EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 20 January 2014

EU BOP ASSISTANCE TO LATVIA

FOURTH REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

The assessment of post-programme developments is overall positive. Macroeconomic, fiscal and political stability during the last years has allowed Latvia to enjoy among the fastest GDP growth rates in the EU and the economic outlook for 2014 and 2015 is equally encouraging. *The EDP for Latvia was abrogated in June 2013 based on the outcome of 2012; Latvia also met its MTO in 2012. Nominal budget deficits are projected to remain in the range between 1% and 1½% of GDP in 2013-2015 despite several income tax cuts planned for these years. The tax policy package underpinning the 2014 budget follows the respective Country Specific Recommendation (CSR) issued to Latvia, in particular through a reduction of taxation for low income earners, shifting taxation to areas such as excise duties, property tax and/or use of natural resources, and by strengthening actions to tackle different types of tax avoidance. Other measures, e.g. on child poverty (increases in child care and parental benefits, support to child care services, free school meals), are expected to partly address social exclusion and demographic challenges. The level of government debt is projected to stay around 40-42% of GDP in 2013-2014 and to decline to 33% of GDP in 2015 as the repayments to the EU take effect and sizable cash buffers will be reduced.*

However, some concerns remain to be addressed. *While the overall policy-making quality has improved, a greater sense of urgency still seems warranted and decision-making procedures still appear long, in particular as regards the review of important legal texts by the Parliament. For several necessary reforms progress is slow and implementation foreseen only in up to three years' time. This applies, inter alia, for reforms of higher education, where the opportunity to use independent international accreditation institutions was missed. Better targeting and broader means-testing of social benefits based on the results of a recently published World Bank study will take significantly more time than hoped for. The same holds true for putting in place a centralised and professional management of state-owned enterprises scheduled from early 2014. Better management of port assets and an overhaul of health financing are also pending issues. In the energy sector the legal obligation to ensure third party access to gas infrastructure by April 2014 is a particular priority. Nonetheless, the government has adopted far-reaching changes to, inter alia, the Construction and Civil Procedures Laws and there are promising steps as regards vocational training and youth unemployment.*

Close monitoring of increasing non-resident bank deposits and further improvements in the capacity to tackle financial crimes and tax evasion remain important. *Positive initiatives to strengthen the judicial system and to reform the insolvency law need to be followed through.*

It will be important for Latvia to keep the pace of reforms and maintain competitiveness and fiscal prudence inside the euro area. *The European Commission will continue its close surveillance of planned and implemented reforms through the European Semester framework and the Post Programme Surveillance process.*

The national authorities confirmed, when signing the last SMoU in December 2011, their commitment under the PPS to consult with EU bodies on major policy intentions *and to stand ready to discuss those with the EFC, should the Commission deem that such changes may jeopardise macroeconomic stability and Latvia's repayment capacity. Overall, the authorities have been co-operative as regards the PPS obligations.*

There are no indications that the authorities would face difficulties in financing upcoming repayments of the EU loans in 2014-15.

xxx

Latvia's past few months have been challenging and turbulent: *after the mission, on 21 November, 54 people died when a shopping mall collapsed; Prime Minister Dombrovskis resigned unexpectedly to assume "political responsibility" for the biggest tragedy since Latvian independence and to allow establishment of a new government that "would enjoy full support of the Parliament" (there were many disagreements among the coalition parties in the past few months). Coalition negotiations, involving also the opposition Greens and Farmers party, are in progress to set up an interim government that would serve until the general elections of October 2014. While overall relations with the EU and prospects for future reforms should not be affected, these recent events have introduced some degree of uncertainty. On 1 January 2014, Latvia adopted the euro as its official currency and the changeover process was smooth.*

1. Introduction

Following the expiry of the financial support programme on 20 January 2012, post-programme surveillance (PPS) missions took place in May 2012, November 2012, May 2013 and on 4-7 November 2013, together with colleagues from other DGs (Employment, Education and Culture, Energy) and the ECB. As Latvia repaid all outstanding liabilities to the IMF in December 2012, more than two years ahead of the original schedule, the IMF did not take part. The main goal was to assess progress in key budgetary, social, financial and structural areas since the EFC report was published in June 2013, as well as review Latvia's repayment capacity in advance of the upcoming EUR 1 billion repayment to the EU by end-March 2014. The press release issued upon the conclusion of the mission is provided in the Annex.

