estimated outturn of a general government deficit of 10.0% of GDP is so far from the original official target of the January 2009 convergence programme for a deficit of 5.3%: the starting position had already deteriorated by 0.6%, and the negative surprise amounts to 3.8% (excluding the denominator effect). The estimated deficit is higher than the Commission services' autumn forecast of 9.0%, given a recent decision of the Constitutional Court, which established on 21 December 2009 that pension cuts introduced and implemented in 2009 have to be fully reversed, hence imposing a 0.6% additional liability towards pensioners in ESA terms. The unexpected extent of the downturn led international lenders to agree with the Latvian authorities on a new fiscal path in June 2009 (cf. supplemental memorandum of understanding issued in July 2009).

The negative surprise is sizeable on the revenue side (-6.8% of GDP excluding the denominator effect) reflecting the rapid erosion of tax bases by the economic downturn (e.g., slump of retail trade hitting value-added tax), hence tax revenues collapsed in nominal terms by one quarter compared to 2008, despite some hikes in rates (for VAT and excises) at the beginning of 2009. The positive surprise on the expenditure side (+2.9% of GDP excluding the denominator effect) is due to discretionary steps taken, namely through the supplementary budget adopted on 16 June 2009, consisting in consolidation measures amounting to 4.4% of GDP almost fully on the expenditure side. The amount of the positive surprise is smaller than the corresponding discretionary effort, given that consolidation measures were partly offset by additional spending for various allowances and benefits around 1% of GDP in comparison with 2008. This is the only automatic stabiliser which could be used, against the backdrop of the agreement with the international lenders on a 2009 deficit ceiling of no more than 10% in ESA terms. The restrictive stance on the expenditure side, though inducing significant savings, was consequently far from sufficient to offset the consequences of the economic crisis on the revenue side. The slippage is particularly obvious for central government. The slippage is somewhat smaller for social security funds and local governments.

Table 3: Budgetary implementation in 2009

	2008		2009	
	Planned	Outcome	Planned	Outcome
	CP Jan 2009	CP Jan 2010	CP Jan 2009	CP Jan 2010
Government balance (% of GDP)	-3.5	-4.1	-5.3	-10.0
Difference compared to target [1]	-0.6		-4.7	
Difference excluding denominator effect [1,2]			**-3.8**	
Of which : due to a different starting position end 2008			-0.6	
due to different revenue / expenditure growth in 2009			-2.9	
p.m. Residual [3]			-0.3	
p.m. Nominal GDP growth (planned and outcome)			*-1.2*	*-19.7*
Revenue (% of GDP)	35.1	34.7	32.5	33.8
Revenue surprise compared to target [1]	-0.4		1.3	
Revenue surprise excluding denominator effect [1,2]			**-6.8**	
Of which : due to a different starting position end 2008			-0.4	
due to different revenue growth in 2009			-5.8	
p.m. Residual [3]			-0.6	
p.m. Revenue growth rate (planned and outcome)			*-8.5*	*-21.8*
Expenditure (% of GDP)	38.6	38.8	37.7	43.8
Expenditure surprise compared to target [1]	-0.2		-6.1	
Expenditure surprise excluding denominator effect [1,2]			**2.9**	
Of which : due to different starting position end 2008			-0.2	
due to different expenditure growth rate in 2009			2.9	
p.m. Residual [3]			0.3	
p.m. Expenditure growth rate (planned and outcome)			-3.5	-9.4

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 and expenditure separately, on the balance they usually largely cancel against each other.

[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

Box 1: The excessive deficit procedure (EDP) for Latvia

On 7 July 2009 the Council adopted a decision stating that Latvia had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2012. In particular, Latvia was recommended to fully implement the consolidation in 2009 as planned in the supplementary budget to reach a general government deficit below 10% of GDP in compliance with the commitments undertaken under the balance of payments programme[10], to adopt a 2010 budget with high-quality consolidation measures consistent with the agreed path for the correction of the excessive deficit (implying an average annual fiscal effort of at least 2¾% of GDP over the period 2010-2012), to broadly outline measures envisaged for 2011 and 2012, and to strengthen fiscal governance and transparency by improving the budgetary framework. Latvia was also recommended to report on the progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programme prepared in the period prior to the abrogation of the excessive deficit procedure. On 27 January 2010 the Commission communicated to the Council that the Commission considers that no further steps in the excessive deficit procedure are needed at present.

[10] Cf. section 2 where the balance of payments programme was already discussed.

4.2. The programme's budgetary strategy for 2010

Table 4. Main budgetary measures for 2010

Revenue measures[1]	Expenditure measures[2]
Increase of general personal income tax (PIT) rate to 26% (0.8% of GDP) Taxation of fringe benefit from using employer's car for personal needs (0.3% of GDP, out of which: 0.1 PIT / 0.2 social contributions) Broadening of PIT base including all capital income, dividends and interests (0.2% of GDP) Annual fee for cars and motorcycles (0.2% of GDP) Taxation of employer's gifts by elimination of exemption (0.2% of GDP, out of which: 0.1 PIT/0.1 social contributions) Increase of tax rate for land and commercial buildings from 1% to 1.5% (0.1% of GDP) Other PIT measures (0.1% of GDP) Broadening of real estate tax base to residential property (0.1% of GDP) Other real estate tax measures (0.1% of GDP) Excise tax: minimum duty level for cigarettes, increase of duty on alcoholic beverages, taxation of natural gas (0.1% of GDP)	Cuts in the wage bill of local governments (-0.4% of GDP) Cuts in road maintenance spending (Ministry of Transport) (-0.3% of GDP) Cuts in subsidies to public transport companies (Ministry of Transport) (-0.2% of GDP) Reorganisation of contracts and functioning of Ministry of Defence (-0.2% of GDP) Reduction of social benefits (sickness, unemployment, maternity and paternity allowances) for higher income recipients (-0.2% of GDP) Savings in Ministry of Culture: reduction of museum opening hours, decrease of capital spending (National Library…), reduction of opera and theatre performances (-0.2% of GDP) Ministry of Education: various cuts (-0.2% of GDP) Ministry of Agriculture: various cuts (-0.1% of GDP) Cuts in other institutions, mostly on maintenance budgets (-0.2% of GDP)

Notes:

[1] Estimated impact on general government revenue
[2] Estimated impact on general government expenditure

Source: Commission services (given the ongoing balance of payments assistance to Latvia, the valuations above were thoroughly discussed with the national authorities and other international lenders ahead of the budget adoption, and there are no significant changes to the initial plans so far)

The State budget for 2010 was adopted by Parliament on December 1, 2009. To ensure its compliance with the deficit targets set in the framework of balance of payments assistance and excessive deficit procedure (EDP), fiscal consolidation measures amounting to roughly 500 million LVL (over 4.2% of GDP) were undertaken, with one-off measures play a negligible role in the adjustment. The consolidation is distributed fairly evenly between expenditure (2.0% of GDP) and revenue (2.2% of GDP). The fiscal effort on the revenue side explains the substantial increase expected for the revenue ratio (+2.4% of GDP), while the significant denominator effect is almost directly offset by the corresponding erosion of tax bases. However, the denominator effect further increases the expenditure ratio (+0.9% of GDP) despite the corresponding consolidation measures, also due to the increase of interest expenditure by 1.1% of GDP. The *primary* expenditure ratio would consequently start decreasing in 2010, although by only 0.2% of GDP.

Among the revenue measures are important reforms that make the personal income tax and social security contribution systems more neutral, including the broadening of the tax base to capital income (capital gains, dividends, and interests), the removal of special exemptions in tourism and agricultural activities, the taxation of fringe benefits-in-kind and gifts (excluding intra-family gifts), and the increase of the self-employed tax rate to the same level as for employees. These measures amount to almost 100 million LVL. In addition, an increase in the personal income tax rate from 23% to 26% should raise 95 million LVL.

Taxation of wealth has been increased through real estate taxes and, notably, broadening their base to include residential property (with some progressivity). However, other real estate tax measures have been taken, including increasing from 1% to 1.5% the rate applying to land and business real estate, broadening the tax base to include private-owned civil engineering structures, and increasing the rate to 3% for uncultivated agricultural lands. The government also introduced additional progressive car taxation measures (based on the stock of cars) expected to raise almost 20 million LVL. Other revenue measures consist of additional excise taxes mostly on gas and tobacco, bringing around 12 million LVL, and additional non-tax revenues.

