Adoption by Latvia of the euro on 1 January 2014

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The Commission presents its **convergence report 2013 on Latvia**.

Article 140(1) of the TFEU requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

The latest Commission and ECB Convergence Reports, relating to all Member State with a derogation, were adopted in May 2012.

With a view to introducing the euro on 1 January 2014, Latvia submitted a formal request for a convergence assessment on 5 March 2013. This report was drafted following this request.

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

(1) Legal compatibility: in the 2012 Convergence Report, the assessment on legal convergence concluded that legislation in Latvia, in particular the Law on the *Latvijas Banka* (Bank of

Latvia), was not fully compatible with the compliance duty under Article 131 of the TFEU. Incompatibilities notably concerned the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute.

Following the assessment of the Convergence Report from 2012, the Latvian Government, in cooperation with Latvijas Banka, prepared amendments to the BoL Law, which the Latvian Parliament adopted on 10 January 2013. The Law on the Bank of Latvia as amended is fully compatible with Articles 130 and 131 of the TFEU.

(2) Convergence criteria: the convergence report gives a favorable assessment of the economic performance of Latvia with regard to the convergence criteria laid down in the Treaty:

Price stability: the average inflation rate in Latvia during the 12 months to April 2013 was 1.3%, i.e. well below the reference value of 2.7%. It is projected to remain below the reference value in the months ahead. In the case of Latvia, the VAT reduction of July 2012 has contributed to the current low level of 12-month average inflation. However, the analysis of underlying fundamentals and the fact that the reference value has been met by a wide margin support a positive assessment on the fulfilment of the price stability criterion.

According to the report, medium-term inflation prospects will hinge notably on wages growing in line with productivity which will mostly depend on continued labour market flexibility.

Price developments will also depend on maintaining a prudent fiscal policy.

Public finances: the Council recommended Latvia to correct the excessive deficit by 2012. The general government deficit in Latvia reached 8.1% of GDP in 2010, but decreased to **1.2% of GDP in 2012**. The

Commission services' Spring 2013 Forecast projects the deficit-to-GDP ratio at 1.2% in 2013 and 0.9% in 2014 under a no-policy-change assumption. The ratio of gross public debt to GDP fell to **40.7% in 2012** and it is projected to fall further to 40.1% of GDP by end-2014.

The Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP in 2012. If the Council decides to abrogate the excessive deficit decision for Latvia, Latvia will fulfil the criterion on public finances.

Exchange rate stability: the Latvian lats has participated in ERM II since 2 May 2005. Upon ERM II entry, the authorities unilaterally committed to keep the lats within a ±1% fluctuation margin around the central rate. During the two years preceding this assessment, **the lats exchange rate did not deviate from its central rate by more than ±1% and it did not experience tensions**. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates do not reveal pressures on the exchange rate.

Long-term interest rates: the average long-term interest rate in Latvia in the year to April 2013 was **3.8%**, below the reference value of 5.5%. Moreover, Latvia's **long-term spreads** to euro area long-term benchmark bonds narrowed significantly in 2010, as confidence in the currency peg was regained, fiscal consolidation yielded results and the conversion of assistance programme funds created ample lats liquidity. Latvia fulfils the criterion on the convergence of long-term interest rates.

Other factors: additional factors have also been examined, including balance of payments developments and integration of labour, product and financial markets.

The external balance reversed in 2008-2009 from large deficits during the boom years to a surplus of around 11% of GDP in 2009, which contracted to around 1% of GDP in 2012. The trade deficit declined substantially from 2008 and Latvia has continued to gain export market shares.

Latvia's economy is well integrated within the EU economy through trade and Foreign Direct Investment linkages while the labour market has demonstrated a high degree of mobility within the EU market and substantial flexibility although structural unemployment is high.

Lastly, in the context of the international financial assistance programme, financial supervision has been strengthened considerably. Cooperation with home country supervisors has been further enhanced.