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# EU BOP ASSISTANCE TO LATVIA – FIRST REVIEW UNDER POST-PROGRAMME SURVEILLANCE

## 1. Executive Summary

Following the successful conclusion on 20 January 2012 of the three-year financial support provided by the EU, **the first post-programme surveillance (PPS) mission to Latvia was carried out by the Commission services from 7 to 11 May**, together with the IMF (which stayed until 16 May), with participation from the World Bank and the ECB. The mission held consultations with government representatives and different ministries, the central bank, public/private institutions and the social partners to review the implementation of the 2012 budget and discuss plans for the 2013 budget, as well as assess the implementation of conditions outlined in the latest Supplemental Memorandum.

Since the last review in November 2011, the economy has performed very well with GDP growth reaching **the highest rates in the EU** during the last two quarters: 5.7% y-o-y in the last quarter of 2011 and 6.8% y-o-y, effected by favourable weather effects in the construction sector, in the first quarter of 2012 (seasonally unadjusted data). The budget deficit has been reduced from 8.2% of GDP in 2010 to 3.5% in 2011 with **budget revenues** strongly over-performing during the first months of the year, while the second **international bond issue** was successfully placed early this year and investment grades by all three mainstream rating agencies have been achieved. The authorities have confirmed their intention to continue fiscal consolidation and approach the MTO with annual steps of 0.5% of GDP. While the authorities intend to over-achieve the stated fiscal objectives (2.5% of GDP in 2012), the buoyancy of the economy offers also scope for reversing some of the less sustainable consolidation measures introduced during the crisis (for example, lowering state contributions to the mandatory funded pension pillar or excessive expenditure cuts in road maintenance).

Recent announcements and decisions by the authorities suggest that the better economic and budgetary results, coupled with the end of the closer surveillance under the BoP, may be leading to **complacency** among the authorities, increasing **risks**. The authorities still need to prove their capacity to **implement prudent policies** and **resist pressures** arising from the improved economic outlook after the end of the programme. The recently proposed tax cuts, if not offset by compensating fiscal measures, may endanger the medium-term strategy expressed in the 2012 convergence programme, prevent implementing a more ambitious deficit reduction strategy and leading to higher financing needs when repaying the EU loan. It also sheds doubts on the quality of the fiscal framework in place. These will be key elements which need to be considered in the context of **the assessment of the Maastricht criteria**.

Also, with the recent tax policy decisions, the **authorities have not sufficiently respected their commitment to consult prior to major policy decisions** laid down in the PPS Agreement.

As regards **euro adoption**, the Treaty framework for the assessment of convergence has proven flexible enough to deal with various situations in the past and was applied in 2012 based on careful judgement and equal treatment. The objective for Latvia should be to ensure durably low inflation for its own sake; the inflation criterion is not mechanical and includes an assessment of sustainability. Publicly questioning the convergence assessment methodology and its application is not helpful.

The authorities need to step up efforts to **finalise the restructuring of state-owned banks** and **improve management of state assets**. To this end, the authorities are encouraged to accept financially reasonable offers received for the commercial assets of the MLB; to intensify efforts to set up the development bank; to respect the conditions in the DG COMP restructuring plan for Citadele Bank and proceed with the sales process as soon as market conditions show signs of improvement; to accelerate the process of SOE management reform, including the establishing of an agency for managing the state owned-assets.

As the Programme years were dominated by fiscal consolidation agenda and the previous government was politically constrained to implement substantial reforms, **the government should intensify the pace and ambition of structural reforms**. Areas where insufficient progress/action has been taken are outlined in this review and in the staff Working Document released on 30 May (e.g., progress with the public administration strategy and the strengthening of the competition framework).

Although **the debt issuance** will be roughly doubled in 2013-15, the high demand for Latvian bonds witnessed at the Eurobond auctions in June 2011 and February 2012 indicates that the Treasury should be able to collect the required funding at favourable yields. The debt issuance prospects are supported by the projected improvement in the budget balance, stable public debt ratios, declining private debt ratios, improving credit ratings and overall sound macroeconomic indicators.

