



EUROPEAN CENTRAL BANK

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CONVERGENCE REPORT JUNE 2013





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ABBREVIATIONS

COUNTRIES

BE	Belgium	LU	Luxembourg
BG	Bulgaria	HU	Hungary
CZ	Czech Republic	MT	Malta
DK	Denmark	NL	Netherlands
DE	Germany	AT	Austria
EE	Estonia	PL	Poland
IE	Ireland	PT	Portugal
GR	Greece	RO	Romania
ES	Spain	SI	Slovenia
FR	France	SK	Slovakia
IT	Italy	FI	Finland
CY	Cyprus	SE	Sweden
LV	Latvia	UK	United Kingdom
LT	Lithuania	JP	Japan
		US	United States

OTHERS

BIS	Bank for International Settlements
b.o.p.	balance of payments
BPM5	IMF Balance of Payments Manual (5th edition)
CD	certificate of deposit
CPI	Consumer Price Index
ECB	European Central Bank
EDP	excessive deficit procedure
EER	effective exchange rate
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
MIP	macroeconomic imbalance procedure
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union
ULCM	unit labour costs in manufacturing
ULCT	unit labour costs in the total economy

In accordance with EU practice, the EU Member States are listed in this report using the alphabetical order of the country names in the national languages.

I INTRODUCTION

Since the introduction of the euro in 11 EU Member States on 1 January 1999, six other countries have adopted the single currency, the most recent being Estonia on 1 January 2011. This means that ten EU Member States do not yet participate fully in EMU, i.e. they have not yet adopted the euro. Two of these, Denmark and the United Kingdom, gave notification that they would not participate in Stage Three of EMU.

This Convergence Report has been prepared following a request for a country examination submitted by Latvia on 5 March 2013. In producing this report, the ECB fulfils its requirement under Article 140 of the Treaty on the Functioning of the European Union (hereinafter the “Treaty”)¹ to report to the Council of the European Union (EU Council) at the request of an EU Member State with a derogation “on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union”. The same mandate has been given to the European Commission, which has also prepared a report, and both reports are being submitted to the EU Council in parallel.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines whether a high degree of sustainable economic convergence has been achieved in Latvia, whether the national legislation is compatible with the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (Statute) and whether the statutory requirements are fulfilled for Latvijas Banka to become an integral part of the Eurosystem. This report covers neither other Member States with a derogation, i.e. Bulgaria, the Czech Republic, Lithuania, Hungary, Poland, Romania and Sweden, nor Denmark and the United Kingdom, which are Member States with a special status and which have not yet adopted the euro.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be subject to political considerations or interference. EU Member States have been invited to consider the quality and integrity of their statistics as a matter of high priority, to ensure that a proper system of checks and balances is in place when compiling these statistics, and to apply minimum standards in the domain of statistics. These standards are of the utmost importance in reinforcing the independence, integrity and accountability of the national statistical institutes and in helping to support confidence in the quality of government finance statistics (see Section 4.5).

This report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 contains a country summary, which provides the main results of the examination of economic and legal convergence in Latvia. Chapter 4 examines in more detail the state of economic convergence in the country and provides an overview of the convergence indicators and the statistical methodology used to compile these indicators. Finally, Chapter 5 examines the compatibility of the national legislation in Latvia, including the statute of its NCB, with Articles 130 and 131 of the Treaty and with the Statute.

¹ See also the clarification between the “Treaty” and “Treaties” in the Glossary.

2 FRAMEWORK FOR ANALYSIS

2.1 ECONOMIC CONVERGENCE

To examine the state of economic convergence in EU Member States seeking to adopt the euro the ECB makes use of a common framework for analysis which has been applied in a consistent manner in all ECB Convergence Reports. The common framework is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, as well as in other factors relevant to economic integration and convergence. Second, it is based on a range of additional backward and forward-looking economic indicators which are considered to be useful for examining the sustainability of convergence in greater detail. The examination of the Member State concerned based on all these factors is important to ensure that its integration into the euro area will proceed without major difficulties. Boxes 1 to 5 below briefly recall the legal provisions and provide methodological details on the application of these provisions by the ECB.

This report builds on principles set out in previous reports published by the ECB (and prior to this by the EMI) in order to ensure continuity and equal treatment. In particular, a number of guiding principles are used by the ECB in the application of the convergence criteria. First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle is that the main purpose of the criteria is to ensure that only those Member States having economic conditions that are conducive to the maintenance of price stability and the coherence of the euro area can participate in it. Second, the convergence criteria constitute a coherent and integrated package, and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of actual data. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, when considering compliance with the convergence criteria, sustainability is an essential factor as convergence must be achieved on a lasting basis and not just at a given point in time. The first decade of EMU has shown that weak fundamentals, an excessively loose macroeconomic stance at country level and overly optimistic expectations about the convergence in real incomes pose risks not only for the countries concerned but also for the smooth functioning of the euro area as a whole. Large and persistent macroeconomic imbalances, for example in the form of sustained losses in competitiveness or the build-up of indebtedness and housing market bubbles, accumulated over the past decade in many EU Member States, including euro area countries, and are one of the main reasons for the current economic and financial crisis. The build-up of imbalances in the past highlights the fact that the temporary fulfilment of the numerical convergence criteria is, by itself, not a guarantee of smooth membership in the euro area. Countries joining the euro area should thus demonstrate the sustainability of their convergence processes and their capacity to live up to the permanent commitments which euro adoption represents. This is in the country's own interest, as well as in the interest of the euro area as a whole. For this reason, the country examinations elaborate on the sustainability of convergence.

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence.

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is paid to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Strong governance and sound institutions are also essential to supporting sustainable output growth

over the medium to long term. Overall, it is emphasised that ensuring the sustainability of economic convergence depends on the achievement of a strong starting position, the existence of sound institutions and the pursuit of appropriate policies after the adoption of the euro.

The cut-off date for the statistics included in this Convergence Report was 16 May 2013. The statistical data used in the application of the convergence criteria were provided by the European Commission (see Section 4.5 as well as the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to April 2013, the latest month for which data on HICPs were available. For monthly data on exchange rates, the period considered in this report ends in April 2013. Historical data for fiscal positions cover the period up to 2012. Account is also taken of forecasts from various sources, together with the most recent convergence programme of the Member State concerned and other information relevant to a forward-looking examination of the sustainability of convergence. The European Commission's spring 2013 forecast and the Alert Mechanism Report 2013, which are taken into account in this report, were released on 3 May 2013 and 28 November 2012 respectively. This report was adopted by the General Council of the ECB on 3 June 2013.

With regard to price developments, the legal provisions and their application by the ECB are outlined in Box 1.

Box 1

PRICE DEVELOPMENTS

1 Treaty provisions

Article 140(1), first indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“the achievement of a high degree of price stability; this 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 Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

“The criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union 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 1½ 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”.

2 Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below:

First, with regard to “an average rate of inflation, observed over a period of one year before the examination”, the inflation rate has been calculated using the change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is May 2012 to April 2013.

Second, the notion of “at most, the three best performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rates of inflation of the following three Member States: Sweden (0.8%), Latvia (1.3%) and Ireland (1.6%). As a result, the average rate is 1.2% and, adding 1½ percentage points, the reference value is 2.7%.

The inflation rate of Greece has been excluded from the calculation of the reference value. Price developments over the reference period resulted in a 12-month average inflation rate of 0.4% in April 2013 in this country. Greece has been treated as an “outlier” for the calculation of the reference value for two main reasons: (i) its inflation rate was significantly lower than those of the other Member States over the reference period; and (ii) this was due to exceptional factors, i.e. the fact that the Greek economy has been undergoing a deep recession for several years, with the result that its price developments have been dampened by an exceptionally large negative output gap.

It should be noted that the concept of “outlier” has been referred to in previous ECB Convergence Reports (see, for example, the 2010 and 2012 reports) as well as in the Convergence Reports of the EMI. In line with those reports, a Member State is considered to be an outlier if two conditions are fulfilled: first, its 12-month average inflation rate is significantly below the comparable rates in other Member States; and second, its price developments have been strongly affected by exceptional factors. The identification of outliers does not follow any mechanical approach. The approach used was introduced to deal appropriately with potential significant distortions in the inflation developments of individual countries.

Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see Section 4.5). For information, the average euro area inflation rate is shown in the statistical part of this report.

To allow a more detailed examination of the sustainability of price developments in the country under review, the average rate of HICP inflation over the 12-month reference period from May 2012 to April 2013 is reviewed in the light of the country’s economic performance over the last ten years in terms of price stability. In this connection, attention is paid to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of supply and demand conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the HICP at constant tax rates, the national CPI, the private consumption deflator,

the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, institutional and structural aspects relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

With regard to fiscal developments, the legal provisions and their application by the ECB, together with procedural issues, are outlined in Box 2.

Box 2

FISCAL DEVELOPMENTS

1 Treaty and other legal provisions

Article 140(1), second indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“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)”.

Article 2 of Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

“The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean 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”.

Article 126 sets out the excessive deficit procedure (EDP). According to Article 126(2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

- (a) the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the EDP as 3% of GDP), unless either:
 - the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
 - the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
- (b) the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the EDP as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report. Finally, in accordance with Article 126(6), the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and excluding the Member State concerned, and following an overall assessment, whether an excessive deficit exists in a Member State.

The Treaty provisions under Article 126 are further clarified by Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011,¹ which among other things:

- confirms the equal footing of the debt criterion with the deficit criterion by making the former operational, while allowing for a three-year period of transition. Article 2(1a) of the Regulation provides that when it exceeds the reference value, the ratio of the government debt to GDP shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace if the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data are available. The requirement under the debt criterion shall also be considered to be fulfilled if the required reduction in the differential looks set to occur over a defined three-year period, based on the Commission's budgetary forecast. In implementing the debt reduction benchmark, the influence of the economic cycle on the pace of debt reduction shall be taken into account;
- details the relevant factors that the Commission shall take into account when preparing a report under Article 126(3) of the Treaty. Most importantly, it specifies a series of factors considered relevant in assessing developments in medium-term economic, budgetary and government debt positions (see Article 2(3) of the Regulation and, below, details on the ensuing ECB analysis).

Moreover, the TSCG, which builds on the provisions of the enhanced Stability and Growth Pact, was signed on 2 March 2012 by 25 EU Member States (all EU Member States except the United Kingdom and the Czech Republic) and entered into force on 1 January 2013.² Title III (Fiscal Compact) provides, inter alia, for a binding fiscal rule aimed at ensuring that the general government budget is balanced or in surplus. This rule is deemed to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit – in structural terms – of 0.5% of GDP. If the government debt ratio is significantly below 60% of GDP and risks to long-term fiscal sustainability are low, the medium-term objective can be set at a structural deficit of at most 1% of GDP. The TSCG also includes the debt reduction

1 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p.6), as last amended by Council Regulation (EU) No 1177/2011 of 8 November 2011 (OJ L 306, 23.11.2011, p.33). A consolidated version has been published: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF>

2 The TSCG applies also to those EU Member States with a derogation that have ratified it, as from the date when the decision abrogating that derogation takes effect or as from an earlier date if the Member State concerned declares its intention to be bound at such earlier date by all or part of the provisions of the TSCG.

benchmark rule referred to in Council Regulation (EU) No 1177/2011, which has amended Council Regulation (EC) 1467/97,³ thus lifting this rule to the level of primary law for the signatory EU Member States. The signatory Member States are required to introduce in their constitution – or equivalent law of higher level than the annual budget law – the stipulated fiscal rules accompanied by an automatic correction mechanism in case of deviation from the fiscal objective.

With respect to the Treaty establishing the European Stability Mechanism (“ESM Treaty”), recital 7 provides that as a consequence of joining the euro area, an EU Member State should become an ESM Member with full rights and obligations. Article 44 sets out the procedure for application and accession to the ESM.⁴

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 2003 to 2012, the outlook and the challenges for general government finances, and focuses on the links between deficit and debt developments. The ECB provides an analysis with respect to the effectiveness of national budgetary frameworks, as referred to in Article 2(3)(b) of Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011 and in Council Directive 2011/85/EU.⁵ Moreover, this report provides a tentative assessment of the application of the expenditure benchmark rule as set out in Article 9(1) of Council Regulation (EC) No 1466/97 as last amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council.⁶ This rule aims to ensure a proper financing of expenditure increases. Under the rule, inter alia, EU Member States that have not yet reached their medium-term budgetary objective should ensure that the annual growth of relevant primary expenditure does not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the EDP. The ECB report only states whether the country is subject to an EDP.

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be “sufficiently diminishing and approaching the reference value at a satisfactory pace”, the ECB examines past and future trends in the debt ratio. For EU Member States in which the debt ratio exceeds the reference value, the ECB provides, for illustrative purposes, a debt sustainability

3 Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP (OJ L 306, 23.11.2011, p.33).

4 In Opinion CON/2012/73, the ECB noted that Article 44 of the ESM Treaty provides that “the ESM Treaty shall be open for accession by other Member States of the EU upon their application for membership. These ‘other’ Member States are those which have not adopted the euro at the time of signature of the ESM Treaty. Article 44 of the ESM Treaty provides further that the Member State shall file with the ESM its application for membership after the adoption by the Council of the European Union of the decision to abrogate the Member State’s derogation from adopting the euro in accordance with Article 140(2) of the Treaty. Article 44 of the ESM Treaty also provides that, following the approval of the application for membership by the ESM’s Board of Governors, the new ESM Member shall accede upon deposit of the instruments for accession with the Depository”. ECB opinions are available on the ECB’s website at www.ecb.europa.eu.

5 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41).

6 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p.1), as last amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 (OJ L 306, 23.11.2011, p. 12). A consolidated version has been published: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF>

analysis, including with reference to the aforementioned debt reduction benchmark laid down in Article 2(1a) of Council Regulation (EC) No. 1467/97 as last amended by Council Regulation (EU) No 1177/2011.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the ESA 95 (see Section 4.5). Most of the figures presented in this report were provided by the Commission in April 2013 and include government financial positions from 2003 to 2012 as well as Commission forecasts for 2013.

With regard to the sustainability of public finances, the outcome in the reference year, 2012, is reviewed in the light of the performance of the country under review over the past ten years. First, the development of the deficit ratio is investigated. It is considered useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences are often divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of both policy measures and special factors. Indeed, assessing how structural budgetary positions have changed during the crisis is particularly difficult in view of uncertainty over the level and growth rate of potential output. As regards other fiscal indicators, past government expenditure and revenue trends are also considered in more detail.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it, namely the difference between nominal GDP growth and interest rates, the primary balance and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors, as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, by focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates can be highlighted.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2013 are considered, and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of the country's medium-term budgetary objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. Finally, long-term challenges to the sustainability of budgetary positions and broad areas for consolidation are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to contingent liabilities incurred by the government, especially during the financial and economic crisis.

In line with past practices, the analysis described above also covers most of the relevant factors identified in Article 2(3) of Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011, as described in Box 2.

With regard to exchange rate developments, the legal provisions and their application by the ECB are outlined in Box 3.

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

Article 140(1), third indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“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 Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

“The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on 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.”

2 Application of Treaty provisions

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period.

The examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERM II central rate, while also taking into account factors that may have led to an appreciation, which is in line with the approach taken in the past. In this respect, the width of the fluctuation band within ERM II does not prejudice the examination of the exchange rate stability criterion.

Moreover, the issue of the absence of “severe tensions” is generally addressed by: i) examining the degree of deviation of exchange rates from the ERM II central rates against the euro; ii) using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; iii) considering the role

played by foreign exchange interventions; and iv) considering the role of international financial assistance programmes in stabilising the currency.

The reference period in this report is from 17 May 2011 to 16 May 2013. All bilateral exchange rates are official ECB reference rates (see Section 4.5).

In addition to ERM II participation and nominal exchange rate developments against the euro over the period under review, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, export market shares and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods are also examined. The section on exchange rate developments further considers measures of the degree of a country's integration with the euro area. This is assessed in terms of both external trade integration (exports and imports) and financial integration. Finally, the section on exchange rate developments reports, if applicable, whether the country under examination has benefited from central bank liquidity assistance or balance of payments support, either bilaterally, or multilaterally with the involvement of the IMF and/or the EU. Both actual and precautionary assistance are considered, including access to precautionary financing in the form of, for instance, the IMF's Flexible Credit Line.

With regard to long-term interest rate developments, the legal provisions and their application by the ECB are outlined in Box 4.

Box 4

LONG-TERM INTEREST RATE DEVELOPMENTS

1 Treaty provisions

Article 140(1), fourth indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“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 Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

“The criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) of the said Treaty 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 two 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”.

2 Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below:

First, with regard to “an average nominal long-term interest rate” observed over “a period of one year before the examination”, the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is from May 2012 to April 2013.

Second, the notion of “at most, the three best performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three Member States entering the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of these three countries were 1.6% (Sweden), 3.8% (Latvia) and 5.1% (Ireland);¹ as a result, the average rate is 3.5% and, adding 2 percentage points, the reference value is 5.5%.

Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see Section 4.5).

¹ In the 2012 Convergence Report, Ireland was excluded from the calculation of the reference value for the long-term interest rate criterion owing to high country-specific risk premia driven by factors other than inflation in the markets at that time. In this report, Ireland is included in the calculation because (i) the Irish government bond yield and country-specific risk premia have decreased significantly relative to the euro area average (this is visible in the fact that the average long-term interest rate for Ireland over the current reference period was 5.1% versus a euro area average of 3.6%, while the respective values in the 2012 Convergence Report were 9.1% and 4.4%), and (ii) liquidity in the Irish government bond market has improved.

As mentioned above, the Treaty makes explicit reference to the “durability of convergence” being reflected in the level of long-term interest rates. Therefore, developments over the reference period from May 2012 to April 2013 are reviewed against the background of the path of long-term interest rates over the past ten years (or otherwise the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. During the reference period, the average euro area long-term interest rate partly reflected the high country-specific risk premia of several euro area countries. Therefore, the euro area AAA long-term government bond yield (i.e. the long-term yield of the euro area AAA yield curve, which includes the euro area countries with an AAA rating) is also used for comparison purposes. As background to this analysis, this report also provides information about the size and development of the financial market. This is based on three indicators (the outstanding amount of debt securities issued by corporations, stock market capitalisation and domestic bank credit to the private sector), which, together, measure the size of capital markets.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors (see Box 5). In this respect, an enhanced economic governance framework in accordance with Article 121(6) of the Treaty entered into force on 13 December 2011 with the aim of ensuring a closer coordination of economic policies and the sustained convergence of EU Member States’ economic performances. Box 5 below briefly recalls these legislative provisions and the way in which the above-mentioned additional factors are addressed in the assessment of convergence conducted by the ECB.

Box 5

OTHER RELEVANT FACTORS**1 Treaty and other legal provisions**

Article 140(1) of the Treaty requires that: “The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices”.

In this respect, the ECB takes into account the legislative package on EU economic governance which entered into force on 13 December 2011. Building on the Treaty provisions under Article 121(6), the European Parliament and the EU Council adopted detailed rules for the multilateral surveillance procedure referred to in Articles 121(3) and 121(4) of the Treaty. These rules were adopted “in order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States” (Article 121(3)), following the “need to draw lessons from the first decade of functioning of the economic and monetary union and, in particular, for improved economic governance in the Union built on stronger national ownership”.¹ The new legislative package includes an enhanced surveillance framework (the macroeconomic imbalance procedure or MIP) aimed at preventing excessive macroeconomic imbalances and helping diverging EU Member States to establish corrective plans before divergence becomes entrenched. The MIP, with both preventive and corrective arms, applies to all EU Member States, except those which, being under an international financial assistance programme, are already undergoing a closer scrutiny coupled with conditionality. The MIP includes an alert mechanism for the early detection of imbalances, based on a transparent scoreboard of indicators with alert thresholds for all EU Member States, combined with economic judgement. This judgement should take into account, inter alia, nominal and real convergence inside and outside the euro area.² When assessing macroeconomic imbalances, this procedure should take due account of their severity and their potential negative economic and financial spillover effects, which aggravate the vulnerability of the EU economy and threaten the smooth functioning of EMU.³

2 Application of Treaty provisions

In line with past practices, the additional factors referred to in Article 140(1) of the Treaty are reviewed in Chapter 4 under the headings of the individual criteria described in Boxes 1 to 4. Regarding the elements of the MIP, most of the macroeconomic indicators have been referred to in this report in the past (some with different statistical definitions), as part of the wide range of additional backward and forward-looking economic indicators that are considered to be useful for examining the sustainability of convergence in greater detail, as required by Article 140 of the Treaty. For completeness, in Chapter 4 the scoreboard indicators (including in relation to the alert thresholds) are presented for the country covered in this report, thereby ensuring the provision of all available information relevant to the detection of macroeconomic imbalances

1 See Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, recital 2.

2 See Regulation (EU) No 1176/2011, Article 4(4).

3 See Regulation (EU) No 1176/2011, recital 17.

that may be hampering the achievement of a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty. Notably, EU Member States with a derogation that are subject to an excessive imbalance procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty.

2.2 COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATIES

2.2.1 INTRODUCTION

Article 140(1) of the Treaty requires the ECB (and the European Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. This report, in the present case at the request of Latvia that is a Member State with a derogation, must include an examination of the compatibility between the national legislation of the Member State with a derogation making the request, including the statute of its NCB, and Articles 130 and 131 of the Treaty and the relevant Articles of the Statute. This Treaty obligation of a Member State with a derogation is also referred to as ‘legal convergence’. When assessing legal convergence, the ECB is not limited to making a formal assessment of the letter of national legislation, but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaties and the Statute. The ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of any Member State’s NCB which would be inconsistent with the spirit of the Treaty as regards central bank independence. The ECB also sees the need for the smooth and continuous functioning of the NCBs’ decision-making bodies. In this respect, the relevant authorities of a Member State have, in particular, the duty to take the necessary measures to ensure the timely appointment of a successor if the position of a member of an NCB’s decision-making body becomes vacant.¹ The ECB will closely monitor any developments prior to making a positive final assessment concluding that a Member State’s national legislation is compatible with the Treaty and the Statute.

