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DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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EU BOP ASSISTANCE TO LATVIA –

SECOND REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

The assessment of Latvian post-programme policies, when compared to commitments in the latest SMoU, is overall positive but also raises important concerns. The structural reforms are pushed forward, even though there are some delays in implementation, and the numerical budgetary targets are persistently overachieved due to a better economic situation and improvements in revenue collection. The government has made significant progress during the past year on important issues like implementing state owned asset management reform, reviewing active labour market and social policies, pursuing the fight against the grey economy, and initiating reforms in higher education and science. Overall, **the authorities seem to have taken the commitments seriously and the increased quality of policymaking of individual ministers and the Cabinet promises good reform and development prospects going forward**. Progress with reforms and positive macroeconomic developments led to an **upgrade by two major rating agencies** and successful international **bond issuance** in February and December 2012 which allowed Latvia to **re-pay the entire IMF loan significantly ahead of schedule**.

At the same time, better economic and budgetary results, coupled with the end of close surveillance under the BoP, have led to some complacency, a relaxation of efforts and a lack of steadfastness of the authorities, resulting in several policy steps that go against the Council CSRs and commitments made in the last SMoU: this in particular concerns tax cuts decided in May which were not included in the Convergence Programme submitted only shortly before, the announcement of the 3-year strategy to lower the PIT rate while postponing plans to raise PIT non-taxable thresholds to help the lower-paid, the 2012 mid-year supplementary budget with measures contrary to the CSRs adopted by the Council just weeks before (only partial reversal of second pillar contributions from January 2013), and planned reductions and decentralisation of financing of the Guaranteed Minimum Income (GMI) from 2013.

Given the robust economic performance and efforts to improve tax collection, **nominal budget targets for 2011-2012 have been over-achieved**. The crucial question is to what extent **cyclical factors play a role**; the mission team tends to see them as more forceful than the government. **Latvia clearly seems to be on course to correct the excessive deficit situation by the deadline recommended by the Council (2012) in a sustainable manner with a sizeable safety margin.** Budget plans for 2013 and plans in the medium term budgetary framework law for 2014-2015 look overall prudent and confirm the nominal targets of the 2012 Convergence Programme. The authorities' strategy to fight the grey economy seems to start producing results, as evidenced by tax revenue above standard elasticities. Strong economic and fiscal performance has also led to **a pronounced reduction in public borrowing rates**, reducing costs of servicing debt in the medium term.

The Commission reminded the authorities that adoption of the **Fiscal Discipline Law (FDL) is necessary** as an insurance against possible future policy mistakes, also those that might occur due to uncertainties related to determining the cyclical position, to meet recommendations given by the EPC and requirements of the six-pack and, in particular, to reassure EU partners.

Indicators of cost competitiveness have substantially improved during the adjustment years. While developments became more muted since 2011, some gradual improvement in ULC relative to trading partners is still expected. Various studies also show a certain improvement in non-cost competitiveness indicators such as quality changes and product differentiation, confirmed by increased export market shares. The current account deficit is expected to remain moderate (reaching 3.5% of GDP in 2014 according to the Commission forecast), largely reflecting investment needs of the economy. Nevertheless, it is important to monitor developments, as domestic demand tends to rise quickly in good economic times, supported by relatively low households' saving rates, which puts pressure on the CA balance.

As regards structural reform measures laid down in the SMoU and the CSRs, the Commission stressed that their implementation would not only be important in their own right but also as it would show that commitments vis-à-vis the EU are kept. The Commission is encouraged by the reform proposals in the education and science sectors and by the liberalisation of the energy market; however, further efforts are needed, inter alia, to restructure Mortgage and Land Bank, set-up a single development institution, implement credible public administration reforms, strengthen the Competition Council capacities, and make further improvements to the Insolvency Law and judicial procedures. The Commission is looking forward to social and labour market reform proposals based on the on-going World Bank study and encourage faster progress with reviewing key sets of legislation submitted to the Parliament (the SOE management, public procurement, and construction laws).

The authorities should accept financially reasonable offers received for the remaining **commercial assets of the MLB** (especially bundle 4), as keeping the latter under state management is unlikely to result in bigger future benefits. The sooner the restructuring/sale will be completed, the sooner the **MLB development part** will be able to implement active development programmes and attract new financing from international financial institutions. The Commission also urges the authorities to respect the conditions set in the DG COMP restructuring plan on **certain Citadele Bank asset divestures** and encourage preparing for the sale, if the market conditions improve. Close cooperation with DG COMP on any possible changes to the restructuring plan is important.

There are risks inherent in a large **non-resident banking sector** as evidenced by some countries. The authorities need to follow closely what kind of financial flows are attracted, where they are invested, what are the activities of non-resident banks in the domestic market, etc. In particular, it must be kept in mind that the business, legal and regulatory environment in CIS countries is often weak and investments/loans in these countries call for caution. Further regulatory changes may be needed to further reduce liquidity, operational and other risks.

The authorities should devote more capacities and attention to tackling complex economic, financial, money laundering and tax evasion crimes. This concerns the investigation of such crimes, prosecution and the work of judges: in many cases, the knowledge and skills of relevant authorities might not be adequate to successfully prosecute and punish perpetuators.

The Commission team once again reminded that assessment of the conditions for euro adoption and the SMoU implementation are completely different processes and underlined that a focus on ensuring sustainability, in particular in the fields of public finances and inflation (energy efficiency and competition measures, improving structural balance, FDL) is important for both processes.

The national authorities' commitment under the PPS Agreement to consult with EU bodies on major policy intentions and to discuss those with the EFC that the Commission deems may jeopardise macroeconomic stability and repayment capacity has not stopped the authorities from non-coordinated actions: e.g., on VAT cut and the supplementary budget in mid-2012. The mission received reassurances during the visit that the authorities will take greater care in ensuring compliance with the consultation clause; this was also reiterated by President Berzins when meeting VP Rehn on 12 November.

The economy has proven quite resilient to recent external shocks and is currently the fastest growing in the EU.

1. Introduction

Following the expiry of the financial support programme on 20 January 2012, the first post-programme surveillance (PPS) mission to Latvia took place from 7 to 11 May 2012. **The second PPS mission was carried out by the Commission services on 20-27 November, together with the IMF and the ECB and participation from the Swedish Finance Ministry.** Colleagues from other DGs joined for meetings that concerned their field of expertise. As Latvia has repaid the IMF loan fully, more than two years ahead of the original schedule (which foresaw the bulk of IMF loan being repaid in 2012-2013 with smaller repayments in 2014-2015), this was the last surveillance mission for the IMF.

For the Commission team the main goals of the visit were to assess implementation of the conditionality included in the last Supplementary Memorandum of Understanding (SMoU, signed in December 2011) and the more recent Country Specific Recommendations (CSRs). Key issues addressed during the visit were the implementation of 2012 budget and the finalisation of 2013 draft budget, fiscal governance reforms/fighting the grey economy, planned reforms in social assistance, the management of EU structural fund spending, setting up of the single development institution, planned energy efficiency reforms, management of state owned assets, improvements in public procurement and competition environment, higher and vocational education and judicial reforms. In addition, meetings with the authorities and private banks were organised to discuss the economic outlook, debt refinancing and repayment capacity, and questions related to euro accession. A meeting with key social partners was organised.