On the expenditure side, the 2010 budget stipulates significant expenditure cuts based to a large extent on structural reforms, notably the merger/abolition of agencies and institutions in the ministries of agriculture, culture, education, and defence. Such measures will bring savings in 2010 and in the longer term. Some cuts will also impact the social budget, with a decrease by half of sickness, unemployment, maternity and paternity allowances above a certain threshold (11.5 LVL per calendar day). Concerning local governments, cuts in their wage bill should raise savings equalling 0.4% of GDP.

Overall, it is expected that in 2010 the general government financial deficit will not exceed 8.5% of GDP, in line with the multiyear fiscal path agreed in both frameworks of balance of payments assistance and EDP procedure. According to the Commission services' calculations on the basis of the information in the programme, the structural balance is expected to improve by slightly more than 2% (from -7.6% to -5.5%), which is consistent with the intention to design a very restrictive fiscal policy, although the improvement is less than the amount of consolidation measures given the mechanical erosion of tax bases and the increase of interest expenditure by 1.1% of GDP.

The improvement of the budget balance by 1.5% of GDP will be recorded almost in full for the central government sub-sector (to which apply 3.6% out of the 4.2% of GDP consolidation package), with its deficit decreasing from 6.2% to 4.8%. The deficit of social security funds will slightly deteriorate from 2.3% to 2.4%, given that social allowances are reduced by 0.2% of GDP whereas social contributions will decrease by almost 50 million LVL (0.4% of GDP). The deficit of local governments will improve by only 0.2% of GDP (from -1.5% to -1.3%), as the positive impact of remuneration cuts (+0.4%) and personal income and real estate tax increases, as well as a possibly better cash/ESA adjustment (lower public-private partnership related costs) will be partly counterbalanced by cuts in transfers from the central budget, decrease of self-earned revenues and increase of social-related expenditure, due to the recently designed safety net strategy partly financed from local budgets.

4.3. The programme's medium-term budgetary strategy

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

Box 2: The medium-term objective (MTO) for Latvia

As noted in the Code of Conduct[11], the MTO aims to (a) provide a safety margin with respect to the 3% of GDP deficit limit; (b) ensure rapid progress towards fiscal sustainability; and (c) allow room for budgetary manoeuvre, in particular taking into account the needs for public investment. The MTO is defined in cyclically adjusted terms, net of one-off and other temporary measures. On 7 July 2009, the ECOFIN Council took note of a new methodology for setting MTOs, ensuring that implicit liabilities (costs related to ageing populations, in particular projected healthcare and pension expenditure) are also accounted for.

Specifically, the country-specific MTOs should take into account three components: (i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; (ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and (iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure. This implies a partial frontloading of the budgetary cost of ageing irrespective of the current level of debt. In addition to these criteria, MTOs should provide a safety margin with respect to the 3% of GDP deficit reference value and, for euro area and ERM II Member States, in any case not exceed a deficit of 1% of GDP.

As communicated by the authorities, the MTO of Latvia is to reduce the structural general government budget deficit to 1% of GDP. In view of the new methodology and given the most recent projections and debt level, the MTO reflects the objectives of the Pact.

[11] "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 on 10 November 2009, available at: http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm

Table 5: Composition of the budgetary adjustment

(% of GDP)	2008	2009		2010		2011		2012	Change: 2009-2012
	COM	COM	CP	COM	CP	COM[1]	CP	CP	CP
Revenue	**34.6**	**34.9**	**33.8**	**33.4**	**36.2**	**32.9**	**38.6**	**39.4**	**5.6**
of which:									
- Taxes on production and imports	10.8	10.3	10.6	9.8	11.0	9.5	optional	optional	n.a.
- Current taxes on income, wealth, etc.	9.7	7.5	7.2	6.7	8.0	6.7	optional	optional	n.a.
- Social contributions	8.6	9.3	9.0	9.3	9.4	9.4	optional	optional	n.a.
- Other (residual)	5.6	7.8	7.0	7.6	7.8	7.4	n.a.	n.a.	n.a.
Expenditure	**38.8**	**43.8**	**43.8**	**45.7**	**44.7**	**45.1**	**44.6**	**42.4**	**-1.4**
of which:									
- Primary expenditure	38.0	42.4	42.5	43.3	42.3	41.3	41.3	39.2	-3.3
of which:									
Compensation of employees	12.0	12.7	11.9	11.2	11.7	10.4	11.7	11.7	-0.2
Intermediate consumption	6.8	6.7	6.8	5.8	6.6	4.9	6.7	6.5	-0.3
Social payments	8.6	13.3	12.3	14.2	13.5	14.0	12.9	12.0	-0.3
Subsidies	0.9	1.1	1.1	1.2	1.1	1.1	1.0	1.0	-0.1
Gross fixed capital formation	4.8	3.6	4.6	3.9	4.6	3.9	4.6	4.6	0.0
Other (residual)	5.0	5.1	5.9	7.0	4.8	6.9	4.3	3.4	-2.5
- Interest expenditure	0.8	1.4	1.3	2.4	2.4	3.8	3.3	3.2	1.9
General government balance (GGB)	**-4.1**	**-9.0**	**-10.0**	**-12.3**	**-8.5**	**-12.2**	**-6.0**	**-2.9**	**7.1**
Primary balance	**-3.4**	**-7.6**	**-8.7**	**-9.9**	**-6.1**	**-8.3**	**-2.7**	**0.3**	**9.0**
One-off and other temporary measures	0.0	0.6	n.a.	0.9	n.a.	0.0	n.a.	n.a.	n.a.
GGB excl. one-offs	**-4.1**	**-9.5**	**n.a.**	**-13.2**	**n.a.**	**-12.2**	**n.a.**	**n.a.**	**n.a.**
Output gap[2]	9.2	-9.1	-8.8	-10.7	-10.7	-7.0	-7.8	-3.8	5.0
Cyclically-adjusted balance[2]	-6.7	-6.4	-7.6	-9.3	-5.5	-10.2	-3.9	-1.8	5.7
Structural balance[3]	**-6.7**	**-7.0**	**-7.6**	**-10.2**	**-5.5**	**-10.2**	**-3.9**	**-1.8**	**5.7**
Change in structural balance		*-0.3*	*-0.9*	*-3.2*	*2.0*	*0.0*	*1.7*	*2.0*	
Structural primary balance[3]	-5.9	-5.6	-6.3	-7.8	-3.1	-6.4	-0.6	1.4	7.6
Change in structural primary balance		*0.3*	*-0.3*	*-2.2*	*3.1*	*1.4*	*2.6*	*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' autumn 2009 forecasts (COM); Commission services' calculations

The medium-term objective (MTO) of Latvia is to reduce the structural general government budget deficit to 1% of GDP, which reflects the objectives of the Pact (see box 2). However, this is not reached within the programme period, according to the structural balances as recalculated by the Commission services using the information provided in the programme (whereas the programme itself indicates a structural deficit of 0.5% of GDP – i.e. meeting the MTO - being reached in 2012).

The fiscal path presented in the programme matches that agreed in the framework of balance of payments assistance, namely deficits limited to 6% and 3% of GDP in 2011 and 2012 and consistent with the Council recommendation of 7 July 2009 of correcting the excessive deficit by 2012 at the latest. These targets require additional consolidation measures, as recommended by the Council on 7 July 2009 and in line with the last supplemental memorandum of understanding signed in March 2010 by the Latvian authorities and the European Commission.

According to the structural *primary* balance as calculated by the Commission services on the basis of the information in the programme, the corresponding discretionary effort amounts to 4½% on two years, with some frontloading in 2011. This is less than the average annual requirement of at least 2¾% of GDP over the period 2010-2012, but compliance with this average should be assessed on the full period, consequently including 2010 when the structural *primary* balance already improves by 3¼%. The improvement in the *overall* structural balance (5¾% of GDP as calculated by the Commission services on the basis of the information in the programme and the commonly agreed methodology) is less than an average annual fiscal effort of at least 2¾% over the period 2010-2012, notably given the increase of interest expenditure by almost 2% of GDP, and the mechanical erosion of tax bases at the beginning of the period. Cyclically-adjusted and structural balances need to be interpreted with caution, taking into account significant uncertainties around potential growth and output gap estimates for Latvia and that the exceptionally volatile economic environment from 2008 may lead to standard elasticities not sufficiently capturing the impact on the budget of the extreme downturn experienced by Latvia. There are significant differences between the recalculated output gaps based on the programme and the output gaps as presented in the programme itself. When taking into account the latter, the adjustment over the period 2010-2012 amounts to 7¾% of GDP, which is close to the annual requested average of 2¾%. Overall, taking into account the amount of discretionary measures already taken or outlined, the discretionary fiscal effort as planned in the programme appears broadly consistent with the 7 July Council recommendations.

