EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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EU BOP ASSISTANCE TO LATVIA

FIFTH REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

Since the previous Post-Programme Surveillance (PPS) visit in November, Latvia has implemented a successful euro changeover at the beginning of 2014, leading to improved public perceptions on the benefits of the single currency. Also, a new government has started work in late January and a protracted political instability was avoided. Macroeconomic, fiscal and political stability has allowed Latvia to enjoy fast GDP growth rates and the outlook for 2014 and 2015 is overall encouraging, despite the potential negative economic fall-out from the Ukrainian crisis. Reflecting good macroeconomic conditions, nominal budget deficits are projected to remain around 1% of GDP in 2014-2015 despite further income tax cuts planned for these years, leading nevertheless to important deviation from the Medium-term Objective (partly due to the implementation of the systemic pension reform). Positively, the tax policy package of 2014 implies a reduction of taxation for low income earners and families with children by shifting taxation to other tax bases and by strengthening actions to tackle tax avoidance. The level of government debt is projected to decline to 33% of GDP in 2015 as the repayments to the EU take effect (ca. 4.8% of GDP).

At the same time, the mission identified important shortfalls in a number of policy areas. The authorities' willingness to maintain sound fiscal policy, including respecting the provisions of the recently adopted Fiscal Discipline Law, is less convincing than during earlier visits. Furthermore there are indications that big-item reforms are put on hold or have slowed down. This applies to introducing a centralised management of state owned enterprises, the sale of minority shares and the appointment of professional board/council members. Likewise, there is little progress with reforms of higher education and science, broader means-testing of social assistance, further electricity/gas market liberalisation, and adoption of the Construction Law. There is also slow progress with reforms to make the public administration more professional, for example as regards changes in the unified wage grid and introducing professional hiring for senior positions. Improving access to, and financing of, healthcare is an additional challenge to which attention must be paid.

The upcoming October 2014 general elections, strong vested-interest groups, and deficiencies in the decision-making process seem to be the main reasons for the reform slow-down. Indeed, important law amendments or new government initiatives are stuck in the Parliament even though PM Straujuma leads a majority government. In addition, complacency seems to setting in as Latvia still enjoys robust growth and has received much international acclaim for tackling a difficult crisis.

Overall, a greater sense of urgency is warranted, especially as several of these reforms were part of the June 2013 Eurogroup commitment letter in the context of Latvia's euro accession: notably the state owned enterprise reform was promised to be in force in early 2014 (after many delays) but in all likelihood will not move forward before 2015, if at all. Implementation of these and other reforms will also be preconditions for Latvia to join the OECD - a process that the Commission will be following closely. As Latvia joined the euro area recently, it is crucial to accelerate the pace of reforms and maintain competitiveness.

As regards monitoring of increasing non-resident bank deposits and further tightening of the anti-money laundering framework, it is unlikely that additional regulatory measures are needed at this point. However, in this context, the capacity to tackle complex financial and tax crimes needs to be improved: e.g., some of the institutions under the Prosecutor General and *the Finance Ministry need more staff, training, and resources. Also, positive initiatives to streamline the judicial system need to be followed through, including by strengthening accountability of insolvency administrators.*

Loan repayment risks are low at present due to the solid cash balance of the Treasury as well as broadly healthy fiscal and growth outlook. Advancing sovereign debt issuance, which is being contemplated, would be fully justified, given currently favourable spreads and with a view to minimising risks stemming from the external environment.

The next, and possibly last, PPS visit is planned for October or November 2014. The authorities committed, when signing the last SMoU in December 2011, to consult with EU bodies on major policy intentions, should the Commission deem that such changes may jeopardise macroeconomic stability and Latvia's repayment capacity. Overall, the authorities have been co-operative as regards this PPS obligation.

