EUROPEAN PARLIAMENT

Background note on EU economic governance procedures and related information in view of the Exchange of Views with LATVIA

ECON Committee, 26 February 2013

This note presents selected information on the current status of the EU economic governance procedures and related relevant information, in view of the Exchange of Views with Mr. Vilks, Minister of Finance, and Mr Rimsevics, Governor of the Bank of Latvia. Specific information on the procedures and criteria for the adoption of the Euro, as well as the latest developments on related issues in Latvia, are presented in a separate note.

LATVIA	2008	2009	2010	2011	2012	EU 27 2012
Population (millions)	2,192	2,163	2,121	2,075	2,042	503,664
GDP, € m	22,890	18,521	18,039	20,211	22,092	9,488,546
GDP per capita, €	10,443	8,563	8,507	9,742	10,820	18,839

1. Recent developments and current economic situation

- In December 2012, Latvia made an **early repayment** of its outstanding obligations to the IMF (€720 m of financial assistance received in 2009-2010) by issuing 7 years bonds at a historical low yield of 2.89%.

- According to Eurostat, the **GDP in Latvia increased by 1.3%** in the fourth quarter of 2012, compared to the previous quarter, and 5.7% compared to the fourth quarter of 2011. The Latvian economy is therefore (again) the fastest growing in the EU. According to its winter 2013 forecast, the European Commission (COM) estimates the Latvian GDP growth in 2012 to be 5.3%**,** and 3.8% in 2013 and by 4.1% in 2014. Both domestic (private consumption and investments) and exports are seen as robust growth drivers, with construction and manufacturing major contributors on the supply side.

- According to Eurostat the **unemployment** rate was in Q3 2012 14.1% (of which and 31.9% among people younger than 25 years). The COM estimates unemployment to be 14.9% in 2012 and forecasts it will decrease to 13.7% in 2013 and to 12.2% in 2014.

- According to the COM, the Latvian **inflation,** measured by the Harmonized Index of Consumer Prices, was 2.3% in 2012, expected to decrease to 1.9% in 2013 and slightly increase to 2.2% in 2014.

- The Latvian **public deficit** is expected by the COM to be 1.5% of GDP in 2012, decreasing to 1.1% in 2013 and 0.9% in 2014. The general **government gross debt** (totalling €8.6 bn in December 2011) is expected to increase from 41.9% of GDP in 2012 to 44.4% in 2013 and thereafter decrease again to 41.5 % in 2014.

Box: The financial assistance programme 2009-2012

In light of a rapidly deteriorating economic situation, increasing current account deficits and concerns related to the banking sector, the Latvian authorities applied in late 2008 to the EU, IMF and regional neighbours for financial assistance. Following negotiations in December 2008, an agreement was reached to provide multilateral financial assistance to Latvia with an overall amount of €7.5 billion over 3 years, consisting of the following contributions:

- European Union, €3.1billion under a balance-of-payments assistance programme (BoP programme)
- International Monetary Fund, SDR 1.5 billion (around €1.7 billion) under an IMF Stand-by arrangement;
- Nordic countries (Sweden, Denmark, Finland, Norway and Estonia), €1.9 billion;
- the World Bank, €0.4 billion;
- the European Bank for Reconstruction and Development, the Czech Republic and Poland, €0.4 billion.

Until December 2010 (last disbursement), Latvia received about €4.5 billion out of the €7.5 billion committed[1]. The average interest rate on the amounts disbursed by the COM is around 3.2%, with repayments starting in 2014.

The previous trend of continuous losses of price competitiveness was compensated by **internal adjustments,** which included wage and employment cuts, fiscal consolidation, deleveraging in the private sector and a wide range of growth-enhancing structural reforms. According to the IMF Ex Post Evaluation of the Stand-by Arrangement (IMF-EPE): "*From the peak at the height of the crisis in end-2008 to trough at early 2010, public wages fell by 27 percent while private wages fell by 6 percent and started growing again in mid 2010 (although anecdotal evidence suggests that the true private wage decline is larger). Much of the adjustment to the drop in demand was achieved through layoffs rather than wage reduction. Unemployment rose even as emigration increased (about 4 percent of the population emigrated during 2008- 2010)*"..