To streamline the PPS and the European Semester surveillance mechanisms and to minimise the administrative burden on the authorities, the visit was used to assess jointly with experts from other DGs action taken to address Country Specific Recommendations (CSRs) on the budget and the financial sector, social inequality, higher education, energy market liberalisation, and judicial reforms. Lastly, a concluding meeting with the Prime Minister was organised to review progress with implementing commitments outlined in Latvia's letter to the June Eurogroup as regards, inter alia, reducing risks from the growing non-resident banking sector, improving the anti-money laundering framework, implementing higher education and state-owned assets management reforms, finalising state-owned bank restructuring, opening of gas market, and establishing a Fiscal Council.

2. Macroeconomic developments and outlook

Economic growth slowed to 4.2% y-o-y in January-September 2013 from a downward revised 5% in 2012. Private consumption was the main growth driver in 2013 as exports faced weaker demand. However, exports are expected to re-accelerate in 2014-15 paced by a better outlook in major trading partners. According to the 2013 Autumn Forecast, growth is projected at 4% in 2013 and 4.2% in 2014 amid broadly balanced risks. On the external side, the steep contraction in the metal industry had broadly symmetric downward effects on exports and imports. As the drop in investment further dampened imports, the foreign trade balance improved in 2013 and had an overall positive net contribution to GDP growth. Imports are nevertheless expected to pick up at a faster pace than exports over the forecast horizon on the basis of the projected rebound in investments.

Despite the small slowdown in economic growth, unemployment dropped markedly to an average of 12.1% in January-September 2013 relative to 15.4% in the corresponding period of the previous year. Employment rose by 2.5% for the same period. Unemployment is projected to decrease at a slower pace over the forecast horizon but is nevertheless likely to move below 10% in 2015, down by 50% from the peak in 2010. As labour demand is catching up with supply, wages are forecast to rise strongly, slightly outpacing expected productivity gains and therefore also pushing up unit labour costs. However, relative unit labour costs are seen as broadly stable due to similar labour market dynamics in major trading partners.

Annual HICP inflation slowed to nearly a zero rate in 2013 from 2.3% in 2012. The steep deceleration is largely linked to commodity prices, in particular crude oil. Price cuts due to efficiency upgrades in heating utilities as well as competitive pressures on the telecom and retail markets also played a role. The liberalisation of the electricity market as of April 2014 will remove certain limitations on household prices and is set to push up inflation along with possible changes to network charges and market conditions. The expected wage and employment growth is also likely to lift core inflation while commodities are assumed to have a further downward impact on prices. Inflation is therefore forecast to reach 2.1% in both 2014 and 2015, including a small one-off effect (0.2-0.3 pp.) from the euro changeover in 2014 to cover rounding effects and some administrative costs at corporate level.

3. Public finances

Following the large-scale correction of fiscal imbalances during the programme years, the public finances remain sound. The authorities are benefitting from the economic recovery, as well as a substantial improvement in tax collection as a result of a strengthening of the State Revenue Service. Expenditure policy has so far been overall prudent, regardless of the mounting pressure and two consecutive election years: local elections took place in June 2013 and general elections are scheduled for October 2014, in addition to the European elections in May 2014.

The general government deficit is expected to remain low and stable in 2013-2015, despite several income tax cuts planned and the gradual restoring of the long-term target level of state contributions to the privately managed funded pension scheme. The Commission's autumn forecast expects a general government deficit at 1.4% of GDP in 2013, very close to the level reached in 2012. While the revenue performance of the first ten months of 2013 is above budgetary plans, some expenditure categories will also be higher than initially planned. Unforeseen expenditure in particular relates to the "Liepājas Metalurgs" guarantee call amounting to 0.3% of GDP which the government had to meet in summer 2013 (the company is currently under insolvency procedure and negotiations with potential investors are on-going). The guarantee call will negatively affect both the nominal and the structural budgetary position, since as a rule no deficit-increasing measures (or events) are excluded from the calculation of the fiscal effort as one-off and temporary measures[1]; moreover, in the case of Liepajas Metalurgs further costs for the state are possible, thus there are no convincing arguments that the transaction is not recurrent. In addition, the government decided to perform an ad hoc indexation of small pensions (below EUR 285) from September 2013; the pension indexation had been frozen from 2009. In 2014 and 2015 the general government deficit is expected to decline to around 1% of GDP.

