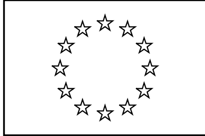


EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 17 June 2013

EU BOP ASSISTANCE TO LATVIA –

THIRD REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

Since the last PPS visit in November 2012, economic and budgetary performance, including budget control, has been commendable. The headline deficit declined to 1.2% of GDP in 2012, with the medium-term budgetary objective of 0.5% of GDP reached in that year. However, pressure to spend is likely to grow in the coming months. A new fiscal framework has been in place since earlier this year but has not been tested yet; the 2014 budget will show its actual clout.

The assessment of post-programme policies is mixed and not re-assuring. Overall, there is little progress on big-item reforms where significant confrontation risks exist with coalition partners or strong vested interest groups (e.g., reforms of higher education and science, health, public administration and management of state owned assets). The focus may be on eliminating any political risks ahead of local elections and the euro adoption decisions in summer. Decision-making procedures appear to be long, in particular as regards the review of important legal texts by Parliament (e.g., Construction, Insolvency, Public Procurement, SOE and other laws). Smaller-scale and less controversial structural reforms (e.g., EU funds management, refinements to ALMPs and judicial procedures, finalising sale of the Mortgage and Land Bank) seem to be pushed forward and prospects for further reforms appear rather good, primarily supported by increased quality of policy-making.

Progress of some on-going reforms seems slow and preparations to match upcoming deadlines should be advanced. This concerns, inter alia, the fields of energy liberalisation/independence and energy efficiency, better targeting of social assistance based on the results of the World Bank study (to be implemented from the 2014 budget), inadequate funding and coverage of active labour market policies, implementing professional management of state-owned enterprises from January 2014, long-overdue higher and vocational education reforms, establishing a single development institution, reforming public administration and improving the efficiency of the judicial system; unfortunately, some of the mentioned reforms are still “left-overs” from the BoP programme. In particular, implementing first elements of the Third Energy Package related to third party access to gas infrastructure by April 2014 will be a true test for the government and show its resolve in implementing commitments vis-à-vis the EU.

While risks associated with increasing non-resident deposits are acknowledged, despite recent measures there is a need for close monitoring, applying the available tools more systematically and being ready to reinforce the regulatory framework. It cannot be excluded that additional regulatory measures, in consultation with ECB and COM, will be needed to further reduce financial risks from non-resident deposits. Capacities for tackling financial crimes and tax evasion need to be significantly enhanced, in particular as regards implementation of anti-money laundering procedures.

The economy has proven quite resilient to external shocks and is currently the fastest growing in the EU, but some downside risks are also emerging. Nevertheless, the economic performance is still in line with the 2013 spring forecast for economic growth of 3.8% in 2013 and 4.1% in 2014, while the labour market survey for the first quarter of 2013 exceeds expectations.

There are no indications that the authorities would face any difficulties in financing upcoming repayments of the EU loans in 2014-15.

1. Introduction

From 2009 to 2011, Latvia benefited from a financial assistance programme (Balance of Payments Support) from the EU, provided in conjunction with an IMF stand-by agreement and financing commitments by the World Bank, the EBRD, several EU countries and Norway. Funds available amounted to EUR 7.5 billion, of which Latvia used EUR 4.5 billion (60%), with EUR 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.

Following the successful conclusion on 20 January 2012 of the three-year financial support programme by the EU, the third Post-Programme Surveillance (PPS) mission to Latvia was carried out by Commission services from 13 to 15 May, together with the ECB/ESRB. As Latvia has repaid the IMF loan fully, more than two years ahead of the original schedule, the IMF was not part of the mission. PPS missions are scheduled to take place twice a year until 75% of the EU loan provided to Latvia will be repaid (expected in 2015).