Regarding the composition of the fiscal adjustment, in 2011 the revenue ratio is expected to increase at the same pace as in 2010, implying a sizeable new consolidation step on the revenue side, whereas the primary expenditure ratio decreases by only 1% of GDP, suggesting a smaller effort on the expenditure side. In 2012, in light of a denominator effect which would mechanically bring ratios down, but also boost tax bases, the pace of the consolidation would decrease both on the revenue and expenditure side, reflecting the frontloading of the medium-term budgetary strategy towards euro adoption.

This scenario for 2011 and 2012 is already backed by several measures which have been outlined by the Latvian authorities, and to which they committed themselves in the context of the balance of payment assistance. Among these measures[12], further steps on the revenue side focus on the taxation of wealth: a car tax reform based on environmental and wealth considerations, and a comprehensive reform of real estate taxation allowing means-tested exemptions. Revenues from car tax reform would benefit central government, whereas additional real estate tax revenues partly explain the improvement of the local governments balance. On the expenditure side, the Latvian authorities intend to carry out a broad review of social insurance benefits and pension systems, hence a fall of "social transfers other than in kind" in terms of GDP, even after correction of the denominator effect in 2012 (whereas current expenditure, gross fixed capital formation or subsidies remain almost stable in terms of GDP). As regards pensions, the various regimes and retirement ages will be reviewed, the goal being to preserve future sustainability and adequacy of the three pillars of the system. However, the improvement of social security funds budget balance would become significant only in 2012, as in 2011 the increase of social contributions to the second pillar would substantially deplete this sub-sector's revenues.

4.4. Risk assessment

This section discusses the plausibility of the programme’s budgetary projections by analysing various risk factors. For the period until 2011, Table 5 compares the detailed

12 The measures referred to include some mentioned in the supplementary memorandum of understanding in the context of EU balance of payments assistance, and not in the updated convergence programme itself.

revenue and expenditure projections in the Commission services’ autumn 2009 forecast, derived under a no-policy change scenario with those in the updated programme. Although the following assessment uses the Commission services’ forecast as a benchmark, it also takes explicitly into account all available information concerning more recent developments, and notably the 2010 budget, the adoption of which post-dated the Commission services' forecast.

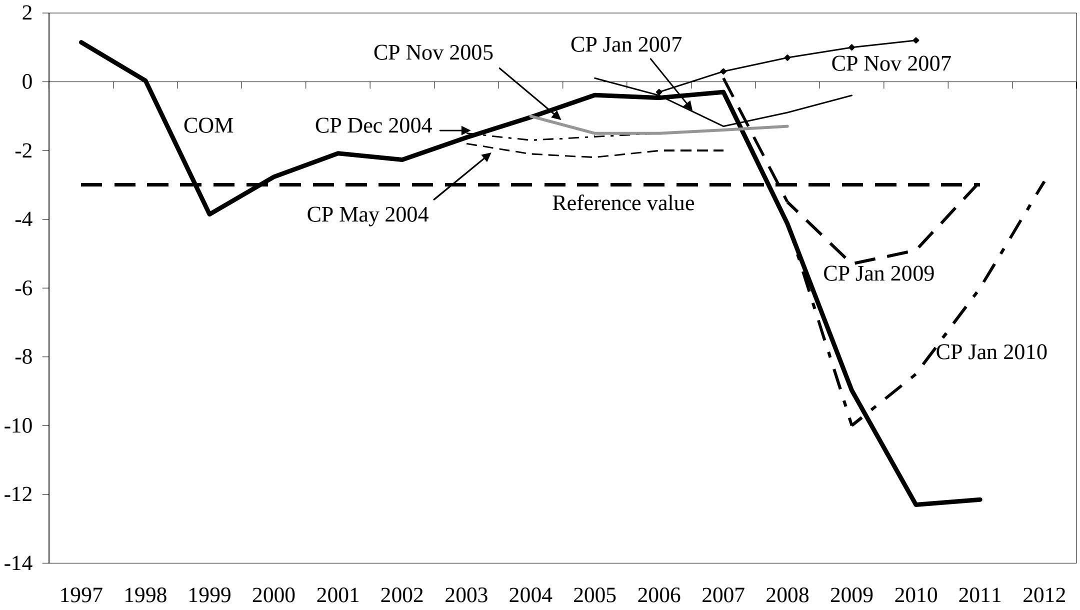
As discussed above in Section 3, the central macroeconomic scenario of the convergence programme update is plausible, but attached to a wide range of positive and negative risks attached to it. Accordingly, the programme provides two alternatives scenarios. A more optimistic scenario is based on the assumption of a faster recovery through the foreign trade channel. Under this scenario, budget revenue in 2010 would be 0.9% of GDP higher than in the central scenario. A more pessimistic scenario assumes weaker support from the external trade channel, no substantial improvement in credit markets and an insufficient boost to competitiveness from structural reforms. Under this scenario, budget revenue in 2010 would be 0.7% of GDP lower than in the central scenario.

Revenue projections are consequently surrounded by a very significant margin of uncertainty, but this also applies to expenditure as regards the consequences of financial system risks. As recognised in the programme, ensuring the stability of the financial sector will be an important pre-condition for economic recovery but also directly for the sustainable development of public finances, taking into account substantial public investments in this sector. Despite significant improvements, banking system solvency and liquidity risks remain, as does the need to restructure state banks.

Moreover, fiscal steps already taken may give rise to subsequent legal challenges (as was the case for pension cuts introduced with the June 2009 supplementary budget, where the Constitutional Court ruled on 21 December 2009 that the cuts did not meet certain procedural principles deriving from the constitution). Furthermore, from a political and technical point of view, it may prove difficult to find additional measures needed to match the programme targets for 2011 and 2012, on top of the extensive measures already adopted, and in the context of forthcoming October 2010 elections, given the very significant consolidation effort that has already taken place.

Latvia's overall track record in meeting headline deficit targets appeared good before the economic downturn, i.e. until the November 2007 update, but this was thanks to very strong revenue overshoots associated with the economic overheating: in structural terms policy was pro-cyclical and structural deficits widened. However, the Latvian authorities have given convincing evidence in the consolidation undertaken to date of being able to implement satisfactorily a very sizeable consolidation effort. Moreover, the authorities have already committed themselves to several steps (often including precise adoption and implementation schedules) under the balance of payments assistance process, so lack-of-information risks are comparatively limited. Risks of in-year expansionary budgets have been largely eliminated, not only because of the obvious consequences of the economic downturn, but also because there is a strong incentive to follow up on the commitments made under the balance of payments assistance agreements, as shown by the improvements of the budget framework already adopted. An important proviso is nevertheless needed, in that a general election is due in October 2010 and fiscal discipline has to be maintained irrespective of the electoral cycle.

Figure 1: Government balance projections in successive programmes (% of GDP)



The Commission services' autumn forecasts were not including the impact of the 2010 budget which was adopted on 1 December 2009

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

Overall, the balance of risks seems neutral and the programme's projections are broadly plausible, provided the Latvian authorities do not deviate from their commitments ahead of the October 2010 general election.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

