Bank of Latvia Conference
Latvia Beyond the Crisis: Towards Sustainable Economic Growth
Riga, 20 October 2010

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An Assessment of Latvia's Economic Policy and Needed Responses

[Introduction]

[SLIDE 1]

Ladies and Gentlemen:

I very much appreciate and I'm thankful to the Bank of Latvia for the opportunity to discuss with you today Latvia's economic policies and responses for achieving sustainable growth.

[SLIDE 2]

About a year and a half ago, at the end of April 2009, I took over the European Commission's team working on the economic and budgetary surveillance and on the financial assistance to Latvia. At that time, Latvia was in the midst of a raging financial storm and the economy was free-falling. Confidence in the Latvian economy, the banking system and in the national currency was very low, with many doubting about the capacity of the government and the country to deliver the adjustment needed to maintain the peg to the euro. To be frank, international lenders were also concerned by the insufficient action taken in response to the assistance provided to Latvia until then and to the deepening crisis.

[SLIDE 3] Today, as you well know, the situation is quite different. The Latvian economy is recovering from the steepest recession in the EU, and financial markets are characterised by relative calm. The brighter environment reflects the stabilisation of global financial markets and the recovery of the global economy. But it also reflects the impact of the policies of the Latvian authorities to stabilise the economy and the banking system.

Clearly two defining moments reflected the political will to deal with the daunting challenge of ensuring macroeconomic stability in Latvia. Both of them relate to budgetary decisions.

The first moment is the adoption of the 2009 supplementary budget, back in June last year, which capped the general government deficit at 10% of GDP in 2009 and paved the way for the release of the EU's instalment of €1.2 billion. This allowed to solve the immediate cash problems of the government and appeased markets. Half of the EU release also served to create a liquidity buffer for potential needs related to the banking sector.

The second defining moment is the adoption of the 2010 budget, last December, which confirmed the capacity of the government to deliver on its commitments taken in July 2009, following ECOFIN Council recommendations to bring the deficit on a downward path towards the 2010 target of 8.5% of GDP.

In the course of 2010, good progress has been made in many areas. First, the budget has been implemented without serious slippages, which was a risk in view of electoral temptations. Thanks to this progress in implementing this crucial part of the programme, the Commission and IMF completed the 3rd review during the summer, and in fact exactly today the Commission is transferring to Latvia the related tranche of 200 million euro.

Second, confidence in the financial system – which triggered the crisis in 2008 – has largely been restored, building on the fact that, throughout the crisis, the Latvian authorities have remained strongly committed to the long-standing monetary and exchange rate arrangement. They have taken significant financial system stabilisation measures, notably by restructuring Parex Banka, while prudential supervision and regulation has been strengthened further.

Third, external competitiveness is improving, following an adjustment of wages and employment of a massive scale. Exports are now picking up and export market shares are increasing. However, risks from surging imports and accelerating inflation should not be overlooked as bottlenecks and vulnerabilities in the economy may be appearing sooner than expected a few months ago.

Fourth, while unemployment is still close to record levels, steps have been taken to help the labour force remain active, retrain and strengthen its skills, using effectively the EU funds, in an effort which hopefully will pay back over the next years.

Against this background, I would like to devote the rest of my remarks to the challenges to be addressed by Latvia, in order to achieve sustainable public finances and sustainable growth.

[Fiscal policy and governance]

[Slide 4] First of all, let me continue on the issue of fiscal policy.

I just talked about the impact of fiscal policy in re-establishing confidence so far. The Commission services estimate that the overall consolidation effort since end-2008 amounts to around 15% of GDP, an impressive amount. Of this adjustment, more than two-thirds is expenditure-based. While we know that in the hurry not every decision was perfect, overall, this composition and most measures are in line with best practices based on past international experience with regard to both the persistence of the budgetary correction and its impact on the economy, the so-called expansionary consolidations.

[SLIDE 5] But there should be no illusion that this is the end of the story. What are the challenges here?

First of all, while the *implementation of the 2010* budget appears to be on target, there is almost no safety margin left. In other words, there is no room for fiscal slippages towards the end of this year. Second, in terms of fiscal adjustment, Latvia is still in the middle of the river. Slowing down the consolidation effort now can waste all the benefits from past efforts. A budget deficit at around 8.5% of GDP is still too high, as it implies a rapid increase in public debt. Looking forward, fiscal consolidation must continue at a high pace, to bring the deficit below 3% by 2012 and beyond, and set the basis for euro adoption by 2014.

Here we see the risk that as the economy improves the temptation of reducing the consolidation increases. My key message here is that postponing some of the adjustment which should be done in 2011 only means increasing the needed adjustment in 2012, making it even more difficult than it would be, while harming the chances of being ready for euro adoption.

What remains to be done, then?

[SLIDE 6] For *next year*, preliminary estimates from our June mission suggest consolidation measures in a range of 395-440 million lats are necessary to ensure that the deficit goes below 6% of GDP. A more precise estimate of the needed consolidation in 2011 will be made in the next weeks once more complete data will be available. We expect that the final amount could be on the lower side of this range. This is still a very high amount in absolute numbers, but it would be unwise to target anything less ambitious than that.

Here, let me underline that the deficit figures which I am talking about, those set in the ECOFIN recommendation, are ceilings, not targets. Any additional revenues or savings achieved should be used to lock in lower-than-targeted budget deficits, lead to the building of buffers against negative surprises and to facilitate the consolidation over the following years. .

There is also a question of *how to deliver* such an adjustment. As also clearly stated in the ECOFIN recommendation, it should result in a structural improvement in the budget balance. Short-sighted, one-off type of measures should be avoided. The EU is not ready to consider measures with mainly accounting effects in its assessment of whether the structural effort is consistent with what recommended. The fiscal crisis in many EU countries shows that such measures simply postpone the adjustment and aggravate the problems. In addition, the budget should be designed with a view to promote structural reforms that reinforce the growth potential of the economy. And, finally, we encourage the government to take into account and minimise the distributional consequences of the adjustment, protecting vulnerable groups in society.

[SLIDE 7] Given the scale of the challenge over the next two years, the government needs to be ambitious and consider all possible ways to cut inefficient *expenditures* further. Possible savings could be found by improving the effectiveness and reducing the costs of the public administration and of state-owned enterprises, by reducing direct subsidies to enterprises and by consolidating budgets in local governments. The system of social insurance benefits could also be rationalised and improved, to achieve a better targeting of benefits and ensure the sustainability of the pension system.

While we believe there is ample scope to make the public sector more efficient and less expensive, the government may have to consider measures on the *revenue side* to finance the gap. We are convinced that if everybody would pay taxes, there would be no need to raise them. Hence, a priority is to fight the grey economy, improving tax administration and raising tax compliance. This would help strengthen revenues, reduce the burden on regular taxpayers and increase the fairness of the tax system. It is also important to continue the review of possible tax reforms. If necessary, as indicated by the Ministry itself in its Tax strategy, a broadening of tax bases and a relative shift of taxation towards property and consumption could be a balanced approach to the simultaneous needs to generate more revenues, prevent new bubbles in the economy and avoid further increases of the tax wedge on labour. . But let me stress that increasing taxation should be used as a last resort, as it can reinforce incentives to go in the grey economy, while discouraging foreign investment.

[SLIDE 8] Going beyond consolidation needs for the next years, it is important to set up a framework promoting the conduct of prudent fiscal policies over the medium term. In Latvia, there is in particular the need to have a framework which promotes counter-cyclical fiscal policies and a prudent behaviour in good times, but also allows a transparent and complete knowledge of the public finances.

The Latvian authorities have already taken some steps in this direction, with ongoing preparations for a fiscal responsibility law; a review of state owned companies; and actions to remove unnecessary rigidities in the budget. Desirable further steps in the forthcoming fiscal framework include a clear reference to the EU fiscal rules, the introduction of more flexibility for reallocations between ministries throughout the year, and, more generally, the design of a more performance-oriented budget structure.

To sum up on budgetary challenges, while achievements are impressive, they should not give room to complacency. Further, significant, ambitious and lasting measures are still necessary, to put public finances on a sound footing, help convince financial markets of Latvia’s commitment to fiscal discipline, and create stability for economic recovery. Achieving such an adjustment is not an easy task, but I understand that the government has been strongly mandated by voters to implement such an agenda.

[Addressing macro-structural bottlenecks to promote sustainable growth]

But, obviously, fiscal consolidation alone will not be enough to achieve sustainable growth.

[SLIDE 9] This brings me to the second part of my speech: How to make Latvia emerge stronger from the economic and financial crisis?

The short answer to the question of how to make Latvia emerge stronger is to boost potential growth and ensure a sufficient adaptability of the country to a fast-changing world. This requires implementing structural reforms, ensuring an efficient allocation of resources, and upgrading the human, physical and knowledge capital of the country.

Under the Europe 2020 strategy, the EU and the national authorities are working together to identify macro-structural bottlenecks and the reform priorities to address them.

[SLIDE 10] In fact, the first Europe 2020 mission to Latvia took place only two days ago. The discussion centred on three broad areas: (i) the labour market; (ii) the business environment; and (iii) education and innovation.

Let me briefly outline some of the challenges we discussed and the ongoing efforts to address them.

[SLIDE 11] First, today, Latvia has the highest unemployment rate in the EU, with obvious social consequences. This also reflects the strategy to accelerate the restructuring of the economy by very large dismissals from unproductive jobs ("creative destruction"). In this context, the challenge is to avoid that the high rate of unemployment becomes structural, as that could damage the skills and motivation of the labour force, resulting in further emigration and social unease. A key priority to support potential growth appears hence to implement effective active labour market policies. Policy should focus on facilitating the transition to regular employment from the emergency public works programme (the so-called "100 lats – a month - jobs"). Increasing the matching in the labour market is another priority. Making training available to vulnerable groups in society, through voucher programmes and in collaboration with the private sector, could yield important results.

[SLIDE 12] Second, *productivity* growth is a main driver of a country's medium-term growth potential, and the only real means to sustainable increases in wages and living standards. The main challenge in this area is to raise the attractiveness of Latvia as a place to work and invest, and at the same time, to channel capital and labour towards productive investment and activities. This requires action to foster the production of exportable goods and services and not new bubbles in the construction, retail and financial sectors, as it happened in the past.

A main priority in this area is to promote a favourable business environment that is able to attract and retain foreign investment and that encourages entrepreneurship. A number of initiatives and measures have been launched and others are in the making (such as the national investment attraction strategy, support programmes for small and micro companies, and a reduction of the administrative burden). Other priorities in this area include ensuring access to finance for SMEs, improving the absorption of EU structural funds by the private sector, strengthening competition, fighting the grey economy, and improving the efficiency of the public sector, only to name a few. Work is ongoing also in these areas, and we encourage pursuing it with energy.

[SLIDE 13] Third and lastly, policies that support the accumulation of human and knowledge capital will benefit growth of *total factor* productivity. The education system has an important role to play in the formation of human capital. A challenge is to produce a sufficient number of graduates in science and technology-intensive fields, and attracting researchers. In Latvia, this challenge is amplified by significant net outward migration of qualified workers. A better performance of the education system is warranted.

In the area of R&D and innovation policy, performance is still considerably below the EU-15 average. Here, Latvia faces a low level of innovative activity and the need to strengthen the links between academia and the business sector. The level of overall R&D spending in Latvia is very low in an EU-wide comparison. Public R&D financing has been reduced significantly in 2009 and 2010, and private R&D financing appears to be constrained by limited availability of bank financing. In this respect, a pressing issue for the authorities is to approve the regulations necessary to implement the EU financing in this area for the full period until 2013, and to start signing project agreements.

But let me stress the strong support given by the EU funds overall to Latvia. Increasing and speeding up their absorption, and ensuring their effective use, remains a key priority as they can help to overcome the crisis and lay the basis for a sustainable catching up.

[Conclusion]

Ladies and Gentlemen:

[SLIDE 14] Let me conclude. For those of you that are familiar with the policy conditionality in our latest Supplemental Memorandum of Understanding (signed in June this year) and in the Letter of Intent to the IMF, these reform priorities and reform measures will not come as a surprise. The policy conditionality is based on Latvia's needs.

Many of these reforms are long overdue and are necessary for Latvia to keep pace with neighbouring countries –especially as some have managed to adopt the euro - and to be able to function in the euro area once it is joined. The agenda is ambitious, but attainable. Implementation of the reform strategy is crucial for Latvia to become a competitive and sustainable economy, where new companies are started and new jobs are created, and where bottlenecks are addressed before they lead to excessive imbalances. Ultimately, this agenda will be for the benefit of all Latvian people. We trust that the Latvian authorities share this ambition and will continue working in this direction.

[SLIDE 15] Thank you **[Word count: approx 2700]**