2. Macroeconomic developments

The economy has proven quite resilient to recent external shocks and is currently the fastest growing in the EU. Real GDP rose by 5.6% y-o-y in January-September and 5.2% y-o-y in the third quarter of 2012. Investments, exports and private consumption were major growth drivers on the demand side while construction and manufacturing were the fastest growing supply components of GDP. Recent retail and industrial sales suggest a significant slowdown in the last quarter of 2012 but nevertheless confidence surveys remain relatively favourable. Full-year growth is projected at 4.3% in 2012 in the Commission 2012 Autumn Forecast. However, the hard data for the third quarter proved better than expected and the full-year growth could reach about 5%. In 2013, the growth prospects remain at 3.6% in 2013, still outpacing all other Member States in the Autumn Forecast. Risks are broadly balanced in 2013 as the sound performance on the domestic market is mitigated by uncertain global environment for exporters. In 2014, growth is projected to accelerate to 3.9% on expectations of better external demand.

The harmonised index of consumer prices (HICP) is projected to slow to 2.3-2.4% in 2012 from 4.2% on average in 2011 as the effects of previous tax hikes and commodity price shocks are fading away. The annualised inflation rate already slowed to 1.6% in October 2012 helped also by the government decision to cut the VAT rate from 22% to 21% as of July. In 2013 and 2014, inflation is forecast at 2.1% and 2.3% respectively. Core inflation is set to move at similar rates as energy and food commodities are not seen as inflationary drivers over the forecast horizon.

The unemployment rate for the age group of 15-74 fell to a year-average of 16.1% in 2011 from 18.7% in 2010. The unemployment rate dropped to an average of 15.3% in January-September **and 13.5% in the third quarter of 2012**. Although this is a substantial improvement from the peak of 20% in the beginning of 2010, unemployment remains above the EU average and about 50% of the job seekers are long-term unemployed. In year-average terms, the rate is projected at around 15% in 2012 and 14% in 2013 but the pre-crisis levels of 6-7% are not likely to be reached soon.

Following a substantial improvement in 2009-10, the cost competitiveness indicators of Latvia deteriorated somewhat in 2011, but are projected to improve again in 2012-14. Following a cumulative drop of about 20% in 2009-10, ULC relative to trading partners increased by about 2% in 2011 but are expected to decline again in 2012-14. Meanwhile, various studies show a certain improvement in non-cost competitiveness indicators such as quality changes and product differentiation. Latvia is gaining export market shares and this process is expected to continue over the forecast horizon.

The **current account** deficit was revised upwards to 2.4% of GDP in 2011 from previously reported 1.2%. However, the external account (i.e. the combined current and capital account) was broadly balanced. The foreign trade deficit continued to expand in 2012 as domestic demand, especially for investment goods, was rising at a high rate. However, exports grew faster than imports in real terms in January-September 2012 and the annualised deficit values stabilised. Projections point to a relatively modest expansion in the following years, bringing the deficit to about 3.5% of GDP in 2014. Non-debt transfers in the capital account are expected to fully offset the current-account gap and to keep the country's net lending position broadly stable.

Table 1: Key macroeconomic data and projections (%, y-o-y)

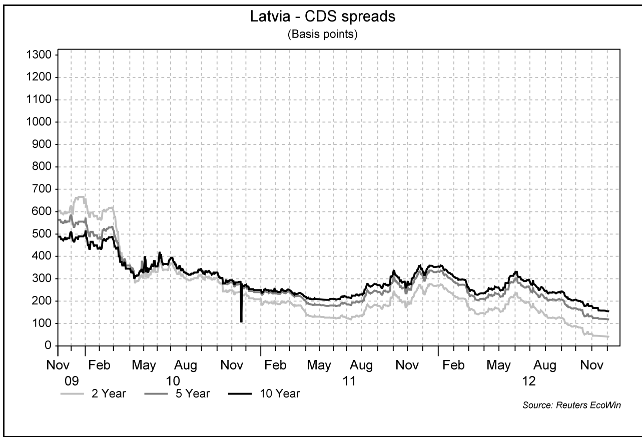
	2009	2010	2011	2012	2013	2014
GDP	**-17.7**	**-0.3**	**5.5**	**4.3**	**3.6**	**3.9**
Private consumption	-22.6	0.4	4.5	4.7	3.9	3.9
Public consumption	-9.4	-9.7	1.1	1.1	1.5	2.0
Gross fixed capital formation	-37.4	-12.2	27.9	9.2	6.7	7.6
Exports (goods and services)	-14.1	11.5	12.7	5.1	4.8	6.9
Imports (goods and services)	-33.3	11.5	22.7	5.3	5.5	7.3
Employment	**-13.2**	**-4.8**	**-8.1***	**1.8**	**1.3**	**2.1**
HICP	3.3	-1.2	4.2	2.4	2.1	2.3
GDP deflator	**-1.2**	**-2.2**	**5.9**	**2.5**	**2.0**	**2.1**
Unemployment (year-average, age group 15-74)	17.1	18.7	16.1*	15.2	14.3	12.7
Current account (% of GDP)	**8.6**	**3.0**	**-2.4**	**-2.9**	**-3.1**	**-3.5**
General budget balance (% of GDP)	**-9.7**	**-8.2**	**-3.4**	**-1.7**	**-1.5**	**-1.4**
General government gross debt (% of GDP)	**36.7**	**44.7**	**42.2**	**41.9**	**44.3**	**44.9**

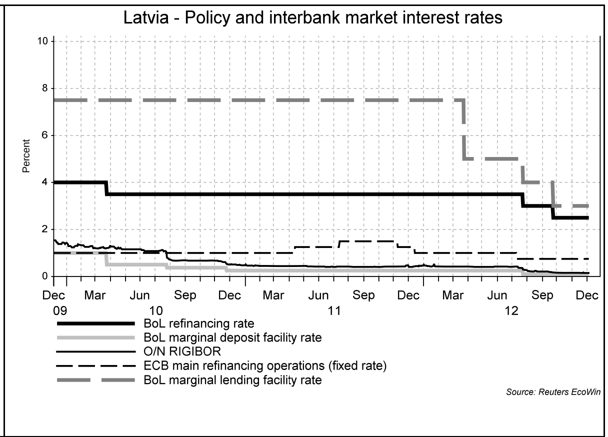
* *Employment and unemployment for 2011 marks a break in the time series*

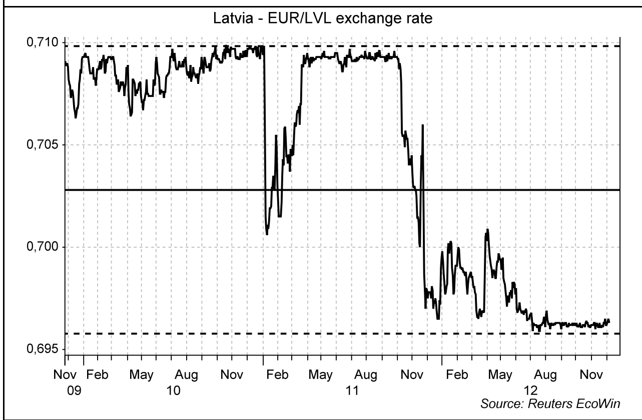
3. Financial markets and monetary policy

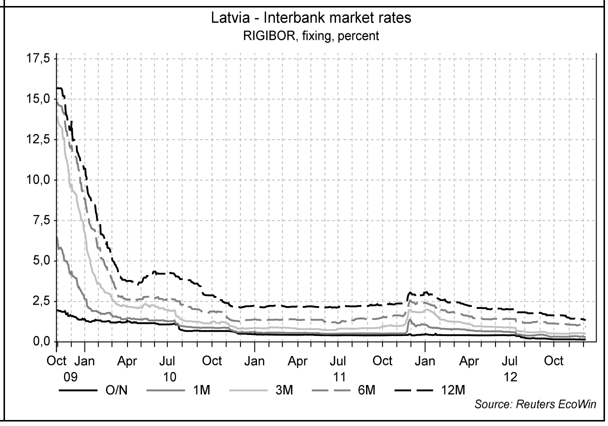
Financial market conditions in Latvia improved further in 2012. **Money market** rates were gradually falling after the moderate spike in late 2011 in the wake of the Krajbanka bankruptcy. The 3-months RIGIBOR declined from 2% in late-November 2011 (and early-January 2012), to close to 0.5% by early December 2012. **Currency in circulation** increased by 15.5% in the year to October 2012, partly as a consequence of the Krajbanka bankruptcy. **Broad money (M3)** was expanding at a moderate 4% p.a. in October 2012. Loans to residents declined by 11% y-o-y in October, due mainly to statistical one-off effects. New lending to residents has improved, but remained weak, while gradual deleveraging continued in the Scandinavian-owned part of the banking sector.

