Committee on Economic and Monetary Affairs

2013/0190(NLE)

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DRAFT REPORT

on the proposal for a Council decision on the adoption by Latvia of the euro on 1 January 2014
(COM(2013)0345 – C7-0000/2013 – 2013/0190(NLE))

Committee on Economic and Monetary Affairs

Rapporteur: Burkhard Balz

Symbols for procedures

*	Consultation procedure
***	Consent procedure
***I	Ordinary legislative procedure (first reading)
***II	Ordinary legislative procedure (second reading)
***III	Ordinary legislative procedure (third reading)

(The type of procedure depends on the legal basis proposed by the draft act.)

Amendments to a draft act

In amendments by Parliament, amendments to draft acts are highlighted in ***bold italics***. Highlighting in *normal italics* is an indication for the relevant departments showing parts of the draft act which may require correction when the final text is prepared – for instance, obvious errors or omissions in a language version. Suggested corrections of this kind are subject to the agreement of the departments concerned.

The heading for any amendment to an existing act that the draft act seeks to amend includes a third line identifying the existing act and a fourth line identifying the provision in that act that Parliament wishes to amend. Passages in an existing act that Parliament wishes to amend, but that the draft act has left unchanged, are highlighted in **bold**. Any deletions that Parliament wishes to make in such passages are indicated thus: **[...]**.

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DRAFT EUROPEAN PARLIAMENT LEGISLATIVE RESOLUTION

on the proposal for a Council decision on the adoption by Latvia of the euro on 1 January 2014
(COM(2013)0345 – C7-0000/2013 – 2013/0190(NLE))

(Consultation)

The European Parliament,

– having regard to the Commission proposal to the Council (COM(2013)0345),

– having regard to the Commission Convergence Report 2013 (COM(2013)0341) and the European Central Bank Convergence Report of June 2013 as regards Latvia,

– having regard to the Commission Staff Working Document accompanying the Commission Convergence report 2013 on Latvia (SWD(2013)0196),

– having regard to its resolution of 1 June 2006 on the enlargement of the euro zone[1],

– having regard to its resolution of 20 June 2007 on improving the method for consulting Parliament in procedures relating to enlargement of the euro area[2],

– having regard to Article 140(2) of the Treaty on the Functioning of the European Union, pursuant to which the Council consulted Parliament (CX-0000/2013),

– having regard to Rule 55 of its Rules of Procedure,

– having regard to the report of the Committee on Economic and Monetary Affairs (A7-0000/2013),

A. whereas Article 140 of the Treaty on the Functioning of the European Union (TFEU) provides for the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria: the achievement of a high degree of price stability; the sustainability of the government's financial position; the observance of the normal fluctuation margins provided for by the exchange rate mechanism; and the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels (the Maastricht criteria);

B. whereas Latvia has complied with the Maastricht criteria in accordance with Article 140 TFEU and Protocol No 13 on the convergence criteria annexed to the Treaty on European Union and to the TFEU;

C. whereas the Rapporteur visited Latvia to assess the readiness of that country to enter the euro area;

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1 OJ C 298 E, 8.12.2006, p. 249.
2 OJ C 146 E, 12.6.2008, p.251.

