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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13 February 2008
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Latvia, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Latvia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Latvia, submitted on 29 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

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

(2) the country's commitments undertaken at the time of entry into ERM II, the exchange rate mechanism

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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

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

In its opinion of 27 March 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2009, as follows. "The overall conclusion is that the worsening of the budgetary position in 2007 is not in line with a prudent fiscal policy aimed at ensuring sustainable convergence, including by reducing the external imbalance and containing inflation. In the subsequent years, the programme envisages progress towards the MTO in a context of strong growth prospects, but the budgetary targets are not ambitious and there are risks to their achievement from 2008 onwards." In view of the above assessment, Latvia was invited to: (i) "reduce the risks of macroeconomic instability by implementing vigorously measures to achieve a significantly better budgetary target for 2007 than foreseen in the programme, as part of a broader reform strategy"; building further on this, measures to enhance consolidation beyond the MTO in subsequent years were recommended; and (ii) "establish a clearer and more binding medium-term framework for the planning and control of public finances".

2.2. ERM II commitments of Latvia

On 2 May 2005, the Latvian lats joined ERM II[2] and Latvia undertook the following commitments to ensure the lats' smooth participation in the mechanism[3]: “The agreement on participation of the Latvian lats in ERM II is based on a firm commitment by the Latvian authorities to achieve a sustainable reduction in inflation. The authorities recognize that strengthening the fiscal stance will be instrumental to this end, while it would also contribute to an orderly and substantial reduction of the current account deficit. The authorities will closely monitor macroeconomic developments together with the responsible EU bodies. To help reduce the external imbalance and contain it at a sustainable level, the authorities will take measures to restrain domestic demand and they will remain vigilant concerning risks of excessive domestic credit growth. Continued effective financial supervision will assist the authorities in promoting prudent credit policies and in limiting credit risk in the banking system. The authorities will also promote wage developments that are supportive to reducing inflationary pressures. Structural reforms aimed at further enhancing the economy’s flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and safeguard the overall competitiveness of the economy.”

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. In the area of budgetary policies, Latvia was recommended to "*maintain economic and budgetary sustainability by pursuing a more restrictive fiscal policy, so as to contribute to the prevention of overheating and a careful prioritisation of expenditure."*

[2] ERM II is the exchange rate mechanism established by the Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union of 16 June 1997 (OJ C 236, 2.8.1997, p. 5).

[3] Available at: http://ec.europa.eu/economy_finance/publications/eurorelated_en.htm.

[4] OJ L 92, 3.4.2007, p. 23.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its strategic report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Latvia's national reform programme[5]. This can be summarized as follows.

Latvia's national reform programme identifies as key challenges/priorities: securing macro-economic stability, stimulating knowledge and innovation; developing a favourable and attractive environment for investment and work; fostering employment; and improving education and skills.

The Commission's assessment is that Latvia has made some progress in implementing its national reform programme over the 2005-5007 period. The programme presents a clear strategy and covers all policy areas, but a more integrated approach based on improved synergies between the different areas is necessary.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Latvia is recommended to give highest priority to the challenges in the areas of fiscal policy; research and innovation policy, labour supply and productivity.

In addition, Latvia should also focus on the areas of better regulatory environment and access to childcare.

[5] Communication from the Commission to the European Council, “Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)”, 11.12.2007, COM(2007)803.

Box: Main points covered by the assessment

As required by Article 9(1) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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6 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU", 12.10.2006, COM (2006) 574 final and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

7 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated convergence programme of Latvia, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[8], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated convergence programme of Latvia, which covers the period 2007 to 2010.

(2) Following a sustained period of high growth since the mid-nineties, Latvia's real GDP increased at double-digit rates in 2005-2007. Growth has primarily been driven by a powerful credit boom boosting private consumption and real estate investment, with net external borrowing surpassing 20% of GDP since 2006. Monetary conditions have been accommodative, given a high degree of euroisation in the framework of a narrowly pegged exchange rate within ERM II. Adding to the overheating from the demand side, labour shortages have contributed to the emergence of a wage-price spiral, with very high wage growth outstripping productivity, leading to the highest inflation in the EU and rapidly deteriorating competitiveness. From mid-2007 some slowdown has become visible in the housing market and in domestic consumption, but insufficient to remove the downside risks of a potential hard landing. In this context fiscal policy has insufficiently tackled the emerging vulnerabilities. Key to addressing internal and external imbalances will be a more ambitious fiscal stance; adherence to an appropriate medium-term budgetary framework; prioritizing public expenditure and re-examining taxation instruments to avoid demand stimulus in sectors which do not

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

significantly strengthen the economy's medium- and long-term supply potential, particularly real estate; and a more responsible public sector wage growth. To foster the catching up process, structural reforms and removal of bottlenecks directed towards strengthening the supply side of the economy are needed.