The exchange rate has been trading on the strong side of the fluctuation band in 2012. The Treasury's on-market conversion of foreign exchange funds (partly still from the international financial assistance programme, but also from international bond issues and EU funds) provided strong demand for lats and was mainly responsible for the strong exchange rate. Boosted by international bond issuances of the government, **BoL's international reserves** covered about 165% of base money at end-October 2012. The BoL cut **the refinancing rate** from 3.5% to 3% in July and to 2.5% in September. It has also lowered its deposit rates to 0.05% on the O/N and to 0.075% on the 7-day facility.









4. Public finances

The robust economic recovery resulted in a very pronounced improvement of the general government budgetary position in both 2011 and 2012. The revised general government deficit was 3.4% of GDP in **2011**, according to the 2012 autumn notification (compared with 3.5% in the spring notification), which is considerably better than both initial (6.0%) and revised (4.5%) targets under the programme. The 2011 outcome, coupled with an estimated impact of the systemic pension reform of around 0.45% of GDP in that year, create a possibility that Latvia might benefit from the provisions in the amended regulation 1467/97 regarding systemic pension reforms already on the basis of the 2011 outcome, i.e. exit from EDP one year earlier than planned, although this is subject to further analysis in the light of forthcoming ESTAT guidance on calculating the impact of systemic pension reforms.

The general government cash position after eleven months of 2012 points to a surplus of 1.3% of the expected annual GDP (State Treasury data), while the ESA95 general government budget position of the first half-year was a surplus of around 1.4% of the expected annual GDP (or ca. 3% of the same period GDP). These numbers are, however, not seasonally adjusted and thus do not take into account the usual pattern of higher expenditure in the last months of the year and in particular in December; the monthly cash balance has been in deficit in October and November. The projected nominal outcome for the year as a whole (deficit of 1.7% of GDP in Commission's autumn forecast) is nevertheless considerably better than the target of a deficit of 2.5% of GDP agreed during the last review mission under the programme in November 2011. The structural budgetary position, assessed at -1.2% of GDP in 2012 in the Commission autumn forecast, improves by ½ percentage points regardless of mid-year decisions outlined below, reflecting the considerable consolidation effort of the initial 2012 budget and possibly an on-going decline in the share of the shadow economy.

The government's strategy to improve tax collection and reduce the share of the undeclared economy is bearing fruit. The State Revenue Service has been considerably reinforced during past few years and its organisational structure has been adapted to strengthen the audit function. In parallel, several policy decisions have been or are being adopted in order to reduce the stock of tax arrears and to limit their accumulation in the future, including measures from the December 2011 SMoU. In particular, the allowed frequency of tax-free movement of goods on the EU external border has been reduced and measures to speed up clearance of past tax arrears are currently being implemented, possibly resulting in noticeable additional revenue in the coming few years. Finally, several legislative measures have been taken in order to limit possibilities for fraudulent behaviour or to strengthen applicable sanctions.

Decisions taken after the adoption of the 2012 Convergence Programme that will impact on the short- and medium-term budgetary outlook point to **the risk that past practice of mid-year adjustments to the budget and of the pro-cyclical fiscal policy are returning**:

i. The VAT rate was reduced by 1 pp. from 1 July, reducing government revenue by some 0.15% of GDP (half-year impact) in 2012 and 0.3% of GDP (full-year impact) in 2013.
ii. The personal income tax rate will be reduced by 5 pps. over the period of three years starting from 1 January 2013 (by 1 pp. in 2013, 2 pps. in 2014 and 2 pps. in 2015), with total cumulative impact of 0.2% of GDP in 2013, 0.6% in 2014 and 1.0% in 2014.
iii. In August the government proposed a draft supplementary budget, which was approved by Parliament in September; it increased revenue and expenditure targets by respectively 1.6% and 1.4% of GDP. While around 0.5% of GDP (EUR 100 million) relates to new expenditure items, the major part of expenditure increases in the supplementary budget is due to the projected more effective absorption of EU funds and accommodating the impact of faster economic recovery on some variables.

The **2013 budget** was adopted by the government on 25 September and by Parliament on 15 November and it **targets a general government deficit of 1.4% of GDP**; the target corresponds to that of the April 2012 Convergence Programme of Latvia. The draft budget implies some increase in own (i.e. not related to the absorption of EU funds) expenditure, with a 7% increase in the basic budget and 1.6% increase in the social budget, while expenditure related to the absorption of EU funds slightly declines. The largest expenditure increases are in the area of the Ministry of Health, while the increase in the public sector wage bill remains modest and targeted. However, there is a likelihood of higher wage growth in areas not directly controlled by the central government and a possibility of higher expenditure increase in local government, taking in particular into account the forthcoming local government elections and the fact that several local governments have sizeable cash buffers.

Main policy changes and decisions that affect the budgetary position in 2013 are listed below.

i. On the revenue side (impact on revenue in brackets):
    a. The 1 pp. reduction of the personal income tax rate (-0.2% of GDP);
    b. The full-year impact of the 1 pp. reduction in the VAT rate (-0.15% of GDP compared with 2012);

    c. The partial resumption of contributions to the mandatory fully funded private pension pillar to 4% of gross wages, compared with the current reduced level of 2% and the target level of 6% to be reached in 2016 (-0.45% of GDP);
    d. Increase of personal income tax allowances for dependents from EUR 100 to 115 per month from mid-2013 (marginal impact).

ii. On the expenditure side (impact on expenditure in brackets):
    a. Raising sliding scale caps for parental benefits (+0.1% of GDP);
    b. Maintaining pension indexation freeze (-0.2% of GDP);
    c. Increasing the duration of unemployment benefits to 9 months for all unemployed independently of the insurance record (marginal impact);
    d. Other measures in the social sphere (+0.1% of GDP)

The partial restoration of contributions to the fully-funded pension pillar – to only 4% of gross wages in 2013 instead of immediately returning to the targeted level of 6% – **goes contrary to previous commitments by the authorities under the programme as well as more recent Country-Specific Recommendations**. Although the Commission's long-term fiscal sustainability projections give a relatively favourable picture for Latvia, these might not fully take into account demographic trends revealed by the recent population census, as well as the likelihood that it will not be politically possible to stick to the low replacement rates implied by the current projections.