A MEMBER STATE WITH A DEROGATION AND LEGAL CONVERGENCE

Latvia, whose national legislation is examined in this report, has the status of a Member State with a derogation, i.e. it has not yet adopted the euro. Article 4² of the Act concerning the conditions of accession provides that: ‘Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 139 of the Treaty’.

The ECB has examined the level of legal convergence in Latvia, as well as the legislative measures that have been taken or need to be taken by it to achieve this goal.

The aim of assessing legal convergence is to facilitate the Council’s decisions as to whether a Member State fulfils its ‘obligations regarding the achievement of economic and monetary union’ (Article 140(1) of the Treaty). In the legal domain, such conditions refer in particular to central bank independence and to the NCBs’ legal integration into the Eurosystem.

¹ Opinions CON/2010/37 and CON/2010/91.

² Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the previous reports of the ECB and the EMI on legal convergence.³

The compatibility of Latvian legislation is considered in the light of legislation enacted before 12 March 2013.

2.2.2 SCOPE OF ADAPTATION

2.2.2.1 AREAS OF ADAPTATION

For the purpose of identifying those areas where national legislation needs to be adapted, the following issues are examined:

- compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2) and with provisions on confidentiality (Article 37 of the Statute);
- compatibility with the prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty) and compatibility with the single spelling of the euro required by EU law; and
- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

2.2.2.2 'COMPATIBILITY' VERSUS 'HARMONISATION'

Article 131 of the Treaty requires national legislation to be 'compatible' with the Treaties and the Statute; any incompatibility must therefore be removed. Neither the supremacy of the Treaties and the Statute over national legislation nor the nature of the incompatibility affects the need to comply with this obligation.

The requirement for national legislation to be 'compatible' does not mean that the Treaty requires 'harmonisation' of the NCBs' statutes, either with each other or with the Statute. National particularities may continue to exist to the extent that they do not infringe the EU's exclusive competence in monetary matters. Indeed, Article 14.4 of the Statute permits NCBs to perform functions other than those specified in the Statute, to the extent that they do not interfere with the ESCB's objectives and tasks. Provisions authorising such additional functions in NCBs' statutes are a clear example of circumstances in which differences may remain. Rather, the term 'compatible' indicates that national legislation and the NCBs' statutes need to be adjusted to eliminate inconsistencies with the Treaties and the Statute and to ensure the necessary degree of integration of the NCBs into the ESCB. In particular, any provisions that infringe an NCB's independence, as defined in the Treaty, and its role as an integral part of the ESCB, should be adjusted. It is therefore insufficient to rely solely on the primacy of EU law over national legislation to achieve this.

³ In particular the ECB's Convergence Reports of May 2012 (on Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2010 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2008 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden), May 2007 (on Cyprus and Malta), December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), May 2006 (on Lithuania and Slovenia), October 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

The obligation in Article 131 of the Treaty only covers incompatibility with the Treaties and the Statute. However, national legislation that is incompatible with secondary EU legislation should be brought into line with such secondary legislation. The primacy of EU law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 131 of the Treaty but also from the case law of the Court of Justice of the European Union.⁴

The Treaties and the Statute do not prescribe the manner in which national legislation should be adapted. This may be achieved by referring to the Treaties and the Statute, or by incorporating provisions thereof and referring to their provenance, or by deleting any incompatibility, or by a combination of these methods.

Furthermore, among other things as a tool for achieving and maintaining the compatibility of national legislation with the Treaties and the Statute, the ECB must be consulted by the EU institutions and by the Member States on draft legislative provisions in its fields of competence, pursuant to Articles 127(4) and 282(5) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions⁵ expressly requires Member States to take the measures necessary to ensure compliance with this obligation.

2.2.3 INDEPENDENCE OF NCBS

As far as central bank independence and confidentiality are concerned, national legislation in the Member States that joined the EU in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute, and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden had to bring the necessary adaptations into force by the date of establishment of the ESCB on 1 June 1998.

CENTRAL BANK INDEPENDENCE

In November 1995, the EMI established a list of features of central bank independence (later described in detail in its 1998 Convergence Report) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCBS' statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely: functional, institutional, personal and financial independence. Over the past few years there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation and the Treaties and the Statute.

FUNCTIONAL INDEPENDENCE

Central bank independence is not an end in itself, but is instrumental in achieving an objective that should be clearly defined and should prevail over any other objective. Functional independence requires each NCB's primary objective to be stated in a clear and legally certain way and to be fully in line with the primary objective of price stability established by the Treaty. It is served by providing the NCBS with the necessary means and instruments for achieving this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the generally held view that the primary objective of price stability is best served by a fully independent institution

⁴ See, amongst others, Case 167/73 Commission of the European Communities v French Republic [1974] ECR 359 ('Code du Travail Maritime').

⁵ OJ L 189, 3.7.1998, p. 42.

with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect of enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

As regards timing, the Treaty is not clear about when the NCBs of Member States with a derogation must comply with the primary objective of price stability set out in Articles 127(1) and 282(2) of the Treaty and Article 2 of the Statute. For those Member States that joined the EU after the date of the introduction of the euro in the EU, it is not clear whether this obligation should run from the date of accession or from the date of their adoption of the euro. While Article 127(1) of the Treaty does not apply to Member States with a derogation (see Article 139(2)(c) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 42.1 of the Statute). The ECB takes the view that the obligation of the NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004 and 1 January 2007 for the Member States that joined the EU on those dates. This is based on the fact that one of the guiding principles of the EU, namely price stability (Article 119 of the Treaty), also applies to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind the regular reports of the ECB and the European Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

The country assessment in this report is based on these conclusions as to the timing of the obligation of the NCBs of Member States with a derogation to have price stability as their primary objective.

INSTITUTIONAL INDEPENDENCE

The principle of institutional independence is expressly referred to in Article 130 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from EU institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit EU institutions, bodies, offices or agencies, and the governments of the Member States from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs' ESCB-related tasks. If national legislation mirrors Article 130 of the Treaty and Article 7 of the Statute, it should reflect both prohibitions and not narrow the scope of their application.⁶

Whether an NCB is organised as a state-owned body, a special public law body or simply a public limited company, there is a risk that influence may be exerted by the owner on its decision-making in relation to ESCB-related tasks by virtue of such ownership. Such influence, whether exercised through shareholders' rights or otherwise, may affect an NCB's independence and should therefore be limited by law.

Prohibition on giving instructions

Rights of third parties to give instructions to NCBs, their decision-making bodies or their members are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Any involvement of an NCB in the application of measures to strengthen financial stability must be compatible with the Treaty, i.e. NCBs' functions must be performed in a manner that is fully compatible with their functional, institutional, and financial independence so as to

⁶ Opinion CON/2011/104.

safeguard the proper performance of their tasks under the Treaty and the Statute.⁷ To the extent that national legislation provides for a role of an NCB that goes beyond advisory functions and requires it to assume additional tasks, it must be ensured that these tasks will not affect the NCB's ability to carry out its ESCB-related tasks from an operational and financial point of view.⁸ Additionally, the inclusion of NCB representatives in collegiate decision-making supervisory bodies or other authorities would need to give due consideration to safeguards for the personal independence of the members of the NCB's decision-making bodies.⁹

Prohibition on approving, suspending, annulling or deferring decisions

Rights of third parties to approve, suspend, annul or defer an NCB's decisions are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Prohibition on censoring decisions on legal grounds

A right for bodies other than independent courts to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks is incompatible with the Treaty and the Statute, since the performance of these tasks may not be reassessed at the political level. A right of an NCB Governor to suspend the implementation of a decision adopted by the ESCB or by an NCB decision-making body on legal grounds and subsequently to submit it to a political body for a final decision would be equivalent to seeking instructions from third parties.

Prohibition on participation in decision-making bodies of an NCB with a right to vote

Participation by representatives of third parties in an NCB's decision-making body with a right to vote on matters concerning the performance by the NCB of ESCB-related tasks is incompatible with the Treaty and the Statute, even if such vote is not decisive.

Prohibition on ex ante consultation relating to an NCB's decision

An express statutory obligation for an NCB to consult third parties ex ante provides the latter with a formal mechanism to influence the final decision and is therefore incompatible with the Treaty and the Statute.

However, dialogue between an NCB and third parties, even when based on statutory obligations to provide information and exchange views, is compatible with central bank independence provided that:

- this does not result in interference with the independence of the members of the NCB's decision-making bodies;
- the special status of Governors in their capacity as members of the ECB's decision-making bodies is fully respected; and
- confidentiality requirements resulting from the Statute are observed.

Discharge provided for the duties of members of the NCB's decision-making bodies

Statutory provisions regarding the discharge provided by third parties (e.g. governments) regarding the duties of members of the NCB's decision-making bodies (e.g. in relation to accounts) should contain adequate safeguards, so that such a power does not impinge on the capacity of

⁷ Opinion CON/2010/31.

⁸ Opinion CON/2009/93.

⁹ Opinion CON/2010/94.

the individual NCB member independently to adopt decisions in respect of ESCB-related tasks (or implement decisions adopted at ESCB level). Inclusion of an express provision to this effect in NCB statutes is recommended.

PERSONAL INDEPENDENCE

The Statute's provision on security of tenure for members of NCBs' decision-making bodies further safeguards central bank independence. NCB Governors are members of the General Council of the ECB and will be members of the Governing Council upon adoption of the euro by their Member States. Article 14.2 of the Statute provides that NCB statutes must, in particular, provide for a minimum term of office of five years for Governors. It also protects against the arbitrary dismissal of Governors by providing that Governors may only be relieved from office if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct, with the possibility of recourse to the Court of Justice of the European Union. NCB statutes must comply with this provision as set out below.

Article 130 of the Treaty prohibits national governments and any bodies from influencing the members of NCBs' decision-making bodies in the performance of their tasks. In particular, Member States may not seek to influence the members of the NCB's decision-making bodies by amending national legislation affecting their remuneration, which, as a matter of principle, should apply only for future appointments.¹⁰

Minimum term of office for Governors

In accordance with Article 14.2 of the Statute, NCB statutes must provide for a minimum term of office of five years for a Governor. This does not preclude longer terms of office, while an indefinite term of office does not require adaptation of the statutes provided the grounds for the dismissal of a Governor are in line with those of Article 14.2 of the Statute. National legislation which provides for a compulsory retirement age should ensure that the retirement age does not interrupt the minimum term of office provided by Article 14.2 of the Statute, which prevails over any compulsory retirement age, if applicable to a Governor.¹¹ When an NCB's statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who are involved in the performance of ESCB-related tasks.

Grounds for dismissal of Governors

NCB statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute. The purpose of this requirement is to prevent the authorities involved in the appointment of Governors, particularly the government or parliament, from exercising their discretion to dismiss a Governor. NCB statutes should either contain grounds for dismissal which are compatible with those laid down in Article 14.2 of the Statute, or omit any mention of grounds for dismissal (since Article 14.2 is directly applicable). Once elected or appointed, Governors may not be dismissed under conditions other than those mentioned in Article 14.2 of the Statute even if the Governors have not yet taken up their duties.

Security of tenure and grounds for dismissal of members of NCBs' decision-making bodies, other than Governors, who are involved in the performance of ESCB-related tasks

Personal independence would be jeopardised if the same rules for the security of tenure and grounds for dismissal of Governors were not also to apply to other members of the decision-making

¹⁰ See, for example, Opinions CON/2010/56, CON/2010/80, CON/2011/104 and CON/2011/106.

¹¹ See paragraph 7 of Opinion CON/2012/89.

bodies of NCBs involved in the performance of ESCB-related tasks.¹² Various Treaty and Statute provisions require comparable security of tenure. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, while Article 130 of the Treaty and Article 7 of the Statute refer to ‘members of the decision-making bodies’ of NCBs, rather than to Governors specifically. This applies in particular where a Governor is ‘first among equals’ with colleagues with equivalent voting rights or where such other members are involved in the performance of ESCB-related tasks.

Right of judicial review

Members of the NCBs’ decision-making bodies must have the right to submit any decision to dismiss them to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for their dismissal.

Article 14.2 of the Statute stipulates that NCB Governors who have been dismissed from office may refer such a decision to the Court of Justice of the European Union. National legislation should either refer to the Statute or remain silent on the right to refer such decision to the Court of Justice of the European Union (as Article 14.2 of the Statute is directly applicable).

National legislation should also provide for a right of review by the national courts of a decision to dismiss any other member of the decision-making bodies of the NCB involved in the performance of ESCB-related tasks. This right can either be a matter of general law or can take the form of a specific provision. Even though this right may be available under the general law, for reasons of legal certainty it could be advisable to provide specifically for such a right of review.

Safeguards against conflicts of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies involved in the performance of ESCB-related tasks in relation to their respective NCBs (and of Governors in relation to the ECB) and any other functions which such members of decision-making bodies may have and which may jeopardise their personal independence. As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

FINANCIAL INDEPENDENCE

Even if an NCB is fully independent from a functional, institutional and personal point of view (i.e. this is guaranteed by the NCB’s statutes), its overall independence would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate (i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute).

Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of the ECB making further calls on the NCBs to contribute to the ECB’s capital and to make further transfers of foreign reserves.¹³ Moreover,

¹² See paragraph 8 of Opinion CON/2004/35; paragraph 8 of Opinion CON/2005/26; paragraph 3.3 of Opinion CON/2006/44; paragraph 2.6 of Opinion CON/2006/32; and paragraphs 2.3 and 2.4 of Opinion CON/2007/6.

¹³ Article 30.4 of the Statute only applies within the Eurosystem.

Article 33.2 of the Statute provides¹⁴ that, in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion to and up to the amounts allocated to the NCBs. The principle of financial independence means that compliance with these provisions requires an NCB to be able to perform its functions unimpaired.

Additionally, the principle of financial independence requires an NCB to have sufficient means not only to perform its ESCB-related tasks but also its national tasks (e.g. financing its administration and own operations).

For all the reasons mentioned above, financial independence also implies that an NCB should always be sufficiently capitalised. In particular, any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over. Any such situation may negatively impact on the NCB's ability to perform its ESCB-related tasks but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence. As concerns the ECB, the relevance of this issue has already been recognised by the Council by adopting Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank.¹⁵ It enables the Governing Council of the ECB to decide on an actual increase at some point in time in the future to sustain the adequacy of the capital base to support the operations of the ECB;¹⁶ NCBs should be financially able to respond to such ECB decision.

The concept of financial independence should be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability to fulfil its mandate, both operationally in terms of manpower, and financially in terms of appropriate financial resources. The aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined recently.¹⁷ These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

If a third party has the power to determine or influence an NCB's budget, this is incompatible with financial independence unless the law provides a safeguard clause so that such a power is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

The accounting rules

The accounts should be drawn up either in accordance with general accounting rules or in accordance with rules specified by an NCB's decision-making bodies. If, instead, such rules are specified by third parties, the rules must at least take into account what has been proposed by the NCB's decision-making bodies.

¹⁴ Article 33.2 of the Statute only applies within the Eurosystem.

¹⁵ OJ L 115, 16.5.2000, p. 1.

¹⁶ Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB's capital (OJ L 11, 15.1.2011, p. 53).

¹⁷ The main formative ECB opinions in this area are: CON/2002/16; CON/2003/22; CON/2003/27; CON/2004/1; CON/2006/38; CON/2006/47; CON/2007/8; CON/2008/13; CON/2008/68 and CON/2009/32.

The annual accounts should be adopted by the NCB's decision-making bodies, assisted by independent accountants, and may be subject to ex post approval by third parties (e.g. the government or parliament). The NCB's decision-making bodies should be able to decide on the calculation of the profits independently and professionally.

Where an NCB's operations are subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework, should be without prejudice to the activities of the NCB's independent external auditors¹⁸ and further, in line with the principle of institutional independence, it should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB's ESCB-related tasks.¹⁹ The state audit should be done on a non-political, independent and purely professional basis.

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. In the absence of such provisions, decisions on the allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks as well as national tasks.

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered²⁰ and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of their profits are not admissible.²¹ Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.²²

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which must aim to ensure that it retains sufficient financial means to fulfil its mandate under Article 127(2) of the Treaty and the Statute as a member of the ESCB. For the same reason, any amendment to the profit distribution rules of an NCB should only be initiated and decided in cooperation with the NCB, which is best placed to assess its required level of reserve capital.²³ As regards financial provisions or buffers, NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets. Member States may also not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the ESCB to fulfil its tasks.²⁴

Financial liability for supervisory authorities

Most Member States place their financial supervisory authorities within their NCB. This is unproblematic if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as

18 For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.

19 Opinions CON/2011/9 and CON/2011/53.

20 Opinion CON/2009/85.

21 Opinion CON/2009/26.

22 Opinion CON/2009/63 and Opinion CON/2009/59.

23 Opinion CON/2009/83 and Opinion CON/2009/53.

24 Opinion CON/2009/26.

a whole. In such cases, national legislation should enable the NCB to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the Treaty and the Statute. Also, an NCB may not be put into a position where it has limited control or no control over its staff, or where the government of a Member State can influence its policy on staff matters.²⁵ Any amendment to the legislative provisions on the remuneration for members of an NCB's decision-making bodies and its employees should be decided in close and effective cooperation with the NCB, taking due account of its views, to ensure the ongoing ability of the NCB to independently carry out its tasks.²⁶ Autonomy in staff matters extends to issues relating to staff pensions.

Ownership and property rights

Rights of third parties to intervene or to issue instructions to an NCB in relation to the property held by an NCB are incompatible with the principle of financial independence.

2.2.4 CONFIDENTIALITY

The obligation of professional secrecy for ECB and NCB staff under Article 37 of the Statute may give rise to similar provisions in NCBs' statutes or in the Member States' legislation. The primacy of EU law and rules adopted thereunder also means that national laws on access by third parties to documents may not lead to infringements of the ESCB's confidentiality regime. The access of a state audit office or similar body to an NCB's information and documents must be limited and must be without prejudice to the ESCB's confidentiality regime to which the members of NCBs' decision-making bodies and staff are subject. NCBs should ensure that such bodies protect the confidentiality of information and documents disclosed at a level corresponding to that applied by the NCBs.

2.2.5 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

On the monetary financing prohibition and the prohibition on privileged access, the national legislation of the Member States that joined the EU in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

2.2.5.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of EU institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition; it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks,

²⁵ Opinion CON/2008/9, Opinion CON/2008/10 and Opinion CON/2012/89.

²⁶ The main Opinions are CON/2010/42, CON/2010/51, CON/2010/56, CON/2010/69, CON/2010/80, CON/2011/104, CON/2011/106, CON/2012/6 and CON/2012/86.

must be given the same treatment as private credit institutions (Article 123(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty,²⁷ which makes it clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensuring that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to the limited exemptions contained in Article 123(2) of the Treaty and Regulation (EC) No 3603/93. Thus, even if Article 123(1) of the Treaty refers specifically to 'credit facilities', i.e. with the obligation to repay the funds, the prohibition applies a fortiori to other forms of funding, i.e. without the obligation to repay.

The ECB's general stance on the compatibility of national legislation with the prohibition has primarily been developed within the framework of consultations of the ECB by Member States on draft national legislation under Articles 127(4) and 282(5) of the Treaty.²⁸

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

In general, it is unnecessary to transpose Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, into national legislation as they are both directly applicable. If, however, national legislative provisions mirror these directly applicable EU provisions, they may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under EU law. For example, national legislation providing for the financing by the NCB of a Member State's financial commitments to international financial institutions (other than the IMF, as provided for in Regulation (EC) No 3603/93) or to third countries is incompatible with the monetary financing prohibition.

FINANCING OF THE PUBLIC SECTOR OR OF PUBLIC SECTOR OBLIGATIONS TO THIRD PARTIES

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. For example, national laws authorising or requiring an NCB to finance judicial or quasi-judicial bodies that are independent of the NCB and operate as an extension of the state are incompatible with the monetary financing prohibition. NCB involvement should not go beyond the provision of advice regarding the financing of the public sector or of public sector obligations to third parties.²⁹ Moreover, in line with the prohibition on monetary financing, an NCB may not finance any resolution fund or deposit guarantee scheme.³⁰ No bridge financing may be provided by an NCB to enable a Member State to honour its obligations in respect of State guarantees of bank liabilities.³¹ However, the provision of resources by an NCB to a supervisory authority does not give rise to monetary financing concerns insofar as the NCB will be financing the performance of a legitimate financial

27 OJ L 332, 31.12.1993, p. 1. Articles 104 and 104b(1) of the Treaty establishing the European Community are now Articles 123 and 125(1) of the Treaty on the Functioning of the European Union.

28 See Convergence Report 2008, page 23, footnote 13, containing a list of formative EMI/ECB opinions in this area adopted between May 1995 and March 2008. Other formative ECB opinions in this area are: CON/2008/46; CON/2008/80; CON/2009/59 and CON/2010/4.