1. Approves the Commission proposal;
2. Favours the adoption of the euro by Latvia on 1 January 2014;
3. Notes that the assessment of the Commission and the European Central Bank (ECB) has taken place against the background of the global financial crisis which has affected the prospects for nominal convergence of many other Member States;
4. Notes that Latvia fulfils the criteria as a result of determined, credible and sustainable efforts by the Latvian Government and the Latvian people;
5. Notes that in its 2013 Convergence Report the ECB expressed some concerns with regard to the long-term sustainability of Latvia's economic convergence; considers that those concerns need to be taken seriously but that they do not change the overall positive assessment on the adoption of the euro by Latvia;
6. Calls on the Latvian Government to maintain its prudent fiscal policy stance, together with its overall stability-oriented policies, anticipating potential future macroeconomic imbalances and risks to price stability;
7. Calls on the Latvian Government and authorities to communicate more actively with the Latvian people in order to ensure more public support for euro adoption; calls on the Latvian authorities to continue their information and communication campaign with the aim of reaching all Latvian citizens;
8. Calls on the Latvian Government to address structural deficiencies in the labour market by appropriate structural and educational reforms;
9. Acknowledges the stability of the Latvian banking sector during the present crisis; notes that Latvia has a long tradition in servicing non-resident banking clients; welcomes the exceptionally stringent regulation of Latvian banks active in the non-resident deposits (NRD) business; calls on the Latvian authorities to ensure that a strict supervision of those banks as well as adequate risk management measures are maintained;
10. Calls on the Latvian authorities to maintain the present course of practical preparations to ensure a smooth changeover process; calls on the Latvian Government to ensure that the introduction of the euro is not used for hidden price increases;
11. Calls on the Council to notify Parliament if it intends to depart from the text approved by Parliament;
12. Asks the Council to consult Parliament again if it intends to amend the Commission proposal substantially;
13. Instructs its President to forward its position to the Council, the Commission and the European Central Bank.

EXPLANATORY STATEMENT

On 4 March 2013 Latvia requested a Convergence Report pursuant to Article 140(1) of the Treaty on the Functioning of the European Union (TFEU). The criteria for Latvia to adopt the Euro on 1 January 2014 are laid out in Article 140(1) of the TFEU.

Latvia is currently a "Member State with a derogation", thus not a member of the euro area.

Article 140(2) TFEU states that the Council, on the basis of the reports from the Commission and the ECB and after consulting the European Parliament shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 140(1) TFEU, and abrogate the derogations of the Member States concerned.

On 5 June 2013 the Commission proposed in its Convergence Report that Latvia adopts the euro from 1 January 2014.

The European Parliament has to examine the Convergence Report with the related legal proposal and issue an opinion. Despite certain reservations on individual issues, the Rapporteur recommends that the derogation be lifted with effect from 1 January 2014.

On the Convergence Criteria under Article 140(1) of the TFEU the Rapporteur observes:

1. *Compatibility of national legislation with Articles 130 and 131 and with the Statutes of the ECB*

Amendments to the Law on the Bank of Latvia as well as the adoption of the Fiscal Discipline Law and the law detailing the switchover to the euro make Latvia fully compatible with the requirements for euro adoption as laid down in the Treaties and the Statutes of the ECB and ESCB.

2. Achievement of a high level of price stability

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%. Next to Sweden and Ireland, Latvia is among the three best-performing Member States which set the inflation reference value. Although HICP inflation is expected to increase from its current very low level, Latvia is projected to remain below the reference value in the months ahead. A prudent fiscal policy stance is expected to maintain a sustainable level of price stability.

3. Sustainability of the government financial position

Latvia is subject to a Council Decision on the existence of an excessive deficit. In the reference year of 2012 Latvia's general government deficit was 1.2% of GDP. The general government gross debt stood at 40.7% of GDP. Taking into account the European Commission Spring Forecast of May 2013 with an estimated general government deficit of

1.2% of GDP and debt of 43.2% of GDP, the Commission considers that the excessive deficit has been corrected.

3.1 Latvia's repayment capacity under BoP programmes

As the Latvian government is accumulating assets for large debt repayments to the EU and World Bank in 2014-2015, the debt level is expected to increase in 2013. The outstanding repayments under the EU's and World Bank's Balance of Payments (BoP) assistance programme have been taken into account in the government debt and interest payments forecasts for the upcoming years. They will be refinanced with public borrowing in the global financial markets where Latvia is currently enjoying very favourable financing conditions. This allowed an early repayment of an outstanding obligation towards the IMF in late 2012. Nearly 60% of these payments were being serviced ahead of schedule. As repayments to the EU and World Bank take effect in 2014/2015 the general government debt-to-GDP ratio is expected to decline again to 40% in 2014.