On 21 December 2011, the Latvian authorities and the COM signed the fifth and last Supplemental Memorandum of Understanding, the concluding step under BoP programme. This followed a positive assessment by the COM of the implementation of the adjustment programme. Latvia is now subject to post-programme surveillance, until 70% of the EU-funded loans are repaid; COM has published the second review under the post-programme surveillance (second PPS review) in January 2013.

2. Public Finances

Latvia has been subject to an **Excessive Deficit Procedure (EDP)** since July 2009, when the Council issued a recommendation calling for the deficit to be corrected at the latest by 2012. In February 2010, the Council shared COM's view that Latvia had so far acted in a manner consistent with its recommendations, and that no further steps were needed at this stage under the EDP[2]. In the second PPS review, COM stated that Latvia clearly seems to be on course to correct the excessive deficit situation by the set deadline, in a sustainable manner with a sizeable safety margin.

The annual **general government deficit** has been continuously decreasing since 2009: from 9.8 % of GDP in 2009 to 3.4% in 2011 and (estimated) 1.7% in 2012, thanks to robust economic

[1] More detailed information about disbursements and applicable conditions by creditors that participated in the programme is available on the Q&A website of the Ministry of Finance of Latvia.

[2] Member States report EDP-related data to Eurostat twice per year – at end-March and end-September; this means that the Council may take a decision on whether to end or to extend the EDP after April 2013, once data are validated by Eurostat.

performance and improved tax collection. The COM winter 2013 forecasts foresee this trend to continue: the projected deficits for 2013 and 2014 are 1.1% and 0.9%.

The **structural budgetary position** improved from -1.4% of GDP in 2011 to -0.5% in 2012. This development reflects the considerable consolidation effort of the initial 2012 budget and possibly an on-going decline in the share of the shadow economy. However, the COM forecast projects that the structural balance deteriorates to -1.0% in 2013 and -1.1% in 2014. This slight deterioration is expected due to policy changes that entered into force in January 2013: a one percentage point reduction in the personal income tax, an increase in state contributions to the private funded pension pillar from 2% to 4% of gross wages and a limited increase in some social benefits.

According to COM winter 2013 forecasts government gross **debt-to-GDP ratio** will rise to above 44% in 2013, as the authorities accumulate assets for future repayments of debt, and to decline below 42% of GDP in 2014, as the repayments take effect.

The COM BoP 2nd Review indicates that some recent policies seem to go against the spirit of the **Country Specific Recommendations** (See Annex 4 for CSRs 2012) and commitments made in the last supplementary Memorandum of Understanding: this in particular concerns tax cuts decided in May 2012, which were not included in the Convergence Programme submitted shortly before; the announcement of the 3-year strategy to lower the Personal Income Tax (PIT) rate, while postponing plans to raise PIT non-taxable thresholds to help the lower-paid; some measures in the 2012 midyear supplementary budget (i.e. only partial reversal of second pillar contributions from January 2013) and planned reductions and decentralisation of financing of the "Guaranteed Minimum Income" from 2013.

According to the December 2012 Fiscal Sustainability Report of the COM, Latvia does not appear to face short-term, medium-term or long-term **sustainability** challenges. This is conditional upon the implementation of the planned fiscal consolidation and on maintaining the primary balance well beyond 2014 at the level expected to be reached in that year. According to the report ageing costs in Latvia are the lowest in the EU in the long term perspective.

The National Parliament approved the **Treaty on Stability, Coordination and Governance (TSCG)** on 31st May 2012.