## 2. Prior Consultation under the PPS

The national authorities confirmed, when signing the last Supplemental Memorandum of Understanding in December 2011, their commitment under the PPS to consult with EU bodies on major policy intentions and to stand ready to discuss those with the EFC, should the Commission deem that such changes may jeopardise macroeconomic stability and thus Latvia's repayment capacity.

Before the PPS mission, there have been several occasions for **dialogue with the authorities** on implementation and policies looking ahead.

However, unfortunately, the government has decided after the PPS mission and without sufficient prior consultation of the Commission or the IMF, to reduce VAT by 1pp from July 2012 (to level it to VAT in neighbouring countries, but with an eye also on inflationary pressures) and in particular PIT by 5pp over 2013-2015. **The Commission** (and the IMF) **regret the action of the Latvian authorities going against the commitment on consultation laid down in the PPS Agreement.**

## 3. Macroeconomic developments and outlook

**Latvia's economy remains resilient to adverse external shocks** as GDP grew by 6.8% y-o-y in the first quarter of 2012, according to seasonally unadjusted data of the flash estimates. The figures thus indicate a further acceleration from the growth rate of 5.5% in 2011. However, the first quarter of 2012 was positively affected by one-off weather effects, in particular the construction sector, while the economic sentiment indicator in March and April point to a slowdown. According to the Commission 2012 spring forecast, growth is expected to decelerate to 2.2% in 2012 but there are substantial upside risks reinforced by the latest hard data. During the mission to Riga, the Bank of Latvia informed the EC and IMF teams that it revised upwards its growth forecast to 2.5% in 2012 from 1.3% while the ministry of finance kept its growth forecast at 2% but planned a significant upward revision after the release of the second GDP estimate in early June. The IMF mission staff revised its growth forecast to 3.5% in 2012 from 2% on better than projected hard data for the first months of the year. In 2013, growth is projected to pick up again to 3.6%, according to the Commission 2012 spring forecast, and the consultations during the mission show balanced risks to this projection.

**Exports and investments** are expected to remain the main growth drivers in the medium run while private consumption is set to rise at a lower rate due to continuous deleveraging in the retail banking segment. However, the recent decision of the parliament to cut VAT by 1pp as of July 2012 and personal income tax by 5pps over a three-year period starting from 2013 will boost domestic demand to higher than previously projected levels and risks to reverse the export-led growth to a model driven by private consumption.

The **harmonised index of consumer prices (HICP)** rose by 4.2% on average in 2011 after a decline of 1.2% in 2010. The index was strongly affected by hikes in VAT rates for selected items and by commodity prices of agricultural products and primary energy resources. The increase in the constant-tax price index is estimated at 2.7% in 2011. The annualised inflation rate slowed to 2.8% in April 2012 and is projected to fall to 2.6% on average in 2012, as the impact of the tax hikes in 2011 weakens substantially. Uncertainties related to commodity prices represent a significant risk to the inflation forecast, as the share of energy and unprocessed food is relatively large in the consumer basket. The VAT cut announced as of July 2012 is likely to have an immediate downside effect of 0.3-0.4pp[1] on consumer prices. On the other hand, the personal income tax cut of 1pp as of the beginning of 2013 would have a demand-pull inflationary impact of about 0.2pp.

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. In the first quarter of 2012, the unemployment rate edged up to 16.3% due to seasonal effects but continued to improve in annualised terms. Although this is a substantial improvement from the peak of 20% in the beginning of 2010, unemployment remains well above the EU average and about 50% of the job seekers are long-term unemployed. The rate is expected to drop further to 14.8% in 2012 and 13.2% in 2013 but the pre-crisis levels of 6-7% are not likely to be reached soon. After strong declines in the previous two years, **average nominal gross wages** increased by 4.4% in 2011. Wage growth is expected to remain moderate in 2012, supported by a freeze in the total wage bill for the public sector.

Following a substantial improvement in 2009-10, the cost competitiveness indicators of Latvia deteriorated somewhat in 2011. Both the **HICP- and the ULC-based real effective exchange rates** appreciated by about 1% in 2011 relative to major trading partners. Following a cumulative drop of about 20% in 2009-10, ULC relative to trading partners increased by 1.5% in 2011 but are expected to decline again in 2012-13. Meanwhile, various studies show a certain improvement in non-cost competitiveness indicators such as quality changes and product differentiation. This is also confirmed by the fact that exports in constant prices grew about 2% faster than imports of Latvia's trading partners in 2011.