The 2014 draft budget was adopted by the government on 1 October and approved by Parliament on 6 November; it targets general government deficit of 0.9% of GDP. This was the first budget prepared on the basis of the new Fiscal Discipline Law and, although the budgetary process was politically difficult, the principles of top-down budgeting were maintained. The tax policy package underpinning the 2014 budget has the following elements:

(i) to reduce the burden of taxation on low wages and families, the personal income tax universal non-taxable threshold and the threshold applicable to dependents have been increased, while the social security contributions rate has been lowered by 1 percentage point. The personal income tax rate will be reduced by 1 percentage point in 2015 and again in 2016. This package replaces earlier plans to lower the personal income tax rate by 2 percentage points in 2014 and again in 2015.

(ii) to partially compensate for lower labour taxation, some consumption and natural resource taxes have been increased and the respective tax bases broadened.

(iii) to reduce the impact of the full liberalisation of the electricity market on consumer prices, a new tax has been imposed on energy producers benefitting from fixed feed-in tariffs, with revenue to be used to reduce the impact on prices and to compensate low-income families.

The 2014 draft budget "unfreezes" some of the expenditure areas which have been under very tight control since the BoP programme. This concerns the indexation of small pensions which will be raised from September 2013 and the public sector wage bill, which is set to grow by around 9% in the 2014 state budget – partly due to an increase in the minimum wage from EUR 285 to EUR 320. The increase should be seen in the context of previous substantial public wage bill cuts in 2009-2010 and only limited increases in 2011-2013, while the on-going recovery on the labour market makes it necessary to improve remuneration to retain experienced staff.

In recent years Latvia has put in place several measures to improve tax collection, but challenges remain. The "tax support measure" was implemented in 2012; it allowed waiving some late payment penalties on accumulated tax arrears, subject to respecting the agreed schedule for repayment of the principal amount. Also, managers involved in tax fraud will now face restrictions on business activity. Several measures are also taken to reduce underreporting of wages: these involve legal amendments to prevent misuse of advance payments and credit to employees. Nevertheless, much remains to be done to increase tax efficiency, as Latvia is among the countries with the lowest tax revenue-to-GDP ratio despite having some tax rates comparable to the EU average level (notably standard VAT rate at 21% and social security contributions rate of 35%); moreover, some estimates point to a relatively sizeable share of unreported economic activity.

[1] See European Commission (2006), Directorate General for Economic and Financial Affairs, Public Finances in the EMU, Part 2, Section 4, Measurement and statistical issues, pp. 110-115, http://ec.europa.eu/economy_finance/publications/publication423_en.pdf

The Fiscal Council, which will be responsible for monitoring fiscal policy on the basis of the Fiscal Discipline Law, is established from 1 January 2014. Parliament nominated six members of the Council on 19 December; these will have to elect a chairperson at their first meeting.

4. Financial sector policies

The mission team reviewed progress with the sale of non-performing commercial assets of the Mortgage and Land Bank (MLB), which were partly transferred to the Privatisation Agency for a gradual wind-down (via the Hiponia subsidiary). It remains unclear how MLB will operate in the future and what resources will be necessary to perform development lending activities: e.g., number of branches, credit experts, availability of international financing, etc. A fair assessment is needed whether senior management, that is partly responsible for past losses, is the best-placed to continue managing MLB as a development bank. DG COMP has not yet adopted the final decision as regards state aid granted to MLB; a positive decision in July 2013 relates only to aid granted to the commercial part of MLB.

In this context, the MLB banking licence has been revoked from 1 January 2014 and the process of setting up the Single Development Institution (SDI) is ongoing, backed by a lending commitment in budget 2014. SDI is to implement mostly EU-financed state aid programmes through financial instruments currently handled by the MLB, the Latvian Guarantee Agency, and the Rural Development Fund. A holding-type structure will be created to oversee different lending/guarantee programmes, followed by the transfer of assets/equity into SDI. The Commission will follow this issue closely to ensure that the SDI management board and supervisory council appointments are selected in a transparent and professional manner.

