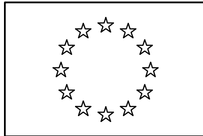


EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 21 December 2011

EUROPEAN UNION BALANCE OF PAYMENTS ASSISTANCE

LATVIA

EC STAFF REPORT FROM THE 5TH REVIEW MISSION TO RIGA

Executive Summary

The Commission Services carried out the fifth review mission in cooperation with IMF staff from 28 October to 10 November 2011, to assess compliance with the conditionality of the fourth Supplemental Memorandum of Understanding (SMoU) and the more immediate conditions for concluding the BoP Programme (due to expire on 20 January 2012). The findings of the pre-review mission, carried out in early October, complemented by the 24 October Compliance Statement by the Latvian authorities, provide the basis for the assessment of the SMoU conditionality implementation.

The **mission's assessment** is that the government's budgetary, financial and structural reform measures since the fourth review **ensure compliance with the policy programme**. In particular, as outlined in the attached SMoU, this conclusion reflects:

a) **Achievement of the 2011 budget deficit target of 4.5% of GDP** in ESA95 terms. The 2011 fiscal deficit was estimated at 4.2% of GDP in the Commission services' autumn forecast, including the expected restructuring costs of the Mortgage and Land Bank and AirBaltic, while the impact of the bankruptcy of Latvijas Krajbanka that occurred after the cut-off date is expected to remain contained;

b) **Agreement on the content of the 2012 budget, targeting a deficit of no more than 2.5% of GDP** in ESA95 terms together with a strong commitment from the government to take additional measures in a supplementary budget, in case the 2.5% deficit target would be endangered;

c) **Progress made with strengthening the fiscal framework**, notably the adoption by the government of a draft Fiscal Discipline Law on 29 November, draft amendments to the Constitution to give FDL higher legal standing, and changes in the medium term budgetary framework, to preserve fiscal sustainability and improve multi-annual budget planning;

d) **Improvements in tax administration practices and in fighting the grey economy**, to support the fiscal adjustment strategy, in particular by implementing from January 2012 key measures of the adopted strategy for fighting the grey economy, such as the "zero declaration" and measures to speed-up payment of tax arrears and strengthen tax collection;

e) **Further actions taken to strengthen the financial system**, including closer supervision of the banking sector (in particular non-resident banking), continued progress with the sale of Citadele Bank and the orderly resolution of Parex Bank, submission of the final sales strategy of the Mortgage and Land Bank and measures to deal with issues emerged in the context of the Krajbanka fall-out;

f) **Clear commitments to continue implementation of structural reforms**, notably in the areas of EU funds absorption, education and active labour market policies, SOE governance and public real estate management, energy efficiency, and public procurement.

While all these elements are reassuring, some questions remain as to the quality of the adjustment, where more could have been done to shift the burden of taxation away from labour to less distortive taxes, and more decisive action could have been taken to reduce grants, subsidies and social spending through better targeting. In particular on the latter, however, the new government is committed to undertake analysis and steps in 2012 to reduce overall spending while ensuring a proper social safety net and more targeted social support.

The Commission intends to closely monitor and assess progress made with these commitments and policy intentions, in particular the structural reform agenda where a clear momentum is warranted, under the post-programme surveillance (PPS). The first PPS mission is expected to take place in spring 2012.

The government does not intend to draw the funds available to them upon completion of this review and has not expressed any interest in a follow-up programme. The government's strong financial position reflects, in part, Latvia's success in returning to international market financing, with a successful Eurobond placement of USD 500 million in June 2011. In effect, the last disbursements under the programme date back to October 2010. Such position is sound even after a significant cash loan was provided to the Deposit Guarantee Fund in November 2011, following bankruptcy of Krajbanka.

After the decision by the Commission - expected by end-December - to release, if requested, the remaining funds, the possibility to make such request remains open until 20 January 2012.

The government submitted its final sales strategy for the Mortgage and Land Bank to the European Commission on 2 November and the sales process of its commercial part has started. This step made available another EUR 100 million for the purpose of general government financing from the funds earmarked for banking sector support. The remaining EUR 249 million shall be released based on progress with the sales processes of MLB and Citadele (expected in the first half of 2012). Should stress in the financial sector lead to undue pressure on the Treasury liquidity position, (part of) such funds could be made available at an earlier stage.

I Overall Context

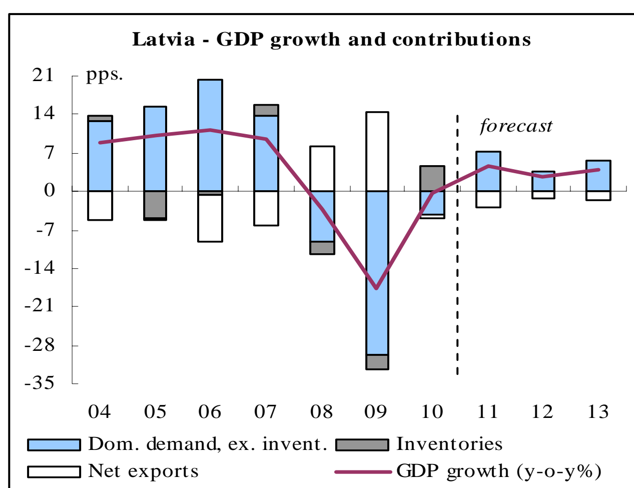
Latvia has made remarkable progress in overcoming the worst financial and economic crisis in its recent history. In spite of social hardship, periods of political change and an uncertain external environment, the country is now in a much sounder position thanks to the implementation of the economic stabilization program: economic growth has resumed after the unprecedented fall in 2008 and 2009; inflation rates are much lower than before the crisis; the pre-crisis external imbalances have been greatly reduced; unemployment, that rose strongly during the crisis, is now steadily declining; access to international funding markets has been regained, though recent tensions in international capital and sovereign markets have added new challenges; and the fixed exchange rate has been preserved.

The EC mission team's overall assessment is that the economic stabilisation programme has achieved its main objectives. These improvements reflect a number of policy actions: Latvia's external competitiveness has improved substantially through a combination of wage cuts and dismissals, rising productivity and structural reorientation; the soaring budget deficit has been reined-in and, while public debt has risen, it is still relatively low in an EU-wide comparison; the banking system has been stabilised and the government is on its way to reduce its intervention in this sector; and a number of structural reform initiatives are in motion that, when fully implemented, will boost Latvia's growth in the medium term.

Full implementation of the Latvian government's policy agenda for 2012, and beyond, is necessary for sustaining the economic recovery, for maintaining the country's ability to borrow on capital markets at affordable interest rates, and for making progress towards meeting the conditions for euro adoption on a sustainable basis, with the government targeting the adoption of the euro by January 2014. The pace of implementation of key reforms stalled after October 2010 parliamentary elections and there is now a need to accelerate. In this respect, it is encouraging that the new government has taken ownership of the goals and key elements, set by its predecessor, within the EU-IMF-supported programme, and is setting deadlines for key reforms. The new SMoU provides a useful anchor for policy steps over the coming year, and its implementation will be assessed under the PPS.

II-a Macroeconomic developments

Since the previous review in April, **the macroeconomic scenario has evolved favourably**, although there are signs that the **more subdued external environment may be less supportive**.



Economic growth accelerated to 5.6% y-o-y in the second quarter and 6.6% y-o-y in the third quarter of 2011, based on seasonally unadjusted series. For Jan-Sep 2011, the growth rate is estimated at 5.4% y-o-y, well above the spring programme scenario of 3.3% full-year growth. Taking into account recent economic developments as well as the recent deterioration in the

external environment, the GDP growth **forecast** in the programme scenario has been upgraded to 4.5% in 2011 (from 3.3%) and downgraded to 2.5% in 2012 (from 4.0%). The latest statistical reports, including hard and soft data, show that the growth rate in 2011 could be even higher as the strong economic performance continued in last months of the year that will also have upside effects on the carry-over to 2012. Nevertheless, the gloomy prospects emerging from the Commission's autumn forecast suggest that the growth scenario for 2012 does not leave significant upside risks and, in fact, the **negative risks** coming from the external demand may be larger than initially thought.

Consumer price inflation (HICP) rebounded to 4.1% y-o-y in Jan-Nov 2011 due to commodity prices and one-off effects from increased indirect tax rates. The inflation rate adjusted to constant taxes is estimated at 2.7% for the same period. Inflation is expected to move down close to the EU average in 2012-13, when external and VAT effects will fade away, though upside risks are present.

Main programme projections		**2009**	**2010**	**2011**	**2012**	**2013**
Real GDP growth	**10/2011**	**-17.7**	**-0.3**	**4.5**	**2.5**	**4.0**
(%, y-o-y)	*05/2011*	*-18.0*	*-0.3*	*3.3*	*4.0*	*n.a.*
GDP deflator	**10/2011**	**-1.2**	**-2.2**	**4.0**	**1.7**	**2.0**
(%, y-o-y)	*05/2011*	*-1.5*	*-2.3*	*2.0*	*1.4*	*n.a.*
CPI Inflation	**10/2011**	**3.5**	**-1.1**	**4.4**	**2.4**	**2.0**
(%, y-o-y)	*05/2011*	*3.5*	*-1.1*	*3.5*	*1.8*	*n.a.*
Unemployment	**10/2011**	**16.9**	**18.7**	**15.5**	**14.1**	**13.1**
(%, age group 15-74)	*05/2011*	*16.9*	*18.7*	*17.2*	*15.5*	*n.a.*

Average **wage growth is stable at around 4% y-o-y in the first half of 2011,** implying a wage bill hike of 5.8% y-o-y due to employment growth in the same period, as compared to a full-year wage bill growth of 3.3% in the programme scenario. The negative wage effect on unit labour costs is largely offset by higher-than-projected GDP growth, but second-round effects on inflation may slightly weaken the country's price competiveness indicators in 2011. There are strong indications that **non-price factors** are also playing in favour of Latvia, which keeps increasing its export shares. Recent estimates of Bank of Latvia suggest that taking quality into account, competitiveness actually increased significantly over the past few years.

Unemployment remains among the highest in the EU after deteriorating to an all-time high of about 20% in the beginning of 2010 from 6-7% in the pre-crisis period. However, the rate is now steadily improving at 16.2% in the second quarter of 2011 and 14.4% in the third quarter of the year.

The **current account** balance moved back to a small deficit in Jan-Oct 2011, following a two-year period of surpluses driven by internal adjustment and cyclical effects. In nominal terms, merchandise exports rose at annualised rate of 30% in Jan-Oct, while imports had growth of 28%. The CA is projected to post small deficits in the tune of about 1% of GDP in 2012 and about 2% in 2013, which seems acceptable for such a catching-up country.

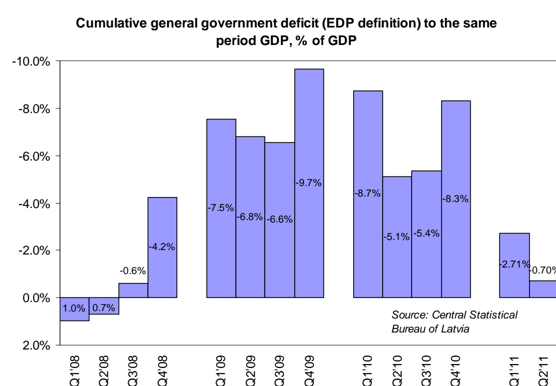
External competitiveness has improved considerably since the start of the programme, as unit labour costs relative to trading partners dropped by around 20% in 2009-10, reflecting both significant cuts in wage costs but also a surge in productivity. At present, unit labour cost and real effective exchange rate adjusted for consumer prices are below the indicative threshold in the scoreboard for external imbalances. The gradual recovery of domestic demand is however pushing up imports to relatively high growth rates and authorities need to maintain a policy stance of continuous improvement in the country's competitiveness, including through wage setting mechanisms that are consistent with productivity, and efforts to increase the latter.

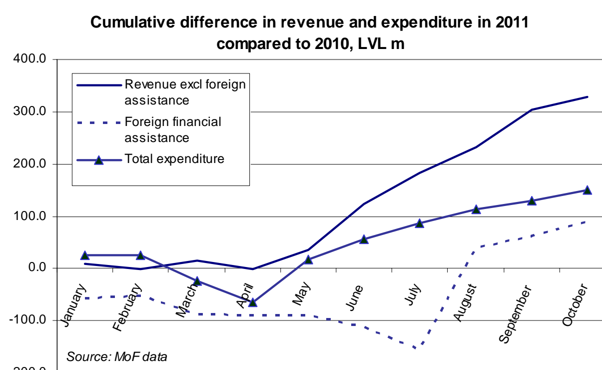
II-b Budgetary developments and fiscal policy

The EC mission team's assessment is that the specific fiscal policy criteria of the fourth SMoU can be considered fulfilled. This conclusion in particular reflects likely achievement of the 2011 budget deficit target of 4.5% of GDP in ESA95 terms, as well as progress made in identifying key measures in the 2012 budget to reach a deficit of no more than 2.5% of GDP in ESA95 terms.

The budgetary outlook continued improving in 2011, with an expected outcome of a deficit of 4.2% of GDP in the Commission services' autumn 2011 forecast; this is better than the target of 4.5% set in the most recent Convergence Programme of Latvia and considerably better than the maximum deficit limit of 6% set in the Council Recommendation of 7 July 2009 and under the Balance-of-Payments programme. Higher than previously projected economic growth in first nine months of the year, as well as continued robust tax revenue in July-October, contribute to the improved outlook for public finances. Income taxes in particular performed above expectations, while the improvement on the labour market led to lower unemployment costs. Despite the mid-year increase in appropriations for some budgetary items (in particular the depletion of the funds for unforeseen events due to previously underestimated structural spending needs, notably those related to family benefits and health), expenditure has overall been contained and there is a possibility that savings may eventually be made under some budgetary items (in particular those related to unemployment benefits). At the same time, additional one-off costs will have a negative impact on the budgetary outlook as the government implements the sales strategy of the Mortgage and Land Bank and has decided to provide financial support, in form of a loan and equity, to the national air-carrier AirBaltic. The impact of these decisions was estimated at ¾% of GDP in the Commission services' autumn forecast.

Recent developments with respect to Latvijas Krajbanka and AirBaltic pose additional risks to the 2011 general government outlook, but the impact will likely remain contained. The suspension of operations in Latvijas Krajbanka that occurred after the cut-off date of the forecast is not expected to affect the general government deficit directly, as government's actions are limited to the provision of a loan to the Deposit Guarantee Fund. Given the higher priority that claims by the Deposit Guarantee Fund will receive in the unwinding process, it is expected that the loan will be fully repaid. At the same time, recent developments with respect to the national carrier AirBaltic, entailing the possibility that the government may be, at least for a limited period, the sole owner of the company (see part II-d), may potentially lead to a higher than previously planned deficit-increasing impact. While full information on the impact is not available at this stage, as the new operational strategy for the company is still being drawn, it nevertheless seems unlikely that the deficit target set in the Convergence Programme will be breached even of some of these risks materialise.





Under the no-policy-change assumption, that is before measures to be adopted within the 2012 budget were known, the deficit was expected to decline further in 2012 to reach 3.3% of GDP, according to the Commission services' autumn 2011 forecast. On the revenue side, the forecast in particular reflected further improvements in tax and non-tax revenue in line with the expected economic growth, as well as full-year impact of indirect tax increases that were adopted in the April 2011 supplementary budget and entered into force in summer 2011. On the expenditure side, the forecast took into account the policy – set in the law – of suspending indexation of pensions until end-2013 and some additional measures in relation to social insurance that were adopted before the cut-off date of the forecast and were to enter into force in January 2012. The forecast also assumed continuation of financing of the social safety net and family benefits at the level of 2011. In addition, the forecast assumed that part of the observed acceleration of spending by local governments in the first nine months of 2011 (in particular those related to purchases of goods and services and investments) would carry forward to 2012.

Due to early elections that took place in September 2011, the budgetary process has been delayed; nevertheless the process was finalised on 15 December when Parliament approved

the 2012 state budget. The new government took office on 25 October 2011 and immediately started preparing the draft budget; measures to support the necessary consolidation to reach the targeted deficit of 2.5% of GDP were extensively discussed with the authorities during the review mission and follow-up consultations (though, regrettably, the Commission and the IMF have been consulted only after crucial steps had been taken by the authorities concerning AirBaltic and Krajbanka). The draft budget was adopted by the government on 5 December, followed by the approval in Parliament on 15 December. The following measures have been agreed in the 2012 budgetary package:

1. **On the revenue side**, no major tax increases are envisaged and most of the expected gain (0.3% of GDP in 2012) would come from measures to strengthen the tax administration and reduce tax expenditure, in particular:
    a. Broadening the real estate tax base and giving municipalities the option to abolish the 25% limit on annual increases in real estate tax on land;
    b. Applying reverse VAT in sectors prone to undeclared activity (construction, scrap metal) and applying a 10% withholding personal income tax to scrap metal sales;
    c. Strengthening the presumptive taxation of small and micro enterprises to minimise its misuse;
    d. Cancelling interest and fines on unpaid taxes to facilitate the collection of those tax claims; reducing the frequency of tax-free movement of excise goods on the non-EU border; improving the regulation of the gambling industry; strengthening the capacity of the State Revenue Service;
    e. Increasing some gambling taxes;
    f. Increasing the financial stability levy.

2. **On the expenditure side**, the expected gain (0.6% of GDP) will come in particular from:
    a. The nominal freeze in public sector wage bill, supported by measures such as continuing to cap vacation allowances at 25% of the monthly wage, the reform of the wage grid, improving effective skill-assessment and motivation, and introducing central control over the establishment of new posts, while autonomy is left to Ministries to decide the distribution of the adjustment between wages and employment;
    b. Reducing subsidies for transport, including for road maintenance, and agriculture;
    c. Limiting the expenditure by local governments through imposing stricter overall borrowing limits; reducing the share of local governments in the personal income tax revenue from 82% to 80% while safeguarding social safety net financed from local governments' budgets and investments (through extending, as an exception to the overall limit, the borrowing capacity to finance investment projects); and discontinuing the central government's co-financing of housing benefits from May 2012;
    d. Implementing stricter controls to limit the duration of sickness benefits and preparing proposals to reduce the replacement rate for long-term sickness benefits;
    e. Limiting expenditure growth through maintaining caps on certain expenditure categories (notably the cap on daily provision allowance for employees of the Ministry of Defence, Ministry of Justice, and Ministry of Interior, as well as maintaining at the level of 2011 compensation payments to landowners engaged in conservation activities), where such caps require changes in the legislation.

In addition, the authorities will undertake in the course of 2012 several actions that, when implemented, would result in **additional fiscal consolidation and more efficient redistribution from 2013**:

a. Reviewing thresholds for tax rates on residential property to ensure a broadly equal distribution of the housing stock between the existing brackets and carrying out cadastral reform to properly reflect the depreciation and market value of residential housing;
b. Implementing a comprehensive reform of family state benefits and social insurance system to improve targeting and reconsidering the role of tax exemptions for children;
c. Undertaking a reform of the social safety net system to improve incentives and reduce poverty traps;
d. Maintaining ceilings for certain social security payments for high-salary earners;
e. Selling EU emission trading permits.

It is reassuring that the authorities are committed to implement additional measures in the course of 2012 to ensure compliance with the ECOFIN Council Recommendation to end the excessive deficit situation at the latest by 2012, should the economic developments and/or revenue fall behind current projections.

The measures in the draft 2012 budget which improve the budgetary position total LVL 125 million or 0.9% of GDP, according to the calculations made by the Commission. Against the no-policy-change forecast of a deficit of 3.3% of GDP in 2012 based on the current macroeconomic scenario, these measures would ensure meeting the target deficit of 2.5% of GDP.[1] According to the Latvian authorities these would lead to a deficit of 2.1% of GDP.

Overall, it can be concluded that the 2012 budget – if rigorously implemented – would ensure continuation of a prudent fiscal policy, and provide a good basis for meeting the requirement to end the excessive deficit situation set in the ECOFIN Council Recommendation of 7 July 2009.

The measures to achieve the budgetary target are to a large extent of good quality, in particular:

- it is welcome that the package is centred on expenditure rather than revenue measures, with expenditure measures comprising 2/3 of the adjustment;
- among the revenue measures, the majority relate to improvements in tax administration and reducing tax expenditure or loopholes, or to real estate, thus having a minimal negative impact on the declared economic activity;
- some distortive subsidies and inefficient spending are further reduced;
- pressure is exerted on local government to generate savings, while enough resources have been preserved to provide social safety net spending.
- the measures to be adopted in the course of 2012, in particular those relating to social spending, are expected to lay ground to further improving the long-term sustainability of public finances.

However, some measures generate some concerns:

- the 2012 budget is based on several policies that could potentially harm the long-term growth potential and effective provision of services by the public sector, notably further reductions in own investments, road maintenance and cuts in the public sector wage bill which may take the form of generalised cuts in real wages; without a targeted approach to increase efficiency of spending and to secure that the best human resources are preserved, these steps could lead to accumulation of pressure on public sector expenditure in the medium- and possibly also short-term, or in the losses of key competences;
- the partial reversal of social safety net measures (albeit more limited than initially planned) could be premature against a still challenging situation on the labour market, in particular if the economy does not grow as expected;
- further cuts in the health budget should be seen against the mid-year increase in spending in 2011, which was financed from the fund for unforeseen events;
- some measures in the 2012 draft budget could deliver only a partial impact, compared to current expectations – this in particular relates to measures that aim at limiting the expenditure by local governments, or at increasing tax collection.

II-c Financial developments

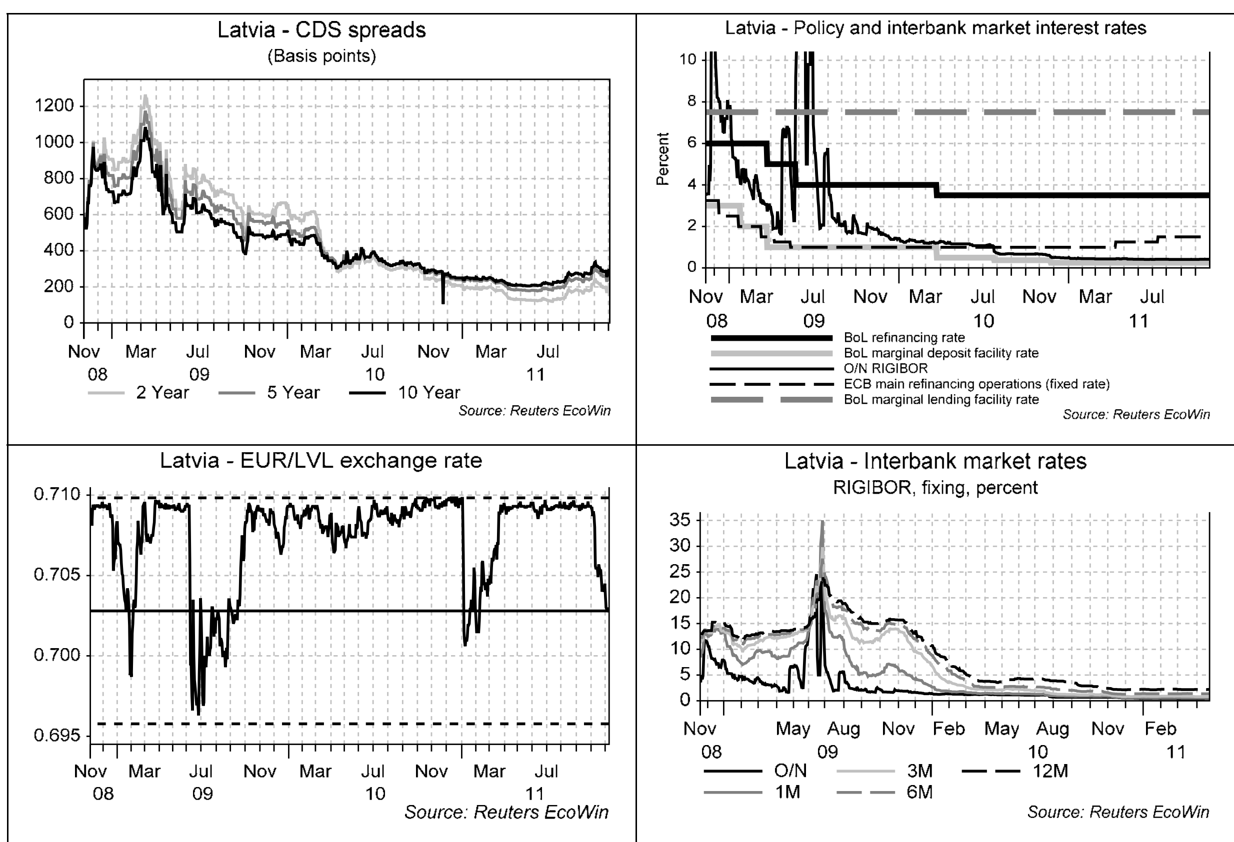
Despite early parliamentary elections in September and a deteriorating sovereign debt crisis elsewhere in Europe, financial market conditions remained stable in Latvia. Since the fourth review, the exchange rate of the lat was on the weak side of the narrow fluctuation band to the euro and the central bank (BoL) occasionally intervened at the edge of the band (up to 1.3% of GDP between January-October 2011). However, as in early October the Treasury stepped up market conversion of its foreign currency deposits to finance budget spending mostly related to EU funds which is more concentrated in the fourth quarter of the year, the lat appreciated to the stronger side of the band. The

[1] The Commission considers eligible only part of the measures in the budget – which includes measures for LVL 156 million.

annual increase in M1 reached 15.6% in September versus a 2.4% increase in M3, the difference being mainly explained by a shift to overnight deposits.

The policy rates of BoL have remained unchanged (0.375% on the 7-day deposit and 0.25% on the overnight deposit) since November 2010. Although the excess lat liquidity of the banking sector fell significantly since the beginning of the year, it remains high, helping to keep interbank rates low. Nevertheless, lending to households and corporates remains subdued. Annual loan growth to residents was minus 8.4% in September, one of the lowest rates since 2008. BoL's foreign exchange reserves have increased since the last review (to around LVL 3.6bn by end-October), due mainly to government borrowing on the international capital markets and payment of delayed EU-funds in August. The foreign exchange reserves covered around twice the monetary base or 6 months of imports.

The low interest rate environment was preserved on the domestic Treasury market and the maturity profile was further extended. Net domestic Treasury issuance reached a negative LVL 40m (about 0.3% of GDP) between January-November 2011. In June 2011, Latvia returned successfully to the international financial market by issuing a 10-year USD 500 million Eurobond priced at 5.491%. Preceding the successful bond issue, Moody's changed the sovereign rating outlook for Latvia from stable to positive (Latvia has investment grade ratings from Moody's and Fitch). Some moderate tension has become visible in the 5Y CDS rate and auctions at medium maturity since early August, after deteriorating situation in the euro area periphery.



Despite the freeze of operations by Latvijas Krajbanka (see below), the most recent developments in the banking sector confirm the trend toward stabilisation and suggest that solvency and liquidity risks have been abating. The deleveraging of the banking sector is continuing at a moderate pace. Latest available data show that banks' total assets decreased by 3% y-o-y, with total loans contracting by more than 9% y-o-y. Meanwhile, securities holdings have increased by almost one quarter. As far as funding is concerned, the significant decline of almost 20% in liabilities to credit institutions, which reflects a 10% decrease in funding from parent banks, has been more than offset by the steep increase in deposits by 8%. While households' deposits have remained flat for the last year, deposits from corporations and from non-residents went up substantially by 16% and 18% respectively.

Despite still increasing gross provisions for doubtful and bad loans, the banking sector has returned to profitability in 2011 with an aggregate profit of 113 million LVL for the first eight months. This is partly due to the reversal of previously built provisions, which is consistent with the overall decline in the ratio of non-performing loans from 19.4% in September 2010 to 18.2% in August 2011. Accordingly, capital adequacy has been continuously increasing and reached 16.2% (core Tier I ratio of 12.9%). Overall liquidity remains well above the regulatory minimum. The supervisory authority plans to remain focused on the issues of capital adequacy and quality of restructured loans, while paying increased attention to consumer protection and education.

The Latvian banking sector supervisor (FCMC) decided on 17 November 2011 to limit the operations of and subsequently to liquidate Krajbanka, a subsidiary of Snoras Bank, following Snoras' nationalisation by the Lithuanian government amid allegation of fraud and the launch of the insolvency procedure. As of end-October, with total assets of about LVL 680 million (ca. EUR 1 billion), Krajbanka held a modest market share of 3.4%. The collection of deposits represented more than 85% of Krajbanka's resources. Current data suggests that 235 000 persons are entitled to claiming deposit reimbursement from Krajbanka. The paying out of deposits has started through Citadele bank, acting as an agent for the DGF, on 29 November. The Deposit Guarantee Fund received a loan of LVL 185 million from the government in order to fulfil its deposit guarantee commitments. Current financial projections do not imply any loss for the government from this intervention, even though the execution of the guarantee does require financial assistance to the DGF in the short to medium term.

The liquidation of Krajbanka is expected to have a more sizable impact on the real economy than on the financial sector. Inter-linkages with other financial institutions, in particular through the interbank market, are almost inexistent; however, the liquidation implies delayed availability of funds for some clients, as well as definitive losses for those with balances above the LVL equivalent of EUR 100 000. Some estimates point to losses for the businesses of about LVL 100 million. It is not expected that these developments would affect the sale process of MLB and Citadele. In any case, their sales strategies foresee some flexibility should there be insufficient market interest over the next months.

The restructuring of the state-owned Mortgage and Land Bank has taken more time than initially anticipated. Due to the changing political situation, the end-of-2011 deadline for disposing of the commercial segment of the bank could not be met. Nevertheless, the authorities have now committed firmly to finalise the sale by end-March 2012. The final sales strategy was adopted by the Cabinet of Ministers on 1 November 2011 and submitted immediately thereafter to DG COMP for consultation and approval. In view of this, EUR 100 million of the blocked funds for financial sector needs at the special account at the Bank of Latvia were released. According to the new SMoU, the unblocking of the remaining EUR 249 million is conditional upon progress with the sale of Citadele bank (EUR 100 million) and of commercial parts of Mortgage and Land Bank (EUR 149 million).