The main goal of the visit was to assess progress in key fiscal, social, financial and structural areas since the last PPS visit in November 2012. In particular, measures to reduce risks from the growing non-resident banking sector were discussed together with the ECB and ESRB colleagues. Also, policy actions planned and taken to address Country Specific Recommendations (CSRs) were discussed in key meetings: social assistance, higher education, energy efficiency, and judicial reforms. Economic outlook, debt refinancing and repayment capacity were addressed during discussions with public and private institutions. In addition, a meeting with Sigulda municipality was organised to hear local government and local business views on key issues.

2. Macroeconomic developments

The Latvian economy has proven quite resilient to the recent external shocks and is currently the fastest growing in the EU. Real GDP rose by 5.6% in 2012, accelerating from 5.5% in 2011. The 2013 Commission spring forecast points to a slowdown in the growth rate to 3.8% in 2013 and 4.1% in 2014 amid a weak external environment. Recent high-frequency indicators confirm the expectations for some slowdown at the beginning of 2013 but economic sentiments remain strong, shaping up broadly balanced risks to growth in 2013-14. According to the Eurostat flash estimate for the first quarter of 2013, Latvia's seasonally adjusted GDP increased by 1.2% q-o-q and 5.6% y-o-y. However, the seasonally unadjusted growth slowed to 3.1% y-o-y. Overall, the data for the first quarter of 2013 looks broadly in line with the 2013 spring forecast and the carryover stemming from the seasonally adjusted time series is even better than projected.

However, certain downside risks have materialised with the reduced production in the metal processing plant Liepajas Metalurgs and weaker than expected GDP growth in Estonia, which is the second largest export market for Latvia. Liepajas Metalurgs accounts for 0.6% of the gross value added in the country and indirect effects to local contractors and incomes of about 2,500 employees can bring the total impact on GDP to about 1%. The current baseline scenario of local analysts is that the company may undergo a 50%

downsizing. Under this assumption, the negative effect on GDP growth would be around 0.5 pp. in 2013; this is already taken into account in the 2013 spring forecast. The risks stemming from Estonia's import demand are difficult to quantify at this stage as quarterly data are quite volatile and often subject to backward revisions. On the upside, positive effects could be expected from the construction sector where property developers have resumed work on some of the projects that were frozen during the crisis in 2008-10.

The annual average inflation, measured by the harmonised index of consumer prices (HICP), slowed to 2.3% in 2012 from 4.2% in 2011 as the effects of previous tax hikes and commodity price shocks faded away. The annualised rate even dropped to -0.4% in April 2013 helped, among others, by the government decision to cut the standard VAT rate from 22% to 21% as of July 2012. In 2013 and 2014, inflation is forecast at 1.4% and 2.1% 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 from 16.2% in 2011 to an average of 14.9% in 2012. Unemployment improved further to 12.8% in the first quarter of 2013, marking a decrease by 3.5 pp. from a year earlier while employment surged by 4.7% for the same period. After a continuous contraction in previous years, labour activity rose substantially in 2012 and early 2013 as discouraged persons returned to the labour market and the flow of net emigration declined significantly. Latvia's unemployment rate remains the only flashing indicator in the MIP scoreboard on internal imbalances but the recent improvements on the labour market indicate a faster-than-projected convergence towards the euro area average.

The Current Account (CA) deficit contracted from 2.4% of GDP in 2011 to 1.7% in 2012. The external account (i.e. the combined current and capital account) was positive at 1.3% of GDP in 2012. Moreover, exports grew much faster than imports in 2012 and the trend was sustained at the beginning of 2013. The 2013 spring forecast points to a relatively modest expansion of the CA gap to 2.1% of GDP in 2013 and 2.6% in 2014, amid increasing imports. Non-debt transfers in the capital account are expected to fully offset the CA gap and to keep the country's net lending position on a small surplus.

