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Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Latvia, 2009-2012

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

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

In accordance with the Regulation, the Council delivered an opinion on the first convergence programme of Latvia on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Latvia, submitted on 29 January 2010, and has adopted a recommendation for a Council Opinion on it.

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

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

(2) the conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the “Exit strategy”;

(3) the country’s position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure);

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

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

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

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions.

The Council agreed on the following principles of the fiscal exit strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term

[2] Communication from the Commission to the European Council of 26 November 2008.

fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The excessive deficit procedure 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, 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.

2.4. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2008-2011, as follows. The Council considered "that Latvia, while facing a severe economic downturn following years of above potential economic growth, is planning a restrictive fiscal stance in 2009 and until 2011, which is an adequate response to the economic situation considering the absence of scope for fiscal manoeuvre and the need to correct economic imbalances. The global financial crisis has amplified the shock of the reversal of Latvia's own lending and house price boom by tightening credit availability and conditions, reinforcing the steep decline of domestic demand over the course of 2008. The concomitant downturn on export markets has hit the relatively small tradable sector, already weakened by huge domestic cost increases over the previous years. The headline deficit exceeded the 3 % of GDP Maastricht Treaty reference value in 2008. This was the result of having followed expansionary fiscal policy during the years of above-potential growth and of the very sharp slowdown in 2008. The programme targets general government deficits of around 5 % of GDP in 2009 and 2010 and below 3 % in 2011. Taking into account risks of lower demand and output in 2009 and lack of information underpinning the revenue-based consolidation in 2010 and 2011, the budgetary outcome could be worse than projected in the programme".

In view of this assessment, the commitments made in the framework of international financial assistance, and also given the need to ensure sustainable convergence and a smooth participation in ERM II, the Council invited Latvia to: "(i) implement fully the planned consolidation in the supplementary budget adopted on 12 December 2008; submit to Parliament by the end of March 2009 the details of the supplementary budget; take sufficient further measures to achieve the targeted general government deficit in 2009 and continue the targeted fiscal consolidation thereafter; (ii) rigorously implement public sector nominal wage reductions to facilitate the alignment of whole economy wages with productivity, thereby improving cost competitiveness; (iii) strengthen fiscal governance and transparency, by improving the medium-term budgetary framework and reinforcing Ministry of Finance spending controls, and strengthen financial market regulation and supervision; (iv) strengthen the supply side of the economy by wide-ranging structural reforms and by making efficient use of available EU structural funds".

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [22 April 2010] the Council examined the updated convergence programme of Latvia, which covers the period 2009 to 2012.

(2) 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 hit the tradeables sector. Furthermore, 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. This prompted the Latvian authorities to seek international financial assistance, which was provided at the end of 2008[4] and made conditional on major fiscal consolidation as well as financial system and structural reforms. Subsequently, in view of a much larger than expected deterioration in economic and budgetary conditions in the first half of 2009, the government implemented additional fiscal consolidation measures, partly underpinned by structural reforms. The above-mentioned developments led the Council to decide on the existence of an excessive deficit in Latvia on 7 July 2009 and to recommend its correction in accordance with Article 104(7) TEC by 2012. In the second half of 2009, the export-oriented sector 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

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

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

market and negative credit growth. Nevertheless, the disbursements of international financial assistance, the rigorous implementation of the 2009 budget and the successful adoption of the 2010 budget with further fiscal consolidation measures helped to stabilise confidence and improved market sentiment towards Latvia. The main challenge for economic policy remains economic stabilisation and a return to a well-founded catching-up process. Economic stabilisation depends to a great extent on anchoring long-term expectations for which the implementation of the planned fiscal consolidation path is crucial. Economic stabilisation also hinges directly on taking structurally-sound and socially equitable fiscal measures and also on the progress with restructuring the economy towards the tradeable sector. In view of the significant deterioration in external competitiveness during the boom years, there appears to be some further need for domestic price adjustment and productivity improvement. The use of EU structural funds should contribute to the strengthening of the tradeable sector and cushion the recession. The sharp decline in domestic demand and the opening up of spare capacity helped unwind existing imbalances, reducing inflation and eliminating the external deficit, largely through a collapse in imports. 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.

