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CONVERGENCE REPORT 2013

(prepared in accordance with Article 140(1) TFUE at the request of Latvia)

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European Commission

Directorate-General for Economic and Financial Affairs

Convergence Report 2013

EUROPEAN ECONOMY xxx/2013

ABBREVIATIONS

LV	Latvia
EA	Euro area
EU-27	European Union, 27 Member States
EU-25	European Union, 25 Member States before 2007 (i.e. EU-27 excl. BG and RO)
EU-15	European Union, 15 Member States before 2004
EUR	Euro
ECU	European currency unit
LVL	Latvian lats
USD	US dollar
SDR	Special Drawing Rights
AMR	Alert Mechanism Report
BoL	Bank of Latvia
BoP	Balance of Payments
CAR	Capital adequacy ratio
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with largest market share)
EC	European Community
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and monetary union
ERM II	Exchange rate mechanism II
ESA95	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Union
FCMC	Financial Capital Market Commission
FDL	Fiscal Discipline Law
FDI	Foreign direct investment
FSAP	Financial Sector Action Plan
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HICP-CT	HICP at constant taxes
IMF	International Monetary Fund
MFI	Monetary Financial Institution
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-term objective
NCBs	National central banks
NEER	Nominal effective exchange rate
NPL	Non-performing loans
OJ	Official Journal
OJL	Official Journal Lex
PIT	Personal Income Tax
PPS	Purchasing Power Standard
PPP	Purchasing Power Percentage
R&D	Research and development
REER	Real effective exchange rate

SITC	Standard International Trade Classification
SME	Small and medium entreprises
TEC	Treaty establishing the European Community
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax

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1. INTRODUCTION

1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States. The decision ([1]) by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency had, in accordance with the Treaty (Article 121(4) TEC) ([2]), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission ([3]) and the European Monetary Institute (EMI), respectively ([4]). These reports, prepared in accordance with Article 121(1) TEC ([5]), examined whether the Member States satisfied the convergence criteria and met the legal requirements.

Since then, Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009) and Estonia (2011) have joined the euro.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Article 140 of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports on such Member States. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty ([6]) and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the euro, they are not the subject of an assessment as to whether they fulfil the necessary conditions.

In 2012, the Commission and the ECB adopted their latest regular Convergence Reports ([7]). None of the Member States assessed in those reports was deemed to meet the necessary conditions for adopting the euro.

On 5 March 2013 Latvia submitted a request for a convergence assessment. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2013 on Latvia and includes a detailed assessment of the progress with convergence.

The financial and economic crisis, along with the recent euro-area debt crisis, in general, has exposed gaps in the current economic governance system of the Economic and Monetary Union (EMU) and showed that its existing instruments need to be used more fully. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union was undertaken over the past three years. Accordingly, this Commission Staff Working Document makes references where appropriate to procedures that help to strengthen the assessment of the convergence process and its sustainability. In particular, it incorporates references to the strengthened surveillance of macroeconomic imbalances (see section 1.2.6.).

([1]) OJ L 139, 11.5.1998, pp. 30-35
([2]) The numbering of Treaty articles cited in this report corresponds to the one of the Treaty on the Functioning of the European Union (TFEU) except when explicitly mentioned. Article 121(4) TEC does no longer exist in the TFEU, as it refers to the first countries deemed ready to adopt the euro on 1 January 1999.
([3]) Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.
([4]) European Monetary Institute, Convergence Report, March 1998.
([5]) The content of this article is now included in Article 140(1) TFEU.
([6]) Protocol (No 16) on certain provisions relating to Denmark, Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.
([7]) European Commission, Convergence Report 2012, COM(2012) 257 final, 30 May 2012; European Central Bank, Convergence Report 2012, May 2012.

Box 1.1: **Article 140 of the Treaty**

"1. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

— the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,

— the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),

— the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,

— the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to the Treaties. The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

2. After consulting the European Parliament and after discussion in the European Council, the Council shall, on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in paragraph 1, and abrogate the derogations of the Member States concerned.

The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal.

The qualified majority of the said members, as referred to in the second subparagraph, shall be defined in accordance with Article 238(3)(a).

3. If it is decided, in accordance with the procedure set out in paragraph 2, to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned."

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapter 2 examines the fulfilment of the convergence criteria and other requirements in the order as they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 16 May 2013.

1.2. APPLICATION OF THE CRITERIA

In accordance with Article 140(1) of the Treaty, the Convergence Reports shall examine the compatibility of national legislation with Articles 130 and 131 of the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, public finances, exchange rate stability and long term interest rates as well as some additional factors. The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 13 on the convergence criteria).

1.2.1. Compatibility of legislation

In accordance with Article 140(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 130 and 131 of the Treaty. This assessment mainly covers three areas.

- First, the independence of the national central bank and of the members of its decision-making bodies, as laid down in Article 130, must be assessed. This assessment covers all issues linked to a national central bank's institutional financial independence and to the personal independence of the members of its decision-making bodies.

- Second, in accordance with Articles 123 and 124 of the Treaty, the compliance of the national legislation is verified against the prohibition of monetary financing and privileged access. The prohibition of monetary financing is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the central banks of Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or central banks of debt instruments. As regards the prohibition on privileged access, the central banks, as public authorities, may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations.

- Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that at the latest by the moment of euro adoption, the objectives of the national central bank are compatible with the objectives of the ESCB as formulated in Article 127 of the Treaty. What is more, the provisions on tasks in national central banks laws are assessed against the relevant provisions of the Treaty and the ESCB/ECB Statute.

1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 140(1) of the Treaty: "the achievement of a high degree of price stability […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

Article 1 of the Protocol on the convergence criteria further stipulates that "the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions".

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation ([8]) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005 ([9]) provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

([8]) Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4), amended Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament of the Council.

([9]) Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

Box 1.2: Assessment of price stability and the reference value

The numerical part of the price stability criterion implies a comparison between a Member State's average price performance and a reference value.

A Member State's **average rate of inflation** is measured by the percentage change in the unweighted average of the last 12 monthly indices relative to the unweighted average of the 12 monthly indices of the previous period, rounded to one decimal. This measure captures inflation trends over a period of one year as requested by the provisions of the Treaty. Using the commonly used inflation rate – calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year – would not meet the one year requirement. The latter measure may also vary importantly from month to month because of exceptional factors.

The **reference value** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers. Defining the reference value in a relative way (as opposed to a fixed reference value) allows to take into account the effects of a common shock that affects inflation rates across all Member States.

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006 and EU-27 for reports as of 2007.

The notion of '**best performer**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a non-mechanical manner, taking into account the state of the economic environment at the time of the assessment. In previous Convergence Reports, when all Member States had a positive rate of inflation, the group of best performers in terms of price stability naturally consisted of those Member States which had the lowest positive average rate of inflation. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability (Lithuania's average 12-month inflation was at that time 2.3 percentage points below the euro area average 12-month inflation). In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers, i.e. the only Member State whose average inflation rate deviated by a wide margin from that of the euro area and other Member States, mainly due to the severe economic downturn in that country (Ireland's average 12-month inflation was at that time -2.3% and that of the euro area 0.3%). At the current juncture, it is warranted to exclude Greece from the best performers, as its inflation rate and profile deviate by a wide margin from the euro area average, mainly reflecting the severe adjustment needs and exceptional situation of the Greek economy, and including it would unduly affect the reference value and thus the fairness of the criterion. In April 2013**,** the 12-month average inflation rate of Greece was 0.4% and that of the euro area 2.2%, with the gap between the two forecast to increase further in the months ahead. Table 1.1 lists the reference value in the Convergence Reports issued since 1998.

(Continued on the next page)

Box (continued)

Table 1:
Inflation reference value in previous and current Convergence Reports

Convergence Report adoption date	Cut-off month	Three best performers [1) 2)]	Reference value [3)]	Euro area average inflation rate [4)]
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, France, Luxembourg [5)]	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3
2012	March 2012	Sweden, Ireland, Slovenia	3.1	2.8
2013	April 2013	Sweden, Latvia, Ireland	2.7	2.2

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 from January 2007 onwards.
2) In case of equal rounded average inflation for several potential best performers, the ranking is determined on the basis of unrounded dc
3) Reference values are only computed at the time of Convergence Reports. All calculations of the reference value between the Convergence Reports are purely illustrative.
4) Measured by the percentage change in the arthmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
5) Based on revised data, Germany would replace Luxembourg as one of the three Member States with the lowest 12 month average inflation in April 2002. This change would not affect the price and long-term interest rate reference values in April 2002

As has been the case in past convergence reports, a Member State's average rate of inflation is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The reference value is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points.

Over the 12-month period covering May 2012-April 2013, the three best-performing Member States in terms of price stability were Sweden (0.8%), Latvia (1.3%) and Ireland (1.6%), yielding a reference value of 2.7%. Greece was excluded from among the best performers, as its inflation rate and profile deviate by a wide margin from the euro area average, mainly reflecting the severe adjustment needs and exceptional situation of the Greek economy (see Box 1.2).

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This deserves particular attention in the current juncture as the financial turmoil exposed unsustainable price developments in many EU Member States, including euro area countries, in the pre-crisis period.

Inflation sustainability implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Technical Annex examines also the role of the macroeconomic situation and policy stance in inflation performance, developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, developments in import prices to assess how external price developments have impacted on domestic inflation. Similarly, the impact of administered prices and indirect taxes on headline inflation is also considered.

Box 1.3: **Excessive deficit procedure**

The excessive deficit procedure is specified in Article 126 of the Treaty, the associated Protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure ([1]), which is the "corrective arm" of the Stability and Growth Pact. Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position. As part of an overall strengthening of economic governance in the Union, Council Regulation (EC) No 1467/97 was amended in 2011. In particular, a numerical benchmark was introduced for operationalising the debt criterion in Article 126(2) of the Treaty.

Article 126(1) states that Member States are to avoid excessive government deficits. The Commission is required to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors (Article 126(2)). In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

"*(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value* [specified in the Protocol as 3 percent]*, unless:*
- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60 percent]*, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*".

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt, nominal GDP and other associated variables twice a year, before 1 April and before 1 October ([2]). After each reporting date, Eurostat examines whether the data are in conformity with ESA95 ([3]) rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 126(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors. These include developments in the medium-term economic position ([4]) the medium-term budgetary position of the Member State ([5]), in the medium-term government debt position ([6]), as well as any other factors which, in the opinion of the Member State concerned, are relevant and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances.

([1]) OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).
([2]) Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure (OJ L 145, 10.06.2009, p1).
([3]) European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 400/2009 of the European Parliament and of the Council (OJ L 126, 21.5.2009, p. 11).
([4]) In particular, potential growth, including the various contributions, cyclical developments, and the private sector net savings position.
([5]) In particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances and in the context of the common growth strategy of the Union, as well as the overall quality of public finances, in particular the effectiveness of national budgetary frameworks.
([6]) In particular, its dynamics and sustainability, including, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government.

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Box (continued)

The Council and the Commission shall make a balanced overall assessment of all the relevant factors. Those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit when assessing compliance on the basis of the debt criterion. When assessing compliance on the basis of the deficit criterion in a country with a debt ratio exceeding the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit subject to the double condition that the deficit is close to the reference value and its excess over it is temporary. Due consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar and the net cost of the publicly managed pillar. ([7])

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 126(4)). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 126(5)). Then, on the basis of a Commission proposal, the Council decides, after an overall assessment, including any observation that the concerned Member State may have, whether an excessive deficit exists (Article 126(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

At the same time as deciding on the existence of an excessive deficit, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, on the basis of a Commission recommendation (Article 126(7)). According to the Stability and Growth Pact, the Council recommendation has to specify when the correction of the excessive deficit should be completed, the annual budgetary targets that the Member State concerned has to achieve, and has to include a maximum deadline of six months at most for effective action to be taken by the Member State concerned. Within this deadline, the Member State concerned shall report to the Council on action taken. The report shall include targets for government expenditure and revenue and for the discretionary measures consistent with the Council's recommendation, as well as information on the measures taken and the nature of those envisaged to achieve the targets.

If effective action has been taken in compliance with a recommendation under Article 126(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. In the case of severe economic downturn for the euro area or the EU as a whole, the Council may also decide, on recommendation by the Commission, to adopt a revised recommendation under Article 126(7), provided that this does not endanger fiscal sustainability in the medium term.

Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 126(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 126(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, as well as the new enforcement mechanisms introduced in 2011, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member State considered in this report. Following a Council decision establishing, under Article 126(8), that the Member State did not take effective action in response to a Council recommendation under Article 126(7), the Council, on recommendation by the Commission, addresses to Member States with a derogation a new recommendation under Article 126(7).

([7]) Where the excess of the deficit over the reference value reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar, the Council and the Commission shall also consider the cost of the reform when deciding on the existence of an excessive deficit, as long as the deficit does not significantly exceed a level that can be considered close to the reference value, and the debt ratio does not exceed the reference value, provided that overall fiscal sustainability is maintained.

(Continued on the next page)

Box (continued)

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, again on the basis of a Commission recommendation (Article 126(12)).

From a forward-looking inflation perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical conditions, labour market developments and credit growth – is complemented by a reference to the most recent Commission services' forecast of inflation. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead ([10]). Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

1.2.3. Public finances

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 140(1) of the Treaty as "the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists".

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2011 reform of the Stability and Growth Pact). The existence of an excessive deficit is determined by Regulation 1467/97 as amended in 2005 and 2011 (most recently under the "Six-Pack") which sets out the way in which government deficit and debt levels are used to assess whether an excessive deficit exists, under article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether a Council decision under 126(6) exists, and the Member State needs to comply with the deficit and debt requirements elaborated in regulation 1467/97 to ensure that it is not subject to such a decision ([11]).

The issue of sustainability deserves particular attention at a time when the financial crisis has significantly impacted on the fiscal positions in many Member States. Related to this, economic governance in the EMU was substantially strengthened in 2011. This included, inter alia, the operationalisation of the debt criterion in the Excessive Deficit Procedure ([12]).

1.2.4. Exchange rate stability

([10]) According to the Commission services' Spring 2013 Forecast, the inflation reference value is forecast to stand at 2.4% in December 2013, with Portugal, Sweden and Cyprus as best performers in terms of price stability. Greece has been excluded from the best performers in December 2013 as its average inflation rate is forecasted to deviate from the euro area average by a wide margin. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to be the best performers in terms of price stability in the forecast period, thereby increasing the possible margin of error.

([11]) The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value (Council Regulation 479/2009). Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

([12]) A directive on minimum requirements for national budgetary frameworks, two new regulations on macroeconomic surveillance and three regulations amending the Stability and Growth Pact and complementing it with new enforcement mechanisms for euro area Member States entered into force on 13 December 2011. Besides the operationalisation of the debt criterion in the Excessive Deficit Procedure mentioned in Box 1.3, the amendments introduced a number of important novelties in the Stability and Growth Pact, in particular an expenditure benchmark to complement the assessment of progress towards the country-specific medium-term budgetary objective.

Box 1.4: **Data for the interest rate convergence**

The fourth indent of Article 140(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the Protocol on the convergence criteria adds that these “Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

Article 5 of the Protocol requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the ECB has developed the criteria for harmonising the series of yields on benchmark 10 year bonds on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series is based on the following criteria:

- issued by central government;
- a residual maturity as close as possible to 10 years;
- adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement;
- fixed coupon;
- yield gross of tax.

The representative interest rates used in this report (for Latvia, Sweden and Ireland) are calculated on the basis of secondary market rates, using single benchmark bonds. For Latvia and Sweden, the residual maturity of the benchmark bond is close to 10 years, while for Ireland it is close to 7½ years.

Data used in this Report can be found on Eurostat ("Maastricht criterion bond yields (mcby): EMU convergence criterion bond yields", code: tec00097). The same series is also published by the ECB's Statistical Data Warehouse (code IRS.M.*Country Code*.U2.L.L40.CI.0000.EUR.N.Z).

The Treaty refers to the exchange rate criterion in the third indent of Article 140(1) as “the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro”.

Article 3 of the Protocol on the convergence criteria stipulates: “The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against the euro on its own initiative for the same period” ([13]). Based on the Council Resolution on the establishment of the ERM II ([14]), the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, in maintaining exchange rate stability.

Latvia was still under an international balance-of-payments assistance programme during the first part of the assessment period for this report. In order to determine whether this constitutes evidence that a country has faced severe tensions

([13]) In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

([14]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

in its exchange rate, the Commission examines the role played by official external financing during the assessment period.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Technical Annex is 17 May 2011 to 16 May 2013.

1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires "the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the long-term interest rate levels". Article 4 of the Protocol on the convergence criteria further stipulates that "the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions" (see Box 1.4).

In the 2012 Convergence Report, the long-term interest rate of Ireland, one of the three best-performing Member States in terms of price stability also at that time, was not included in the calculation of the reference value for the long-term interest rate criterion due to the severe distortions in its sovereign bond market ([15]). However, supported by the successful implementation of its financial assistance programme, the long-term interest rate of Ireland has converged significantly closer to that of other euro area Member States since then and Ireland's bond market access improved considerably ([16]). This suggests that the long-term interest rate of Ireland became an economically meaningful benchmark, which would not distort the reference value any more.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In April 2013, the reference value, derived from the average interest rate in Sweden (1.6%), Latvia (3.8%) and Ireland (5.1%), was 5.5%.

1.2.6. Additional factors

The Treaty in Article 140 also calls for an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 140 of the Treaty, is covered in the subchapter on price stability.

The assessment of additional factors is an important indication of whether the integration of a Member State into the euro area would proceed without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ([17]). Integration of product markets is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, progress in financial integration is examined, together with the impact of the financial crisis, the main characteristics, structures and trends of the financial sector and compliance with the acquis of the Union in this area.

([15]) In March 2012, the 12-month average long-term interest rate in Ireland was 9.1%. Ireland has been the beneficiary of an EU/IMF financial assistance programme since December 2010 and it had practically no market access.

([16]) Disruptions were still present in Ireland's sovereign debt market during the reference period, but were gradually diminishing with the successful implementation of its EU/IMF financial assistance programme. In March 2013 Ireland issued a 10-year bond of EUR 5 billion with a yield of 4.15%.

([17]) The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.

Box 1.5: The Macroeconomic Imbalance Procedure (MIP)

The Macroeconomic Imbalance Procedure (MIP): key elements

A key lesson from the economic and financial crisis has been that the economic governance framework underpinning EMU needed to be further strengthened to address the issue of unsustainable macroeconomic trends. The new procedure on prevention and correction of macroeconomic imbalances – the Macroeconomic Imbalance Procedure (MIP) – responds to this need and was one of the key elements of the legislative package (the "6-pack") to enhance the governance structures in EMU.

A two-step approach with a preventive and a corrective arm

The overall design of the MIP includes a "preventive" arm and a stronger "corrective" arm for more serious cases. For euro area countries, the corrective arm is supplemented by an enforcement mechanism including the possibility of financial sanctions. The procedure relies on a two-step approach where the first step consists of an alert mechanism that aims to identify Member States with potentially emerging macroeconomic imbalances and which require more in-depth investigation. If, on the basis of such an in-depth analysis, the situation is considered unproblematic no further steps are taken. If the Commission however considers that macroeconomic imbalances exist, it may come forward with proposals for policy recommendations for the Member State concerned (which will be – in the preventive arm – part of the integrated package of recommendations under the European semester). In case the in-depth review points to severe imbalances in a Member State, the Council would declare the existence of an excessive imbalance and adopt a recommendation asking the Member State to present a Corrective Action Plan (CAP). After submission of the CAP by the Member State, the Council would assess the CAP which either can be deemed sufficient or insufficient; if found insufficient, the Member State should present a new CAP. If the new CAP is again found insufficient, a fine can be imposed (0.1% of GDP), though just for euro area Member States ([1]). When a sufficient CAP is in place, the Council will assess whether or not the Member State concerned has taken the recommended actions according to the set deadlines. For euro area Member States a first assessment of non-compliance would lead to an interesting-bearing deposit (0.1% of GDP). After a second decision by the Council declaring non-compliance, the Council can take the decision to convert the deposit into an annual fine. If the Council considers that the Member State has taken the recommended corrective action, but imbalances are not yet corrected, the procedure will be placed in abeyance. If the Council considers that the Member State concerned has taken the appropriate action and the Member State is no longer experiencing excessive imbalances, the procedure will be closed.

The alert mechanism scoreboard: design and rationale

The scoreboard is an element of the alert mechanism and is intended to facilitate the identification of trends of imbalances that are under the scope of the MIP and require closer examination. In line with the different challenges facing the Member States, it comprises indicators of the external position (current account and net international investment position), competitiveness developments (real effective exchange rates, unit labour cost, export market shares) and indicators of internal imbalances (private sector and general government debt, private sector credit flow, house prices and the unemployment rate). The scoreboard thus encompasses variables where both the economic literature and recent experiences suggest associations with economic crises, while indicative alert thresholds were identified for each indicator.

The 2013 Alert Mechanism Report (AMR)

As the first step of the MIP process of 2013, the Commission published its second Alert Mechanism Report in November 2012. The AMR made an economic reading of the scoreboard as foreseen by the legislation and on this basis, similarly to the conclusion of the 2012 AMR, Latvia was not identified for an in-depth review related to possible imbalances.

([1]) These decisions are taken with so called "reversed qualified majority voting" (RQMV), which implies that there needs to be a majority against taking the step (as opposed to the normal approach where a decision needs the backing of a qualified majority).

Starting with the 2012 Convergence Report, the convergence assessment is aligned with the broader "European semester" approach which takes an integrated and upstream look at the economic policy challenges facing the EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth. The section on additional factors makes reference to the surveillance of macroeconomic imbalances under the Macro-economic Imbalance Procedure, which was adopted in December 2011 as one of the key elements of the legislative package (the "Six-Pack") to enhance the governance structures in EMU, and integrates its results into the assessment.

2. LATVIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The Bank of Latvia (Latvijas Banka) was founded in 1922 and re-instated in 1991, under the Law on the Bank of Latvia (hereinafter: BoL Law).

Following the assessment of the Convergence Report from 2012, the Latvian Government, in cooperation with Latvijas Banka, prepared amendments to the BoL Law, which the Latvian Parliament (Saeima) adopted on 10 January 2013. The last amendment of the BoL Law prior to the changes in 2013 dates back to 2009.

The Council of Latvijas Banka is the decision making body of the Bank and consists of the Governor, the Deputy Governor and six other Council members. The Governor is appointed by the Saeima upon recommendation of at least ten of its members. The Deputy Governor and the other members of the Council of Latvijas Banka are appointed by the Saeima upon the proposal of the Governor. The Governor, the Deputy Governor and the other members of the Council of Latvijas Banka hold office for six years.

2.1.2. Objectives

The objectives of Latvijas Banka are compatible with the TFEU.

An imperfection under the former BoL Law (2009) regarding the objective of Latvijas Banka has been remedied. In line with Article 127(1) of the TFEU, Article 3 of the new BoL Law now clearly states that the primary objective of the Bank is to maintain price stability.

2.1.3. Central bank independence

No incompatibilities or imperfections with the TFEU and the ECB/ESCB Statute exist in this respect given that the incompatibilities and imperfections of the former BoL Law with regard to the independence of the Central Bank as enshrined in the TFEU and the ESCB/ECB Statute have been remedied.

A provision of the BoL Law (2009) under which the Saeima by means of a resolution could liquidate Latvijas Banka and thereby breach the financial and institutional independence of the Bank has been repealed.

Articles 22 and 28 of the new BoL Law have brought the rules on resignation, absence and dismissal of the Governor including the right of judicial review of dismissal before the Court of Justice of the EU in line with the provisions of the TFEU and the ECB/ESCB Statute on the Central Bank independence.

Pursuant to the new Article 13 of the BoL Law, the prohibition of Latvijas Banka to seek or take instructions from the Government or any other institution explicitly includes also the prohibition to seek or take instructions from Union institutions, bodies, offices or agencies as referred to in Article 130 of the TFEU and Article 7 of the ESCB/EC Statute.

With regard to the financial independence of Latvijas Banka, the new Article 18[1] of the BoL Law now provides that parts of the profits and payments for the usage of state capital shall be transferred to the state general budget only after accumulated losses in the previous years, if any, have been covered.