[1] The cut in the VAT standard rate from 22% to 21% can have a maximal effect of 0.8pp on final prices as the cut of 1pp is applied on the pre-tax price base that is about 80% of the final price. The pass-through effect will be further offset by the new price equilibrium on the demand and supply curves and part of the tax cuts will result into higher profit margins of suppliers. A small share (about 2%) of the consumer basket will not be affected as the reduced VAT rate of 12% and the set of services exempted from VAT remain unchanged.

The **current account balance** swung to a deficit of 1.2% of GDP in 2011 as domestic demand rebounded substantially, driven mainly by corporate investments. However, the external account (i.e. the combined current and capital account) posted a surplus of 0.9% of GDP in 2011 and is expected to remain on small surplus in 2012-13. The GDP breakdown by demand components confirms the continuous rebalancing of the economy towards export-oriented industries. This process is however put at risk by the recently announced tax cuts that will tend to shift incentives towards consumption if not offset by increases in property, environment or excise taxes. **Net inflow of FDI** rose sharply to 5.2% of GDP, marking nearly a fourfold increase from a year earlier. **Gross external debt** fell to 146% of GDP at the end of 2011 from 164% a year earlier, supported by strong nominal GDP growth and continuous deleveraging in the banking system.

**Key macroeconomic data and projections (%, y-o-y),** ***EC 2012 spring forecast***

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| **GDP** | **-3.3** | **-17.7** | **-0.3** | **5.5** | **2.2** | **3.6** |
| Private consumption | -5.8 | -22.6 | 0.4 | 4.4 | 2.2 | 3.3 |
| Public consumption | 1.6 | -9.4 | -9.7 | 1.3 | 0.0 | 0.3 |
| Gross fixed capital formation | -13.8 | -37.4 | -12.2 | 24.6 | 6.0 | 10.4 |
| Exports (goods and services) | 2.0 | -14.1 | 11.5 | 12.6 | 4.5 | 6.3 |
| Imports (goods and services) | -10.8 | -33.3 | 11.5 | 20.7 | 5.1 | 7.5 |
| **Employment** | **0.9** | **-13.2** | **-4.8** | **3.4** | **0.7** | **1.2** |
| HICP | 15.3 | 3.3 | -1.2 | 4.2 | 2.6 | 2.1 |
| **GDP deflator** | **13.0** | **-1.2** | **-2.2** | **5.4** | **2.1** | **1.6** |
| Unemployment (year-average, age 15-74) | 7.5 | 17.1 | 18.7 | 16.1 | 14.8 | 13.2 |
| **Current account (% of GDP)** | **-13.1** | **8.6** | **3.0** | **-1.2** | **-1.8** | **-2.6** |
| **General budget balance (% of GDP)** | **-4.2** | **-9.7** | **-8.2** | **-3.5** | **-2.1** | **-2.1** |
| **General govern't gross debt (% of GDP)** | **19.8** | **36.7** | **44.7** | **42.6** | **43.5** | **44.7** |

## 4. Financial markets and monetary policy

Financial market conditions in Latvia generally improved further in 2012. Tensions in the euro area and the bankruptcy of Krajbanka created a temporary, moderate spike **in interbank rates** in late 2011. The 3-months RIGIBOR rose from below 1% to 2% in late-November 2011 (and early-January 2012), but it fell back to around 1% by late April. **Currency in circulation** increased by 28% in the year to December 2011 (+21% in March 2012), partly as a consequence of the Krajbanka bankruptcy and of unfounded rumours around the liquidity of Swedbank. **Broad money** (M3) growth was flat by March 2012 (+0% y-o-y) as deleveraging continued and new lending remained weak. The favourable market trend for treasuries broke in July 2011 as international financial markets came under renewed pressure.