Introduction

Following the successful conclusion on 20 January 2012 of the three-year financial support by the EU, the fifth Post-Programme Surveillance (PPS) mission to Latvia was carried out by staff of the European Commission from 7 to 10 April, under the lead of DG ECFIN, together with the European Central Bank and some line-DGs (EMPL, EAC, ENER, JUST, SANCO, TAXUD). As Latvia repaid all outstanding liabilities to the IMF in December 2012, more than two years ahead of schedule, the IMF did not take part in the mission. PPS missions are scheduled to take place twice a year until 75% of the EU loan provided to Latvia will be repaid. This is expected to be achieved in early 2015, so Latvia will have been subject to PPS for three years only. The first tranche of EUR 1 billion (1/3 of the total EUR 2.9 billion EU loan) was repaid on 25 March.

The main objective of the visit was to assess progress in key budgetary, social, financial and structural areas since the previous PPS visit, as well as to review Latvia's BoP loan repayment capacity. In particular, Latvia's vulnerability to the consequences of possible economic sanctions to Russia and a general worsening of the investment climate was evaluated. To streamline the PPS and the European Semester surveillance mechanisms and to minimise the administrative burden on the authorities, the visit assessed jointly with experts from other DGs actions taken to address the Country Specific Recommendations (CSRs) on budgetary and financial sector prudence, social assistance/inequality, higher education, energy efficiency/energy market liberalisation, and judicial reforms. In view of a possible CSR on health care, DG SANCO also had dedicated meetings with relevant stakeholders.

In the concluding meeting, the mission team discussed with the new Prime Minister Ms Laimdota Straujuma progress with implementing commitments outlined in Latvia's letter to the June Eurogroup as regards, inter alia, reducing risks from the growing non-resident banking sector, improving the anti-money laundering framework, implementing higher education and state-owned enterprise management reforms, finalisation of state-owned bank restructuring, opening of the electricity market, and addressing poverty.

1. Macroeconomic situation and euro changeover

The Latvian economy grew by 4.1% in 2013, slowing from 5.2% in 2012, but still maintaining the fastest growth rate in the EU for the second year in a row. The growth outlook also remains favourable but the recent tensions in Ukraine bring downside risks on the side of external trade and investments. About 12% of Latvia's exports are directed to Russia and any disruptions in trade flows would weigh heavily on growth and dampen investment and consumer sentiments. The large port and railway cargo transit sectors are also exposed to external risks with a potential 10 000 jobs-at-risk. The year-average HICP inflation slowed from 2.3% in 2012 to 0% in 2013 and is expected to rebound to about 2% in 2014-15. Preliminary estimates on the price effects of the euro changeover show that the pass-through of transition costs to inflation was within the expected range of 0.2-0.3pps, in line with the experience in other countries. Although consumer prices rose by 0.7% m-o-m in January, this was mostly due to seasonal factors; in February, consumer prices remained unchanged on a monthly basis.

The unemployment rate fell to 11.9% in 2013 from 15% in 2012 and the rate is projected to decline further to below 10% by 2015. Wage adjustments and comprehensive structural reforms during the BoP programme in 2009-2011 recovered Latvia's competitiveness and the country's external balance is now broadly balanced. The current-account deficit is estimated at 0.9% of GDP in 2013 and is well below the net FDI inflows. The current-account deficit is expected to remain below 4% of GDP in the medium run and the external indebtedness is set to drop further.

Economic performance: 2014 Winter Forecast (actual data for 2012-13)

	2012	2013	2014	2015
GDP (%, y-o-y)	5.2	4.1	4.2	4.3
Employment (%, y-o-y)	1.4	2.3	2.0	2.0
Unemployment rate (%)	15.0	11.9	10.5	9.2
Unit labour cost (%, y-o-y)	3.5	2.3	2.8	2.3
HICP (%, y-o-y)	2.3	0.0	1.9	2.1
Gross public debt (% of GDP)	40.6	38.2	38.7	32.7

2. Public finances

The authorities benefitted in 2013 from the economic recovery, as well as some improvements in tax collection, in particular as regards labour taxes. The fiscal framework of Latvia has been considerably strengthened in 2013 and early 2014 thanks to the adoption and entering into force of the Fiscal Discipline Law (FDL) and to the creation of the Fiscal Council in early 2014. This is a very timely development in view of mounting expenditure pressures, which are becoming especially pronounced in the light of forthcoming European Parliament elections and general elections in October 2014, even though fiscal discipline held in the context of June 2013 local elections.