The 2013 draft budget implies that the structural balance would improve by ¼ pp. of GDP according to the projections of the authorities, while it is expected to worsen by ¼ pp. of GDP according to the Commission autumn forecast. The difference is partly due to the fact that the more recent Commission forecast projects a somewhat better nominal outcome in 2012; the assessment of the cyclical position provides another source of discrepancy. Although Latvia has not yet reached its MTO and would thus need to improve the structural balance by 0.5% of GDP annually as a benchmark, the impact of the partial resumption of contributions to the mandatory fully-funded pension pillar in 2013 (estimated at -0.45% of GDP) would fall under the provisions of the amended regulation 1466/97, which allows deviation from the adjustment path towards the MTO or from the MTO itself in case of a systemic pension reform.

In line with the 2012 Convergence Programme**, the authorities target further improvements in the nominal budgetary position in 2014 and 2015**, with the nominal deficit declining respectively to 0.8% of GDP and 0.3% of GDP. These targets have been confirmed in the 2013-2015 medium-term budget framework law (see below), which includes expenditure ceilings for 2014 and 2015; however, these ceilings remain not fully binding as long as the Fiscal Discipline Law is not in force. The Commission's autumn forecast for 2014 is a deficit of 1.4% of GDP; the forecast is based on the customary no-policy change assumption and does not take into account targeted expenditure restraint that is not yet backed by concrete measures, although it does take into account decisions already in force, notably the 2 pps reduction of the personal income tax rate and resuming pension indexation from late 2014. The structural deficit would slightly worsen in 2014, according to the Commission's autumn forecast, while meeting the targeted nominal position would secure the ½ percentage points improvement in the structural balance, according to the estimates by the authorities.

5. Fiscal governance reform

To reinforce the foundation for prudent fiscal policy making, it is essential that the principles of fiscal discipline take root in a more formalised way, notably through a well-designed fiscal framework. Following several delays, **the draft Fiscal Discipline Law** (FDL) and draft amendments to the Constitution were adopted by the government on 29 November 2011 and submitted to Parliament (Saeima) on 6 December 2011. The draft FDL was extensively discussed, prior to its adoption, with COM and IMF experts in the framework of the last programme review. Following the first reading on 12 January 2012, the Ministry of Finance proposed several substantial amendments to the draft law to bring it into compliance with the new EU fiscal governance framework, notably the entry into force of the "six-pack" and the adoption of the Treaty on Stability, Coordination and Governance.

The **interim EPC Peer Review of Fiscal Frameworks** that took place in May 2012 recalled the need to develop a fiscal framework that would limit the possibility for mid-year budgetary revisions. The EPC reiterated its earlier recommendation to Latvia to adopt the Fiscal Discipline Law, possibly supported by amendments to the Constitution, to provide a credible and enforceable framework for limiting expenditure growth in good economic times, and to ensure its effective implementation from 2013. However, there was limited progress in adopting the law since early spring, which the authorities explain by the complicated and technical nature of the law. Nevertheless, the authorities expect the law to be adopted in early 2013.

The **medium-term budget framework law for 2013-2015** was adopted together with the 2013 budget, providing for the first time **expenditure ceilings for the next three years**. This is the first time that such a draft law is adopted and thus constitutes a positive development towards a more comprehensive fiscal framework; as a transitional development the draft law was adopted in autumn, whereas in future the adoption of the medium-term budgetary framework would take place in spring, in parallel to the European Semester. However, the expenditure ceilings in the medium-term budget framework law remain not fully binding as long as the Fiscal Discipline Law is not in force.

6. Social and active labour market policies

As regards **reforms of the social assistance system**, **the government has decided to decentralise the financing of the Guaranteed Minimum Income benefit (GMI) and to lower its minimum amount**. These steps go against the relevant CSR and SMoU conditionality. The decisions were made without consulting the Commission, as stipulated in the SMoU. There was no substantial prior analysis of the impact on poverty and incentives to work, even though one relevant analysis is in the pipeline (*the World Bank study Latvia: Who is Unemployed, Inactive or Needy?;* results to be ready by early 2013). The Commission has concerns that the decision of the central government to retract from centralised financing of the GMI benefit will maintain an uneven system with negative impact on benefit coverage and adequacy. In addition, the new system will reduce incentives for the central government to invest in oversight and monitoring of the social assistance. The steps taken do not address any of the problems identified before such as poor targeting and transparency and weak conditionality on benefit recipients.

The effectiveness and sustainability of the social protection system could be improved by **targeting the social benefits** more to lower income households. In this regard, there has been no progress concerning SMoU conditionality on the targeting of the family state benefits. The authorities seem also reluctant to consider changes towards this direction in the social insurance system, for example by introducing ceilings on social insurance benefits and/or reviewing the planned contribution caps. Encouragingly, the Parliament has adopted changes in legislation to **increase the retirement age from currently 62 years to 65 years in 2025 (by 3-months annual steps starting from 2014)**.

The Welfare and Education Ministries have introduced significant changes as regards **active labour market policies and training of the unemployed** (amendments to the EU co-financed vocational education reform programme, extension of short-term vocational education programme, in-company trainings, mobility allowances, etc.), and also adopted measures for the **improvement of the demographic situation** (relaxing caps on maternity/paternity allowances, increasing minimum paternal benefits to EUR 150, increasing child care benefit to EUR 150, increasing PIT allowance for dependents to EUR 115, supporting families and municipalities in providing kindergarten, financing IVF procedures, etc.).

7. Financial sector policies

Following progress with the stabilisation of the financial system, and with the envisaged sales of the public-owned banks, the Commission agreed during 2012 to two separate requests of the authorities to release the remaining EUR 249 million of the **blocked financial sector account at the Central Bank**. Further actions have been taken to **strengthen the financial system over the past months**. This includes a closer supervision of the banking sector, in particular banks owned by non-EU entities and having high exposure to non-EU customers, continued progress with the orderly resolution of Parex Bank (its banking licence was revoked in March 2012 to optimise costs), selling of the Mortgage and Land Bank commercial assets and measures to deal with issues that emerged in the context of the Krajbanka fall-out (e.g., thorough checks of availability of correspondent account financing). The three main challenges ahead remain **the sale of Citadele Bank**, which has been postponed due to the uncertainty at the international level and with a view to maximising returns to the state, **the sale of remaining "problematic" bundles of the state-owned Mortgage and Land Bank**, and further measures to reduce risks from **non-resident banking**.

7.1 Sale and restructuring of Citadele Bank and Reverta

On Citadele Bank, the Commission has reminded the authorities **to respect the conditions in the DG COMP restructuring plan on certain asset divestures and the eventual bank's sale,** if market conditions improve (the government will once again review the market conditions in May 2013). In 2011 Latvia informed the Commission that Citadele bank would have serious difficulties in implementing a number of commitments and sought several amendments. With the adoption of the Commission decision on 10 August 2012, amending the final decision of 15 September 2010 on restructuring aid to Parex banka, the Commission agreed to the proposed amendments. The authorities have recently re-approached the Commission services seeking an amendment to the commitment, whereby wealth management business would be kept by the bank. The sale of this business is a measure for limiting distortions of competition. Thus, in line with similar cases, Latvia shall provide valid justification for any changes to commitments and possibly offer other compensatory measures.

Citadele has repaid all state liquidity support, which was quite expensive. However, there is still some subordinate debt from the state with around 8-9% interest (some 65 million EUR), which the bank will try to substitute with cheaper market resources. According to the authorities, the possible price for Citadele could be in the range of 0.5 to 1.7 of book value, but currently the prospects of a bank sale in Eastern Europe is weak (some interest in Polish/Turkish bank assets). The Citadele sale almost happened a year ago when several interested banks were selected to perform due diligence, however due to the Krajbanka fall-out and the sharpening of the euro crisis the preliminary offers were withdrawn.