(3) The macroeconomic scenario underlying the programme envisages a soft landing with real GDP growth gradually decreasing from 10.5% in 2007 to 6.8% by 2010. According to the programme, domestic demand will remain the main growth contribution, although it is expected to slow significantly from 2007 to 2008. Assessed against currently available information[9], this scenario appears to be based on plausible growth assumptions. However, the envisaged slowdown of domestic demand is far from assured and the programme's economic scenario is attended by very high risks for macroeconomic stability, with a harder landing being a distinct possibility. Furthermore, without a larger adjustment of aggregate demand and supply than depicted in the programme, the country's external position would not be sustainable in the longer run. The programme’s projections for inflation, which appear to be plausible, show that Latvia will be moving further away from nominal convergence at least until 2008. Moreover, uncertainties remain large due – inter alia – to ongoing volatility in energy and other commodity prices and to how the current wage-price spiral may evolve. Restraining public sector compensation is critically important for achieving a reduction in whole-economy wage growth which would be necessary to break the current cost-price dynamics and arrest rapidly deteriorating cost competitiveness.

(4) For 2007, the previous programme initially targeted a budget deficit of 1.3% of GDP, while the new update estimated a 0.3% of GDP budget surplus. The autumn forecast projected a budget surplus of 0.9% of GDP for 2007, which is very close to the provisional result of a 0.8% of GDP fiscal surplus. The structural deficit, calculated according to the commonly agreed methodology, is estimated to have decreased from 1% of GDP in 2006 to ½% in 2007. The difference between the autumn forecast headline figure and the previous programme's target reflects higher revenues, which however was partly offset by higher-than budgeted expenditure growth. Even based on a surplus close to 0.8% of GDP, the budgetary policy in 2007 was only partly in line with the invitation in the Council opinion of 27 March 2007 on the previous update of the convergence programme[10], as the background of continuing high demand and risks to stability shows that fiscal policy remained short of that required. Nevertheless, there has been some progress in limiting the previously usual surge in end-of-year spending by public institutions, following guidelines to this end adopted by the government in November 2007.

(5) The main goal of the budgetary strategy is to foster macroeconomic stability by continuing to respect the medium-term objective (MTO) of a structural deficit of 1% of GDP - achieved since 2006 - by a growing margin over the programme period. Compared to the previous programme, which planned to achieve the MTO only from 2008 onwards, the new update broadly confirms the envisaged consolidation path but from a much better budgetary starting position against a broadly unchanged

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[9] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

[10] OJ C 89, 24.4.2007, p.15

macroeconomic scenario. According to Commission services' calculations on the basis of information in the programme, the structural balance is projected to improve from a deficit of ½% of GDP in 2007 to a surplus of ½% of GDP in 2008 and by ½ percentage point per year in 2009-2010. Two-thirds of the rise in the headline surplus by almost 1 percentage point of GDP owes to an increase in the revenue-to-GDP ratio and the remaining third from a fall in the expenditure-to-GDP ratio. On the revenue side, the projected rise in indirect taxes and "other revenues" as a share of GDP more than offsets a projected decline in social contributions due to the ongoing pension reform. Restraint in expenditure on public consumption and compensation of employees relative to GDP (which is not assured by measures described in the programme) is assumed to provide budgetary room for proposed increases in social payments, including in the areas of pensions and parent benefit, and public investment.

(6) The budgetary outcomes could be much worse than projected in the programme. There are significant risks for the overall macroeconomic stability stemming from the wide external imbalance and the currently overheated state of the economy. Were the credit-financed, domestically-driven growth to slow abruptly, the budget could come under strong pressure, as the programme's revenue projections are based on the assumption of continuing high consumption and favourable labour market conditions. The projected reduction in the expenditure ratio seems difficult to achieve in the absence of underpinning measures. As medium-term expenditure ceilings for ministries and public institutions were introduced only in 2007, it is not yet possible to judge their effectiveness. The track record of recent years rather points to overruns as high nominal growth has created the opportunity each year to spend extra revenues in the framework of a supplementary budget. Finally, the programme counts on substantial revenues related to privatization (amounting to a total of 0.5% of GDP according to the programme), which are surrounded by uncertainties.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO throughout the programme period, as envisaged in the programme. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact, but it should be tightened given the size of the economic imbalances and the heightened responsibility of fiscal policy due to the limited scope of monetary policy under a quasi-fixed exchange rate regime within ERM II. The likelihood of a better-than-estimated 2007 outturn should be used to aim for a much higher surplus position in 2008.

(8) Latvia appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with age-related expenditure projected to fall as a share of GDP over the coming decades, influenced by the expenditure-reducing impact of the reform of the pension system. The current level of gross debt is very low and improving the budgetary position as planned in the convergence programme update would contribute to limiting the risks to the long-term sustainability of public finances.

(9) The convergence programme seems to be consistent with the October 2007 implementation report of the national reform programme. In particular, the implementation report identifies securing macroeconomic stability as the main challenge with implications for public finances and to that end allots a major role to the strengthening of fiscal discipline and budgetary planning procedures. While the programme contains a qualitative assessment of the overall impact of the national

reform programme within the medium-term fiscal strategy, it does not provide detailed information on the direct budgetary costs/savings associated with the main reforms envisaged in the national reform programme.