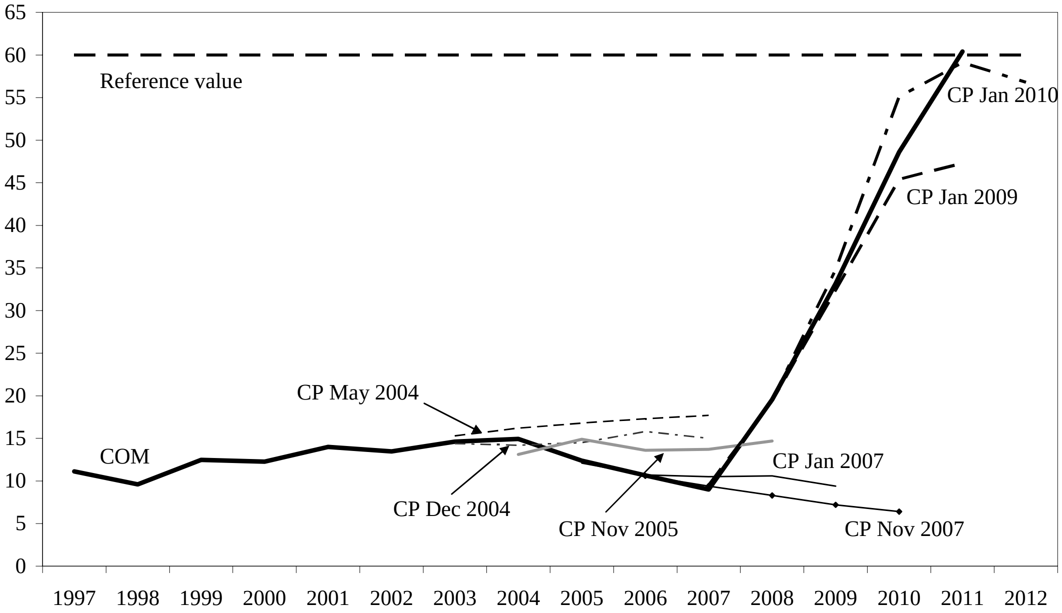
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The debt ratio is expected to increase sharply over the programme period, driven by significant fiscal deficits, but also due to a substantial stock-flow adjustment amounting to 8% of GDP in 2010, as disbursements from various international lenders are expected to reach around 15% of GDP for that year, more than necessary to cover strict budgetary needs. However, the final cost of banking sector support measures could amount to several GDP pp in cash terms, which represents a negative risk regarding the planned negative stock-flow adjustments in 2011 and 2012. Consequently, despite the low debt ratio until the onset of the crisis, there are risks surrounding the programme projection for the ratio to peak at slightly below 60% in 2011. The estimated ratio for 2009 is in line with the Commission services' autumn forecasts.

Figure 2: Debt projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2009 forecast (COM) and successive convergence programmes

Table 6: Debt dynamics

(% of GDP)	average 2003-07	2008	2009		2010		2011		2012
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**12.3**	**19.5**	**33.2**	**34.8**	**48.6**	**55.1**	**60.4**	**59.1**	**56.8**
Change in the ratio	-0.9	10.6	13.6	15.3	15.4	20.3	11.8	4.0	-2.3
Contributions[2] *:*									
1. Primary balance	**0.2**	**3.4**	**7.6**	**8.7**	**9.9**	**6.1**	**8.3**	**2.7**	**-0.3**
2. "Snow-ball" effect	**-1.5**	**-0.1**	**6.3**	**6.2**	**5.7**	**5.8**	**3.5**	**3.4**	**0.8**
Of which:									
Interest expenditure	0.6	0.8	1.4	1.3	2.4	2.4	3.8	3.3	3.2
Growth effect	-1.1	0.4	4.4	4.4	1.5	1.5	-1.0	-1.1	-2.2
Inflation effect	-1.0	-1.3	0.5	0.5	1.8	1.9	0.6	1.2	-0.2
3. Stock-flow adjustment	**0.5**	**7.2**	**-0.1**	**0.5**	**-0.1**	**8.4**	**0.0**	**-2.2**	**-2.8**
Of which:									
Cash/accruals diff.	-0.1	0.1		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	0.4	7.3		n.a.		n.a.		n.a.	n.a.
Privatisation	-0.3	0.0		n.a.		n.a.		n.a.	n.a.
Val. effect & residual	0.2	-0.1		n.a.		n.a.		n.a.	n.a.

<u>Notes</u>:

[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.

<u>Source</u> :

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations

5.1.2. Assessment

Debt projections in the programme are close to Commission services' forecasts regarding 2011 and seem plausible overall, while the latter already stressed that projections "may be affected by further financial sector costs and the profile of international financial assistance". In the medium term the Latvian authorities plan to continue regular issuance of government domestic securities (currently one fourth of public debt, mostly denominated in local currency), and to include longer maturities. They also intend to return to the international financial market as the macroeconomic situation stabilises, thereby progressively repaying the international assistance. In that regard, recent positive developments as concerns the views of rating agencies may be indicative of renewed market access in the future[13]. So far, foreign debt mostly consists of loans issued by international lenders in the context of international financial assistance.

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 projected by the Member States and the EPC in 2009 according to an agreed methodology[14].

Table 7 shows that age-related spending is projected to rise by 1.3% of GDP between 2010 and 2060, clearly below the EU average. Sustainability indicators for two scenarios are presented in Table 8. The '2009 scenario' is based on a no-policy-change assumption and the 2009 structural primary balance as a starting year, while the 'programme scenario' takes into account at face value the consolidation planned in the programme up to 2012 and is based on the projected 2012 structural primary balance as a starting position. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2009 level, the sustainability gap (S2)[15] is 9.0% of GDP, about 2 percentage points more than in the previous year's assessment, due to a significantly worse estimated structural primary balance in the starting year. The starting budgetary position is thus insufficient 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 '2009 scenario', the 'programme scenario' based on the 2012 (final programme year) structural primary balance shows a far smaller gap. If the budgetary consolidation planned in the programme were achieved, risks to long-term sustainability of public finances would thus be significantly reduced, as shown by the sustainability gap (S2) of 1.1% of GDP.

---

[13] On 12 February 2010, S&P changed the outlook for Latvia's rating from negative to stable (BB). On the other hand, Moody's remains the only one of the three major rating agencies which assigns an investment grade rating to Latvia (Baa3 with negative outlook).

[14] Economic Policy Committee and the European Commission (2009), '2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-60)', *European Economy* No. 2/2009. European Commission (2009), 'Sustainability Report 2009', *European Economy* No. 9/2009. European Commission (2008), 'Public finances in EMU – 2008', *European Economy* No. 4/2008.

[15] 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.

Table 7: Long-term age-related expenditure: main projections

(% of GDP)	2007	2010	2020	2030	2040	2060	Change 2010-60
Total age-related spending	**13.2**	**12.3**	**12.4**	**13.5**	**13.8**	**13.6**	**1.3**
- Pensions	5.4	5.1	5.2	5.9	6.1	5.1	0.0
- Healthcare	3.5	3.5	3.7	3.8	3.9	4.1	0.5
- Long-term care	0.4	0.4	0.4	0.5	0.6	0.9	0.5
- Education and unemployment benefits	3.9	3.3	3.2	3.4	3.1	3.5	0.3
Property income received	0.7	0.6	0.6	0.5	0.5	0.5	-0.2

Source: Economic Policy Committee and Commission services.

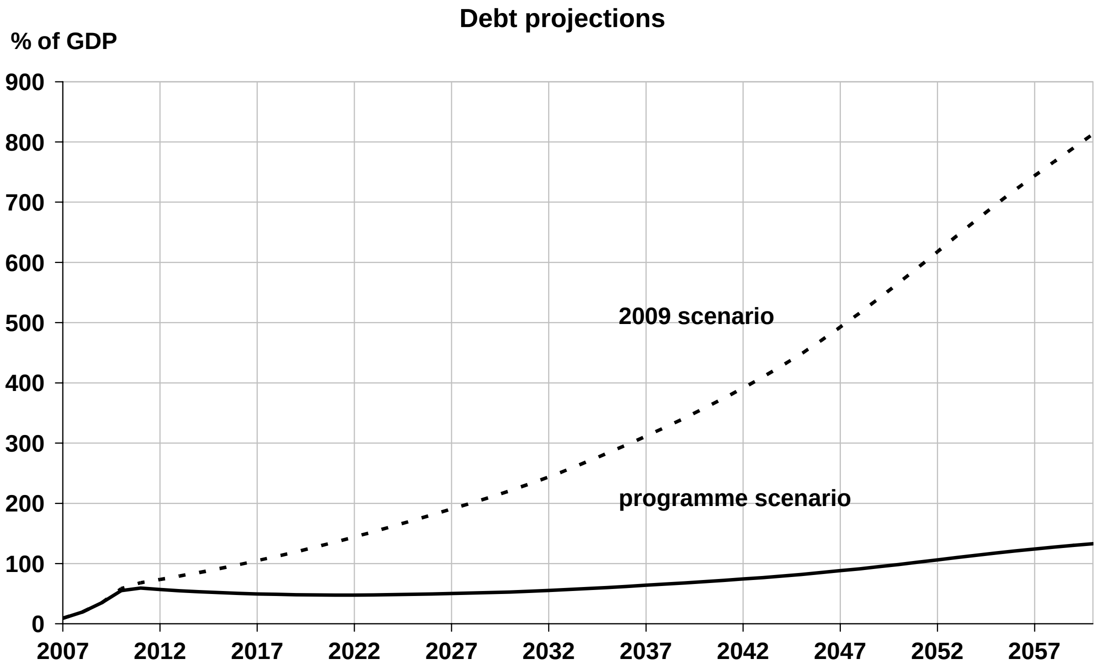
Table 8: Sustainability indicators and the required primary balance

	2009 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	9.0	9.0	2.8	0.9	1.1	2.5
of which:						
Initial budgetary position (IBP)	7.5	7.6		-0.4	-0.4	
Debt requirement in 2060 (DR)	0.2	-		0.0	-	
Long-term change in the primary balance (LTC)	1.3	1.4		1.3	1.4	

Source: Commission services.