As for **Reverta (Parex),** the Treasury deposit is still around EUR 550 million. In 2012 Reverta has paid EUR 90 million to the state as principal and interest. Losses are materialising largely according to the restructuring plan, though some assumptions in the restructuring plan were too optimistic: e.g., the rebound of the real estate market has been slower than expected and there is a glut of banks' repossessed real estate assets which depress property prices. Also, there are serious legal challenges with the repayment of loans in Russia (especially one large loan of above USD 100 million for gas exploration assets) and loopholes in the Latvian laws, which, inter alia, hinder repossession/realisation of collateral (e.g., fictitious rental agreements).

7.2 Sale of MLB commercial parts

The Commission encouraged the authorities to accept financially reasonable offers received for the remaining commercial assets of the MLB (especially bundle 4), as keeping the latter under state management is unlikely to result in bigger future benefits. Nevertheless, if the price for one or two of the bundles is far below both the estimated current and the long term economic values, the Commission may agree that such assets are given for work-out management to another state company. Currently, four packages of the MLB's commercial assets have been sold to Swedbank Latvia (personal and corporate loans, payment and deposit services and a leasing company) and SEB Wealth Management (second-pillar pension plans earlier managed by Hipo Fondi).

DG COMP is closely following the on-going sale of the MLB commercial segment; however, it does not have the full information required for **the adoption of the final decision** (e.g., still unclear development bank plans; final amount of aid needed by the bank). In this context, the sooner the MLB restructuring process will be completed, the sooner the MLB development part will be able to **implement more active development programmes** and attract new financing from international financial institutions (EIB, NIB, EBRD, etc.).

During the mission, the Commission also asked the sales consultant SEB Enskilda to prepare an **overview of all state support granted to MLB since 2008** (expected to reach at least EUR 300 million, which is a large amount considering the size of the bank). Publicly available income statements show that MLB made losses of LVL 117.8 or EUR 168 million in 2008-2011. Strangely, the performance of past and present senior managers has never been assessed against this background.

7.3 Single Development Institution

The Commission stressed during the mission that the work of the Finance Ministry needs to be intensified on the set-up of a **Single Development Institution (SDI),** including deciding on further operations of the MLB development part (staff, managers, branches). According to the SMoU conditionality, the authorities had to present an action plan by end-June, but the progress has been slow, especially as the Economics and Finance Ministries are unable to agree which institution will be responsible for overseeing the SDI. The SDI is to implement state aid programmes through financial instruments currently handled by the MLB, the Latvian Guarantee Agency, the Rural Development Fund and the Environment Investment Fund.

It seems that expectations should not be high as regards establishing a single institution, as each ministry is closely guarding its financial instrument (some sort of financial independence). The already existing advisory council could be developed into a smaller, joint consultative/strategic council on top of these four development institutions/instruments that would set overall goals/objectives. In this context, the Finance Ministry has tendered **a legal analysis** of the best possible approach for merging existing institutions with results expected in early 2013. Decisions on the single development institution are particularly important in view of the new EU funds financing period, where emphasis on **financial engineering** programmes/instruments (revolving credit funds, guarantees, export credits, etc.) may be quite significant.

7.4 Non-resident banking

The management of savings of foreigners has increased quickly as confidence in the stability of the Latvian financial system has returned while it diminished in other places. There seem to be significant country-specific advantages for Latvia to continue growing as a popular non-resident banking destination: language, geographical proximity to CIS, benefits for CIS customers operating in the EU, experience with CIS customers, clear and fast procedures related to money laundering, establishment of company origin, and property checks, labour intensive business requiring extended working hours, etc. Besides, the tax treaty with Russia on avoidance of double taxation (to come into force from January 2013), the new law on holding companies, and the continued selling of residence permits in exchange for investments is expected to further boost the trend, including moving Russian/CIS corporate registrations to Latvia from countries like Cyprus.

However, there are risks inherent in a large non-resident banking sector as evidenced by some countries. The Commission invites the authorities to follow closely what kind of financial flows are attracted, where they are invested, what are the activities of non-resident banks in the domestic market, etc. In particular, it must be kept in mind that the business, legal and regulatory environment in CIS countries is often weak and investments/loans in these countries call for caution (checking creditworthiness, enforceability of collateral, etc.). Also, attention should be paid to the capital hikes where the source of financing may be coming from loans between related entities/persons. The Financial and Capital Market Commission may need to further enhance knowledge of activities of individual non-resident banks and on times be more intrusive to reduce risks similar to Latvijas Krajbanka. Further regulatory changes, to be devised with the involvement of the Commission, ECB and IMF experts, may be needed to further reduce liquidity, operational and other risks.

7.5 Financial and economic crimes

The authorities should devote more financial and human resource capacities and attention to tackling **complex economic, financial, money laundering and tax evasion crimes**. This concerns the investigation of such crimes, prosecution and the work of judges: in many cases, the knowledge and skills of relevant authorities might not be adequate to successfully investigate, prosecute and punish perpetuators of complex and elaborate financial schemes, which are often of international nature (off-shore companies, trusts, correspondent accounts, etc.). There is evidence that institutions like the economic and the financial police have inadequate resources to offer attractive remuneration and keep or hire experienced and well-qualified staff.

In this context, DG HOME has recently approved financing of EUR 0.18 million for **a special multi-year training programme** for prosecutors, investigators, judges involved in tackling economic and financial crimes, however this falls short of the identified needs for the years to come. This initiative is also supported by the position of the Commission Services on the development of the Partnership Agreement and programmes for period 2014-2020 (CPP), proposing areas to be funded by the authorities in the next programming period, incl. capacity building in the judicial system. It will depend on the responsible Latvian authorities to propose measures for funding under the ESF that are directly linked to reforms in the judicial system. One idea is to establish a comprehensive national training centre for all judicial and investigative institutions. However, it should be based on the infrastructure and human resources of the successfully-working NGO "Judges Training Centre".

8. Structural policies

During the BoP financial assistance programme, **Latvia has implemented far-reaching structural reforms aimed at enhancing competitiveness and potential growth**. The pace of reforms has strongly accelerated after the October 2011 elections. However, this effort needs to be sustained and focused on measures that will further improve cost and non-cost competitiveness of the economy. In particular, as outlined in the latest SMoU conditionality and the CSRs, challenges remain in the fields of energy liberalisation/independence (high monopoly power in gas and electricity markets) and energy efficiency (one of the worst performances in the EU), better targeting of social assistance (GMIs, family state benefits, design of social safety net), implementing a quality-rewarding financing model in higher education and science (based on independent, international assessments to support future EU funds allocations), establishing a single development institution, reforming public administration (amendments to unified wage grid, incentives for best-performers, career development path, etc.) and improving the efficiency of the judicial system (i.e., reducing length of cases, assessing judges' qualifications, closing loopholes in insolvency procedures, etc.). Competition and procurement policies also need to be strengthened to ensure adequate price levels, a fair competition and attraction of foreign investment.

Assessment of implementation of CSRs is continuous and the Commission assessment report is expected in spring 2013. It is important that the authorities maintain the pace of reform in these and other fields to attract new investment, achieve faster income convergence with richer EU countries, and reduce poverty and emigration.

8.1 EU funds management

The financing through EU funds has been an origin of many important reforms undertaken over the past years, as public investment consists almost entirely of EU-funded activities. In the past few years some delays have occurred, especially for large EU co-financed projects (reconstructions in Riga airport and port, East-West road network, purchase of new railway carriages, etc.), mainly due to public procurement procedures (including founded/un-founded disputing of tender results), still insufficient administrative capacity in line ministries, and lack of bank financing.