4. Compliance with the normal fluctuation margins of the EMS's Exchange Rate Mechanism II for at least the past 2 years

The Latvian lats (LVL) joined the Exchange Rate Mechanism (ERM II) on 2 May 2005. The standard fluctuation band is set at +/- 15%. Since ERM II entry Latvia maintained a tighter fluctuation margin of +/- 1% around the central rate. During the 2 year preceding the assessment the EUR/LVL exchange rate did not deviate from its central rate by more than +/- 1%. The exchange rate was not subject to severe tensions over the past 2 years.

5. Durability of Convergence, as reflected in long-term interest-rate levels

The development of long-term interest rates is assessed on the basis of secondary market yields on a single benchmark government bond with a residual maturity of close to 10 years. Latvia is again, next to Sweden and Ireland, among the three reference Member States which set the reference value of 5.5%. The 12-months moving average of the yield on the Latvian benchmark bond stood at 3.8% in April 2013, which is well below the reference value.

6. Economic integration and convergence(Art. 140(1), last section)

Latvia has made substantial economic progress in the last decades since its transition to a market economy. Economic reforms have been central to this progress, increasing competitiveness and facilitating the integration with the EU economy, but also the world economy at large. Successive governments in Latvia have also been exceptionally stringent in terms of structural reforms. The latest reforms implemented in 2009-2010 saw significant wage cuts and tax increases during the crisis. These austerity measures have been very successful and paved the way for Latvia's way out of the crisis. Despite high short-term costs, Latvia managed to implement credible policies which put it back on a stable growth trajectory. The past years have also been exceptionally volatile in terms of economic indicators. As a result of massive capital inflow which had persisted largely to finance outsized construction and consumption booms, the current account deficit stood at a record low of -22.5% of GDP in 2006. It was radically corrected in the severe crisis of 2009-2010, resulting in a surplus of 8.6% in 2009. The current account has since stabilized at a low deficit of -1.7% in 2012 and is projected to remain stable.

Latvia is well integrated into the EU economy through trade and investment linkages. It is a small open economy which gained in export markets and trade openness since its accession to the EU in 2004. The share of exports of goods and services to GDP is still lower than for its Baltic neighbours. But trade integration with the EU is progressing very fast as well as exports to Russia, Latvia's main trading partner outside the EU-27.

Ambitious reforms in the business sector favours Latvia's competitiveness. Start-up costs were reduced, procedures for property registration, construction permits and tax collection were simplified and insolvency procedures streamlined. The Commission's 2012 competitiveness monitoring report ranks Latvia in terms of business environment above the EU average. Latvia's industrial competitiveness is steadily improving whereas work still needs to be done in terms of its innovation performance.

In terms of transposition of EU legislation, Latvia's performance is among the best in the EU with a transposition deficit of 0.4% in November 2012.[1]

7. Specific challenges in the case of Latvia

7.1 The stability of the financial sector

Latvia's financial sector is well integrated into the EU financial system, especially through its linkages to the Nordic financial groups. The size of the Latvian banking sector is relatively modest in terms of total assets which amount to 129% to GDP (EU average 369% to GDP) and rather small in absolute figures (28 billion EUR). The financial service sector in Latvia equals only 3.5% of GDP.

Latvia has a long tradition in servicing non-resident banking clients. The high share of non-resident deposits (NRDs), which amount to 48.9% in 2012, can be considered as characteristic for the Latvian banking sector. According to the IMF 80% to 90% of NRDs come from investors from former CIS countries. Geographical, historical and cultural reasons play an important role here, especially the geographical proximity to Russia and the large Russian-speaking minority living in Latvia.

Banks that are specialized and active in the NRDs business account for approximately 1/3 of the total banking sector assets. These banks operate only marginally on the domestic market which is dominated by subsidiaries and branches of large Scandinavian banks. The share of NRD-banks in the domestic loan and deposit market was 11.2% and 10.3% respectively by the end of 2012. The overall net contribution of the NRD-sector to the financial account and foreign reserves is rather limited.