Based on the assumptions used in the projection of age-related expenditure and the calculation of the sustainability indicators, Figure 3 displays the projected debt-to-GDP ratio over the long term.

Figure 3: Long-term projections for the government debt ratio

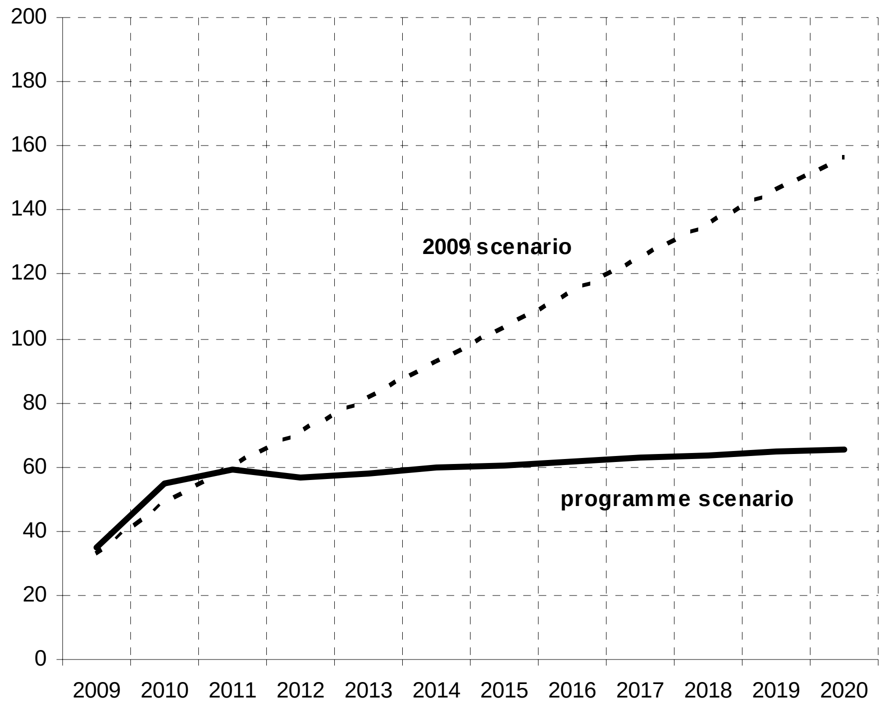


Note: Being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication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

Based on the alternative assumptions of economic developments presented in the Commission services' autumn 2009 forecast publication[16], Figure 4 shows a projected medium-term trajectory of the debt/GDP ratio. The two scenarios are broadly similar, although, taking into account the latest economic development (below), debt is slightly increasing in the programme scenario while in the baseline (above) it stabilises by 2020.

[16] Section 3.5 in European Commission (2009), 'European Economic Forecast – autumn 2009', European Economy No. 10/2009. This economic scenario assumes that the output gap caused by the crisis will be closed by 2017.

Figure 4: Medium-term projections for the government debt ratio



Source: Commission services

5.2.1. Additional factors

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. As indicated in Table 9, in the case of Latvia none of these factors has an impact on the overall long-term sustainability assessment.

Table 9: Additional factors for the assessment of long-term sustainability risks

	Impact on risk
Debt and pension assets	na
Decline in structural balance until 2011 in COM Autumn 2009 forecast	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	na
High tax burden	na
Difference between S1 and S2	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 V of: European Commission (2009), Sustainability Report 2009, European Economy No. 9/2009.

Source: Commission services.

5.2.2. Assessment

The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap, although as a result of pension reforms already enacted the long-term budgetary impact of ageing is clearly lower than the EU average. Reducing the primary deficit over the medium term, as foreseen in the programme, would contribute to reducing the high risks to the sustainability of public finances. Medium-term debt projections that assume GDP growth rates to recover only gradually to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, is almost sufficient to stabilise the debt-to-GDP ratio by 2020.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES

6.1. Fiscal framework

The pro-cyclical fiscal policy implemented during the years leading up to the crisis calls for a strengthening of the Latvian public finance management system. Strengthening the binding nature of the medium-term budgetary framework seems essential. To support the fiscal consolidation, there seems a need to put in place effective sanction procedures for individual misuses of public funds, to improve the collection and processing of general government data (notably as regards local government finances) and to strengthen the monitoring of outstanding and planned commitments (inter alia ex ante control). Close fiscal monitoring of EU structural funds-related expenditure has been supported by the changes in the 2010 state budget law, where expenditure will be divided into two parts, one specifically devoted to EU funded projects and activities. The Ministry of Finance commits itself in the programme to develop and submit a draft fiscal discipline law, in collaboration with the Ministry of Regional Development and Local Government, the Ministry of Justice and the State Chancellery, in order to ensure contra-cyclical fiscal discipline at all public administrations levels (a rule set at the national level is already limiting local governments' borrowing and lending capacity). Such a step would be highly desirable provided the underlying macroeconomic assumptions are credible. Several wide-ranging reviews should improve the prioritisation and decision-making process prior to the design of future budgets. An analysis of all functions and services provided by the public institutions (and their respective costs) is planned, aiming at assessing whether they need to be continued, modified, suspended or outsourced, and a review of all public companies and their subsidiaries will take place against the criteria set in the Latvian State administration law, with a view to a possible restructuring. The need to remove unnecessary rigidities in the budget to improve spending flexibility and efficiency has been addressed in a Cabinet Regulation of 3 November 2009, giving the Minister of Finance the right to reallocate the appropriations allocated to an individual budget entity across programmes, sub-programmes and expenditure economic categories.

6.2. Quality of public finances

The quality of public expenditure should benefit from substantial changes impacting the revenue structure, including an increased focus on wealth taxation, which should be particularly welcome when the relevant tax bases are immovable and not strongly subject to international competition, in so far as such decisions do not hamper long-term growth. However, attention needs to be paid to the labour tax wedge, following the increase of the personal income tax rate by 3%. There is therefore a need to design a consistent longer-term tax strategy in order to optimise the calibration of further revenue-side consolidation measures, in view of their economic impact. The design of appropriate administrative and legal devices to tackle the substantial grey economy also seems necessary.

As consolidation needs have squeezed resources, several significant steps have been taken to strengthen the efficiency of public spending. The government has taken many initiatives to promote growth and job creation while consolidating public finances. In view of the very high unemployment, the need for active labour market policies fostering potential growth has been addressed in the allocation of additional European Social Fund (ESF) resources to the Ministry of Welfare. This decision is welcome, while strengthening the capacities of the State Employment Agency, could improve the efficiency of the labour market activation measures. In more general terms, using EU structural funds related financing in a timely and well-targeted manner should prove helpful in mitigating the impact of the economic crisis.

In September 2009, municipalities began work experience schemes to maintain professional skills (with total financing planned in 2009-2010 of 0.2% of GDP). New targeted preventive unemployment reduction measures have also been created for persons with reduced working hours, as well as training programmes for adult life-long learning. The total financing planned for these two training programmes in 2009-2013 is more than 0.1% of GDP. It is also planned to offer a new activity for young people within the ESF project “Complex Support Measures”, in order that they acquire basic professional skills.

However, in the medium term, the recovery of the labour market also hinges on cost-competitiveness. In view of the strategy of "internal devaluation" underlying the balance of payment programme, the government has a strong interest in promoting wage restraint. In that regard, the Law on Remuneration for Civil Servants and Employees of Central and Local Government Institutions, adopted by Parliament on 1 December 2009, makes the remuneration system more transparent by merging all regulations referring to wages and social guarantees for public sector employees, and by envisaging common criteria for remuneration, bonuses, additional payments and social guarantees. Although most planned central administration wage cuts have already taken place, this reform will secure the implementation of corresponding cuts in the local government wage bill. This law will provide a consistent wage-setting signal to the private sector, while strengthening transparency of the remuneration system will create additional incentives for public sector employees.

The decrease of the number of employees in central state institutions by 20%, the substantial reduction of the number of agencies by centralising support functions or delegating some non-core functions, and the specific structural reforms performed in the health and education sector, constitute significant steps to strengthen the efficiency of public spending.