Difficult negotiations with the authorities are expected as regards the **2014-2020 financing period** (informal negotiations were launched on 4 December), as projected financing will need to be prioritised among **few, selected funding priorities**, while further **optimising the EU funds management system (**e.g., limiting the institutional set-up to one intermediate body/line ministry for one priority axis based on investment priorities set in the CPP) may upset some of the institutions currently involved in the EU funds implementation. Based on the experiences from the 2007-2013 period, further **simplification of procedures for final beneficiaries** - reducing the number of intermediaries, delegating more decision-making to the relevant Ministers, using wider e-Cohesion tools, etc. - is expected. **Implementation of large-scale EU co-financed projects** (roads, ports, railways) will also need to be improved to further reduce public procurement and corruption risks.

8.2 State owned enterprises

The Commission regrets that (i) establishing and equipping of **a centralised State Owned Enterprise (SOE) management under the PM**, (ii) **the gradual transfer of ministries' stakes in SOEs to this SOE management**, and (iii) **the minority and non-core-activity share divestments will take longer than expected** (against what is set in the latest SMoU). While the technical ground for further steps has been completed (drafting of the relevant SOE legislation changes), there is a risk that SOE law changes may get stuck in the Parliament (similar to the Construction Law) or may be subject to significant revisions, thus further reducing their scope and ambition. It is important to move swiftly on these long-overdue reforms, especially while the political and other conditions allow it. The authorities should also revisit privatisation plans for some bigger state assets (e.g., Latvian Mobile Telephone company), partly in view of reducing future public debt levels.

8.3 Energy market

In 2012, Latvia has achieved significant progress in **opening its electricity market for competition**. The market for industrial users is now fully liberalised as they have an obligation to sign separate contracts with power suppliers and network operators. As of November 2012, households also have the opportunity to sign separate contracts with suppliers and network operators and this will be mandatory as of September 2013. So far, some industrial users have signed more beneficial contracts with suppliers as the competition in the sector is significant. The dominant Latvenergo is losing market shares as electricity suppliers from Estonia and Russia are strongly interested in the Latvian market. At the same time, Latvenergo is improving its position in Estonia and Lithuania.

The market opening has put some **downward price pressure on the electricity market for industrial users so far and full opening to household users is expected to keep prices**

either stable or slightly decreasing as there is no upside pressure on the side of production costs for the moment. Latvia will join the Nord Pool for electricity contracting on 3 June 2013 but power suppliers are already using Nord Pool price benchmarks for offering short- or long-term contracts to final users. In effect, forward prices at the Nord Pool exchange will be playing an increasing role for future price dynamics on the Latvian market.

In the **natural gas sector**, the market remains fully dominated by Latvia Gaze as the country has a derogation on the implementation of the EU's third energy pack and for the moment there are no concrete plans for market liberalisation.

As regards **investment in energy efficiency projects**, some progress is achieved in insulation of administrative and residential buildings and results show significant energy savings of above 30% for the pilot residential projects. However, the number of insulated residential buildings remains very small relative to the stock of buildings with large energy losses. The potential for efficiency gains in this field are significant as Latvia is the worst performing in the EU in terms of energy efficiency in the household sector. The authorities would like to allocate more EU financing from the 2007-2013 period for housing insulation projects, however there is a 4% cap in place limiting how much EU funding from the total EU funds envelope can be devoted to one activity. At the same time, it must be acknowledged that so far the implementation of housing insulation projects has been slow and currently hundreds of projects are still in the pipeline for which there is sufficient funding available from Structural Funds of the current period. Besides, the authorities could allocate more funding for these projects from other sources of financing (e.g., Climate Change Instrument, inexpensive loans from EIB, EBRD) and from Structural Funds from the 2014-2020 period

8.4 Roads and ports

In line with the SMoU condition, the Transport Ministry is introducing improvements in the **road construction quality system in line with JASPERS recommendations** (insurance of responsibility of engineers/contractors, longer warranty periods, training and international experience of road engineers, etc.) and additional financing was allocated for the maintenance of roads built with EU co-financing (some EUR 8 million in 2013). A report by the Transport Ministry on the measures taken and those planned for the next construction season to further improve the road construction quality system is to be sent to DG REGIO shortly.

The state of roads in Latvia is very poor if compared to neighbouring countries, let alone Western Europe, mostly due to severe underfinancing over the last 20 years. The Transport Ministry has recently submitted a proposal to the government to change the road financing system from 2014 by allocating all road and fuel excise tax revenues for road construction/maintenance expenditures, but the Finance Ministry is likely to object. National financing for road construction has been steadily decreasing, while the EU funds have stepped in place, but their levels are insufficient to radically improve the road network quality, even assuming that in the next EU funds financing period a similar amount of financing may be earmarked for roads. **Thus, to achieve a significant improvement in the medium/long term, the authorities may need to greatly increase national financing, propose public private partnership schemes, or even introduce pay-roads**.

As a follow-up to the SMoU condition, which asked for a review of governance and operational standards of Latvian ports, the World Bank has been invited to do **a comprehensive study on competitiveness, governance and investment return assessment**

of Latvian ports. More than EUR 0.1 million have been allocated and the work is expected to start soon with results expected around mid-2013. Whether any policy follow-up can be expected depends mainly on the June 2013 municipal elections, which can result in governance changes in Riga and Ventspils ports. In any case, ports management has always been a politically very sensitive issue.

As regards the protracted **Spanish train procurement**, the authorities are in contact with DG REGIO to agree on a proposal to redirect EUR 174 million for the modernisation of the railway infrastructure. Mediation talks are on-going with the Spanish company CAF at the Stockholm arbitration court; CAF claims that the authorities should implement the agreement that was concluded in early 2012.

8.5 Judicial reforms

For the first time ever the Commission has issued a CSR to Latvia as regards the need to promote judicial reforms, especially to reduce the backlog and length of court procedures, improve the insolvency regime and introduce mediation laws. Importantly, the CSRs will be linked to the allocation of funding from the 2014-2020 EU funds envelope, thus implementation of judicial reforms is expected to be partly supported by ESF financing.

In line with the Commission's assessment of the key challenges in the judicial sector, a **professional evaluation process for judges is to start from January 2013.** This should support the establishment of a comprehensive human resources management policy within/by the judiciary rather than focusing on identifying and dismissing "bad judges". Stronger involvement of the Judicial Council, re-thinking of the role of management positions within the judiciary and more training of judges might be necessary to develop a sustainable solution towards a high quality judiciary.

According to the Ministry of Justice, **amendments to the Law on Insolvency are to be proposed by the end of 2012**, inter alia, to prevent a repetition of cases like Palink, where the Commission had to get involved to protect a foreign investor. Clarification of the insolvency law seems to be necessary as its interpretation is not always straightforward. However, there are doubts about the Ministry of Justice approach of amending the law by bits and pieces rather than addressing its imperfections comprehensively. **More problematic aspects of the practical implementation of the law need to be addressed, in particular with regard to the role of the insolvency practitioners, their responsibilities with regard to the judges and the effective liquidation of assets, as well as issues with personal insolvencies.**

With the amendments of the Law on Judicial Power, a **pure instance system will be introduced in the coming years,** whereby all cases will be submitted first to district courts and the Supreme Court Chambers will be eliminated. A transition period for criminal matters has been agreed up to end-2015, while for civil matters it is end-2019. **Amendments of civil, administrative and criminal procedural law** have been proposed and partly implemented, including wider application of written procedure, limitations for producing new evidence, possibilities for appeal, choice of courts, etc. Further amendments are under development by a permanent civil procedure working group.