The sale process of Citadele bank is proceeding according to the plan, even though its final outcome remains uncertain. Due to uncertainty at the international level, it is difficult to estimate possible final bid price; nevertheless, it is still hoped that Citadele could be sold slightly above its book value. **The orderly resolution of Parex Bank continues**, with a view to maximising returns to the state.

II-d Assessment of compliance with other SMoU conditions

Notwithstanding several delays in implementing some key reform measures, the programme has overall proceeded according to plans. The economy and the budget have performed significantly better than expected. Growth has clearly picked up in the course of 2011, supporting revenues and a rapid fall in unemployment. The fiscal adjustment implemented since mid-2009 has contributed to the improvement in the underlying budgetary position. Nevertheless, the worsening external outlook and risk of financial market spill-overs from the euro area may have stronger implications on the budgetary results and on growth than currently envisaged. At the same time, internal risks cannot be excluded arising from reform fatigue. Accordingly, taking into account expiration of the BoP assistance, it is very important that the government honours the agreed SMoU reform and policy conditionality and cooperates closely during the post-programme surveillance. A number of areas covered by SMoU conditionality remain crucial looking forward, building on the progress achieved over the past months.

The draft Fiscal Discipline Law (FDL) has been adopted by the government on 29 November 2011 and has been submitted to Parliament on 6 December; when implemented, the new law would considerably strengthen the basis for maintaining fiscal discipline. The authorities also intend to pass constitutional amendments to enhance the legal standing of the law. The current draft of the FDL clearly defines (i) principles of a counter-cyclical fiscal policy; (ii) a fiscal balance rule as an instrument for a sustainable and counter-cyclical policy; (iii) a debt rule; (iv) transitional provisions, including consistency with the SGP provisions; and (v) escape clauses, moral sanctions, and monitoring and reporting requirements to ensure compliance with the fiscal rules. In the future, once the FDL will be adopted, the authorities also plan to adopt the medium-term budget framework law, setting binding expenditure ceilings for 2+1 years on a rolling basis.

As regards strengthening tax administration and combating grey economy, in 2011 the authorities have, inter alia, strengthened institutional capacities, expanded international cooperation agreements with neighbouring customs authorities, and improved cooperation with sectoral business associations. Going forward, the authorities are planning to provide sufficient resources and incentives to the State Revenue Service and ensure stricter implementation of internal control standards and administrative and criminal fines within the public sector. The authorities intend to implement in the beginning of 2012 the key measures proposed in the action plan for fighting grey economy and illicit trade: i.e., implementing the zero declaration of income and assets for physical persons and measures to speed payment of tax arrears, establishing a "white list" of companies, enhancing exchange of information among tax compliance enforcement institutions, reviewing penalty system, enforcing tax audits, limiting tax-free trade crossings of borders with non-EU countries, regulating online gambling industry, and other measures.

As regards further savings in expenditure, the authorities intend to review options for rationalizing the system of social benefits and improving the sustainability of the pension system. The authorities will submit to the Parliament legislative proposals to increase, starting from 2014, the early and statutory retirement ages and the qualification period for retirement. In addition, the authorities will review the possibility of extending the suspension of pension indexation, while the elimination of supplementary pension payments for pre-1996 working years for new retirees will take effect from 2012. The authorities are committed to restoring contributions to the second pillar to 6% of gross salaries by 2013 and plan to keep reductions in social insurance allowances (unemployment, sickness, parental, and maternity and paternity benefits) in force until end-2014. The authorities are also committed to maintaining a comprehensive social safety net programme for 2012 and beyond, and to improve the targeting of the allowances. The authorities have committed to continue funding half of Guaranteed Minimum Income payments centrally for the full year 2012 and to co-finance the housing benefit until end-April 2012, and in the first half of 2012, in cooperation with the EC and the World Bank, will consider reforms of the safety net, GMI and tax system to increase incentives to work, to be implemented with the 2013 budget.

The authorities have made progress with the implementation of structural reform agenda. The authorities have, inter alia, improved the use and efficiency of EU structural funds, started planning for the 2014-2020 financing period, and ensured that the EU co-financed programs for research and development are finally started. The authorities have also, inter alia, taken measures to reduce structural unemployment by making more efficient use of active labour market policies, including by diverting additional ESF financing for such programs (around 50 million EUR), presented options for more effective state-owned company and real estate management, improved central government and municipal cooperation in attracting new foreign investments, as well as amended public procurement procedures (increased ex ante checks, expanded electronic and centralised procurement) and strengthened the Competition authority capacities.

As regards efforts to strengthen the management of state owned enterprise and real estate, the authorities are adopting in December 2011 the "Concept paper on SOE governance" that sets principles for setting up a centralized SOE manager, relations with line ministries, measuring SOE performance, revising dividend and remuneration policies, and reviewing supervisory institutions of government and municipality-owned companies and by end-January-2012 will outline a precise timetable for the steps leading to the new governance model, to be fully effective by the end-March 2013 at the latest, including adopting a special law on SOE management, transferring assets/companies under the new SOE management authority, adopting all legal decisions by related companies, as well as starting

divesting of non-core assets. Also, plans for further centralisation of state real estate management under the State Real Estate Agency have been recently finalised, deciding which real estate assets to hold or auction-off and which need to be transferred to the Agency, as well as centralising decisions on real estate investment projects in the process of state budget drafting.