The new law and the Fiscal Council already faced a first real challenge: in late March, the government proposed to Parliament a draft law altering the pension indexation formula, which was adopted by Parliament in early April. The new law implies marginally higher expenditure in 2014-2016, with a somewhat stronger impact in the longer term. However, the draft law was proposed to Parliament without any measures to counterbalance this higher expenditure, as it would have been required under the FDL in case of in-year proposals. It is encouraging that the Fiscal Council intervened on this occasion, presenting an irregularity report to Parliament. Nevertheless, the law was adopted as proposed by the government. While the authorities intend to establish counterbalancing measures in the context of the 2015 draft budget law and the 2015-2017 medium-term framework law, this first test puts doubts on the authorities' willingness to implement fully the new fiscal framework.

Looking ahead, the outlook for public finances will very much depend on the realisation, or not, of macroeconomic risks. While the 2014 Winter Forecast expected the general government deficit to remain around 1% of GDP in both 2014 and 2015, a moderation of the economic recovery – if it materialises – could imply a weaker nominal outcome. Moreover, according to Commission's projections in the 2014 Winter Forecast, the output gap turns markedly positive in 2014-2015, implying that this nominal stance leads to an important deviation from the Medium-Term Objective (MTO), although the deviation is partly due to the cost of the systemic pension reform (with an incremental impact of 0.5% of GDP in 2014 and 0.3% of GDP in 2015). The authorities argued that there are no signs in the economy indicating economic activity exceeding the potential level, as inflation remains low, wage growth is mainly attributable to an administrative increase in minimum wage and deleveraging of the private sector continues. Based on the authorities' projections – which imply a higher estimate of potential growth – the deviation of the structural balance from the MTO remains limited to the cost of systemic pension reform.

Fiscal developments: 2014 Winter Forecast, unless indicated otherwise

	2013		2014	2015
	WF 2014	2014 1st fiscal notification		
General government balance, % of GDP	-1.3	-1.0	-1.0	-1.0
Output gap, % of potential GDP	0.1	n/a	1.7	2.8
Structural balance, % of potential GDP	-1.3	n/a	-1.5	-1.8
MTO (2013 Convergence Programme)	-0.5			

Looking ahead, in order to improve the revenue base of the budget the authorities would need to focus more on improving tax compliance, as there remains ample room to improve tax efficiency, especially with regard to VAT, despite some recent improvements. The impact of the crisis is still affecting the work of the tax authorities, as the level of corporate tax debt remains high. Also, the ease of creating new companies makes the tax system vulnerable to abuse. While the tax authorities are gradually improving techniques for identifying and preventing fraudulent behaviour and strengthen cross-border cooperation, the results remain inconclusive. Moreover, the capacity of courts also seems to create bottlenecks in fighting tax fraud.

3. Financial sector policies

In the preparation of Latvia's entry in the euro area, financial supervision was tightened and resources increased, in particular as regards monitoring the growing non-resident banking sector. Additional liquidity and capital adequacy requirements for non-resident banks were introduced in 2011 and 2013, regular on- and off-site checks are performed, the Deposit

Guarantee Fund has been further strengthened, and banks are diversifying their funding base. The capacities of the financial regulator (FCMC) are strong, while those of the Financial Intelligence Unit were recently reinforced. The anti-money laundering framework is sound, though implementation should be improved further. Also, non-resident banks' activities in the domestic market are limited. Overall, it is unlikely that additional measures are needed at this point.[1]

The mission team reviewed progress of the restructuring of the Mortgage and Land Bank (MLB), which, according to the Finance Ministry, should form the backbone of the yet-to-be-established Single Development Institution (SDI) that will implement mostly EU funds-financed state aid programmes through financial instruments. A professional restructuring team under leadership of the State Treasurer has been nominated to make proposals to the Cabinet of Ministers by summer as regards the future shape of MLB, including downsizing options, and possible synergies with other parts of the SDI: the Latvian Guarantee Agency and the Rural Development Fund. Also, the SDI council and board members have been recently appointed; unfortunately, board member appointments were not open to competition as had been suggested by the Commission.