3. Public finances

The outlook for public finances remains in line with expectations in the Commission's 2013 spring forecast. The preliminary results of the first four months confirm that public finances remain overall strong, with most revenue categories performing broadly in line with budgetary plans, i.e. without noticeable over-performance that characterised previous years. The tax revenue could be positively affected in the second half of 2013 and in 2014 by the implementation of the "tax support measure", which allows settling tax arrears accumulated at the peak of the crisis without full penalty, subject to strict conditions. On the other hand, in addition to risks related to the possible economic slowdown, there are some specific fiscal risks which could materialise already in 2013. The most prominent of these is the risk that the state could face assumption of debt of Liepajas Metalurgs, amounting up to 0.3 pp. of GDP, and likely other costs related to this company.

The pressure to increase spending is growing. The recently adopted Fiscal Discipline Law is offering the first line of defence against pro-cyclical loosening of the fiscal policy; the budgetary process of 2014 will provide the first test for the practical implementation of the

new law and will thus show its actual clout. The no-policy-change outlook for 2014 in the Commission's 2013 spring forecast reflects, on the one hand, the 2 pp. cut in the personal income tax rate and, on the other hand, a legislated increase in the statutory pension age by three months annually from 2014 as well as maintaining the pension indexation freeze until late 2014 in line with current legislation. However, there has been a discussion in the country whether the pension indexation could resume earlier, while other priorities are likewise "queuing" for available fiscal space; the latter will be defined during the 2014 budgetary process as the difference between costs of on-going projects and policies (so-called "base expenditure") and the fiscal target defined according to the top-down approach.

Reducing taxation for low-income earners is another priority which could materialise in the 2014 budget. The Ministry of Finance is preparing a proposal for differentiated personal income tax exemption, which would establish some progressivity in labour taxation. If implemented, this will be a step towards addressing the problem of high tax wedge on low income earners that the Commission has previously highlighted. However, it is still unclear whether this proposal will materialise or what would be the offsetting measures.

4. Social and active labour market policies

Although there have been notable improvements in the labour market, high unemployment remains the most pressing issue, alongside social inequality. The funding and coverage of active labour market policies (ALMPs) is still insufficient considering the high number of long-term and young unemployed, and the roll-out of new ALMPs is too slow. Families with children and the unemployed are particularly vulnerable to poverty. Child and family related benefits are poorly targeted as a large share accrues to the wealthiest part of population. The social assistance system portrays high disparities across local governments, weak incentives to work and insufficient conditionality on benefit recipients. There are also concerns about social assistance benefit adequacy and coverage.

As of January 2013, the level of the guaranteed minimum income (GMI) was decreased and state budget financing of the GMI benefit was abolished. These decisions were seemingly taken without analysis of their impact on incentives to work and poverty and prior to the results of two studies on social assistance. Encouragingly, Latvia has partially addressed the problem of low coverage of unemployment benefits and, with a view to an improving demographic situation and helping poorer families, the sliding scale cap for maternity/paternity allowances, minimum monthly paternal and child care benefits, and PIT allowance for dependents were increased, while additional support for kindergarten services was provided.

The mission reiterated that high social inequality has to be addressed already within the 2014 budget; however any significant changes in social assistance policy need to be based on recommendations of a just finalised comprehensive World Bank social system and ALMPs study. On 3 June a high-level conference will be held in Riga to present the World Bank findings, while the Welfare Ministry has been tasked to present to the Cabinet of Ministers proposals for changes in the social security system by 1 August. The authorities have already announced that measures like increasing the minimal salary, non-taxable PIT thresholds for low-paid and dependents and support for certain groups will be implemented in the framework of the 2014 budget.

5. Financial sector

The mission team reviewed the latest steps of the sale of the "problematic" commercial asset bundles of MLB (Mortgage and Land Bank), especially bundles 3 and 4. The mission team reminded that the MLB sale process had already taken a very long time, and it would be better for the authorities to accept financially reasonable offers received for the remaining commercial assets, as keeping them under state management would unlikely result in bigger future benefits. However, it appears that bundles 3 and 4 will not be sold due to the allegedly low price offered by private investors, but instead transferred to the Latvian Privatisation Agency, which will conclude a wind-down agreement with Reverta (bad bank of the split Parex bank).