(3) 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. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Latvia it is important to step up implementation of wide-ranging structural reforms in the areas of budgetary and public sector management, raise skill levels as part of the effort to raise productivity, and make efficient use of the available EU structural funds.

(4) The macroeconomic scenario underlying the programme envisages that after an estimated exceptionally severe 18.0% fall in output in 2009, real GDP will decrease by a further 4.0% in 2010 before growing by 2.0% in 2011 and 3.8% in 2012. The expected transition back to positive growth is led by the external sector and more mutedly by fixed investment, with private consumption and overall domestic demand registering significant expansion only late in the programme period. Assessed against currently available information[5], this scenario appears plausible, but uncertainty remains very high due to the severity of the recession. The programme’s projection for marked deflation in 2010 is realistic, but the degree of continued deflation projected for 2011 may underestimate the pace of the return to stability of prices. The external balance is expected to remain in significant surplus over the programme period, which seems broadly plausible, although the size of the expected surpluses

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

appears high. The monetary and exchange rate assumptions of the programme are consistent with the macroeconomic scenario.

(5) The programme estimates the general government deficit in 2009 at 10.0% of GDP. The significant deterioration from a deficit of 4.1% of GDP in 2008 reflects the impact of the crisis on government finances, despite the adoption of a restrictive supplementary budget on 16 June 2009 in consultation with international lenders, implying a consolidation effort of 4.4% of GDP, almost fully on spending. Tax revenue collapsed by one quarter in nominal terms compared to 2008, despite increases in VAT and excise rates at the beginning of 2009. According to the programme and in compliance with commitments made in the framework of international financial assistance, fiscal policy is planned to remain severely restrictive throughout the programme period, given the absence of room for fiscal manoeuvre and the need to correct economic imbalances. This is in line with the exit strategy advocated by the Council for Latvia, anchored on correcting the excessive deficit by 2012.

(6) The 2010 State budget adopted by Parliament on 1 December 2009 entails a further discretionary consolidation effort amounting to over 4.2% of GDP, as set in the context of the balance of payments assistance and endorsed in the Council Recommendation to Latvia of 7 July 2009. 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 results in a substantial increase expected for the revenue ratio (+2.4% of GDP; the significant denominator effect almost directly offset by the corresponding erosion of tax bases). However, the primary expenditure ratio is expected to decrease by only 0.2% of GDP despite the substantial consolidation effort (including the carry-over impact of the June 2009 measures), mostly due to the sizeable denominator effect. Among the revenue measures are the increase of the personal income tax rate (+0.8% of GDP), various reforms that make the personal income tax and social contribution systems more neutral (+0.8% of GDP), as well as additional taxation of real estate (+0.3% of GDP, including through broadening of the base to residential property with some progressivity), progressive taxation of car usage (+0.2% of GDP), and increased excise duties on gas and tobacco. On the expenditure side, the 2010 State budget introduced significant expenditure cuts based to a large extent on structural reforms with a medium-term impact, notably the merger/abolition of agencies and institutions, under the responsibilities of the ministries of agriculture, culture, education, and defence, while further cuts worth 0.5% of GDP are made in transport maintenance expenditure and subsidies. Further wage cuts in local government bring savings of 0.4% of GDP, while cuts in sickness, unemployment, maternity and paternity allowances above a certain threshold result in savings amounting to 0.2% of GDP. There is no significant recourse to one-off measures. According to the Commission services' calculations on the basis of the information in the programme, the structural balance (i.e., the cyclically-adjusted balance net of one-off and other temporary measures) is expected to improve by slightly more than 2% (from -7.6% to -5.5%), which is consistent with the needed restrictive fiscal stance. 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.