The reform launched in the health sector in 2009 consists in optimising the management of the health care system: concentration of in-patient services has been achieved by separating emergency medical assistance from health care service provision, while re-orienting in-patient services to out-patient care and home care. Consequently, between September 2009 and January 2010, the number of hospitals providing in-patient health care has been reduced from 59 to 42. A unique Emergency Medical Assistance Service has been created, aiming at providing emergency medical assistance throughout Latvia by mid-2010. This should have improved - and improve further - the efficiency of the distribution of available resources and workload in the health sector. The authorities intend to improve the availability of primary health care by using "second nurses" supplementing family doctors, while paediatric health care services will benefit from the creation of paediatric practices in parallel with the network of family doctors' practices. This should curb part of the bottleneck effect, although attention should be paid to the need to avoid such bottlenecks in the case of hospitals.

In 2009, major structural reforms were also launched in the education sector, aiming at improving the optimisation of the use of existing resources, taking into account recent negative demographic trends, through a new "money follows student" financing model. The objective is to ensure the effectiveness of the financing allocated to education, while providing equal and transparent distribution of financial resources for each student. The new financing model should benefit students, as schools will be motivated to attract as many students as possible, thus encouraged to offer different education programmes (general and/or vocational) matching their different interests, and it should also benefit municipalities, giving them the opportunity to optimise the allocation of the financing for education, taking into account identified needs and possible scale savings. It is planned to reduce the number of general education institutions in municipalities from 982 to 873. In order to expand higher education opportunities for people from socially disadvantaged groups, the system for allocation of state budget resources for scholarships has been changed, setting social circumstances as a key additional criterion for successful students.

7. ASSESSMENT OF THE STRATEGY ENSURING A SMOOTH PARTICIPATION IN ERM II

The Latvian lats entered ERM II on 2 May 2005. The central rate was set at the parity at which the lats had been re-pegged from the SDR to the euro on 1 January 2005, with a standard fluctuation band of ±15%. Upon ERM II entry, the authorities unilaterally committed themselves to maintain a tighter fluctuation margin of ±1% around the central rate.

7.1.1 Recent exchange rate and financial market developments

The official EUR/LVL exchange rate has been maintained within the agreed fluctuation band but has experienced several episodes of severe tensions in recent years. In particular, the global financial crisis had a pronounced impact on the Latvian financial system, given the large asset share of domestic banks in Latvia by comparison with its peers. The lat came under heavy pressure in autumn 2008 when markets grew increasingly concerned over the likelihood that contingent financial sector liabilities would have to be absorbed by the government. Latvia was downgraded by rating agencies, Eurobond and CDS spreads increased substantially, interbank market rates rose, capital outflows from the banking system surged and the Bank of Latvia had to defend the peg by depleting part of its international reserves. The Latvian authorities sought recourse to international financial assistance, which calmed the markets and led to the easing of exchange rate pressures and a significant improvement of financial market conditions in early 2009. However, the exchange rate came under renewed pressure in the first half of 2009 amid waves of political instability, a more sharply deteriorating economic outlook, contracting credit and an increasing demand for foreign currency. Tensions culminated in the second half of June when short-term interbank market rates rose above 30%, reflecting the system-wide lat liquidity shortage, a general loss of confidence among banks, as well as mounting uncertainty over the exchange rate regime. While the peg was successfully defended, gross foreign assets were depleted by more than one-third between end-February and end-June. Only after the European Council's support of the Latvian authorities' supplementary budget in mid-June and, in particular, following the disbursement of the EU's second loan tranche in July, did financial market conditions visibly improve.

Since the second half of 2009, pressures on the exchange rate have been largely absent. Helped by the significant disbursements from the international assistance package, the liquidity situation in the banking system has improved while investor concerns linked to the stability of the peg have eased. Signs of economic stabilisation, renewed commitments from foreign banks to maintain overall exposure to Latvia, and the subsequent approval of a strong 2010 budget strengthened confidence and reduced financial market risks further. In early 2010 CDS spreads had declined by more than half from their peak level, while short-term money market interest rates fell close to pre-crisis levels. In February 2010, one of the major rating agencies changed the outlook on Latvia's sovereign credit rating from negative to stable, signalling a certain restoration of financial stability.

7.1.2 Policies supporting participation in ERM II

In late 2008, in order to encourage credit growth, stimulate the longer-term funding of banks and ease money market liquidity conditions, the Latvian authorities relaxed some of the restrictive measures that had been introduced the previous year. The Bank of Latvia reduced reserve requirements for liabilities above two years in three steps between October and December 2008 from 6% to 3%. In addition, the reserve ratio for all other liabilities included in the reserve base was reduced from 8% to 5% in the same period. As a response to the further downturn in economic activity and weakening lending activity, the Bank of Latvia's refinancing rate was cut from 6% to 4% in the first half of 2009. In the same period, the deposit facility rate was reduced from 3% to 1% in an attempt to support activity in the lats interbank market and to encourage banks to channel available financial resources into the economy. The cuts in minimum reserve requirements and official interest rates provided alleviation for the financial system at a very turbulent time. However, these measures were inconsistent with the need to tighten monetary policy in order to support the currency peg and minimise unnecessary drains on international reserves. Part of the massive outflows seen in the first half of 2009 was made possible by the excess liquidity generated by the reduction in reserve requirements. Furthermore, the effect of these measures on market rates and lending remained limited.

The authorities have made good progress in the area of financial sector stabilisation policy, but challenges remain. Financial sector supervision has been satisfactorily strengthened through adequate credit risk analyses and close monitoring of banks' foreign currency exposure. Steps have been taken to ensure that banks are adequately capitalised and that losses are properly provisioned. Cooperation with foreign supervisory agencies has proved to be of high quality. An adequate legal framework has been created for private sector workouts in the field of debt restructuring, in terms of both maturity and currency. Major future policy steps will include restructuring Parex Banka and reforming the state-owned Mortgage and Land Bank.

During the years of economic overheating, fiscal policy was not sufficiently used to ensure a smooth participation in the ERM II. However, in response to the challenges posed by the severe recession, an ambitious correction of the significant structural deficit has begun. Implementation of the 2009 budget has been very tight, which met the 10% of GDP deficit limit set under Latvia's balance of payments assistance programme. The 2010 budget includes a fiscal consolidation by 500 million LVL (over 4.2% of GDP) in line with the Council's July 2009 recommendations to correct the excessive deficit by 2012. In order to further enhance the credibility of the medium-term consolidation strategy, it will be crucial to address the weaknesses of the current budgetary framework as regards medium-term planning and control of public finances.

Against the backdrop of a decentralised wage setting system, the role of public sector in economy-wide wage setting is limited, but not insignificant. In 2009, public wages adjusted at a faster pace than in the private sector, as fiscal consolidation efforts concentrated on correcting the large excesses of the boom years. In the private sector, the adjustment took place mainly at the expense of employment, although some unofficial surveys indicate that wage reductions were much stronger in this sector than the officially reported figures[17]. Outward migration has intensified, partly limiting the unemployment increase. Looking ahead, the number of those working abroad seems set to rise further, especially once the economic situation in the EU recovers; this may contribute to upward wage pressures from 2011.

The role of public policy in promoting reforms which can support external competitiveness is vital given low internal demand, rising unemployment, highly leveraged balance sheet positions and limited availability of new credit. This includes reforms of, inter alia, the public administration and the pursuit of ongoing education and health-care reforms, increasing the qualifications of the working people, prioritising and increasing R&D funding, improving the degree of competition in the economy by strengthening public procurement procedures, and expanding export guarantee schemes. In this context, Latvia's stabilisation and recovery plan put the main emphasis on export promotion, better regulation and access to finance. The plan envisages reorienting EU structural fund expenditure and financial assistance instruments towards tradable sectors. The government has recently supported the establishment of a special programme in support of micro-enterprises. Some improvements to the tax administration system to the benefit of enterprises are also on the agenda.

The low absorption of EU structural funds was a concern during 2009, but there was a significant improvement towards the end of the year thanks to a more efficient allocation across ministries and a more appropriate budgeting: the capacity of the Managing Authority and Ministry of Finance has been strengthened, the accountability of line ministries, agencies and beneficiaries has been improved, there is a possibility and practice established that budgetary resources are reallocated away from underperforming activities. New receipts of funding during summer 2009, supported by a ring-fenced account for such receipts, are allowing the government to ensure necessary payments for EU funded projects. In addition, against the background of overarching staff and wage cuts in the public administration, Latvia nevertheless needs to maintain human resources at the required level to implement 2007-2013 programmes effectively.