(10) The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines in the area of budgetary policies issued in the context of the Lisbon strategy. However, the projected fiscal stance does not contribute adequately to countering overheating and promoting economic sustainability.

(11) In terms of progress in implementing its ERM II commitments, the authorities have done little to strengthen the fiscal stance and restrain domestic demand, although some steps have been taken to curb credit growth but with limited impact. The March 2007 anti-inflation plan was a step in the right direction but fell short of the measures needed to stabilise the economy and to achieve a sustainable reduction in inflation. Further structural reforms are needed to address the weak supply-side of the economy and worsening competitiveness. The economic stabilization plan currently under consideration by the Latvian authorities is likely to include further fiscal and tax measures, as well as steps to improve the business environment and competitiveness.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has a gap in compulsory data, but provides most of the optional data[11].

The overall conclusion is that the programme aims to reduce economic imbalances and excessive demand pressure by setting slightly increasing but overall modest surplus target for 2008-2010, in excess of the MTO. However, the risks to the achievement of the budgetary targets are high primarily due to large macroeconomic uncertainty and a track record of slippages from expenditure plans. Moreover, a considerably tighter stance of fiscal policy is urgently needed to meet the programme's aims in a context of an economy subject to risks to stability - stemming from inflationary pressures, deteriorating cost competitiveness and sharply increasing net foreign liabilities. While medium-term expenditure ceilings have been introduced, they remain to be tested. As regards the long-term sustainability of public finances Latvia is assessed to be at low risk.

In view of the above assessment and given the need to ensure sustainable convergence and a smooth participation in ERM II, Latvia is invited to contribute to reducing overheating pressures and risks to macroeconomic instability by:

(i) aiming for significantly more ambitious budgetary targets in 2008 and beyond than foreseen in the programme, notably by fully saving any revenue over-performance and respecting the expenditure ceilings;

(ii) within the overall public sector expenditure limits set within the medium-term budget planning framework, carefully prioritizing public expenditure and re-examining taxation instruments to avoid demand stimulus in sectors which do not significantly strengthen the economy's medium- and long-term supply potential;

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[11] In particular the data on capital taxes (compulsory data), the subcomponents of the stock-flow adjustment and some elements of the long-term sustainability of public finances table are missing.

(iii) adopt further policies to contain inflationary pressures, including through a responsible public sector wage-setting, thus contributing to the sharp reduction in whole-economy wage growth necessary to break the current cost-price dynamics and arrest rapidly deteriorating competitiveness.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Nov 2007**	**11.9**	**10.5**	**7.5**	**7.0**	**6.8**
	COM Nov 2007	11.9	10.5	7.2	6.2	n.a.
	CP Jan 2007	*11.5*	*9.0*	*7.5*	*7.5*	*n.a.*
HICP inflation (%)	**CP Nov 2007**	**6.6**	**10.1**	**12.5**	**7.2**	**4.9**
	COM Nov 2007	6.6	9.6	9.8	6.0	n.a.
	CP Jan 2007	*6.6*	*6.4*	*5.2*	*4.2*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Nov 2007**	**2.0**	**2.8**	**1.3**	**-0.3**	**-1.7**
	COM Nov 2007[2]	2.1	2.7	0.8	-1.7	n.a.
	CP Jan 2007	*1.8*	*1.3*	*-0.5*	*-2.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2007**	**-21.1**	**-23.5**	**-20.3**	**-18.3**	**-16.4**
	COM Nov 2007	-19.9	-22.2	-18.9	-18.0	n.a.
	CP Jan 2007	*-17.4*	*-17.2*	*-16.3*	*-15.8*	*n.a.*
General government balance (% of GDP)	**CP Nov 2007**	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**
	COM Nov 2007	-0.3	0.9	0.8	0.5	n.a.
	CP Jan 2007	*-0.4*	*-1.3*	*-0.9*	*-0.4*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**0.2**	**0.7**	**1.0**	**1.2**	**1.5**
	COM Nov 2007	0.2	1.3	1.2	0.9	n.a.
	CP Jan 2007	*0.2*	*-0.8*	*-0.4*	*0.1*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Nov 2007**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**
	COM Nov 2007	-0.8	0.2	0.5	1.0	n.a.
	CP Jan 2007	*-0.9*	*-1.7*	*-0.8*	*0.2*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2007**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.7**
	COM Nov 2007	-0.8	0.2	0.5	1.0	n.a.
	CP Jan 2007	*-0.9*	*-1.7*	*-0.8*	*0.2*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**10.6**	**9.4**	**8.3**	**7.2**	**6.4**
	COM Nov 2007	10.6	10.2	7.8	6.4	n.a.
	CP Jan 2007	*10.7*	*10.5*	*10.6*	*9.4*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 9.8%, 9.8%, 9.3% and 8.9% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures according to the most recent programme and the autumn forecast.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations