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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

Convergence Report 2013 on Latvia

**(Prepared in accordance with Article 140(1) of the Treaty on the functioning of the
European Union at the request of Latvia)**

{SWD(2013) 196 final}

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1. PURPOSE OF THE REPORT

Article 140(1) of the Treaty on the Functioning of the European Union (hereafter TFEU) requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation¹, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. The latest Commission and ECB Convergence Reports, relating to all Member State with a derogation, were adopted in May 2012.

This report has been prepared in response to a request of Latvia, submitted on 5 March 2013. A more detailed assessment of the state of convergence in Latvia is provided in a Technical Annex to this report (SWD(2013) 196).

The content of the reports prepared by the Commission and the ECB is governed by Article 140(1) of the TFEU. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of the national central bank, with Articles 130 and 131 of the TFEU and the Statute of the European System of Central Banks and of the European Central Bank (hereafter ESCB/ECB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, public finances, exchange rate stability, long-term interest rates), and by taking account of other factors mentioned in the final sub-paragraph of Article 140(1) of the TFEU. The four convergence criteria are developed in a Protocol annexed to the Treaties (Protocol No 13 on the convergence criteria).

The economic and financial crisis has, in general, exposed gaps in the current economic governance of the Economic and Monetary Union (EMU) and showed that its existing instruments need to be used more fully. The present examination takes place within a context of the reform of EMU governance, which was undertaken over the past three years with the aim of ensuring a sustainable functioning of EMU. The assessment of convergence is thus aligned with the broader "European semester" approach which takes an integrated and upstream look at the economic policy challenges in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth. The key innovations in the area of governance reform, reinforcing the assessment of each Member States' convergence process and its sustainability, include *inter alia* the strengthening of the excessive deficit procedure by the 2011 reform of the Stability and Growth Pact and new instruments

¹ The Member States that have not yet fulfilled the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty and do not participate in the third stage of EMU.

in the area of surveillance of macroeconomic imbalances. In particular, this report takes into account the assessment of the 2013 update of Latvia's Convergence Programme² and the findings under the Alert Mechanism Report of the Macroeconomic Imbalances Procedure³.

Convergence criteria

The examination of the **compatibility of national legislation**, including the statutes of the national central bank, with Article 130 and with the compliance duty under Article 131 of the TFEU encompasses an assessment of observance of the prohibition of monetary financing (Article 123) and the prohibition of privileged access (Article 124); consistency with the ESCB's objectives (Article 127(1)) and tasks (Article 127(2)) and other aspects relating to the integration of the national central bank into the ESCB at the moment of the euro adoption.

The **price stability criterion** is defined in the first indent of Article 140(1) of the TFEU: *“the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”*.

Article 1 of the Protocol on the convergence criteria further stipulates that *“the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”*⁴. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a reference to the most recent Commission services' forecast of inflation⁵. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 2.7% in April 2013, with Sweden, Latvia and Ireland as the three best-performing Member States⁶.

² Available at http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2013_en.htm

³ The Commission published its first Alert Mechanism Report (AMR) in February 2012 and the second AMR (under the cycle for 2013) in November 2012. Based on the conclusions of the two reports, Latvia was not subject to an in-depth review in the context of the Macroeconomic Imbalance Procedure.

⁴ For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95.

⁵ All forecasts for inflation and other variables in the current report are from the Commission services' Spring 2013 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy change assumption while taking into consideration measures that are known in sufficient detail. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to be the best performers in terms of price stability in the forecast period, thereby increasing the possible margin of error.

⁶ The cut-off date for the data used in this report is 16 May 2013.

It is warranted to exclude from the best performers countries whose inflation rates could not be seen as a meaningful benchmark for other Member States. Such outliers were in the past identified in the 2004 and 2010 Convergence Reports⁷, as their inflation rates differed by a wide margin from the euro area average. At the current juncture, it is warranted to exclude Greece from the best performers, as its inflation rate and profile deviate by a wide margin from the euro area average, mainly reflecting the severe adjustment needs and exceptional situation of the Greek economy, and including it would unduly affect the reference value and thus the fairness of the criterion⁸. Greece is replaced by Ireland among the best performers.

The convergence **criterion dealing with public finances** is defined in the second indent of Article 140(1) of the TFEU as “*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “*at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists*”. As part of an overall strengthening of economic governance in EMU, the secondary legislation related to public finances was enhanced in 2011, including the new regulations amending the Stability and Growth Pact⁹.

The TFEU refers to the **exchange rate criterion** in the third indent of Article 140(1) as “*the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro*”.

Article 3 of the Protocol on the convergence criteria stipulates: “*The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against the euro on its own initiative for the same period*”¹⁰.

The relevant two-year period for assessing exchange rate stability in this report is 17 May 2011 to 16 May 2013. In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of

⁷ Lithuania and Ireland, respectively.

⁸ In April 2013, the 12-month average inflation rate of Greece was 0.4% and that of the euro area 2.2%, with the gap between the two forecast to increase further in the months ahead.

⁹ A directive on minimum requirements for national budgetary frameworks, two new regulations on macroeconomic surveillance and three regulations amending the Stability and Growth Pact (SGP) entered into force on 13 December 2011 (one out of two new regulations on macroeconomic surveillance and one out of three regulations amending the SGP include new enforcement mechanisms for euro area Member States). Besides the operationalisation of the debt criterion in the Excessive Deficit Procedure, the amendments introduced a number of important novelties in the Stability and Growth Pact, in particular an expenditure benchmark to complement the assessment of progress towards the country-specific medium-term budgetary objective.

¹⁰ In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

policy measures, including foreign exchange interventions, in maintaining exchange rate stability. The analysis also takes into account the impact of external official financing arrangements wherever relevant, including their size, the amount and profile of assistance flows and the possible policy conditionality.

The fourth indent of Article 140(1) of the TFEU requires “*the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the **long-term interest rate levels***”. Article 4 of the Protocol on the convergence criteria further stipulates that “*the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*”.

The interest rate reference value was calculated to be 5.5% in April 2013. The reference value is based on the long-term interest rates in Sweden, Latvia and Ireland¹¹.

In the 2012 Convergence Report, the long-term interest rate of Ireland, one of the three best-performing Member States in terms of price stability, was not included in the calculation of the reference value for the long-term interest rate criterion due to the severe distortions in its sovereign bond market. However, the long-term interest rate of Ireland has converged significantly closer to that of other euro area Member States since then and Ireland's bond market access improved considerably, suggesting that the long-term interest rate of Ireland has become a meaningful benchmark again.

Article 140(1) of the TFEU also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability. The additional factors are important indicators that the integration of a Member State into the euro area would proceed without difficulties and broadens the view on sustainability of convergence.

2. LEGAL COMPATIBILITY

In the 2012 Convergence Report, the assessment on legal convergence concluded that legislation in Latvia, in particular the Law on the Latvijas Banka (Bank of Latvia, BoL), was not fully compatible with the compliance duty under Article 131 of the TFEU. Incompatibilities notably concerned the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute.

Following the assessment of the Convergence Report from 2012, the Latvian Government, in cooperation with Latvijas Banka, prepared amendments to the BoL Law, which the Latvian Parliament adopted on 10 January 2013. The Law on the

¹¹ The reference value for April 2013 is calculated as the simple average of the average long-term interest rates in Sweden (1.6%), Latvia (3.8%) and Ireland (5.1%).

Bank of Latvia as amended is fully compatible with Articles 130 and 131 of the TFEU.

3. PRICE STABILITY

In Latvia, the 12-month average inflation rate was above the reference value at the time of the last convergence assessment in 2012. The average inflation rate in Latvia during the 12 months to April 2013 was 1.3%, i.e. well below the reference value of 2.7%. It is projected to remain below the reference value in the months ahead.

After a peak of annual HICP inflation at 15.3% in 2008, significant nominal wage adjustment and a correction in import prices led to a period of negative headline inflation in 2009 and 2010. As the cycle turned and a rising global commodity price trend set in, average inflation rose from -1.2% in 2010 to 4.2% in 2011, boosted also by indirect tax increases. As these temporary effects faded, inflation moderated to 2.3% in 2012 and by April 2013 annual inflation fell to -0.4%.

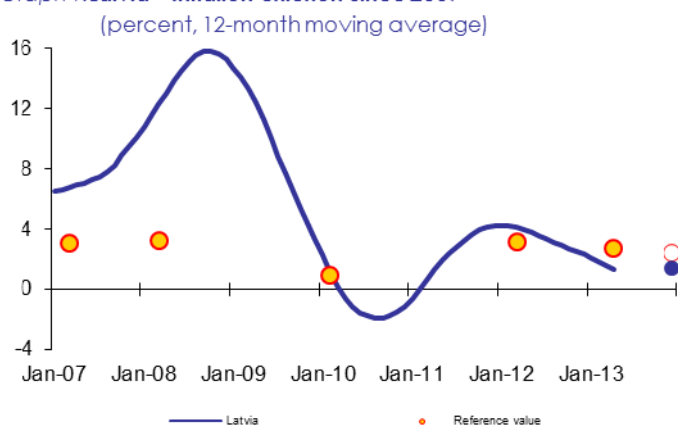
Annual HICP inflation is expected to be 1.4% on average in 2013, according to the Commission services' Spring 2013 Forecast, due i.a. to falling energy prices and a 1 percentage point reduction in the standard VAT rate as of July 2012. It is projected to pick up in 2014 to 2.1% on average, in the context of improving domestic demand and liberalisation of the electricity market. The price level in Latvia (around 71% of the euro area average in 2011) suggests potential for further price level convergence over the long term.

Sustainable convergence implies that the respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Latvia, the VAT reduction of July 2012 has contributed to the current low level of 12-month average inflation. However, the analysis of underlying fundamentals and the fact that the reference value has been met by a wide margin support a positive assessment on the fulfilment of the price stability criterion.

Medium-term inflation prospects will hinge notably on wages growing in line with productivity which will mostly depend on continued labour market flexibility. Looking ahead, it is essential that sustainable convergence is not jeopardised by a re-emergence of a credit-fuelled expansion in domestic demand and an associated rise in asset prices – notably in the housing market. The prospects of such an outcome are reduced by Latvia's policy responses to the 2008-2009 crisis, while the combination of factors that drove buoyant credit expansion in the past (pent-up credit demand, accelerated financial deepening and integration, rapid risk spread compression) is not expected to recur in the foreseeable future. Improvements in the business environment, progress in attracting new investment, addressing remaining bottlenecks in the labour market and competitive price formation in product markets will be key to maintain price stability in the medium term. Price developments will also depend on maintaining a prudent fiscal policy, including cautious wage setting in the public sector, to keep domestic demand in line with fundamentals and help anchor inflation expectations.

Latvia fulfils the criterion on price stability.

Graph 1: Latvia - Inflation criterion since 2007



Note: The dots in December 2013 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2013 Forecast.

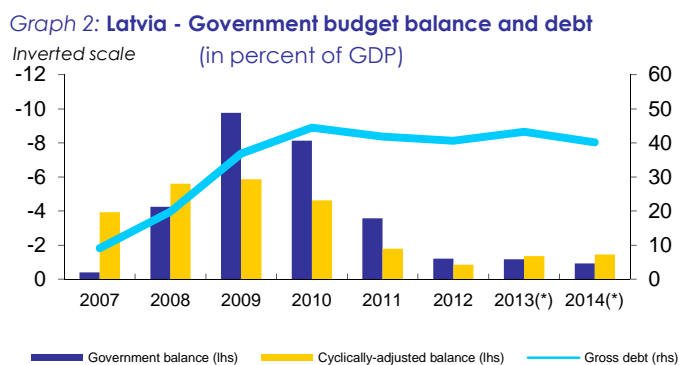
4. PUBLIC FINANCES

Latvia is at present subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009). The Council recommended Latvia to correct the excessive deficit by 2012. The general government deficit in Latvia reached 8.1% of GDP in 2010, but decreased to 1.2% of GDP in 2012, due in particular to a considerable consolidation effort. The Commission services' Spring 2013 Forecast projects the deficit-to-GDP ratio at 1.2% in 2013 and 0.9% in 2014 under a no-policy-change assumption. The ratio of gross public debt to GDP fell to 40.7% in 2012 and it is projected to fall further to 40.1% of GDP by end-2014.

In March 2012, Latvia signed the Treaty on Stability, Coordination and Governance in the EMU, and the respective ratification law was approved by Parliament in May 2012. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. Moreover, in January 2013, Parliament approved the Fiscal Discipline Law (FDL) in the final reading. The law establishes the principle of budgetary targeting throughout the cycle, with a benchmark structural deficit of 0.5% of GDP, and will provide a framework for a rules-based fiscal policy, in particular through limiting pro-cyclical expenditure increases. The law also contains provisions regarding the establishment of an independent Fiscal Council, to be set up from 1 January 2014, which will oversee compliance with the set of fiscal rules. Thorough implementation of the FDL will be crucial to counter the risks related to pressure to loosen fiscal policy after the successful adjustment programme.

In view of these developments and the Commission services' Spring 2013 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP in 2012, which was the deadline recommended by the Council. The Commission has therefore recommended that the Council abrogate the decision on the existence of an excessive deficit for Latvia (SEC(2013) XYZ).