The authorities also outlined plans for the sale of Citadele Bank. Its sale almost happened in 2011, but was cancelled due to the Latvijas Krajbanka fall-out; it was decided in spring 2012 to postpone the sale for at least a year to wait for better market conditions. Following negotiations with DG COMP about revisions to Parex restructuring plan conditionality (e.g., selling of Citadele's Commonwealth of Independent States loan portfolio), it was decided to re-open the sale of Citadele. Societe General SA has been hired as sales advisor and several options are being considered (IPO or strategic investor); the government will decide on preferable sales scenario in early 2014 after "market testing" by advisors.

5. Non-resident banking and financial crimes

The growth rate in the non-resident banking sector moderated in 2013 mainly due to the depreciation of the US dollar, which forms a substantial share of the non-resident bank assets and liabilities. The ratio of non-resident deposits even dropped slightly below 50% of all deposits and stabilised at about 40% of GDP. The latest data show that predictions of large financial flows from Cyprus to Latvia have not materialised. Some of the non-resident banks report that the interest of moving accounts from Cyprus has indeed increased, but also the percentage of refusals has risen due to tighter compliance requirements of Latvian banks.

The supervision of the non-resident banking business poses continuous challenges due to the dynamic cross-border nature of transactions. The Financial and Capital Markets Commission (FCMC) and the Bank of Latvia have implemented during 2012-2013 several decisive measures to reduce the risks of non-resident banking, including levying capital add-ons for individual non-resident banks and higher liquidity requirements; more intensive on- and off-site checks; carrying out balance sheet stress tests, including macro-prudential tests; and by reviewing funding mechanisms for the deposit insurance scheme and the resolution and recovery tools. Also, the biggest non-resident banks have been issuing significant amounts of bonds and subordinate debt to diminish reliance on short term deposits on the liability side and limiting CIS lending activities.

The mission also discussed risks related to the exposure of non-resident banks to US securities and correspondent accounts. Both regulating authorities and non-resident banks admit risks linked to the US budget and debt ceiling negotiations as a large part of tradable assets are held in US securities. However, these risks are mitigated by large cash holdings of non-resident banks and a recent tendency of moving towards euro operations that is likely to pick up speed after the euro changeover. As regards the decision of JP Morgan to close correspondent accounts of Latvian banks, the Association of Private Banks informed that correspondent accounts have been swiftly moved to the US branch of Deutsche Bank. The decision of JP Morgan is not seen as targeted at Latvia, but as part of a downsizing and "cleaning-up" strategy affecting a number of countries.

The team met the Finance Ministry, the FCMC and the Financial Intelligence Unit (FIU) to assess implementation of the March 2013 Anti-Money Laundering Plan. Implementation of the AML plan seems broadly on track: the authorities have allocated significant additional resources in the 2014 budget for institutions fighting money laundering and other financial crimes. FIU is supported by additional staff, IT and logistical upgrades, and comprehensive training programmes; also, FIU is working with the banks to improve the analytical value of "suspicious transactions" reporting. Nevertheless, as evidenced by relatively few court cases and actual convictions, the need for building further expertise and improving institutional capacity remains a long-term challenge due to the dynamic nature of investigating, prosecuting and punishing complex international financial schemes.

6. Structural policies

The issues below have formed an integral part of the BoP conditionality and are now part of the European Semester assessment framework. As outlined in the May 2013 Staff Working Document, the main structural policies challenges for Latvia are: high unemployment; poor coverage of social assistance and insufficient activation of benefit recipients; reforming higher education and science; gas market liberalisation and energy efficiency, as well as implementing reforms in public administration and the judiciary.

6.1. Social and labour market policies

A high proportion of people in Latvia are at risk of poverty and income inequality is high. This has been confirmed by a comprehensive World Bank study from June this year, which indicates that, while there is little evidence of large scale benefit dependency, benefit adequacy and coverage of the last resort benefits are reasons for concern. The main conclusions are in line with the Commission views that the tax and benefit system could be modified to be more favourable for low income households and to improve incentives to work. Unfortunately, it seems that only few of these findings were addressed so far, i.e. by the 2014 budget. Concrete measures to tackle inequality are limited to a rise in PIT non-taxable thresholds. The Guaranteed Minimum Income and housing allowances were left untouched. Hesitation to reform the tiny (EUR 11/month) universal family state benefit over the past 3-4 years also illustrates lack of determination on the authorities' side. While the 2014 budget also foresees further increases in child care and parental benefits, support to child care services, relieving parents from the costs associated with school supplies and extending the scope of free lunch in the schools, these measures are not means-tested and, thus, do not directly address the problem of poverty and inequality.