29 Opinion CON/2012/85.

30 Opinions CON/2011/103 and CON/2012/22.

31 Opinion CON/2012/4.

supervisory task under national law as part of its mandate, or as long as the NCB can contribute to and have influence on the decision-making of the supervisory authorities.³² Also, the distribution of central bank profits which have not been fully realised, accounted for and audited does not comply with the monetary financing prohibition. To comply with the monetary financing prohibition, the amount distributed to the State budget pursuant to the applicable profit distribution rules cannot be paid, even partially, from the NCB's reserve capital. Therefore, profit distribution rules should leave unaffected the NCB's reserve capital. Moreover, when NCB assets are transferred to the State, they must be remunerated at market value and the transfer should take place at the same time as the remuneration.³³

Similarly, intervention in the performance of other Eurosystem tasks, such as the management of foreign reserves, by introducing taxation of theoretical and unrealised capital gains is not permitted.³⁴

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

National legislation which requires an NCB to take over the liabilities of a previously independent public body, as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies), without insulating the NCB from financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation which provides for financing by an NCB, granted independently and at their full discretion, of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular the support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition.

This applies, in particular, to the support of insolvent credit institutions. The rationale is that by financing an insolvent credit institution, an NCB would be assuming a State task. The same concerns apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of a direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter 'recapitalisation bonds'), and where such bonds are to be used as collateral. In such case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.³⁵

Emergency liquidity assistance, granted by an NCB independently and at its full discretion to a solvent credit institution on the basis of collateral security in the form of a State guarantee, has to meet the following criteria: (i) it must be ensured that the credit provided by the NCB is as short term as possible; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans.³⁶

32 Opinion CON/2010/4.

33 Opinions CON/2011/91 and CON/2011/99.

34 Opinion CON/2009/63.

35 Opinions CON/2012/50, CON/2012/64, and CON/2012/71.

36 Opinion CON/2012/4, footnote 42 referring to further relevant Opinions in this field.

To this end, inserting references to Article 123 of the Treaty in national legislation should be considered.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive³⁷ and the Investor Compensation Schemes Directive³⁸ provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion. To this end, inserting references to Article 123 of the Treaty in national legislation should be considered. When exercising its discretion to grant a loan, the NCB must ensure that it is not de facto taking over a State task.³⁹ In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.⁴⁰

In line with the prohibition of monetary financing, an NCB may not finance any resolution fund. Where an NCB acts as resolution authority, it should in no event assume or finance any obligation of either a bridge institution or an asset management vehicle.⁴¹

FISCAL AGENCY FUNCTION

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to enable NCBs to continue to provide the fiscal agent service traditionally provided by central banks to governments and other public entities without automatically breaching the monetary financing prohibition. Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;⁴² (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;⁴³ and (iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.⁴⁴

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular. Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services as a legitimate function

37 Recital 23 of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).

38 Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

39 Opinion CON/2011/83.

40 Opinion CON/2011/84.

41 Opinions CON/2012/99 and CON/2011/103.

42 See Article 4 of Regulation (EC) No 3603/93.

43 See Article 5 of Regulation (EC) No 3603/93.

44 See Article 6 of Regulation (EC) No 3603/93.

traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the prohibition on monetary financing, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93.⁴⁵ National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.⁴⁶ Moreover, the provision without remuneration by an NCB of fiscal agent services does not raise monetary financing concerns, provided they are core fiscal agent services.⁴⁷

2.2.5.2 PROHIBITION ON PRIVILEGED ACCESS

As public authorities, NCBs may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.⁴⁸ Member States' legislation in this area may not establish such privileged access.

This report focuses on the compatibility both of national legislation or rules adopted by NCBs and of the NCBs' statutes with the Treaty prohibition on privileged access. However, this report is without prejudice to an assessment of whether laws, regulations, rules or administrative acts in Member States are used under the cover of prudential considerations as a means of circumventing the prohibition on privileged access. Such an assessment is beyond the scope of this report.

2.2.6 SINGLE SPELLING OF THE EURO

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'евро'.⁴⁹ Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro⁵⁰ makes it clear that the name of the single currency must be the same in all the official languages of the EU, taking into account the existence of

45 Opinions CON/2009/23, CON/2009/67 and CON/2012/9.

46 See, among others, Opinions CON/2010/54 and CON/2010/55.

47 Opinion CON/2012/9.

48 See Article 3(2) of and recital 10 of Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition on privileged access referred to in Article 104a [now Article 124] of the Treaty (OJ L 332, 31.12.1993, p. 4).

49 The 'Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties', annexed to the Treaties, states that: 'Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages'.

50 OJ L 139, 11.5.1998, p. 1.

different alphabets. The Treaties thus require a single spelling of the word ‘euro’ in the nominative singular case in all EU and national legislative provisions, taking into account the existence of different alphabets.

In view of the exclusive competence of the EU to determine the name of the single currency, any deviations from this rule are incompatible with the Treaties and should be eliminated. While this principle applies to all types of national legislation, the assessment in the country chapter focuses on the NCB’s statute and the legislation concerning the name of the single currency in Latvian.

2.2.7 LEGAL INTEGRATION OF NCBs INTO THE EUROSISTEM

Provisions in national legislation (in particular an NCB’s statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with the ECB’s decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 131 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004 and 1 January 2007 (as regards the Member States which joined the EU on these dates). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

The main areas examined in this report are those in which statutory provisions may hinder an NCB’s compliance with the Eurosystem’s requirements. These include provisions that could prevent the NCB from taking part in implementing the single monetary policy, as defined by the ECB’s decision-making bodies, or hinder a Governor from fulfilling their duties as a member of the ECB’s Governing Council, or which do not respect the ECB’s prerogatives. Distinctions are made between economic policy objectives, tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where an NCB’s statutes may need to be adapted are mentioned.

2.2.7.1 ECONOMIC POLICY OBJECTIVES

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB’s objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a ‘national flavour’ – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB’s secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.⁵¹

2.2.7.2 TASKS

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB’s status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB’s statutes

⁵¹ Opinions CON/2010/30 and CON/2010/48.

therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.⁵² This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the EU's monetary policy is to be carried out through the Eurosystem.⁵³ An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

In the context of recent national legislative initiatives to address the turmoil in the financial markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.⁵⁴

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.⁵⁵

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute, while the right to issue euro banknotes belongs to the ECB and the NCBs. National legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of euro banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.⁵⁶

With regard to foreign reserve management,⁵⁷ any Member State that has adopted the euro and which does not transfer its official foreign reserves⁵⁸ to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with

⁵² See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

⁵³ First indent of Article 127(2) of the Treaty.

⁵⁴ Opinions CON/2009/99 and CON/2011/79.

⁵⁵ Opinion CON/2010/8.

⁵⁶ Opinion CON/2008/34.

⁵⁷ Third indent of Article 127(2) of the Treaty.

⁵⁸ With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.

foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

2.2.7.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts,⁵⁹ auditing,⁶⁰ capital subscription,⁶¹ the transfer of foreign reserve assets⁶² and the allocation of monetary income.⁶³ NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.2.7.4 EXCHANGE RATE POLICY

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that a Member State adopts the euro, such legislation must reflect the fact that responsibility for the euro area's exchange rate policy has been transferred to the EU level in accordance with Articles 138 and 219 of the Treaty.

2.2.7.5 INTERNATIONAL COOPERATION

For the adoption of the euro, national legislation must be compatible with Article 6.1 of the Statute, which provides that in the field of international cooperation involving the tasks entrusted to the Eurosystem, the ECB decides how the ESCB is represented. National legislation allowing an NCB to participate in international monetary institutions must make such participation subject to the ECB's approval (Article 6.2 of the Statute).

2.2.7.6 MISCELLANEOUS

In addition to the above issues, in the case of certain Member States there are other areas where national provisions need to be adapted (for example in the area of clearing and payment systems and the exchange of information).

59 Article 26 of the Statute.

60 Article 27 of the Statute.

61 Article 28 of the Statute.

62 Article 30 of the Statute.

63 Article 32 of the Statute.

3 SUMMARY CHAPTER FOR LATVIA

Over the reference period from May 2012 to April 2013, the 12-month average rate of HICP inflation in Latvia was 1.3%, i.e. well below the reference value of 2.7% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Latvia has been very volatile, ranging between annual averages of -1.2% and 15.3% in the past ten years. After Latvia's accession to the EU in 2004, inflation picked up and fluctuated between 6% and 7% for a few years, before accelerating sharply in 2007 and 2008. Particularly during the boom years in the second half of the decade, the Latvian economy exhibited growing signs of serious overheating and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the Latvian economy experienced a deep crisis beginning in 2008. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply. Consumer prices and, in particular, unit labour costs declined, which helped the country to regain price and cost competitiveness. This adjustment came to an end in the course of 2010 as macroeconomic conditions stabilised and unit labour costs started to gradually pick up again. Inflation developments over the past few years have mainly been driven by fluctuations in global commodity prices and changes in indirect taxes and administered prices. Looking at recent developments, the year-on-year rate of HICP inflation continued to decline in early 2013 and stood at -0.4% in April, after peaking at 4.8% in mid-2011. However, this decline also reflected the impact of a lower rate of VAT as of July 2012 (by one percentage point to 21%) and lower increases in administered prices as of January 2013 (the latter also reflect a fall in commodity prices).

The latest available forecasts from major international institutions project inflation to rise in 2013-14, ranging between 1.4% and 1.8% in 2013 and between 2.1% and 2.7% in 2014. For 2014, these forecasts are above those for the euro area average. The balance of risks surrounding these inflation projections for the years ahead is on the upside. Such risks stem in particular from the possibility of higher commodity prices and stronger than expected increases in wage costs.

Looking further ahead, maintaining low inflation rates in Latvia will be challenging in the medium term, given monetary policy's limited room for manoeuvre in a context characterised by little room for nominal exchange rate flexibility. Experience during the boom years of 2005 to 2007 shows that it may be difficult to control domestic price pressures and avoid renewed economic exuberance. At the same time, past losses in competitiveness will mitigate growth and could thereby also weaken inflationary pressure somewhat in the coming years. In any case, the catching-up process is likely to drive up the inflation differential between Latvia and the euro area over the medium term, given that GDP per capita and price levels are still lower in Latvia than in the euro area. However, it is difficult to assess the exact magnitude of the inflation effect resulting from this process. Overall, in the context of the process of economic convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the lack of nominal exchange rate flexibility and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

To sum up, the 12-month average rate of HICP inflation in Latvia is currently well below the reference value. However, there are concerns regarding the sustainability of inflation convergence.

Latvia is, at the time of finalisation of this report, subject to an EU Council decision on the existence of an excessive deficit, with a deadline for correcting the excessive deficit in 2012. In the reference year 2012 the general government budget balance showed a deficit of 1.2% of GDP, i.e. well below the 3% reference value. The general government gross debt-to-GDP ratio was 40.7%, i.e. below

the 60% reference value. In 2013 the deficit ratio is forecast by the European Commission to be unchanged at 1.2% and the government debt ratio is projected to increase to 43.2%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2012. Latvia must ensure progress with fiscal consolidation in line with the requirements of the preventive arm of the Stability and Growth Pact in 2013 and beyond, adhering strictly to the recently adopted Fiscal Discipline Law.

The Latvian lats has been participating in ERM II since 2 May 2005 with a standard fluctuation band of $\pm 15\%$. At the time of ERM II entry, the Latvian authorities unilaterally undertook to maintain the exchange rate of the lats within a fluctuation band of $\pm 1\%$ around the central rate, thus placing no additional obligations on the ECB. Over the two-year period under review, from 17 May 2011 to 16 May 2013, the lats has remained close to its central rate. Both the maximum upward deviation and maximum downward deviation of the exchange rate from the ERM II central rate amounted to 1.0%. Between late 2008 and January 2012, an international financial assistance arrangement (led by the EU and the IMF) of €7.5 billion was in place. Between late 2008 and late 2010, the Latvian authorities drew a total amount of €4.5 billion from this arrangement, thereby lowering financial vulnerabilities and helping to reduce exchange rate pressures. Over the two-year reference period from 17 May 2011 to 16 May 2013, the Latvian authorities did not draw on the remaining resources of €3.0 billion and repaid the IMF ahead of schedule. Nevertheless, as the international financial assistance arrangement also helped to reduce risks related to financial vulnerabilities, it may also have helped to reduce the risk of exchange rate pressures. The exchange rate volatility of the Latvian lats vis-à-vis the euro, as measured by annualised standard deviations of daily percentage changes, mostly stood at very low levels in the period under review. Short-term interest rate differentials against the three-month EURIBOR were negative throughout 2011 and increased to very small positive levels thereafter. In a longer-term context, in April 2013 both the real effective exchange rate of the Latvian lats and its real bilateral exchange rate against the euro stood relatively close to the corresponding ten-year historical averages. Latvia was characterised by very large deficits in the combined current and capital account of its balance of payments, in excess of 20% of GDP, in 2006 and 2007. After a strong fall in domestic demand, which led to lower imports, as well as gains in competitiveness and a strong recovery of exports, the deficit decreased substantially and the combined current and capital account registered a very large surplus of 11.1% of GDP in 2009. This drastic shift reflected a substantial decrease in the goods deficit and, to a lesser extent, increases in the surpluses in services and transfers, as well as a temporary improvement in the income balance. This surplus narrowed subsequently to 0.0% in 2011 and 1.3% in 2012, reflecting the rebound of domestic demand, particularly investment, with strong growth in imports outpacing the growth in exports. The country's net international investment position deteriorated substantially until the onset of the crisis, from -43.8% of GDP in 2003 to -82.7% in 2009, but improved thereafter to -65.1% in 2012. The fact that the country's net foreign liabilities are still very high points to the importance of fiscal and structural policies supporting external sustainability.

Long-term interest rates were 3.8% on average over the reference period from May 2012 to April 2013 and were thus below the 5.5% reference value for the interest rate convergence criterion. During the reference period long-term interest rates declined as macroeconomic conditions and government finances improved, credit ratings were upgraded and – particularly in the second half of 2012 – global financial market conditions improved. Long-term interest rates stood at 3.2% at the end of the reference period, 0.3 percentage point higher than the euro area average (and 1.6 percentage points higher than the euro area AAA long-term government bond yield).

All in all, although Latvia is within the reference values of the convergence criteria, the longer-term sustainability of Latvia's economic convergence is of concern. Indeed, in the past, Latvia has experienced major boom-bust episodes and high macroeconomic volatility, which were also visible inter alia in domestic prices and long-term interest rates. More recently, Latvia has introduced a number of policy measures to enhance the domestic framework for counter-cyclical policies. Joining a currency union entails foregoing monetary and exchange rate instruments and implies an increased importance of internal flexibility and resilience. Economic sustainability is thus conditional on a permanent willingness, on the part of both the authorities and the public at large, to adjust and to introduce the necessary reforms and policy measures to safeguard macroeconomic stability and the competitiveness of the economy.

Achieving and maintaining an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Regarding macroeconomic imbalances, the European Commission did not select Latvia for an in-depth review in its Alert Mechanism Reports in 2012 and 2013. At the same time, given monetary policy's limited room for manoeuvre owing to the lack of nominal exchange rate flexibility, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and avoid the possible re-accumulation of macroeconomic imbalances. The authorities should, therefore, consider avenues to further strengthen the alternative counter-cyclical policy instruments at their disposal, in addition to what has been done since 2009. Specifically, progress in the areas below will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

First of all, it is necessary for Latvia to continue along a path of comprehensive fiscal consolidation in line with the requirements of the Stability and Growth Pact, and to implement and to adhere to a fiscal framework that helps to avoid a return to pro-cyclical policies in the future. In addition, it is important to lock in the competitiveness gains achieved in recent years by avoiding a renewed increase in unit labour cost growth. Moreover, it is essential to implement further structural reform measures that focus in particular on improving the functioning of the labour market, in which high unemployment coincides with skill mismatches and labour shortages in some sectors.

Although Latvia's adjustment capacity has been strong, its indicators of the quality of institutions and governance point to a need to make progress in this field. Looking at the current rankings of the 27 Member States of the EU as reported by various international organisations, while Latvia's business environment is regarded as particularly positive, its relatively weak overall performance in terms of governance suggests that a stronger institutional environment is desirable (see Section 4.1 for more details). Furthermore, the shadow economy, although declining, is estimated to still be relatively large in Latvia. These weaknesses not only entail public revenue losses but also distort competition, harm Latvia's competitiveness and reduce the country's attractiveness as a destination for foreign direct investment, thus hampering longer-term investment and productivity.

Finally, in the financial sector, the reliance by a significant part of the banking sector on non-resident deposits as a source of funding, while not a recent phenomenon, is again on the rise and represents an important risk to financial stability. Moreover, a potential renewed emergence of domestic imbalances or excessive credit growth could pose additional risks to financial stability. In addition to appropriate micro-prudential policies, it is crucial that a comprehensive policy toolkit is available. This should include: (i) macro-prudential measures, national balance sheet analysis and stress tests; (ii) proper funding mechanisms for the deposit insurance scheme; (iii) effective resolution and recovery tools; (iv) strengthened monitoring of any build-up of macroeconomic

imbalances that could threaten financial stability, with readiness to adopt additional measures if warranted; and (v) the highest standards possible in the implementation of international anti-money laundering rules. Finally, financial stability should benefit from Latvia's participation in the Single Supervisory Mechanism (SSM), which is expected to enter into force in 2014.

Latvian law complies with all the requirements for central bank independence, the prohibition on monetary financing and legal integration into the Eurosystem. However, the provision of the first paragraph of Article 43 of the Law on Latvijas Banka which requires the Parliament of Latvia to supervise Latvijas Banka would benefit from being clarified on the occasion of a further revision of its provisions to ensure legal certainty.

4 EXAMINATION OF ECONOMIC CONVERGENCE

4.1 PRICE DEVELOPMENTS

Over the reference period from May 2012 to April 2013, the 12-month average rate of HICP inflation in Latvia was 1.3%, i.e. well below the reference value of 2.7% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation in Latvia has been very volatile, ranging between annual averages of -1.2% and 15.3% in the past ten years. After Latvia's accession to the EU in 2004, inflation picked up and fluctuated between 6% and 7% for a few years, before accelerating sharply in 2007 and 2008 (see Chart 1). The pick-up in inflation after EU accession was initially attributable mainly to an increase in administered prices and indirect taxes. During the second half of the decade, excessive demand and accelerating credit growth (supported, inter alia, by low, and at times negative, real interest rates and strong capital inflows), very strong wage increases and hikes in global energy and food prices also increasingly contributed to driving up inflation and led to an erosion of competitiveness. Particularly during the boom years of 2005 to 2007, the Latvian economy exhibited growing signs of serious overheating and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the country's economy experienced a deep crisis starting in 2008. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply to a trough of -1.2% in 2010. This adjustment process helped Latvia to regain price competitiveness. However, in 2010 and particularly in 2011, the annual rate of inflation picked up again owing to increases in global food and energy prices and higher indirect taxes, before slowing significantly in 2012, reflecting a declining impact of global food and energy prices, as well as a decrease in the rate of VAT.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. Monetary policy is aimed towards the achievement of price stability, which is the primary objective as enshrined in the central bank law. Latvijas Banka aims at achieving this key objective via a strict exchange rate peg, initially to the IMF's special drawing right and, since early 2005, to the euro. In May 2005 Latvia joined ERM II at the previously established central rate and unilaterally retained the existing narrow fluctuation band of $\pm 1\%$. As economic growth strengthened during 2005-07, fiscal policies became increasingly pro-cyclical. At the same time, the country's monetary policy was constrained by the aim of maintaining the unilateral band within ERM II, and the overall policy stance (including fiscal policy) was not tight enough to counter the growing signs of overheating. During the subsequent downturn, significant fiscal consolidation measures were implemented as part of the international financial assistance programme led by the EU and the IMF. These measures included cuts in public expenditure to adjust the imbalances, restore investor confidence and put public finances on a sustainable track. In addition, the government implemented a range of structural reform measures to streamline the public sector (including health, public administration and other reforms), improve the ease of doing business and support productivity. These fiscal and structural policies, along with a sharp contraction in aggregate demand and increasing economic slack, supported an internal adjustment which reduced previous losses in competitiveness and macroeconomic imbalances.

Inflation developments over the past ten years should be viewed against the background of a volatile macroeconomic environment. Latvia's business cycle has moved broadly in line with the euro area over this time, although macroeconomic fluctuations have been substantially more pronounced in Latvia. Very robust and accelerating real GDP growth until 2007 turned into an abrupt and painful contraction between 2008 and 2010, owing to a build-up and subsequent correction of significant

macroeconomic imbalances and vulnerabilities. This turnaround was exacerbated by the impact of the global financial and economic crisis. Liquidity tensions started to cause balance of payments problems in late 2008, triggering Latvia to seek international financial assistance. As part of this assistance programme led by the EU and the IMF, drastic fiscal adjustment measures were implemented to stabilise the financial sector, restore confidence, ensure the sustainability of public finances and regain competitiveness. Macroeconomic conditions weakened abruptly, in particular in 2009, reflecting the collapse of domestic demand, the unwinding of the credit and housing bubble and the significant deterioration in the external environment. After a cumulative decline of approximately 25%, real GDP started to recover in the course of 2010, with growth picking up further to stand at more than 5% in 2011 and 2012. Following a peak of 21.2% in early 2010, the unemployment rate started to decrease gradually, although the share of long-term unemployment still remains high at 47% of total unemployment. Wages and employment have been fairly flexible. After falling significantly, compensation per employee recovered somewhat in 2011 as labour market conditions started to improve again. Thanks to a certain pick-up in labour productivity and a decrease in compensation per employee, unit labour costs declined significantly in 2010, before increasing moderately in 2011 and 2012. Consumer prices also declined during the contraction of GDP, although the size of the fall was relatively limited as the impact of declines in wage costs was partly offset by higher indirect taxes, rising commodity prices and an increase in corporate mark-ups (see Table 2). After declining by a cumulative 55% during the downturn, residential property prices have recovered gradually in recent years and currently stand around one third below their peak in 2007.

Looking at recent developments, the year-on-year rate of HICP inflation continued to decline in early 2013 and stood at -0.4% in April (see Table 3a), after peaking at 4.8% in mid-2011. The gradual decline in inflation reflected the fading impact of past increases in global commodity prices, which resulted in lower increases in administered prices, as well as lower indirect taxes. Excluding food and energy, inflation has also declined as a result of lower cost-push pressure in other industries. In more detail, a reduction in the standard rate of VAT as of July 2012 (by one percentage point to 21%) helped to reduce inflation. In addition, the association of large food retailers has made voluntary agreements with the government to ensure that this VAT cut is passed on to consumer prices. If passed on fully and immediately, the HICP at constant tax rates suggests that the reduction in VAT would lower HICP inflation by 0.6-0.7 percentage point between July 2012 and June 2013. In addition, in early 2013 lower increases in administered prices contributed to the fall in inflation. More specifically, a decline in administered heat energy and gas prices, which depend on the nine-month average price of heavy fuel oil in the world market, was a major contributor to the decline in inflation. Finally, declines in the prices of clothing and footwear also had a downward impact on inflation in early 2013. The annual rate of growth in compensation per employee has been stable at around 5% in recent quarters, with growth increasingly stemming from flexible components, such as bonuses (in line with higher profitability). Increases in unit labour costs have been muted by a pick-up in labour productivity, reflecting strong output growth and a restructuring of production processes. Unemployment fell to around 14% in late 2012 (which is still high compared with the euro area average), underpinned by strong job creation, despite an increase in the participation rate. However, a large part of unemployment is structural in nature, associated with skill mismatches in some sectors and a sizeable informal economy.

The latest available forecasts from major international institutions project inflation to rise in 2013-14, ranging between 1.4% and 1.8% in 2013 and between 2.1% and 2.7% in 2014 (see Table 3b). For 2014, these forecasts are above those for the euro area average. The balance of risks surrounding inflation projections in Latvia for the years ahead is on the upside. Such risks

stem in particular from the possibility of higher food or energy prices and stronger than expected increases in wages as labour market slack diminishes. Developments in global commodity prices for food and energy tend to have a relatively large impact on consumer prices in Latvia. A further tightening of the labour market, together with rising skill mismatches, would put some upward pressure on wages. The planned liberalisation of the electricity market, which is likely to take place by early 2014, may also have a temporary upward impact on inflation.

Looking further ahead, maintaining low inflation rates will be challenging in the medium term, given monetary policy's limited room for manoeuvre in a context characterised by little room for nominal exchange rate flexibility. Experience during the boom years of 2005 to 2007 shows that it may be difficult to control domestic price pressures and avoid renewed economic exuberance. At the same time, past losses in competitiveness will mitigate growth and could thereby also weaken inflationary pressure somewhat in the coming years. In any case, the catching-up process is likely to drive up the inflation differential between Latvia and the euro area over the medium term, given that GDP per capita and price levels are still lower in Latvia than in the euro area (see Table 2). However, it is difficult to assess the exact magnitude of the inflation effect resulting from this process. Nevertheless, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation will manifest itself in higher inflation. Overall, in the context of the process of economic convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the lack of nominal exchange rate flexibility and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

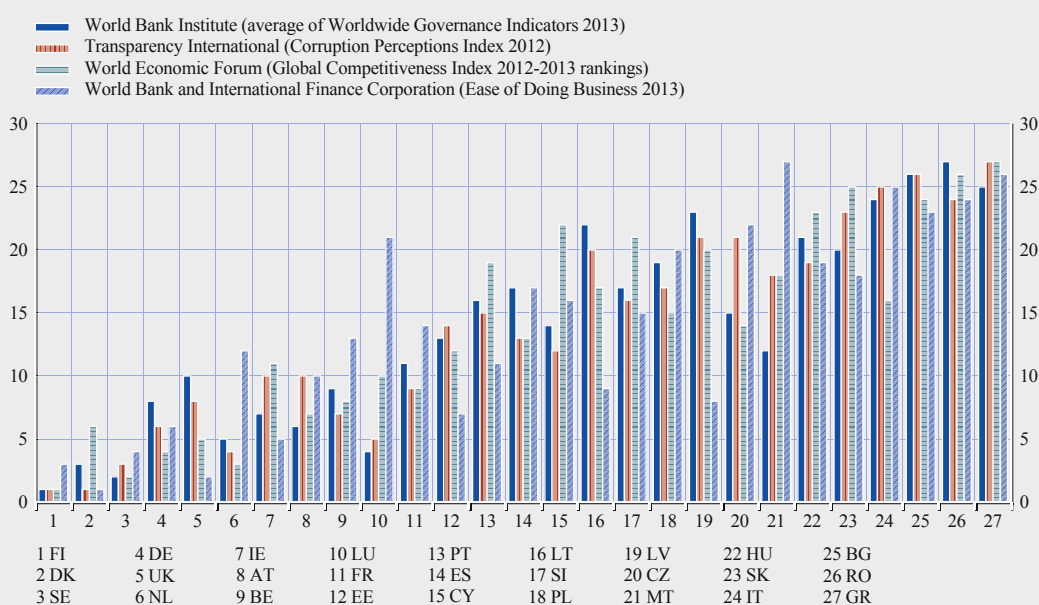
To sum up, the 12-month average rate of HICP inflation in Latvia is currently well below the reference value. However, there are concerns regarding the sustainability of inflation convergence.

Indeed, in the past, Latvia has experienced major boom-bust episodes and high macroeconomic volatility. More recently, it has introduced a number of policy measures to enhance the domestic framework for counter-cyclical policies. Joining a currency union entails foregoing monetary and exchange rate instruments and implies an increased importance of internal flexibility and resilience. Economic sustainability is thus conditional on a permanent willingness, on the part of both the authorities and the public at large, to adjust and to introduce the necessary reforms and policy measures to safeguard macroeconomic stability and competitiveness.

Achieving and maintaining an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Regarding macroeconomic imbalances, the European Commission did not select Latvia for an in-depth review in its Alert Mechanism Reports in 2012 and 2013. At the same time, given monetary policy's limited room for manoeuvre owing to the lack of nominal exchange rate flexibility, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and avoid the possible re-accumulation of macroeconomic imbalances. The authorities should, therefore, consider avenues to further strengthen the alternative counter-cyclical policy instruments at their disposal, in addition to what has been done since 2009. More specifically, progress in the areas below will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

First of all, it is necessary for Latvia to continue along a path of comprehensive fiscal consolidation in line with the requirements of the Stability and Growth Pact, and to implement and to adhere to

Country rankings in the EU



Source: The World Bank Institute (Worldwide Governance Indicators 2013), World Economic Forum (The Global Competitiveness Index 2012-2013 rankings), Transparency International (Corruption Perceptions Index 2012) and the World Bank and the International Finance Corporation (Ease of Doing Business 2013).
 Note: Countries are ranked from one (best performer in the EU) to 27 (worst performer in the EU) and ordered according to their average position in the rankings.

a fiscal framework that helps to avoid a return to pro-cyclical policies in the future. In addition, it is important to lock in the competitiveness gains achieved in recent years by avoiding a renewed increase in unit labour cost growth.

Although Latvia's adjustment capacity has been strong, its indicators of the quality of institutions and governance point to a need to make progress in this field. While the business environment is regarded as particularly positive in Latvia according to the Ease of Doing Business Report (International Finance Corporation and World Bank), the relatively weak performance in terms of governance as reported by the Worldwide Governance Indicators (World Bank Institute), the Global Competitiveness Index (World Economic Forum) and the Corruption Perceptions Index (Transparency International) suggests that a stronger institutional environment is desirable (see the above chart).¹ Furthermore, the shadow economy, although declining, is estimated to still be relatively large in Latvia. These weaknesses not only entail public revenue losses but also distort competition, harm Latvia's competitiveness and reduce the country's attractiveness as a destination for foreign direct investment, thus hampering longer-term investment and productivity. Latvia's labour market demonstrated flexibility during the economic downturn, supported by decentralised wage formation and public sector wage cuts. Nevertheless, there is a clear need to improve the functioning of the labour market, in which high unemployment coincides with skill mismatches and labour shortages in some sectors.

¹ These indicators provide mostly qualitative information and, in some cases, they reflect perceptions rather than observed facts. Nevertheless, taken as a whole, they do summarise a broad set of highly relevant information on the quality of the institutional environment.

Finally, in the financial sector, the reliance by a significant part of the banking sector on non-resident deposits as a source of funding, while not a recent phenomenon, is again on the rise and represents an important risk to financial stability. Inflows of non-resident deposits have increased strongly over the past two years. They currently amount to almost 40% of GDP and constitute around half of the total deposit base, a share which is substantially higher than in most other EU countries. Non-resident deposits are potentially highly volatile in nature, represent an increase in short-term external debt and create contingent fiscal liabilities. Moreover, a potential renewed emergence of domestic imbalances or excessive credit growth could pose additional risks to financial stability. In addition to appropriate micro-prudential policies, it is crucial that a comprehensive policy toolkit is available. This should include: (i) macro-prudential measures, national balance sheet analysis and stress tests; (ii) proper funding mechanisms for the deposit insurance scheme; (iii) effective resolution and recovery tools; (iv) strengthened monitoring of any build-up of macroeconomic imbalances that could threaten financial stability, with a readiness to adopt additional measures if warranted; and (v) the highest standards possible in the implementation of international anti-money laundering rules. Also, given the potential financial stability risks associated with the very high share of foreign currency-denominated loans in Latvia (predominantly in euro), the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be taken adequately into account. To address risks related to non-resident deposits, the Latvian authorities have introduced stricter prudential requirements for banks that focus on servicing non-residents. Close cooperation between home and host country supervisory authorities is important to ensure the effective implementation of these measures. Finally, financial stability should benefit from Latvia's participation in the Single Supervisory Mechanism (SSM), which is expected to enter into force in 2014.

4.2 FISCAL DEVELOPMENTS

Latvia is, at the time of finalisation of this report, subject to an EU Council decision on the existence of an excessive deficit, with a deadline for correcting the excessive deficit in 2012. In the reference year 2012 the general government budget balance showed a deficit of 1.2% of GDP, i.e. well below the 3% reference value. The general government gross debt-to-GDP ratio was 40.7%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 2.4 percentage points, while the public debt ratio decreased by 1.2 percentage points. These improvements were supported by favourable macroeconomic conditions and continued consolidation efforts. In 2013 the deficit ratio is forecast by the European Commission to be unchanged at 1.2% and the government debt ratio is projected to increase to 43.2%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2012 and is not expected to exceed it in 2013.

Looking at developments in Latvia's budgetary position over the past ten years, after declining to 0.4% in 2007, the deficit-to-GDP ratio rose sharply to 4.2% in 2008 and to 9.8% in 2009. This trend has been reversed since 2010 (see Table 5 and Chart 2a). As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Latvia and set the deadline for correcting it at 2012. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a positive impact on the budget balance until 2007 and during 2010-12. In 2008 and particularly in 2009, when the financial and economic crisis sharply affected public finances, cyclical factors had a strongly negative impact on the budget balance. Non-cyclical factors contributed overall to increasing the budget deficit over the period 2005-08, suggesting that fiscal policy was expansionary. The

largest adverse contribution by non-cyclical factors occurred in 2008, owing to a slow adjustment of government expenditure to the rapidly weakening macroeconomic environment. This trend has been reversed since 2009, when the Latvian government started to implement significant fiscal consolidation measures, in particular under the international financial assistance programme led by the EU and the IMF. The fiscal consolidation package consisted primarily of deep cuts in the compensation of employees and intermediate consumption, increases in VAT and the taxation of personal income and property, as well as a broadening of the social security contribution bases. After adjusting for relatively large deficit-increasing temporary measures in 2009 and especially in 2010 owing to injections of capital into the banking sector, the underlying changes in the budget deficit seem to reflect a structural deterioration of Latvia's fiscal position until 2008, and thereafter a significant consolidation effort. This effort has borne fruit, as witnessed by the marked decline in the deficit-to-GDP ratio from 9.8% in 2009 to 1.2% in 2012, also helped by the strong economic recovery.

Turning to developments in general government gross debt, between 2003 and 2012 the debt-to-GDP ratio increased cumulatively by 27.1 percentage points; over the 2008-10 period the rise was 35.4 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, among the factors underlying the annual change in the debt ratio, the primary budget balance was broadly neutral during the period 2004-07. It had a debt-increasing impact during the period 2008-11, reaching a peak in 2009, and was again broadly neutral in 2012. The interest-growth differential contributed to the increase in the debt ratio in 2009 and 2010, while it had, if anything, a dampening role in the periods 2003-08 and 2010-12. The deficit-debt adjustment made a substantial contribution to the increase in the debt ratio in 2008, and to a lesser extent in 2009, reflecting the financial flows received from, inter alia, the IMF and the EU in the context of balance of payments and financial sector support. In 2012, the general government debt-to-GDP ratio decreased by 1.2 percentage points, owing to a positive interest-growth differential and a small primary surplus, which more than compensated for a slight adverse effect from the deficit-debt adjustment.

As regards Latvia's general government debt structure, the share of government debt with a short-term maturity was rather volatile. It ranged between 6.6% and 12.5% in the period from 2003 to 2007, and increased sharply to 35.9% in 2008 on account of the issuance of short-term securities to ensure financial stability before the funding under the EU-IMF programme was available. Thereafter, the share of short-term debt started to decline and reached 6.2% in 2012 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the Latvian government has contingent liabilities – not reflected in gross government debt – resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 4.5.3.2) as well as interventions in state-owned enterprises (such as the national airline). In addition, the ongoing financial difficulties besetting Latvia's largest steelmaker pose a risk to the fiscal outlook. Latvia has a considerable number of state-owned companies, including the providers of infrastructure services in energy, rail transportation and telecommunications. In 2012, 85.3% of government debt was denominated in foreign currency, suggesting a high sensitivity of fiscal balances to changes in exchange rates. However, 62.2% of the total government debt (loans and securities) was denominated in euro, against which the Latvian lats fluctuates within a narrow band of $\pm 1\%$. This leaves fiscal balances relatively insensitive to changes in exchange rates other than the EUR/LVL exchange rate. The share of debt denominated in foreign currency other than euro decreased from 12.9% in 2003 to 5.7% in 2004, and again to 2.1% in the period until 2007. On account of the international financial assistance programme led by the EU and the IMF, this amount rose to 13.8% in 2008 and 23.1% in 2012.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased overall from 34.9% in 2003 to 36.4% in 2012. The expenditure ratio peaked at 43.8% of GDP in 2009, with the increase in relation to the previous two years resulting from the denominator effect, i.e. the significant GDP contraction during 2009 and 2010. Over this period expenditure declined in nominal terms, thus correcting part of the large increases in the preceding period. The expenditure-to-GDP ratio declined in 2011 and 2012, mainly as a result of the reduction across practically all expenditure items with the exception of interest payable. In particular, the share of “compensation of employees” in GDP was decreased and remained below the 2003-10 levels. Capital spending increased as a ratio to GDP in 2010, but declined in 2011 and 2012. Total government revenue as a share of GDP increased from 33.3% of GDP in 2003 to 35.2% of GDP in 2012. After peaking at 37.8% of GDP in 2006 on the back of rapid economic growth, the total revenue-to-GDP ratio declined until 2009. This trend was reversed in 2010, as a result of significant tax increases implemented in the context of the EU-IMF programme.

The medium-term fiscal policy strategy of the Latvian government was successful in bringing the ESA 95 deficit below the 3% of GDP reference value in 2012. Looking ahead, the most recent projections by the European Commission suggest an unchanged deficit of 1.2% of GDP in 2013. This is based on robust economic developments, lagged effects of consolidation measures included in the 2012 budget and efforts to improve tax compliance, the sum of which more than offsets the effect of expansionary measures such as the cut in the VAT rate contained in the mid-2012 supplementary budget and the reduction in the personal income tax rate, as well as the restoration of state contributions to the funded pension pillar which entered into force in January 2013. In the recently approved 2013-16 convergence programme update, the structural deficit is projected to be about 0.5 percentage point above the medium-term budgetary objective of a structural deficit of 0.5% of GDP (specified in line with the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)) in the period 2013-16. Primary expenditure excluding EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 3.4 percentage points between 2013 and 2016. The annual growth rate of relevant expenditure is projected to remain below the growth rate of potential GDP over the projection horizon. While the convergence programme puts the government’s structural balance at -1.1% of GDP for 2013, with improvements envisaged in the following years, the European Commission’s projections see the structural deficit increasing to 1.4% of GDP in 2013 and rising marginally further in 2014. The structural deficit would hence exceed the medium-term objective of 0.5% of GDP, even taking into account costs related to the pension reform (restoration of contributions to the second pension pillar). However, it should be taken into account that both these estimates are surrounded by a significant degree of uncertainty given the difficulties in the estimation of output gaps after deep recessions and structural changes in the economy. Nevertheless, it seems that further consolidation is required to meet the medium-term objective, in particular when taking into account possible adverse effects related to implicit or contingent liabilities stemming from the government intervention in some banks and state-owned or co-owned enterprises.

As regards fiscal governance, Latvia introduced a multi-annual budgetary framework in 2007. The Fiscal Discipline Law adopted by the Parliament on 31 January 2013 complements and addresses some of the weaknesses of the initial framework, such as the lack of an effective mechanism to limit expenditure growth in good economic times. Moreover, it provides the legal framework for the implementation in future budget laws of the fiscal rules (the balance rule, the expenditure growth rule and the debt rule) specified, inter alia, under Title III, “Fiscal Compact”, of the TSCG. In this respect, after having signed the TSCG on 2 March 2012, Latvia notified the EU Council of its ratification on 22 June 2012. Full compliance with the Fiscal Discipline Law, as well as with the

provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the TSCG, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Latvia's public finances over the long term, a rapid ageing of the population is expected, as highlighted in Table 8. However, according to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 18.5% of GDP in 2010, Latvia is likely to experience a notable decrease in strictly age-related public expenditure amounting to 3.0 percentage points of GDP in the years to 2060, as the adverse impact of population ageing on public finances has been mitigated by the implementation of a major pension reform in 2001, which established a state funded pension scheme, and consolidation measures taken in the context of the EU-IMF financial assistance programme during 2009-11.² Challenges related to the restoration of the second-pillar pension contribution scheme (e.g. lower government revenues) remain.

Turning to fiscal challenges, Latvia must ensure compliance with its medium-term fiscal objective on a lasting basis, in line with the requirements of the preventive arm of the Stability and Growth Pact, and thus provide a safety margin with respect to the 3% reference value and ensure sustainability. Latvia achieved its medium-term objective in 2012. However, the government plans an increase in the structural deficit in 2013 with only stabilisation thereafter (according to the recent convergence programme). This increase largely reflects pension reform-related costs. It is important that the medium-term objective is rapidly reached again. To this end, it is necessary that Latvia pursues a prudent expenditure policy in the medium run, focusing on the quality of fiscal adjustment to preserve medium-term growth prospects. Moreover, Latvia should continue its efforts to limit the fiscal risks related to government interventions in several banks and state-owned companies. The quality of public finances should be further improved by strengthening medium-term budgetary planning as well as by strictly adhering to the Fiscal Discipline Law in order to reduce the risk of pro-cyclical policies being pursued in the future. Every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact and to implement effectively the provisions of the TSCG.

4.3 EXCHANGE RATE DEVELOPMENTS

The Latvian lats joined ERM II on 2 May 2005 and was therefore participating in ERM II for the two-year reference period from 17 May 2011 to 16 May 2013 assessed in the context of this report (see Table 9a). The central rate for the Latvian currency has remained at 0.702804 lats per euro with a standard fluctuation band of $\pm 15\%$. At the time of ERM II entry, the Latvian authorities unilaterally undertook to maintain the exchange rate of the lats within a fluctuation band of $\pm 1\%$ around the central rate, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Latvian authorities, relating, among other things, to pursuing sound fiscal policies, promoting wage moderation, reducing inflation, containing credit growth, reducing the current account deficit and implementing structural reforms. This commitment to the $\pm 1\%$ fluctuation band has meant that the lats has always remained close to its central rate within ERM II. Furthermore, Latvia has not devalued its currency's central rate against the euro on its own initiative. Both the maximum upward deviation and maximum downward deviation of the exchange rate from the ERM II central rate amounted

² European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

to 1.0% over the reference period (see Chart 5 and Table 9a). As implied by its commitment to a $\pm 1\%$ unilateral fluctuation band, Latvijas Banka conducted interventions in the foreign exchange market. Overall, its sales and purchases of foreign currency over the two-year reference period resulted in a net purchase.

Between late 2008 and January 2012, an international financial assistance arrangement (led by the EU and the IMF) of €7.5 billion was in place. Between late 2008 and late 2010, the Latvian authorities drew a total amount of €4.5 billion from this arrangement, thereby lowering financial vulnerabilities and helping to reduce exchange rate pressures. Over the two-year reference period from 17 May 2011 to 16 May 2013, the Latvian authorities did not draw on the remaining resources of €3.0 billion and repaid the IMF ahead of schedule. Nevertheless, as the international financial assistance arrangement also helped to reduce risks related to financial vulnerabilities in this period, it may also have helped to reduce the risk of exchange rate pressures.