Given its comfortable liquidity position, the Treasury initially put on hold the **domestic issuance of 10-year bonds** and later completely suspended domestic issuance for about two months at end-2011. Nevertheless, the yields on outstanding 10-year bonds weathered rather well the late 2011 financial turmoil. On 25 April 2012, the Treasury issued again 10-year bonds for an amount of LVL 6.1m with an average yield of 5.3%. The generally positive market sentiment towards Latvia was confirmed by a largely oversubscribed 5-year USD 1 billion **international issuance** in February 2012 with a yield of 5.375%. CDS spreads fell to around 200bp until mid-2011, but rose to close to 400bp towards end-2011, before receding back towards 200bp by end-March 2012.

**The exchange rate** has been trading on the strong side of the fluctuation band in 2012 (as of end-May). The Treasury's on-market conversion of its 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 presumably responsible for the strong exchange rate. Boosted by international bond issuances of the government, **BoL's international reserves** covered around 200% of base money at end-April 2012. The BoL left its **7-day and overnight deposit facility rates** unchanged at 0.375% and 0.25% respectively since November 2010. The BoL has also left steady the **refinancing rate** at 3.5% since March 2010, but lowered its marginal lending facility rates in March 2012. **The reserve requirement** was set at 3% for bank liabilities above two years and 5% for all other liabilities included in the reserve base from November 2008 until January 2012, when both were lowered by 1 percentage point to facilitate lending.

## 5. Financial sector

Further actions have been taken to **strengthen the financial system over the past months**. This included a closer supervision of the banking sector, in particular banks owned by non-EU entities and having high exposure to non-EU customers (additional capital requirements were introduced from July 2011 for banks dealing with non-resident flows), some progress with the sale of Citadele Bank and the orderly resolution of Parex Bank (its banking licence was revoked in March 2012 to optimise costs), starting of the sale of Mortgage and Land Bank commercial assets and measures to deal with issues emerged in the context of the Krajbanka fall-out (bankruptcy decision finally taken on 8 May which allows inter alia to start asset disposals).

During the mission the authorities were encouraged to accept financially reasonable offers received for **the commercial assets of the MLB**, as keeping the latter under state management is unlikely to result in bigger future benefits. If the price for some of the bundles is unreasonably low such assets may be given to the Latvian Privatisation Agency for work-out, with the latter conducted by the management of Reverta (former Parex Banka). The government is to decide in June on whether to accept the offered price and terms for MLB assets and how much additional state support may be needed (liquidity and capital). Depending on the adoption of these steps, the European Commission will decide on **the release of the remaining 150 m EUR** in the blocked financial sector account in the Bank of Latvia.

**On Citadele Bank**, the government took in late 2011 a decision to postpone the sale process of the bank (currently owned by the government) due to an unfavourable market situation. This decision was taken following preliminary consultations with potential buyers. The Commission team reminded the authorities of the need to respect the conditions in the DG COMP approved restructuring plan and to proceed with the bank’s sale as foreseen by the restructuring plan, once market conditions improve. As regards the plans to create an integrated **Development Bank**, the work of the Finance Ministry needs to be intensified. Decisions need to be taken soon as regards the remaining staff and branches of the MLB development part.

**The credit crunch** experienced during the crisis has abated in 2011 as house prices bottomed out and lending to export-oriented companies and household mortgages has started to recover. The **share of foreign currency lending**, almost entirely in euro, reached around 86% in the private sector by end-2011. The **management of savings of foreigners** deposited in Latvia, which represents an important business for domestic banks, has recovered quickly as confidence in the stability of the Latvian financial system has returned. The reliance on external funding, the main vulnerability of the Latvian banking system in the past, was reduced further over the past two years, but it remains substantial.

Despite still increasing gross **provisions for doubtful and bad loans**, the banking sector has returned to profitability in 2011. The surge of non-performing loans (due over 90 days) reversed since the second half of 2010 and their level reached 17.2% at the end of 2011. The Latvian banking sector is well capitalised due to additional **capital increases** by the owners during the recession. The average capital adequacy ratio of the banking sector reached 17.4% at the end of 2011.

## 6. Budgetary developments and outlook

**The general government deficit was 3.5% of GDP in 2011**, following deficits of 8.2% in 2010 and 9.8% in 2009, considerably better than both the initial deficit target set under the balance-of-payments assistance programme and the EDP recommendation (deficit of no more than 6% of GDP) and the revised deficit of no more than 4.5% of GDP set in the Fifth Supplementary Memorandum of Understanding signed in December 2011. This improvement reflects mainly:

(i) past consolidation efforts;
(ii) a more robust growth recovery than expected;
(iii) adherence to set expenditure limits with some savings;
(iv) lower capital transfers than in previous years (linked to exceptional banking sector support measures and the restructuring of state-owned companies).

**The deficit target for 2012 (2.5% of GDP) is likely to be over-achieved as well**. The Commission 2012 spring forecast of a deficit of 2.1% of GDP for 2012 reflects the robust tax revenue observed in the first months of the year. Macroeconomic data that became available after the cut-off date of the forecast, notably higher-than-expected economic growth in the first quarter, suggest that – without taking into account the impact of tax changes explained below – the estimate in the Commission spring 2012 forecast could be considered as cautious.

**The 2012 convergence programme of Latvia targets deficits of 1.4% of GDP in 2013, 0.8% in 2014 and 0.3% in 2015.** The strategy to deliver this adjustment involves continuous restraint in public sector wage bill (i.e. public sector nominal wage freeze) and further cuts in intermediate consumption, although the programme does not provide any information on specific measures to achieve these cuts in real government consumption. The Latvian authorities have in the past demonstrated the ability to implement large-scale expenditure cuts, although this has often been done in the form of "across-the-board" cuts. Such a strategy increasingly involves risks related to slippages in the implementation, excessive cuts in public employment being detrimental to efficiency, and uncompetitive wages which may lead to better performing employees quitting the public sector. The limits of this strategy are already visible in some sectors, notably healthcare and road maintenance. Moreover, the pressure to increase expenditure in several categories is quickly mounting. The Commission spring 2012 forecast expects the deficit in 2013 to remain broadly unchanged at 2.1% of GDP, based on the assumption of unchanged policies (i.e. not taking into account recent tax cuts announced after the cut-off date)[2].

**Tax cuts adopted by Parliament through the urgency procedure on 24 May 2012 are not reflected in the 2012 convergence programme adopted on 30 April, nor were EU bodies consulted prior to this decision.** According to these legislative changes, the standard VAT rate is to be lowered from 22% to 21% from 1 July 2012, whereas the personal income tax rate is to be lowered from 25% to 24% from 2013, to 22% from 2014 and to 20% from 2015. The fiscal impact of these decisions is expected to be as follows:

| | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|
| VAT (incremental impact) | -0.15 | -0.15 | | |
| PIT (incremental impact) | | -0.2 | -0.4 | -0.4 |
| **Total incremental impact** | **-0.15** | **-0.35** | **-0.4** | **-0.4** |
| **Total cumulative impact** | **-0.15** | **-0.5** | **-0.9** | **-1.3** |

*(Time-adjusted, % of GDP, Commission estimate)*

**These tax cuts were not accompanied by compensatory measures.** As a result, they put at risk the achievement of an improvement of 0.5% in the structural balance as required by the TSCG and the preventive arm of the SGP. The European Commission has previously recommended shifting the tax burden from labour to consumption, environment and wealth. However, the magnitude of these cuts, their uncompensated nature and the pre-announcement of the tax schedule for 2014 and 2015 go well beyond these recommendations. Moreover, given the high tax wedge in particular in the lower paid segment, the European Commission advised **lowering the labour taxation by raising the non-taxable minimum**, which is by far

[2] At the same time, the Commission forecast, as well as the 2012 convergence programme, take into account the planned increase of state contributions to the mandatory funded pension scheme to 6% of gross wages, compared with the current temporarily reduced level of 2%.

the lowest in the Baltics[3], rather than cutting the flat rate. Given that 80% of personal income tax revenue is received by local governments, there will be a need to ensure that the ability of municipalities to perform their main tasks is not affected.

With regard to the VAT tax cut, where the standard tax rate is currently the highest in the Baltics in Latvia (at 22%, compared with 21% in Lithuania and 20% in Estonia), it is worth recalling that – due to the comparatively higher share of informal economy in Latvia – the actual revenue remains low in relation to the tax base. Thus, the **implicit tax rate on consumption**, according to the 2012 Taxation Trends report, was 17.3% in Latvia, 18.2% in Lithuania and 25.6% in Estonia in 2010. These figures highlight the importance of fighting the grey economy.

## 7. Fiscal governance

Given the current underdeveloped nature of fiscal frameworks in Latvia, adoption of a **comprehensive Fiscal Discipline Law** has been one of principal parts of the programme conditionality; after several delays **the draft law was adopted by the government and submitted to Parliament in late 2011**. The draft law underwent further substantial changes in early 2012, following the first reading in Parliament in January 2012. The initial schedule envisaged the law to be adopted by mid-2012; however, there seems to be a risk of further delays to the process. Draft constitutional amendments to ensure higher legal standing of the Fiscal Discipline Law (and avoid the risk that the Fiscal Discipline Law can be overwritten in the annual budgetary process) were adopted together with the draft law itself, but given the higher degree of parliamentary support necessary for adoption of constitutional amendments, it has not yet been discussed by the legislative, while political consultations are on-going.

The initial draft of the Fiscal Discipline Law adopted by the government in late 2011 covered all principal elements discussed with programme partners, as explained in the note to EFC following the fifth review mission under the programme. Amendments to the draft law following the first reading, which took place in January 2012, seek to **bring the current draft in full compliance with the evolving EU *acquis* on economic governance**, notably the adoption of the inter-governmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as well as the entry into force of legal acts strengthening the Stability and Growth Pact ("six-pack"). These changes notably involve replacing the previous balance rule (based on long-term average growth rate) by the rule based on structural balance; provisions incorporating the medium-term expenditure benchmark; provisions establishing a mechanism for treating deviations from the adjustment path or MTO; and provisions establishing the Fiscal Council. The latter will be the principal body in charge of monitoring compliance with the rules and is expected to provide analysis related to practical implementation of the budget balance rule (without, however, producing separate macroeconomic forecast). The state-of-play with regard to fiscal rules in Latvia has been discussed during the EPC interim peer review of national fiscal frameworks on 23 May 2012.

Provisions enabling the use of **binding multi-annual expenditure targets** have already been adopted and it is expected that the first medium-term framework law involving rule-based and binding multi-annual expenditure ceilings will be implemented from the 2013 budgetary cycle, following the adoption of the Fiscal Discipline Law.

[3] The basic monthly exemption is LVL 45 (EUR 64) in Latvia, compared to EUR 144 in Estonia and LTL 470 (EUR 136) in Lithuania.

However, the recent tax cuts described above, which were adopted in the mid-year outside the regular budgetary process in response to better-than-expected tax revenue, and which could potentially have a pro-cyclical impact on the economy, **contrast with basic principles of the draft Fiscal Discipline Law currently considered by Parliament**.

## 8. Implementation of the SMoU structural reform conditionality

During the BoP financial assistance programme, **Latvia has implemented far-reaching structural reforms aimed at enhancing the country's competitiveness and potential growth**. The pace of reforms stalled somewhat in 2011, due to political difficulties, which have ultimately led to new elections in 2011. While the re-elected government is showing significant energy in its strive to reform the public sector and the economy at large, this effort needs to be sustained and focused on measures that will further improve the underlying factors of both cost and non-cost competitiveness of the economy.

**The main challenges for the government**, as presented in the latest National Reform Plan (NRP) and Convergence Programme (CP), are to continue reducing budget deficit and debt levels, refocus and adequately finance active labour market policies, reform and better target the social safety net, improve the judiciary system and the economy's energy efficiency, strengthen the capacity to monitor and enforce competition, and continue reforms in higher and vocational education.

**While progress is remarkable in many areas, the PPS mission revealed less progress than expected as regards several conditions included in the latest Memorandum of Understanding**, notably on management of state owned enterprises (SOEs), public administration and the unified public sector wage grid reforms, strengthening of the competition framework, and setting up of the Development Bank.