Proposals on the reform of the social security system are under preparation. While these broadly address most of the recommendations of a recent World Bank study, their implementation is foreseen only in 2016 or later. Also, guidelines to improve the work of social services have been proposed. In terms of addressing child poverty, the above-mentioned increase in various child and family-related benefits within the social security system is expected to have some positive impact.

Although there have been notable improvements in the labour market and long-term/youth unemployment rates have decreased in comparison to 2012, they are still relatively high. The authorities should continue implementing productivity-enhancing structural reforms, including improving the learning-content of vocational programmes and ALMPs (focusing on work based learning). The public works programme should be replaced by programmes that directly address the labour market barriers of long term-unemployed, such as lack of skills, caring responsibilities, poor health etc.

6.2. Higher/vocational education and science

In the 2013 European Semester, the Commission assessed the proposed higher education reforms as going in the right direction. They included, inter alia, a quality-based accreditation of study fields, better targeting of public funding to universities, consolidation of higher education institutions, promoting the use of EU foreign languages in teaching, and introducing a financing model that rewards quality. The immediate challenge concerns their proper implementation, given strong vested interests in the education sector.

Progress has been very slow. The opportunity to use independent international accreditation institutions has been missed, as accreditation was done in a very short period of time by the Ministry of Education and Science and most study fields were accredited for 6 years. A new financing model for higher education is currently being prepared in cooperation with World Bank experts to ensure better accessibility and improved efficiency of higher education, but its introduction is foreseen in 2016 only. It seems the only effective tool for the government to introduce quality elements in the higher education system is the annual allocation of budget-financed study places.

The main challenges for the vocational education and training (VET) system are to provide sufficient skills for the workforce and increase availability of quality work-based learning, including traineeship/apprenticeship schemes. Several measures are ongoing to enhance the attractiveness and labour-market relevance of VET: modernisation of infrastructure, introduction of career guidance services, more flexible curricula, and increased involvement of social partners. Moreover, a pilot project on a dual VET system, implemented in co-operation with German partners, has started in September 2013.

The effectiveness of science policy has been undermined by a lack of independent, external evaluation of the relevance of scientific output. Such evaluation is undertaken by the Nordic Council and was supposed to be finalised this autumn, but progress is unclear. A comprehensive assessment of state-financed scientific institutions would allow determining which institutions are to be merged or liquidated and which would be eligible for more EU and national funding.

The Commission monitors closely how the ERDF/ESF financing is used in these fields and will work together with the authorities to ensure that higher and vocational education and science sector reforms are continued with EU funds support also in the next financing period (2014-2020). In particular, allocation of EU funds will need to be in line with merit and quality considerations.

6.3. Energy

Latvia is in the process of liberalising its gas and electricity markets. There are significant differences in progress made for both sectors as a result of ownership and regulatory divergences.

6.3.1. Gas Market

The authorities are preparing for the termination of the "emerging market derogation" on 4 April 2014: the necessary legislative changes were recently proposed by the government to the Parliament. This means that Third Party Access (TPA), Distribution System Operator (DSO) unbundling, unbundling of accounts for the Transmission System Operator (TSO) and various storage/LNG rules need to be implemented. Latvia will, however, hold on to its "isolated market derogation" until there is a connection to a different supplier and will remain exempted from Market Opening and TSO Unbundling rules.

As a first step, non-controversial rules (e.g., on LNG, which is non-existent) were put forward for adoption. TPA, however, is not part of the first proposal. While de facto there is some form of TPA to transmission and storage facilities, these services are not regulated as strictly as the Third Package prescribes (terms and tariffs). As both the transmission grid and the highly important Incukalns storage are owned and operated by the vertically integrated Latvijas Gaze (owned by Gazprom/Itera and E.On) and there are no alternative sources of supply, the situation in the gas market will not change immediately upon implementation of these rules. However, given the development of various infrastructure projects, including the Lithuanian LNG Terminal, the Regional LNG in the Gulf of Finland and the Lithuania-Poland interconnector, the Commission has urged the authorities to put in place the legal framework in preparation for the end of the isolated market derogation.

