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PRESS RELEASE

ECB PUBLISHES ITS CONVERGENCE REPORT 2013 ASSESSING THE ECONOMIC AND LEGAL CONVERGENCE OF LATVIA

At the request of the Latvian authorities, the European Central Bank (ECB) is today publishing its assessment of the economic and legal convergence of Latvia. The ECB's Convergence Report examines whether a high degree of sustainable economic convergence has been achieved in the country under review and gauges compliance with the statutory requirements to be fulfilled by national central banks to become an integral part of the Eurosystem.

Economic convergence

Over the reference period from May 2012 to April 2013, Latvia recorded a 12-month average inflation rate of 1.3%. This was well below the reference value for the criterion on price stability, which was 2.7%. The reference value was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rates of HICP inflation over these 12 months in Sweden (0.8%), Latvia (1.3%) and Ireland (1.6%).

However, in the past ten years consumer price inflation in Latvia has been very volatile, ranging between annual averages of -1.2% and 15.3%. This reflects the fact that the country has experienced major boom-bust periods and high macroeconomic volatility. More recently, after peaking in mid-2011, inflation in Latvia has declined to low levels, reflecting in particular the effects of lower global commodity prices and a lower rate of VAT as of July 2012. Yet the latest available forecasts project inflation to rise, and the balance of risks surrounding inflation projections for the years ahead is on the upside.

Looking further ahead, maintaining low inflation rates in Latvia will be challenging in the medium term. The catching-up process is likely to drive up the inflation differential between Latvia and the euro area over the medium term. There are therefore 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 general government budget 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%.

The Latvian lats has been participating in the exchange rate mechanism (ERM II) since 2 May 2005, with a fluctuation band of ±1% as a unilateral commitment on the part of the Latvian authorities. Over the two-year reference period from 17 May 2011 to 16 May 2013 the lats has remained close to its central rate.

Long-term interest rates in Latvia were 3.8% on average over the 12-month reference period from May 2012 to April 2013. This was below the reference value of 5.5%, as calculated by adding 2 percentage points to the average of the long-term interest rates on government bonds over these 12 months in Sweden (1.6%), Latvia (3.8%) and Ireland (5.1%).

All in all, Latvia is within the reference values of the convergence criteria. Nevertheless the longer-term sustainability of its economic convergence is of concern. Joining a currency union entails foregoing monetary and exchange rate instruments and implies an increased importance of internal flexibility and resilience. In this respect, 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. It is also important to lock in the competitiveness gains achieved in recent years by avoiding a renewed increase in unit labour cost growth. In addition, although Latvia´s economic adjustment capacity has been strong, it needs to make progress in improving the quality of its institutions and governance. Moreover, it is crucial that a comprehensive policy toolkit is available to deal with risks to financial stability, including those stemming from the reliance of a significant part of the banking sector on non-resident deposits as a source of funding.

Legal convergence

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.

The ECB's Convergence Report 2013 is available on the ECB's website. In producing this report, the ECB fulfils the requirement under Article 140 of the Treaty on the Functioning of the European Union to report to the EU Council at the request of a Member State with derogation on its readiness to adopt the euro.

European Central Bank
Directorate General Communications and Language Services, Press and Information Division
Kaiserstrasse 29, D-60311 Frankfurt am Main
Tel.: +49 69 1344 7455, Fax: +49 69 1344 7404
Internet: http://www.ecb.europa.eu