(7) Taken at face value, 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 fiscal targets require additional consolidation measures, as recommended by the Council and in line with the February 2010 supplemental memorandum of understanding. According to the Commission services' recalculation of the structural balance based on the information provided in the programme according to the commonly agreed methodology, the updated convergence programme does not achieve the medium-term budgetary objective (MTO) of a structural deficit of 1% of GDP within the programme period[6]. In view of the new methodology[7] and given the most recent projections and debt level, the MTO itself nevertheless reflects the objectives of the Stability and Growth Pact. According to the structural balance as calculated by the Commission services, the corresponding fiscal effort amounts to 3¾% over two years, with some frontloading in 2011. The scenario for 2011 and 2012 is already backed by several measures on both the revenue and the expenditure side, which have been outlined by the Latvian authorities, and to which they have committed in the context of the balance of payment assistance. On the expenditure side, the Latvian authorities intend notably to carry out a broad review of social insurance benefits and pension systems, the goal for the latter being to preserve the future sustainability and adequacy of the three pillars of the pension system.

(8) Looking forward, the developments could turn out worse than projected in the programme given the size of the remaining adjustment in the context of a sluggish economy, uncertainty on future revenue trends and on the measures which should back the consolidation, and the scope of the reforms which still need to be undertaken to underpin a sustainable recovery. As recognised by the programme, ensuring the stability of the financial sector is an important pre-condition for economic recovery. Regarding political and implementation risks, the extent of fiscal steps to be undertaken could expose the government to legal challenges, while, in the context of forthcoming elections, and given the major consolidation to date, 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. On the other hand, there is a very strong incentive for the Latvian authorities to meet the binding commitments made under the balance of payments assistance agreements. Moreover, the Latvian authorities have given convincing evidence in the consolidation undertaken to date of being able to implement satisfactorily a very sizeable consolidation effort. The risks to the budgetary projections and the macroeconomic scenario thus appear broadly balanced over the whole programme period.

(9) Government gross debt is estimated at 34.8% of GDP in 2009, up from 19.5% in the year before. The debt ratio is projected to increase sharply by a further 22 pps. over the programme period, driven by significant fiscal deficits, but also due to a substantial positive stock-flow adjustment amounting to 8% of GDP in 2010, as

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6 While the programme itself presents the structural deficit in 2012 as declining to 0.5% of GDP, the Commission services' recalculation is a structural deficit of 1.8% of GDP.

7 The country-specific MTO 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.

disbursements of around 15% of GDP from various international lenders are expected to more than cover strict budgetary needs. However, the final cost of banking sector support measures represents a risk in 2011 and 2012. Consequently, there are risks surrounding the programme projection showing the debt ratio peaking at slightly below 60% in 2011. The projection for the final programme year of 2012 is 56.8% of GDP. While the debt ratio is projected to remain below the Treaty reference value throughout the programme period, it is on a rapidly increasing trend up to 2011.

(10) The long-term budgetary impact of ageing is clearly lower than the EU average, as a result of the pension reforms already enacted. However, the budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Reducing the primary deficit over the medium term, as foreseen in the programme, would contribute to reducing the risks to the sustainability of public finances, which were assessed in the Commission 2009 Sustainability Report[8] as high. Medium-term debt projections that assume GDP growth rates to only gradually recover 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, would almost stabilise the debt-to-GDP ratio by 2020.

(11) The pro-cyclical fiscal policy implemented during the years preceding the crisis calls for a radical strengthening of the budgetary framework and public finance management system. Some progress has already been made, and more initiatives are planned. The need to remove unnecessary rigidities in the budget to improve spending flexibility has been addressed in a Cabinet Regulation of 3 November 2009, giving the Minister of Finance the ability to reallocate appropriations for one budget entity across programmes, sub-programmes and expenditure economic categories. Monitoring of EU structural funds-related expenditure has been strengthened by changes in the state budget law made with the 2010 budget. Going forward, the Ministry of Finance is committed to develop and submit a draft fiscal discipline law, in collaboration with other relevant institutions, in order to ensure counter-cyclical fiscal discipline at all public administration levels. Some broad reviews are likely to improve the prioritisation and decision-making process prior to the design of next budgets: an analysis is planned of all services provided by public institutions, aimed at assessing whether such services need to be continued, suspended or outsourced, and a review of all public companies is to take place with a view to their possible restructuring. To support fiscal consolidation, there also is a need to put in place effective sanction procedures for individuals' misuse of public funds, to improve the collection and processing of general government data, and to strengthen the monitoring of outstanding and planned commitments.