2.1.4. Prohibition of monetary financing and privileged access

Following the changes introduced by the new BoL Law there is no longer any incompatibility with regard to the prohibition of monetary financing under Article 123 of the TFEU.

The new Article 36 of the BoL Law has clarified the scope of the public sector entities falling within the ambit of the prohibition under Article 123 TFEU. Now Article 36 of the BoL Law states clearly that Latvijas Banka shall not be entitled to grant any type of credit facilities and purchase debt instruments in accordance with Article 123 of the TFEU and Article 21 of the ECB/ESCB Statute.

2.1.5. Integration in the ESCB

There are no incompatibilities or imperfections as to the integration of the BoL into the ESCB.

Table 2.1:
Latvia - Components of inflation

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**Apr-13**	**weights in total 2013**
					(percentage change)¹⁾			
HICP	10.1	15.3	3.3	-1.2	4.2	2.3	1.3	1000
Non-energy industrial goods	3.3	2.7	0.0	-3.5	-1.0	-1.5	-1.4	237
Energy	10.4	27.3	4.0	5.4	13.5	8.7	4.3	159
Unprocessed food	12.3	13.7	0.4	-0.1	3.8	2.2	3.3	103
Processed food	14.4	27.4	6.8	1.0	9.1	2.5	1.2	207
Services	12.9	15.4	4.7	-4.5	0.5	1.7	1.2	293
HICP excl. energy and unproc. food	9.7	13.8	3.5	-2.7	2.4	0.9	0.4	738
HICP at constant taxes	9.8	13.6	-1.9	-1.4	2.7	2.4	1.7	1000
Administered prices HICP	16.6	31.8	17.6	2.1	7.3	7.4	4.2	142

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

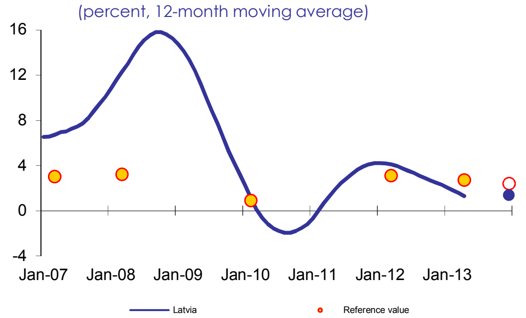
Sources: Eurostat, Commission services.

Following the amendments to Articles 4, 5, 7, 9, 15, 26, 34 to 38 and 43 of the BoL Law, the incompatibilities and imperfections described in the Convergence Report from 2012 with regard to the ESCB/ECB tasks have been remedied.

2.1.6. Assessment of compatibility

The Law on the Bank of Latvia as amended is fully compatible with Articles 130 and 131 of the TFEU.

Graph 2.1: **Latvia - Inflation criterion since 2007**
(percent, 12-month moving average)



Note: The dots in December 2013 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2013 Forecast.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate for Latvia, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment in 2012. Since then, average annual inflation declined from above 4% to well below 2%. In April 2013, the reference value was 2.7%, calculated as the average of the 12-month average inflation rates in Sweden, Latvia and Ireland plus 1.5 percentage points. The average inflation rate in Latvia during the 12 months to April 2013 was 1.3%, i.e. 1.4 percentage points below the reference value. It is projected to remain below the reference value in the months ahead.

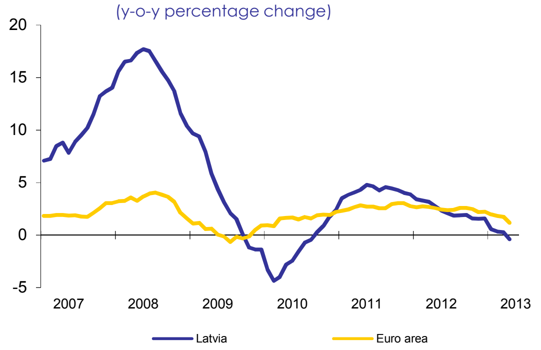
2.2.2. Recent inflation developments

In previous years, Latvia's inflation rate moved in quite a wide range mainly as a consequence of volatile commodity price movements and a very intense business cycle. These factors were amplified by the composition of the consumer basket, which includes a relatively high share of food and energy products and significant taxation changes.

HICP inflation ([18]) peaked at over 17% in 2008, with price dynamics turning around sharply after the intra-year collapse of demand. Significant nominal wage adjustment and a correction in import prices led to almost a year of negative headline inflation from October 2009. Inflation however rose from -2.8% in April 2010 to 4.8% by May 2011, as the cycle turned and a new global commodity price shock set in, exacerbated by the impact of a regional drought and the effect of indirect tax increases. From that local peak, annual inflation fell to -0.4% by April 2013, helped mainly by a continuing wage restraint in the Latvian economy, a decreasing contribution from food and energy prices and the cut of the standard VAT rate by 1 percentage point as of July 2012. Average HICP inflation slowed from 4.2% in 2011 to 2.3% in 2012.

Graph 2.2: **Latvia - HICP inflation**

(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has been well below headline inflation in recent years, highlighting the strong effect that rising commodity prices had on inflation. However, the gap closed in early 2013, as energy inflation fell below zero and core inflation stood at -0.4% in April 2013. In mid-2011, processed food prices temporarily lifted core inflation to over 3%, but it has declined since then as underlying price and cost pressures from the real economy remained subdued. In contrast to Latvia's EU-neighbours, non-energy industrial goods prices continued to fall in April 2013, which may partly be explained by increasing competition on the Latvian retail market. Services prices started to edge up from 2010, but this trend reversed in July 2012 despite the continuing strong recovery of domestic demand, due inter alia to the impact of taxes, energy prices and still moderate wage growth. In addition, the price of telecommunication services declined very significantly in late-2012, contributing to an overall services price inflation of -0.4% in April 2013. Producer price inflation declined in 2012 and remained low in early 2013, indicating that there is no short-term cost pressure from the domestic industry.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Real GDP growth was above 10% on average between 2005 and 2007, but fell to around -7% in 2008-2010. As credit flows abruptly reversed, Latvia required an EU/IMF led international financial assistance programme and ambitious fiscal consolidation began. The reallocation of resources to the tradable sector created the basis for an export-driven recovery. Domestic demand revived only slowly under the burden of financial deleveraging and fiscal consolidation, but from 2011 it was supported by favourable labour market developments. The positive trends continued in 2012 and while growth shifted more towards domestic demand, it remained broadly balanced. Real GDP growth reached 5.5% in 2011 and 5.6% in 2012, helped also by an exceptionally good harvest. Growth is projected by the Commission services' 2013 Spring Forecast to slow to 3.8% in 2013, and to recover to 4.1% in 2014 with the expected improvement in the external environment. Commission services estimate that the Latvian economy will operate slightly above its potential output in 2013-2014.

The fiscal stance, as measured by changes in the structural balance, deteriorated until 2008, as pro-cyclical fiscal policy contributed to the boom and failed to prepare for the crisis. Fiscal policy turned restrictive in 2009, when a huge adjustment was imposed by the crisis and implemented in the

([18]) Eurostat has been reviewing the statistical practices used to compile the HICP in Latvia against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat considers that the methods used for producing the Latvian HICP are of a good standard. Eurostat's recommendations have been followed and the quality of the consumer price statistics for Latvia improved during recent years. The representativity of the Latvian HICP in terms of accuracy and reliability is adequate. There were no apparent instances of non-compliance with the HICP methodology. The Latvian data pass all standard HICP validation tests – they are internally consistent. Latvian HICP data should therefore be considered comparable to the HICPs of other EU countries. The full report will be published in the relevant section on Eurostat's website.

Table 2.2:
Latvia - Other inflation and cost indicators **(annual percentage change)**

	2007	2008	2009	2010	2011	2012[1)]	2013[2)]	2014[2)]
HICP inflation								
Latvia	10.1	15.3	3.3	-1.2	4.2	2.3	1.4	2.1
Euro area	2.1	3.3	0.3	1.6	2.7	2.5	1.6	1.5
Private consumption deflator								
Latvia	9.9	16.2	3.2	-1.8	5.0	3.0	1.9	2.3
Euro area	2.2	2.6	-0.4	1.7	2.5	2.1	1.6	1.7
Nominal compensation per employee								
Latvia	35.1	15.7	-12.7	-6.7	17.2	3.9	3.1	3.8
Euro area	2.6	3.5	1.8	2.0	2.2	1.8	1.8	1.8
Labour productivity								
Latvia	5.8	-4.2	-5.3	4.0	14.8	2.9	1.9	1.9
Euro area	1.3	-0.3	-2.4	2.6	1.2	0.3	0.3	0.9
Nominal unit labour costs								
Latvia	27.7	20.7	-7.9	-10.4	2.1	1.0	1.2	1.9
Euro area	1.3	3.8	4.3	-0.7	0.9	1.4	1.4	0.8
Imports of goods deflator								
Latvia	5.7	9.7	-6.7	7.6	6.1	7.7	2.0	2.1
Euro area	1.0	4.2	-8.1	5.7	6.6	2.6	0.6	1.2

1) 2012 data (except HICP inflation) are estimates.
2) Commission services' Spring 2013 Forecast.

Source: Eurostat, Commission services.

framework of the EU-IMF assistance programme. As a result of the large fiscal adjustment, the structural deficit improved to -0.3% by 2012. According to the Commission services' Spring 2013 Forecast, the structural balance is projected to deteriorate to -1.4% in 2013 and to -1.5% in 2014 under the assumption of unchanged policy, including due to the increase in state contributions to the fully funded private pension scheme.

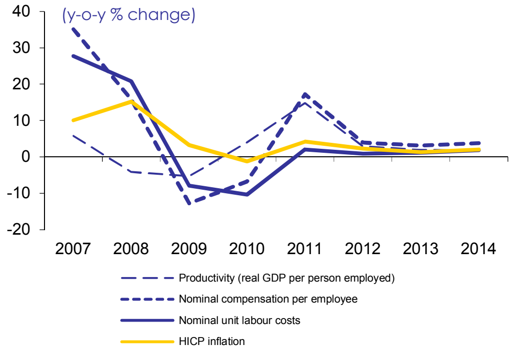
The narrow fluctuation band to the euro, the high degree of euroisation and integration with the European financial system constrain the scope and effectiveness of domestic monetary policy. Nevertheless, the Bank of Latvia continued to loosen monetary conditions with the aim to stimulate the channelling of abundant lats liquidity to economic development. In 2012, the Bank of Latvia cut its refinancing rate in two steps from 3.5% to 2.5% and lowered its marginal lending facility rates in three steps. The reserve requirement was set at 3% for bank liabilities above two years and 5% for all other liabilities included in the reserve base from November 2008 until January 2012, when both were lowered by 1 percentage point. By September 2012, the Bank of Latvia reduced the interest rate on its 7-day deposit facility to 0.075% and on its overnight deposit facility to 0.05%. On the macro-level, the deleveraging of the Latvian economy appears to have abated by early 2013, as new lending nearly counterbalanced the amortisation of the outstanding loan stock, after correction for bank insolvencies (Parex, Krajbanka) and write-offs.

Wages and labour costs

A considerable wage adjustment took place in Latvia over 2009 and 2010, with compensation per employee falling by a cumulative 19% in two years, supported by policies implemented under the EU-IMF assistance programme. Employment declined at a high rate, especially in the private sector, as jobs were shed heavily in construction and manufacturing. The unemployment rate started to decline from around 20% in early 2010, due mainly to employment growth, and fell below 15% by 2012, while the participation rate increased significantly. The economic recovery led to a moderate increase in private sector wages in 2011 and 2012 amid some tightening of the labour market. Nominal unit labour costs (ULC) rebounded somewhat in 2011, but the pace of ULC growth slowed in 2012 to a sustainable level. Labour productivity growth is expected to be low over the next two years, partly reflecting more cautious business investment ([19]).

The Latvian labour market demonstrated substantial flexibility during the crisis, underpinned by a decentralised wage-setting system. That said, large public sector wage cuts indirectly supported nominal wage reduction in the private sector in 2009 and 2010. Public sector wages picked up somewhat earlier in 2011 and increased somewhat faster than those of the private sector in 2012, partly reflecting a correction of earlier excessive cuts in some fields. In 2013-2014, wages are projected by the Commission services' 2013 Spring Forecast to grow broadly in line with productivity, although the labour market is tightening and structural problems, in particular regional differences and skills mismatches on specific labour market segments could lead to some pressures, if not addressed.