If the Council decides to abrogate the excessive deficit decision for Latvia, Latvia will fulfil the criterion on public finances.



(*) Commission services' Spring 2013 Forecast.
 Source: Eurostat, Commission services.

5. EXCHANGE RATE STABILITY

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for more than eight years at the time of adoption of this report. Upon ERM II entry, the authorities unilaterally committed to keep the lats within a $\pm 1\%$ fluctuation margin around the central rate. During the two years preceding this assessment, the lats exchange rate did not deviate from its central rate by more than $\pm 1\%$ and it did not experience tensions. The lats traded mostly on the strong side of the unilateral band, as the Latvian Treasury converted its ample foreign currency funds on the market. The lats depreciated towards the middle of the band in late 2012 and early 2013, against the background of lower foreign currency supply by the Treasury and market expectations regarding euro adoption. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates do not reveal pressures on the exchange rate. The last disbursements by the IMF and the EU under the financial assistance programme took place in August and October 2010, respectively. In June 2011, Latvia successfully returned to the international bond market with USD issuance, followed by further transactions, signalling good market access.

Latvia fulfils the exchange rate criterion.

6. LONG-TERM INTEREST RATES

The average long-term interest rate in Latvia in the year to April 2013 was 3.8%, below the reference value of 5.5%. The average long-term interest rate in Latvia had been at the reference value at the 2012 convergence assessment (5.8%) and it gradually declined further since then. Latvia's long-term spreads to euro area long-term benchmark bonds narrowed significantly in 2010, as confidence in the currency peg was regained, fiscal consolidation yielded results and the conversion of assistance programme funds created ample lats liquidity. After a pause in 2011, the spread compression continued in 2012, as market confidence in Latvia improved further. The Treasury returned to the 10-year domestic bond market with several smaller issues during the first half of 2011. In 2012, the Treasury launched a new series of benchmark 10-year bonds, but issued only a relatively limited amount, benefitting from its favourable liquidity position, due partly to its successful USD-denominated issuances.

Latvia fulfils the criterion on the convergence of long-term interest rates.

7. ADDITIONAL FACTORS

Additional factors have also been examined, including balance of payments developments and integration of labour, product and financial markets. The external balance reversed in 2008-2009 from large deficits during the boom years to a surplus of around 11% of GDP in 2009, which contracted to around 1% of GDP in 2012. The trade deficit declined substantially from 2008, but deteriorated somewhat with the recovery since 2010. However, the significant correction of the real effective exchange rate in 2009-2010 has remained broadly preserved and Latvia has continued to gain export market shares. The income account swung into surplus in 2009, reflecting the huge loan loss provisions made by foreign-owned banks and it returned to a deficit in 2011 when most banks regained profitability. The FDI balance gradually improved from 2009, but it declined somewhat in 2012. The EU-IMF balance of payments assistance programme granted to Latvia in late 2008 was successfully concluded in January 2012. Latvia borrowed altogether about EUR 4.5 billion out of the total EUR 7.5 billion that was available under the programme. Reflecting confidence in its policies and its regained market access, Latvia has not requested a follow-up programme. By December 2012, Latvia fully repaid its programme-related liabilities to the IMF, while repayments to the European Commission will fall due between 2014 and 2025.

Latvia's economy is well integrated within the EU economy through trade and FDI linkages while the labour market has demonstrated a high degree of mobility within the EU market and substantial flexibility although structural unemployment is high. On the basis of selected business environment indicators, Latvia performs broadly in line with the average of euro area Member States. The integration of the domestic financial sector into the EU financial system is substantial, mainly thanks to a high level of foreign ownership of the banking system. In the context of the international financial assistance programme, financial supervision has been strengthened considerably. Cooperation with home country supervisors has been further enhanced.

Latvia has a long tradition and several competitive advantages in servicing non-resident banking clients, mainly corporates from CIS countries. The supervision of the non-resident banking business poses additional challenges, inter alia, due to the cross-border nature of transactions. The national supervising authority has implemented several measures to reduce the specific risks of this business activity; banks with a non-resident business model have to keep a high share of liquid assets and are subject to additional capital requirements. Going forward, close monitoring of financial stability risks, readiness to adopt further regulatory measures if needed, and determined implementation of anti-money laundering rules will remain key.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, taking into account the additional factors, and provided that the Council will follow the Commission's recommendation for the abrogation of the excessive deficit procedure, the Commission considers that Latvia fulfils the conditions for the adoption of the euro.