It remains unclear how MLB intends to operate in the future and what resources will be necessary: this concerns the number of branches and development lending experts, availability of international financing, etc. An open competition should be organised to attract a management team with, inter alia, extensive experience in development bank activities.

There has been little progress as regards the setting-up of a Single Development Institution (SDI). The institution's aim is to implement state aid programmes through financial instruments currently handled by the MLB, the Latvian Guarantee Agency, and the Rural Development Fund. On April 2, 2013 the Cabinet of Ministers approved that creation of the SDI will be a «two-step merger model» into the SDI holding, which should be established by end of 2013. The Ministry of Finance is appointed as a future shareholder of the institution. The current proposal also involves setting-up a joint consultative/strategic council on top of these institutions that would set overall goals and deliverables. Timely setting up of the institution is particularly important in view of the new EU funds financing period, where emphasis on financial engineering programmes/instruments may be significant. The team encouraged the Finance Ministry to intensify work in this regard.

The authorities were encouraged to devote more financial and human resource capacities and attention to tackling complex economic, financial, money laundering and tax evasion crimes, in view of very few conviction cases in the last two decades and many public financial scandals. In many cases, the knowledge and skills of relevant authorities might not be adequate to successfully investigate, prosecute and punish complex and elaborate financial fraud schemes, which are often of international nature (off-shore companies, trusts, correspondent accounts, etc.). There is evidence that institutions like the State Police Economic Crime Prevention Unit and the Financial Police have inadequate resources to offer attractive remuneration and keep or hire experienced and well qualified staff.

Finally, another emerging challenge with significant social implications is containing and enhancing the monitoring of **non-bank lending activities**.

5.1. Non-resident banking

Latvia has a long tradition and several competitive advantages in servicing non-resident banking clients, mainly corporates from CIS countries. While there was a drop in this business during the financial crisis, it has fully recovered by 2012 and around half of the banking system's total deposits stems from non-residents. Although this part of banking is a characteristic element of the Latvian financial market, neither the share of total banking assets

relative to GDP (128% in Latvia versus 359% in the EU on average in 2012, see annex 1) nor the share of non-resident banking within these assets is extraordinarily high when compared with some other EU Member States. As of end-2012, non-resident deposits account for about 40% of GDP or around half of the banking system's total deposits. In nominal terms, the stock of non-resident deposits increased by 16.8% in 2012 and 12.1% y-o-y in April 2013.

There seem to be significant country-specific advantages for Latvia to continue growing as a popular non-resident banking destination for CIS customers: language, geographical proximity, EU membership, experience with CIS customers, clear and fast procedures related to anti-money laundering compliance, labour-intensive business requiring extended working hours, etc. Also, the tax treaty with Russia on avoidance of double taxation (which came into force in January 2013) and the continued selling of residence permits in exchange for investments are expected to further boost the trend, including moving Russian/CIS corporate registration to Latvia.

The non-resident banking segment is heavily concentrated in three banks – ABLV, Rietumu, and the state-owned Citadele (established in the context of unwinding Parex Banka after the fall-out in Autumn 2008) – which control about two-thirds of the total assets and deposit values of the segment. ABLV and Rietumu are strongly focused on non-resident services with most of their assets and liabilities being defined in this category. ABLV and Rietumu banka are owned by private individuals, thus recapitalisation risk can be an issue, as owners' capacity for raising capital may be lower than for Scandinavian owned banks, where the parent companies have already demonstrated strong financial commitment during the crisis in 2008-10 (as evidenced by the Parex case).