However, despite these actions, there is insufficient political support in the current pre-election environment for setting up a single-balance-sheet SDI with important economies of scale, as some ministries are against losing "their" financing instruments to the Finance Ministry (in charge of setting up the SDI). DG COMP has not yet adopted the final decision as regards state aid granted to MLB due to delays in setting up the SDI.

The authorities outlined prospects for the sale of Citadele Bank. Sociélé Génerale has been hired to explore market conditions and the first indications are favourable both as regards a possible sale to other banks or institutional investors, or listing shares in one of the regional stock exchanges. However, rather unexpectedly, some details related to the 2010 Parex restructuring plan need to be cleared with DG COMP which may delay the process somewhat. According to the Parex restructuring plan, Citadele is to be sold by end-2014, conditions permitting.

The authorities have not dedicated sufficient financial and human resources for tackling financial and tax evasion crimes: there is clear evidence that institutions like the Economic and Financial police, the Customs Authority and the State Revenue Service lack resources to attract and retain professional staff and provide relevant training. Moreover, it is not uncommon that ex-SRS employees are engaged in supervising tax evasion schemes. Also, the poorly-prepared court cases by investigators and prosecutors are often rejected by courts, while punishments for financial crimes seem too lenient to deter involvement in such crimes.

4. Structural policies

The issues below have formed an integral part of the BoP conditionality and are now part of the European Semester assessment framework. As outlined in the 2013 Country Specific Recommendations, the main challenges for Latvia are: fighting tax evasion, better targeting of social assistance; inadequate coverage of active labour market policies; reforming higher

[1] A more detailed assessment on these issues can be found in an ECFIN Country Focus on the Latvian financial sector published on 9 April 2014: http://ec.europa.eu/economy_finance/publications/country_focus/2014/cf-vol11_6_en.htm

education and science; gas/electricity market liberalisation/interconnections and energy efficiency, as well as judiciary and public administration reforms. A number of structural reform commitments were also outlined in the June 2013 Eurogroup letter in the context of Latvia's euro accession, including reforms of state owned assets management, strengthening of public administration and the Competition Council, opening of the gas market, and establishment of the Fiscal Council. These reforms are being followed-up during PPS mission.

4.1. Higher education and science

The Commission team insisted that credible higher education reforms should be implemented and the allocation of EU funds has to be in line with merit and quality considerations: e.g. the provision of higher education quality assurance services should only be open to accreditation agencies recognised by the European Quality Assurance Register; the national higher education sector is too small to rely on domestic accreditation by non-registered institutions. The biggest challenge is implementing earlier Ministry of Education and Science reform proposals, given strong vested interests in the education sector and the reform-aversion of the Education Ministry. This includes, inter alia, implementation of quality-based accreditation of study fields (unfortunately, most programmes were accredited for maximum six years in the autumn of 2013, so independent, quality-based accreditation is unlikely before 2019-2020), better targeting of public funding to universities (e.g., shifting financing to mathematics, engineering, technology study places), adopting changes in governance of higher education institutions (e.g., involvement of private sector stakeholders), promoting use of EU foreign languages in teaching (e.g., limiting Latvian language requirements for permanent professorships), and introducing a financing model that rewards quality. A new financing model for higher education is being prepared in cooperation with World Bank experts; according to the Education Ministry, its implementation is planned from the 2015/2016 study year; however the recent reform track record creates some doubts.

For many years the effectiveness of Latvian science policy was undermined by a lack of independent, external evaluation of the relevance of scientific output. Such evaluation was recently done by the Nordic Council and should serve as a basis for determining which institutions are to be merged or liquidated and which are eligible for more EU and national funding. The authorities are also preparing proposals by June 2014 on how to achieve the mandated 1.5% of GDP private and public expenditure on R&D by 2020 (this would require a steep national financing increase and strong tax incentives for private companies).