---

17 Official wage statistics are distorted by composition changes (lower-paid, less-qualified employees have disproportionately become unemployed in the downturn) and by the large grey economy (it being easier to cut the undeclared part of wages, because there is no need to rewrite contracts and also because a large share of the workforce is already reported to be earning the statutory minimum wage, so 'officially' there is no room to cut wages further).

7.1.3 Assessment

Latvia has been hit severely by the crisis and has had to seek recourse to international financial assistance. Weakness of the labour market, financial deleveraging and the need for fiscal consolidation will hold back economic recovery, although there are positive signs that competitiveness indicators have started improving. Pressures on the exchange rate have subsided significantly since summer 2009, but the situation remains highly dependent on maintaining the political will to comply with the terms agreed with international donors. Financial sector supervision has been strengthened, including better cooperation with foreign supervisory bodies, and steps have been taken to ensure adequate capitalisation of the banking system. Latvia has taken bold measures to address the deterioration of public finances. It has taken action to implement reforms in the areas of public administration, education and health care and has made efforts to introduce emergency measures in employment. Achieving a sustainable improvement in the public finances (including a deficit below 3% in 2012), supporting the competitiveness of the economy and ensuring a fair distribution of its burden across the population at the same time is clearly challenging and will require continued efforts. Strengthening the absorption and governance of EU structural funds in order to provide more support for FDI and export-generating businesses and promoting relevant training and education for labour force, as well as setting clearer priorities for competitiveness and R&D policy, remain important objectives.

8. OVERALL ASSESSMENT

Taking into account risks attached to the budgetary targets discussed above, this section assesses the appropriateness of the fiscal strategy in relation to the Council Recommendations under Article 104(7) of 7 July 2009 with a view to correcting the excessive deficit and the budgetary objectives of the Stability and Growth Pact, against the background of the current economic situation, the debt and long-term sustainability position of the country, and the institutional features of its public finances.

The fiscal path as shown in the programme is consistent with the deficit targets set in both frameworks of balance of payments assistance and excessive deficit procedure, and reflects the authorities' ambition to comply with the Maastricht criteria in 2012 and join the euro area by 2014. Fiscal policy now seems appropriate to ensure a smooth participation in ERM II, responding to the challenges posed by the severe recession through the ambitious correction of the significant structural deficit now underway. The improvement in the structural balance (5¾% of GDP as calculated by the Commission services on the basis of the information in the programme and the commonly agreed methodology) is less than an average annual fiscal effort of at least 2¾% over the period 2010-2012 recommended by the Council in July 2009, notably given the increase of interest expenditure by almost 2% of GDP, and the mechanical erosion of tax bases at the beginning of the period.

However, cyclically-adjusted and structural balances need to be interpreted with caution, taking into account significant uncertainties around potential growth and output gap estimates for Latvia and that the exceptionally volatile economic environment from 2008 may lead to standard elasticities not sufficiently capturing the impact on the budget of the extreme downturn experienced by Latvia. Overall, in view of the balanced risks and taking into account the amount of discretionary measures already taken or outlined, the discretionary fiscal effort as planned in the programme appears broadly consistent with the July Council recommendations. However, given the amount of remaining fiscal adjustment to be undertaken and not yet backed by fully-defined measures, there is a risk of budgetary outcomes worse than planned, although this risk is counter-balanced by the binding commitments given under the international financial assistance agreements and the authorities' record to date in meeting these. This reinforces the need for the Latvian authorities to improve the budgetary framework and decision-making processes, as planned in the course of 2010.

* * *

ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned. It also assesses to what extent Country followed up on the Council's recommendation to report on progress made in the correction of the excessive deficit, in a separate chapter of the programme.

(i) Model structure

The programme broadly follows the model structure outlined in the code of conduct, covering all principal sections.

(ii) Data requirements

As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data.

The tables on the following pages show the data presented in the January 2010 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

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

(iv) Separate chapter on progress made in the correction of the excessive deficit

In its recommendations under Article 104(7) of 7 July 2009 with a view to bring the excessive deficit situation to an end, the Council also invited Latvia to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the convergence programmes. Latvia fully complied with this recommendation.

* * *

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

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.		X	
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].			Not applicable (autumn forecast

The SCP…	Yes	No	Comments
			excluded the impact of the 2010 budget)
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.			Not applicable (budgetary targets already agreed under excessive deficit procedure and balance of payments assistance)
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			In the case of Latvia, continuity has to be assessed against last EDP and BoP steps, which were taken after the new government has taken office
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).			Not applicable (no deviations compared to last EDP and BoP requirements)
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.		X	Information not fully comprehensive
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions		X	In particular, the impact of interest rate and exchange rate changes on debt is not

The SCP…	**Yes**	**No**	**Comments**
c) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.			analyzed.
… (in case of “major structural reforms”) analyses how changes in assumptions would affect budget and potential growth.		X	
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.		X	Some description, but very indirectly linked to the topic (and usually not in the corresponding part of the programme)
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

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

Source:
Commission services

TABLES FROM ANNEX 2 OF THE CODE OF CONDUCT

Table 1a. Macroeconomic prospects

	ESA Code	2008 Level	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change	2012 rate of change
1. Real GDP	B1*g	*8293.4*	-4.6	-18.0	-4.0	2.0	3.8
2. Nominal GDP	B1*g	*16243.2*	9.9	-19.7	-8.8	-0.3	4.2
Components of real GDP							
3. Private consumption expenditure	P.3	*5601.3*	-11.0	-22.0	-11.0	0.5	3.1
4. Government consumption expenditure	P.3	*1224.0*	1.5	-9.0	-10.3	-4.0	0.8
5. Gross fixed capital formation	P.51	*2707.3*	-13.2	-34.0	-12.0	3.0	7.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*n.a.*	4.5	-1.7	0.8	1.3	1.2
7. Exports of goods and services	P.6	*3589.0*	-1.3	-17.5	1.5	5.0	5.6
8. Imports of goods and services	P.7	*4953.9*	-13.6	-35.0	-9.7	2.6	5.2
Contributions to real GDP growth							
9. Final domestic demand		-	-12.5	-27.3	-11.9	0.4	3.6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.6	-4.0	2.6	0.5	-0.1
11. External balance of goods and services	B.11	-	8.5	13.3	5.2	1.2	0.3

Table 1b. Price developments

	ESA Code	2008 Level	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change	2012 rate of change
1. GDP deflator		*n.a.*	15.2	-2.1	-5.0	-2.2	0.4
2. Private consumption deflator		*n.a.*	15.6	3.0	-3.7	-2.8	0.0
3. HICP[1]		*n.a.*	15.4	3.5	-3.7	-2.8	0.0
4. Public consumption deflator		*n.a.*	24.2	-6.0	-8.0	-3.1	-1.0
5. Investment deflator		*n.a.*	13.7	-5.0	-3.0	-0.1	2.1
6. Export price deflator (goods and services)		*n.a.*	10.2	-7.0	0.0	2.0	2.0
7. Import price deflator (goods and services)		*n.a.*	12.0	-6.5	1.0	2.0	2.0

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*1124.1*	0.5	-11.3	-5.6	-0.2	1.1
2. Employment, hours worked[2]		*1607800000*	-2.2	-23.0	-3.6	1.8	3.3
3. Unemployment rate (%)[3]		*n.a.*	7.5	16.9	20.0	18.9	17.5
4. Labour productivity, persons[4]		*n.a.*	-3.3	-5.7	2.1	2.2	2.7
5. Labour productivity, hours worked[5]		*n.a.*	-0.6	8.6	0.1	0.2	0.5
6. Compensation of employees	D.1	*6843.5*	15.6	-18.8	-14.8	-0.4	4.3
7. Compensation per employee		*479*	20.5	-5.0	-9.8	-0.2	2.7