Because of the cross-border nature of business both on the asset and liabilities side, **non-resident banking may entail higher risks compared with banks focused on domestic clients**: this includes possibly higher credit and operational risks (differing regulatory framework, enforceability of contracts, concentration of exposures, etc.), liquidity risk (possible volatility of funding), reputational risk (knowing non-resident clients business/background) and others. The Commission has encouraged the authorities to follow closely what kind of financial flows are attracted, where they are invested, what the activities of non-resident banks in the domestic market are, etc. In particular, it must be noted that the business, legal and regulatory environment in CIS countries may be weak and CIS investments/loans may call for caution (borrowers' creditworthiness, enforceability of collateral, etc.). Also, the regulator's attention should be paid to capital hikes where the source of financing may be coming from loans between related entities/persons.

The ECB/ESRB colleagues took part in meetings on non-resident banking, outlining issues which the authorities should give consideration to in the nearest future, including (i) better capturing macro-prudential risks through balance sheet tests and stress tests, (ii) ensuring proper funding mechanisms for the deposit insurance scheme, (iii) ensuring effective resolution and recovery tools, (iv) further strengthening the monitoring of macroeconomic imbalances that could threaten financial stability (adequate risk management in banks, re-consideration of policies/incentives for attracting non-resident deposits, making attraction of sight deposits more stringent), and (v) ensuring the highest levels of anti-money laundering standards.

The authorities have already implemented several measures to reduce the risks of this sector: on top of the capital add-ons (beyond Pillar 1), higher individual liquidity

requirements (40-60% liquidity ratio) for banks dealing with non-resident deposits were introduced in February 2013, a macro-prudential stress test was performed, and amendments were proposed to the Deposit Guarantee Law. The main supervisor, the Financial and Capital Market Commission (FCMC), also monitors these banks more actively, including their internal risk assessment procedures, asset quality, collateral enforceability and accessibility of correspondent accounts. Still, the authorities may have to consider additional regulatory measures and a more systematic use of available instruments (e.g. stress tests), in consultation with ECB and COM, to further reduce financial risks from non-resident deposits and improve money laundering/tax evasion controls.

5.2. *Anti-money laundering framework*

The Financial Intelligence Unit (FIU) under the supervision of the General Prosecutor and the FCMC are the main institutions tasked with the anti-money laundering (AML) fight. In July 2012, the MONEYVAL Committee of the Council of Europe adopted an evaluation report, which concludes that, while Latvia's legislation and institutional setup are largely compliant with the international AML standards, several loopholes exist as regards implementation, including too high proof needed for prosecuting offences, weaknesses in customer due diligence assessments, questionable effectiveness of sanction regime, inadequate training and capacities of institutions dealing with offences. For example, the FIU annually receives notifications on more than 30,000 unusual or suspicious transactions from the financial institutions. However, as these, according to MONEYVAL, mostly rely on schematic indicators without paying sufficient attention to relevant circumstances, a large number of these reports may provide little analytical value.

In response, the Council for Financial Sector Development chaired by the Prime minister has approved on 28 March 2013 an action plan for implementing recommendations of the MONEYVAL report. The FIU is tasked with monitoring the implementation of the action plan and different measures are assigned to various institutions directly or indirectly involved in fighting financial crimes. As part of the measures, the government is committed to increase the financing and human resource capacities of the main AML institutions and make legislative changes to the somewhat outdated AML framework. The Council for Financial Sector Development is expected to review the implementation progress in September 2013.

Also, it appears that the biggest non-resident banks are particularly diligent as regards compliance checks and risk prevention related to correspondent accounts with big US banks. As most non-resident deposits/transactions are in USD, local banks are particularly cautious to avoid risks of losing their US correspondent accounts. The main non-resident banks (ABLV, Rietumu) claim to devote significant attention to "know your customer" compliance checks and regularly invite professional outside expertise to review their risk assessment procedures and to eliminate any risks to their USD dealings. Also, the Latvian Private Banking Association, which comprises the main banks engaged in non-resident banking business, seems to advocate efforts to further train and assist their members in properly applying AML procedures.