Graph 2.3: **Latvia - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2013 Forecast.

External factors

Over the past three years, consumer prices were largely driven by global commodity prices and a regional food price shock in 2010. Latvia's small and open economy is in general highly sensitive to external impulses, but the composition of the consumer basket and the relatively high share of material inputs in production costs also aggravate the impact of volatile commodity prices. After supporting disinflation in 2009, import prices, measured by the imports of goods deflator in the national accounts, rose sharply in the second half of 2010 and early 2011, reflecting increasing world energy and food prices. The subsequent broad stabilisation in the Brent oil price (in euro terms), coupled with a good regional harvest in 2011, led to a moderation in the growth of import prices. The rate of import price growth fell further in 2012, despite a temporary spike in oil prices (in euro terms) around March of that year. The contribution of energy prices to HICP inflation remained high in 2012, with 1.4 percentage points on average.

The nominal effective exchange rate of the lats, measured against a group of 35 trading partners, remained broadly stable since the beginning of 2010. Between late 2008 and early 2010, there was a period when the nominal effective exchange rate was somewhat stronger, as the currencies of many of Latvia's trading partners depreciated against the euro during this phase of the financial crisis. From May 2010, the currencies of some of Latvia's major trading partners in Central and Eastern Europe depreciated against the euro usually when the euro depreciated to the dollar, which resulted in a broadly stable lats nominal effective exchange rate. Towards the end of 2011, the lats appreciated by 2%, i.e. from the weak to the strong side of its fluctuation band to the euro, which resulted in a temporary nominal effective exchange rate appreciation in late 2011. However, these gains were eroded in 2012, as the euro weakened versus currencies of other trading partners.

Administered prices and taxes

Changes in administered prices and indirect taxes significantly influenced inflation over the past three years, although the extent of the contribution fluctuated both in size and direction ([20]). Administered prices, which account for about 14% of the HICP basket, to a large extent reflected the impact of volatile global energy prices, transmitting their generally rising price trend. Indirect tax changes raised inflation in 2010-2011, as the government relied partly on revenue-side measures in stabilising public finances. On the other hand, the July 2012 VAT rate reduction reinforced the strong disinflationary trend that was already evident since mid-2011.

The annual average increase of administrative prices fell from 19% in 2009 to 2.3% in 2010, before picking up again to 7.3% in 2011 and 7.4% in 2012, largely reflecting the delayed impact of changes in the international price of oil. In

([19]) The 2011 compensation per employee and productivity data presented in Table 2.2 is distorted by the currently incomplete consideration of the 2011 Census results. Consistent, revised time series for these variables are set to be published only after the cut-off date of this report.

([20]) According to the Eurostat definition, administered prices in Latvia include inter alia electricity, gas, heat energy, hospital services, public transport and postal services. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/administered_prices particular, tariffs for heat energy rose significantly in the first half of 2010 and in January 2012, those of natural gas in the summer of 2010 and 2011 and those of electricity in the first half of 2011. Administered price growth demonstrated a declining profile in 2012 and early 2013, dropping from 10.7% in March 2012 to -0.7% by April 2013. Rather unusually, administered prices fell (month-on-month) in January and February 2013. This was due mainly to a drop in the wholesale natural gas price of Latvia with automatic effects on heating prices

The indirect tax changes over 2009-2011 were motivated mainly by the need for rapid fiscal consolidation and a strategy to rebalance taxation across bases, as the process of accession-related excise tax harmonisation with EU legal requirements has been completed. In January 2009, the standard VAT rate was increased by 3 percentage points and the reduced VAT rate by 5 percentage points. In January 2011, there was a further VAT increase (of 1 percentage point for the standard rate and 2 percentage points for the reduced rate) and a further broadening of the tax base under the standard VAT rate. In addition, excise taxes on alcohol, tobacco and fuel were raised in mid-2011. In July 2012, the standard VAT rate was reduced by 1 percentage point to 21%, based on an unexpected proposal by the Ministry of Finance in late-April 2012. Annual constant-tax inflation (HICP-CT) was on average 2.4% in 2012, i.e. about 0.1 percentage points above headline inflation ([21]). Assuming full and immediate pass-through ([22]), the average impact of the VAT reduction during the reference period is estimated at around 0.5 percentage point. Adding this to the annual average inflation of Latvia during the reference period would produce a figure of 1.8% that is still below the reference value.

Inflation outlook

HICP inflation is expected to pick up from its current very low level in the context of strengthening domestic demand and some one-off factors. The crisis-related freeze of pension indexation is to end in 2014 and the PIT rate is scheduled to be reduced further by 2 percentage points in 2014 and 2015. The forthcoming liberalisation of the retail electricity market is expected to result in a one-off electricity price increase. The excise tax on tobacco is to rise in January 2014. On the other hand, economic activity will remain constrained by a weak external environment, while tight credit conditions and a prudent fiscal policy are expected to restrain demand pressures on prices. The available data indicate that despite an increase in early 2013, inflation expectations remained relatively well-anchored, in the context of declining headline inflation and slowing economic growth. The Commission services' Spring 2013 Forecast projects the average HICP inflation rate to fall to 1.4% in 2013 and to 2.1% in 2014, compared to 2.3% in 2012.

Risks to the inflation outlook are broadly balanced. Upside risks are mainly related to a possible rise of commodity prices, to which Latvia is particularly exposed, and to the difficulty of controlling wage growth with the tightening of the labour market which will gradually strengthen the bargaining position of employees. Stronger output growth could lead to more upward pressure on wages. Downside risks to the inflation outlook could emerge with a weaker-than-expected growth in Latvia or abroad. Downward effects may also emerge from on-going energy efficiency projects in district heating networks that are expected to reduce sales prices. Uncertainty around the short-term inflation forecast is heightened by the rather unclear price impact of the upcoming retail electricity market liberalisation; however, a significant upward effect is already factored in the forecast.

2.3. PUBLIC FINANCES

2.3.1. The excessive deficit procedure for Latvia

On 7 July 2009, based on a recommendation by the Commission, the Council decided in accordance with Article 104(6) TEC that an excessive deficit existed in Latvia and addressed recommendations to Latvia in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive government deficit. The Council recommended that Latvia puts an end to the excessive deficit situation as rapidly as possible and at the latest by 2012, by ensuring an average annual fiscal effort of at least 2¾% of GDP over

([21]) In the first semester of 2012, HICP-CT was well below the headline due to the excise tax increases of mid-2011, but in the second semester HICP-CT rose well above the headline due to the July 2012 VAT cut.

([22]) Resulting in a hypothetical direct impact on headline HICP of around 2/3 percentage point between July 2012 and June 2013.

Table 2.3:
Latvia - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	
General government balance	-0.4	-4.2	-9.8	-8.1	-3.6	-1.2	-1.2	-0.9	
- Total revenues	35.6	34.9	34.0	35.3	34.9	35.2	34.3	33.8	
- Total expenditure	36.0	39.1	43.8	43.4	38.4	36.4	35.5	34.7	
of which:									
- Interest expenditure	0.4	0.6	1.5	1.4	1.5	1.3	1.5	1.6	
p.m.: Tax burden	30.8	29.7	27.0	27.4	27.7	28.1	27.3	27.0	
Primary balance	0.0	-3.6	-8.3	-6.7	-2.1	0.1	0.3	0.6	
Cyclically-adjusted balance	-3.9	-5.6	-5.9	-4.6	-1.8	-0.8	-1.4	-1.5	
One-off and temporary measures	0.0	0.0	-0.3	-1.7	-0.2	-0.5	0.0	0.0	
Structural balance [2]	-3.9	-5.6	-5.5	-2.9	-1.6	-0.3	-1.4	-1.5	
Government gross debt	9.0	19.8	36.9	44.4	41.9	40.7	43.2	40.1	
p.m: Real GDP growth (%)	9.6	-3.3	-17.7	-0.9	5.5	5.6	3.8	4.1	
p.m: Output gap	11.5	4.4	-12.6	-11.4	-5.7	-1.2	0.6	1.7	
Convergence programme							**2013**	**2014**	**2015**	**2016**
General government balance							-1.1	-0.9	-0.9	-0.9
Structural balance [2] [3]							-1.5	-1.7	-2.1	-2.3
Government gross debt							44.5	41.0	36.4	34.6
p.m. Real GDP (% change)							4.0	4.0	4.0	4.0

1) Commission services' Spring 2013 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme.
There are no one-off and other temporary measures in the programme for the period 2013-2016.
Sources: Commission services and 2013 Convergence Programme of Latvia.

the period 2010-2012. In its recommendation, the Council established a deadline of 7 January 2010 for the Latvian government to take effective action. On 16 February 2010, the Council concluded that Latvia had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council and that no further action under the excessive deficit procedure was necessary, thereby putting the procedure in abeyance ([23]).

According to the data provided by the Commission (Eurostat), Latvia's general government deficit was 1.2% of GDP in 2012, while the general government debt stood at 40.7% of GDP at the end of 2012. In view of this data and taking into account the Commission's spring 2013 forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the deficit below 3% of GDP. The Commission is therefore recommending to the Council to abrogate the decision on the existence of an excessive deficit in Latvia.

([23]) An overview of all on-going excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

2.3.2. Recent fiscal developments

In 2009-2011 Latvia benefited from a medium-term financial assistance programme with the EU, which was provided in conjunction with an IMF Stand-by agreement and was also financed by the World Bank, the European Bank for Reconstruction and Development, with an involvement of several EU countries and Norway. This assistance was subject to a number of policy conditions including fiscal consolidation and structural reforms which were consistent with the Council recommendations under the EDP. The comprehensive fiscal consolidation implemented in the course of these years put Latvia's public finances on a sustainable path, with the structural deficit declining from its peak of 5½% of GDP in 2008 to 1½% in 2011, while the nominal balance improved from a deficit of 9.8% of GDP in 2009 to a deficit of 3.6% in 2011. Main consolidation measures implemented during these years included increases in several tax rates (notably the VAT rate was increased from 18% to 22%) and a wide-ranging reduction in government expenditure, as wages and employment in the public sector were adjusted downwards and the structure of public spending improved in several areas. In addition, several social benefits were partly reduced and partly temporarily capped, and some indexation mechanisms were suspended. The improvement in the underlying government budgetary position, however, remained partly obscured by revenue shortfalls in 2009-2011.

Following the finalisation of the international financial assistance programme, the public finances continued their improvement trend in 2012. Reflecting past consolidation efforts and supported by the robust economic recovery, the nominal general government deficit declined to 1.2% of GDP in that year. At the same time, the structural balance improved by 1¼ pp. and reached a structural deficit of ¼% of GDP, which is better than Latvia's medium-term objective of -0.5% of GDP set in the 2012 and 2013 Convergence Programmes. This improvement in the structural budgetary position reflects consolidation measures contained in the 2012 budget law, although the improvement was partly scaled back through the mid-year supplementary budget and the VAT rate reduction by 1 pp. to 21% from July 2012. The decline of both the nominal and structural deficit was also supported by a notable improvement in tax efficiency, helped by considerable policy efforts that have been put in place in recent years in this area.

The debt-to-GDP ratio increased steeply in 2009 and 2010, reflecting borrowing under the international financial assistance programme, but stabilised in 2011 and declined in 2012 to a level of 40.7% of GDP. Since June 2011, Latvia has regained full access to financial markets and is currently enjoying very favourable financing conditions. This allowed an early repayment of Latvia's outstanding obligations towards the IMF in late 2012, replacing this part of official debt by market financing.

2.3.3. Outlook for public finances

The budget for 2013 was adopted by Parliament on 15 November 2012. At the time of its adoption, the budget law targeted a general government deficit of 1.4% of GDP; however, due to the better-than-expected outcome of 2012 it is likely that this target will be over-achieved in the absence of new policy measures. On the revenue side, the budget reflects (i) the first step of the three-year strategy to lower the personal income tax rate from 25% to 20%, with the rate being lowered to 24% from January 2013; (ii) the impact of the 1 pp. VAT rate reduction from July 2012 and (iii) the lower share of social security contributions which the government retains, whereas the share of contributions to the second pillar pension scheme correspondingly increases. On the expenditure side, the increase in the public sector wage bill is limited and targeted, while pension indexation remains frozen and some social benefits are capped, implying a diminishing ratio of government expenditure to GDP. Overall, the general government deficit is expected to remain at the level of 1.2% of GDP in 2013. The structural deficit is expected to increase by some 1 pp. of GDP, including on account of the increasing cost of the systemic pension reform described above.