In order to cater for the risks inherent in NRD activities, NRD-banks face stringent regulation. Latvia implemented already comprehensive measures such as additional capital and liquidity

[1] Cf. most recent 29th annual report by the European Commission on monitoring the application of EU law [COM(2012) 714], http://ec.europa.eu/eu_law/infringements/infringements_annual_report_29_en.htm.

requirements for these banks. Moreover, so-called liquidity stress-tests assure that each bank would be able to withstand an outflow of up to half of its NRDs without the need to resort to other sources of financing. The Financial and Capital Markets Commission monitors NRD-banks very actively and ensures a stringent supervision including their internal procedures, the asset quality and correspondent accounts.

Although Latvia largely complies with international rules on anti-money laundering, it remains essential to ensure a determined and effective implementation of these standards.

7.2 Moderate public support for the timing of the euro adoption

A major concern in the case of Latvia remains the low to moderate public support for the euro. Concerns over a possible loss of national identity, loss of control over national finances and abusive price setting during the transition to the euro were among leading fears of Latvians according to a Eurobarometer survey conducted in 2012. Moreover, almost all branches of society criticise the lack of communication from government and the authorities. Although a comprehensive information and communication campaign is underway, a large part of the public was not reached yet by these initiatives.

In Parliament, the opposition voted against the euro adoption arguing that neither the Latvian economy nor society is ready for the euro and that the current state of the Eurozone is not favourable. Hence, uncertainty in the Latvian society prevails of whether the timing for euro adoption is appropriate.

Polling data from February 2013 (TNS) indicated that 63% of the interviewed Latvian citizens are either very or rather negative towards the euro, compared to 33% who have a very or rather positive attitude towards it. However, recent polling trends show that the very negative opinions tend to decline slowly. It is of utmost importance that the Latvian Government and authorities continue their efforts in informing the public and engaging them in a constructive debate about euro adoption.

7.3 The Latvian labour market

Long-term unemployment remains another challenge. Although the labour market was characterized by a high degree of flexibility during the crisis, job seekers demonstrated high mobility within the EU resulting in an increase in emigration and a significant outflow of valuable labour. The recovery of the economy and continuous job creation efforts reduced emigration in 2012. The strong growth rates are bringing unemployment figures down slowly from the peak of 19.8% in 2010 to 14.9% in 2012. Especially regional differences and mismatches in skills for certain labour market segments keep structural unemployment high. Improvements in the functioning of the labour market remain key in order to avoid constant loss in potential output and excessive wage adjustments. The structural deficiencies in the labour market need to be addressed by active labour market policies and educational reforms.

8. Note regarding consultation of the European Parliament

In past euro adoption procedures, the European Parliament has often been pushed into unacceptable time constraints as regards its formal consultation.

The formal time allotted this time between the publication of the Convergence Report on 5 June and the necessary Parliament consultation in Plenary of 1-4 July is equally unsatisfactory. The tight schedule for the Parliament's procedure allows for neither translations to be produced on the Draft Report (resulting in an EN only procedure) nor a sufficient substantial and in-depth scrutiny of the Convergence Report.

Anticipating these challenges, the ECON Committee and the Rapporteur started their work early on by organizing a hearing of the Latvian authorities (Minister of Finance and Central Bank Governor) already in February 2013. In May, confidential consultations with the Commission and the ECB were conducted. Finally, the Rapporteur visited Riga from 29-31 May 2013 in order to gain a direct insight on-site. The Rapporteur did not only meet government officials but also representatives from the central bank, financial supervisors, the financial sector, social partners as well as representatives of citizen's initiatives and the opposition that have been rather sceptical towards the euro introduction in Latvia.

Despite the above mentioned challenges, the Parliament again shows with its proactive early involvement that it is a reliable partner when it comes to rapid decision-making in the EU.