4.2. State owned enterprise management

A comprehensive reform of establishing a centralised State Owned Enterprise (SOE) manager under the PM, the gradual transfer of ministries' stakes in SOEs to this manager, minority and non-core-activity share divestments and an independent selection of board and council members of SOEs appear to be stuck in Parliament and may not be adopted before the elections. This reform was promised to be in force by early 2014 (after many delays) in the June 2013 Eurogroup commitment letter in the context of Latvia's euro accession. SOE reform may be one of the key conditions for acceding to OECD, so the government may at least move forward before elections with independent selection of board and council members of SOEs. However, currently SOE management board members' salaries are capped and low compared to the private sector making it difficult to attract professional, high-level experts;

besides, there are limitations on combining board position responsibilities with other engagements. The authorities should also revisit privatisation plans for some bigger state assets (e.g., Mobile Company or Lattelecom) and continue divestments of minority shares (as initiated by the Privatisation Agency in case of State Social Insurance Agency holdings).

The team encouraged the authorities to implement actions improving Riga and Ventspils ports' operational management, transparency, and regional competitiveness, as supported by 2013 World Bank and State Audit analyses of Latvian ports' management deficiencies. In view of the recent events in Ukraine, it is becoming increasingly important to reduce the overly high dependence on Russian goods in port turnover.

4.3. Social policies

As social inequality was only partly addressed within the 2014 budget through some changes in the social security system, well-prepared social assistance/benefit reforms should be implemented as soon as possible in line with the June 2013 World Bank study recommendations and the respective CSR. In December 2013, the government agreed on the directions of the reform and announced the next steps: e.g., devising a new minimum income formula by 1 August 2014; however, the implementation of social assistance reform is not planned before 2016. Also, the authorities have not reversed the decisions adopted in 2012-2013 as regards reducing the already low Guaranteed Minimum Income level and, in particular, of transferring full-financing responsibilities to local governments. Discussions with the local governments are planned in May as regards increasing the GMI level and revising the eligibility criteria starting from 2015. Positively, with a view to improving the demographic situation and helping poorer families, the authorities have increased the sliding scale cap for maternity/paternity allowances, the minimum monthly paternal and child care benefits, and the PIT allowance for dependents, as well as support for kindergarten services. Similarly, partial indexation of pensions has resumed and disability benefits were increased.

4.4. Energy independence and efficiency

Key challenges for Latvia involve the continued implementation of the Third Energy Package, including regulated third-party access to gas infrastructure; re-negotiation of the Incukalns gas storage management contract; and upgrading interconnections with neighbouring countries, in particular Estonia. Latvia's emergent market exemption expired on 4 April 2014 and legislation has been put in place to introduce third party access to the networks and the important Incukalns storage (rules and associated tariffs will be assessed by the utilities regulator in coming months). The unbundling of the District System Operator (DSO) should have been implemented as well but was postponed to take place simultaneously with the Transmission System Operator (TSO) unbundling in 2017, when the 20-year privatisation agreement comes to an end. It is important that Latvia prepares well for the expiration of the isolated market exemption. As a new development, German E.on is currently in talks with the Latvian government on selling their 47% share in Latvijas Gaze (the other shareholders are Russia's Gazprom and Itera).

Full electricity market opening has been delayed to January 2015 as the appropriate support mechanism for the most vulnerable has not been put in place on time. However, the success of retail market opening is to a large extent dependent on the situation on the wholesale market. Even though Latvia is part of Nord Pool Spot since June 2013, it suffers from low liquidity and hence price instability. The main cause is the Lithuanian generation deficit which causes congestion on the Latvian-Estonian border, from where cheaper Finnish and Estonian electricity is imported. Unfortunately, the third interconnector with Estonia may only be operational from around 2020, but the situation may ease when the Lithuanian-Swedish interconnection becomes operational from 2016.

4.5. Judicial reforms

Lengthy civil and commercial case proceedings in the first instance and rather low clearance rates have led to a significant backlog of court cases; court decisions often take years. The main challenges include implementing amendments proposed by the Ministry of Justice to civil, administrative and criminal procedural laws (the government and the Parliament should review the submitted legal texts with greater expediency), improving implementation of the insolvency law (e.g., strengthening accountability of insolvency administrators and increasing transparency in their appointments), establishing a comprehensive human resource policy linked to the professional evaluation of judges that started in January 2013, reforming the system of arbitration courts, and implementing the Law on Mediation that would alleviate the workload of courts. Significant EU funds financing will be allocated to the judiciary in the 2014-2020 financing period.