The gas market reforms are further hindered by the Privatisation Agreement of 1997, whereby Latvijas Gaze was granted a twenty-year monopoly. The government wants to have absolute legal certainty about the consequences of liberalisation before the Privatisation Agreement expires in April 2017, in particular whether the planned unbundling of gas distribution could result into sanctions for breaching commitments signed before the country's entry into the EU. Latvijas Gaze has already warned of court proceedings if the legal amendments are in conflict with the Privatisation Agreement. The authorities have commissioned an internationally-renowned consultant to investigate this and suggest options for moving forward. In this context, Incukalns gas storage ownership modalities and possible management contract renegotiation after 2017 will also require complicated analysis and negotiations with Latvijas Gaze owners.

6.3.2. Electricity Market

On 1 April 2014 the Latvian electricity market will be open for all consumers: around one million household consumers will be subject to free market conditions. It is generally expected that moving away from (low) regulated prices will mean a significant price increase of some 20-30%. To ensure a targeted support for most vulnerable consumers through the municipalities' social services, from January 2014 a new energy tax is levied by Latvenergo on those producers that currently benefit from the feed-in tariff for renewables. Proceeds from this new tax will be used to ensure that the feed-in tariff for renewable energy production will remain unchanged until 2017.

Latvia joined the Nordpoolspot trading (NPS) in June 2013; however there have been wild price fluctuations in the Baltic bidding areas. Neighbouring Estonia has blamed Latvenergo for not bidding sufficiently on NPS thereby contributing to large price hikes. It seems the Estonian companies selling electricity to clients in Latvia have to procure their electricity on the Latvian/Lithuanian bidding area, which is not liquid and volatile, while Latvenergo does not face the same problems in Estonia. The Latvian Public Utilities Commission claims that the real problem is the reduced interconnection capacity on the Estonian border. Shortages in generation capacity in Lithuania, following the closure of the Ignalina plant, and different maintenance works have also contributed. In the long run, the Swedish-Lithuanian interconnector and bigger interconnection capacity on the Estonian border should help to alleviate problems. DG ENER has invited the three Baltic TSOs and the relevant ministries for a meeting to resolve these issues.

6.4. Public administration

Only few commendable public administration reform measures have been implemented in recent years despite such reforms being part of several SMoUs. Weak common public HRM policy and development planning, and uncompetitive remuneration result in relatively high staff turnover and risk sub-standard policy-making. The Commission has repeatedly urged the Finance Ministry as the responsible institution to review the unified wage grid set-up (job classifications, salary coefficients, links to performance assessment, etc.), possibly inviting external expertise. The Prime Minister has been unwilling to raise his salary, which is an anchor for the whole public sector, due to possible public reaction; as a result, the ministers and other senior officials are under-paid. While across-the-board public sector wage increases should be avoided, the best-performers should be properly remunerated. Positively, additional financing has been granted within the 2014 budget to the lowest paid wage grid categories (policemen, firemen, social staff), as well as for further equalisation of salary levels across different ministries/institutions. Institutions like the Competition Council and the Financial Intelligence Unit have also received significant budget increases.

A concept paper for public administration human resource development was approved by the government in February 2013. It includes elements like staff recruitment, assessment, rotation, mobility, career development and special trainings for top

managers, some elements of which are being implemented (appraisal of managers, improvement of job classifications, talent management, new training modules, etc.). However, the timetable for implementation could be more ambitious and the municipalities are exempt from these proposals. There are also proposals to streamline parts of the overall decision-making process, which the Commission has deemed overly long and complicated.

6.5. Judicial reforms

The efficiency and quality of the judicial system remain weak, although positive ambitious steps are taken since the current Justice Minister started work. Lengthy civil and commercial case proceedings in the first instance and rather low clearance rates have led to a significant backlog of court cases; court decisions often take years. The main challenges include, inter alia, implementing recent civil, administrative and criminal procedural law amendments, redistributing case files among courts, enhancing the role of the chairman of the court in reducing the length of procedures, establishing a comprehensive HRM policy linked to the professional evaluation of judges that started in January 2013, ensuring proper interpretation and implementation of the insolvency law (amendments are discussed in the Parliament), reforming the system of arbitration courts, and implementing the Law on Mediation that would partly alleviate the workload of courts.

As judicial reforms comprise one of the CSRs, significant EU funds financing will be allocated in 2014-2020 for judicial training and IT systems, giving the Commission additional leverage. The Commission has expressed its support for the proposed Ministry of Justice reforms, especially as regards improving the supervision of insolvency practitioners' activities.

6.6. State owned enterprise management

It appears that establishing a centralised State Owned Enterprise (SOE) manager under the PM, the gradual transfer of ministries' stakes in SOEs to this SOE manager, and minority and non-core-activity share divestments will take longer than expected (and scheduled in the December 2011 SMoU). Draft laws are in the Parliament awaiting the second reading with many amendments to review. The most contentious issue seems to be the establishment of a centralised SOE manager bureau - a staff of six civil servants and six sectoral experts - that will actually oversee SOE performance, appoint SOE managers and supervisory board members, and propose public sector divestments. The mission team reminded that SOE reform had been well-prepared with help from international institutions and it is important to implement it swiftly. The Commission will follow-up on SOE reform also in the context of Latvia's accession negotiations with the OECD. The authorities should also revisit privatisation plans for some bigger state assets: e.g., Mobile Telephone Company.

As a follow up to one of the SMoU conditions, the World Bank has published in November a comprehensive study on the Latvian ports' regional competitiveness. This is highly contentious, as port management in Riga and Ventspils is heavily politicised and few reforms have taken place in the past decade due to strong vested interests. The State Audit Office published a negative opinion in early 2013 as regards the ports' financial management, which prevents the state from receiving bigger gains from these strategic assets. The mission team urged the authorities to address without further delay the State Audit Office and World Bank findings as regards ports' management deficiencies.

6.7. Other reforms

Difficult negotiations with the authorities are expected in the coming weeks as regards the allocation of the 2014-2020 EU funds envelope, as the positions are divergent on some key issues: financing for regional development, public IT systems, ports and cultural infrastructure, science and education, etc. Based on the experience from 2007-2013, the authorities should propose a further simplification of procedures for final beneficiaries and optimisation of implementation (e-Cohesion, more decision-making at the relevant Ministers' level). Implementation of large-scale EU co-financed projects (roads, ports, railways) needs to be improved (public procurement, corruption risks).

In line with SMoU conditionality, the Transport Ministry is continuously introducing improvements in the road construction quality system since early 2012 and additional financing was allocated for 2012-2015 for the maintenance of EU co-financed roads. The Commission is receiving regular progress reports on improvements made or planned.

Strong and transparent competition and procurement policies are important to ensure adequate price levels, fair competition, attraction of foreign investment, and a smooth implementation of EU funds. There have been several ambitious conditions in these fields during the BoP programme. Encouragingly, the authorities have implemented conditions as regards introducing administrative liability for violations of public procurement procedures (starting from September 2013), achieved greater centralisation of public procurements among local governments and expanded application of electronic procurement system. The authorities are also discussing possibilities of moving towards economically-advantageous procurements, rather than solely based on lowest price criteria. As regards competition, the Commission has expressed support for the institutional independence of the Competition Council (currently under the Ministry of Economics), including being exempt from the unified wage grid that prevents keeping the most qualified staff.

7. Loan repayment

The Treasury is preparing a new foreign bond or a tap bond issue for boosting its cash buffer ahead of the forthcoming large repayments in spring 2014 - EUR 1 billion to be repaid to the Commission end-March (accounting for 34.5% of the total outstanding liability under the BoP programme) and EUR 400 million for repaying a 10-year bond at the beginning of April 2014. As of end-2013, the cash buffer of the Treasury was close to the amount of debt due in spring 2014. However, in order to maintain a sound liquidity position, some debt issuing ahead of the major repayments is warranted. It is currently expected that the Treasury will issue up to EUR 750 million on the external markets in January 2014 with yields projected in the range of 3-4% for maturity profiles of 7 to 10 years. Another debt issue is scheduled for the second half of 2014, bringing the total external borrowing to about EUR 2 billion in 2014. Depending on market conditions and given the large size of the existing cash buffer, the Treasury is also holding alternative options for taking a syndicated loan or tapping the domestic bond market for refinancing the first repayment.

Although debt issuance will be relatively large by the end of 2014 (8.8% of GDP), loan repayment risks are low at present due to a solid cash balance of the Treasury, low spreads on domestic and international bonds, as well as sound fiscal and growth indicators.