3. Macro-economic imbalances

In the first round of the Macro-economic Imbalances Procedure (see AMR - 2012), Latvia was not identified as experiencing imbalances, despite two indicators of the scoreboard (**net international investment position** and **unemployment)** were above the threshold. Also the second Alert Mechanism Report 2013 show that these two indicators remain above their indicative thresholds. The COM concludes, however, that Latvia does not need further in-depth review analysis in the context of the MIP (see Annex 2) on following grounds:

After the accumulation of external imbalances which prompted the BoP financial assistance in 2008, external competiveness has improved substantially. With high growth rates of GDP in 2011-2, the **current account balance** moved to a moderate deficit, which is expected to remain in the next years. Latvia's main trading partners are[3] the other Baltic countries, Russia, Germany, Poland, Sweden, Belarus and the rest of the EU.

The country's net liabilities, measured by the **net international investment position**, remain on a downward path, from a relatively high level. The large negative net international investment position is, to a large extent, explained by the stock of foreign direct investment (around half of the net international investment position), while the external debt component is rapidly declining.

As regards internal indicators, public debt has stabilised at levels slightly above 40% of GDP, while **house prices** and **credit growth** are slowly recovering from the steep correction during the crisis.

In the financial sector, **commercial lending** in terms of newly approved credits is now stabilised among households, and slightly on the rise among corporations.

The ratio of **private debt** to GDP kept falling to 125% of GDP in 2011, but private investments were nevertheless rising at a high rate, helped by high corporate profits.

The **unemployment rate** remains well above the EU average and the indicative threshold, but is now gradually shrinking, a trend that is expected to continue in the coming years, helped by the recovery and active labour market policies.

BOX: Latvia's demography[4]

From 2000 to 2012 the **Latvian population declined by about 14%** (340 thousands people, over about 2 millions inhabitants):

- **Emigration** accounted for 2/3: 200-215 thousands people are estimated to have left the country (9%, mainly young people); the largest waves of emigration took place in the early 2000's and the financial crisis in 2008-2010. The preferred destinations in 2011 were EU countries, mainly Germany, the UK and Ireland.
- **Low fertility** accounted for the remainder third: estimates are of 125-140 thousands (5% of population). The number of births has halved since early 1990, from 40 thousands to around 20 thousands births, falling below replacement levels.

Demographic decline is an economic issue - and an important national concern. In the short term emigration may enhance welfare, but in the long term, emigration and demographic decline have negative economic consequences, mainly on human capital, public finances and pension systems.With regards to emigration, the authorities are engaged in reducing emigration and encouraging return of expatriate, by promoting economic growth: net emigration declined sharply in late 2011, and surveys indicate that 20% of emigrants are planning to return by 2020.

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[3] Source: European Competitiveness Report 2012 (COM).

[4] Source: Latvia's demographic challenge, Appendix II in IMF staff report for the 2012 article iv consultation and second post-program monitoring discussions - pg 50.

Authorities have drafted the "National Development Plan 2014-20", aimed at increasing the birth rate and setting a stable basis for demographic growth, focused on health care, tax policy and social support.

4. Reforms under the Europe 2020 strategy for smart and sustainable growth

According to COM's second PPS review, Latvia has in the past years made significant progress in pushing forward far-reaching structural reforms. On the basis of the available data, it can be concluded that in five of the eight EU2020 indicators Latvia has made improvements and got closer to its targets, while three of them, namely the number of people at risk of poverty , employment rate and share of renewable energy show a declining tendency (see Annex 3).

Despite the positive developments and reforms, challenges remain for instance in the field of **energy liberalisation** and also in **energy efficiency**, where Latvia has one of the lowest results in the EU. In 2012, it achieved a considerable progress in opening its electricity market, while its gas sector remains fully monopolized. As regards energy efficiency, the tax system does not provide sufficient incentives for reducing energy costs and for shifting consumption and investment towards energy efficient products.

Concerning **social policies**, the COM considers a positive step that Latvia increased the retirement age from currently 62 years to 65 years in 2025. It also supports the changes in the area of active labour policies and training of the unemployed. However, the unemployment rate is still above the EU average with 13.5% in the third quarter of 2012 and about 40% of the population is facing the risk of poverty and social exclusion. Therefore, the COM recommends reforming the social assistance system, making it more efficient, while better protecting the poor and also ensuring better targeting and increasing incentives to work. It is looking forward to social and labour market reform proposals based on the on-going World Bank study.

Concerning further reforms, both the Review and the CSRs call for the establishment of a **single development institution**, the restructuring of **public administration** (amendments to unified wage grid, incentives for best-performers, career development path, etc.) and the improvement of the **judicial system** (reducing length of cases, assessing judges' qualifications, closing loopholes in insolvency procedures, etc.).

5. Financial Stability

During 2012, the COM agreed to **release the remaining €249m** of blocked funds to assist the financial sector (BoP Review). This was the final part of the overall amount of €600m agreed for banking sector support in the supplemental MoU of July 2009. This decision was taken due to progressing stabilisation of the financial system and undertaken sales of the publicly owned banks as envisaged. The review acknowledges that in the past months Latvia introduced a **closer supervision** of the banking sector, in particular of banks owned by non-EU entities with high exposure to non-EU customers. Latvia continued with the orderly resolution of *Parex Bank*, the banking licence of which was revoked in March 2012 to optimise costs, with the sale of the *Mortgage and Land Bank* commercial assets and with measures to deal with the *Krajbanka* fall-out.

The **three main challenges** ahead are the sale of *Citadele Bank,* the sale of remaining commercial bundles of the state-owned Mortgage and Land Bank, and further measures to reduce risks from non-resident banking. According to the Latvian authorities all these issues are being tackled.

According to the IMF evaluation report of January 2013 the **balance sheet of the banking system has shrunk substantially** from its pre-crisis peak. Since end-2008 total assets of the banking sector have decreased by about 15%. The nominal stock of loans to residents is about 30% lower. The stock of credit outstanding is still decreasing as some borrowers, especially households, continue to deleverage and credit demand by firms remains weak. The negative credit growth also reflects the ongoing process of dealing with problematic loans and as well as the exclusion of loan portfolios of banks with revoked licenses (*Parex Bank* and *Krajbanka*).

Deleveraging by foreign-owned banks has also been substantial over recent years through reducing of liabilities of foreign banks subsidiaries to parent banks. According to the Bank of Latvia the private sector loan-to-deposit ratio (LTD) of subsidiaries and branches of foreign banks has dropped significantly from almost 260% (end-2008) to 150% (end-2012). However, almost all banks have **returned to profitability since 2011** with the weighted-average return on equity of about 6% in 2012.

According to the Latvian Financial and Capital Market Commission (FCMC) the **share of non-performing loans** (NPLs) has been decreasing steadily from its mid-2010 peak of about 19.5% to 11.1% at the end of 2012. The corporate loan portfolio has been performing better than the household loan portfolio, partly because the latter was hit particularly hard by the collapse of the housing bubble. The share of NPLs was 9.2% for corporate loans and 15.2% for household loans at the end of 2012, with the system wide **capital adequacy ratio of 17.6%**, well above the regulatory minimum of 8%.

Non-resident deposits (NRDs) have been historically high in Latvia. According to the latest figures of the FCMC the share of NRDs reached 48.9% of the total deposit base at the end of 2012. Latvian authorities attribute this to a reversal of previously observed deposit outflows during the past crisis in Latvia. The IMF believes that the increase is mainly due to depositors from the Commonwealth of Independent States relocating their funds from the euro area.

ANNEXES:

- ANNEX 1 Key Macro-Economic Indicators and Outlook for Latvia
- ANNEX 2 Scoreboard used in the surveillance of macro-economic imbalances in Latvia
- ANNEX 3 Targets and current situation in the context of the Europe 2020
- ANNEX 4 Country Specific Recommendations for Latvia in 2012

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ANNEX 1: Key Macro-Economic Indicators and Outlook for Latvia