6. Structural policies

A comprehensive Commission staff assessment of Latvia's reforms was published on 29 May: the Staff Working Document assessing Latvia's National Reform and Convergence

Programmes. It shows that Latvia has made some progress on measures to address the Country-Specific Recommendations by the Council. While progress in several fields has been slow in recent months, overall prospects for future implementation still appear to be encouraging, due to improved policy-making and broad support for reforms. As regards the social assistance system, ambitious reforms are needed to address poverty and social exclusion. The proposed reforms in the education and science sectors respond well to the challenges identified by the Commission, though implementation will be difficult. Liberalisation of the electricity market is a positive step, though further action is needed to prepare for the opening of the gas market, improve energy efficiency performance and implement a stable, transparent and cost-effective support scheme for renewable energy. Further efforts are needed to expand the reach of active labour market policies (ALMPs) to address high long-term and youth unemployment, continue to make improvements in judicial procedures and the Insolvency Law, and to implement credible public administration reforms (management of human resources and of state-owned assets). Regrettably, decision-making procedures regarding key structural reforms appear to be long, in particular as regards reviewing of important legal texts by the Parliament.

7. Repayment capacity

Latvia's debt repayment capacity has further improved since the early repayment of all outstanding liabilities to the IMF in late 2012, as the economic and fiscal performance has exceeded expectations and the cash balance of the Treasury relative to outstanding liabilities has been rising. As of end-April 2013, the cash balance of the Treasury stands at LVL 1.1 billion (EUR 1.5 billion) covering almost the full amount of debt repayments by the end of 2014. The accumulated cash buffer is more than sufficient to meet the forthcoming repayment of LVL 703 million (EUR 1 billion) to the Commission in early 2014 while the bond issuing conditions for the country remain favourable with long-term yields (10-year) staying below 3.5% for both domestic and foreign-traded securities. The long-term interest rate, as reported by the ECB on the basis of the domestic secondary market, declined to 3.2% in April 2013 from 5.1% a year earlier. Yields on global Latvian bonds were only marginally higher. The current market conditions and the reduced debt service profile after the early repayment to the IMF in 2012 are providing significant options to the Treasury to reduce debt service costs that would have further positive impacts on the general budget position.

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

	2012	2013	2014	2015	2016-18	2019	2020-25	Total
EU			**702.8**	**843.4**		**351.4**	**140.6**	**2,038.2**
IMF	810.5							810.5
WB				42.2	168.6	56.2	14.1	281.1
Total, LVL mn	**810.5**	**0.0**	**702.8**	**885.5**	**168.6**	**407.6**	**154.7**	**3,129.9**
Total, % of GDP	5.2%		4.0%	4.8%		2.0%		

The Treasury is planning to issue international bonds in various denominations in the amount of LVL 800 million (EUR 1.15 billion) by the end of 2013 that will also cover the second major repayment to the Commission in early 2015 when Latvia is expected to have repaid more than 75% of the EU loan. The timing of the bond issuance will depend on the market conditions as the Treasury also expects rating upgrades and the high liquidity position allows flexibility for selecting optimal debt issuing cycles. Options are evaluated for issuing bonds denominated in EUR and USD. In the latter case, currency swaps will be immediately

purchased to avoid exchange rate risks. The Treasury is also considering small debt issuance on niche markets provided that cost savings could be achieved in medium term.

As it was the case in previous reviews, **the mission team supported the government's policy of pre-funding debt repayments** in order to avoid concentration of large debt issues over a short period of time and therefore reduce exposure to short-term market volatilities. The overall conclusion of the mission is that the low yields on Latvian bonds as well as the solid fiscal and economic performance indicate that the Treasury should be able to collect the required funding at low cost. There seems to be low and declining refinancing risks amid favourable forecasts on budget deficit, debt ratios, and overall economic performance.