As regards **SOE management**, the government has decided in mid-May that the unified SOE management agency under the PM would be established from January 2013 with around 10 experts (the law package to establish the SOE manager will be submitted to the Parliament on 4 September). The agency would deal with transparency issues (publish quarterly accounts of SOEs), promote good governance principles and monitor the performance of SOEs. Shares of some small state companies and minority shares are to be transferred to the SOE manager from January 2013; however the decision on transfer of more significant state assets to the manager will only be taken at the end of 2013. The same applies to converting selected SOEs into state agencies (which would provide more control over their budgets/performance) and selling of minority rights; little of this would happen in 2013. While it is commendable that big steps have been taken in this field after years of delays, the adopted plan departs in terms of content and timing quite substantially from the SMoU conditionality, which foresaw transferring key assets to the SOE agency already before April 2013. In particular, the current plan does not include any comprehensive strategy in relation to the management of state assets, likely resulting in a piecemeal approach. The authorities argued that the steps taken in 2013 would allow a controlled transfer of assets to the new management to minimise risks and assess the progress, before the bulk of the assets is transferred.

As regards **state real estate management**, the Finance Ministry has taken a decision that public institutions that want to rent premises from private parties will first have to prove that no similar rent space was available from vacant public real estate. Also, it has been decided that any new real estate projects would have to be included in the state budget and the Finance Ministry would be the central institution overseeing any public real estate development plans. The proposal for rent market pricing for public institutions has been dropped, while some real estate divestments are planned for next years.

There has been rather little progress and the authorities are again to miss a SMoU deadline for preparing a **public administration strategy,** which should include elements like staff motivation, remuneration, training, preparing the 2015 EU Presidency, staff selection, performance appraisal, etc. As regards changes to the **unified wage grid** to increase the salaries for the lowest paid employees (social workers, policemen, nurses, etc) and reward the best-performers, the authorities are unfortunately not planning anything substantial. The Commission team proposed that private experts may need to be invited to propose reforms to the unified wage grid. As regards **expanding the subsidiarity principle** to ministry/EU funds Managing Authority/Cabinet of Ministers level, thus making the overall decision-making more effective and faster, the authorities are considering possible options (also in view of Constitutional restrictions).

The **strengthening of the competition policy framework** remains an on-going challenge, albeit there has been some progress recently, in particular as regards strengthening the administrative capacity of the Competition Council; the number of market studies and investigations is on the rise. The Commission emphasized the need to strengthen the capacity of the Competition Council further to perform more active, targeted market surveillance and to address existing monopoly power in network industries, including electricity, heating and natural gas supplies. There are also concerns of insufficient competition in the fields of road construction and maintenance as well as rail freight transportation. Further strengthening of the competition framework could also provide a valuable instrument to reduce inflationary pressures in a sustainable way.

Regarding other issues more progress has been made although this has happened partly with some delays and several steps and decisions are still to be made.

The authorities have implemented most of the **grey economy strategy** actions, however this happened with some delay and their effectiveness is hard to judge. Nevertheless, the State Revenue Service is being gradually strengthened both in terms of the staff number and their competences; some reorganisation is planned to improve coherence between tax control and tax audit functions. With a view to strengthen internal control standards, the Ministry of Justice developed the concept of administrative penalty.

The Welfare Ministry has introduced significant changes as regards **active labour market policies and training of the unemployed**, and also made preliminary proposals on the **reform of social assistance**, part of which is expected to be implemented in 2013. These represent crucial areas and although results will need time to materialise, the commitment of the government to tackle key challenges is welcome.

The authorities have also started work on the **preparation for the new EU financing period**, including simplification of the **EU funds** management system and concentrating resources on fewer priorities. The big challenge is to decide as soon as possible on the institutional model for 2014-2020 as this affects many ministries/institutions. In line with the Memorandum condition, the Transport Ministry is introducing improvements in **the road construction quality system** and additional financing was allocated for the maintenance of EU co-financed roads. Also, the **Construction Law** is in second reading and should be adopted by October (some construction procedures for local governments have already been simplified in July 2011).

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 about which the government is in contact with DG COMP. The mission was presented with the new Air Baltic business plan prepared by Boston Consulting Group that takes into account the recent capital increase and aims to return the company to profitability by 2014 and, in the meantime, attract a foreign investor.

The Commission encouraged the on-going reforms in **education and social protection**. In the education sector, efforts should be focused on the tertiary education and vocational education and training with the aim of strengthening the links with the business sector and addressing the high long-term and youth unemployment. The social protection system needs to be better targeted at the poor while at the same keeping employment incentives.