	2009	2010	2011	2012 (e)	2013 (f)	2014(f)
GDP Growth (%)						
Latvia	-17.7	-0.9	5.5	5.3	3.8	4.1
Euro area	-4.4	2.0	1.4	-0.6	-0.3	1.4
Government balance (% of GDP)						
Latvia	-9.8	-8.1	-3.4	-1.5	-1.1	-0.9
Euro area	-6.3	-6.2	-4.2	-3.5	-2.8	-2.7
Structural balance (% of GDP)						
Latvia	-5.7	-2.9	-1.4	-0.5	-1.0	-1.1
Euro area	-4.5	-4.4	-3.6	-2.1	-1.3	-1.5
Government debt (% of GDP)						
Latvia	36.7	44.5	42.2	41.9	44.4	41.5
Euro area	80.0	85.6	88.1	93.1	95.1	95.2
Inflation						
Latvia	3.3	-1.2	4.2	2.3	1.9	2.2
Euro area	0.3	1.6	2.7	2.5	1.8	1.5
Unemployment (% of labour force)						
Latvia	18.2	19.8	16.2	14.9	13.7	12.2
Euro area	9.6	10.1	10.2	11.4	12.2	12.1
Current account balance (% of GDP)						
Latvia	8.6	2.9	-2.4	-2.5	-2.8	-3.2
Euro area	0.1	0.3	0.2	1.5	2.2	2.
Exports (% change)						
Latvia	-14.1	11.6	12.7	6.9	4.8	6.6
Euro area	-12.4	11.2	6.3	2.8	2.6	4.9
Imports (% change)						
Latvia	-33.3	11.4	22.7	4.8	5.5	7.4
Euro area	-11.1	9.6	4.2	-0.7	1.2	4.8
Domestic demand (% change)						
Latvia	-27.4	-0.5	11.3	4.2	4.3	4.8
Euro area	-3.8	1.3	0.5	-2.1	-0.9	1.2
Investments (% change)						
Latvia	-37.4	-18.1	27.9	9.8	7.1	8.2
Euro area	-12.7	-0.1	1.5	-4.1	-1.8	2.4
Unit labour cost (% change)						
Latvia	-7.9	-10.4	5.2	0.8	0.8	1.4
Euro area	4.3	-0.7	0.9	1.3	1.2	0.8

Source: EC Winter Forecast, February 2013

ANNEX 2: Scoreboard used in the surveillance of macro-economic imbalances for Latvia

		Thresholds	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External imbalances and competitiveness	3 year average of **Current account balance** as % of GDP	**-4/+6%**	-7.1	-6.4	-7.5	-9.3	-11.2	-16.0	-19.2	-19.4	-9.0	-0.5	3.1
	Net international investment position as % of GDP	**-35%**	-37.6	-41.3	-43.8	-52.3	-59.6	-69.9	-74.7	-79.0	-82.7	-80.3	-73.3
	% change (3 years) of **Real Effective Exchange Rate** with HICP deflator	**±11%**	13.3	5.1	-7.1	-6.9	-4.4	4.8	11.1	24.0	23.7	8.7	-0.6
	% change (5 years) in **Export Market Shares**	**-6%**	14.9	13.9	10.1	29.8	43.5	32.0	45.7	41.1	31.7	13.9	23.6
	% Change (3 years) in **Nominal unit labour cost**	**+12%**	-1.4	-4.9	2.1	10.5	29.2	42.9	71.4	79.4	42.0	-0.3	-15.0
Internal imbalances	% y-o-y change deflated **House prices**	**+6%**	-1.0	71.7	21.6	-3.4	23.1	9.2	24.0	-13.0	-39.3	-9.3	4.9
	Private sector credit flow as % of GDP	**15%**	8.9	9.8	14.3	18.1	26.4	43.0	36.6	14.3	-6.1	-8.7	-2.5
	Private sector debt as % of GDP	**160%**	50	54	62	75	95	122	128	132	147	140	125
	General government gross debt (EDP) as % of GDP	**60%**	14	14	15	15	13	11	9	20	37	45	42
	3 year average of **Unemployment rate**	**10%**	13.6	13.1	12.4	11.8	10.7	9.3	7.8	7.3	10.9	15.3	18.1
	%y-o-y change in **Total Financial Sector Liabilities**, non consolidated	**16.5%**	20.2	24.7	23.6	35.6	41.0	47.8	36.7	7.8	-8.1	-0.1	-4.5