The law on mediation is planned to come into force in mid-2013. Importantly, the law needs to be accompanied by "mediation" awareness and promotion campaigns to ensure rapid take-up and a quick impact on the work-load of traditional courts.

To increase the quality and transparency of judicial proceedings and decisions, **ICT communication between courts and the general public has been improved**. With the support of Swiss funding, installation of video-conferencing and audio recording equipment has taken place. Electronic publication of judgements and e-calendars for lawyers have also been introduced, while electronic processing of documents for certain procedures (small claims) may soon be implemented. It is too early to assess the effectiveness of these measures.

8.6 Public administration reforms

One important element in the SMoU throughout the Programme was the need to prepare a comprehensive **public administration reform,** as public sector efficiency and quality of decision-making can be greatly improved; however, there have been multiple delays and little action with the authorities usually retorting to the standard response that "there is no money". Recently, in line with SMoU conditionality, a **strategy for public sector HRM reforms,** which includes elements like staff recruitment, assessments, rotations, mobility, career development, special trainings/assessments for top managers, has been proposed, however the timetable for its implementation seems too stretched-out and the municipalities want to be exempt from these changes. The Prime Minister has promised to review the plans in this regard (mid-mission meeting of 21 November).

The Commission has repeatedly asked the authorities to seriously **review the unified wage grid set-up** (job classifications, salary coefficients, links to performance assessment, etc.) to ensure, inter alia, adequate pay for the lower-paid job categories (policemen, firemen, social workers, etc.) and reward the best performers in middle and senior management levels (there are growing indications that the best public sector staff are leaving for the private sector). In this context, the adequacy of existing wage bill allocations for different institutions needs to be reviewed to see, for example, if more staff/experts would need to be moved higher up the wage grid. Also, **the remuneration levels of the state- and municipality-owned enterprise board and supervisory council members seem inadequate vis-à-vis the private sector**. In addition, private sector experts are not allowed to combine their private sector activities with work in public boards/councils, thus limiting the pool of professionals.

Inviting external expertise to devise wage grid amendments and appropriate remuneration levels for public companies might be the most appropriate approach (the OECD, the World Bank, a reputable HRM company or other). While additional budget resources may be needed to make substantial public administration remuneration changes, an efficient and motivated public sector will certainly pay-off in the longer term.

The State Chancellery has recently commissioned a study to look at the **job classifications in the unified wage grid** (financed by ESF funding) with results expected around mid-2013; these should be used to make amendments in the 2014 budget framework. Also, to improve motivation, in 2013 budget some **incentives** have been re-instated that were cut during the consolidation years: higher vacation allowances, health insurance, bonus payments for outstanding work, etc. The heads of institutions have liberty which employees to reward within the allocated wage bill. Further, **the upcoming EU Presidency in 2015** is used as a pre-text for providing material motivation for employees involved in preparation of the Presidency (bonus payments).

In line with SMoU conditions, the Chancellery is looking for ways to **lighten the agenda** of the Cabinet of Ministers by reviewing the Rules of Procedure (e.g., shorter procedures for decision-making, delegating more technical decisions to State Secretary/Minister level) and a study will be launched on how to improve and expedite the overall **policy planning system** (informative reports, conceptions, strategies, etc.).

8.7 Higher and vocational education reforms

As regards **higher education and science,** ambitious reforms have been proposed concerning accreditation, financing system, internationalisation, management of higher education institutions, relaxation of language law in teaching, and consolidation of resources. Similarly, a comprehensive assessment of **state-financed scientific institutions** done by the Nordic Council (ESF-financed) is on-going to determine which institutions are to be reorganised and which would be eligible for more EU and national funding. **Although these reforms are in an early stage, they appropriately respond to the relevant CSR and SMoU conditions.** Thus, if properly implemented, the reforms will have a significant positive impact on the quality and internationalisation of higher education.

Concerning **vocational education and training,** Latvia is, inter alia, modernising vocational school infrastructure with the help of EU structural funds and has introduced short-cycle vocational programmes to bring young unemployed back into education. The measures to promote attractiveness of vocational education and training should be based on increasing their quality and labour-market relevance. Scope for further action includes promoting in-company apprenticeships within VET, as well as better aligning the governance of vocational education and general secondary education to ensure better complementarities of the two systems. The implementation of on-going reforms should be continued.

8.8 Public procurement

It seems the key SMoU conditions in the public procurement field have been fulfilled, largely due to the fact that authorities realise bottlenecks in this field slow down absorption of EU funds. Most importantly, comprehensive changes to **the Public Procurement Law** are discussed in the Parliament and their adoption is expected around April 2013. One of the key changes concerns **obliging local governments (LG) to further centralise their procurements** primarily by wider use of the **Electronic Procurement System (EPS)**.

The number of **disputed procurements** is falling compared to last year: most likely a result of more intensive ex ante procurement documentation checks by the Procurement Monitoring Office (PMO) and other contracting agencies and more training for officials dealing with procurements. The government has also recently decided to review all procurement tenders of above EUR 1.5 million after the failure of the EU funds co-financed Spanish train procurement. Procurement disputes are addressed by PMO in 30-40 days which is a relatively good value compared to EU-27.

As regards **administrative responsibility** for officials for negligence in procurement tenders, which envisages for the first time administrative penalties for individual contracting officials, key law amendments will likely be adopted by the Parliament by April 2013, as set in the SMoU. Three punishments, to be administered by the PMO, are envisaged: a warning, a fine of ca. EUR 70-700, or a disqualification from any public procurement evaluation committee. This is expected to increase the usage of EPS and improve the quality of work of procurement evaluation committees, as procurement experts/consultants are likely to be invited more extensively to take key decisions.

As for **LG "in-house" procurements,** which are exempt from normal public procurement regulations (as the service providing company belongs to the municipality), further tightening can be expected through Procurement Law amendments. **Unfortunately, in the past few years there has been a trend to increase administrative intervention of municipalities and other public bodies in commercial activities in port services** (e.g., PKL Flote case**), waste management sector** (ZAAO case in North Vidzeme region) **and provision of house maintenance services** (a recent case whereby the Riga municipality assigned municipal schools' maintenance services to one company). "Deloitte" is expected to finish a study in the first quarter of 2013 on the impact such municipal enterprises have on free competition environment.

8.9 Competition Council

Although in line with the SMoU additional EUR 0.2 million were granted to the Competition Council (CC) in the 2012 budget, **capacities of the CC remain poor**. In particular, the unified wage grid restricts higher level/expert salaries and the gap to the private sector continues to widen, thus the best CC experts, who have received extensive on-the-work training and practice, are later attracted by the law offices and other institutions. With staff of only 35 employees, loss of each expert has a significant effect on the analytical capacity and the accumulated know-how of the CC. Unified wage grid restrictions also prevent attracting new experts, especially strong economists, so positions are filled with fresh university graduates with no prior experience in the field of competition.

A solution could be to **change the financing model,** independent of the unified wage grid and similar to the other niche competence authorities like the Public Utilities Commission (PUC) and the Financial and Capital Markets Commission (FCMC) that get revenues from the actors they are monitoring (utilities and financial institutions). Similarly, the CC could, for example, get fees from every merger and acquisition deal approved, or, similar to the State Revenue Service, get extra allocations if the operational plans - cases closed, fines imposed - are overachieved. The Commission has on several occasions emphasised the importance of active surveillance of the companies' compliance with competition rules, as this may contribute towards ensuring long term price level sustainability (or even reduction in certain sectors). **The issue of inadequate CC capacities and the need to address financing issue in earnest will likely be raised when assessing the prospects for inflation sustainability in future years.**

There are currently 14 **market inquiries** on-going in the sectors of electricity trade, natural gas market, fuel retail, LPG market for cars, pharmacy retail and wholesale markets and medical equipment, animal food market, retail-chain handling of small specialised food shops and others. 37 cases (inquiries) have been closed in 2012: 13 cases of prohibited agreements (6 with infringements), 8 cases of abuse of dominance (3 with infringements), 10 notified mergers, and 6 cases of market inquiries. There are currently 34 cases in the court where the CC decision has been appealed.