Principal debt repayments under the programme (EUR million)

	2012	2013	2014	2015	2016-18	2019	2020-25	**Total**
EC			**1,000**	**1,200**		**500**	**200**	**2,900**
IMF	1,100							1,100
WB				60	240	80	20	400
Total	**1,100**	**0.0**	**1,000**	**1,260**	**240**	**580**	**220**	**4,400**
Total, % of GDP	5.2%		4.0%	4.8%		2.0%		

The replacement of EU loans with market funding is not expected to have a substantial impact on the interest burden. However, the final outcome of the rollover will also depend on the international market conditions and the domestic political environment in the aftermath of the PM resignation in November 2013.

Overall, the staff supports the policy of maintaining sound cash buffers and further encourages the Treasury to pre-fund debt repayments at an early stage to efficiently balance cost considerations and risks of market volatilities or possible speculative attacks that may arise from debt rollovers shortly before maturity dates. The political turmoil in late November 2013 has further highlighted the benefits of advanced pre-funding.

ANNEX

EUROPEAN COMMISSION

PRESS MEMO / 13 / 967

Brussels, 8 November 2013

Fourth Post-Programme Surveillance mission to Latvia by the Commission services

Following the successful conclusion on 20 January 2012 of the three-year financial support by the EU, the fourth Post-Programme Surveillance (PPS) mission to Latvia was carried out by the European Commission services from 4 to 7 November, together with the ECB. PPS missions are scheduled to take place twice a year until 75% of the EU loan provided to Latvia will be repaid (expected in 2015).

The assessment of post-programme developments is overall positive. Macroeconomic, fiscal and political stability has allowed Latvia to enjoy among the fastest GDP growth rates in the EU and the outlook for 2014 and 2015 is equally encouraging. Nominal budget deficits are projected to remain in the range between 1% and 1½% of GDP in 2013-2015 despite several income tax cuts planned for these years. The tax policy package underpinning the 2014 budget follows the respective Country Specific Recommendation (CSR) issued to Latvia, in particular through a substantial reduction of taxation for low income earners by shifting taxation to areas such as excise duties, property and/or use of natural resources, and by strengthening actions to tackle different types of tax avoidance. Other measures, e.g. on child poverty, are expected to partly address social exclusion and demographic challenges.

However, some concerns remain to be addressed. The government has adopted far-reaching changes to, inter alia, the Construction and Civil Procedures Laws and there are promising steps as regards vocational training and youth unemployment; nonetheless, a greater sense of urgency still seems warranted. For several necessary reforms, progress is very slow and implementation foreseen only in up to three years' time. This applies for, inter alia, reforms of higher education and science where the opportunity to use independent international accreditation institutions has already been missed. Better targeting and broader means-testing of social benefits based on the results of a recently published World Bank study will take significantly more time than had been hoped. The same holds true for putting in place centralised and professional management of state-owned enterprises from early 2014 and for making public administration more professional. In the energy sector significant challenges with regard to the liberalisation of the gas and electricity markets are still to be overcome. The legal obligation to ensure third party access to gas infrastructure by April 2014 is a particular priority.

Close monitoring of increasing non-resident bank deposits and further improving the capacity to tackle financial crimes and tax evasion remain important. Positive initiatives to strengthen the judicial system and to reform the insolvency law need to be followed through.

It will be important for Latvia to keep the pace of reforms and maintain competitiveness and fiscal prudence once inside the eurozone. The European Commission will continue its close surveillance of planned and implemented reforms through the European Semester framework and the Post Programme process.

Background

From 2009 to 2011, Latvia benefited from a financial assistance programme (Balance of Payment Support) from the EU, provided in conjunction with an IMF stand-by agreement and financing commitments by the World Bank, the European Bank for Reconstruction and Development, several EU countries and Norway. Funds available amounted to € 7.5 billion, of which Latvia used € 4.5 billion (60%), with € 2.9 billion lent by the European Commission, on behalf of the EU. The lending was subject to an ambitious action plan, including fiscal consolidation and wide-ranging structural reforms, which have proven quite effective to help the country to recover from a deep financial and economic crisis.

For more information:

http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/latvia/latvia_en.htm

See also the recent ECFIN Occasional Paper "EU Balance-of-Payments assistance for Latvia: foundations of success":

http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op120_en.htm