4.6. Public administration reforms

There are no plans to implement a comprehensive public administration reform based on an independent needs assessment. Although a strategic framework for human resource development exists since 2013 (i.e. Concept on Human Resource Development in Public Administration), it only applies to the central public administration (local governments exempted) and has so far failed to ensure credible reforms related to common standards for hiring, remuneration, and career development. Insufficient pay compared to responsibilities and private sector salaries as well as weak development opportunities result in high staff rotation. Positively, additional financing has been granted within the 2014 budget to the lowest paid wage grid categories (policemen, firemen, cultural experts, social staff), as well as for further equalisation of salary levels for similar work across different ministries/institutions. This needs to continue on a broader scale.

Overall, to reduce the exit of best-performers from public service and improve the quality of policy-making, the Finance Ministry and the State Chancellery should do more to align the unified wage grid with efficiency and quality considerations, even if it requires additional budget financing. Proposed reforms as regards professional hiring of senior staff (part of Public Service Act) should be implemented as soon as possible, so that senior officials could be paid competitive salaries from 2015 (e.g., 80% of private sector levels). Also, a comprehensive national training strategy for public administration could be implemented through the Public Administration School if a more centralised financing for training was introduced (with limited co-payments by public institutions).

4.7. Public procurement and competition

In line with the SMoU condition, since September 2013 the Code of Administrative Violations sets administrative sanctions for violations of procedures in public procurement and the award of concessions. This is likely to bring a greater degree of discipline and accuracy to public procurement decisions. Amendments to the Public Procurement Law of June 2013 also include an obligation for local governments to use centralised procurement, stricter consequences for suppliers who fail to deliver according to procurement contracts, and the requirement to publish small procurement contracts online. Also, the Procurement Monitoring Office has made further improvements in the complaints examination system to improve the quality and timeliness of decisions (even though the review of complaints is relatively swift compared with other EU countries).

The Commission team reviewed the Competition Council's planned amendments to the Competition Law as regards greater institutional and financial independence. The proposed amendments should strengthen the Council's capacities to prevent experienced staff from leaving and intervene effectively against actions of public and private bodies restricting competition. One of the key proposals refers to independent budgeting of the institution, which would ensure greater financial independence similar to other regulators (e.g., financial, utilities regulators). The Commission is overall supportive of these proposals.

5. June 2013 Eurogroup letter commitments

The team together with the ECB representative took stock of the commitments made in the June 2013 letter to the Eurogroup. The authorities have made good progress as regards fiscal policy commitments: improving cyclically-adjusted primary budget balances and reaching MTO, introducing Fiscal Discipline Law and Medium Term Budget Framework Law, and implementing comprehensive pension reforms. The notable exception is lack of progress in improving the adequacy and coverage of means-tested social benefits and improving public health financing. On structural reforms, the most important unfulfilled commitments refer to the state-owned asset management and higher education reforms, as well as revising the public sector unified wage grid (i.e., increasing senior staff salaries to around 80% of private sector). The restructuring of Mortgage and Land Bank and the Single Development Institution setting-up are significantly delayed, while the comprehensive insolvency regulation amendments are awaiting final reading in the Parliament. As regards financial sector, commitments seem to have been implemented to a large extent, in particular closer supervision of non-resident banking and improving the anti-money laundering framework.

6. Loan repayment

On 25 March 2014, Latvia repaid EUR 1 billion in principal balance to the European Commission in line with the schedule set under the balance-of-payments programme. This first repayment accounts for 34.5% of the total amount of EUR 2.9 billion disbursed by the Commission in 2009-2010. At the beginning of April, the country also repaid a EUR 400 million eurobond to private investors, completing most of its debt service schedule for 2014. After the two major repayments, the cash balance of the Treasury is estimated at around EUR 600, which is significantly above minimum operational requirement.