The exchange rate volatility of the Latvian lats vis-à-vis the euro, as measured by annualised standard deviations of daily percentage changes, mostly stood at very low levels in the period under review. Until late 2011 the Latvian lats traded mostly below its central rate, but thereafter it appreciated towards the stronger end of its $\pm 1\%$ unilateral fluctuation band, also as a result of the Treasury's conversion of its foreign currency funding into domestic currency. Since late 2012, the Latvian lats has moved closer to its central rate. Short-term interest rate differentials against the three-month EURIBOR were negative throughout 2011 and increased to very small positive levels thereafter (see Table 9b).

In a longer-term context, in April 2013 both the Latvian lats' real effective exchange rate and its real bilateral exchange rate against the euro stood relatively close to the corresponding ten-year historical averages (see Table 10). However, these indicators should be interpreted with caution, as in this period Latvia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, between 2003 and 2008 Latvia was characterised by substantially widening deficits in the combined current and capital account of its balance of payments, which almost tripled from 7.6% of GDP in 2003 to very large deficits in excess of 20% of GDP in 2006 and 2007 (see Table 11). After a strong fall in domestic demand, which led to lower imports, as well as gains in competitiveness and a strong recovery of exports, the deficit decreased substantially and the combined current and capital account registered a very large surplus of 11.1% of GDP in 2009. This drastic shift reflected a substantial decrease in the goods deficit and, to a lesser extent, increases in the surpluses in services and transfers, as well as a temporary improvement in the income balance. However, this surplus narrowed subsequently to 0.0% in 2011 and 1.3% in 2012, reflecting the rebound of domestic demand, particularly investment, with strong growth in imports outpacing growth in exports. The shifts recorded in Latvia's balance of payments over the past two years have also been associated with recovering capital inflows in the form of direct and portfolio investment, despite the continuing deleveraging process. Against this background, gross external debt increased sharply from 79.8% of GDP in 2002 to 164.8% in 2010, before gradually declining to 136.2% in 2012. At the same time the country's net international investment position deteriorated substantially, from -43.8% of GDP in 2003 to -82.7% in 2009, but improved thereafter to -65.1% in 2012.

Latvia is a small, open economy; the ratio of foreign trade in goods and services to GDP increased markedly from 41.9% of GDP in 2003 to 60.5% in 2012 for exports, and from 54.6% of GDP

in 2003 to 63.5% in 2012 for imports. Over the same period, Latvia's share in world exports increased from 0.05% to 0.08%.

Concerning measures of economic integration with the euro area, in 2012 exports of goods to the euro area constituted 30.5% of total goods exports, whereas the corresponding figure for imports was higher at 40.4%. The share of euro area countries in Latvia's inward direct investment stood at 38.3% in 2012 and that in its portfolio investment liabilities at 80.6% in 2011. The share of Latvia's assets invested in the euro area amounted to 25.6% in the case of direct investment in 2012 and 31.9% for portfolio investment in 2011 (see Table 12).

With regard to the fulfilment of the commitments made by the Latvian authorities upon ERM II entry in May 2005, the following observations can be made. Fiscal policies during the boom years were not prudent enough as they failed to contribute sufficiently to containing the emergence of significant macroeconomic imbalances. Moreover, the tightening of reserve and prudential requirements did not effectively contain excessive credit growth. Furthermore, efforts to contain wage growth were largely ineffective during the economic upturn. As the boom resulted in substantial macroeconomic imbalances, significant policy adjustments were necessary when the crisis began in 2008. Fiscal policies were tightened substantially during the subsequent adjustment. Comprehensive budgetary consolidation put the public finances on a more sustainable footing and strengthened market confidence. As the size of the adjustment was large and there may be concerns about the quality and composition of some of the adjustment measures, it is important that the sustainability of the adjustment is preserved. Efforts to stabilise the financial sector in the context of the international financial assistance programme proved successful. A sizeable decline in both private and public wages in 2009 and 2010 and a simultaneous increase in labour productivity per hour improved competitiveness during the adjustment. However, further measures to increase productivity and support the supply of skilled labour will be needed to ensure that the gains in competitiveness achieved over the past few years are sustained.

4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from May 2012 to April 2013, long-term interest rates in Latvia were 3.8% on average and thus below the 5.5% reference value for the interest rate convergence criterion (see Table 13).

Over the last few years, long-term interest rates in Latvia have shown significant fluctuations. From 2003 until mid-2006, they declined from 5% to below 4%, mainly reflecting strong economic growth and the entry of the Latvian lats into ERM II in May 2005 (see Chart 6a). From mid-2006 to mid-2008, they generally followed an upward trend, reaching a level of around 6% in mid-2008, in line with increasing market concerns regarding overheating in the economy and rising inflationary pressures. In addition, during the first half of 2007 Latvijas Banka increased its refinancing rate from 5% to 6% in response to rising inflation. In late 2008 the situation deteriorated rapidly. Mounting liquidity shortages, doubts about the viability of banks and the reliance of the banking system on foreign funding triggered deposit outflows from the banking system. Around the same time, all major rating agencies downgraded Latvian long-term sovereign debt, and long-term interest rates increased to around 10% at the end of 2008. The Latvian authorities had to seek international financial assistance. In May and June 2009 financial market pressures intensified, reflecting delays in the fiscal policy decision-making process as well as further rating downgrades. In view of the weak lending activity and the continued deterioration in economic activity, Latvijas Banka reduced

its refinancing and marginal deposit facility rates. After reaching a peak of around 14% at the beginning of 2010, long-term interest rates started to follow a declining trend which continued throughout 2010, as macroeconomic conditions stabilised and the Latvian government intensified its efforts to comply with the policy conditionality of the financial assistance programme. In 2010 Latvijas Banka lowered its refinancing and marginal deposit facility rates further and introduced a seven-day deposit facility to reduce volatility in the money market. The improving overall outlook for the Latvian economy was reflected in rating upgrades by some agencies. The decline in long-term interest rates was also supported by a general improvement in global risk appetite, especially towards emerging economies. Starting in 2010, the Latvian government was again able to issue debt in domestic and foreign markets. Long-term interest rates were broadly stable during most of 2011, but increased somewhat at the end of the year following the failure of one of the commercial banks in Latvia, Latvijas Krājbanka, and associated financial market tensions. In 2012 long-term interest rates declined to below 4% as macroeconomic conditions and government finances improved, Latvijas Banka reduced its refinancing and marginal deposit facility rates, credit ratings were upgraded and – particularly in the second half of the year – global financial market conditions improved. Latvia was able to issue two dollar-denominated government bonds in 2012 and finalise the early repayment of loans from the IMF. At the same time, the government scaled back its bond issuance denominated in lats significantly. About 22% of the outstanding amount of government debt securities is denominated in lats, while 31% is in euro and the rest is in other currencies.

The interest rate differential³ with the euro area average was small between 2003 and 2006. In the subsequent period until October 2008, it increased to around 2.3 percentage points (see Chart 6b), mainly reflecting the significant increase in the inflation differential between Latvia and the euro area. Broadly mirroring the developments in yields on long-term Latvian government bonds, the spread with the euro area average then increased markedly in late 2008 and throughout 2009. It subsequently fell from 2010 onwards. In 2012 the interest rate differential with the euro area average turned temporarily negative, before standing at 0.3 percentage point (and 1.6 percentage points with respect to the euro area AAA long-term government bond yield) at the end of the reference period.

Although Latvia's banking system is stable and its size as a share of GDP remains fairly small in comparison with most other EU countries, 14 (predominantly domestically-owned) banks, accounting for more than one-third of total bank assets, rely on non-resident deposits as a source of funding. While this is not a new phenomenon for Latvia, inflows of non-resident deposits have increased strongly over the past two years, partly reflecting the reversal of earlier outflows during the crisis and improved confidence in the Latvian economy. They currently amount to almost 40% of GDP and constitute around half of the total deposit base. This increasing reliance on non-resident deposits implies risks to financial stability (and thereby also risks to future conditions for government funding), as these deposits are potentially highly volatile in nature, represent an increase in short-term external debt and create contingent fiscal liabilities. The non-resident business model may intensify a number of risks, such as credit, concentration, liquidity, market and recapitalisation risk. In addition to appropriate micro-prudential policies, it is crucial that a comprehensive policy toolkit is available to address the risks stemming from these deposits.

The Latvian capital market is smaller and much less developed than that of the euro area. Corporate sector market-based indebtedness is very low: the value of outstanding fixed-income securities

³ The comparisons made in this chapter with the euro area average and the euro area AAA long-term government bond yield are for illustrative purposes only.

issued by corporations was 1.5% of GDP in 2012 (see Table 14). Stock market capitalisation (3.8% of GDP in 2012) is also very low compared with the euro area. The value of outstanding bank credit to non-government residents increased very rapidly between 2003 and 2009, when its ratio to GDP more than doubled, before declining to 65.5% in 2012. This level is still one of the highest among EU Member States in central and eastern Europe. The majority of loans to the private sector are denominated in foreign currency, mostly euro. Foreign-owned banks, predominantly Nordic banking groups, play a major role in the Latvian banking sector. Funding from parent banks has decreased as a result of a deleveraging process, and this has gone hand in hand with declines in credit to the private sector. All in all, the deleveraging process has proceeded in an orderly way. Since the start of the financial crisis, international claims of euro area banks in the country have been declining, and reached 10.4% of total liabilities in 2012.

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I PRICE DEVELOPMENTS

Table 1 HICP inflation

(annual percentage changes)

	2013				May 2012 to Apr. 2013
	Jan.	Feb.	Mar.	Apr.	
HICP inflation	0.6	0.3	0.3	-0.4	1.3
Reference value ¹⁾					2.7
Euro area ²⁾	2.0	1.8	1.7	1.2	2.2

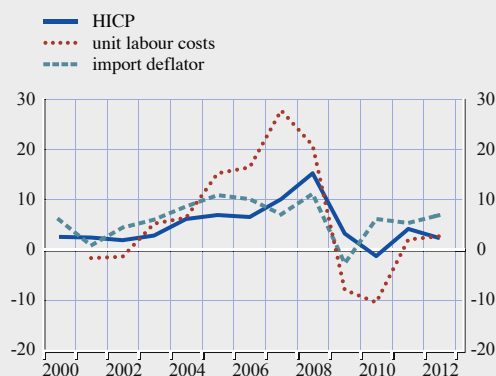
Source: European Commission (Eurostat).

1) The basis of the calculation for the period May 2012-April 2013 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Latvia and Ireland plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Measures of inflation										
HICP	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3
HICP excluding unprocessed food and energy	2.9	5.8	5.5	5.1	9.7	13.8	3.5	-2.7	2.4	0.9
HICP at constant tax rates ¹⁾	-	5.8	6.7	6.2	9.8	13.6	-1.9	-1.4	2.7	2.4
CPI	2.9	6.2	6.7	6.5	10.1	15.4	3.5	-1.1	4.4	2.3
Private consumption deflator	4.2	7.6	8.8	5.9	9.9	16.2	3.2	-1.8	5.0	3.0
GDP deflator	3.8	7.0	10.1	11.2	20.7	13.0	-1.2	-1.3	5.9	3.0
Producer prices ²⁾	1.8	7.3	7.1	9.6	18.6	15.7	-1.7	-0.2	8.8	5.3
Related indicators										
Real GDP growth	7.6	8.9	10.1	11.2	9.6	-3.3	-17.7	-0.9	5.5	5.6
GDP per capita in PPS ³⁾ (euro area = 100)	39.8	42.6	45.4	48.6	52.7	53.7	49.7	49.7	54.1	.
Comparative price levels (euro area = 100)	52.9	54.5	55.8	59.7	65.7	72.7	71.9	70.3	71.0	.
Output gap ⁴⁾	1.3	2.9	5.2	8.7	11.5	4.4	-12.6	-11.4	-5.7	-1.2
Unemployment rate (%) ⁵⁾	11.3	11.2	9.6	7.3	6.5	8.0	18.2	19.8	16.2	14.9
Unit labour costs, whole economy	5.2	6.4	15.3	16.4	27.7	20.7	-7.9	-10.4	2.1	2.8
Compensation per employee, whole economy	11.0	14.5	25.1	23.2	35.1	15.7	-12.7	-6.7	4.2	5.8
Labour productivity, whole economy	5.5	7.6	8.4	5.9	5.8	-4.2	-5.3	4.0	2.0	2.9
Imports of goods and services deflator	6.0	8.7	10.9	10.1	7.1	11.1	-2.6	6.2	5.4	6.9
Nominal effective exchange rate ⁶⁾	-6.9	-3.0	-5.5	-0.3	-0.3	-0.3	2.0	-2.9	0.1	0.1
Money supply (M3)	-	25.2	37.3	41.0	15.7	-5.2	-2.7	11.1	0.5	5.8
Lending from banks	-	43.7	61.2	59.1	34.9	9.8	-6.8	-6.7	-4.9	-1.0
Stock prices (Riga Stock Exchange Index)	47.0	43.5	63.5	-3.1	-9.2	-54.4	2.8	41.1	-5.7	6.7
Residential property prices	26.1	4.1	34.0	75.2	39.4	-10.6	-40.5	-4.7	29.2	2.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).

1) The difference between the "HICP" and the "HICP at constant tax rates" shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.

2) Domestic sales, total industry excluding construction.

3) PPS stands for purchasing power standards.

4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

5) The definition conforms to ILO guidelines.

6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2012		2013			
	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
HICP						
Annual percentage change	1.5	1.6	0.6	0.3	0.3	-0.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	1.3	0.9	0.0	-0.9	-2.2	-2.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.3	1.3	1.1	0.7	0.2	-0.2

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2013	2014
HICP, European Commission (spring 2013)	1.4	2.1
CPI, IMF (April 2013)	1.8	2.1
CPI, Consensus Economics (April 2013)	1.6	2.7

Sources: European Commission, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2011	2012	2013 ¹⁾
General government surplus (+)/deficit (-)	-3.6	-1.2	-1.2
<i>Reference value</i>	-3.0	-3.0	-3.0
Surplus/deficit, net of government investment expenditure ²⁾	0.7	2.7	2.7
General government gross debt	41.9	40.7	43.2
<i>Reference value</i>	60.0	60.0	60.0

Sources: European Commission (Eurostat) and ECB calculations.

1) European Commission projections.

2) A positive (negative) sign indicates that the government deficit is lower (higher) than government investment expenditure.

Table 5 General government budgetary position

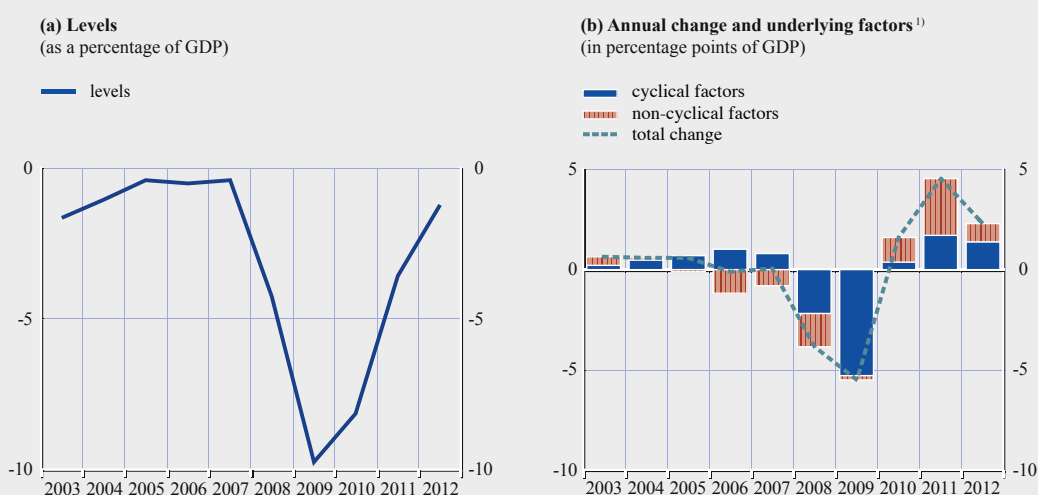
(as a percentage of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total revenue	33.3	34.9	35.4	37.8	35.6	34.9	34.0	35.3	34.9	35.2
Current revenue	33.2	34.4	34.3	36.7	34.8	33.9	32.9	33.8	33.3	33.6
Direct taxes	7.6	7.9	7.9	8.5	9.2	9.8	7.2	7.4	7.4	7.7
Indirect taxes	12.1	11.7	12.5	12.9	12.3	10.9	10.7	11.3	11.4	11.6
Social security contributions	9.1	8.9	8.7	9.0	9.0	8.7	8.9	8.6	8.7	8.6
Other current revenue	4.4	5.8	5.2	6.3	4.4	4.6	6.1	6.6	5.9	5.7
Capital revenue	0.1	0.5	1.1	1.1	0.7	0.9	1.1	1.5	1.5	1.7
Total expenditure	34.9	35.9	35.8	38.3	36.0	39.1	43.8	43.4	38.4	36.4
Current expenditure	32.1	31.7	30.8	31.2	29.1	33.4	37.9	36.0	31.6	31.7
Compensation of employees	10.8	10.5	10.1	10.1	10.7	12.1	12.1	10.2	9.5	9.1
Social benefits other than in kind	9.5	9.2	8.4	8.1	7.1	8.1	12.6	12.5	10.6	9.8
Interest payable	0.7	0.7	0.5	0.4	0.4	0.6	1.5	1.4	1.5	1.3
of which: impact of swaps and FRAs ¹⁾	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Other current expenditure	11.2	11.2	11.7	12.6	10.9	12.6	11.7	11.9	10.0	11.5
Capital expenditure	2.8	4.2	5.0	7.1	6.9	5.7	5.9	7.5	6.8	4.7
Surplus (+)/deficit (-)	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.1	-3.6	-1.2
Primary balance	-0.9	-0.3	0.1	0.0	0.0	-3.6	-8.3	-6.7	-2.1	0.1
Surplus/deficit, net of government investment expenditure	0.8	2.1	2.7	4.1	5.3	0.6	-5.5	-4.4	0.7	2.7

Sources: ESCB and European Commission (Eurostat).

Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure.

1) FRAs stands for forward rate agreements. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (OJ L 344, 28.12.2001, p. 1).

Chart 2 General government surplus (+)/deficit (-)

Sources: European Commission (Eurostat) and ECB calculations.

Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

1) In 2009 the large drop in nominal GDP (-18.7%) may have led to a lower estimate of the non-cyclical factors affecting the government deficit, i.e. the fiscal consolidation effort.

Table 6 General government gross debt – structural features

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total debt (as a percentage of GDP)	14.7	15.0	12.5	10.7	9.0	19.8	36.9	44.4	41.9	40.7
Composition by currency (% of total)										
In domestic currency	41.6	42.6	41.8	39.6	32.6	35.7	20.7	18.3	16.5	14.7
In foreign currencies	58.4	57.4	58.2	60.4	67.4	64.3	79.3	81.7	83.5	85.3
Euro ¹⁾	45.5	51.7	54.6	57.6	65.3	50.5	67.0	67.3	66.3	62.2
Other foreign currencies	12.9	5.7	3.6	2.9	2.1	13.8	12.3	14.4	17.2	23.1
Domestic ownership (% of total)	51.0	47.7	48.1	45.0	38.1	49.5	24.2	21.3	20.6	20.2
Average residual maturity (in years)	4.6	6.2	5.8	7.6	8.8	6.3	6.7	6.6	6.1	5.9
Composition by maturity ²⁾ (% of total)										
Short-term (up to and including one year)	12.5	9.8	9.4	6.6	7.7	35.9	14.6	9.4	8.4	6.2
Medium and long-term (over one year)	87.5	90.2	90.6	93.4	92.3	64.1	85.4	90.6	91.6	93.8

Sources: ESCB and European Commission (Eurostat).

Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.

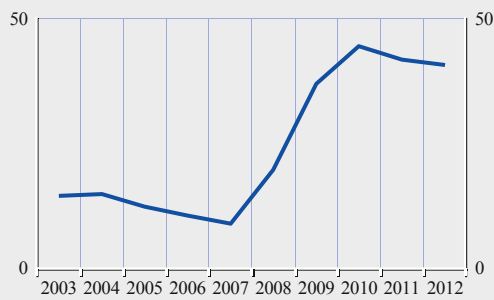
1) Comprises debt denominated in euro.

2) Original maturity.

Chart 3 General government gross debt

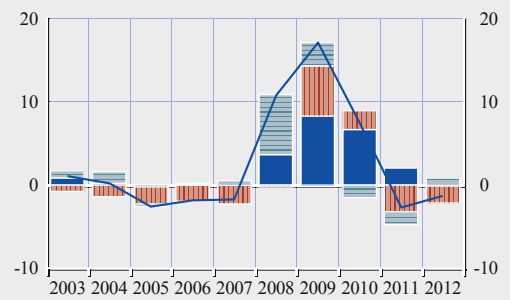
(a) Levels
(as a percentage of GDP)

— levels



(b) Annual change and underlying factors
(in percentage points of GDP)

— primary balance
 ■ interest-growth differential
 ■ deficit-debt adjustment
 — change in debt-to-GDP ratio



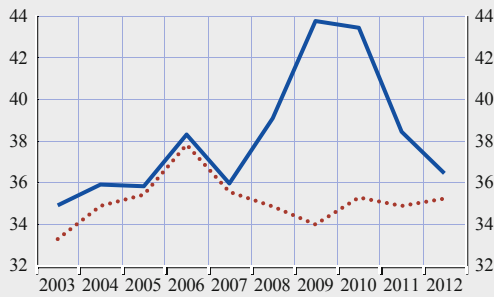
Sources: European Commission (Eurostat) and ECB.

Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)

— total expenditure
 total revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Change in general government debt ¹⁾	2.5	2.4	0.1	0.6	1.0	11.5	12.6	6.7	2.0	2.2
General government surplus (+)/deficit (-)	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.1	-3.6	-1.2
Deficit-debt adjustment	0.9	1.3	-0.3	0.1	0.6	7.3	2.8	-1.4	-1.5	1.0
Net acquisitions (+)/net sales (-) of financial assets	1.0	1.5	-0.3	2.7	1.8	7.6	3.2	-1.4	-1.2	0.7
Currency and deposits	0.3	1.0	-1.0	1.4	1.1	2.9	3.5	-0.9	-2.5	2.2
Loans and securities other than shares	0.4	-0.5	0.0	-0.2	0.0	4.2	-0.1	-1.6	0.6	-1.7
Shares and other equity	-0.4	0.1	0.4	-0.5	0.1	0.2	0.1	0.7	0.0	0.1
Privatisations	-0.1	-0.1	0.0	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Equity injections	0.1	0.2	0.4	0.2	0.1	0.2	0.1	0.7	0.1	0.1
Other	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.6	0.8	0.4	2.0	0.6	0.3	-0.3	0.5	0.7	0.0
Valuation changes of general government debt	0.3	0.3	0.1	0.0	0.0	0.1	-0.3	-0.4	-0.3	0.0
Foreign exchange holding gains (-)/losses (+)	0.4	0.3	0.1	0.0	0.0	0.0	0.2	0.1	-0.2	0.1
Other valuation effects ²⁾	-0.1	0.0	0.0	0.0	0.0	0.1	-0.5	-0.5	-0.2	-0.1
Other changes in general government debt³⁾	-0.5	-0.4	-0.1	-2.6	-1.2	-0.4	0.0	0.3	0.0	0.3

Sources: ESCB and European Commission (Eurostat).

Note: Differences between totals and the sum of their components are due to rounding.

1) Annual change in debt in period t as a percentage of GDP in period t, i.e. $[\text{debt}(t) - \text{debt}(t-1)]/\text{GDP}(t)$.

2) Includes the difference between the nominal and market valuation of general government debt.

3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.2	29.1	36.4	43.7	55.1	67.9
Age-related government expenditure (in percentage points of GDP) ¹⁾	18.5	16.0	15.2	15.0	15.6	15.5

Source: The 2012 Ageing Report: Economic and budgetary projections for the 27 EU Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	Yes
Participation since	2 May 2005
ERM II central rate in LVL/EUR	0.702804
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation ¹⁾	1.0
Maximum downward deviation ¹⁾	-1.0

Source: ECB.

1) Maximum percentage deviations from ERM II central rate over the period 17 May 2011-16 May 2013, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Latvian lats

(average of three-month period ending in specified month)

	2011			2012				2013
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility ¹⁾	0.5	0.4	1.9	1.1	1.0	0.4	0.3	0.7
Short-term interest rate differential ²⁾	-0.6	-0.7	-0.1	0.4	0.3	0.3	0.3	0.3

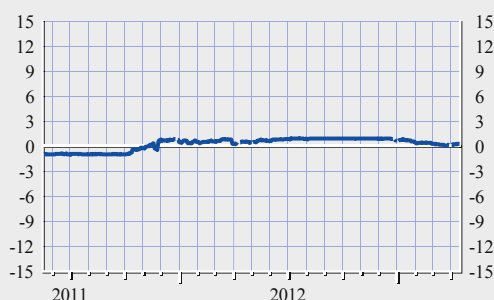
Sources: National data and ECB calculations.

1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.

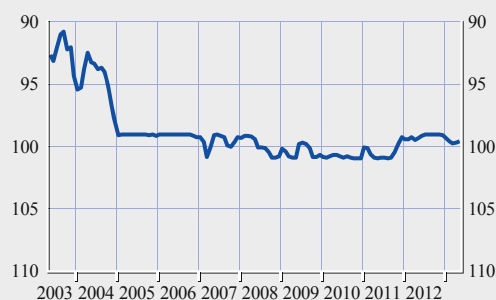
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Latvian lats: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation;
17 May 2011-16 May 2013)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100;
May 2003-April 2013)



Source: ECB.

Note: A positive (negative) deviation from the central rate implies that the currency is on the strong (weak) side of the band. For the Latvian lats, the fluctuation band is ±15%.

Table 10 Latvian lats: real exchange rate developments

(monthly data; percentage deviation in April 2013 from the ten-year average calculated for the period May 2003-April 2013)

	Apr. 2013
Real bilateral exchange rate against the euro ¹⁾	8.3
<i>Memo items:</i>	
Nominal effective exchange rate ²⁾	-2.2
Real effective exchange rate ^{1),2)}	5.5

Source: ECB.

Note: A positive (negative) sign indicates an appreciation (depreciation).

1) Based on HICP and CPI developments.

2) Effective exchange rate against the euro, the currencies of the non-euro area EU Member States and those of ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Balance of payments										
Current account and capital account balance ¹⁾	-7.6	-11.8	-11.2	-21.3	-20.4	-11.7	11.1	4.9	0.0	1.3
Current account balance	-8.2	-12.9	-12.6	-22.5	-22.4	-13.1	8.6	2.9	-2.2	-1.7
Goods balance	-17.9	-20.3	-19.1	-25.7	-24.0	-17.8	-7.1	-7.0	-10.8	-9.8
Services balance	5.2	4.4	3.8	3.3	3.5	4.0	6.0	6.1	6.5	6.8
Income balance	-0.2	-2.0	-1.1	-2.7	-3.2	-1.6	6.3	0.2	-0.9	-1.5
Current transfers balance	4.7	5.0	3.8	2.4	1.3	2.2	3.4	3.6	3.1	2.9
Capital account balance	0.7	1.1	1.3	1.2	2.0	1.5	2.4	1.9	2.1	3.0
Combined direct and portfolio investment balance ¹⁾	0.3	5.5	2.8	7.7	4.5	4.2	1.3	-0.2	2.7	7.3
Direct investment balance	2.3	3.8	3.6	7.5	6.8	3.0	0.6	1.5	4.9	2.8
Portfolio investment balance	-2.0	1.6	-0.8	0.2	-2.4	1.1	0.7	-1.7	-2.2	4.5
Other investment balance	7.9	9.5	14.1	22.7	19.4	7.6	-9.8	-0.8	-7.2	-5.4
Reserve assets	-0.6	-2.9	-3.3	-9.9	-3.4	2.0	-5.0	-4.0	4.4	-3.6
Exports of goods and services	41.9	43.6	47.3	44.1	41.5	42.0	43.2	53.0	58.2	60.5
Imports of goods and services	54.6	59.5	62.6	66.4	62.0	55.8	44.3	53.9	62.5	63.5
Net international investment position²⁾	-43.8	-52.3	-59.6	-69.9	-74.7	-79.0	-82.7	-80.3	-73.3	-65.1
Gross external debt ²⁾	79.8	93.5	100.0	114.5	128.1	130.0	156.5	164.8	145.0	136.2
<i>Memo item:</i>										
Export market shares ³⁾	0.05	0.05	0.06	0.06	0.07	0.07	0.07	0.07	0.07	0.08

Source: ECB.

1) Differences between totals and the sum of their components are due to rounding.

2) End-of-period outstanding amounts.

3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
External trade with the euro area										
Exports of goods	36.8	35.8	36.0	36.2	35.2	34.7	34.8	33.3	31.2	30.5
Imports of goods	46.5	44.4	42.7	43.9	44.4	40.8	39.9	41.6	40.4	40.4
Investment position with the euro area										
Inward direct investment ¹⁾	37.5	42.3	41.3	42.7	47.9	48.9	50.2	48.5	39.1	38.3
Outward direct investment ¹⁾	31.8	19.8	18.6	16.0	24.3	14.4	22.6	21.5	21.7	25.6
Portfolio investment liabilities ¹⁾	75.6	94.8	90.1	82.8	68.9	62.1	73.3	72.2	80.6	.
Portfolio investment assets ¹⁾	-	-	-	6.9	11.8	21.1	26.8	29.2	31.9	.
<i>Memo items:</i>										
External trade with the EU										
Exports of goods	79.4	77.3	76.5	72.5	72.5	68.6	67.6	67.2	66.0	63.4
Imports of goods	75.6	75.7	75.3	76.5	77.4	75.5	75.4	76.1	77.6	77.9

Sources: ESCB, European Commission (Eurostat) and IMF.

1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

	2013				May 2012 to Apr. 2013
	Jan.	Feb.	Mar.	Apr.	
Long-term interest rate	3.2	3.2	3.2	3.2	3.8
Reference value ¹⁾	5.5
Euro area ²⁾	3.1	3.2	3.1	2.9	3.6
Euro area (AAA) ³⁾	1.9	1.9	1.8	1.6	1.9

Sources: ECB and European Commission (Eurostat).

1) The basis of the calculation for the period May 2012-April 2013 is the unweighted arithmetic average of the interest rate levels in Sweden, Latvia and Ireland plus 2 percentage points.

2) The euro area average is included for information only.

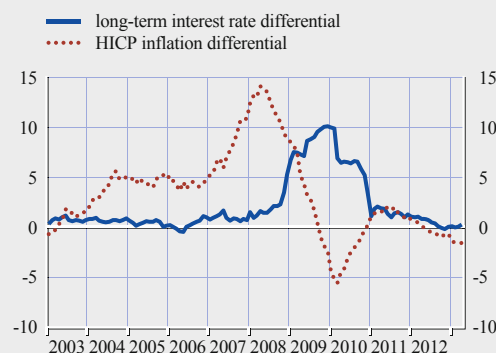
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)



(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Memo item: euro area 2012
Debt securities issued by corporations ¹⁾	1.2	1.2	2.0	3.1	2.5	1.5	1.6	1.6	4.0	1.5	102.8
Stock market capitalisation ²⁾	9.5	11.4	16.6	12.9	10.0	5.1	7.1	5.2	4.1	3.8	47.4
MFI credit to non-government residents ³⁾	39.9	50.4	68.2	87.4	88.7	90.6	103.4	97.0	79.6	65.5	131.4
Claims of euro area MFIs on resident MFIs ⁴⁾	6.2	7.4	11.0	11.5	12.8	15.9	15.0	12.9	10.9	10.4	7.2
Private sector credit flow ⁵⁾	14.3	18.1	26.4	43.0	36.6	14.3	-6.1	-8.7	-2.5	-	1.1
Private sector debt ⁶⁾	61.8	74.5	94.8	122.1	127.5	132.1	147.4	140.4	125.1	-	164.6

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.

1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.

2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.

3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.

4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.

5) Transactions in securities other than shares issued and loans taken out by non-financial corporations, households and non-profit institutions serving households.

6) Outstanding amounts of securities other than shares issued and loans taken out by non-financial corporations, households and non-profit institutions serving households.

5 OTHER RELEVANT FACTORS

LATVIA

Table 15 Scoreboard for the surveillance of macroeconomic imbalances

	2010	2011	2012	Threshold
External imbalance/competitiveness indicators				
Current account balance ¹⁾	-0.5	3.1	-0.3	-4.0/+6.0%
Net international investment position ²⁾	-80.3	-73.3	-65.1	-35.0%
Real effective exchange rate, HICP-deflated ³⁾	8.7	-0.6	-4.6	±11.0%
Export market share ⁴⁾	13.9	23.4	12.0	-6.0%
Nominal unit labour costs ⁵⁾	-0.3	-15.7	-5.9	+12.0%
Internal imbalances				
House prices, consumption-deflated ⁶⁾	-9.3	4.7	0.7	+6.0%
Private sector credit flow ²⁾	-8.7	-2.5	.	+15.0%
Private sector debt ²⁾	140.4	125.1	.	+160%
Financial sector liabilities ⁶⁾	-0.1	-4.5	.	+16.5%
General government debt ²⁾	44.4	41.9	40.7	+60%
Unemployment rate ⁷⁾	15.3	18.1	17.0	+10.0%

Sources: European Commission (Eurostat, DG ECFIN) and ECB.

1) As a percentage of GDP, three-year average.

2) As a percentage of GDP.

3) Index: 1999=100. Three-year percentage change relative to 35 other industrial countries. A positive value indicates an appreciation of the domestic currency.

4) Five-year percentage change.

5) Three-year percentage change.

6) Year-on-year percentage change.

7) Three-year average.

4.5 STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics (GFS), must not be subject to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics and to apply certain standards with respect to governance and quality in the domain of statistics.

National statistical authorities in each Member State and the EU statistical authority within the European Commission (Eurostat) should enjoy professional independence and ensure that European statistics are impartial and of a high quality. This is in line with the principles laid down in Article 338(2) of the Treaty, Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European statistics (Regulation on European statistics) and the European Statistics Code of Practice endorsed by the Commission in 2005 and revised in September 2011 (the Code of Practice). Article 2(1) of the Regulation on European statistics states that the development, production and dissemination of European statistics shall be governed by the following statistical principles: a) professional independence; b) impartiality; c) objectivity; d) reliability; e) statistical confidentiality; and f) cost effectiveness. Pursuant to Article 11 of the Regulation, these statistical principles are further elaborated on in the Code of Practice.⁴

Against this background, the quality and integrity of the convergence indicators in terms of the underlying statistics are reviewed in the statistical section. This section refers to some institutional features of the national statistical institutes (NSIs) concerned and provides information on the statistical methodology of the convergence indicators, as well as on the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process. Moreover, Sub-section 3.2 reviews in particular the public interventions to support financial institutions and financial markets during the financial crisis, as well as the financial support provided by international institutions or countries during the financial crisis.

4.5.1 INSTITUTIONAL FEATURES RELATING TO THE QUALITY OF STATISTICS FOR THE ASSESSMENT OF THE CONVERGENCE PROCESS

In recent years, the governance of the European Statistical System (ESS) has been improved, in particular with the adoption of the Code of Practice in 2005. Initially the implementation and monitoring of the Code relied to a large extent on a self-regulatory approach (self-assessments, peer reviews and national implementation plans). In 2009, the Regulation on European statistics entered into force and the European Statistical Governance Advisory Board (ESGAB) was established in order to provide an independent overview of the ESS with particular regard to implementing the European Statistics Code of Practice. The ESGAB aims to enhance professional independence, integrity and accountability in the ESS, as well as the quality of European statistics. Its tasks include preparing an annual report for the European Parliament and the Council on the implementation of the Code of Practice insofar as it relates to Eurostat, including an assessment of the implementation of the Code in the ESS as a whole.⁵

⁴ See Articles 2(1) and 11 of Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European statistics.

⁵ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:087:0164:0173:en:PDF>

However, the experience gained in recent years has highlighted some remaining weaknesses in the governance framework of the ESS which need to be addressed. These weaknesses were described in the Communication from the Commission to the European Parliament and the Council of 15 April 2011 entitled “Towards robust quality management for European Statistics”.⁶

In the specific context of the EU fiscal surveillance system and of the EDP exercise, Council Regulation (EU) No 679/2010⁷ granted Eurostat new competences for regularly monitoring and verifying public finance data, which it exercises by conducting more in-depth dialogue visits to Member States and by extending such visits to public entities supplying upstream public finance data to the NSIs.

Furthermore, the legislative package of six legal texts adopted to strengthen the economic governance structure of the euro area and the EU as a whole relies on high-quality statistical information, which needs to be produced under robust quality management.⁸

In this context, the Code of Practice was revised in September 2011 in order to distinguish between the principles to be implemented by ESS members and the principles relating to the institutional environment that are to be implemented by Member State governments.

Moreover, the Regulation on European statistics is currently under revision with a view to clarifying, among other things, that the principle of professional independence of NSIs applies unconditionally. Statistics must indeed be developed, produced and disseminated in an independent manner, free of any pressures from political or interest groups or from EU or national authorities, and existing institutional frameworks must not be allowed to restrict this principle.

Table 1 provides an overview of some of the institutional features relating to the quality of the statistics in Latvia, namely the specification of the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions governing statistical confidentiality.

6 COM/2011/0211 final.

7 Council Regulation (EU) No 679/2010 of 26 July 2010 amending Regulation (EC) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure.

8 On 13 December 2011, the reinforced Stability and Growth Pact (SGP) entered into force with a new set of rules for economic and fiscal surveillance. These new measures, known as the “six-pack”, consist of five regulations and one directive, proposed by the European Commission and approved by all 27 EU Member States and the European Parliament in October 2011.

Table 1 Quality and integrity of convergence statistics

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process in Latvia	
Legal independence of the national statistical institute	According to Article 3 of the Official Statistics Law, statistics are based on objectivity, reliability, relevancy, efficiency, confidentiality and transparency. The Head of the NSI is appointed by the Cabinet of Ministers on the basis of a recommendation by the Minister of Economics. The term of office is fixed (five years; reappointment is possible).
Administrative supervision and budget autonomy	The NSI is a public institution under the supervision of the Ministry of Economics. It has budget autonomy, financed by the state budget, by its own income and by financial resources received from foreign countries.
Legal mandate for data collection Legal provisions regarding statistical confidentiality	The Official Statistics Law determines the main principles of data collection. According to Article 18 of the Official Statistics Law, the confidentiality of the statistical data is secured.
HICP inflation	
Compliance with legal minimum standards	Eurostat carried out a compliance monitoring visit in 2007 and concluded that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology. These results were confirmed by a compliance monitoring visit in March 2013.
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2003-12.
Outstanding statistical issues	Eurostat carried out a pre-euro accession mission in April 2013. There are no major outstanding issues.
Deficit-debt adjustment (DDA)	The DDA is a high and positive cumulative amount, owing to the acquisition of deposits and loans in 2008 and 2009 in connection with the financial crisis.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions and participation in the inter-institutional working group for the compilation of EDP data.

4.5.2 HICP INFLATION

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the HICP. The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all EU Member States by Eurostat.⁹ The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

Article 1 of the Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty requires price convergence to be measured by means of the CPI on a comparable basis, taking into account differences in national definitions. In October 1995, Council Regulation (EC) No 2494/95 concerning harmonized indices of consumer prices was adopted. Furthermore, the harmonisation measures introduced for HICPs have been based on several EU Council and European Commission regulations. HICPs use common standards for the coverage of the items, the territory and the population included (all these elements are major reasons for differences between national CPIs). Common standards have also been established in several other areas, for example the treatment of new goods and services.

⁹ For details on methodological aspects of the HICP, see *Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users*, Publications Office for Official Publications of the European Union, Luxembourg, 2004.

The HICPs use annually updated expenditure weights (or, until 2011, less frequent updates if this did not have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure, which is derived from the national accounts domestic concept of household final consumption expenditure, but excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (minus subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services are covered to the extent that they are financed (directly or through private insurance) by households and not reimbursed by the government.

Estimates of the development of administered prices in the HICP refer to prices which are directly set or significantly influenced by the government, including national regulators. They are based on a common definition and compilation and are published by Eurostat.

Eurostat must ensure that the statistical practices used to compile national HICPs comply with HICP methodological requirements and that good practices in the field of consumer price indices are being followed. Eurostat carries out compliance monitoring visits and publishes its findings in information notes made available on its website.

In 2007 Eurostat carried out a compliance monitoring visit to Latvia, concluding that the methods used for producing the HICP were satisfactory and revealed no apparent instances of non-compliance with the HICP methodology. Moreover, Eurostat revisited Latvia in March 2013 and a forthcoming report is expected to show similar results.

4.5.3 GOVERNMENT FINANCE STATISTICS

This section describes the methodology and quality of the statistics used to measure fiscal developments. GFS are based mainly on national accounts concepts and should comply with the ESA 95¹⁰ and Council Regulation (EU) No 479/2009. Concepts such as “government”, “surplus/deficit”, “interest expenditure”, “investment”, “debt” and “gross domestic product (GDP)” with reference to the ESA 95 are defined in the Protocol (No 12) on the excessive deficit procedure, as well as in Council Regulation (EU) No 479/2009. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (1993 SNA). EDP statistics refer to the ESA 95 institutional sector “general government”. This comprises central government, state government (in Member States with a federal structure), local government and social security funds. It typically does not include public corporations.

The EDP general government deficit (-)/surplus (+) is equal to the ESA 95 “net lending (+)/net borrowing (-)” plus “net settlements under swaps and forward rate agreements”.¹¹ ESA 95 net lending (+)/net borrowing (-) is equal to “total revenue” minus “total expenditure”. While most transactions among general government units related to revenue and expenditure are not consolidated, the distributive transactions “interest”, “other current transfers”, “investment grants” and “other capital transfers” are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

10 See Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

11 The inclusion of “net settlements under swaps and forward rate agreements” in the EDP deficit implies a discrepancy between the two balancing items, the EDP general government deficit (-)/surplus (+) and the ESA 95 net lending (+)/net borrowing (-). Settlements received by government reduce the EDP deficit, whereas settlements paid by government increase the EDP deficit.

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories “currency and deposits”, “securities other than shares excluding financial derivatives” (e.g. government bills, notes and bonds) and “loans”. It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. However, in March 2008 Eurostat released a guidance note that includes accounting rules on the treatment of lump sums received by government under “off-market interest rate swaps”. This guidance states that such transactions are basically borrowing in disguise. The lump sum paid to government at the inception of an off-market swap should therefore be recorded as a loan to government in national accounts, and thus has an impact on government debt. The EDP debt also excludes contingent liabilities, such as government guarantees and pension commitments. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

4.5.3.1 DATA COVERAGE

In April 2013 the European Commission transmitted to the ECB data on GFS (general government deficit/surplus and debt) for the period 2003-12, as well as forecasts for 2013. The NCBs of the Eurosystem provide the ECB with detailed GFS data under the ECB’s GFS Guideline.¹² Although the Guideline is only legally binding for the euro area NCBs, the non-euro area NCBs also transmit GFS data to the ECB by the same deadlines and using the same procedures. The GFS Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt, and deficit-debt adjustment. In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement for Latvia to transmit GFS data to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 2003-12 have been transmitted.