8.10 Air Baltic

The non-participation of the private sector investor in the capital increase of **Air Baltic** in the beginning of 2012 means that the government is in full control of the company and there are possible state aid implications**. The Commission announced the opening of a state aid investigation on 20 November to assess whether certain transactions constitute state aid and whether they are compatible with state aid rules**. The investigation could take up to 3 years, though sometimes it can be as fast as 6 months if the authorities are cooperative and ready to implement certain remedy measures embedded in a credible restructuring plan (reducing staff and flight connections, improving revenue ratios, reviewing supply/subcontracting contracts, etc.).

The authorities maintain that according to their assessment all transactions pass the **"private investor criterion"** and their readiness to co-operate throughout the investigation will mitigate possible outcomes. The authorities believe that existence of guarantees from financial institutions (Krajbanka and Snoras) and the preliminary financial deal for acquiring new fleet also proves that the whole capital injection can be seen as being done on market conditions.

The state aid investigation is likely to hinder efforts to **attract a foreign investor**, especially as several other state airlines in Europe are looking for strategic investors. On the positive side, based on recent performance, Air Baltic should achieve profitability from 2014 as planned (after an expected loss of around EUR 45 million in 2012 and EUR 15 million in 2013), though key headwinds are, inter alia, the continuously high fuel prices, litigations with the previous shareholders and an unfavourable competition position in Riga airport vis-à-vis Ryanair.

9. Euro adoption planned for 2014

The authorities have reconfirmed their goal of adopting the euro in 2014. A formal request of Latvia for an ad hoc convergence assessment may be made in early 2013. It should be stressed that the assessment of the state of convergence is a separate process from the post-programme surveillance and - if such assessment is requested – it will be dealt with in a dedicated convergence report (the next regular convergence report is due in 2014). The Commission has emphasised in the past that the objective for Latvia should be to ensure durable convergence for its own sake and that the assessment of the convergence criteria is not mechanical, but importantly also includes an assessment of sustainability of convergence.

The necessary practical preparations for possible euro adoption in 2014 are under way in Latvia: e.g. preparation of the legal framework, information website, working groups, euro coin design, etc.

Public support for euro adoption is currently very low in Latvia (below 20% of the population is in favour of adopting the euro 'as soon as possible', i.e. in 2014). Some political parties may use this situation to push for a referendum on the euro. The idea of a referendum is on the political agenda and will continue to be so also in the light of the 1 June 2013 local elections.

10. Repayment capacity

As of end-September 2012, Latvia has already repaid 39% of all outstanding liabilities to the IMF**.** Apart from regular repayments, on 14 September 2012 the authorities pre-paid EUR 211 million due to the IMF in 2012-14. **On 5 December, the government issued a 7-year bond in the amount of USD 1.25 billion (ca. EUR 970 million) at a historical low yield of 2.89%.** The bond will mature in January 2020 and will be repaid in euro as the government has purchased currency swaps to hedge against exchange rate risks. The issuing followed one-notch rating upgrades by S&P and Fitch to BBB, positive outlook. The bond proceeds are earmarked for pre-payment of the whole outstanding liability to the IMF, SDR 603 million (EUR 720 million; USD 928 million). The remaining part will top up the government reserves, providing a substantial buffer to the forthcoming repayments under the EU's balance-of-payments programme. **The EU financing under the programme has reached EUR 2.9 billion and about 75.9% of this amount has to be repaid in 2014-15.**

The bond issue in December, earmarked for full prepayment to the IMF, significantly improves the country's repayment capacity for four reasons:

1. The early repayment to the IMF reduces debt service costs as the country will avoid extra-charges to the IMF on liabilities exceeding 300% of the quota
2. The volume of total debt service in the critical years of 2014-15 is reduced;
3. The bond issue provides additional buffer in the country's reserve for servicing the forthcoming large debt repayments in 2014-15;
4. The low yield of 2.89%, which is in fact slightly below the interest rates Latvia is paying to the EU, sets favourable refinancing terms that will not put pressure for increasing interest expenditures and will support medium-term fiscal sustainability. The favourable bond rates even provide chances for Latvia to reduce interest rate expenditures after the replacement of official lending with market borrowing. On this note, the Treasury is also considering the option for pre-paying the EUR 400 million loan from the World Bank, where the interest rate is set at 4.2%, amid a sanction of 0.5pp for early repayment.

Principal debt repayments under the programme (Treasury estimates in LVL million)

	2012	2013	2014	2015	2016-18	2019	2020-25	Total
EC			**702.8**	**843.4**		**351.4**	**140.6**	**2,038.2**
IMF	323.0	290.5	112.7	47.1				801.4
WB				42.2	168.6	56.2	14.1	281.1
Total, LVL m	**323.0***	**290.5**	**815.6**	**932.6**	**168.6**	**407.6**	**154.7**	**3,120.7**
Total, % of GDP	2.1%	1.8%	4.8%	5.1%		2.0%		

**About 85% of the amount scheduled for repayment in 2012 is already paid*

As of end-September 2012, **the outstanding balance of the Treasury stood at around EUR 1.7 billion covering nearly two years of debt service**. The government intends to continue **tapping international debt markets in 2013 to further pre-fund debt service in 2014-15** to avoid concentration of large debt issues over a short period of time and therefore reduce exposure to short-term market volatilities. The mission team supported the government's policy of pre-funding debt repayments so that the debt issuance for rolling over programme loans could be broadly uniform over the key period of 2013-15. The **debt issuance plan** has been already significantly **frontloaded** in the light of favourable market conditions in 2012 that will allow even more flexibility for issuing cheaper debt in future. Options are evaluated for issuing bonds denominated in EUR, USD, CHF or JPY. In the latter cases, currency swaps will be immediately purchased to avoid exchange rate risks.

The secondary markets for both domestic and foreign bonds show that long-term yields dropped 200bps in a year and a similar trend is observed on the domestic primary debt market. **The long-term interest rate**, as reported by the ECB, **declined to 3.5% in October 2012 from 5.6% a year earlier and international markets were tapped at a record low yield of 2.89% over 7-year maturity in December 2012**. CDS spreads fell from around 350bp towards end-2011 to well below 200bp by early December 2012. This was broadly consistent with the developments in the sovereign bond markets of some other Member States, e.g. Lithuania and Bulgaria. In the **domestic currency segment**, the Treasury used its favourable liquidity position (partly due to the successful foreign issuances) to issue smaller amounts on the primary market. From April to December it sold EUR 65 million of bonds under its 10Y programme. On the latest 10Y lats auctions the achieved yield was around 3%.

The very favourable terms of the latest international bond issue, as well as the better than projected fiscal and growth performance, indicate that **the Treasury should be able to collect the required funding at low debt rollover cost**. **There seems to be low and declining refinancing risks amid favourable forecasts of a low budget deficit, stable public debt ratios, declining private debt ratios, and overall sound macroeconomic indicators.** The debt issuance prospect is further supported by the recent rating upgrades by S&P and Fitch, the expected upgrade by Moody's, and the ahead-of-schedule debt repayments.