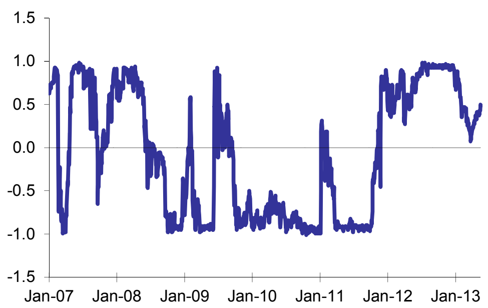
Under the no-policy change assumption, the deficit is expected to slightly improve in nominal terms to 0.9% of GDP in 2014, with the structural deficit remaining broadly unchanged. In particular, the further decrease in the personal income tax rate offsets the positive impact of economic growth on tax revenue, while some restrictions on the increase of social benefits are maintained and the statutory retirement age is gradually increased, implying a further decline in the share of public expenditure in GDP. The general government debt-to-GDP ratio is expected to rise again in 2013, reaching 43.2% as the authorities accumulate assets for future repayments of debt, and to decline to around 40% of GDP by the end of 2014 as these repayments take effect.

A further planned personal income tax rate cut in 2015 and restoring the long-term level of state contributions to private pension funds by 2016 will affect the public finances in coming years, whereas potential gains in terms of tax efficiency also remain ample. The possibility of further substantial tax efficiency gains, in response to recent measures to reduce the share of the informal economy, represents the main upside risk to the medium-term budgetary outlook. Some of the social benefit restraints implemented during the years of fiscal adjustment are yet to be lifted; at the same time the on-going reforms in the area of public expenditure – including the gradual increase in statutory pension age – could provide an offsetting effect. At the same time, some of the fiscal risks might materialise, in particular those that stem from publicly owned companies, of which some are in on-going restructuring processes. Moreover, the state could face assumption of debt it has guaranteed in relation to an industrial company in difficulties, amounting up to 0.3 pp. of GDP if the debt is assumed in full, and possibly other costs related to this company in 2013 or 2014. Nevertheless, overall risks to the medium-term outlook are considered to be balanced.

2.4. EXCHANGE RATE STABILITY

The Latvian lats entered ERM II on 2 May 2005, i.e. it has spent more than eight years in ERM II at the time of the adoption of this report. 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 (LVL 0.702804 per EUR 1), with a standard fluctuation band of ±15%. Upon ERM II entry, the authorities unilaterally committed to maintain a tighter fluctuation margin of ±1% around the central rate. During the two years preceding this assessment, the official EUR/LVL exchange rate did not deviate from its central rate by more than ±1%, in line with the Latvian authorities' unilateral commitment. The evolution of additional indicators also suggest that the EUR/LVL exchange rate was not subject to severe tensions over the past two years, though Latvia's international financial assistance programme was in place until January 2012.

Graph 2.4: **LVL - Spread vs central rate**
(as percent, daily values)

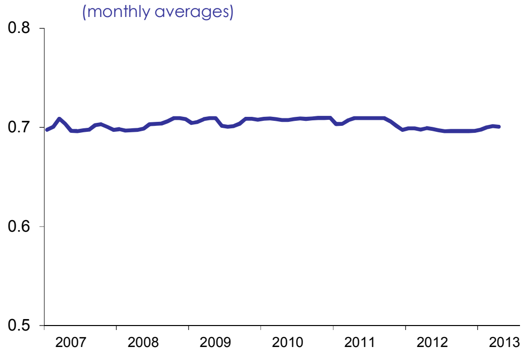


Source: Commission services, ECB, Reuters EcoWin.

In 2007-2008, the nominal exchange rate of the lats was relatively volatile within the narrow fluctuation band, influenced by currency devaluation rumours, in the context of large macro-imbalances. Initial failure to stabilise the situation in the banking sector in late 2008 led to capital outflows that forced the Bank of Latvia to intervene heavily to protect the value of the lats. The December 2008 agreement on an international financial assistance package helped to calm markets. However, market stress returned in spring 2009, as it became evident that the fiscal situation was worse than expected and political uncertainty hindered an appropriate policy response. Market tensions peaked in June 2009, when speculation about an imminent lats devaluation drove short-term interest rates to over 30%. More than a third of Bank of Latvia's foreign assets was sold during the financial turmoil between February and end-June to sustain the peg. Following the Latvian authorities' supplementary budget in mid-June and the disbursement of the EU's large second loan tranche in July, financial market conditions rapidly improved.

The exchange rate peg did not come under significant pressure over the past two years. The lats remained within its fluctuation band during the assessment period and the Bank of Latvia had to intervene mostly on the strong side of the narrow band. From the beginning of 2011, the Treasury changed its financial assistance programme-related practice of converting foreign currency with the Bank of Latvia and started to buy lats on the market (as it had done before mid-2009). The Treasury regularly pre-announced these transactions to make the exchange rate impact predictable for market participants. Nevertheless, these transactions may have served as intra-band interventions by selling foreign exchange from official reserves in exchange for lats. In early and late 2011, large (relative to the size of the Latvian market) Treasury transactions drove the lats exchange rate to the strong side of the fluctuation band. The lats stayed on the strong side in 2012, but it depreciated towards the middle of the band in late 2012 and early 2013, against the background of lower foreign currency supply by the Treasury and market anticipation regarding euro adoption.

Graph 2.5: **Exchange rates - LVL/EUR**
(monthly averages)



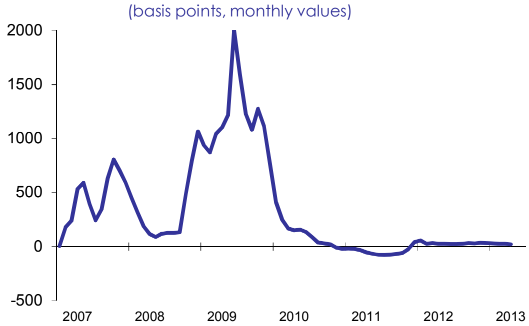
Source: ECB, Reuters EcoWin.

The international reserve position of the central bank has been quite strong as it covered around 150% of base money and around 60% of M3 in early 2013. The credibility of the peg gradually improved from mid-2009, as indicated by a reversal of deposit euroisation and the return of non-resident deposits to the Latvian banking system. The share of euro-denominated deposits in total resident deposits started to increase in 2012, presumably in expectation of Latvia's future euro adoption. The last disbursements from the IMF and the EU under the programme took place in August 2010 and October 2010, respectively. After that, Latvia opted not to ask for further funds committed by the EU and the IMF under the international Balance of Payments assistance ([24]). In June 2011, Latvia successfully returned to the international bond market by issuing a 10-year USD 500 million bond, with the achieved yield of 5.491% signalling good market access. That was followed by a 5-year USD 1 billion issuance in February 2012 with yield of 5.375%. In December 2012, Latvia issued a 7-year USD 1.25 billion bond at a historical low yield of 2.89% and used part of the proceeds to repay its remaining programme-related liability to the IMF.

Financial market conditions in Latvia improved significantly since 2010, also including strengthened supervision (see section 2.6.3), demonstrating resilience to political uncertainty ahead of the October 2010 and September 2011 parliamentary elections. Major credit rating agencies assessed the results of Latvia's economic stabilisation programme positively and raised their ratings for Latvia over the past two years([25]).

Over the past two years, the policy rates of the Bank of Latvia were broadly aligned with those of the ECB, with the overnight deposit rate at 0.05% since September 2012. Abundant lats liquidity that was created by the off-market conversion of international programme funds before 2011 and got locked by the limits on banks' open foreign currency position kept interbank rates low, at times even below those of the euro area, although the interbank market remained illiquid beyond the very short term. There was some limited tension in the Latvian money market during the Krajbanka insolvency case in late 2011, but the situation calmed down by early 2012. Since then, the 3-months RIGIBOR moved broadly in parallel with the 3-months EURIBOR. As an increasing tendency since mid-2012, some banks keep overnight euro deposits in the Bank of Latvia (at zero interest).

Graph 2.6: **Latvia - 3-M Rigibor spread to 3-M Euribor**
(basis points, monthly values)

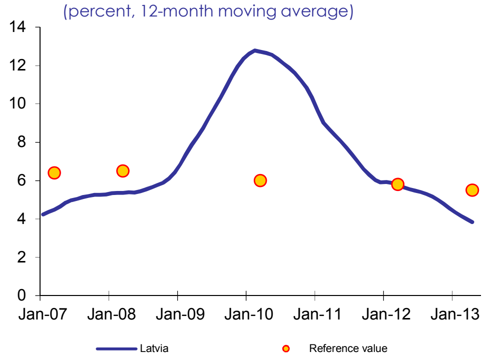


Source: Eurostat.

2.5. LONG-TERM INTEREST RATES

For Latvia, the development of long-term interest rates over the current reference period is assessed on the basis of secondary market yields on a single benchmark government bond with a residual maturity of close to, but below 10 years.

Graph 2.7: **Latvia - Long-term interest rate criterion**
(percent, 12-month moving average)



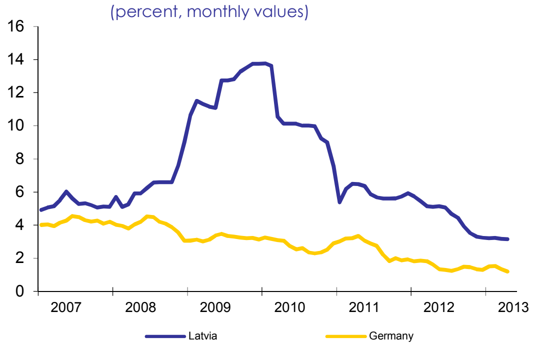
Source: Commission services.

The Latvian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was at the reference value at the 2012 convergence assessment. It declined further from 5.8% then to well below 5% by end-2012. In April 2013, the last month for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Latvia and Ireland plus 2 percentage points, stood at 5.5%. In that month, the 12-month moving average of the yield on the Latvian benchmark bond stood at 3.8%, i.e. below the reference value.

([24]) In December 2011 Latvia drew the second development policy loan of the World Bank's Safety Net and Social Sector Reform Program for an amount of EUR 100 million (0.5% of GDP).

([25]) The long-term foreign-currency rating was raised from BB+ (Fitch, Standard&Poor's) / Baa3 (Moody's) in 2010 to BBB (Fitch, Standard&Poor's) / Baa2 (Moody's) in 2013.

Graph 2.8: **Latvia - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

Long-term interest rate spreads vis-à-vis the euro area were gradually rising from their lows in 2006 until late 2008, when they spiked in reaction to fears of a lats devaluation and Latvia's deteriorating fiscal outlook, peaking in late 2009. Spreads compressed in 2010, as confidence in the currency peg was regained, fiscal consolidation yielded results and conversion of assistance programme funds created ample lats liquidity. Against this background, the Treasury returned to the 10-year domestic bond market with several smaller issues in the first half of 2011, thereby extending the maturity profile of lats-denominated government papers. The favourable market trend broke in July 2011, as international financial markets came under renewed pressure and the issuance of 10-year bonds was temporarily suspended. After some pausing in 2011, the spread-compression continued in 2012, as market confidence in Latvia improved further. In 2012, the Treasury launched a new series of benchmark 10-year bonds, but issued only a relatively limited amount, benefitting from its favourable liquidity position, due partly to its successful dollar issuances. The 10-year yields fell rapidly in 2012, both on the primary and on the secondary market. Spreads against the German benchmark bond stood around 200 basis points in April 2013 ([26]).

2.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. These additional factors – including balance of payments developments, product and financial market integration – are important indicators that the integration of a Member State into the euro area would proceed without difficulties.