Source: EC, ECFIN Alert Mechanism Report 2013

Imbalances (above threshold)

ANNEX 3: Targets and current situation in the context of the Europe 2020

Indicator		EU27	Latvia
Employment rate (% of population)	**target**	**75**	**73**
	2011	68.6	66.3
	2010	68.6	65.0
	2009	69.0	67.1
Expenditure on R&D (% of GDP)	**target**	**3**	**1.5**
	2011	2.03	0.7
	2010	2.01	0.6
	2009	2.02	0.46
CO2 emission reduction (Index=1990)	**target**	**80**	**n.a.**
	2011	n.a.	n.a
	2010	85	45
	2009	83	41
Share of renewable energy (%)	**target**	**20**	**40.0**
	2011	n.a.	n.a
	2010	12.5	32.6
	2009	11.7	34.3
Primary energy consumption (1 000 tonnes of oil equivalent-TOE)	**target**	**1 474 000**	**n.a**
	2011	n.a.	n.a
	2010	1 646 839	4465
	2009	1 596 185	4253
Early school leaving (% of population aged 18-24)	**target**	**10**	**13.4**
	2011	13.5	11.8
	2010	14.1	13.3
	2009	14.4	13.9
Tertiary educational attainment (% of population aged 30-34)	**target**	**40**	**34**
	2011	34.6	35.7
	2010	33.5	32.3
	2009	32.2	30.1
Population at risk of poverty or social exclusion(thousand)	**target**	**reduce by 20 million**	**n.a**
	2011	n.a.	.n.a
	2010	116 300	846
	2009	113 767	834

Source: Eurostat, European Commission

**Mtoe (Million Tons of Oil equivalents)*

ANNEX 4: **Country Specific Recommendations for Latvia in 2012**[5]

1. Ensure planned progress towards the timely correction of **the excessive deficit**. To this end, implement the budget for the year 2012 as envisaged and achieve the fiscal effort specified in the Council recommendation under the excessive deficit procedure. Thereafter, implement a budgetary strategy, supported by sufficiently specified structural measures, for the year 2013 and beyond, to make sufficient progress towards the MTO, and to respect the expenditure benchmark. Use better than expected cyclical revenue to reduce **government debt**.
2. Implement measures to **shift taxation away from labour** to consumption**,** property, and use of natural and other resources while improving the structural balance; **ensure adoption of the Fiscal Discipline Law** and develop a medium term budgetary framework law to support the long-term sustainability of public finances; **restore contributions to the mandatory funded private pension scheme at 6 % of gross wages** from 2013.
3. Take measures to **reduce long-term and youth unemployment** by fighting early school leaving, promoting more efficient vocational education and training and its apprenticeship component, enhancing the quality, coverage and effectiveness of active labour market policy and its training component and through an effective wage subsidy scheme.
4. Tackle high rates of poverty and social exclusion by **reforming the social assistance system** to make it more efficient, while better protecting the poor. Ensure better targeting and increase incentives to work.
5. Further **encourage energy efficiency** by implementing measures and providing incentives for reducing energy costs and shifting consumption towards energy-efficient products, including vehicles, buildings and heating systems. Promote competition in major energy networks and improve connectivity with EU energy networks.
6. Take measures to **improve management and efficiency of the judiciary**, in particular to reduce the backlog and length of procedures. Take steps to improve the insolvency regime and the mediation laws.
7. **Continue reforms in higher education**, inter alia, by implementing a new financing model that rewards quality, strengthens links with market needs and research institutions, and avoids fragmentation of budget resources. Design and implement an effective research and innovation policy encouraging companies to innovate, including via tax incentives, upgrading infrastructure and rationalising research institutions.

[5] In 2011 Latvia was under BoP financial assistance programme, therefore the **Country Specific Recommendations 2011**simply recommended to implement the measures laid down in Decision 2009/290/EC, as amended by Decision 2009/592/EC, and further specified in the Memorandum of Understanding of 20 January 2009 and its subsequent supplements, in particular the last supplement of 7 June 2011.