8. Medium-term commitments for a continuation of the structural reform policy: possible list of topics

To safeguard continuous structural reform policy, the mission encouraged the authorities to commit themselves to, inter alia, conduct responsible fiscal and economic policies, continue implementing competitiveness-improving structural reforms (Europe 2020), implement prudent financial supervision and contribute to measures/initiatives to further strengthen economic governance and surveillance. These points are frequently linked to the application to adopt the euro; while the mission team emphasised that this discussion is not within the remit of the PPS visit, there is some overlap in substance. Below are some of the key elements the authorities might reflect in their further reform agenda:

- *Sustainability of economic and fiscal developments and the strength of competitiveness; keeping up the momentum of the process of structural reforms (tackling social inequality, education reform, strengthening HR management in the public sector, reformed management of state-owned enterprises);*

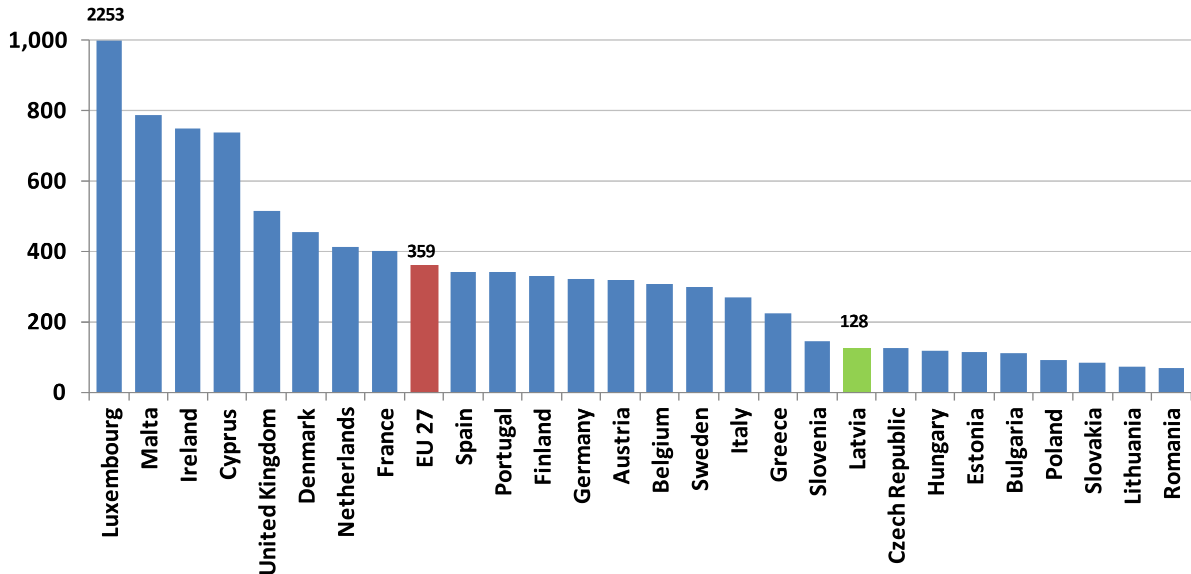
- *Further strengthening of the financial sector, including quality and efficiency of macro-prudential oversight, in particular regarding non-resident banking; anti-money laundering measures; completing the privatisation process;*

- *Quality of institutions (e.g., the State Police Economic Crimes Unit, Financial police, Financial Intelligence Unit, Competition Council, Single Development Institution, etc.);*

- *Implementation of more demanding obligations for Euro Area member states (six-pack, two-pack, the fiscal compact, ESM): eventual implementation;*

- *Constructive participation and fulfilling of obligations arising from the building of genuine EMU: starting with the Single Supervisory Mechanism.*

ANNEX 1 - Size of the banking sector in EU Member States (end 2012, %)



Source: ECB BSI, Eurostat, BoL calculations
Eurostat GDP data forecast for Ireland, France, Luxembourg, Spain; provisional for Greece