4.5.3.2 METHODOLOGICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. On 15 July 2009 Eurostat published a decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis. The public interventions to support the financial sector have covered a wide range of operations, for which the methodologies applied are based on ESA 95. These operations refer to recapitalisations of banks and other financial institutions, provisions of loans, asset purchases and securities lending. Furthermore, Eurostat’s decision also covered the issue of how to classify specific institutional units, such as government-owned special purpose entities (SPEs), and how to treat guarantees which the government has provided in order to support the financial sector.

12 Guideline of the European Central Bank of 31 July 2009 on government finance statistics (recast) (ECB/2009/20), OJ L 228, 1.9.2009, p. 25.

Table 2 Government interventions to support the financial sector during the financial crisis

(as a percentage of GDP)

Latvia	Impact on government deficit/surplus ¹⁾	Cumulative amounts							Impact on government contingent liabilities ⁴⁾	
		Impact on government debt						Total impact		Redemptions
		Capital injections		Asset purchases	Other measures ²⁾	Net impact ³⁾				
		Acquisition of shares	Loans							
2008	0.0	0.0	4.2	0.0	0.0	4.2	4.2	0.0	0.0	
2009	-1.0	1.1	5.0	0.0	0.0	6.1	8.3	2.1	3.6	
2010	-2.1	2.7	3.6	0.0	1.3	7.6	12.4	4.8	2.0	
2011	-0.5	2.6	2.5	0.0	1.5	6.6	11.6	5.1	0.6	
2012	-0.9	2.6	2.0	0.0	2.1	6.7	11.6	4.9	0.6	

Source: ESCB.

1) A negative sign indicates that the government measures increased the government deficit (or decreased the government surplus) while a positive sign indicates that the government measures increased the government surplus (or decreased the government deficit).

2) For instance debt assumption/cancellations and deposits with private banks.

3) Net impact is equal to direct total impact on government debt excluding redemptions.

4) Government contingent liabilities are contractual arrangements which specify one or more conditions that must be fulfilled before government assumes the liabilities of the other party to the contract. Contingent liabilities are off-balance sheet items and are not part of government debt.

In order to restore confidence in the banking sector during the financial and economic crisis, EU governments have provided financial support in the form of recapitalisations and by providing liquidity (purchasing impaired assets, issuing loans, and performing asset exchanges/swaps). By the end of 2012, Latvia had already recovered around 4.9% of GDP (redemptions) from its support to the financial sector; the remaining net impact of its interventions on government debt was 6.7% of GDP (see Table 2). Moreover, support to the financial sector has taken the form of guarantees of interbank lending and guarantees of debt issued by SPEs. These guarantees are contingent government liabilities and are normally recorded off-balance sheet in the ESA 95 unless there is certainty that a guarantee will be called in the future. In the case of Latvia, the government had granted guarantees of 3.6% of GDP to the financial sector by the end of 2009, which was gradually reduced to 0.6% of GDP by the end of 2012.

Latvia has received international financial assistance to deal with the effects of the financial crisis from the IMF, the European Commission and the World Bank in various instalments since the end of 2008. Table 3 shows that, since the start of the financial crisis, Latvian government borrowing in the form of loans from the European Commission, the IMF and the World Bank had amounted to 23.9% of GDP by the end of 2010. After the IMF loan had been fully paid off, the remaining government loans totalled 14.9% of GDP by the end of 2012.

Table 3 Financial support provided by international institutions during the financial crisis¹⁾

(cumulative amounts; as a percentage of GDP)

Latvia	Loans to the government			
	Total	European Commission	IMF	World Bank
2008	2.5	0.0	2.5	0.0
2009	17.1	11.8	4.2	1.1
2010	23.9	15.9	6.3	1.6
2011	22.0	14.3	5.8	2.0
2012	14.9	13.1	0.0	1.8

Source: ESCB.

1) The exchange rate refers to the end of the year.

4.5.3.3 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year for reasons explained in Box 6. A large or volatile deficit-debt adjustment does not necessarily indicate a quality issue, as long as its components are fully explained.

Box 6

DEFICIT-DEBT ADJUSTMENT

The change in the debt level in any given period can be larger or smaller than the deficit. The difference between the change in debt and the deficit is known as the “deficit-debt adjustment” (DDA) or, more generally, as the “stock-flow adjustment” (SFA). As long as the components of the DDA are sound, the difference between the change in debt and the deficit does not raise concerns regarding data quality. Unexplained differences between the deficit and change in debt, however, could signal statistical shortages.

A positive DDA means that the increase in debt exceeds the deficit or that the reduction in debt is lower than the surplus. A negative DDA means that the increase in debt is less than the deficit or that the reduction in debt is greater than the surplus.

The DDA can be described in terms of three main pillars:

- (i) The first and most important pillar in terms of amplitude consists of the transactions in main financial assets. These transactions include the net accumulation of currency and deposits held by the ministry of finance or other government units at the central bank and other MFIs, shares held by government in public corporations, securities held by social security funds (investment in shares excluding privatisations), and loans. With a given deficit, government financial investment increases the borrowing requirement (the amount that government needs to borrow to finance its activities) and thereby also government debt. Conversely, a reduction in financial assets (as a result of privatisations for instance) tends to reduce the borrowing requirement as it generates cash, while leaving the deficit unchanged.
- (ii) The second pillar consists of the valuation effects and other changes in the volume of debt. Government debt is measured at nominal value (or face value), even though new borrowings and the repayment of debt may be at prices which differ from the nominal value (issuances and redemptions below or above par). Moreover, as government debt is measured in the national currency, exchange rate changes modify the debt denominated in foreign currencies without affecting the deficit. Changes in the debt related to reclassification are recorded under other changes in the volume of debt. These include changes in the statistical classification of units from the government to a non-government sector (or the reverse).
- (iii) The third pillar, named time of recording and other differences, refers to the time difference between the recording of expenditure and the related payments and between the recording of revenue and the related cash flow to government. For instance, taxes are recorded as government revenue at the time they are assessed, even though payment may take place

somewhat later. The delayed payment of taxes does not reduce the government borrowing requirement, although the taxes themselves decrease the deficit. A large accumulation of delayed taxes may lead to concerns as to whether tax revenue is overstated owing to amounts that are unlikely to be collected. Other time of recording differences may arise on account of advance or delayed EU reimbursement of funds spent by the government on its behalf, or the gap between the delivery of military equipment (at which time the deficit is affected) and the time of payment.

This third pillar also includes the statistical discrepancy between the calculation of the government deficit in the non-financial and financial accounts, and also any unexplained remaining factors, which may lead to doubts about the quality of the government accounts.

The cumulative amount of the DDA in Latvia, as shown in Table 4, was positive (8.7% of GDP) over the period 2007-12. The DDA was high mainly on account of the acquisition of deposits and loans in 2008 and 2009 in connection with the financial crisis. The Latvian government received a considerable amount of loans in those years through the special borrowing agreements granted by international institutions (the EU, the IMF and the World Bank). These loans were not used up in full in 2008 and 2009, which resulted in an increase in deposits (6.4% of GDP). Part of these loans were used by the government to provide Parex Bank with a sizeable loan (4.2% of GDP) in 2008. However, the rise in trade credits associated with various instances of government expenditure (e.g. the construction of hospitals) – which is included in the remaining factors – helped to reduce the DDA. The development of trade credits over time should be further monitored.

Table 4 Deficit-debt adjustment

(as a percentage of GDP)

Latvia	Deficit-debt adjustment ¹⁾												
	Total	Transactions in main financial assets					Valuation effects and other changes in the volume of debt	Time of recording and other differences					
		Total	Transactions in currency and deposits	Transactions in loans	Transactions in shares	of which privatisations		Total	Change in fiscal receivables	Non-tax components	Remaining factors		
											Total	Statistical discrepancy	Other ²⁾
2007	0.6	1.2	1.1	0.0	0.1	0.0	0.0	-0.6	0.3	-0.6	-0.3	-0.1	-0.2
2008	7.3	7.3	2.9	4.2	0.2	0.0	0.0	0.0	-0.3	0.2	0.1	0.2	-0.1
2009	2.8	3.5	3.5	-0.1	0.1	0.0	-0.2	-0.4	-0.3	0.1	-0.2	-0.1	0.0
2010	-1.4	-1.8	-0.9	-1.6	0.7	0.0	-0.4	0.8	0.3	0.7	-0.2	0.0	-0.2
2011	-1.5	-1.9	-2.5	0.6	0.0	0.0	-0.3	0.7	0.3	0.9	-0.4	0.0	-0.5
2012	0.9	0.7	2.2	-1.7	0.1	0.0	0.3	-0.1	0.2	-0.3	0.1	0.0	0.1
Sum	8.7	9.0	6.4	1.5	1.2	-0.1	-0.7	0.4	0.4	0.9	-0.9	0.0	-0.9

Source: ESCB.

1) Deficit-debt adjustment refers to the difference between the annual change in gross nominal consolidated debt and the deficit as a percentage of GDP. A positive figure means that the increase in debt exceeds the deficit or that the reduction in debt is lower than the surplus. A negative figure means that the decrease in debt is smaller than the surplus or that the debt has decreased despite a deficit.

2) "Other" refers to transactions in derivatives and possibly "unexplained" differences.

4.5.4 EXCHANGE RATES

Article 3 of the Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty defines what is meant by the criterion on participation in the ERM of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB specified that this criterion refers to participation in ERM II for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro.

The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks), which are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real EERs are constructed by applying trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of selected trading partners. Both nominal and real EER statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation of the Member State's currency. Trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The EER indices are based on moving weights for the periods 1995-97, 1998-2000, 2001-03, 2004-06 and 2007-09. The EER indices are obtained by chain-linking the indicators based on each of these five sets of trade weights at the end of each three-year period. The base period of the resulting EER index is the first quarter of 1999. The group of trading partners comprises the euro area, non-euro area EU Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

4.5.5 LONG-TERM INTEREST RATES

Article 4 of the Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 5. Long-term interest rates refer to bonds denominated in national currency.

Table 5 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bond should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	The "redemption yield" formula should be applied.
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

4.5.6 OTHER FACTORS

The last paragraph of Article 140(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, the results of the integration of markets, the situation and development of the national balance of payments and an examination of the development of unit labour costs and other price indices. Whereas, for the four main criteria, the Protocol (No 13) stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

Concerning the results of the integration of markets, two sets of indicators are used, namely: i) statistics on financial development and integration referring to the structure of the financial system;¹³ and ii) statistics on (external) financial and non-financial integration with the euro area.¹⁴

The data underlying the indicator concerning the debt securities issued by resident corporations are reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2007/9. The indicator relating to the stock market capitalisation refers to quoted shares issued by resident corporations following the methodology given in the same Guideline.

The indicators concerning MFI credit to residents and claims of euro area MFIs on resident MFIs are based on available data collected by the ECB as part of the MFI balance sheet statistics collection framework. The data are obtained from the countries under review and, for the latter indicator, also from the euro area countries covered by Regulation ECB/2008/32. Historical data are compiled by the relevant NCBs, where appropriate. For the indicators mentioned, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

The private sector debt and credit flow indicators are derived from the annual sector accounts reported by the national statistical authorities under the ESA 95 Transmission Programme. Private sector debt includes outstanding amounts at the end of the year of securities issued and loans taken out by the institutional sectors of non-financial corporations (NFCs) and households (including non-profit institutions serving households – NPISH). The private sector debt-to-GDP ratio is defined as the ratio of private sector debt to GDP at current market prices. Private sector credit flow

¹³ Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non-government residents and claims of euro area MFIs on resident MFIs.

¹⁴ External trade and investment position with the euro area.

includes annual transactions on securities issued and loans taken out by the institutional sectors of NFCs and households (including NPISH). The private sector credit flow to GDP ratio is defined as the ratio of private sector credit flow to GDP at current market prices.

The total financial sector liabilities indicator is defined as the year-on-year growth of the sum of all outstanding gross liabilities as classified in the ESA 95 Transmission Programme. The instruments comprising total financial sector liabilities are “currency and deposits”, “securities other than shares”, “loans”, “shares and other equity”, “insurance technical reserves” and “other accounts payable”. The indicator is expressed in non-consolidated terms, i.e. it takes into account liabilities between units within the financial sector.

With regard to the balance of payments and the international investment position, the statistics are compiled in accordance with the concepts and definitions laid down in the BPM5 and with methodological standards set out by the ECB and Eurostat. This report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient’s use of the transfer. In particular, this applies to the classification of the current and capital components of transfers between EU institutions and EU Member States.¹⁵

As far as foreign trade statistics are concerned, Latvia provides Eurostat with harmonised data according to the so-called community concept (i.e. for imports, the breakdown by trading partners is based on the country of consignment) and may therefore publish a different geographical breakdown at national level.

With regard to producer price indices, these data refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU regulation concerning short-term statistics.¹⁶

Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 95 Transmission Programme.

Statistics on the harmonised unemployment rate (calculated as the number of unemployed over the labour force) take into account persons between the ages of 15 and 74.

15 For more details, see *European Union balance of payments/international investment position statistical methods*, ECB, Frankfurt am Main, May 2007.

16 Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998, p. 1, as amended by Regulation (EC) No 1158/2005 of the European Parliament and of the Council of 6 July 2005, OJ L 191, 22.7.2005, p. 1.

5 EXAMINATION OF COMPATIBILITY OF LATVIAN LEGISLATION WITH THE TREATIES

5.1 COMPATIBILITY OF NATIONAL LEGISLATION

The Law on Latvijas Banka (hereinafter the ‘Law’)¹ forms the legal basis for Latvijas Banka and its operations.

The Law has been amended twice since the ECB’s Convergence Report of May 2012: (i) by the law of 19 April 2012,² which amended the Law to address the procedure for the appointment of the Governor, the Deputy Governor and the other members of the Council of Latvijas Banka by the Parliament, deleting the rule that the appointment is made through a secret ballot, and (ii) by the law of 10 January 2013,³ which amended the Law to address Treaty and Statute requirements in respect of Latvijas Banka’s independence, integration into the Eurosystem and compliance with the prohibition on monetary financing and privileged access. The latter entered into force on 6 February 2013 with the exception of the provisions related to the integration of Latvia in the Eurosystem, which will enter into force on the date when the Council abrogates Latvia’s derogation. The Law now addresses most of the issues raised in the ECB’s Convergence Report of May 2012 and in its opinions.⁴

The Law on the prevention of the conflict of interest in public officials’ activities has also been amended in the light of the ECB’s Convergence Report of May 2012 by the law of 20 December 2012.⁵

The discrepancy as regards the spelling of the euro in non-legal acts⁶ has been removed by repealing Regulation No 564 of the Cabinet of Ministers on the name of the single currency in Latvian, adopted on 26 July 2005.⁷ As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which require adaptation under Article 131 of the Treaty.

5.2 INDEPENDENCE OF THE NCB

With regard to the Latvian legislation which the ECB considered to be problematic from the perspective of Latvijas Banka’s independence in the ECB’s Convergence Report of May 2012, the Law was adapted as set out in the paragraphs below. The Law contains one provision which would benefit from clarification to ensure legal certainty.

5.2.1 FUNCTIONAL INDEPENDENCE

The ECB’s Convergence Reports since December 2006 noted in relation to Article 3 of the Law that the objective of price stability should not be confined to the territory of the Member State concerned. Ensuring full compliance with Article 127 of the Treaty and Article 2 of the Statute, the first sentence of Article 3 of the Law now provides that Latvijas Banka’s primary objective is to maintain price stability.

1 *Likums par Latvijas Banku, Ziņotājs, 22/23, 4.6.1992.*

2 *Grozījums likumā par Latvijas Banku, LV, 70 (4673), 8.5.2012. See Opinion CON/2012/19.*

3 *Grozījums likumā par Latvijas Banku, LV, 16 (4822), 23.1.2013.*

4 See Opinions CON/2012/73 and CON/2012/80.

5 *Grozījumi likumā par interešu konflikta novēršanu valsts amatpersonu darbībā, LV, 6 (4812), 09.01.2013.*

6 See ECB’s Convergence Report of May 2012, p. 240 and Opinion CON/2012/87.

7 *MK noteikumi Nr.115 par Ministru kabineta 2005.gada 26.jūlija noteikumu Nr.564 “Noteikumi par Eiropas Savienības vienotās valūtas vienības nosaukuma atveidi latviešu valodā” atzīšanu par spēku zaudējušiem, LV, 45 (4851), 05.03.2013.) See also Opinion CON/2012/87.*

5.2.2 INSTITUTIONAL INDEPENDENCE

In its Convergence Report of May 2012, the ECB considered that Article 13 of the Law needed to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute since it did not expressly prohibit the Government from seeking to influence the members of Latvijas Banka's decision-making bodies in situations where this may have an impact on Latvijas Banka's fulfilment of its ESCB-related tasks. Also, Article 13 needed to be adapted for legal certainty reasons, to make it clear that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. Article 13 of the Law was adapted to reflect both prohibitions provided in Article 130 of the Treaty and Article 7 of the Statute and, in addition, it now refers explicitly to Article 130 of the Treaty.

In Opinions CON/2012/73 and CON/2012/80,⁸ the ECB stated that it understands that the term 'supervision' in the context of the first paragraph of Article 43 of the Law refers to the Parliament's right to ask questions pursuant to the Law on the Rules of Procedure of the Parliament⁹ so as to enhance Latvijas Banka's accountability for its decisions. Furthermore, the Constitutional Court of the Republic of Latvia has established¹⁰ that when performing a controlling function or any other function, the Parliament may only act within the limits of the Constitution and Latvian law. Based on the understanding that in accordance with Latvian legislation the 'supervision' exercised by the Parliament is limited to the possibility to ask questions, and the Law does not provide for other 'supervision' mechanisms or tools, the first paragraph of Article 43 of the Law is compatible with the principle of central bank independence enshrined in Article 130 of the Treaty and mirrored in Article 7 of the Statute. Nevertheless, this provision would benefit from being clarified on the occasion of a further revision of the Law to ensure legal certainty.

5.2.3 PERSONAL INDEPENDENCE

Article 22 of the Law provided grounds for dismissal of the Governor in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute.¹¹ Therefore, in the relevant ECB Convergence Reports since 2004, the ECB considered that Article 22 needed to be adapted to fully comply with Article 14.2 of the Statute. The fourth paragraph of Article 22 of the Law no longer includes additional grounds for dismissal. It now provides that the Governor, the Deputy Governor and members of the Council of Latvijas Banka may be relieved from office by the Latvian Parliament before the end of their term of office where:

- they have tendered their resignation;
- they have been found guilty of serious misconduct pursuant to Article 14.2 of the Statute;
- the other ground of dismissal stipulated by Article 14.2 of the Statute applies.

The Law was previously silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Latvijas Banka's decision-making bodies who is involved in the performance of ESCB-related tasks. The sixth paragraph of Article 22 of the Law has been adapted to provide for such a right of review of national courts.

⁸ See paragraph 3.2 of each of these two opinions.

⁹ *Saiemas Kārības rullis, LV*, 96 (227), 18.08.1994.

¹⁰ See paragraph 2 of the conclusions in the Case No 03-05(99) of 1 October 1999. <http://www.satv.tiesa.gov.lv/upload/03-05-99E.rtf>.

¹¹ Article 22 of the Law included two legal grounds for relieving the Governor from office, namely being found guilty of a deliberate crime and the inability to perform his/her functions for a period of more than six months.

The fifth paragraph of Article 28 of the Law provided that if Latvijas Banka's Governor is absent, the Governor's rights and obligations are exercised by the Deputy Governor or by the person appointed by an express order. The ECB noted in its Convergence Reports of May 2010 and May 2012 that only a person who is subject to the same rules for security of tenure and grounds of dismissal as the Governor should be appointed to deputise for the Governor. Article 28 of the Law has therefore been adapted to fully comply with Article 14.2 of the Statute. The second sentence of the fifth paragraph of Article 28 of the Law now provides that in the absence of Latvijas Banka's Governor, the Governor's duties shall be performed by the Deputy Governor. The third sentence of the fifth paragraph of Article 28 of the Law further provides that in the absence of Latvijas Banka's Governor and the Deputy Governor, the duties of the Governor shall be performed by a member of the Council of Latvijas Banka appointed by the Governor.

As noted in the ECB's Convergence Reports of May 2010 and May 2012, Article 31 of the Law provides that restrictions on members of the Council of Latvijas Banka holding other positions are specified in the Law on the prevention of the conflict of interest in public officials' activities.¹² Pursuant to the previous wording of Section 7(3) of the Law on the prevention of the conflict of interest in public officials' activities, members of the Council of Latvijas Banka were permitted to hold other offices if that was provided for in other laws or international agreements, ratified by the Parliament, and Government regulations and orders. Such public officials could also work as a teacher, scientist, professional sportsperson and in creative work, defined as journalistic, literary or artistic work for which royalties or fees are received. The ECB understood that the above mentioned provisions did not permit the Government to authorise the Governor or other members of the Council of Latvijas Banka to hold other offices if that would have created a conflict of interest. The Law on the prevention of the conflict of interest in public officials' activities was amended on 20 December 2012.¹³ In Article 7(3)(1) of this law the condition was added that when combining their office with other offices, the latter should not result in a threat to the statutory independence of the public official or institution where the public official works.