The Treasury is planning another benchmark Eurobond issue for pre-funding the forthcoming second principal repayment of EUR 1.2 billion to the Commission due in January 2015. The target volume of the bond is EUR 1.5 to EUR 2 billion depending on the market conditions. Currently, the market conditions for debt issuing are favourable as the 10-year yield on Latvian bonds is just over 3% and bond prices have not suffered any negative effects from the external political environment.[2] So far, the Latvian debt placements have been very successful allowing the Treasury to refinance its liabilities at lower cost. In January 2014, the country issued a 7-year Eurobond in the amount of EUR 1 billion at a yield of 2.815% (coupon of 2.625%) as compared to an interest rate of 3.125% charged on the 5-year EU loan maturing in March 2014. The previous 7-year bond issue in USD December 2012 was priced at 2.88%.

Principal debt repayments under the programme (EUR million)

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

**Repaid on 25 March 2014*

[2] On 24 April 2014, after the cut-off date of this report, Latvia has priced an issue of 10-year bonds in an amount of EUR 1 billion with a coupon of 2.875% (yield rate of 2.961%) for pre-funding the forthcoming second principal repayment of EUR 1.2 billion to the Commission due in January 2015. The issue was oversubscribed more than three times.

EUROPEAN COMMISSION

MEMO

Brussels, 10 April 2014

Commission staff carry out fifth Post-Programme Surveillance mission to Latvia

Following the successful conclusion on 20 January 2012 of the three-year financial support by the EU, the fifth Post-Programme Surveillance (PPS) mission to Latvia was carried out by staff of the European Commission from 7 to 10 April, together with the European Central Bank. PPS missions are scheduled to take place twice a year until 75% of the EU loan provided to Latvia will be repaid (expected in early 2015). Latvia made a EUR 1 billion repayment on 25 March 2014.

The assessment of post-programme developments is mixed. Macroeconomic, fiscal and political stability has allowed Latvia to enjoy fast GDP growth rates and the outlook for 2014 and 2015 is overall encouraging, despite the potential negative economic fall-out from the crisis over Crimea. Reflecting good macroeconomic conditions, nominal budget deficits are projected to remain around or slightly above 1% of GDP in 2014-2015 despite several income tax cuts planned for these years. This would depend on consequent implementation of the Fiscal Discipline Law. Positively, the tax policy package underpinning current projections implies a further reduction of taxation for low income earners by shifting taxation to areas such as excise duties, property and/or use of natural resources, and by strengthening actions to tackle tax avoidance. Nevertheless, the tax wedge for low-income earners is still too high.

Some problems remain to be addressed with a greater sense of urgency. The authorities should implement credible higher education and science sector reforms and allocate EU funds in line with merit and quality considerations: e.g., the provision of higher education quality assurance services should only be open to accreditation agencies recognised by the European Quality Assurance Register and allocation of financing for scientific institutions should be based on the results of independent international assessments.

There has been no concrete progress with better targeting and broader means-testing of social benefits. Access to and financing of healthcare need to be improved significantly. Implementation of the management reform of state-owned enterprises, selling of minority and non-core-activity shares, and the appointment of professional board and council members have been significantly delayed. Reforms to make public administration more professional are slow, including as regards aligning the unified wage grid with efficiency and quality consideration and, introducing professional hiring for senior positions.

Full electricity market opening has been delayed to January 2015 as the political will to put an appropriate support mechanism for the most vulnerable in place on time seems not to have been strong enough. The government should foster the functioning of the electricity wholesale market.

Close monitoring of increasing non-resident bank deposits remains important. The capacity to tackle complex financial crimes and tax evasion has to be improved. Some of the institutions under the Prosecutor General and the Finance Ministry need more staff, training, and resources.

Positive initiatives by the Justice Ministry to streamline the judicial system need to be followed through. The appointment process of insolvency administrators needs to be more transparent and their accountability strengthened.

Overall, loan repayment risks are low at present due to the solid cash balance of the Treasury as well as sound fiscal and growth indicators.

Background

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

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

See also the ECFIN Occasional Paper "EU Balance-of-Payments assistance for Latvia: foundations of success":
http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op120_en.htm