## 9. Convergence process

Upon the request of the Latvian authorities, the on-going exercise of the convergence report was discussed. The Commission team emphasized during the mission that **publicly questioning the convergence assessment methodology and its application is not helpful**[4]. The Treaty framework for the assessment of convergence has proven flexible enough to deal with various situations in the past and will be applied in 2012 (and in future) based on careful judgement and equal treatment.

As regards the **inflation criterion**, given the uncertainties in particular on the evolution of exogenous factors such as commodity prices, the objective of the Latvian authorities should be to ensure a durably low inflation through, for example, strengthening market surveillance capacities of the Competition Council, rather than trying to "target" any particular inflation rate next year (including through VAT cuts) or focusing unduly on the reference value. The inflation criterion is not mechanical, but, very importantly, includes an assessment of sustainability. In this perspective, it was stressed that measures that attempt to fulfil the criteria which neglect or even counteract the need to sustain or improve competitiveness and the sustainability of the fiscal adjustment may be detrimental for **the qualitative assessment of Latvia's readiness to join the euro**.

Apart from necessary efforts to get fit for the euro, the authorities may need to consider enhancing **communication activities** to the general public, as the support for the euro has reached historical lows: the latest survey showed only 15% of the population being in favour of euro adoption.

[4] There had been several recent press reports and statements by key Latvian policymakers blaming the ECB and the Commission that the treatment of programme countries in calculating the inflation reference value would be unfavourable for Latvia's prospects, although, based on the 2012 Convergence Report, the choice of calculation method will not make a difference at the upcoming assessment and is unlikely to make a difference at a possible assessment next year.

## 10. Assessment of repayment capacity

According to the schedule agreed under the international financial assistance programme, **Latvia's repayments will peak in 2014-15** with principal repayments of 5.3% of GDP in each year. In 2012-13, the major part of liabilities to the IMF will be repaid while the debt service to the EC will commence in the beginning of 2014.

**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 | 236.6 | 355.0 | 164.1 | 45.7 | | | | 801.4 |
| WB | | | | 42.2 | 168.6 | 56.2 | 14.1 | 281.1 |
| **Total** | **236.6** | **355.0** | **866.9** | **931.3** | **168.6** | **407.6** | **154.7** | **3,120.7** |
| Total, % of GDP | 1.6% | 2.3% | 5.3% | 5.3% | | 2.00% | | |
| **Treasury balance,** end-period estimate | **763** | **1,189** | **1,546** | **446** | | | | |

In the first quarter of 2012, Latvia has already repaid LVL 57m to the IMF with full-year principal payments scheduled at LVL 236.6m (1.6% of GDP). So far, **the outstanding position of the government reserves provides a full coverage of the scheduled payments of the programme loans coming to maturity in 2012-13** (relates to financing provided by the IMF), as the government has successfully issued a USD 1bn Eurobond in February 2012 to cover budget financing needs and to pre-fund debt service payments. As of the end of April 2012, **the outstanding balance of the Treasury stood at LVL 1.1bn covering two years of debt service**.

**The government intends to continue tapping international debt markets in 2013 to partly pre-fund the debt service in 2014-15**. This approach will avoid a concentration of large debt issues over a short period of time and will therefore reduce exposure to short-term market volatilities. The sound reserve position allows flexibility in terms of bond issuing timing and provides the Treasury with options to tap the markets at favourable terms.

**Although the debt issuance will be roughly doubled in 2013-15**, the high demand for Latvian bonds witnessed at the Eurobond auctions in June 2011 and February 2012 - the debt offer in February was overbid 5 times - indicates that **the Treasury should be able to collect the required funding at favourable yields**. The debt issuance prospects are strongly supported by the projected improvement in the budget balance, stable public debt ratios, declining private debt ratios, and overall sound macroeconomic indicators. The debt issuance prospects are further supported by the decision of S&P on 2 May 2012 to upgrade Latvia's long-term foreign currency rating by one notch to BBB-, stable outlook. **Latvia now has investment grades by all three mainstream rating agencies.**

On the downside, the recently proposed tax cuts, if not offset by other fiscal measures, will not allow the government to implement **a more ambitious deficit reduction strategy and reduce the overall refinancing needs further**, especially in 2014-15 when the concentration of programme repayments is the highest.