5.2.4 FINANCIAL INDEPENDENCE

In relation to the provisions of Article 18¹ of the Law regarding distribution of profits, the ECB noted in the Convergence Reports of May 2010 and May 2012 that, in order to safeguard Latvijas Banka's financial independence, profits should be distributed to the state budget only after any accumulated losses from previous years have been covered and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. The ECB stressed that Latvijas Banka should be in a position to carry out its functions independently. In addition, the ECB noted that Latvijas Banka is still in the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs. It was the ECB's understanding that the profit distribution rule reduced the financial means available to Latvijas Banka for allocation to its reserve capital. The ECB concluded that Latvia should ensure that Latvijas Banka can continue to increase the level of its reserve capital and create financial provisions deemed necessary to safeguard the real value of its capital and assets.

Article 18¹ of the Law was amended to take that conclusion into account. Pursuant to the first paragraph of Article 18¹, Latvijas Banka now transfers parts of its profit to the State budget following the approval of the annual report by the Council of Latvijas Banka and after covering

¹² *Likums par interešu konflikta novēršanu valsts amatpersonu darbībā, LV*, 69 (2644), 9.5.2002.

¹³ See footnote 5.

losses accumulated in the previous years, if any. Further, pursuant to the second paragraph of Article 18¹ of the Law, Latvijas Banka is now entitled to reduce the percentage share of the payment for the usage of State capital where it is necessary to increase the reserve capital of Latvijas Banka in relation to the financial risks it is exposed to when executing its tasks. The provisions of Article 18¹ of the Law reflect requirements arising from the financial independence principle.

5.3 MONETARY FINANCING AND PRIVILEGED ACCESS

On the provisions of Article 36 of the Law, which provided that Latvijas Banka may not issue loans to the Government or buy government securities on the primary market, the ECB noted in its Convergence Reports of May 2008, May 2010 and May 2012 that the range of public sector entities referred to in Article 36 needed to be significantly extended to be consistent with Article 123 of the Treaty to also cover local and other public authorities, other bodies governed by public law and public undertakings in Latvia as well as central, regional, local and other public authorities, other bodies governed by public law and public undertakings of the other Member States and EU institutions and bodies. The inconsistency has been removed by limiting the second sentence of Article 36 of the Law to a reference to Article 123 of the Treaty and Article 21 of the Statute in relation to any type of credit facility and purchase of debt instruments by Latvijas Banka.

5.4 SINGLE SPELLING OF THE EURO

Until December 2007 all Latvian legal and non-legal acts referred to the single currency as the “eiro”. This was consistent with Regulation No 564 of the Cabinet of Ministers on the name of the single currency in Latvian, adopted on 26 July 2005, which provided that the name of the single European currency in Latvian must be the masculine non-declinable form “eiro”. On 18 December 2007 the Latvian Cabinet of Ministers adopted Regulation No 933 amending Regulation No 564. While the original provision establishing the name “eiro” in Latvian for the single currency remained intact, as a result of the 2007 amendment, Regulation No 564 provided that specifically in legal acts the name of the single currency is the “euro” written in italics. However, a discrepancy remained between the name of the single currency in Latvian retained for non-legal acts in the amended Regulation No 564 (“eiro”) and the name of the single currency in Latvian as established by EU law (“euro”). On 4 March 2013 the Latvian Cabinet of Ministers repealed Regulation No 564;¹⁴ this removed the remaining discrepancy between Latvian and EU law.

5.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSISTEM

With regard to the legal integration of Latvijas Banka into the Eurosystem, the Law was adapted in the respects set out in the ECB’s Convergence Report of May 2012 as follows.

5.5.1 ECONOMIC POLICY OBJECTIVES

In the ECB’s Convergence Report of May 2012, the ECB noted that the Law should be adapted so that the primary objective of price stability stipulated in Article 3 of the Law should not be confined to the territory of the Member State. In addition, the ECB noted that the secondary objectives of

¹⁴ See footnote 7.

Latvijas Banka should be subordinated to the ESCB's primary and secondary objectives in line with Article 127(1) of the Treaty and Article 2 of the Statute. Article 3 of the Law no longer confines the primary objective of price stability to the territory of Latvia. In addition, it specifies that Latvijas Banka shall support the general economic policies in the EU without prejudice to the primary objective, in accordance with Article 127(1) of the Treaty. Article 9 of the Law provides that Latvijas Banka shall participate in promoting the smooth operations of payment systems and refers to the relevant provisions of the Treaty and the Statute.

5.5.2 TASKS

Monetary policy, collection of statistics, official foreign reserve management, payment systems and issue of banknotes

In the ECB's Convergence Reports of May 2008, May 2010 and May 2012, the ECB noted that the provisions of the Law which established Latvijas Banka's powers with regard to monetary policy, collection of statistics, official foreign reserve management, payment systems and issue of banknotes did not recognise the ECB's powers in those fields. The amendments to the Law removed these incompatibilities either by references to the ECB's powers or the ESCB's tasks or by general references to the application of the Treaty, the Statute, or EU law and legal acts and instruments of the ECB, as appropriate.

5.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

The second paragraph of Article 43 of the Law provides that the annual financial statements of Latvijas Banka shall be audited by independent external auditors recommended by the ECB's Governing Council and approved by the EU Council. The State Audit Office shall carry out compliance and audit performance audits of Latvijas Banka adhering to the provisions of Article 13 of the Law (concerning the independence of Latvijas Banka and the members of its decision-making bodies) and without prejudice to the audit performed by the independent external auditors. The State Audit Office is prohibited from carrying out audits of ESCB tasks. Hence, the incompatibility of the second paragraph of Article 43 of the Law, which did not recognise the Council's and the ECB's powers under Article 27.1 of the Statute, has been removed.

Financial reporting

Article 15 of the Law did not reflect Latvijas Banka's obligation to comply with the Eurosystem's regime for financial reporting of operations under Article 26 of the Statute. Article 15 of the Law now makes reference to the legal acts and instruments of the ECB on accounting and financial statements as regards drawing up Latvijas Banka's financial statements.

5.5.4 INTERNATIONAL COOPERATION

The second sentence of Article 7 of the Law which empowered Latvijas Banka, inter alia, to participate in the activities of international monetary and credit organisations, did not recognise the ECB's powers in this field. This incompatibility has been removed. Pursuant to Article 7 of the Law, Latvijas Banka may participate in international monetary institutions subject to the ECB's approval required by Article 6.2 of the Statute.

5.5.5 ADAPTATION OF OTHER LEGISLATION

As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which require adaptation under Article 131 of the Treaty.

5.6 CONCLUSIONS

The Law is compatible with Treaty and Statute requirements for central bank independence, the prohibition on monetary financing and legal integration into the Eurosystem. For legal certainty reasons, as described above, the Law would benefit from a clarification of the first paragraph of Article 43 of the Law in a further revision of its provisions.

GLOSSARY

Acquis communautaire: the body of EU legislation, including its interpretation by the Court of Justice of the European Union, by which all EU Member States are bound.

Alert Mechanism Report: the first step of the EU's new surveillance procedure for preventing and correcting macroeconomic imbalances. In the report, the **European Commission** identifies EU Member States that will be subject to further in-depth analysis under the **macroeconomic imbalance procedure**.

Banking union: one of the building blocks for completing Economic and Monetary Union, which consists of an integrated financial framework with a single rulebook, a **Single Supervisory Mechanism**, common deposit protection and a single bank resolution mechanism.

Central government: the government as defined in the **European System of Accounts 1995**, but excluding regional and local governments (see also **general government**). The term includes all administrative departments of the (central) state and other central agencies whose competence extends over the entire economic territory, except for the administration of social security funds.

Central rate: the exchange rate of each **ERM II** member's currency vis-à-vis the euro, around which the **ERM II fluctuation margins** are defined.

Combined direct and portfolio investment balance: the sum of the direct investment balance and the portfolio investment balance in the financial account of the balance of payments. Direct investment is cross-border investment for the purpose of acquiring a lasting interest in an enterprise resident in another economy (assumed, in practice, for ownership of at least 10% of ordinary shares or voting power). This includes equity capital, reinvested earnings and "other capital" associated with inter-company operations. Portfolio investment includes equity securities (when not a direct investment) and debt securities (bonds and notes, and money market instruments).

Contingent liabilities: government obligations that arise only upon the realisation of particular events (e.g. state guarantees).

Convergence criteria: the criteria set out in Article 140(1) of the **Treaty** (and developed further in the Protocol (No 13) on the convergence criteria referred to in Article 140) that must be fulfilled by each EU Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 140(1) by the **European Commission** and the **European Central Bank** examine whether a high degree of sustainable convergence has been achieved by each EU Member State on the basis of its fulfilment of these criteria, in addition to examining the compatibility of their national legislation, including the statute of their respective **national central bank**, with the **Treaties**.

Convergence programme: a programme outlining the path towards the achievement of **reference values** indicated in the **Treaty**, containing medium-term government plans and assumptions regarding the development of key economic variables. Measures to consolidate fiscal balances are also highlighted, together with underlying economic scenarios. Convergence programmes normally cover the following three to four years and are updated annually. They are examined by the **European Commission** and the **Economic and Financial Committee**, whose reports serve as the basis for an assessment by the **ECOFIN Council**. Following the start of Stage Three of **Economic and Monetary Union**, EU Member States with a derogation continue to submit

convergence programmes, whereas countries which are members of the **euro area** present annual stability programmes, in accordance with the **Stability and Growth Pact**.

Council of the European Union (EU Council): an institution of the EU made up of representatives of the governments of the EU Member States, normally the ministers responsible for the matters under consideration.

Current transfers: transfers of the **general government** (e.g. relating to international cooperation), payments of current taxes on income and wealth and other transfers, such as workers' remittances, which are not related to capital expenditure; they also include production and import subsidies, social benefits and transfers to EU institutions.

Cyclical component of the budget balance: the effect on the budget balance of the **output gap**, as estimated by the **European Commission**.

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

Deficit-debt adjustment: the difference between the **general government** budget balance (government deficit or surplus) and the change in general government debt. Such adjustments may stem from, among other things, changes in the amount of financial assets held by the government, revaluations or statistical adjustments.

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

ECOFIN Council: the **EU Council** meeting in the composition of the ministers of economics and finance (see also **Council of the European Union**).

Economic and Financial Committee: a consultative EU body which carries out preparatory work for the **ECOFIN Council** and the **European Commission** on topics related to the economic and financial situation of the EU Member States. Its composition and tasks are set out in Article 134 of the **Treaty**.

Economic and Monetary Union (EMU): the outcome of the process for the harmonisation of the economic policies of the EU Member States that led to the single currency, the euro, and the single monetary policy of the **euro area**. The process for achieving EMU, as laid down in the **Treaty**, involves three stages. Stage Three, the final stage, began on 1 January 1999 with the irrevocable fixing of exchange rates, the transfer of monetary competence to the **European Central Bank** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (EER) (nominal/real): a weighted average of the bilateral exchange rates of a country's currency against the currencies of major trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for competition in third markets. The real EER is the nominal EER deflated by a weighted average of foreign prices relative to domestic prices.

Elderly dependency ratio: the proportion of the population of a country aged 65 and over in relation to the population aged 15-64.

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the non-euro area EU Member States. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of $\pm 15\%$. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the **European Central Bank (ECB)** and the other EU Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

ERM II fluctuation margins: the mutually agreed floor and ceiling within which **ERM II** member currencies are allowed to fluctuate against the euro.

Excessive imbalance procedure: refers to the corrective arm of the **macroeconomic imbalance procedure**, which is initiated when excessive macroeconomic imbalances are identified in an EU Member State, including imbalances that jeopardise the proper functioning of **Economic and Monetary Union**. The procedure includes issuing policy recommendations, the preparation of a corrective action plan by the Member State concerned, enhanced surveillance and monitoring requirements and, in respect of EU Member States whose currency is the euro, the possibility of financial sanctions in the event of a failure to take corrective action.

Euro area: the area formed by the EU Member States whose currency is the euro and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank**. The euro area currently comprises Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

Eurogroup: an informal gathering of the ministers of economy and finance of the EU Member States whose currency is the euro. Its status is recognised under Article 137 of the **Treaty** and in Protocol No 14. The Eurogroup meets on a regular basis (usually prior to meetings of the **ECOFIN Council**) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **European Central Bank** are regularly invited to take part in these meetings.

European Central Bank (ECB): the EU institution which, together with the **national central banks (NCBs)** of the EU Member States whose currency is the euro, defines and implements the monetary policy for the euro area. The ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)**, which are governed by the decision-making bodies of the ECB, the **Governing Council** and the **Executive Board**, and, as a third decision-making body, the **General Council**. The ECB has its own legal personality under Article 282(3) of the **Treaty**.

It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB.

European Commission: the EU institution which ensures the application of the provisions of the **Treaty**. The Commission develops EU policies, drafts proposals for new EU laws and makes sure that EU decisions are properly implemented. In the area of economic policy, the Commission proposes Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **Council of the European Union (EU Council)** on economic developments and policies. It also monitors public finances within the framework of multilateral surveillance and submits reports on this to the EU Council.

European Council: the EU institution which brings together the Heads of State or Government of the EU Member States, the President of the **European Commission** and the European Council's own President (see also **Council of the European Union**) to provide the EU with the necessary impetus for its development and to define the general political directions and priorities thereof. It does not have a legislative function.

European Monetary Institute (EMI): a temporary institution established on 1 January 1994 at the start of Stage Two of **Economic and Monetary Union**. It went into liquidation following the establishment of the **European Central Bank** on 1 June 1998.

European Parliament: an institution of the EU comprising 754 (as of March 2012) directly elected representatives of the citizens of the EU Member States. Parliament plays a role in the EU's legislative process, although with differing prerogatives depending on the various procedures used for enacting different EU laws. In matters related to monetary policy and the **European System of Central Banks**, Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **European Central Bank (ECB)** to Parliament (e.g. presentation of the ECB's Annual Report, including a general debate on monetary policy, and regular testimonies before Parliament's Committee on Economic and Monetary Affairs).

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU Member States. The ESA 95 is the EU's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): composed of the **European Central Bank (ECB)** and the **national central banks (NCBs)** of all 27 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those EU Member States whose currency is not the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurostat: the Statistical Office of the EU. It is part of the **European Commission** and responsible for the production of EU statistics.

Eurosystem: the central banking system of the **euro area**. It comprises the **European Central Bank** and the **national central banks** of the EU Member States whose currency is the euro.

Excessive deficit procedure: the provisions set out in Article 126 of the **Treaty** and specified in the Protocol (No 12) on the excessive deficit procedure require EU Member States to maintain budgetary discipline, define the criteria for a budgetary position to be considered an excessive deficit and regulate steps to be taken following the observation that the requirements for the budgetary balance or government debt have not been fulfilled. Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure is also an element of the **Stability and Growth Pact**.

Executive Board of the ECB: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and four other members appointed by the **European Council**, acting by a qualified majority among the Heads of State or Government of the euro area member countries, on a recommendation from the **Council of the European Union**, after it has consulted the European Parliament and the ECB.

Exchange rate volatility: a measure of the variability of exchange rates, usually calculated on the basis of the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are schemes that finance pension payments by drawing down on segregated and earmarked assets. These schemes can be exactly funded, under-funded or over-funded, depending on the size of the accumulated assets in relation to the pension entitlements. Unfunded pension schemes are schemes that finance current pension payments with the ongoing contributions paid by future pensioners and/or other ongoing revenue, such as taxes or transfers; unfunded schemes may hold sizeable assets (e.g. for liquidity reasons or as buffer funds).

General Council of the ECB: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and the governors of all the **national central banks** of the **European System of Central Banks**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council of the ECB: the supreme decision-making body of the **European Central Bank (ECB)**. It comprises all the members of the **Executive Board** of the ECB and the governors of the **national central banks** of the EU Member States whose currency is the euro.

Gross external debt: the outstanding amount of an economy's financial liabilities that require payments of principal and/or interest at some point in the future to the rest of the world.

Harmonised Index of Consumer Prices (HICP): a measure of the development of consumer prices that is compiled by **Eurostat** and harmonised for all EU Member States.

Harmonised long-term interest rates: Article 4 of the Protocol (No 13) on the convergence criteria referred to in Article 140 of the **Treaty** requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into

account differences in national definitions. In order to fulfil the Treaty requirement, the **European Central Bank** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the **national central banks**, in cooperation with and on behalf of the **Eurostat**. Harmonised data are used for the convergence examination in this report.

Interest-growth differential: the difference between the annual change in nominal GDP and the nominal average interest rate paid on outstanding government debt (the “effective” interest rate). The interest-growth differential is one of the determinants of changes in the government **debt ratio**.

International investment position (i.i.p.): the value and composition of an economy’s outstanding financial claims on and financial liabilities to the rest of the world. The net i.i.p. is also referred to as the net external or foreign asset position.

Intervention at the limits: compulsory intervention by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention by a central bank to influence the exchange rate of its currency within its **ERM II fluctuation margins**.

Investment: gross fixed capital formation as defined in the **European System of Accounts 1995**.

Legal convergence: the process of adaptation by EU Member States of their legislation, in order to make it compatible with the **Treaties** and the **Statute** for the purposes of: i) integrating their NCBs into the **European System of Central Banks**, and ii) adopting the euro and making their NCBs an integral part of the **Eurosystem**.

Macroeconomic imbalance procedure (MIP): a procedure aimed at broadening the surveillance of economic policies of the EU Member States to include a detailed and formal framework to prevent and correct excessive imbalances and to help the EU Member States affected to establish corrective action plans before divergences become entrenched. The MIP is based on Article 121(6) of the Treaty. The first step of this surveillance procedure of the EU is the **Alert Mechanism Report**. The MIP has a preventive and a corrective arm. The latter is made operational by the **excessive imbalance procedure**.

Measures with a temporary effect: all non-cyclical effects on fiscal variables which: i) reduce (or increase) the **general government** deficit or gross debt (see also **debt ratio** and **deficit ratio**) in a specified period only (“one-off” effects), or ii) improve (or worsen) the budgetary situation in a specified period at the expense (or to the benefit) of future budgetary situations (“self-reversing” effects).

National central bank (NCB): a central bank of an EU Member State.

Net capital expenditure: comprises a government’s final capital expenditure (i.e. gross fixed capital formation, plus net purchases of land and intangible assets, plus changes in stocks) and net capital transfers paid (i.e. investment grants, plus unrequited transfers paid by the **general government** sector to finance specific items of gross fixed capital formation by other sectors, minus capital taxes and other capital transfers received by the general government sector).

Non-cyclical factors: influences on a government budget balance that are not due to cyclical fluctuations (see the **cyclical component of the budget balance**). They can therefore result from either structural, i.e. permanent, changes in budgetary policies or from **measures with a temporary effect**.

Output gap: the difference between the actual and potential levels of output of an economy as a percentage of potential output. Potential output is calculated on the basis of the trend rate of growth of the economy. A positive output gap means that actual output is above the trend or potential level of output and suggests the possible emergence of inflationary pressures. A negative output gap signifies that actual output is below the trend or potential level of output and indicates the possible absence of inflationary pressures.

Primary balance: the **general government** sector's net borrowing or net lending excluding interest payments on consolidated government liabilities.

Private sector debt: outstanding amounts at the end of the year of securities issued and loans taken out by non-financial corporations and households (including non-profit institutions serving households). The private sector debt-to-GDP ratio is defined as the ratio of private sector debt to GDP at current market prices.

Private sector credit flow: annual transactions on debt securities issued and loans taken out by non-financial corporations and households (including non-profit institutions serving households). The private sector credit flow-to-GDP ratio is defined as the ratio of private sector credit flow to GDP at current market prices.

Realignment: a change in the **central rate** of a currency participating in **ERM II**.

Reference period: the time interval specified in Article 140 of the **Treaty** and in the Protocol (No 13) on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol (No 12) on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol (No 13) on the convergence criteria referred to in Article 140 of the **Treaty** specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Single Supervisory Mechanism: a mechanism composed of the ECB and national competent authorities for the exercise of the supervisory tasks to be conferred upon the ECB. The ECB will be responsible for the effective and consistent functioning of this mechanism, which will form part of the **banking union**.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in the EU Member States in order to strengthen the conditions for price stability and for strong, sustainable growth conducive to employment creation. To this end, the Pact prescribes that EU Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and three Council Regulations, namely: i) Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies,

ii) Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, and iii) Regulation (EU) No 1173/2011 of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area. The Stability and Growth Pact is complemented by the **ECOFIN Council**'s report entitled "Improving the implementation of the Stability and Growth Pact", which was endorsed by the Brussels European Council of 22 and 23 March 2005. It is also complemented by a Code of Conduct entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of stability and convergence programmes", which was endorsed by the ECOFIN Council on 11 October 2005.

Statute: refers to the Protocol (No 4) on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaties**.

Treaties: unless otherwise stated, all references in this report to the "Treaties" refer to both the Treaty on European Union and the Treaty on the Functioning of the European Union.

Treaty: unless otherwise stated, all references in this report to the "Treaty" refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009.

Treaty of Lisbon (Lisbon Treaty): amended the EU's two core treaties, the Treaty on European Union and the Treaty establishing the European Community, and renamed the latter as Treaty on the Functioning of the European Union. The Treaty of Lisbon was signed in Lisbon on 13 December 2007 and entered into force on 1 December 2009.

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG): a Treaty signed by 25 EU Member States (all EU Member States except the Czech Republic and the United Kingdom) on 2 March 2012 that builds on the provisions of the enhanced **Stability and Growth Pact** and includes binding national rules which ensure close-to-balance budget positions in structural terms. The TSCG entered into force on 1 January 2013 following its ratification by the required number of euro area member countries (12).

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