Despite earlier delays in implementing relevant conditions in the previous SMoUs, the authorities have committed to preparing a strategy on public administration by Spring 2012, which will inter alia, establish a stronger institutional model responsible for HR and recruitment policy and payroll, normalise the distribution of employees within the unified wage grid based on effective skills-assessment, and introduce central control for the establishment of new posts. There should also be proposals to reform the wage grid to make it fairer towards low-paid employees, award best-performers and attract highly-skilled officials (e.g. setting wages for higher positions closer to private sector levels) and proposals to reward the performance of employees through earnings and career developments.

The authorities have taken prompt action to stabilise Air Baltic, limit risks that it creates new fiscal liabilities in the future, and manage the company in a manner consistent with best practice in public financial management. The economic losses and management weaknesses emerged over the past year in AirBaltic, a company in which the state had substantial shares, highlight the importance of strengthening the management of such participation.

III Programme financing

Given its financial position, the government does not intend to draw funds available upon completion of this review. Already after the fourth review the Treasury's cash balance and the outlook for market financing had improved to the extent that additional funding from the international assistance programme was not requested. The last disbursements under the programme date back to October 2010. Completion of this review by the EU and the IMF will unlock remaining tranches of support from both institutions (EUR 200 million of EU loan will remain available until the expiration of the BoP programme), as well as credit lines from the Nordic countries and other EU countries. Given its strong financial position, the Latvian government does not intend to draw the funds available upon completion of this review. After the decision by the Commission to release, if requested, the remaining funds, the possibility to make such request remains open until 20 January 2012.

Table: Latvia: financing contributions and profile, quarterly disbursements

Projected financing, millions euro	2008 Q4	2009 Q1/Q2	2009 Q3	2009 Q4	2010 Q1/Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	**Total**
Total	**591**	**1 000**	**1 474**	**200**	**694**	**405**	**226**	**226**	**126**	**126**	**227**	**4 466**
EU		1 000	1 200		500		200					**2 900**
IMF /1	591		194		194	107						**1 086**
World Bank				200		100					100	**400**
EBRD			80									**80**
Nordics /2												*1 900*
Others /3												*300*

/1 Euro values change due to exchange rate effects

/2 DK, EE, FI, NO and SE; total EUR 1,900 m in credit facility arrangement

/3 CZ and PO; total EUR 300 m in credit facility arrangement

The Treasury has started the transition back to market-based financing with a USD 500 million Eurobond placement in June 2011. The debt strategy of the Treasury entails pre-financing the repayments to official creditors in the coming years. In 2012, the Treasury intends to issue an equivalent of USD 1 billion in new bonds in international capital markets. In line with the debt strategy, the Treasury intends to continue the current practice of regularly issuing short- and long-term domestic debt.

Assessing risks to the Treasury's debt strategy and to Latvia's ability to timely repay official creditors will be a key element under the Post-Programme Surveillance. The improved economic and financial situation is creating more favourable conditions for the central government to

continue borrowing in international capital markets under reasonable terms, but risks remain due to uncertain future liquidity conditions both in Europe and globally.

Funds remain to be released from the blocked account for banking sector support. In June 2011, an amount of EUR 300 million was released in line with the agreements on concluding the fourth review. The submission of the final sales strategy for the Mortgage and Land Bank to the European Commission on 2 November made available another EUR 100 million from the blocked account for the purpose of general government financing. The remaining EUR 249 million will remain blocked until the conditions agreed for releasing them, based on progress with the sale of Citadele Bank and of MLB commercial assets and liabilities, are met. The assessment of these conditions, and the agreement for releasing the funds, will be carried out under the post-programme surveillance. Overall, despite the Krajbanka fall-out, the government is encouraged to keep the sub-account for other unexpected costs in the bank sector.

The authorities have not requested or expressed any interest in a follow-up programme, primarily as Latvia is regaining access to international capital markets. However, recent tensions in international capital and sovereign markets have added new challenges which call for prudence in the implementation of policies and for vigilance as concerns the evolution of the financial position**.**

IV Post-programme surveillance (PPS)

Upon expiration of the BoP assistance programme in January 2012, Latvia will be subject to post-programme surveillance. The purpose of PPS is to ensure the repayment capacity for EU assistance in the aftermath of the programme, by closely monitoring risks that *inter alia* could jeopardise macro-economic stability and sustainable growth. PPS ensures a smooth phasing out of the programme and provides an assurance that progress made under the programme will be consolidated. The implementation of policy intentions for 2012 and onwards will be assessed within the post-programme surveillance.

The Commission will manage PPS as an integral part of the existing procedures and surveillance mechanisms. Upon expiry of the programme on 20 January 2012 and until repayment of a large fraction of the EU loans (up to 70% of total loans), Latvia will continue to provide the Commission with information laid out in Annex II of the 5th Supplementary Memorandum of Understanding, including prior information on major policy intentions.

PPS missions will be aligned with the IMF's Post-Program Monitoring (PPM) missions, to avoid duplications and ensure efficient use of resources. Two PPS missions per year are planned and close cooperation with the IMF will be ensured in the post-programme period. Staff from the ECB will be invited to participate in the missions. The first PPS/PPM mission is expected to take place in spring 2012.