([26]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

Table 2.4:
Latvia - Balance of payments **(percentage of GDP)**

	2007	2008	2009	2010	2011	2012
Current account	-22.4	-13.2	8.6	2.9	-2.1	-1.7
of which: Balance of trade in goods	-24.0	-17.8	-7.1	-7.0	-10.8	-9.8
Balance of trade in services	3.5	4.0	6.0	6.1	6.5	6.8
Income balance	-3.2	-1.6	6.3	0.2	-0.9	-1.5
Balance of current transfers	1.3	2.2	3.4	3.6	3.1	2.9
Capital account	2.0	1.5	2.4	1.9	2.1	3.0
External balance [1]	-20.4	-11.7	11.1	4.9	0.0	1.3
Financial account	21.2	13.5	-11.8	-6.1	0.4	-1.4
of which: Net FDI	6.8	3.1	0.6	1.5	4.9	2.8
Net portfolio inflows	-2.4	1.1	0.7	-1.7	-2.2	4.5
Net other inflows [2]	20.2	7.3	-8.1	-1.9	-6.8	-5.1
Of which International financial assistance		4.2	12.5	6.1	0.5	-5.2
Change in reserves (+ is a decrease)	-3.4	2.0	-5.0	-4.0	4.5	-3.6
Financial account without reserves	24.7	11.5	-6.8	-2.1	-4.1	2.2
Errors and omissions	-0.8	-1.8	0.8	1.2	-0.4	0.1
Gross capital formation	40.0	31.2	20.5	19.8	25.3	25.9
Gross saving	17.6	18.1	29.1	22.8	23.0	24.2
External debt	128.1	130.0	156.5	164.8	145.0	136.2
International investment position	-75.1	-78.4	-82.3	-80.2	-74.0	-65.0

1) The combined current and capital account.
2) Including financial derivatives.

Sources: Eurostat, Commission services, Bank of Latvia.

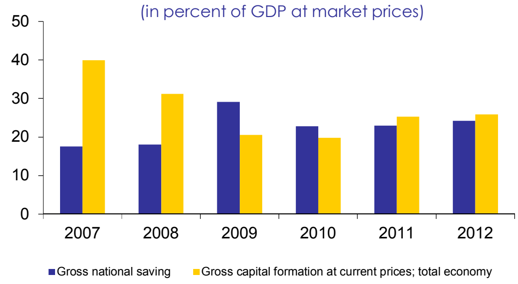
2.6.1. Developments of the balance of payments

The external balance (i.e. the combined current and capital account) moved from a very large deficit in the boom period before mid-2008 to a surplus of about 11% in 2009. As the economic recovery gained speed, the surplus in the external balance contracted to about 1% in 2012. The merchandise trade deficit declined substantially since 2008 while the surplus in trade with services kept improving. Nevertheless, the overall balance of trade with goods and services posted a deficit of about 3% of GDP in 2012 which is a substantial contraction from the record-high deficit of about 21% of GDP in 2006-2007. The income account swung into surplus in 2009, reflecting the huge loan loss provisions made by foreign-owned banks and it returned to a deficit in 2011-2012 when most of the banks regained profitability. Current transfers and the capital account were consistently posting surpluses in the past years on the basis of net inflows from EU funds.

According to the Commission services' 2013 Spring Forecast, the external balance is projected to remain in a small surplus in 2013 and to decline towards balance in 2014 as domestic demand, especially for investment goods, is set to rise at strong pace.

The large savings-investment gap during the boom years was closed abruptly in 2009, with the sudden reversal of capital flows during the international financial crisis. Gross savings peaked in 2009, amid high uncertainty regarding the future prospects for the economy. In 2011-2012, investments exceeded savings by a small margin reflecting negative saving rates in the household sector. In contrast, both the government and the corporate sector reported positive saving rates. Following the steep fall in 2008- 2009, albeit from very high level, investment activity rebounded substantially in 2011-2012 but remained below the pre-crisis level.

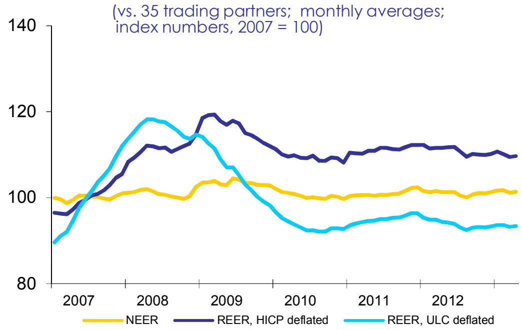
Graph 2.9:**Latvia - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

External cost competitiveness has improved markedly since 2008, as labour cost has dropped substantially and consequently labour productivity has increased. The major improvement took place in 2009-2010 when the real effective exchange rate depreciated substantially, deflated by both HICP and ULC. The indicator appreciated somewhat in 2011 as the abrupt wage correction from the previous two years was reversed but the depreciation resumed again in 2012 when economic growth outpaced labour costs ([27]). The overall real exchange rate correction is even larger when the ULC of the manufacturing sector is used as a deflator. Latvia's export market shares in both world and EU trade increased markedly in 2010-2012 paced mainly by large market gains in merchandise trade. The growth in export market share was also supported by non-price competitiveness improvements, such as quality upgrades, product and market differentiation ([28]).

Graph 2.10:**Latvia - Effective exchange rates**
(vs. 35 trading partners; monthly averages; index numbers, 2007 = 100)



Source: Commission services.

([27]) The reference group of 36 trade partners used in the calculation of effective exchange rates does not include Russia, which results into slight underestimation of Latvia's competitiveness indicators.

([28]) Non-price competitiveness indicators are analysed in more detail in the Occasional Paper issued by the European Commission, Directorate-General for Economic and Financial Affairs: "EU Balance-of-Payments assistance for Latvia: Foundations of success" -- http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op120_en.htm

The balance of payments assistance granted to Latvia under the EU-IMF programme of late 2008 was successfully concluded by early 2012. Latvia borrowed altogether about EUR 4.5 billion out of the total EUR 7.5 billion available under the programme. Also with a view to its regained market access, Latvia has not requested a follow-up programme. Moreover, by the end of 2012 Latvia has repaid all liabilities (EUR 1.1 billion) to the IMF, with nearly 60% of them being serviced ahead of schedule.

The financial account (without reserves) recorded net outflows in the period of 2008-2011 amid on-going deleveraging in the banking sector and substantial decline in real estate and portfolio equity investments. However, the financial account moved to a positive territory in 2012 due mainly to the government bond issues partly aimed at accumulating cash reserves for financing large repayments to the EU due in 2014-2015.

Non-resident banking, in particular the stock of non-resident deposits, recovered strongly after the retreat in 2009. However, most of the related inflow was offset by investments of non-resident banks in foreign short-term securities so that the overall net contribution of the sector to the financial account and foreign reserves was limited.

The net FDI balance has improved considerably after the collapse in 2009 and peaked at 4.9% of GDP in 2011, helped by better financial results in the banking sector. However, net FDI subsided to 2.8% of GDP in 2012 as the external environment deteriorated. Gross external debt to GDP remained on a steady downward path reaching 136% of GDP at the end of 2012 as compared to 165% at the end of 2010, supported by strong GDP growth and by further repayment of inter-company bank funding. Net external debt also fell substantially to 38% of GDP at the end of 2012 from 54% at the end of 2010. The improvement in the net international investment position was less pronounced and its negative net position remained substantial. However, about 50% of the net international investment position is generated by its FDI component, which significantly offsets external liquidity and solvency risks.

2.6.2. Product market integration

Latvia is well integrated into the EU economy through trade and investment linkages. The country is a small open economy with strong gains in export markets and increasing trade openness since its EU accession (except for a set-back during the crisis of 2008-2009). However the share of exports of goods and services to GDP is still lower than for the Baltic neighbours. In 2009, the global crisis resulted in a temporary contraction of trade openness, as external demand faltered and financial flows reversed. Trade integration with the EU is progressing at a fast pace but exports to Russia, including tourists services, are also expanding rapidly in the past years. The main trading partners within EU 27 were Lithuania, Estonia and Germany, while Russia remained the main trading partner outside EU 27. The geographical differentiation of Latvia's exports is also improving as exports to fast growing Asian economies have surged recently.

Latvia still has a predominant specialisation in medium-to-low technology products, although there are developments pointing to an improvement of the trade structure toward medium-to-high technology products. The shares of exports in machinery, electrical, optical and transport equipment have increased recently, showing favourable structural shifts towards higher value-added production. However, intermediate goods and raw materials retain high importance in the country's export portfolio while the overall weight of export products with high technology and innovation costs remains relatively low. Nevertheless, trade data show that export quality, including product differentiation, market positioning and other sales factors, is steadily improving ([29]).

([29]) More details on export competitiveness are provided in the Occasional Paper issued by the European Commission, Directorate-General for Economic and Financial Affairs: "EU Balance-of-Payments assistance for Latvia: Foundations of success" -- http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op120_en.htm

Table 2.5:
Latvia - Product market integration

	2006	2007	2008	2009	2010	2011
Trade openness [1] (%)	55.8	52.6	50.0	44.7	54.2	61.2
Intra-EU trade in goods GDP ratio [2] (%)	33.1	31.0	28.4	24.4	32.0	37.9
Intra-EU trade in services GDP ratio [3] (%)	6.3	6.1	6.2	6.3	6.3	6.5
Extra-EU trade in goods GDP ratio [4] (%)	11.0	10.0	10.6	9.5	12.4	14.4
Export in high technology [5] (%)	4.2	4.6	4.6	5.3	4.8	6.7
Technological balance [6] (%)	-3.0	-2.4	-2.0	-1.1	-1.8	-1.7
Total FDI inflows GDP ratio [7] (%)	8.4	8.1	3.8	0.4	1.6	5.2
Intra-EU FDI inflows GDP ratio [8] (%)	6.1	7.0	3.0	-2.3	1.1	4.2
FDI intensity [9]	3.1	3.8	1.7	-1.1	0.5	2.1
Internal Market Directives [10] (%)	0.5	0.6	0.5	0.4	0.4	0.5
Value of tenders in the EU Official Journal [11]	96.7	62.1	59.8	42.5	55.7	87.2
Time to start up a new company [12]	16.0	16.0	16.0	16.0	16.0	16.0
Real house price index [13]	168.5	208.9	181.7	110.3	100.0	104.7
Residential investment [14] (%)	3.4	4.7	4.6	3.2	1.7	1.7
Building permits index [15]	132.3	139.1	54.2	32.4	27.7	26.3

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EU-27 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EU-27 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EU-27 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.
12) Time to start a new company (in days), Doing Business World Bank.
13) Experimental house price index (2005=100), Eurostat.
14) Gross capital formation in residential buildings (in % of GDP), Eurostat.
15) Number of new residential buildings (2005=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

After its accession to the EU in 2004, Latvia has witnessed a substantial inflow of foreign investments driven by convergence prospects, privatisation deals, and large inflows to the real estate market. In the boom years prior to 2008, a large share of the investments has been directed to the real estate market and has partly contributed to the overheating of the economy. However, the structure of new foreign investments has changed recently and it is now skewed towards the tradable sector and contributes in a more sustainable way to the country's export-oriented growth model. The FDI stock at the end of 2012 was 45% of GDP, lower than the EU average of 60% (47% when Luxembourg is excluded). FDI inflows mainly originate in the EU, with Sweden being by far the largest investor with a share of 24% of the FDI stock at end-2012. The overwhelming majority of the outstanding FDI stock was channelled into the service sector, while the share of manufacturing was only around 12%. The main competitive advantages in attracting FDI inflows in the medium term include lower labour cost vis-à-vis the EU average, relatively low income taxes and a flexible labour market.

Following the steep house price inflation in the boom years, the real estate market experienced a radical downward correction in 2009-2010. The house price index dropped by 37.3% in 2009 and 11% in 2010 and recovered only partially by 9.9% in 2011 and 3.8% in 2012. A more substantial recovery is reported on the market for new dwellings while the existing housing stock witnessed only a very modest rebound. Residential construction was very responsive to house price developments, and increased from about 1.4% of GDP in 2003 to 4.8% of GDP in 2007, before adjusting rapidly in the downswing phase to 2% of GDP in 2010. A significant shift of resources from construction and real estate to manufacturing and transport sectors took place in 2009-2010. While the construction sector started growing again in 2011-2012, its share in GDP is not likely to reach the pre-crisis peak anytime soon.