(12) The quality of public finances is likely to benefit from substantial changes impacting the revenue structure, including an increased focus on more efficient and equitable

[8] In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

taxation of wealth. However, the tax wedge on labour will remain high, following the increase of the personal income tax rate. A consistent longer-term tax strategy would help in optimising the impact of the taxation structure on growth. The design of appropriate administrative and legal devices to tackle the grey economy also seems necessary to ensure the success of the ongoing fiscal consolidation. As consolidation needs have squeezed resources, several significant steps have been taken to strengthen the efficiency of public spending. 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 is likely to prove helpful in mitigating the impact of the economic crisis. The law regulating the remuneration of civil servants and employees of central and local government institutions, adopted on 1 December 2009, merges all regulations for public sector employees and creates additional incentives for these employees by strengthening the transparency of the remuneration system, while for the budgetary authorities at different levels of government it tightens expenditure control and underpins the consolidation process.

(13) Latvia has been hit very severely by the crisis and has had to have 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 to improve. Financial market pressures have subsided significantly since summer 2009, but the situation remains highly dependent on further action to address the remaining challenges. Financial sector supervision has been strengthened, including better cooperation with foreign supervisory bodies, and steps have been taken to ensure adequate capitalisation in the banking system. Latvia has taken bold measures to address the deterioration of public finances. Achieving a sustainable improvement in the public finances while ensuring a fair burden-sharing and supporting the competitiveness of the economy could be supported by a further strengthening of the absorption and governance of EU structural funds, a focus on actions supporting FDI and export-generating businesses, relevant training and education for the labour force as well as by clearer priorities for competitiveness and R&D policy.

(14) Overall, in 2010 the budgetary strategy set out in the programme is consistent with the Council recommendations under Art. 104(7) TEC and the deficit targets set in the framework of balance of payments assistance. From 2011 on, taking into account the risks, the budgetary strategy also appears broadly consistent with the deficit targets set in both frameworks, 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. However, the average annual improvement in the structural balance of around 2% of GDP 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.

(15) 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. In its recommendations under Article 104(7) TEC 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 recommendations in a separate chapter in the updates of the convergence programmes. Latvia has fully complied with this recommendation.

The overall conclusion is that Latvia is undertaking a significant fiscal consolidation and economic adjustment in line with the Council recommendations, supported by the adoption of a 2010 budget based on high-quality measures, wide-ranging reforms in the public sector, an improved absorption of EU structural funds, targeted labour market policies, and action to strengthen the financial sector. Looking forward, risks pertain to the size of the remaining adjustment in the context of a sluggish economy, uncertainty on future revenue trends and on the measures which should back the consolidation, and the scope of the reforms which still need to be undertaken to underpin a sustainable recovery. Further improvements in the budget framework could facilitate the identification and implementation of the necessary measures, reducing the risk that the budgetary outcome is worse than planned.

In view of the above assessment and in the light of the recommendation under Article 104(7) TEC and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Latvia is invited to:

(i) fully implement the 2010 budget as adopted on 1 December 2009; prepare a menu of budgetary options producing savings or additional revenues allowing the adoption of a 2011 budget in accordance with the consolidation needs; adopt a 2012 budget also consistent with the targeted fiscal path;

(ii) carry out the thorough and forward-looking analysis needed for a wide-ranging social benefits reform, with a view to implement such a reform in the course of 2011 together with further measures on the revenue side;

(iii) improve fiscal governance and transparency, inter alia by adopting the draft fiscal discipline law, by strengthening the binding nature of the medium-term budgetary framework, and by putting in place effective sanction procedures for individuals' misuses of public funds; strengthen control, coordination and sanction mechanisms aiming at tackling the grey economy;

(iv) foster economic growth by promoting the shift towards the tradeable sector and productivity improvements, including by ensuring that the available EU structural funds reach the real economy, and restructuring state-owned banks in a timely manner, within a medium-term strategy.

Overview 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