[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	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-10.8	8.2	10.7	10.4	8.0
of which :						
- Balance on goods and services		-13.0	-1.6	2.9	4.2	4.5
- Balance of primary incomes and transfers		0.6	8.0	6.0	4.3	1.5
- Capital account		1.5	1.9	1.9	2.0	2.0
2. Net lending/borrowing of the private sector	B.9	-6.7	18.2	19.2	16.4	10.9
3. Net lending/borrowing of general government	EDP B.9	-4.1	-10.0	-8.5	-6.0	-2.9
4. Statistical discrepancy		-1.8	-0.1	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA Code	2008 Level	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP	2012 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-672.2*	-4.1	-10.0	-8.5	-6.0	-2.9
2. Central government	S.1311	*-722.0*	-4.4	-6.2	-4.8	-2.7	-1.4
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	*-203.5*	-1.3	-1.5	-1.3	-1.0	-0.5
5. Social security funds	S.1314	*253.4*	1.6	-2.3	-2.4	-2.3	-1.1
General government (S13)							
6. Total revenue	TR	*5635.9*	34.7	33.8	36.2	38.6	39.4
7. Total expenditure	TE[1]	*6308.8*	38.8	43.8	44.7	44.6	42.4
8. Net lending/borrowing	EDP B.9	*-672.2*	-4.1	-10.0	-8.5	-6.0	-2.9
9. Interest expenditure	EDP D.41	*124.8*	0.8	1.3	2.4	3.3	3.2
10. Primary balance[2]		*-547.4*	-3.4	-8.7	-6.1	-2.7	0.3
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)		*3323.4*	20.5	17.9	19.0	19.7	19.7
12a. Taxes on production and imports	D.2	*1749.7*	10.8	10.6	11.0	optional	optional
12b. Current taxes on income, wealth, etc	D.5	*1571.1*	9.7	7.2	8.0	optional	optional
12c. Capital taxes	D.91	*2.6*	0.0	0.0	0.0	optional	optional
13. Social contributions	D.61	*1399.8*	8.6	9.0	9.4	optional	optional
14. Property income	D.4	*167.2*	1.0	1.6	1.2	optional	optional
15. Other[4]		*745.5*	4.6	5.4	6.6	optional	optional
16=6. Total revenue	TR	*5635.9*	34.7	33.8	36.2	38.6	39.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		4773.8	29.4	27.1	28.7	28.6	28.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*3049.9*	18.8	18.6	18.3	18.4	18.2
17a. Compensation of employees	D.1	*1946.6*	12.0	11.9	11.7	11.7	11.7
17b. Intermediate consumption	P.2	*1103.3*	6.8	6.8	6.6	6.7	6.5
18. Social payments (18=18a+18b)		*1395.1*	8.6	12.3	13.5	12.9	12.0
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*85.4*	0.5	0.9	1.1	1.1	1.1
18b. Social transfers other than in kind	D.62	*1309.6*	8.1	11.3	12.4	11.8	10.9
19=9. Interest expenditure	EDP D.41	*124.8*	0.8	1.3	2.4	3.3	3.2
20. Subsidies	D.3	*149.2*	0.9	1.1	1.1	1.0	1.0
21. Gross fixed capital formation	P.51	*781.7*	4.8	4.6	4.6	4.6	4.6
22. Other[6]		*808.1*	5.0	5.9	4.8	4.3	3.4
23=7. Total expenditure	TE[1]	*6308.8*	38.8	43.8	44.7	44.6	42.4
p.m.: Government consumption (nominal)	P.3	*3204.3*	19.7	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	2007	2012
1. General public services	1	4.0	6.6
2. Defence	2	1.5	1.2
3. Public order and safety	3	2.7	2.2
4. Economic affairs	4	5.0	6.9
5. Environmental protection	5	1.0	1.1
6. Housing and community amenities	6	1.3	0.6
7. Health	7	4.5	4.5
8. Recreation, culture and religion	8	1.8	1.5
9. Education	9	5.8	5.9
10. Social protection	10	8.4	11.9
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	35.9	42.4

[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	2008	2009	2010	2011	2012
1. Gross debt[1]		19.5	34.8	55.1	59.1	56.8
2. Change in gross debt ratio		10.6	15.2	20.3	4.0	-2.3
Contributions to changes in gross debt						
3. Primary balance[2]		-3.4	-8.7	-6.1	-2.7	0.3
4. Interest expenditure[3]	EDP D.41	0.8	1.3	2.4	3.3	3.2
5. Stock-flow adjustment		6.4	5.2	11.8	-2.0	-5.2
of which:						
- Differences between cash and accruals[4]		0.2	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		7.3	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]		-0.2	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		9.3	5.5	6.3	6.0	5.7
Other relevant variables						
6. Liquid financial assets[8]		6.1	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		13.4	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	2008	2009	2010	2011	2012
1. Real GDP growth (%)		-4.6	-18.0	-4.0	2.0	3.8
2. Net lending of general government	EDP B.9	-4.1	-10.0	-8.5	-6.0	-2.9
3. Interest expenditure	EDP D.41	0.8	1.3	2.4	3.3	3.2
4. One-off and other temporary measures[1]		n.a.	n.a.	n.a.	n.a.	n.a.
5. Potential GDP growth (%)		0.8	-1.4	-0.8	1.0	3.2
contributions:						
- labour		0.4	0.4	0.4	0.4	0.3
- capital		2.9	1.1	0.7	0.7	0.8
- total factor productivity		-2.4	-2.9	-1.9	-0.1	2.0
6. Output gap		11.9	-6.9	-9.9	-9.0	-8.5
7. Cyclical budgetary component		3.3	-1.9	-2.8	-2.5	-2.4
8. Cyclically-adjusted balance (2 - 7)		-7.4	-8.1	-5.7	-3.5	-0.5
9. Cyclically-adjusted primary balance (8 + 3)		-6.6	-6.8	-3.3	-0.2	2.7
10. Structural balance (8 - 4)		-7.4	-8.1	-5.7	-3.5	-0.5

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

Table 6. Divergence from previous update

	ESA Code	2008	2009	2010	2011	2012
Real GDP growth (%)						
Previous update		-2.0	-5.0	-3.0	1.5	n.a.
Current update		-4.6	-18.0	-4.0	2.0	3.8
Difference		-2.6	-13.0	-1.0	0.5	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-3.5	-5.3	-4.9	-2.9	n.a.
Current update		-4.1	-10.0	-8.5	-6.0	-2.9
Difference		-0.6	-4.7	-3.6	-3.1	n.a.
General government gross debt (% of GDP)						
Previous update		19.4	32.4	45.4	47.3	n.a.
Current update		19.5	34.8	55.1	59.1	56.8
Difference		0.1	2.4	9.7	11.8	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2005	2007	2010	2020	2030	2050
Total expenditure	35.6	35.9	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	13.0	13.2	12.3	12.4	13.5	13.8
Pension expenditure	5.9	5.4	5.1	5.2	5.9	5.8
Social security pension	5.9	5.4	5.1	5.2	5.9	5.8
Old-age and early pensions	5.1	4.8	4.7	4.8	5.5	5.5
Other pensions (disability, survivors)	0.8	0.6	0.4	0.3	0.4	0.3
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	3.5	3.5	3.5	3.7	3.8	4.0
Long-term care *(this was earlier included in the health care)*	0.4	0.4	0.4	0.4	0.5	0.7
Education expenditure	3.3	3.7	3.1	3.0	3.2	3.1
Other age-related expenditures	0.0	0.2	0.2	0.2	0.2	0.2
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	35.1	35.5	n.a.	n.a.	n.a.	n.a.
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)	6.2	6.8	6.2	6.0	5.8	5.7
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	8.8	6.4	5.1	3.4	2.7	1.7
Real GDP growth	10.6	8.4	4.9	2.1	1.8	-0.1
Participation rate males (aged 20-64)	82.4	85.6	85.1	84.4	83.5	80.7
Participation rates females (aged 20-64)	71.9	74.9	75.3	75.5	75.4	72.3
Total participation rates (aged 20-64)	76.9	80.0	80.0	79.8	79.4	76.5
Unemployment rate	9.0	6.5	4.9	4.9	4.8	4.8
Population aged 65+ over total population	16.5	17.1	17.4	18.6	22.2	29.6

Table 8. Basic assumptions

	2008	2009	2010	2011	2012
Short-term interest rate[1] (annual average)	7.9	13.2	10.3	6.3	5.0
Long-term interest rate (annual average)	6.4	12.4	11.0	9.0	6.0
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.47	1.39	1.48	1.48	1.48
Nominal effective exchange rate	1.1	2.1	-0.3	0.0	0.0
(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	3.8	-0.4	3.8	4.1	4.0
EU GDP growth	0.8	-4.1	0.7	1.6	1.9
Growth of relevant foreign markets	7.0	-12.3	4.7	5.3	5.0
World import volumes, excluding EU	4.6	-12.6	4.6	5.0	5.0
Oil prices (Brent, USD/barrel)	98.5	61.3	76.5	80.5	86.0

[1] If necessary, purely technical assumptions.