

BNS: EC representative Gabriele Giudice: to join the euro area Latvia needs to stabilise its economy by carrying out structural reforms

Does the European Commission see problems with the 2011 draft budget prepared by the Latvian government?

-I find the word "problems" to be too strong. We have evaluated the original ideas that have been incorporated into the budget and we will continue to do so also after the budget is transmitted to the Saeima. We would like to see that high quality measures were foreseen for 280 m LVL consolidation. By high quality measures we mean sustainable measures for reduction of government deficit with positive effect for economic growth, increasing competitiveness and ensuring a proper allocation of public resources. Those are the main principles.

Therefore we have reviewed the present proposals according to those principles. The major part conforms with them. However, there is another part, which does not. Indeed, we also need some additional information, because some issues have been insufficiently analysed. Yet we are sceptical about the conformity of some proposals with the above mentioned principles.

Like which ones?

- We have repeatedly pointed out that the 2nd level pension contributions cannot be regarded as a long-term solution for improvement of the situation, even if in short-term it improves the situation with the government deficit. It is possible to boost the budgetary revenue by diverting the 2nd level pension contributions, however, at one point it can turn out to be counterproductive. Sooner or later one would be forced to go back to the regular 2nd level pension contributions. This is a short-term solution, which in a longer term will mean that there will be less money left in the 2nd level pension scheme and smaller pensions. We are confident that there are better solutions to be found. Indeed, the government has given up the initial idea of setting the rate of contributions at 0 %, but, in fact, it should be reverting to 4 % contributions next year. This is one area.

But there are others too: for example, the decision about company dividends. In our view too high state companies' dividend pay-outs will prevent further investments and growth.

Furthermore, the government initially defined that the major part of consolidation will be carried out through spending cuts - two thirds - and for one third at the expense of increase of revenue. Now we see that the draft budget rather focuses on the increase of revenue than on the government spending cuts. Judging from other countries' experience and also historically the most efficient growth-facilitating consolidation measures have proved to be the ones which address the problem at its roots. Latvia's major problem is that the budget spending has been shooting up in the past, believing that the revenues will never cease to increase. The crisis has shown strong revenues have been a side-effect of the economic boom, and since then revenues have decreased considerably. In the future they will surely increase, however to a lesser extent than in the past.

These are our present concerns. Some of them can be addressed by improving the envisaged solutions or providing better alternatives.

The government plans to submit the draft budget to the Parliament on 7th December. Is

there enough time left for those amendments?

- The government may submit new proposals until the very last moment. That was the case also with the two previous budgetary proposals, which I followed since I have been working with those issues in the EC. I believe that the government can still improve the draft budget, and we hope that those improvements will come.

If no improvements will come, will the EC act on it, or rather these reservations are not that critical?

- We will take a view on Latvia' progress with the programme in January, when the budget will be adopted. I can just encourage you to do your best already this year. It is vital to remember that the current situation is not the end of the world. 2012 will be an important year, in 2013 the EC will assess the compliance of euro candidate countries, therefore it is vital to view the country's development in a long-term perspective. The more is done now, the easier it will be in the years to come.

Estonia will switch to euro already the next year. Will it make difference between Estonia and the other Baltic states, for instance, in the view of investors?

- Although the present time is complicated and some investors doubt the future of euro, it is perfectly clear that being a member of euro area is an advantage. At the moment Latvia hardly feels any advantages; rather it is the difficulties in connection with pegging of currency to the euro. The benefits will be obvious: no more risk in connection with the exchange rate fluctuations and a full integration of financial markets into the euro area. That will undoubtedly be an advantage. Hopefully, we will all see that in Estonia. I hope for a positive development, and it will give Latvia and Lithuania motivation to complete the consolidation plans and be prepared for introduction of the euro. The current situation shows that for many countries the euro has been a shield from the crisis.

What might be the major threat for Latvia's plan to introduce the euro in 2014? Could it be inflation?

- To make sure that the overall position of the state is healthy all the criteria will be taken into account: inflation, long-term interest rates, government deficit, government debt and national competitiveness in general. The fiscal situation has been the major issue of concern in the last years. Now it has improved greatly. Still, even if under the Maastricht criteria government deficit should not exceed 3 % of GDP, you have to be convincing in proving that the deficit is low and improved in a sustainable manner.

Inflation is another factor to focus on, however, we hope, it will not be that decisive. Still one has to admit that the inflation has started to grow faster than we thought it would. Also the balance of payments is becoming negative much earlier than we thought. This proves that there is still instability in the economy and the structural reforms should be continued in order to improve it. The government has done a lot already in this respect, but there is more to do to boost the economic competitiveness, to avoid inefficiency and to make the economy less dependant of the developments elsewhere in the world. Latvia should focus more on production for its own consumption and selling to others as well, in that way reducing the dependency on import.