According to the latest edition of the Internal Market Scoreboard, Latvia is one of the best performing countries in terms of transposition deficit, registering a 0.4% rate in November 2012 (compared to an EU average of 0.6%). However, a small increase in the backlog has been registered with respect to May 2012, when the transposition deficit amounted to 0.1% (best performance in that edition). The share of public procurement tenders announced in the Official Journal appears significantly higher than the EU average (67.3% over 2006-11 compared with an EU average of 17.8% over the same period) ([30]).

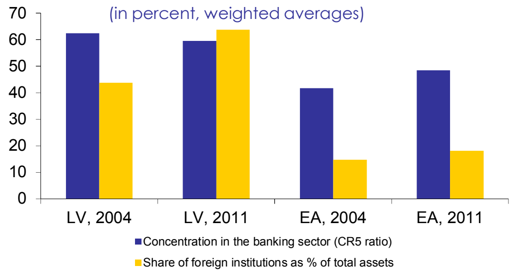
Concerning the business environment, Latvia has implemented a series of ambitious reforms in recent years, aimed at reducing start-up costs, simplifying procedures for property registration, construction permits and tax collection, and streamlining insolvency procedures, also by introducing out-of-court settlement of insolvencies. As a result of these reform efforts, Latvia has significantly closed the gap with respect to the best regulation practices. The 2012 competitiveness monitoring report published by the Commission's Directorate General for Enterprise and Industry ranks Latvia above the EU average in terms of business environment. Good performance is reported in the areas of market entries and exits, SMEs lending, and timeliness of government payments. At the same time Latvia is still lagging behind in terms of enterprise survival rate and to a lesser extent in terms of time required for starting business and early stage financing. The report also concludes that Latvia is improving its industrial competitiveness, especially in terms of specialisation, although its innovation performance remains weak. In the World Bank's 2013 report on ease of doing business, covering performance in 2012, Latvia is relatively well positioned at the 25th place in the ranking, out of 185 countries, and there are only four EA members that are better ranked than Latvia. In the 2012-2013 Global Competitiveness Index of the World Economic Forum, Latvia is ranked at the 55th place out of 144 countries, moving up by 9 positions in comparison with the previous edition of the ranking. The country is lagging behind 13 euro area members in the ranking.

([30]) The value of tenders published in the EU Official Journal may serves as a proxy of the extent to which national public procurement are open to foreign bidders.

2.6.3. Financial market integration

Latvia's financial sector is well integrated into the EU financial system, particularly through its strong linkages to Nordic financial groups. The relative importance of foreign-owned credit institutions, as measured by their share in the banking sector's total assets, has increased considerably since EU accession. Despite the increase of financial deepening, the relative size of Latvia's financial system is still small compared to the euro area average. Concentration in the banking sector, as measured by the market share of the five largest institutions, is above the euro area average.

Graph 2.11: **Latvia - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

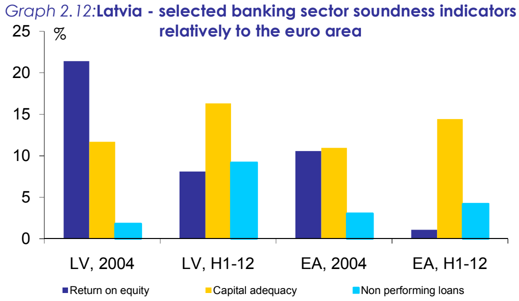


Source: ECB, Structural indicators for the EU banking sector, 2 Jan 2013.

Financial intermediation in Latvia is performed predominantly by commercial banks. Their buoyant expansion resulted in a classical boom-bust cycle that ended in 2008. Banks were heavily affected by significant loan losses and stretched liquidity. However, the sector successfully managed its adaptation to the new economic conditions and has proved resilient to financial stability shocks. Foreign-owned institutions were supported by their parents, while domestic banks ensured sufficient capitalisation on their own.

Overall, the sector's strategy in dealing with the crisis has been to deleverage the balance sheets in order to keep liquidity high and to strengthen the quality of assets. From a macro-financial stability perspective, the strategy has been successful. The aggregate core Tier 1 ratio has reached 15.3% in January 2013, while the ratio of non-performing loans has been reduced to 11.1% from its peak level of 19.4% in September 2010. The sector's liquidity has been strengthened significantly, with a liquidity ratio of well above 30%. The consolidation of the banking sector in Latvia has implied, nevertheless, a contraction of bank credit by around 40 percentage points of GDP since its peak. However, the deleveraging is related to the necessary economic restructuring in the bust phase of the cycle and does not affect the flow of new credit to viable businesses.

Graph 2.12: **Latvia - selected banking sector soundness indicators relatively to the euro area**

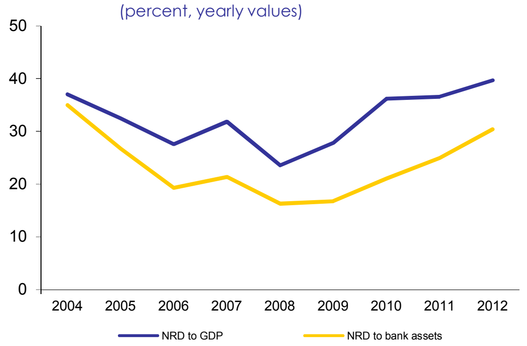


Note: For H1-2012, EU-27 non performing loans are a proxy for EA.
Source: ECB, Consolidated banking data, EC calculations.

The financial crisis also affected the business landscape in the banking sector, leading to the nationalisation of Parex Banka, the second biggest bank in the country at that time. Confidence gradually returned, in particular after mid-2009, supported by large disbursements of international financial assistance, fiscal consolidation and structural reforms. Latvia achieved progress in dealing with Parex Banka by splitting it into a viable (Citadele) and a resolution bank and initiated the privatisation of Citadele along with the commercial assets of Mortgage and Land Bank. The Latvian financial supervisor decided in November 2011 to limit the operations and subsequently to initiate bankruptcy proceedings against Krajbanka, a subsidiary of Snoras Bank, after the latter was nationalised by the Lithuanian government and an insolvency procedure was launched amid allegations of fraud. Krajbanka had a market share of 3.4% and its depositors were compensated from the deposit guarantee fund for amounts of up to EUR 100,000. The sector's stability has been enhanced after these successfully conducted restructuring and resolution experiences.

Latvia has a long tradition and several competitive advantages in servicing non-resident banking clients, mainly corporates from CIS countries. While there was a drop in this business during the financial crisis aggravating Latvia's external funding problem, it has fully recovered by 2012 and around half of the banking system's total deposits stems from non-residents. Although this part of banking is a characteristic element of the Latvian financial market, neither the share of total banking assets relative to GDP (147% in Latvia versus 367% in the EU on average in 2011) nor the share of non-resident banking within these assets is extraordinarily high when compared to some other EU Member States.

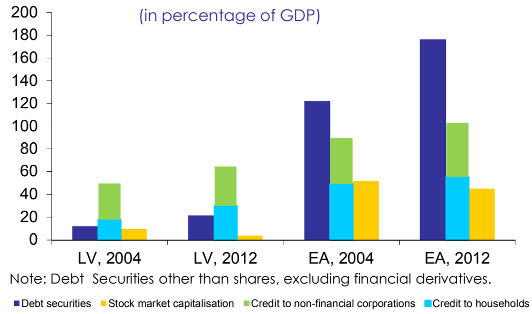
Graph 2.13: **Latvia - Non-resident deposits (NRD)**
(percent, yearly values)



Source: FCMC, Eurostat.

Although there are several small banks which deal with non-residents, the activity is concentrated mainly in three banks. Some recent changes in the administrative environment (selling of residence permits, double-taxation agreement with Russia from 2013, new law on holding companies) may favour the further development of this business. To cater for their specific risks, banks with non-resident business keep a high share of liquid assets and are subject to additional capital requirements (see below).

Graph 2.14: **Latvia - Recent development of the financial system relatively to the euro area**
(in percentage of GDP)



Note: Debt Securities other than shares, excluding financial derivatives.

Source: Eurostat, Bank of Latvia.

The non-banking part of the Latvian financial sector remains small compared to the euro area average and has grown only slowly. The dynamic increase in second pillar pension savings ended in 2009 with the partial redirection of social security contributions to the budget. The accumulated second-pillar pension savings amounted to around 6.2% of GDP at the end of 2011. Voluntary private pension fund savings amounted to less than 1% of GDP at the end of 2012. Assets managed by life and non-life insurance companies, respectively at around 0.6% and about 2% of GDP, are still low, even in comparison to other new Member States.

The Riga stock exchange belongs to the NASDAQ OMX group and uses a single trading platform together with other exchanges in the Baltic-Nordic region. The stock market plays a marginal role in the financing of the Latvian economy. The debt securities market remains dominated by government issuances and represents only a limited source of funding for private companies.

Regulation and supervision of all financial institutions is carried out by the Financial and Capital Market Commission (FCMC). In the context of the international financial assistance programme, financial supervision has been strengthened considerably. Cooperation with home country supervisors has been further enhanced.

The supervision of the non-resident banking business poses additional challenges, inter alia, due to the cross-border nature of transactions. The FCMC implemented several measures to reduce the risks of this sector: on top of the capital add-ons (beyond Pillar 1), it recently introduced additional liquidity requirements. The FCMC also monitors these banks more actively (including their internal procedures, asset quality and correspondent accounts).

Latvia achieved full compliance with the transposition of the Financial Sector Action Plan (FSAP) directives and is on the way of completing transposition of the post-FSAP directives.

Latvia's legislation largely complies with international standards in the field of anti-money laundering (AML). However, a determined and effective implementation of AML rules will remain key. The Financial Intelligence Unit (FIU) under the supervision of the General Prosecutor and the Financial and Capital Market Commission (FCMC) are the main institutions set to fight money laundering. In July 2012, the MONEYVAL Committee of the Council of Europe published an evaluation report ([31]), which concludes that Latvia's legislation and institutional setup are largely compliant with the international AML standards. In reference to 40 assessment benchmarks, the country is ranked from partly compliant to compliant on each of them. The report also points to several loopholes in the overall money laundering control system, in particular implementation and statistical reporting. In response, the Council of Ministers approved on 28 March 2013 an Action Plan for implementing the recommendations of the MONEYVAL report. The FIU is tasked with monitoring the implementation of the Action Plan and different measures are assigned to various institutions directly or indirectly involved in fighting financial crimes. All underlying deadlines will expire by the end of 2013. As part of the measures, the government is committed to increase the financing and human resource capacities of the main AML institutions. The Council of Ministers is expected to review the implementation progress in September 2013.

2.7. SUSTAINABILITY OF CONVERGENCE

This concluding section draws together elements that are key for gauging the sustainability of Latvia's convergence vis-à-vis the euro area. Such an assessment is appropriate in view of the fact that Latvia remains in a process of profound economic adjustment, having recently exited an IMF-EU macro-economic programme which was necessitated by the unwinding of macro-financial imbalances accumulated in the mid-2000s. To this end, the analysis reviews sustainability from a number of angles:

First, the sustainability dimension is inherent in the individual convergence criteria themselves. This holds most explicitly for the price stability criterion, which includes the requirement of a "sustainable price performance". The fiscal criterion (EDP) also involves a forward-looking aspect, providing a view on the durability of the correction of fiscal imbalances. While the exchange and interest rate criteria are, by construction, backward-looking, they aim at capturing an economy's ability to operate durably under conditions of macroeconomic stability, hence indicating whether the conditions for sustainable convergence following euro adoption are in place.

Second, the assessment of additional factors (balance of payments, product and financial market integration) required by the Treaty broadens the view on sustainability of convergence and allows for a more complete picture,

([31]) http://www.coe.int/t/dghl/monitoring/moneyval/Evaluations/round4/LTV4_MER_MONEYVAL(2012)16_en.pdf complementing the quantitative criteria. In particular, a sound external competitiveness position, effectively functioning markets for goods and services and a robust financial system are key ingredients to ensure that the convergence process remains smooth and sustainable.

Third, the convergence assessment should be informed by the results and findings of enhanced policy co-ordination and surveillance procedures (MIP, fiscal governance). The aim of these new governance instruments is not to add to the existing requirements for euro adoption, but to make full use of the more comprehensive analysis undertaken under the new surveillance tools in assessing sustainability of convergence. While individual elements drawn from the new governance framework (e.g. related to AMR scoreboard indicators) are included in the relevant chapters on convergence above, this section uses the new framework to provide a more integrated view of the sustainability dimension.

Any assessment of the sustainability of convergence has limits and must be based on a judgement of the likely future evolution of the economy. In particular, as experience has shown, the sustainability and robustness of the convergence process after euro adoption is to a significant extent endogenous, i.e. it depends on a Member State's domestic policy orientations after it has joined the euro area. Therefore, while the assessment of sustainability is an essential element in determining a Member State's readiness to adopt the euro based on initial conditions and existing policy frameworks, the outcome of such a sustainability assessment must ultimately be conditional and can only be validated by the adoption of appropriate policies over time. In this respect, the on-going strengthening of governance mechanisms in EMU will have a major part to play in ensuring that such policies are implemented by the Member State after euro adoption.

The analysis below looks at sustainability from five different perspectives: price stability; fiscal performance and governance; macroeconomic imbalances; competitiveness and market functioning; and financial stability.

Price stability

Latvia's present inflation rate is well below the reference value, and while the inflation rate is projected to rise from the current unusually low levels, it is expected to remain moderate over the forecast horizon. Going beyond the headline view, a sustainable price performance implies that the respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Latvia, it is evident that the VAT reduction of July 2012 has contributed to the current low level of 12-month average inflation. However, the VAT reduction has not been the decisive factor in bringing the inflation rate below the reference value. Moreover, analysis of underlying fundamentals (e.g. cyclical conditions and policy stance, wage and productivity developments, imported inflation, administered prices – see section 2.2) and the fact that the reference value has been met by a wide margin support a positive assessment on the fulfilment of the price stability criterion.

In Latvia, the level of final consumption prices of private households stood at around 71% of the euro area average in 2011. This suggests potential for further price level convergence in the long term, as income levels (around 54% of the euro-area average in PPS in 2011) rise towards the euro-area average. To the extent that this is an equilibrium phenomenon, it does not imply a loss of price and cost competitiveness, but the process needs to be managed carefully so as to detect and counteract the emergence of excessive price pressures at an early stage

Longer-term inflation prospects will hinge on wages growing in line with productivity. As Latvia is still a catching-up economy, wages are expected to grow at a faster rate than in most advanced euro area members. However, risks to price stability from catching-up related price adjustment are limited by the recently demonstrated flexibility of the labour market and wage-setting mechanisms which should ensure that labour costs are aligned with productivity. They are also contained by the country's significant progress in implementing the EU services directive and low market entry costs, which keep competitive pressures high, as witnessed by the recent new entries in the retail market. A shortage of well-qualified labour in the medium term could drive up wages relative to productivity. Addressing the remaining bottle-necks will be important in limiting any tightening of the labour market.

The productivity growth required to ensure a smooth catching-up in the price level will largely depend on improvements in the business environment and progress in attracting new investment. Increased market competition should also support favourable price developments (and there is no evidence that Latvia would fare worse in this respect than the euro area average). Price developments will also depend on maintaining a prudent fiscal policy stance, including cautious wage setting in the public sector, to keep domestic demand in line with fundamentals and help anchor inflation expectations. Finally, if commodity prices rise again in the medium-term, Latvia would be particularly affected due to the composition of its consumer basket, low energy efficiency and high material input share in production.

Fiscal performance and governance

The 2013 Convergence Programme covering the period of 2013-2016 was submitted on 29 April 2013. The budgetary strategy outlined in the programme is to maintain a structural budgetary position which is based on the medium-term budgetary objective (MTO), with any deviation from it limited to the incremental impact of the systemic pension reform (i.e. the increase in state contributions to the second pillar pension scheme). The MTO itself is set at the level of -0.5% of GDP. In terms of nominal targets, this strategy implies a headline deficit of 1.1% of GDP in 2013, with the deficit declining further to 0.9% in 2014 and stabilising at that level in 2015-2016. The headline budgetary targets for 2013 and 2014 are very close to projections in the Commission's 2013 spring forecast with a deficit of 1.2% of GDP in 2013 and 0.9% of GDP in 2014.

Further details on the assessment of the 2013 Convergence Programme for Latvia, including the assessment of the long-term budgetary impact of ageing, can be found in the Commission Staff Working Paper ([32]). This is accompanied by the Commission recommendation for a Council Recommendation on the 2013 National Reform Programme of Latvia and delivering a Council opinion on the 2013 Convergence Programme of Latvia.

Latvia has put in place a number of governance measures, which demonstrate a longer-term commitment to sound public finances. In March 2012, Latvia signed the Treaty on Stability, Coordination and Governance in the EMU, and the respective ratification law was approved by Parliament in May 2012. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. Moreover, in January 2013, the Parliament approved the Fiscal Discipline Law (FDL) in the final reading. The law establishes the principle of budgetary targeting throughout the cycle, with the benchmark structural deficit of 0.5% of GDP, and will provide a framework for a rules-based fiscal policy, in particular through limiting pro-cyclical expenditure increases. The law also contains provisions regarding the establishment of an independent Fiscal Council, to be set up from 1 January 2014, which will oversee the compliance with the set of fiscal rules.

To ensure a sustainable fiscal position, it is decisive that the freshly adopted FDL is implemented in a robust way according to its intentions, in order to pre-empt pressures to soften fiscal discipline in the future. After the successful exit from the adjustment programme and a return to a favourable macroeconomic setting, there is a risk of popular demands to undo some of the budgetary consolidation achieved during the crisis, for example to compensate for the loss in real income of some population groups or to slow down the pace of efficiency-seeking reforms in public administration. The FDL can help in pursuing a sound and determined fiscal strategy for the medium term and in reacting to such demands in a balanced way; however, the new fiscal governance framework is not yet tested.

Macroeconomic imbalances

The assessment of convergence also draws on the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), embedded in the broader "European semester" approach to enhance the governance structures in EMU, and integrates the MIP results into the analysis. Related to this, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (MIP) ([33]), the Commission published its first Alert Mechanism Report (AMR) in February 2012 ([34])

([32]) Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

([33]) The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011. http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898

([34]) http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm and the second AMR (under the cycle for 2013) in November 2012.

The related scoreboard update shows that Latvia breaches the indicative threshold in two out of ten indicators, one in the area of external imbalances (namely on net international investment position) and one in the area of internal imbalances (on unemployment). Both indicators are moving towards the indicative thresholds. Based on the conclusions of the two reports, Latvia was not subject to an in-depth review in the context of the MIP.

The AMR from November 2012 notes that after accumulation of imbalances prior to the crisis in 2008-2009, Latvia's external competiveness has s improved substantially. The process of internal adjustment included wage and employment cuts, fiscal consolidation, deleveraging in the private sector, and growth-enhancing structural reforms.

Competitiveness, labour and product market functioning

Standard indicators of cost competitiveness, such as real effective exchange rates (REER) and relative unit labour costs, are now below the indicative thresholds set under the scoreboard for monitoring external imbalances under the MIP. In 2008, the REER adjusted for unit labour costs reached a peak of 64% above the 2000 level. However, the REER depreciated by about 20% in 2009-2010 and stayed broadly stable afterwards. This level of the REER is considered sustainable, as the country has steadily gained market shares over the past years even when exports are adjusted for growth of markets. It should be also noted that the REER estimates do not include Russia, which is one of the major trade partners of Latvia. Inclusion of Russia would result in an even more favourable assessment of Latvia's cost competitiveness. As far as non-cost competitiveness indicators are concerned, ECFIN studies have shown wide-ranging gains in terms of quality, variety, and product and market differentiation, which have contributed to the increase in export market shares([35]). Consequently, the latest projections suggest that the current account deficit will remain below 3% of GDP in 2013-2014 while the overall external balance (current and capital accounts) will be slightly positive for the same period.

The Latvian labour market demonstrated a high degree of flexibility during the crisis. Job seekers also showed high mobility within the EU as emigration increased substantially in the process of structural adjustment. More recently, as of 2012, the economic recovery and the steady pace of job creation not only reduced emigration but raised significantly the number of immigrants in Latvia. Underpinned by a decentralised wage-setting system, a considerable wage adjustment took place in Latvia over 2009 and 2010 and wages moved broadly in line with productivity afterwards. In 2013-2014, wages are projected by the Commission services' 2013 Spring Forecast to remain consistent with productivity. Vacancy rates remain among the lowest in the EU indicating that at aggregated level labour supply is adequate. Nevertheless, regional differences and skills mismatches on specific labour market segments keep structural unemployment relatively high. However, the latest statistics show that youth unemployment, though still high, has moved slightly below the EU average while long-term unemployment remains a major challenge. All these structural deficiencies on the labour market amount to a significant loss in potential output and pose risks of excessive wage adjustments; they need to be properly addressed by active labour market policies and education reforms, as stipulated in the Commission and Council country specific recommendations.

Latvia has achieved significant progress in liberalising its markets and integrating its trade of goods and services within the Single Market. Much of the structural adjustments related to this process have been already completed. However, challenges still remain and they are being addressed in the context of the country's specific recommendations issued by the Commission and the Council. The recommendations emphasise the importance of enhancing energy efficiency and energy interconnections with other EU Member States, reducing the backlog in the judicial system, and modernising the education and research institutions. The recent opening of the electricity market to cross-border competition is one of the positive examples in the field of energy reforms while the gas market is still closed for competition.

([35]) More details on export competitiveness are provided in the Occasional Paper issued by the European Commission, Directorate-General for Economic and Financial Affairs: "EU Balance-of-Payments assistance for Latvia: Foundations of success" -- http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op120_en.htm

The associated process of further structural adjustment needs to be supported by flexible resource allocation and functioning markets. Moreover, some social policy indicators are still significantly below the euro area average, which puts additional risks on the full completion of the convergence process. However, on balance, the size of the economic restructuring and convergence progress in the past several years shows that the country's institutional capacity and market maturity are already sufficient to address remaining challenges.

Financial stability

The integration of the domestic financial sector into the EU financial system is substantial, mainly thanks to a high level of foreign ownership of the banking system. The relative size of Latvia's financial system is small compared to the euro area average and the economy has recently gone through a significant deleveraging process. The foreign-owned segment of the financial sector proved resilient to the recent economic and financial crisis, benefitting from substantial recapitalisation from parent banks, while weaknesses in the domestic banking sector contributed to the need for balance-of-payment support at the outset of the crisis. In the context of the international financial assistance programme, financial supervision has been strengthened considerably and domestic banking sector resilience has been strengthened. Cooperation with home country supervisors has been further enhanced.

Looking ahead, it is essential that sustainable convergence is not jeopardised by a re-emergence of a credit-fuelled expansion in domestic demand and an associated rise in asset prices – notably in the housing market. The prospects of such a boom re-emerging are reduced by Latvia's policy responses to the 2008-2009 crisis, which included the establishment of a Credit Register, changes in real estate taxation (property and transaction taxation) and tightened banking sector regulation (see section 2.6.3). The combination of other factors that drove buoyant credit expansion in the past (pent-up credit demand, accelerated financial deepening and integration, rapid risk spread compression) is not expected to recur either, as higher property and consumption taxes as well as tighter credit regulation are providing sufficient safeguards. That said, in view of the expected price level convergence, real interest rates may *ceteris paribus* be lower for Latvia than for the euro area average, which needs to be counteracted both by a prudent macro stance and appropriate supervisory practices. An appropriate and timely use of macro-prudential policies will also be important in limiting any undesirable consequences related to credit growth.

Latvia has a long tradition and several competitive advantages in servicing non-resident banking clients, mainly corporates from CIS countries. To cater for their specific risks, banks with a non-resident business model are required to keep a high share of liquid assets and are subject to additional capital requirements. The supervision of the non-resident banking business poses additional challenges, inter alia, due to the cross-border nature of transactions. As the management of such financial inflows is key to sustaining economic convergence, the national supervising authority has implemented several measures to reduce the risks of this business activity. Going forward, close monitoring of financial stability risks, readiness to adopt further regulatory measures if needed, and determined implementation of anti-money laundering rules will remain key.

Conclusion

Overall, a broad-based look at underlying factors suggests that sufficiently strong conditions are in place for Latvia to be able to maintain a robust and sustainable convergence path in the medium term, thus supporting a positive assessment. However, significant challenges remain, and policy discipline – which has increased during and after the crisis but has not always been strong in the past – will need to be maintained in a determined manner to fully exploit the benefits of participation in the euro area and minimise risks to the convergence path going forward.